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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., May 2000

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-sixth annual report of the Board of Governors of the Federal Reserve System.

This report covers operations of the Board during calendar year 1999.

Sincerely,

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Monetary Policy and Economic Developments

Monetary Policy and the Economy in 1999

The U.S. economy posted another exceptional performance in 1999. Economic growth was robust, and, aside from the direct effects of higher crude oil prices, inflation remained subdued, in marked contrast to the rising inflation that eventually emerged in many previous economic expansions. The year brought additional evidence of substantial improvement in productivity growth since the mid-1990s, boosting living standards while helping to hold down increases in costs and prices despite very tight labor markets.

The Federal Open Market Committee's pursuit of financial conditions consistent with sustained expansion and low inflation required some adjustments to the settings of monetary policy instruments during the year. In the latter part of 1998, to cushion the U.S. economy from the effects of disruptions in world financial markets and to ameliorate some of the resulting strains, money market conditions had been eased. By the middle of 1999, however, with financial markets resuming normal functioning, foreign economies recovering, and domestic demand continuing to outpace increases in productive potential, the Committee began to reverse that easing.

As the year progressed, foreign economies, on the whole, recovered more quickly and displayed greater vigor than had seemed likely at the start of the year. Domestically, the rapid productivity growth raised expectations of future incomes and profits and thereby helped keep spending moving up at a faster clip than current productive capacity. Meanwhile, the prices of most internationally traded materials rebounded from their earlier declines; this turnaround, together with a flattening of the exchange value of the dollar after its earlier appreciation, translated into an easing of downward pressure on the prices of imports in general. Core inflation measures generally remained low, but with the labor market at its tightest in three decades and becoming still tighter, the risk that pressures on costs and prices would eventually emerge mounted over the course of the year. To maintain the low-inflation environment that has been so important to the sustained health of the current expansion, the FOMC implemented three quarter-point increases in the intended federal funds rate over the year, ultimately reversing the easings undertaken during the autumn 1998 financial market turmoil.

The first quarter of 1999 saw a further unwinding of the heightened levels of perceived risk and risk aversion that had afflicted financial markets in the autumn of 1998; investors became much more willing to advance funds, securities issuance picked up, and risk spreads fell further—though not back to the unusually low levels of the first half of 1998. At the same time, domestic demand remained quite strong, and foreign economies showed some early signs of rebounding. The FOMC concluded at its February and March meetings that if these trends were to persist, the risks of the eventual emergence of

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NOTE. The discussion here and in the next chapter is adapted from *Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978* (Board of Governors, February 2000). The data cited in the two chapters are those available as of mid-February 2000.

somewhat greater inflation pressures would increase, and it noted that a case could be made for unwinding part of the easing actions of the preceding fall. However, the Committee hesitated to adjust policy before having greater assurance that the recoveries in domestic financial markets and foreign economies were on firm footing.

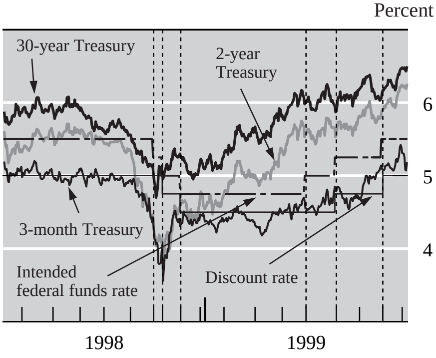
By the May meeting, these recoveries were solidifying, and the pace of domestic spending appeared once again to be outstripping the growth of the economy's potential, even allowing for an appreciable acceleration in productivity. The Committee still expected some slowing in the expansion of aggregate demand, but the timing and extent of any moderation remained uncertain. Against this backdrop, the FOMC maintained an unchanged policy stance but announced immediately after the meeting that it had chosen a directive tilted toward the possibility of a firming of rates. This announcement implemented the disclosure policy adopted in December 1998, whereby major shifts in the Committee's views about the balance of risks or the likely direction of future policy would be made public immediately. Members expected that by making the FOMC's concerns public earlier, such announcements would encourage financial market reactions to subsequent information that would help stabilize the economy. In practice, however, those reactions seemed to be exaggerated and to focus even more than usual on possible near-term Committee action.

Over subsequent weeks, economic activity continued to expand vigorously, labor markets remained very tight, and oil and other commodity prices rose further. In this environment, the FOMC saw an updrift in inflation as a significant risk in the absence of some policy firming, and at the June meeting it raised the intended level of the federal funds rate ¼ percentage point. The Committee also announced a symmetric directive, noting that the marked degree of uncertainty about the extent and timing of prospective inflationary pressures meant that further firming of policy might not be undertaken in the near term, but that the Committee would need to be especially alert to those pressures. Markets rallied on the symmetric-directive announcement, and the strength of this response, together with market commentary, suggested uncertainty about the interpretation of the language used to characterize possible future developments and about the time period to which the directive applied.

In the period between the June and August meetings, the ongoing strength of domestic demand and further expansion abroad suggested that at least part of the remaining easing put in place the previous fall to deal with financial market stresses was no longer needed. Consequently, at the August meeting the FOMC raised the intended level of the federal funds rate a further ¼ percentage point, to 5¼ percent. The Committee agreed that this action, along with that taken in June, would substantially reduce inflation risks and again announced a symmetric directive. In a related action, the Board of Governors approved an increase in the discount rate to 4¾ percent. At this meeting the Committee also established a working group to assess the FOMC's approach to disclosing its view about prospective developments and to propose procedural modifications.

At its August meeting, the FOMC took a number of actions that were aimed at enhancing the ability of the Manager of the System Open Market Account to counter potential liquidity strains in the period around the century date change and that would also help ensure the effective implementation of the Committee's monetary policy objectives. Although members believed that efforts to prepare computer systems for the century date change had made the probability of significant disruptions quite small, some aversion to Y2K risk exposure was already evident in the markets, and the costs that might stem from a dysfunctional financing market at year-end were deemed to be unacceptably high. The FOMC agreed to authorize, temporarily, (1) a widening of the pool of collateral that could be accepted in System open market transactions, (2) the use of reverse repurchase agreement accounting in addition to the currently available matched sale–purchase transactions to absorb reserves temporarily, and (3) the auction of options on repurchase agreements, reverse repurchase agreements, and matched sale–purchase transactions that could be exercised in the period around year-end. The Committee also authorized a permanent extension of the maximum maturity on regular repurchase and matched sale–purchase transactions from sixty to ninety days.

Selected Interest Rates



NOTE. The data are daily. Short ticks indicate days on which the Federal Open Market Committee held a scheduled meeting or a policy action was announced. Vertical lines mark days on which policy actions were announced: September 29, October 15, and November 17, 1998; and June 30, August 24, and November 16, 1999.

The broader range of collateral approved for repurchase transactions—mainly pass-through mortgage securities of government-sponsored enterprises and STRIP securities of the U.S. Treasury—would facilitate the Manager's task of addressing what could be very large needs to supply reserves in the succeeding months, primarily in response to rapid increases in the demand for currency, at a time of potentially heightened demand in various markets for U.S. government securities. The standby financing facility, authorizing the Federal Reserve Bank of New York to auction the above-mentioned options to the government securities dealers that are regular counterparties in the System's open market operations, would encourage marketmaking and the maintenance of liquid financing markets essential to effective open market operations. The standby facility was also viewed as a useful complement to the special liquidity facility, which was to provide sound depository institutions with unrestricted access to the discount window, at a penalty rate, between October 1999 and April 2000. Finally, the decision to extend the maximum maturity on repurchase and matched sale–purchase transactions was intended to bring the terms of such transactions into conformance with market practice and to enhance the Manager's ability over the following months to implement the unusually large reserve operations expected to be required around the turn of the year.

Incoming information during the period leading up to the FOMC's October meeting suggested that the growth of domestic economic activity had picked up from the second quarter's pace, and foreign economies appeared to be strengthening more than had been anticipated, potentially adding pressure to already-taut labor markets and possibly creating inflationary imbalances that would undermine economic performance. But the FOMC viewed the risk of a significant increase in inflation in the near term as small and decided to await more evidence on how the economy was responding to its previous tightenings before changing its policy stance. However, the Committee anticipated that the evidence might well signal the need for additional tightening, and it again announced a directive that was biased toward restraint.

Information available through mid-November pointed toward robust growth in overall economic activity and a further depletion of the pool of unemployed workers willing to take a job. Although higher real interest rates appeared to have induced some softening in interest-sensitive sectors of the economy, the anticipated moderation in the growth of aggregate demand did not appear sufficient to avoid added pressures on resources, predominantly labor. These conditions, along with further increases in oil and other commodity prices, suggested a significant risk that inflation would pick up over time, given prevailing financial conditions. Against this backdrop, the FOMC raised the target for the federal funds rate an additional ¼ percentage point in November. At that time, a symmetric directive was adopted, consistent with the Committee's expectation that no further policy move was likely to be considered before the February meeting. In a related action, the Board of Governors approved an increase in the discount rate of ¼ percentage point, to 5 percent.

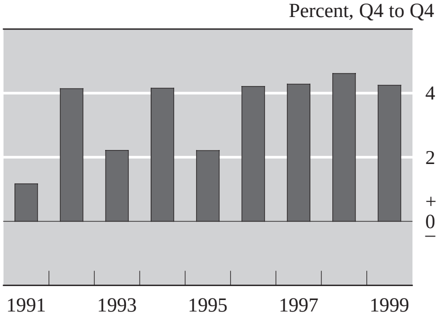
At the December meeting, FOMC members held the stance of policy unchanged and, to avoid any misinterpretation of policy intentions that might unsettle financial markets around the century date change, announced a symmetric directive. But the statement issued after the meeting highlighted members' continuing concern about inflation risks going forward and indicated the Committee's intention to evaluate, as soon as its next meeting, whether those risks suggested that further tightening was appropriate.

The FOMC also decided on some modifications to its disclosure procedures at the December meeting, at which the working group established at the August meeting transmitted its final report and proposals. These modifications, announced in January 2000, consisted primarily of a plan to issue a statement after every FOMC meeting that not only would convey the current stance of policy but also would categorize risks to the outlook as either weighted mainly toward conditions that may generate heightened inflation pressures, weighted mainly toward conditions that may generate economic weakness, or balanced with respect to the goals of maximum employment and stable prices over the foreseeable future. The changes eliminated uncertainty about the circumstances under which an announcement would be made; they clarified that the Committee's statement about future prospects extended beyond the intermeeting period; and they characterized the Committee's views about future developments in a way that reflected policy discussions and that members hoped would be more helpful to the public and to financial markets. ■

Economic and Financial Developments in 1999

The U.S. economy retained considerable strength in 1999. According to the Commerce Department's advance estimate, the rise in real gross domestic product over the four quarters of the year exceeded 4 percent for the fourth consecutive year. The growth of household expenditures was bolstered by further substantial gains in real income, favorable borrowing terms, and a soaring stock market. Businesses seeking to maintain their competitiveness and profitability continued to invest heavily in high-tech equipment; external financing conditions in both debt and equity markets were quite supportive. In the public sector, further strong growth of revenues was accompanied by a step-up in the growth of government consumption and investment expenditures, the part of government spending that enters directly into real GDP. The rapid growth of domestic demand gave rise to a further huge increase in real imports of goods and services. Exports picked up as foreign economies strengthened, but the gain fell short of that for imports by a large margin.

Change in Real GDP



NOTE. The data are based on chained (1996) dollars and come from the Department of Commerce.

The combination of a strong U.S. economy and improving economic conditions abroad led to firmer prices in some markets in 1999. Industrial commodity prices turned up—sharply in some cases—after having dropped appreciably in 1998. Oil prices, responding both to OPEC production restraint and to the growth of world demand, more than doubled over the course of the year, and the prices of non-oil imports declined less rapidly than in previous years, when a rising dollar, as well as sluggish conditions abroad, had pulled them lower. The higher oil prices of 1999 translated into sharp increases in retail energy prices and gave a noticeable boost to consumer prices overall; the chain-type price index for personal consumption expenditures rose 2 percent, double the increase of 1998. Outside the energy sector, however, consumer prices increased at about the same low rate as in the previous year, even as the unemployment rate continued to edge down. Rapid gains in productivity enabled businesses to offset a substantial portion of the increases in nominal compensation, thereby holding the rise of unit labor costs in check, and business pricing practices continued to be influenced by strong competitive forces that limited the scope for boosting prices.

The Household Sector

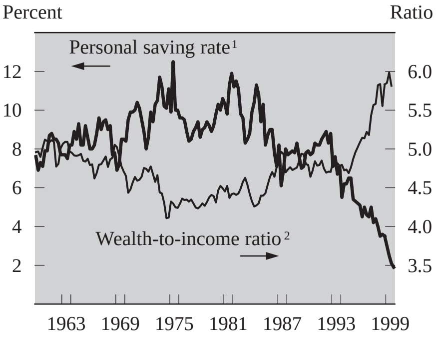
Personal consumption expenditures increased about 5½ percent in real terms in 1999, a second year of exceptionally rapid advance. As in other recent years, the strength of consumption in 1999 reflected sustained increases in employment and real hourly pay, which bolstered the growth of real disposable personal income. Added impetus came from another year of rapid growth in net worth, which, coming on top of the big gains of previous years, led households in the aggregate to spend a larger portion of their current income than they would have otherwise. The personal saving rate, as measured in the national income and product accounts, dropped further, to an average of about 2 percent in the final quarter of 1999; it has fallen about 4½ percentage points over the past five years, a period during which the yearly gain in household net worth has averaged more than 10 percent in nominal terms and the ratio of household wealth to disposable personal income has moved up sharply.

The strength of consumer spending in 1999 extended across a broad front. Appreciable gains were reported for most types of durable goods. Spending on motor vehicles, which had surged about 13½ percent in 1998, moved up another 5½ percent. The inflation-adjusted increases for furniture, appliances, electronics equipment, and other household durables also were quite large, supported in part by a strong housing market. Spending on services advanced about 4½ percent in real terms, led by sizable increases for recreation and personal business services. Outlays for nondurables, such as food and clothing, also rose rapidly. Exceptional strength in the purchases of some nondurables toward the end of the year may have reflected precautionary buying by consumers in anticipation of the century date change.

Households continued to boost their expenditures on residential structures as well. After having surged 11 percent in 1998, residential investment rose about 3¼ percent over the four quarters of 1999, according to the advance estimate from the Commerce Department. Moderate declines in investment in the second half of the year offset only part of the increases recorded in the first half. As with consumption expenditures, investment in housing was supported by the sizable advances in real income and household net worth, but this spending category was also tempered a little by a rise in mortgage interest rates, which likely was an important factor in the second-half downturn.

Nearly all the indicators of housing activity showed upbeat results for the year. Sales of new and existing homes reached new peaks in 1999, surpassing the previous highs of 1998. Although sales dropped back a touch in the second half of the year, their level through year-end remained quite high by historical standards. Builders' backlogs also were at high levels and helped support new construction activity even as sales eased. Late in the year, reports that shortages of skilled workers were delaying construction became less frequent as building activity wound down seasonally, but builders also continued to express concern about potential worker shortages in 2000. For 1999 in total,

Wealth and Saving



1. The data are from the Department of Commerce.

2. Ratio of net worth of households to disposable personal income. The data extend through 1999:Q3.

construction began on more than 1.3 million single-family dwellings, the most since the late 1970s; approximately 330,000 multifamily units also were started, about the same number as in each of the two previous years. House prices rose appreciably and, together with the new investment, further boosted household net worth in residential real estate.

The increases in consumption and residential investment in 1999 were financed, in part, by an expansion of household debt estimated at 9½ percent, the largest increase in more than a decade. Mortgage debt, which includes the borrowing against owner equity that may be used for purposes other than residential investment, grew a whopping 10¼ percent. Higher interest rates led to a sharp drop in refinancing activity and prompted a shift toward the use of adjustable-rate mortgages, which over the year rose from 10 percent to 30 percent of originations. Consumer credit advanced 7¼ percent, boosted by heavy demand for consumer durables and other big-ticket purchases. Credit supply conditions were also favorable; commercial banks reported in Federal Reserve surveys that they were more willing than in the previous year or two to extend consumer installment loans and that they remained quite willing to extend mortgage loans.

The household sector's debt-service burden edged up to its highest level since the late 1980s; however, with employment rising rapidly and asset values escalating, measures of credit quality for household debt generally improved in 1999. Delinquency rates on home mortgages and credit cards declined a bit, and those on auto loans fell more noticeably. Personal bankruptcy filings fell sharply after having risen for several years through 1997 and remaining elevated in 1998.

The Business Sector

Private nonresidential fixed investment increased 7 percent over 1999, extending by another year a long run of rapid growth in real investment outlays. Strength in capital investment has been underpinned in recent years by the vigor of the business expansion, by the advance and spread of computer technologies, and by the ability of most businesses to readily obtain funding through the credit and equity markets.

Investment in high-tech equipment continued to soar in 1999. Outlays for communications equipment rose about 25 percent over the course of the year, boosted by a number of factors, including the expansion of wireless communications, competition in telephone markets, the continued spread of the Internet, and the demand of Internet users for faster access to it. Outlays on computers rose nearly 40 percent in real terms, and purchases of computer software, which in the national accounts are now counted as part of private fixed investment, rose about 13 percent; for both computers and software the increases were roughly in line with the annual average gains during previous years of the expansion.

The timing of investment in high-tech equipment in both 1998 and 1999 was likely affected to some degree by business preparations for the century date change. Many large businesses reportedly invested most heavily in new computer equipment before the start of 1999 to leave sufficient time for their systems to be tested well before the start of 2000; a very steep rise in computer investment in 1998—roughly 60 percent in real terms—is consistent with those reports. Some of the purchases in preparation for Y2K most likely spilled over into 1999, but the year also brought numerous reports of businesses wanting to stand pat with existing systems until the start of 2000. Growth in computer investment in the final quarter of 1999, just before the century rollover, was the smallest in several quarters.

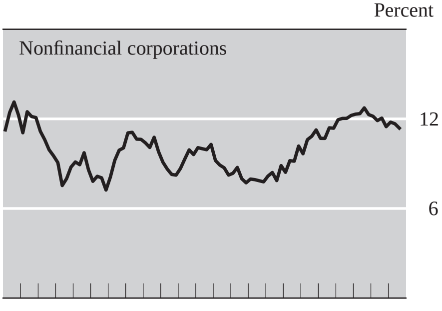
Spending on other types of equipment rose moderately, on balance, in 1999. Outlays for transportation equipment increased substantially, led by advances in business purchases of motor vehicles and aircraft. By contrast, a sharp decline in spending on industrial machinery early in the year held the yearly gain for that category to about 2 percent; over the final three quarters of the year, however, outlays picked up sharply as industrial production strengthened.

Private investment in nonresidential structures fell 5 percent in 1999, according to the advance estimate from the Commerce Department. Spending on structures had increased in each of the previous seven years, rather briskly at times, and the level of investment, though down in 1999, remained relatively high and likely raised the real stock of capital invested in structures appreciably further. Real expenditures on office buildings, which have been climbing rapidly for several years, moved up further in 1999, to the highest level since the peak of the building boom of the 1980s. In contrast, investment in other types of commercial structures, which had already regained its earlier peak, slipped back a little, on net. Spending on industrial structures, which accounts for roughly 10 percent of total real outlays on structures, fell for a third consecutive year. Outlays for the main types of institutional structures also were down, according to initial estimates. Revisions to the data on nonresidential structures often are sizable, and the estimates for each of the three years preceding 1999 have eventually shown a good bit more strength than was initially reported.

After increasing for two years at a rate of about 6 percent, nonfarm business inventories expanded more slowly in 1999—about 3¼ percent according to the advance GDP report. During the year, some businesses indicated that they planned to carry heavier stocks toward year-end to protect themselves against possible Y2K disruptions, and the rate of accumulation did in fact pick up appreciably in the fall. But business final sales remained strong, and the ratio of nonfarm stocks to final sales changed little, holding toward the lower end of the range of the past decade. With the ratio so low, businesses likely did not enter 2000 with excess stocks.

After slowing to a 1 percent rise in 1998, the economic profits of U.S. corporations—that is, book profits with inventory valuation and capital consumption adjustments—picked up in 1999. Economic profits over the first three quarters of the year averaged about 3½ percent above the level of a year earlier. The earnings of corporations from their operations outside the United States rebounded in 1999 from a brief but steep decline in the second half of 1998, when financial market disruptions

Before-Tax Profits as a Share of GDP



Note. Profits from domestic operations, with inventory valuation and capital consumption adjustments, divided by gross domestic product of nonfinancial corporate sector. The data extend through 1999:Q3 and are from the Department of Commerce.

were affecting the world economy. The profits earned by financial corporations on their domestic operations also picked up after having been slowed in 1998 by the financial turmoil; growth of these profits in 1999 would have been greater but for a large payout by insurance companies to cover damage from Hurricane Floyd. The profits that nonfinancial corporations earned on their domestic operations in the first three quarters of 1999 were about 2½ percent above the level of a year earlier; growth of these earnings, which account for about two-thirds of all economic profits, had slowed to just over 2 percent in 1998 after having averaged 13 percent at a compound annual rate in the previous six years. Nonfinancial corporations boosted volume substantially further from 1997 to 1999, but profits per unit of output dropped back somewhat from their 1997 peak. As of the third quarter of 1999, economic profits of nonfinancial corporations amounted to slightly less than 11½ percent of the nominal output of these companies, compared with a quarterly peak of about 12¾ percent two years earlier.

The borrowing needs of nonfinancial corporations remained sizable in 1999. Capital spending outstripped internal cash flow, and equity retirements that resulted from stock repurchases and a blockbuster pace of merger activity more than offset record volumes of both seasoned and initial public equity offerings. Overall, the debt of nonfinancial businesses grew 10½ percent, down only a touch from its decade-high 1998 pace.

The strength in business borrowing was widespread across funding sources. Corporate bond issuance was robust, particularly in the first half of the year, though the markets' increased preference for liquidity and quality, amid an appreciable rise in defaults on junk bonds, left issuance of below-investment-grade securities down more than a quarter from the record pace of 1998. The receptiveness of the capital markets helped firms pay down loans at banks, and growth of these loans—which had been boosted to an 11¾ percent gain in 1998 by the financial market turmoil that year—slowed to a more moderate 5¼ percent pace in 1999. The commercial paper market continued to expand rapidly, with domestic nonfinancial outstandings rising 18 percent on top of the 14 percent gain in 1998.

Commercial mortgage borrowing was strong again as well, as real estate prices generally continued to rise, albeit at a slower pace than in 1998, and vacancy rates generally remained near historical lows. The mix of lending shifted back to banks and life insurance companies from commercial-mortgage-backed securities, as conditions in the CMBS market, especially investor appetites for lower-rated tranches, remained less favorable than they had been before the credit market disruptions in the fall of 1998.

Risk spreads on corporate bonds seesawed during 1999. Over the early part of the year, spreads reversed part of the 1998 run-up as markets recovered. During the summer, they rose again in response to concerns about market liquidity, expectations of a surge in financing before the century date change, and anticipated firming of monetary policy. Swap spreads, in particular, exhibited upward pressure at this time. The likelihood of year-end difficulties seemed to diminish in the fall, and spreads again retreated, ending the year down on balance but generally above the levels that had prevailed over the several years up to mid-1998.

Federal Reserve surveys indicated that banks firmed terms and standards for commercial and industrial loans a bit further, on balance, in 1999. In the syndicated loan market, spreads for lower-rated borrowers also ended the year higher, on balance, after rising substantially in 1998. Spreads for higher-rated borrowers were fairly steady through 1998 and early 1999, widened a bit around midyear, and then fell back to end the year about where they had started.

The ratio of net interest payments to cash flow for nonfinancial firms, a measure of debt strain, remained in the low range it has occupied for the past few years, but many measures of credit quality nonetheless deteriorated in 1999. Moody’s Investors Service downgraded more nonfinancial debt issuers than it upgraded over the year, affecting a net $78 billion of debt. The problems that emerged in the bond market were concentrated mostly among borrowers in the junk sector and partly reflected a fallout from the large volume of issuance and the generous terms available in 1997 and early 1998; default rates on junk bonds rose to levels not seen since the recession of 1990–91. Delinquency rates on C&I loans at commercial banks ticked up in 1999, albeit from very low levels, while the charge-off rate for those loans continued on its upward trend of the past several years. Business failures edged up but remained in a historically low range.

The Government Sector

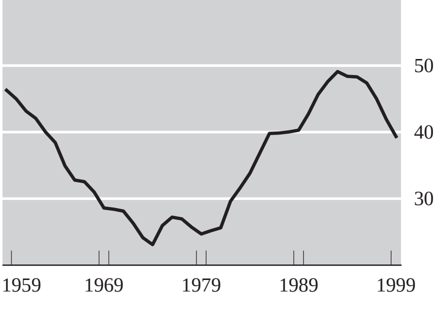
Buoyed by rapid increases in receipts and favorable budget balances, the combined real expenditures of federal, state, and local governments on consumption and investment rose about 4¾ percent from the fourth quarter of 1998 to the fourth quarter of 1999. Annual data, which smooth through some of the quarterly noise that is often evident in government outlays, showed a gain in real spending of more than 3½ percent for the year, the largest increase of the expansion. Federal expenditures on consumption and investment were up nearly 3 percent in annual terms; real defense expenditures, which had trended lower through most of the 1990s, rose moderately, and outlays for nondefense consumption and investment increased sharply. Meanwhile, the consumption and investment expenditures of state and local governments rose more than 4 percent in annual terms; growth of these outlays has picked up appreciably as the expansion has lengthened.

At the federal level, expenditures in the unified budget rose 3 percent in fiscal year 1999, just a touch less than the 3¼ percent rise of the preceding fiscal year. Faster growth of nominal spending on items that are included in consumption and investment was offset in the most recent fiscal year by a deceleration in other categories. Net interest outlays fell more than 5 percent—enough to trim total spending growth about ¾ percentage point—and only small increases were recorded in expenditures for social insurance and income security, categories that together account for nearly half of total federal outlays. In contrast, federal expenditures on Medicaid, after having slowed in 1996 and 1997, picked up again in the past two fiscal years. Spending on agriculture doubled in fiscal 1999; the increase resulted both from a step-up in payments under farm safety net programs that were retained in the “freedom to farm” legislation of 1996 and from more recent emergency farm legislation.

Federal receipts grew 6 percent in fiscal 1999 after increases that averaged close to 9 percent in the two previous fiscal years. Net receipts from taxes on individuals continued to outpace the growth of personal income, but by less than in other recent fiscal years, and receipts from corporate income taxes fell moderately. Nonetheless, with total receipts growing faster than spending, the surplus in the unified budget continued to rise, moving from $69 billion in fiscal 1998 to $124 billion in fiscal 1999. Excluding net interest payments—a charge resulting from past deficits—the federal government recorded a surplus of more than $350 billion in fiscal 1999.

Federal saving, a measure that results from a translation of the federal budget surplus into terms consistent with the national income and product accounts, amounted to 2¼ percent of nominal GDP in the first three quarters of 1999, up from 1½ percent in 1998 and ½ percent in 1997. Before 1997, federal saving had been negative for seventeen consecutive years—by amounts exceeding 3 percent of nominal GDP in several years, most recently in 1992. The change in the federal government's saving position from 1992 to 1999 more than offset the sharp drop in the personal saving rate and helped lift national saving from less than 16 percent of nominal GDP in 1992 and 1993 to a range of about 18½ percent to 19 percent over the past several quarters.

Federal Government Debt
Held by the Public



NOTE. The data are annual.

Federal debt growth has mirrored the turnabout in the government's saving position. In the 1980s and early 1990s, borrowing resulted in large additions to the volume of outstanding government debt. In contrast, with the budget in surplus the past two years, the Treasury has been paying down debt. Without the rise in federal saving and the reversal in borrowing, market interest rates in recent years likely would have been higher than they have been, and private capital formation, a key element in the vigorous economic expansion, would have been lower, perhaps appreciably.

The Treasury responded to its lower borrowing requirements in 1999 primarily by reducing the number of auctions of thirty-year bonds from three to two and by trimming auction sizes for notes and Treasury inflation-indexed securities. Weekly bill volumes were increased from 1998 levels, however, to help build up cash holdings as a Y2K precaution.

State and local government debt expanded 4¼ percent in 1999, well off the elevated pace of 1998. Borrowing for new capital investment edged up, but the roughly full-percentage-point rise in municipal bond yields over the year led to a sharp drop in advance refundings, which in turn pulled gross issuance below last year's level. Tax revenues continued to grow at a robust rate, improving the financial condition of states and localities, as reflected in a ratio of debt-rating upgrades to downgrades of more than three to one over the year. The surplus in the current account of state and local governments in the first three quarters of 1999 amounted to about ½ percent of nominal GDP, about the same as in 1998 but otherwise the largest of the past several years.

The External Sector

Trade and the Current Account

U.S. external balances deteriorated in 1999, largely because of continued declines in net exports of goods and services and some further weakening of net investment income. The nominal trade deficit for goods and services widened more than $100 billion, to an estimated $270 billion, as imports expanded faster than exports. For the first three quarters of the year, the current account deficit increased more than one-third, reaching $320 billion at an annual rate, or 3½ percent of GDP. In 1998, the current account deficit was 2½ percent of GDP.

Real imports of goods and services expanded strongly in 1999—about 13 percent according to preliminary estimates—as the rapid import growth during the first half of the year continued through the second half. The expansion of real imports was fueled by the continued strong growth of U.S. domestic expenditures. The ongoing though waning effects of past dollar appreciation also contributed by helping to push non-oil import prices down through most of the year. All major import categories other than aircraft and oil recorded strong increases. Although U.S. consumption of oil rose about 4 percent in 1999, the quantity of oil imported was about unchanged, and inventories were drawn down.

Real exports of goods and services rose an estimated 4 percent in 1999, a somewhat faster pace than in 1998. Exports were stimulated by a pickup in economic activity abroad, particularly in Canada, Mexico, and the developing economies of Asia. However, this effect was muted by upward pressure on U.S. prices relative to those abroad, a delayed response to past dollar appreciation. An upturn in U.S. exports to Canada, Mexico, and key Asian emerging markets contrasted with a much flatter pace of exports to Europe, Japan, and South America. Capital equipment accounted for about 45 percent of U.S. goods exports, industrial supplies for 20 percent, and agricultural, automotive, and consumer goods each for roughly 10 percent.

Capital Account

U.S. capital flows in 1999 reflected the relatively strong cyclical position of the U.S. economy and the global wave of corporate mergers. Foreign purchases of U.S. securities remained brisk—near the level of the previous two years, in which they had been elevated by the global financial unrest. The mix of foreign securities purchased in 1999 showed a continued shift away from Treasuries that was due partly to a decline in the supply of Treasuries relative to other securities, reflecting the U.S. budget surplus. Another reason might have been greater tolerance of foreign investors for risk as markets calmed after their turmoil of late 1998. Available data indicate that private foreigners sold on net about $20 billion in Treasuries, compared with net purchases of $50 billion in 1998 and $150 billion in 1997. The net sale of Treasuries was more than offset by a pickup in net foreign purchases of their nearest substitute—government agency bonds—and of corporate bonds and equities.

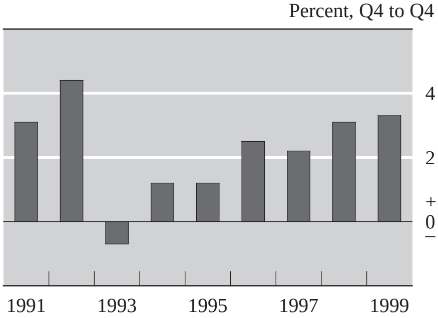
Foreign direct investment flows into the United States were also robust in 1999, with the pace of inflows in the first three quarters only slightly below the record set in 1998. As in 1998, inflows in 1999 were elevated by several large mergers, which left their imprint on other parts of the capital account as well. In 1998 and 1999, many of the largest mergers were financed by a swap of equity in the foreign acquiring firm for equity in the U.S. firm being acquired. The Bureau of Economic Analysis estimates that U.S. residents acquired more than $100 billion of foreign equity through this mechanism in the first three quarters of 1999. Separate data on market transactions indicate that U.S. residents made net purchases of Japanese equities and net sales of European equities, probably in an attempt to rebalance portfolios in light of the equity acquired through stock swaps. U.S. residents on net purchased a small volume of foreign bonds in 1999. U.S. direct investment in foreign economies also reflected the global wave of merger activity in 1999 and likely totaled something near its record level of 1998.

Available data indicate a return to sizable capital inflows from foreign official sources in 1999, following a modest outflow in 1998. The decline in foreign official assets in the United States in 1998 was fairly widespread, as many countries found their currencies under unwanted downward pressure during the turmoil. By contrast, the increase in foreign official reserves in the United States in 1999 was fairly concentrated among a relatively few countries that experienced unwanted upward pressure on their currencies vis-à-vis the U.S. dollar.

The Labor Market

As in other recent years, the rapid growth of aggregate output in 1999 was associated with both strong growth of productivity and brisk gains in employment. According to the initial estimate for 1999, output per hour in the nonfarm business sector rose 3¼ percent over the four quarters of the year, and historical data were revised to show stronger gains in the years preceding 1999 than previously reported. The average annual rate of rise in output per hour over the past four years was about 2¾ percent—up from an average of 1½ percent from the mid-1970s to the end of 1995. Some of the step-up in productivity growth since 1995 can be traced to high levels of capital spending and an accompanying faster rate of increase in the amount of capital per worker. Beyond that, the causes are more difficult to pin down quantitatively but are apparently related to increased technological and organizational efficiencies. Firms are not only expanding the stock of capital but are also discovering many new uses for the technologies embodied in that capital, and workers are becoming more skilled at employing the new technologies.

Change in Output per Hour

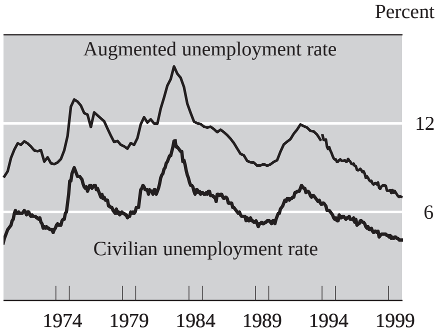


NOTE. Nonfarm business sector. The data are from the Department of Labor.

The number of jobs on nonfarm payrolls rose slightly more than 2 percent from the end of 1998 to the end of 1999, a net increase of 2.7 million. Annual job gains had ranged between 2¼ percent and 2¾ percent over the 1996–98 period. Once again in 1999, the private service-producing sector accounted for most of the total rise in payroll employment, led by many of the same categories that had been strong in previous years—transportation and communications, computer services, engineering and management, recreation, and personnel supply. In the construction sector, employment growth remained quite brisk—more than 4 percent from the final quarter of 1998 to the final quarter of 1999. Manufacturing employment, influenced by spillover from the disruptions in foreign economies, continued to decline sharply in the first half of the year, but losses thereafter were small, as factory production strengthened. Since the start of the expansion in 1991, the job count in manufacturing has changed little, on net, but with factory productivity rising rapidly, manufacturing output has trended up at a brisk pace.

In 1999, employers continued to face a tight labor market. Some increase in the workforce came from the pool of the unemployed, and the jobless rate declined to an average of 4.1 percent in the fourth quarter, down from an average of 4.4 percent in the same quarter one year earlier. Because the unemployment rate is a reflection only of the number of persons who are available for work and actively looking, it does not capture potential labor supply that is one step removed—namely, those individuals who are interested in working but are not actively seeking work. However, like the unemployment rate itself, an augmented rate that includes these interested nonparticipants also has declined to a low level, as more individuals have taken advantage of expanding opportunities to work.

Measures of Labor Utilization



NOTE. The augmented unemployment rate is the number of unemployed plus those who are not in the labor force and want a job, divided by the civilian labor force plus those who are not in the labor force and want a job. The break in data at January 1994 marks the introduction of a redesigned survey; data from that point on are not directly comparable with those of earlier periods.

Although the supply–demand relationship in the labor market tightened further in 1999, the added pressure did not translate into larger increases in nominal hourly compensation. The employment cost index for hourly compensation of workers in private nonfarm industries rose 3.4 percent in nominal terms during 1999, little changed from the increase of the previous year. An alternative measure of hourly compensation from nonfarm productivity and cost data slowed from a 5¼ percent increase in 1998 to a 4½ percent rise in 1999. Compensation gains in 1999 probably were held down, in part, by the very low inflation rate of 1998, which resulted in unexpectedly large increases in inflation-adjusted pay in that year and probably damped wage increments in 1999. According to the employment cost index, the hourly wages of workers in private industry rose 3½ percent in nominal terms after having increased about 4 percent in each of the two previous years. The hourly cost to employers of the nonwage benefits provided to employees also rose 3½ percent in 1999, but this increase was considerably larger than those of the preceding few years. Much of the pickup in benefit costs came from a faster rate of rise in the costs of health insurance, which were reportedly driven up by several factors: a moderate acceleration in the price of medical care, the efforts of some insurers to rebuild profit margins, and the recognition by employers that an attractive health benefits package was helpful in hiring and retaining workers in a tight labor market.

Because the employment cost index does not capture some forms of compensation that employers have been using more extensively—for example, stock options, signing bonuses, and employee price discounts on in-store purchases—it has likely been understating the true size of workers' gains. The productivity and cost measure of hourly compensation captures at least some of the labor costs that the employment cost index omits, and this broader coverage may explain why the productivity and cost measure has been rising faster. However, it, too, is affected by problems of measurement, some of which would lead to overstatement of the rate of rise in hourly compensation.

With the rise in output per hour in the nonfarm business sector in 1999 offsetting about three-fourths of the rise in the productivity and cost measure of nominal hourly compensation, nonfarm unit labor costs were up just a shade more than 1 percent. Unit labor costs had increased slightly more than 2 percent in both 1997 and 1998 and less than 1 percent in 1996. Because labor costs are by far the most important item in total unit costs, the small size of the increases has been crucial to keeping inflation low.

Prices

Rates of increase in the broader measures of aggregate prices in 1999 were somewhat larger than those of 1998. The chain-type price index for GDP—which measures inflation for goods and services *produced* domestically—moved up about 1½ percent, a pickup of ½ percentage point from the increase of 1998. In comparison, acceleration in various price measures for goods and services *purchased* amounted to 1 percentage point or more: The chain-type price index for personal consumption expenditures increased 2 percent, twice as much as in the previous year, and the chain-type price index for gross domestic purchases, which measures prices of the aggregate purchases of consumers, businesses, and governments, moved up close to 2 percent after increasing just ¾ percent in 1998. The consumer price index rose more than 2½ percent over the four quarters of the year after having increased 1½ percent in 1998.

The acceleration in the prices of goods and services purchased was driven in part by a reversal in import prices. The chain-type price index for imports of goods and services had fallen 5 percent in 1998, but it rose 3 percent in 1999. A big swing in oil prices—

Alternative Measures of Price Change

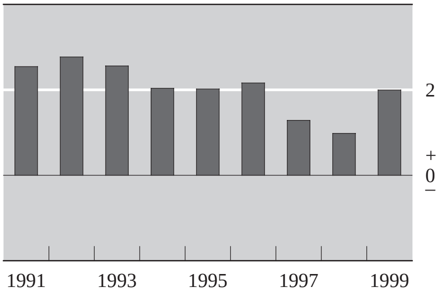
Percent

Price measure	1998	1999
Chain-type		
Gross domestic product	1.1	1.6
Gross domestic purchases	.7	1.9
Personal consumption expenditures	1.0	2.0
Excluding food and energy	1.4	1.5
Fixed-weight		
Consumer price index	1.5	2.6
Excluding food and energy	2.3	2.0

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.

Change in PCE Chain-Type Price Index

Percent, Q4 to Q4



NOTE. The data are from the Department of Commerce.

down in 1998 but up sharply in 1999—accounted for a large part of this turnaround. Excluding oil, the prices of imported goods continued to fall in 1999 but, according to the initial estimate, less rapidly than over the three previous years, when downward pressure from appreciation of the dollar had been considerable. The prices of imported materials and supplies rebounded, but the prices of imported capital goods fell sharply further. Meanwhile, the chain-type price index for exports increased 1 percent, reversing a portion of the 2½ percent drop of 1998, when the sluggishness of foreign economies and the strength of the dollar had pressured U.S. producers to mark down prices charged to foreign buyers.

Prices of domestically produced primary materials, which tend to be especially sensitive to developments in world markets, rebounded sharply in 1999. The producer price index for crude materials excluding food and energy advanced about 10 percent after having fallen about 15 percent in 1998, and the PPI for intermediate materials excluding food and energy increased about 1½ percent, reversing a 1998 decline of about that same size. But further along in the chain of processing and distribution, the effects of these increases were not very visible. The producer price index for finished goods excluding food and energy rose slightly less rapidly in 1999 than in 1998, and the consumer price index for goods excluding food and energy rose at about the same low rate that it had in 1998. Large gains in productivity and a margin of excess capacity in the industrial sector helped keep prices of goods in check, even as growth of domestic demand remained exceptionally strong.

‘‘Core’’ inflation at the consumer level—which takes account of the prices of services as well as the prices of goods and excludes food and energy prices—changed little in 1999. The increase in the core index for personal consumption expenditures, 1½ percent over the four quarters of the year, was about the same as the increase in 1998. As measured by the CPI, core inflation was 2 percent in 1999, about ¼ percentage point lower than in 1998, but the deceleration was a reflection of a change in CPI methodology that had taken place at the start of 1999; on a methodologically consistent basis, the rise in the core CPI was about the same in both years.

In the national accounts, the chain-type price index for private fixed investment edged up ¼ percent in 1999 after having fallen about ¾ percent in 1998. With construction costs rising, the index for residential investment increased 3¾ percent, its largest advance in several years. By contrast, the price index for nonresidential investment declined moderately, as a result of another drop in the index for equipment and software. Falling equipment prices are one channel through which faster productivity gains have been reshaping the economy in recent years; the drop in prices has contributed to high levels of investment, rapid expansion of the capital stock, and a step-up in the growth of potential output.

U.S. Financial Markets

Financial markets were somewhat unsettled as 1999 began, with the disruptions of the previous autumn still unwinding and the devaluation of the Brazilian *real* causing some jitters around mid-January. However, market conditions improved into the spring, evidenced in part by increased trading volumes and narrowed bid–asked and credit spreads, as it became increasingly evident that strong growth was continuing in the United States and that economies abroad were rebounding. In this environment, market participants began to anticipate that the Federal Reserve would reverse the policy easings of the preceding fall, and interest rates rose. Nevertheless, improved profit expectations apparently more than offset the interest rate increases, and equity prices continued to climb until late spring. From May into the fall, both equity prices and longer-term interest rates moved in a choppy fashion, while short-term interest rates moved up with monetary policy tightenings in June, August, and November. Worries about Y2K became pronounced after midyear, and expectations of an acceleration of borrowing ahead of the fourth quarter prompted a resurgence in liquidity and credit premiums. In the closing months of the year, however, concerns about outsized demands for credit and liquidity over the year-end subsided, causing spreads to narrow, and stock prices surged once again.

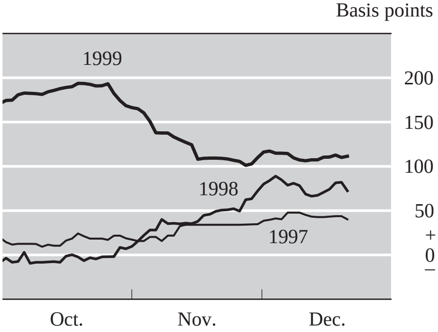
Interest Rates

Over the first few months of 1999, short-term Treasury rates moved in a narrow range, anchored by an unchanged stance of monetary policy. Yields on intermediate- and long-term Treasury securities rose, however, as the flight to quality and liquidity of the preceding fall unwound, and incoming data pointed to continued robust economic growth and likely Federal Reserve tightening. Over most of the rest of the year, short-term Treasury rates moved broadly in line with the three quarter-point increases in the target federal funds rate; longer-term yields rose less, as markets had already anticipated some of those policy actions. Bond and note yields moved sharply higher from early November 1999 to the end of the year, as Y2K fears diminished and incoming economic data indicated surprising vitality.

Concerns about liquidity and credit risk around the century date change led to large premiums in private money market rates in the second half of 1999. During the summer, this ‘‘safe haven’’ demand held down rates on Treasury bills maturing early in the new year, until the announcement in August that the Treasury was targeting an unusually large year-end cash balance, implying that it would issue a substantial volume of January-dated cash management bills. Year-end premiums in eurodollar, commercial paper, term federal funds, and other money markets—measured as the implied forward rate for a monthlong period spanning the year-end relative to the rate for a neighboring period—rose earlier and reached much higher levels than in recent years.

Those year-end premiums peaked in late October and then declined substantially, as markets reflected increased confidence in technical readiness and special assurances from central banks

Eurodollar Deposit Forward Premium Over Year-End



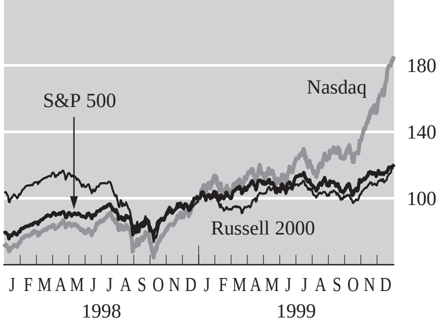
Note. The data are daily. For October the forward premiums are one-month forward rates two months ahead less one-month forward rates one month ahead; for November they are one-month forward rates one month ahead less one-month deposit rates; and for December they are three-week forward rates one week ahead less one-week deposit rates. The December forward premiums extend into the third week of December.

that sufficient liquidity would be available around the century date change. Important among these assurances were several of the Federal Reserve initiatives described in the preceding chapter. Securities dealers took particular advantage of the widened pools of acceptable collateral for open market operations and used large volumes of federal agency debt and mortgage-backed securities in repurchase agreements with the Open Market Desk in the closing weeks of the year, which helped relieve a potential scarcity of Treasury collateral over the year-end. Market participants also purchased options on nearly $500 billion worth of repurchase agreements under the standby financing facility and pledged more than $650 billion of collateral for borrowing at the discount window. With the smooth rollover, however, none of the RP options were exercised, and borrowing at the discount window turned out to be fairly light.

Equity Prices

Nearly all major stock indexes ended 1999 in record territory. The Nasdaq composite index paced the advance by soaring 86 percent over the year, and the S&P 500 and Dow Jones industrial average posted still-impressive gains of 20 percent and 25 percent, marking the fifth consecutive year that all three indexes posted double-digit returns. Most stock indexes moved up sharply over the first few months of the year and were about flat on net from May through August; they then declined into October before surging in the final months of the year. The Nasdaq index, in particular, achieved most of its annual gains in November and December. Stock price advances in 1999 were not very broad-based, however: More than half of the S&P 500 issues lost value over the year.

Major Stock Price Indexes



NOTE. The data are daily.

Almost all key industry groups performed well. One exception was shares of financial firms, which were flat, on balance. Investor perceptions that rising interest rates would hurt earnings and, possibly, concern over loan quality apparently offset the boost resulting from passage in the fall of legislation reforming the depression-era Glass–Steagall constraints on combining commercial banking with insurance and investment banking. Small-cap stocks, which had lagged in 1998, also performed well; the Russell 2000 index climbed 20 percent over the year and finally surpassed its April 1998 peak in late December.

Stock price gains at large firms about kept pace with expected earnings growth in 1999, and the S&P 500 one-year-ahead earnings–price ratio fluctuated around the historically low level of 4 percent even as real interest rates rose. Meanwhile, the Nasdaq composite index's earnings–price ratio (using actual twelve-month trailing earnings) plummeted from an already-slim 1¼ percent to ½ percent, suggesting that investors were pricing in expectations of tremendous earnings growth at technology firms relative to historical norms.

Debt and the Monetary Aggregates

Debt and Depository Intermediation

The debt of domestic nonfinancial sectors is estimated to have grown 6½ percent in 1999 on a fourth-quarter-to-fourth-quarter basis, near the upper end of the FOMC's 3 percent to 7 percent range and about a percentage point faster than nominal GDP. As was the case in 1998, robust outlays on consumer durable goods, housing, and business investment, as well as substantial net equity retirements, helped sustain nonfederal sector debt growth at rates above 9 percent. Meanwhile, the dramatically increased federal budget surplus allowed the Treasury to reduce its outstanding debt about 2 percent. These movements follow the pattern of recent years whereby increases in the debt of households, businesses, and state and local governments relative to GDP have come close to matching declines in the federal government share, consistent with reduced pressure on available savings from the federal sector facilitating private borrowing.

After increasing for several years, the share of total credit accounted for by depository institutions leveled out in 1999. The growth of credit extended by those institutions edged down to 6½ percent, from 6¾ percent in 1998. Adjusted for mark-to-market accounting rules, bank credit growth retreated from 10¼ percent in 1998 to 5½ percent in 1999, with a considerable portion of the slowdown attributable to an unwinding of the surge in holdings of non-U.S. government securities and business loans that had been built up during the

Growth of Money and Debt

Percent

Period	M1	M2	M3	Domestic nonfinancial debt
Annual[1]				
1989	.6	5.2	4.1	7.4
1990	4.2	4.2	1.9	6.7
1991	7.9	3.1	1.1	4.5
1992	14.4	1.8	.6	4.5
1993	10.6	1.4	1.0	4.9
1994	2.5	.6	1.7	4.9
1995	−1.5	3.9	6.1	5.5
1996	−4.5	4.5	6.8	5.4
1997	−1.2	5.6	8.9	5.2
1998	2.2	8.5	10.9	6.7
1999	1.9	6.2	7.5	6.6
Quarterly (annual rate)[2]				
1999:1	1.9	7.5	8.2	6.7
2	2.2	6.0	6.0	6.9
3	−2.0	5.5	5.1	6.0
4	5.3	5.4	10.0	6.2

NOTE. M1 consists of currency, travelers checks, demand deposits, and other checkable deposits. M2 consists of M1 plus savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds. M3 consists of M2 plus large-denomination time deposits, balances in institutional money market funds, RP liabilities (overnight and term), and eurodollars (overnight and term). Debt consists of the outstanding credit market debt of the U.S. government, state and local governments, households and nonprofit organizations, nonfinancial businesses, and farms.

[1] From average for fourth quarter of preceding year to average for fourth quarter of year indicated.

[2] From average for preceding quarter to average for quarter indicated.

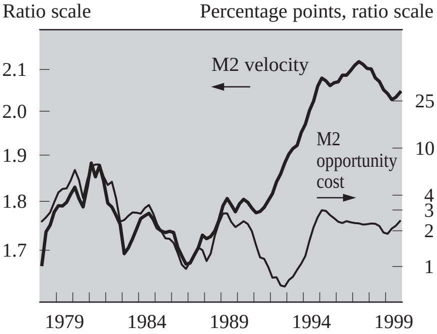
market disruptions in the fall of 1998. Real estate loans constituted one of the few categories of bank credit that accelerated in 1999. By contrast, thrift credit swelled 9 percent, up from a 4½ percent gain in 1998, as rising mortgage interest rates led borrowers to opt more frequently for adjustable-rate mortgages, which thrifts tend to keep on their books. The trend toward securitization of consumer loans continued in 1999: Bank originations of consumer loans were up about 5 percent, while holdings ran off at a 1¾ percent pace.

The Monetary Aggregates

The growth of the broad monetary aggregates moderated significantly in 1999. Nevertheless, as was expected by the FOMC last February and July, both M2 and M3 finished the year above their annual price-stability ranges. M3 rose 7½ percent in 1999, somewhat outside the Committee's range of 2 percent to 6 percent but far below the nearly 11 percent pace of 1998. M3 growth retreated early in 1999, as the surge in depository credit in the final quarter of 1998 unwound and depository institutions curbed their issuance of the managed liabilities included in that aggregate. At that time, the expansion of institution-only money funds also slowed with the ebbing of heightened preferences for liquid assets. However, M3 bulged again in the fourth quarter of 1999, as loan growth picked up and banks funded the increase mainly with large time deposits and other managed liabilities included in M3. U.S. branches and agencies of foreign banks stepped up issuance of large certificates of deposit, in part to augment the liquidity of their head offices over the century date change, apparently because it was cheaper to fund in U.S. markets. Domestic banks needed the additional funding because of strong loan growth and a buildup in vault cash for Y2K contingencies. Corporations apparently accumulated year-end precautionary liquidity in institution-only money funds, which provided a further boost to M3 late in the year.

M2 increased 6¼ percent in 1999, somewhat above the FOMC's range of 1 percent to 5 percent. Both the easing of elevated demands for liquid assets that had boosted M2 in the fourth quarter of 1998 and a rise in its opportunity cost (the difference between interest rates on short-term market instruments and the rates available on M2 assets) tended to bring down M2 growth in 1999. That rise in opportunity cost also helped to halt the decline in M2 velocity that had begun in mid-1997, although the 1¾ percent (annual rate) rise in velocity over the second half of 1999 was not enough to offset the drop in the first half of the year. Within M2, currency demand grew briskly over the year as a whole, reflecting booming retail sales and, late in the year, some precautionary buildup for Y2K.

M2 Velocity and the Opportunity Cost of Holding M2



NOTE. The data are quarterly. The velocity of M2 is the ratio of nominal gross domestic product to the stock of M2. The opportunity cost of M2 is a two-quarter moving average of the difference between the three-month Treasury bill rate and the weighted average return on assets included in M2.

In anticipation of a surge in the public's demand for currency, depository institutions vastly expanded their holdings of vault cash, beginning in the fall to avoid potential constraints in the ability of the armored car industry to accommodate large currency shipments late in the year. Depositories' cash drawings reduced their Federal Reserve balances and drained substantial volumes of reserves, and in mid-December, large precautionary increases in the Treasury's cash balance and in foreign central banks' liquid investments at the Federal Reserve did as well. The magnitude of these flows was largely anticipated by the System, and, to replace the lost reserves, during the fourth quarter the Desk entered into a number of longer-maturity repurchase agreements timed to mature early in 2000. The Desk also executed a large number of short-term repurchase transactions for over the turn of the year, including some in the forward market, to provide sufficient reserves and support market liquidity.

The public's demand for currency through year-end, though appreciable, remained well below the level for which the banking system was prepared, and vault cash at the beginning of January 2000 stood about $38 billion above its year-ago level. This excess vault cash, and other century date change effects in money and reserve markets, unwound quickly after the smooth transition into the new year.

International Developments

Global economic conditions improved in 1999 after a year of depressed growth and heightened financial market instability. Financial markets in developing countries, which had been hit hard by crises in Asia and Russia in recent years, recovered during the year. The pace of activity in developing countries increased, with Asian emerging-market economies in particular bouncing back strongly from the output declines of the preceding year. Real growth improved in almost all the major industrial economies as well. This broad strengthening of activity contributed to a general rise in equity prices and a widespread increase in interest rates. Despite stronger activity and higher prices for oil and other commodities, average foreign inflation was lower in 1999 than in 1998, as output remained below potential in most countries.

Although the general theme in emerging financial markets in 1999 was a return to stability, the year began with heightened tension as a result of a financial crisis in Brazil. With the effects of the August 1998 collapse of the ruble and the default on Russian government debt still reverberating, Brazil was forced to abandon its exchange-rate-based stabilization program in January 1999. The *real*, allowed to float, soon fell nearly 50 percent against the dollar, generating fears of a depreciation–inflation spiral that could return Brazil to its high-inflation past. In addition, there were concerns that the government might default on its domestic-currency and dollar-indexed debt, the latter totaling more than $50 billion. In the event, these fears proved unfounded. The turning point appears to have come in March when a new central bank governor announced that fighting inflation was a top priority and interest rates were substantially raised to support the *real*. Over the remainder of the year, Brazilian financial markets stabilized on balance, despite continuing concerns about the government's ability to reduce the fiscal deficit. Inflation, although up from the previous year, remained under 10 percent. Brazilian economic activity also recovered somewhat in 1999, after declining in 1998, as the return of confidence allowed officials to lower short-term interest rates substantially from their crisis-related peak levels of early in the year.

The Brazilian crisis triggered some renewed financial stress in other Latin American economies, and domestic interest rates and Brady bond yield spreads increased sharply from levels already elevated by the Russian crisis. However, as the situation in Brazil improved, financial conditions in the rest of the region stabilized relatively rapidly. Even so, the combination of elevated risk premiums and diminished access to international credit markets tended to depress activity in much of the region in the first half of 1999. Probably the most strongly affected country was Argentina, where the exchange rate peg to the dollar was maintained only at the cost of continued high real interest rates that contributed to a decline in real GDP in 1999. In contrast, real GDP in Mexico rose an estimated 6 percent, aided by strong growth in exports to the United States and higher oil prices. The peso appreciated against the dollar for the year as a whole, despite a Mexican inflation rate about 10 percentage points higher than the U.S. rate.

The recovery of activity in Asian developing countries was earlier, more widespread, and sharper than in Latin America, just as the downturn had been the previous year. After a steep drop in activity in the immediate wake of the financial crises that hit several Asian emerging-market economies in late 1997, the preconditions for a revival in activity were set by measures initiated to stabilize shaky financial markets and banking sectors, often in conjunction with International Monetary Fund programs that provided financial support. Once financial conditions had been stabilized, monetary policies turned accommodative in 1998. This stimulus, along with a shift toward fiscal deficits and an ongoing boost to net exports provided by earlier sharp currency depreciations, laid the foundation for a strong revival in activity in 1999. Korea's recovery was the most robust, with real GDP estimated to have increased more than 10 percent in 1999 after falling 5 percent the previous year. The government continued to make progress toward needed financial and corporate sector reform. However, significant weaknesses remained, as evidenced by the near collapse of Daewoo, Korea's second largest conglomerate. Other Asian developing countries that experienced financial difficulties in late 1997 (Thailand, Malaysia, Indonesia, and the Philippines) also recorded increases in real GDP in 1999 after declines the previous year. Indonesian financial markets were buffeted severely at times during 1999 by concerns about political instability, but the rupiah ended the year with a modest net appreciation against the dollar. The other former crisis countries also saw their currencies stabilize or slightly appreciate against the dollar. Inflation rates in these countries generally declined, despite the pickup in activity and higher prices for oil and other commodities. Inflation was held down by the elevated, if diminishing, levels of excess capacity and unemployment and by a waning of the inflationary impact of previous exchange rate depreciations.

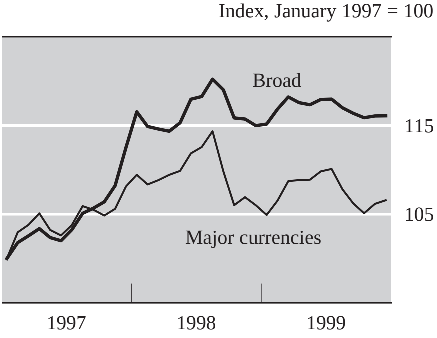
In China, real growth slowed moderately in 1999. Given China's exchange rate peg to the dollar, the sizable depreciations elsewhere in Asia in 1997 and 1998 led to a sharp appreciation of China's real effective exchange rate, and there was speculation that the renminbi might be devalued. However, with China's trade balance continuing in substantial though reduced surplus, Chinese officials maintained the exchange rate peg to the dollar in 1999 and stated their intention of extending it for at least another year. After the onset of the Asian financial crisis, continuance of the Hong Kong currency board's peg to the U.S. dollar was also questioned. In the event, the tie to the dollar was sustained, but only at the cost of high real interest rates, which contributed to a decrease in output in Hong Kong in 1998 and early 1999 and a decline of consumer prices over this period. However, real GDP started to move up again later in the year, reflecting in part the strong revival of activity in the rest of Asia.

In Russia, economic activity increased in 1999 despite persistent and severe structural problems. Real GDP, which had dropped nearly 10 percent in 1998 as a result of the domestic financial crisis, recovered about half the loss during the year. Net exports rose strongly, boosted by the lagged effect of the substantial real depreciation of the ruble in late 1998 and by higher oil prices. The inflation rate moderated to about 50 percent, somewhat greater than the depreciation of the ruble.

The dollar's average foreign exchange value, measured on a trade-weighted basis against the currencies of a broad group of important U.S. trading partners, ended 1999 little changed from its level at the beginning of the year. There appeared to be two main, roughly offsetting, pressures on the dollar over the year. On the one hand, the continued very strong growth of the U.S. economy relative to foreign economies tended to support the dollar. On the other hand, the further rise in U.S. external deficits—with the U.S. current account deficit moving up toward 4 percent of GDP by the end of the year—may have tended to hold down the dollar because of investor concerns that the associated strong net demand for dollar assets might prove unsustainable. Against the currencies of the major foreign industrial countries, the dollar's most notable movements in 1999 were a substantial depreciation against the Japanese yen and a significant appreciation relative to the euro.

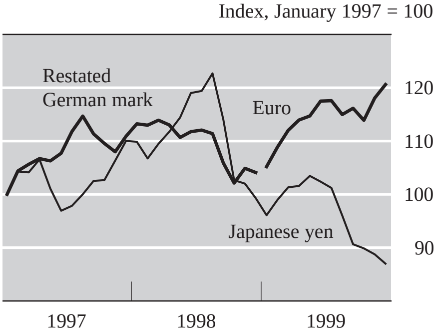
The dollar depreciated 10 percent on balance against the yen over the course of 1999. In the first half of the year, the dollar strengthened slightly relative to the yen, as growth in Japan appeared to

Nominal Dollar Exchange Rate Indexes



Note. The data are monthly. Indexes are trade-weighted averages of the exchange value of the dollar in terms of major currencies and in terms of the currencies of a broad group of important U.S. trading partners.

U.S. Dollar Exchange Rate against the Japanese Yen and the Euro



Note. The data are monthly. Restated German mark is the dollar–mark exchange rate rescaled by the official conversion factor between the mark and the euro, 1.95583, through December 1998. Euro exchange rate as of January 1999.

remain sluggish and Japanese monetary authorities reduced short-term interest rates to near zero in an effort to jump-start the economy. However, around midyear, several signs of a revival of activity—particularly the announcement of unanticipated strong growth in real GDP in the first quarter—triggered a depreciation of the dollar relative to the yen amid reports of large inflows of foreign capital into the Japanese stock market. Data releases showing that the U.S. current account deficit had reached record levels in both the second and third quarters of the year also appeared to be associated with depreciations of the dollar against the yen. Concerned that a stronger yen could harm the fledgling recovery, Japanese monetary authorities intervened heavily, but with limited success, to weaken the yen on numerous occasions.

Japanese real GDP increased somewhat in 1999 after having declined for two consecutive years. Growth was concentrated in the first half of the year, when domestic demand surged, led by fiscal stimulus. Later in the year, domestic demand slumped, as the pace of fiscal expansion flagged. Net exports made virtually no contribution to growth for the year as a whole. Japanese consumer prices declined slightly on balance over the year.

The new European currency, the euro, came into operation at the start of 1999, marking the beginning of stage three of European economic and monetary union. The rates of exchange between the euro and the currencies of the eleven countries adopting the new currency were set at the end of 1998; based on these rates, the value of the euro at its creation was just under $1.17. From a technical perspective, the introduction of the euro went smoothly, and on its first day of trading its value moved higher. However, the euro soon started to weaken against the dollar, influenced by indications that euro-area growth would remain very slow. After approaching parity with the dollar in early July, the euro rebounded, partly on gathering signs of European recovery. However, the currency weakened again in the fall, and in early December it reached parity with the dollar, about where it closed the year. The euro's weakness late in the year was attributed in part to concerns about the pace of market-oriented structural reforms in continental Europe and to a political wrangle over the proposed imposition of a withholding tax on investment income. On balance, the dollar appreciated 16 percent relative to the euro over 1999. Although the euro's foreign exchange value weakened in its first year of operation, the volume of euro-denominated transactions—particularly the issuance of debt securities—expanded rapidly.

In the eleven European countries that now fix their currencies to the euro, real GDP growth remained weak early in 1999 but strengthened subsequently and averaged an estimated 3 percent rate for the year as a whole. Net exports made a significant positive contribution to growth, supported by a revival of demand in Asia and Eastern Europe and by the effects of the euro's depreciation. The areawide unemployment rate declined, albeit to a still-high rate of nearly 10 percent. In the spring, the European central bank lowered its policy rate 50 basis points, to 2½ percent. This move was reversed later in the year in reaction to accumulating evidence of a pickup in activity. The euro-area inflation rate edged up in 1999, boosted by higher oil prices, but still remained below the 2 percent target ceiling.

Growth in the United Kingdom also moved higher on balance in 1999, picking up over the course of the year.

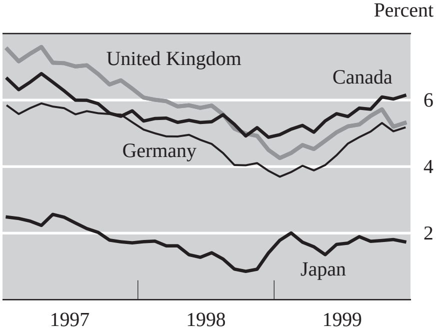
Along with the strengthening of global demand, a key factor stimulating the recovery was a series of official interest rate reductions, totaling 250 basis points, undertaken by the Bank of England over the second half of 1998 and the first half of 1999. Later in 1999 and early in 2000, the policy rate was raised three times, for a total of 100 basis points, with officials citing the need to keep inflation below its 2½ percent target level in light of the strength of consumption and the housing market and continuing tight conditions in the labor market. On balance, the dollar appreciated slightly against the pound over 1999.

In Canada, real growth recovered in 1999 after slumping the previous year in response to the global slowdown and the related drop in the prices of Canadian commodity exports. Strong demand from the United States spurred Canadian exports, while rising consumer and business confidence supported domestic demand. In the spring, the Bank of Canada lowered its official interest rate twice, for a total of 50 basis points, in an effort to stimulate activity in the context of a rising Canadian dollar. The easing was reversed by 25-basis-point increases near the end of the year and early in 2000 as Canadian inflation moved above the midpoint of its target range, the pace of output growth increased, and U.S. interest rates rose. Over the year, the U.S. dollar depreciated 6 percent on balance against the Canadian dollar.

Concerns about liquidity and credit risk related to the century date change generated a temporary bulge in year-end premiums in money market rates in the second half of the year in some currencies. For the euro, the premium—as measured by the implied forward interest rate for a one-month loan spanning the year-end relative to the rates for neighboring months—started to rise in late summer. However, nearly all of the increase was reversed in late October and early November. The premium moved up more moderately in December. The sharp October–November decline in the funding premium came in response to a series of announcements by major central banks that outlined and clarified the measures these institutions were prepared to take to alleviate potential liquidity problems related to the century date change. For yen funding, the premium moved in a different pattern, fluctuating around a relatively low level before spiking sharply for several days just before the year-end. The late-December jump was partly in response to date-change-related illiquidity in the Japanese government bond repo market that emerged in early December and persisted. To counter these conditions, toward the end of the year the Bank of Japan infused huge amounts of liquidity into its domestic banking system, which soon brought short-term yen funding costs back down to near zero.

Bond yields in the major foreign industrial countries generally moved higher on balance in 1999. Long-term interest rates were boosted by mounting evidence that economic recovery was taking hold abroad and by rising expec-

Foreign Ten-Year Interest Rates



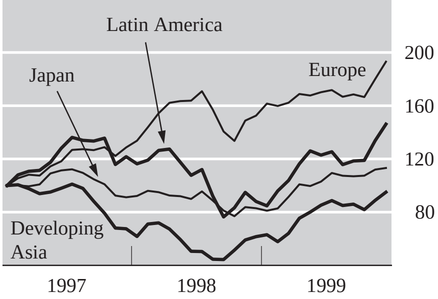
Note. The data are monthly.

tations of monetary tightening in the United States and, later, in other industrial countries. Over the year, long-term interest rates increased on balance more than 100 basis points in nearly all the major industrial countries. The notable exception was Japan, where long-term rates were little changed.

Equity prices showed strong and widespread increases in 1999, as the pace of global activity quickened and the threat from emerging-market financial crises appeared to recede. In the industrial countries, equity prices on average rose sharply, extending the general upward trend of recent years. The average percentage increase of equity prices in developing countries was even larger, as prices recovered from their crisis-related declines of the previous year. The fact that emerging Latin American and Asian equity markets outperformed those in industrial countries lends some support to the view that global investors increased their risk tolerance, especially during the last months of the year.

Oil prices increased dramatically during 1999, fully reversing the declines in the previous two years. The average spot price for West Texas intermediate, the U.S. benchmark crude, more than doubled, from around $12 per barrel at the beginning of the year to more than $26 per barrel in December. The rebound was driven by a combination of strengthening world demand and constrained world supply. The strong U.S. economy, combined with a recovery of economic activity elsewhere and a somewhat more normal weather pattern than in recent years, led to a 2 percent increase in world oil consumption. Oil production, on the other hand, declined 2 percent, primarily because of reduced supplies from OPEC and other key producers. Starting in the spring, OPEC consistently held production near targeted levels, in marked contrast to the widespread lack of compliance that characterized earlier agreements.

Foreign Equity Indexes



Note. The data are monthly and are from Morgan Stanley Capital International, Inc.

The price of gold fluctuated substantially in 1999. It declined to about $250 per ounce at midyear—the lowest in twenty years—as several central banks, including the Bank of England and the Swiss National Bank, announced plans to sell a sizable portion of their reserves. The September announcement that fifteen European central banks, including the two just mentioned, would limit their aggregate sales of bullion and curtail leasing activities boosted the price; it briefly exceeded $320 per ounce before turning down later in the year.

Foreign Exchange Operations

No foreign exchange intervention operations for the accounts of the Federal Reserve System or the U.S. Treasury were conducted during the year. Major foreign central banks reported net purchases of $67 billion in 1999, versus net sales of $29 billion in 1998.

At the end of the year, the Federal Reserve held the equivalent of $16,140 million, valued at current exchange rates, in euros and yen. Taking into account the dollar's appreciation against the euro and depreciation against the yen in 1999, the cumulative valuation gains on System foreign currency holdings decreased $560 million, to $1,668 million.

On March 18, the Federal Reserve exchanged $4.8 billion of euros for $1.4 billion of Japanese yen and $3.4 billion of U.S. dollars from the U.S. Treasury's Exchange Stabilization Fund. The transaction, designed to redress imbalances between the foreign currency holdings of the two monetary authorities, was conducted at prevailing market exchange rates. The sale of euros resulted in a realized profit of $56 million for the System. ■

Monetary Policy Reports to the Congress

The reports in this chapter were submitted to the Congress on February 23 and July 22, 1999, pursuant to the Full Employment and Balanced Growth Act of 1978.

Report on February 23, 1999

Monetary Policy and the Economic Outlook

In 1998, the U.S. economy again performed impressively. Output expanded rapidly, the unemployment rate fell to the lowest level since 1970, and inflation remained subdued. Transitory factors, most recently falling prices for imports and commodities, especially oil, have helped to produce the favorable outcomes of recent years, but technological advances and increased efficiency, likely reflecting in part heightened global competition and changes in business practices, suggest that some of the improvement will be more lasting.

Sound fiscal and monetary policies have contributed importantly to the good economic results: Budgetary restraint at the federal level has bolstered national saving and permitted the Federal Reserve to maintain lower interest rates than would otherwise have been possible. This policy mix and sustained progress toward price stability have fostered clearer price signals, more efficient resource use, robust business investment, and sizable advances in the productivity of labor and in the real wages of workers. The more rapid expansion of productive potential has, in turn, helped to keep inflation low even as aggregate demand has been surging and as labor markets have tightened.

This past year, economic troubles abroad posed a significant threat to the performance of the economy. Foreign economic growth slowed markedly, on average, as conditions in many countries deteriorated. The recession in Japan deepened, and several emerging market economies in Asia, which had started to weaken in the wake of the financial crises of 1997, contracted sharply. A worsening economic situation in Russia last summer led to a devaluation of the ruble and a moratorium by that country on a substantial portion of its debt payments. As the year progressed, conditions in Latin America also weakened. Although some of the troubled foreign economies are showing signs of improvement, others either are not yet in recovery or are still contracting.

The Russian crisis in mid-August precipitated a period of unusual volatility in world financial markets. The losses incurred in Russia and in other emerging market economies heightened investors' and lenders' concerns about other potential problems and led them to become substantially more cautious about taking on risk. The resulting effects on U.S. financial markets included a substantial widening of risk spreads on debt instruments, a jump in measures of market uncertainty and volatility, a drop in equity prices, and a reduction in the liquidity of many markets. To cushion the U.S. economy from the effects of these financial strains, and potentially to help reduce the strains as well, the Federal Reserve eased monetary policy on three occasions in the fall. Global financial market stresses lessened somewhat after mid-autumn, reflecting, in part, these policy steps as well as interest rate cuts in other industrial countries and international efforts to provide support to troubled emerging market economies. Although some U.S. financial flows were disrupted for a time, most firms and households remained able to obtain sufficient credit, and the turbulence did not appear to constrain spending to a significant degree. More recently, some markets were unsettled by the devaluation and subsequent floating of the Brazilian *real* in mid-January, and the problems in Brazil continue to pose risks to global markets. Thus far, however, market reaction outside Brazil to that country's difficulties has been relatively muted.

The foreign exchange value of the dollar rose substantially against the currencies of the major foreign industrial countries over the first eight months of 1998, but subsequently it fell sharply, ending the year down a little on net. The appreciation of the dollar in the first half of the year carried it to an eight-year high against the Japanese yen. In June, this strength against the yen prompted the first U.S. foreign exchange intervention operation in nearly three years, an action that appeared to slow the dollar's rise against the yen over the following days and weeks. Later in the summer, concerns about the possible impact on the U.S. economy of increasing difficulties in Latin America began to weigh on the dollar's exchange value against major foreign currencies. After peaking in mid-August, it fell sharply over the course of several weeks, reversing by mid-October the appreciation that had occurred earlier in the year. The depreciation during this period was particularly sharp against the yen. The reasons for this decline against the yen are not clear, but repayment of yen-denominated loans by international investors and decisions by Japanese investors to repatriate their assets in light of increased volatility in global markets seem to have contributed. The exchange value of the dollar fluctuated moderately against the major currencies over the rest of the year, and after declining somewhat early in 1999, it has rebounded strongly in recent weeks, as incoming data have suggested continued strength of economic activity in the United States. Since the end of 1998, the dollar has appreciated about 7 percent against the yen, partly reflecting further monetary easing in Japan. At the turn of the year, the launch of the third stage of European Economic and Monetary Union fixed the eleven participating countries' conversion rates and created a new common currency, the euro. The dollar has appreciated more than 5 percent against the euro, in part because of signs that growth has slowed recently in some euro-area economies.

With the U.S. economy expanding rapidly, the economies of many U.S. trading partners struggling, and the foreign exchange value of the dollar having risen over 1997 and the first part of 1998, the U.S. trade deficit widened considerably last year. Some domestic industries were especially affected by reductions in foreign demand or by increased competition from imports. For example, a wide range of commodity producers, notably those in agriculture, oil, and metals, experienced sharp price declines. Parts of the manufacturing sector also suffered adverse consequences from the shocks from abroad. Overall, real net exports deteriorated sharply, as exports stagnated and imports continued to surge. The deterioration was particularly marked in the first half of the year;

the second half brought a further, more modest, net widening of the external deficit.

Meanwhile, domestic spending continued to advance rapidly. Household expenditures were bolstered by gains in real income and a further rise in wealth, while a low cost of capital and optimism about future profitability spurred businesses to invest heavily in new capital equipment. Although securities markets were disrupted in late summer and early fall, credit generally remained available from alternative sources. Once the strains on securities markets had eased, businesses and households generally had ready access to credit and other sources of finance on relatively favorable terms, although spreads in some markets remained quite elevated, especially for lower-rated borrowers. All told, household and business outlays rose even more rapidly than in 1997, and that acceleration kept the growth of real GDP strong even as net exports were slumping.

Deteriorating economic conditions abroad, coupled with the strength of the dollar over the first eight months of the year, helped to hold down inflation in the United States by trimming the prices of oil and other imports. These declines reduced both the prices paid by consumers and the costs of production in many lines of business, and the competition from abroad kept businesses from raising prices as much as they might have otherwise. As the result of a reduced rate of price inflation, workers enjoyed a larger rise in real purchasing power even as increases in nominal hourly compensation picked up only slightly on average. Because of increased gains in productivity, corporations in the aggregate were able to absorb the larger real pay increases without suffering a serious diminution of profitability.

Monetary Policy, Financial Markets, and the Economy over 1998 and Early 1999

Monetary policy in 1998 needed to balance two major risks to the economic expansion. On the one hand, with the domestic economy displaying considerable momentum and labor markets tight, the Federal Open Market Committee (FOMC) was concerned about the possible emergence of imbalances that would lead to higher inflation and thereby, eventually, put the sustainability of the expansion at risk. On the other hand, troubles in many foreign economies and resulting financial turmoil both abroad and at home seemed, at times, to raise the risk of an excessive weakening of aggregate demand.

Over the first seven months of the year, neither of these potential tendencies was sufficiently dominant to prompt a policy action by the FOMC. Although the incoming data gave no evidence of a sustained slowing of output growth, the Committee members believed that the pace of expansion likely would moderate as businesses began to slow the rapid rates at which they had been adding to their stocks of inventories and other investment goods, and as households trimmed the large advances in their spending on consumer durables and homes. Relatively firm real interest rates, buoyed by a high real federal funds rate resulting from the decline in the level of expected inflation, were thought likely to help restrain the growth of spending by businesses and households. Another check on growth was expected to come from the effects on imports and exports of the economic difficulties in emerging market economies in Asia and elsewhere. Indeed, production in the manufacturing sector slowed substantially in the first half of the year, and capacity utilization dropped noticeably. Moreover, inflation remained subdued, and a pickup was not expected in the near-to-intermediate term because of declining oil prices, and because of economic weakness abroad and the appreciation of the dollar, which were expected to trim the prices of imported goods and to increase price competition for many U.S. producers. Nonetheless, with labor markets already quite taut and aggregate demand growing rapidly—a combination that often has signaled the impending buildup of inflationary pressures—the Committee, at its meetings from March through July, judged conditions to be such that, if a policy action were to be taken in the period immediately ahead, it more likely would be a tightening than an easing; its directives to the Account Manager of the Domestic Trading Desk at the Federal Reserve Bank of New York noted that asymmetry.

By the time of the August FOMC meeting, however, the situation was changing. Although tight labor markets and rapid output growth continued to pose a risk of higher inflation, the damping influence of foreign economic developments on the U.S. economy seemed likely to increase. The contraction in the emerging market economies in Asia appeared to be deeper than had been anticipated, and the economic situation in Japan had deteriorated. Financial markets in some foreign economies also had experienced greater turmoil, and, the day before the Committee met, Russia was forced to devalue the ruble. These difficulties had been weighing on U.S. asset markets: Stock prices had fallen sharply in late July and into August as investors became concerned about the outlook for profits, and risk spreads in debt markets had widened, albeit from very low levels. Taking account of these circumstances, the Committee again left monetary policy unchanged at the August meeting, but it shifted to a symmetric directive, reflecting its perception that the risks to the economic outlook, at prevailing short-term rates, had become roughly balanced.

Over subsequent weeks, conditions in financial markets and the economic outlook in many foreign countries deteriorated further, increasing the dangers to the U.S. expansion. With investors around the world apparently reevaluating the risks associated with various credits and seemingly becoming less willing or able to bear such risks, asset demands shifted toward safer and more liquid instruments. These shifts caused a sharp fall in yields on Treasury securities. Spreads of yields on private debt securities over those on comparable Treasury instruments widened considerably further, and issuance slowed sharply. Measures of market volatility increased, and liquidity in many financial markets was curtailed. Equity prices continued to slide lower, with most broad indexes falling back by early September to near their levels at the start of the year. Reflecting the weaker and more uncertain economic outlook, some banks boosted interest rate spreads and fees on new loans to businesses and tightened their underwriting standards.

Against this backdrop, at its September meeting the FOMC looked beyond incoming data suggesting that the economy was continuing to expand at a robust pace, and it lowered the intended level of the federal funds rate ¼ percentage point. The Committee noted that the rate cut would cushion the effects on prospective U.S. economic growth of increasing weakness in foreign economies and of less accommodative conditions in domestic financial markets. The directive adopted at the meeting suggested a bias toward further easing over the intermeeting period. In the days following the policy move, disturbances in financial markets worsened. Movements in the prices of securities were exacerbated by a deterioration in market liquidity, as some securities dealers cut back on their market-making activities, and by the expected unwinding of positions by hedge funds and other leveraged investors. In early October, Treasury yields briefly tumbled to their lowest levels in many years, reflecting efforts by investors to exchange other instruments for riskless and liquid Treasury securities.

Although some measures of market turbulence had begun to ease a bit by mid-October, financial markets remained extremely volatile and risk spreads were very wide. On October 15, consistent with the directive from the September meeting, the intended federal funds rate was trimmed another ¼ percentage point, to 5 percent. This policy move, which occurred between FOMC meetings, came at the initiative of Chairman Greenspan and followed a conference call with Committee members. At the same time, the Board of Governors approved a ¼ percentage point reduction in the discount rate. These actions were taken to buffer the domestic economy from the impact of the less accommodative conditions in domestic financial markets, in part by contributing to some stabilization of the global financial situation.

Following the October policy move, strains in domestic financial markets diminished considerably. As safe-haven demands for Treasury securities ebbed, Treasury yields generally trended higher, and measures of financial market volatility and illiquidity eased. Nonetheless, risk spreads remained very wide, and liquidity in many markets continued to be limited. Moreover, although pressures on some emerging market economies had receded a bit, partly reflecting concerted international efforts to provide assistance to Brazil, the foreign economic outlook remained uncertain. With downside risks still substantial, and in light of the cumulative effect since August of the tightening in many sectors of the credit markets and the weakening of economic activity abroad, the FOMC reduced the intended federal funds rate a further ¼ percentage point at its November meeting, bringing the total reduction during the autumn to ¾ percentage point. The Board of Governors also approved a second ¼ percentage point cut in the discount rate. The Committee believed that, with this policy action, financial conditions could reasonably be expected to be consistent with fostering sustained economic expansion while keeping inflationary pressures subdued. The action provided some insurance against an unexpectedly severe weakening of the expansion, and the Committee therefore established a symmetrical directive. By the time of the December meeting, the situation in financial markets had changed little, on balance, and the Committee decided that no further change in rates was desirable and that the directive should remain symmetrical.

Some measures of financial volatility eased further in the new year, although risk spreads on corporate bonds remained at quite high levels. Yields on Treasury securities were about flat, on balance, in January, as the effect of stronger-than-expected economic growth appeared to be about offset by data suggesting that inflation remained quiescent and perhaps also by the effects of some safe-haven flows prompted by the deteriorating situation in Brazil. Over the same period, stock prices surged higher, led by computer and other technology shares, and most stock price indexes posted new highs. By the time of the February 2–3 meeting, financial markets were easily accommodating robust demands for credit, and economic activity seemed to have more momentum than many had anticipated. However, the foreign sector continued to pose a threat to U.S. growth going forward, inflation showed no signs of picking up despite the rapid pace of growth and the very tight labor market, and some slowing of economic growth remained a likely prospect. In these circumstances, the FOMC concluded that it was prudent to wait for further information, and it left policy unchanged.

Economic Projections for 1999

By and large, 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 moderately, on average, in 1999. The central tendency of the FOMC participants' forecasts of real GDP growth from the fourth quarter of 1998 to the fourth quarter of 1999 is 2½ percent to 3 percent. The anticipated expansion is expected to create enough new jobs to keep the civilian unemployment rate near its recent average, in a range of 4¼ percent to 4½ percent. With tightness of the labor market expected to persist and oil and import prices unlikely to be as weak in 1999 as they were in 1998, inflation is expected to move up somewhat from the rate of this past year but to remain low by the standards of the past three decades: The central tendency of the FOMC participants' CPI inflation forecasts for 1999 is 2 percent to 2½ percent. The Federal Reserve officials' inflation forecasts are closely aligned with that of the Administration, and their forecasts of real GDP and unemployment depict a somewhat stronger real economy than the Administration is projecting.

Present circumstances suggest that domestic demand could continue to rise briskly for a while longer. Consumer spending continues to be driven by strong gains in employment, increases in real incomes, and rising levels of wealth. Those same factors, together with low mortgage interest rates, are keeping housing activity robust. Businesses are still investing heavily in new capital, especially computers and other high-tech equipment. Households and businesses appear willing to take on more debt in support of spending; although spreads on corporate debt

Economic Projections for 1999

Percent

Indicator	Federal Reserve governors and Reserve Bank presidents		Administration
	Range	Central tendency	
Change, fourth quarter to fourth quarter[1]			
Nominal GDP	3¾–5	4–4½	4.0
Real GDP[2]	2–3½	2½–3	2.0
Consumer price index[3]	1½–2½	2–2½	2.3
Average level, fourth quarter			
Civilian unemployment rate	4¼–4¾	4¼–4½	4.9

1. Change from average for fourth quarter of 1998 to average for fourth quarter of 1999.

2. Chain-weighted.

3. All urban consumers.

remain elevated, rate levels are perceived to be attractive for most borrowers, and restraint on access to finance is not much in evidence.

As the year progresses, however, gains in domestic spending should begin to moderate. Spending increases for housing, consumer durables, and business equipment have been exceptionally large for a while now, substantially raising the rate of growth in the amounts of these goods owned by businesses and households; some moderation in outlays seems likely, lest these holdings become disproportionate to underlying trends in income and output. The outlook for spending continues to be obscured to some degree by uncertainties about the course of equity prices; a failure of these prices to match the outsized gains posted in recent years would contribute to some moderation in spending growth, especially by households. Government spending, which accounts for about one-sixth of domestic demand, seems likely to expand at a moderate pace overall. Along with the numerous other uncertainties that attend the outlook, an additional uncertainty is present this year because of the approach of the year 2000 and the associated Y2K problem.

Growth abroad is expected to remain sluggish, on balance, in 1999, limiting the prospects for exports. At the same time, growth of the U.S. economy probably will continue to generate fairly brisk increases in imports. In total, real net exports of goods and services seem likely to fall further in the coming year, although several factors—the decline in the dollar from its peak of last summer, the expected slowing of income growth in the United States, and the possibility of a slight pickup in economic growth abroad—provide a basis for thinking that this year's drop in net exports might not be as large as that of 1998.

The future course of inflation will depend in part on what happens to the prices of oil and other imports, and restraint from those sources seems unlikely to be as great as it was in 1998. The drop in the price of oil this past year left it toward the lower end of its range of the past couple of decades and has thereby reduced the incentives for exploration, drilling, and production. Futures markets have been showing a gradual rise in the price of oil going forward. Prices of nonoil imports changed little in the fourth quarter of last year after having fallen sharply in previous quarters. Indicators of the pressures on domestic resources provided mixed signals over the past year. In manufacturing, capacity utilization declined considerably, to a level below its long run average, reflecting slower production growth and sizable additions to the stock of capital. However, labor markets remained very taut, and with the economy apparently carrying substantial momentum into this year, data on costs and prices will need to be monitored carefully for signs that a rising inflation pattern might start to take hold. In that regard, the FOMC will continue to rely not only on the CPI but also on a variety of other price measures to gauge the economy's inflation performance in the period ahead.

Money and Debt Ranges for 1999

At its most recent meeting, the FOMC reaffirmed the 1999 monetary growth ranges that were chosen on a provisional basis last July: 1 percent to 5 percent for M2, and 2 percent to 6 percent for M3. As has been the case for some time, the FOMC intends these money growth ranges to be benchmarks for growth under conditions of price stability, sustainable real economic growth, and historical velocity relationships rather than ranges that encompass the expected growth of money over the coming year or that serve as guides to policy.

Given continued uncertainty about movements in the velocities of M2 and M3 (the ratios of nominal GDP to the aggregates), the Committee would have little confidence that money growth within any particular range selected for the year would be associated with the economic performance it expected or desired. Nonetheless, the Committee believes that, despite the apparent large shift in velocity behavior in the early 1990s, money growth has some value as an economic indicator. Indeed, some FOMC members have expressed the concern that the unusually rapid growth in the money and debt aggregates in 1998 might have reflected monetary conditions that were too accommodative and would ultimately lead to an increase in inflation pressures. The Committee will continue to monitor the monetary aggregates as well as a wide variety of other economic and financial data to inform its policy deliberations.

Last year, M2 increased 8½ percent, and with nominal GDP rising 5 percent, M2 velocity decreased 3 percent. This drop in velocity was considerably larger than would have been expected on the basis of historical relationships and the modest decline in the opportunity cost of M2 (measured as the difference between the interest rate on Treasury bills and the weighted average rate available on M2 assets). The fall in velocity in part reflected an increased demand for the safe and liquid assets in M2 as investors responded to the heightened volatility in financial markets in the second half of the year. Other factors that may have contributed include lower long-term interest rates and a very flat yield curve, which might have suggested to households that they would be giving up very little in earnings by parking savings in short-term assets in M2. In addition, M2 may have been boosted by a desire on the part of some investors to redirect savings flows away from equities after several years of outsized gains in stock market wealth. With equity wealth still elevated and the yield curve likely to remain flat, M2 velocity could continue to fall this year. However, the pace of decline should slow as some households respond to the easing of concerns about financial market volatility by reversing a portion of the shift toward M2 assets that occurred last fall. Indeed, this effect may already be visible, as M2 growth, while still robust, has slowed considerably early this year. If velocity does fall, given the Committee's expectations for nominal income growth, M2 could again exceed its price-stability benchmark range.

M3 expanded 11 percent last year, and its velocity fell 5¼ percent, the largest drop in many years. The rapid growth in this aggregate owed in large part to a substantial rise in institutional money funds. These funds have been expanding rapidly in recent years as nonfinancial firms increasingly employ them to provide cash management services. Investments in these funds provide businesses with greater liquidity than direct holdings of money market instruments, and by substituting for such direct holdings, they boost M3. M3 was also buoyed last year by a large advance

Ranges for Growth of Monetary and Debt Aggregates

Percent

Aggregate	1997	1998	1999
M2	1–5	1–5	1–5
M3	2–6	2–6	2–6
Debt	3–7	3–7	3–7

NOTE. Change from average for fourth quarter of preceding year to average for fourth quarter of year indicated.

in the managed liabilities banks used to fund rapid growth in bank credit. In part, the growth in bank credit reflected demand by borrowers shifting from the securities markets, and with these markets again receptive to new issues, bank credit growth this year is expected to slow to a pace more in line with broader debt aggregates However, institutional money funds are likely to continue their robust gains, contributing to a further diminution in M3 velocity and, possibly, to growth of this aggregate above its price-stability range.

Domestic nonfinancial debt grew 6¼ percent in 1998, somewhat above the middle of the 3 percent to 7 percent growth range the Committee established last February. This robust growth reflected large rises in the debt of businesses and households owing to substantial advances in spending as well as debt-financed mergers and acquisitions. However, the increase in private-sector debt was partly offset by the first annual decline in federal debt in almost thirty years. As with the monetary aggregates, the Committee left the range for debt growth unchanged for 1999. After an aberrant period in the 1980s during which debt growth greatly exceeded growth of nominal GDP, debt growth over the past decade has returned to its historical pattern of about matching growth of nominal GDP, and the Committee members expect debt to fall within its range this year.

Economic and Financial Developments in 1998 and Early 1999

The U.S. economy continued to display great vigor in 1998, despite a sharp slowing of growth in foreign economies and an unsettled world financial environment. According to the Commerce Department's advance estimate, real GDP increased a little more than 4 percent over the four quarters of the year. The economic difficulties facing many of our trading partners and the strength of the dollar through much of the year led to sluggishness in real exports of goods and services. However, the drag on the economy from that source was more than offset by exceptional strength in the real expenditures of households and businesses, which were powered by strong real income growth, large gains in the value of household wealth, ready access to finance during most of the year, and widespread optimism regarding the future of the economy. Although turmoil in financial markets seemed to threaten the economy for a time in late summer and early autumn, that threat later receded, in part because of the steps taken by the Federal Reserve to prevent the tightening of credit markets from impairing the expansion of activity. The final quarter of the year brought brisk expansion of employment and income, and the limited indicators of activity in early 1999 have been strong, on balance.

The increase in the general price level this past year was smaller than that in the previous year, which had itself been among the smallest in decades. The chain-type price index for GDP rose slightly less than 1 percent. The further slowing of price increases was in large part a reflection of sluggish conditions in the world economy, which brought declines in the prices of a wide range of imported goods, including oil and other primary commodities. In the domestic economy, nominal hourly compensation of workers picked up only slightly despite the tightness of the labor market, and much of the compensation increase was offset by gains in labor productivity. As a result, unit labor costs, the most important item in total business costs, rose only modestly.

The Household Sector

Personal consumption expenditures increased more than 5 percent in real terms in 1998, the biggest gain in a decade and a half. Support for the large rise in spending came from a combination of circumstances that, on the whole, were exceptionally favorable to households. Strong gains in employment and real hourly pay gave another appreciable boost to the growth of real labor income. At the same time, the wealth of households recorded another year of substantial increase, bolstered in large part by the continued rise in equity prices. Although not all balance sheet data for the end of 1998 are available, household net worth at that point appears to have been up about 10 percent from the level at the end of 1997. The cumulative gain in household wealth since 1994 has amounted to nearly 50 percent.

The rise in net worth probably accounts for much of the decline in the personal saving rate over the past few years, to an annual average of ½ percent in 1998. Households tend to raise their saving from current income when they feel that wealth must be increased to meet longer-run objectives, but they are willing to reduce their saving from current income when they feel that wealth already is at satisfactory levels. The low level of the saving rate in 1998 is not so remarkable when gauged against a wealth-to-income ratio that has been running in a range well above its longer-run historical average.

All of the major categories of personal consumption expenditures—durables, nondurables, and services—recorded gains in 1998 that were the largest of the 1990s. Spending on durable goods rose more than 12 percent over the year. Within that category, expenditures on home computers once again stood out, rising roughly 70 percent in real terms, a gain that reflected both increased nominal outlays and a further substantial decline in computer prices. Consumer outlays on motor vehicles also rose sharply, despite some temporary limitations on supply from a midyear auto strike. Spending on most other types of durable goods registered increases that were well above the averages of the past decade or so. Because goods such as these are not consumed all at once—but, rather, add to stocks of durable goods that will be yielding services to consumers for a number of years—they embody a form of economic saving that is not captured in the normal measure of the saving rate in the national income accounts.

The increases in income and net worth that led households to boost consumption expenditures also led them to invest heavily in additions to the stock of housing. Declines in mortgage interest rates weighed in as well, helping to maintain the affordability of housing even as house prices moved up somewhat faster than overall inflation. These developments brought the objective of owning a home within the reach of a greater number of households, and the home-ownership rate, which has been trending up this decade, rose to another new high in 1998.

In the single-family sector, sales of new and existing homes surged, the former rising more than 10 percent from the previous year's total and the latter more than 13 percent. Construction of single-family houses strengthened markedly. The number of these units started during the year was the largest since the late 1970s, and it exceeded the previous year's total by about 12 percent. In the fourth quarter, unusually mild weather permitted builders to maintain activity later into the season than they normally would have and gave an added kick to housing starts. Starts increased further in January of this year, despite harsher weather in some regions.

In contrast to the strength in the single-family sector, the number of multifamily units started in 1998 was up only a little from the total for 1997. After bottoming out at a very low level early in the 1990s, construction of these units had been trending back up fairly briskly until this past year. But with vacancy rates on multifamily rental units running a touch higher this past year, builders and their creditors may have become concerned about adding too many new units to the stock. Financing appeared generally to be in ample supply for projects that looked promising; during the period of financial turmoil, the flow of credit was supported by substantial purchases of multifamily mortgages and mortgage-backed securities by Freddie Mac and Fannie Mae.

Total outlays for residential investment increased about 12½ percent in real terms during 1998, according to the Commerce Department's initial tally. The large increase reflected not only the construction work undertaken on new residential units during the year but also sizable advances in real outlays for home improvements and in the volume of sales activity being carried on by real estate brokers, which generated substantial gains in commissions.

The robust growth in household expenditures in 1998 was accompanied by an expansion of household debt that likely exceeded 8½ percent, a somewhat larger rise than in other recent years. Nonmortgage debt increased about 6 percent, about 2 percentage points above the previous year's pace but down considerably from the double-digit increases posted in 1994 and 1995. Home mortgage debt is estimated to have jumped more than 9 percent, its largest annual advance since 1990, boosted in part by the robust housing market. In addition, with mortgage rates reaching their lowest levels in many years, many households refinanced existing mortgages, and some households likely took the opportunity presented by refinancing to increase the size of their mortgages, using the extra funds raised to finance current expenditures or to pay down other debts.

The growth in household debt reflected both supply and demand influences. With wealth rising faster than income over the year and with consumer confidence remaining at historically high levels, households were willing to boost their indebtedness to finance increased spending. In addition, lenders generally remained accommodative toward all but the most marginal households, even after the turmoil in many financial markets in the fall. After a more general tightening of loan conditions in response to a rise in losses on such loans between mid-1995 and mid-1997, a smaller and declining fraction of banks tightened consumer lending standards and terms last year, according to Federal Reserve surveys. However, the availability of high loan-to-value and subprime home equity loans likely was reduced in the fall because of difficulties in the market for securities backed by such loans.

Despite the rapid increase in debt, measures of household financial stress were relatively stable last year, although some remained at high levels. The delinquency rate on home mortgages has stayed quite low in recent years, while the delinquency rate on auto loans at domestic auto finance companies has trended lower. The delinquency rate on credit card loans at banks fluctuated in a fairly narrow range in 1997 and 1998, but it remained elevated after having posted a substantial rise over the previous two years. Personal bankruptcy filings have followed a broadly similar pattern: Annual growth has run at about 3 percent over the past year and a half, down from annual increases of roughly 25 percent between mid-1995 and early 1997. The stability of these measures over the past couple of years likely owes in part to the earlier tightening of standards and terms on consumer loans. In addition, lower interest rates and longer loan maturities, which resulted from the shift toward mortgage finance, have helped to mitigate the effects of increased borrowing on household debt-service burdens.

The Business Sector

Business fixed investment increased about 12½ percent during 1998, with a 17½ percent rise in equipment spending more than accounting for the overall advance. The strength of the economy and optimism about its longer-run prospects provided underpinnings for increased investment. Outlays were also bolstered by the efficiencies obtainable with new technologies, by the favorable prices at which many types of capital equipment could be purchased, and, except during the period of financial market turmoil, by the ready availability and low cost of finance, either through borrowing or through the issuance of equity shares.

Real expenditures on office and computing equipment, after having risen at an average rate of roughly 30 percent in real terms from 1991 through 1997, shifted into even higher gear in 1998, climbing about 65 percent. The outsized increase likely owed in part to the efforts of some businesses to put new computer systems in place before the end of the millennium, in hopes of circumventing potential difficulties arising from the Y2K problem. But, beyond that, investment in computers is being driven by the same factors that have been at work throughout the expansion—namely, the introduction of machines that offer greater computing power at increasingly attractive prices and that provide businesses new and more efficient ways of organizing their operations. Price declines this past year were especially large, as the cost reductions associated with technical change were augmented by heightened international competition in the markets for semiconductors and other computer components and by price cutting to work down the stocks of some assembled products.

Investment in communications equipment—another high-tech category that is an increasingly important part of total equipment outlays—rose about 18½ percent in 1998. After having traced out an erratic pattern of ups and downs through the latter part of the 1980s and the early 1990s, real outlays on this type of equipment began to record sustained large annual increases in 1994, and the advance last year was one of the largest. Spending on other types of equipment displayed varying degrees of strength across different sectors but recorded a sizable gain overall. Investment in transportation equipment was strong across the board, spurred by the need to move greater volumes of goods or to carry more passengers in an expanding economy. Spending on industrial machinery advanced about 4½ percent after larger gains in most previous years of the expansion, a pattern that mirrored a slowing of output growth in the industrial sector.

Business investment in nonresidential structures, which accounts for slightly more than 20 percent of total business fixed investment, was down slightly in 1998, according to the advance estimate. Sharply divergent trends were evident within the sector, ranging from considerable strength in the construction of office buildings to marked weakness in the construction of industrial buildings. The waxing and waning of industry-specific construction cycles appears to be the main explanation for the diverse outcomes of this past year. Although some of the more speculative construction plans may have been shelved because of a tightening of the terms and standards on loans, partly in reaction to the financial turmoil, most builders appear to have been able to eventually obtain financing. Despite the sluggishness of spending on structures this past year, the level of investment remained high enough to generate continued moderate growth in the real stock of structures.

Business inventories increased about 4½ percent in real terms this past year after having risen more than 5 percent during 1997. Stocks grew at a 7 percent annual rate in the first quarter, appreciably faster than final sales, but inventory growth over the remainder of the year was considerably slower than in the first quarter. At year-end, stocks in most nonfarm industries were at levels that did not seem likely to cause firms to restrain production going forward. Inventories of vehicles may even have been a little on the lean side, as a result of both a strike that held down assemblies through the middle part of 1998 and exceptionally strong demand, which prevented the rebuilding of stocks later in the year. By contrast, inventories at year-end appear to have been excessive in a few nonfarm industries that have been hurt by the sluggish world economy. Stocks of farm commodities also appeared to be excessive, having been boosted further this past year by large harvests and sluggish export demand.

The economic profits of U.S. corporations—that is, book profits adjusted so that inventories and fixed capital are valued at their current replacement cost—rose further, on net, over the first three quarters of 1998 but at a much slower pace than in most other years of the current expansion. Companies' earnings from operations in the rest of the world fell back a bit, as did the profits of private financial corporations from domestic operations. The profits of nonfinancial corporations from domestic operations increased at an annual rate of about 1¾ percent. Although the volume of output of the nonfinancial companies continued to rise rapidly, profits per unit of output were squeezed a bit by companies' difficulties in raising prices in step with costs in a competitive market environment.

With profits expanding more slowly and investment spending still on the upswing, businesses' external funding needs increased substantially last year. Aggregate borrowing by the nonfinancial business sector is estimated to have expanded 9½ percent from the end of 1997 to the end of 1998, the largest increase in ten years. The rise reflected growth in all major types of business debt. Business borrowing was also boosted by substantial merger and acquisition activity. Indeed, mergers and acquisitions, share repurchases, and foreign purchases of U.S. firms last year overwhelmed the high level of both initial and seasoned public equity issues, and net equity retirements likely exceeded $250 billion.

The disruptions in the financial markets in late summer and early fall appear to have had little effect on total business borrowing but caused a substantial temporary shift in the sources of credit. With investors favoring high credit quality and liquidity, yields on lower-rated corporate bonds rose despite declining Treasury rates; the spread of yields on junk bonds over those on comparable Treasury securities roughly doubled between mid-summer and mid-autumn before falling back somewhat as conditions in financial markets eased. The spread of rates on lower-tier commercial paper over those on higher-quality paper rose substantially during the fall but had retraced the rise by the early part of this year.

Reflecting these adverse market conditions, nonfinancial corporate bond issuance fell sharply in August and remained low through mid-October, with issuance of junk bonds virtually halted for a time. Commercial paper issuance rose sharply in August and September, as some firms apparently decided to delay bond issues, turning temporarily to the commercial paper market instead. Bond issuance picked up again in late October, however, and issuance in November was robust. Reflecting this rebound, commercial paper outstanding fell back in the fourth quarter. More recently, bond issuance has remained healthy, while borrowing in the commercial paper market has picked up.

During the period when financial markets were strained, some borrowers substituted bank loans—in some cases under credit lines priced before the markets became volatile—for other sources of credit, and business loans at banks expanded very rapidly for a time before tailing off late in the year. Federal Reserve surveys indicate that banks responded to the turmoil in financial markets by tightening standards and terms on new loans and credit lines, especially loans to larger customers and those to finance commercial real estate ventures. The tightening reflected the less favorable or more uncertain economic outlook as well as a reduced tolerance for risk on the part of some banks. Bank lending standards and terms appear to have tightened only a little further since the fall, however, and business loans at banks have expanded a bit since the end of December.

Despite the rapid growth in debt and the relatively small gain in profits last year, the financial condition of nonfinancial businesses remained strong. Interest rates for many businesses fell, on balance, over the course of the year, and bond yields for investment-grade firms reached their lowest level in many years. Reflecting these low borrowing costs, the aggregate debt-service burden for nonfinancial corporations, measured as the ratio of net interest payments to cash flow, remained about 9½ percent, near its low of 9 percent in 1997 and less than half the peak level reached in 1989. The delinquency rate for banks' commercial and industrial loans also remained near the trough reached in late 1997, while that for commercial real estate loans fell a bit further from the already very low level posted in 1997. Although Moody's Investors Service downgraded more nonfinancial firms than it upgraded over the second half of the year, the downgraded firms were smaller on average, and so the debt of those upgraded about equaled the debt of those downgraded. Through October, business failures remained at the low end of the range seen over the past decade.

The Government Sector

The federal government recorded a surplus in the unified budget this past fiscal year for the first time in nearly three decades. The surplus, amounting to $69 billion, was equal to about ¾ percent of GDP, a huge turnabout from the deficits of the early 1990s, which in some years were more than 4½ percent of GDP. The swing from deficit to surplus over the past few years is partly the result of fiscal policies aimed at lowering the deficit and partly the result of the strength of the economy and the stock market. Excluding net interest payments—a charge stemming from past deficits—the government recorded a surplus of more than $300 billion in fiscal 1998.

The improvement in the government's saving position has permitted national saving—the combined gross saving of households, businesses, and governments—to move up about 3 percentage points from its low of a few years ago, even though personal saving has fallen sharply. In turn, that increase in national saving has helped facilitate the boom in investment spending—in contrast to the experience of the 1980s and early 1990s, when persistent large budget deficits tended to reduce national saving, boost interest rates higher than they otherwise would have been, and thereby crowd out private capital formation.

Federal receipts in the unified budget in fiscal year 1998 were up 9 percent from the previous fiscal year, with much of the gain coming from personal income taxes, which rose more than 12 percent for a second consecutive year. These receipts have been rising faster than personal income in recent years, for several reasons: Tax rates at the high end of the income scale were raised by legislation that was passed in 1993 to help reduce the deficit; more taxpayers have moved into higher tax brackets as income has increased; and large increases in asset values have raised tax receipts from capital gains. Social insurance tax receipts, the second most important source of federal revenue, increased 6 percent in fiscal 1998, just a touch faster than the increase in fiscal 1997 and roughly in step with the growth of wages and salaries. Receipts from the taxes on corporate profits, which account for just over 10 percent of federal revenues, rose less rapidly than in other recent years, restrained by the slower growth of corporate profits. In the first three months of fiscal 1999, net receipts from corporate taxes dipped below year-earlier levels, but gains in individual income taxes and payroll taxes kept total federal receipts on a rising trajectory.

Unified outlays increased 3¼ percent in fiscal 1998 after having risen 2½ percent in the preceding fiscal year. Net interest payments and nominal expenditures for defense fell slightly in the latest fiscal year, and outlays for income security and Medicare rose only a little. Social security expenditures increased moderately but somewhat less than in other recent years. By contrast, the growth of Medicaid payments picked up to about 6 percent after having increased less than 4 percent in each of the preceding two years; however, even the 1998 rise was not large compared with those of many earlier years when both medical costs and Medicaid caseloads were increasing rapidly and rates of federal reimbursement to the states were being raised. Federal spending in fiscal 1999 will be boosted to some degree by new budget authority for a variety of functions, including defense, embassy security, disaster relief, preparation for Y2K, and aid to agriculture; this authority was created in emergency legislation that provided an exception to statutory spending restrictions.

Real federal outlays for consumption and investment, the part of federal spending that is counted in GDP, increased 1 percent, on net, from the final quarter of calendar year 1997 to the final quarter of 1998. A reduction in real defense outlays over that period was more than offset by a jump in the nondefense category.

With the budget balance shifting from deficit to surplus, the stock of publicly held federal debt declined last year for the first time since 1969 and fell further as a share of GDP. From the end of 1997 to the end of 1998, U.S. government debt fell 1½ percent, as the government reduced the outstanding stock of both bills and coupon securities. Despite the reduction in its debt, the federal government continued substantial gross borrowing to fund the retirement of maturing securities. However, with the need for funds trimmed substantially, the Treasury changed its auction schedules, discontinuing the three-year note auctions and moving to quarterly, rather than monthly, auctions of five-year notes. By reducing the number of coupon security issues, the Treasury is able to boost the size of each, thereby contributing to their liquidity. The decrease in the total volume of coupon securities is intended to boost the size of bill offerings over time, helping liquidity in that market and also allowing, as the Treasury prefers, for balanced issuance across the yield curve. The Treasury also announced in October that all future bill and coupon security auctions would employ the single-price format that had already been adopted for the two-year and five-year note auctions and for auctions of inflation-indexed securities. The Treasury judged that the single-price format had reduced servicing costs and resulted in broader market participation.

The Treasury continued to auction inflation-indexed securities in substantial volume last year in an effort to build up this part of the Treasury market. In April, the Treasury issued its first thirty-year indexed bond, and in September it announced a regular schedule of ten- and thirty-year indexed security auctions. The Treasury also began offering inflation-indexed savings bonds in September.

State and local governments recorded further increases in their budgetary surpluses in 1998, both in absolute terms and as a share of GDP. Revenue from the taxes on individuals' incomes has been growing very rapidly, keeping total receipts on a solid upward course. At the same time, the growth of transfer payments, which had threatened to overwhelm state and local budgets earlier in the decade, has slowed substantially in recent years. Growth of other types of spending has been trending up moderately, on balance. The 1998 rise in real expenditures for consumption and investment amounted to about 2¼ percent, according to the initial estimate; annual gains have been in the range of 2 percent to 2¾ percent in each of the past seven years.

Despite rising surpluses, state and local government debt increased an estimated 7 percent in 1998, a pickup of about 2 percentage points from growth in 1997. Somewhat more than half of the long-term borrowing by state and local governments last year reflected new borrowing to fund current and anticipated capital spending on utilities, transportation, education, and other capital projects. The combination of budget surpluses and relatively heavy borrowing likely reflected a number of factors. First, some of these governments may have spent the newly raised funds on capital projects while at the same time building up surpluses in "rainy day funds" for later use. Second, because state and local governments under some circumstances are allowed to hold funds raised in the markets for as long as five years before spending them, some of the money raised last year may not have been spent. Finally, there was a substantial volume of "advance refunding" last year. In an advance refunding, the borrower issues new bonds before existing higher-rate bonds can be called, in anticipation of calling the old bonds on the date that option becomes available. While this sort of refinancing temporarily boosts total debt, it allows the state or local government to lock in the lower rate even if municipal bond yields subsequently rise over the period before the call date. The high level of advance-refunding activity last year was the result of lower borrowing costs. Although yields on tax-exempt municipal securities did not decline nearly as much as those on comparable Treasury securities, they nonetheless reached their lowest levels in many years. In addition, rating agencies upgraded about five times as many state and local government issues last year as they downgraded, trimming borrowing costs further for the upgraded entities.

The External Sector

Trade and the Current Account

U.S. external balances deteriorated further in 1998, largely because of the disparity between the rapid growth of the U.S. economy and the sluggish growth of the economies of many of our trading partners. The nominal trade deficit for goods and services was $169 billion, considerably larger than the $110 billion deficit in 1997. For the first three quarters of the year, the current account deficit averaged $220 billion at an annual rate, substantially larger than the 1997 deficit of $155 billion. The large current account deficits of recent years have been funded with increased net foreign saving in the United States. As a result, U.S. gross domestic investment has exceeded the level that could have been financed by gross national saving alone, but at the cost of a rise in net U.S. external indebtedness.

The increase in the current account deficit last year was due to a decline in net exports of goods and services as well as a further weakening of net investment income from abroad. Until 1997, net investment income had helped to offset persistent trade deficits. But as the U.S. net external debt has risen in recent years, net investment income has become increasingly negative, moving from a $14 billion surplus in 1996 to a $5 billion deficit in 1997 and a deficit averaging $15 billion at an annual rate over the first three quarters of 1998. Net income from portfolio investment became increasingly negative during that period as the net portfolio liability position of the United States grew larger. In addition, net income from direct investment slowed last year because slower foreign economic growth lowered U.S. earnings on investment abroad, the appreciation of the dollar reduced the value of U.S. earnings, and buoyant U.S. growth boosted foreigners’ earnings on direct investment in the United States.

The rise in the trade deficit reflected an increase of about 10 percent in real imports of goods and services during 1998, according to the advance estimates from the Commerce Department. The expansion was fueled by robust growth of U.S. domestic demand and by continued declines in import prices, which stemmed in part from the strength of the dollar through mid-August and in part from the effects of recessions abroad. Of the major trade categories, increases in imports were sharpest for finished goods, especially capital equipment and automotive products. The quantity of imported oil rose appreciably as demand increased in response to the strength of U.S. economic activity and lower oil prices, while domestic production declined slightly. The price of imported oil fell about $6.50 per barrel over the four quarters of the year. World oil prices fell in response to reduced demand associated with the economic slowdown in many foreign nations and with unusually warm weather in the Northern Hemisphere as well as to an increase in supply from Iraq.

Real exports of goods and services grew about 1 percent, on net, in 1998 after posting a 10 percent rise in 1997. Declines during the first three quarters (especially in machinery exports) were offset by a rebound in the fourth quarter, which was led by increases in exports of automotive products. The price competitiveness of U.S. products decreased, reflecting the appreciation of the dollar through mid-August. In addition, economic activity abroad weakened sharply; total average foreign growth (weighted by shares of U.S. exports) plunged from 4 percent in 1997 to an estimated ½ percent in 1998. Moderate expansion of exports to Europe, Canada, and Mexico was about offset by a decline in exports associated with deep recessions in Japan and the emerging Asian economies (particularly in the first half of the year) and in South America (in the second half of the year).

Capital Flows

The financial difficulties in a number of emerging market economies had several noticeable effects on U.S. international capital flows in 1998. Financial turmoil put strains on official reserves in many emerging market economies. Foreign official assets in the United States fell $43 billion in the first three quarters of the year. This decline, which began in the fourth quarter of 1997, has been largest for developing countries, as many of them drew down their foreign exchange reserves in response to exchange rate pressures. OPEC nations' foreign official reserves also shrank in the first three quarters of 1998, as oil revenues dropped. Preliminary data indicate that foreign official assets in the United States, especially those of industrial countries, rebounded in the fourth quarter.

Private capital flows also were affected by the global turmoil. On a global basis, capital flows to emerging market economies fell substantially in the first half of 1998 and then dropped precipitously in late summer and early fall in the wake of the Russian crisis. During the first half of the year, U.S. residents acquired more than $40 billion of foreign securities. Net purchases virtually stopped in July, and in the August–October period U.S. residents, on net, sold about $40 billion worth of foreign securities. Preliminary data indicate a resumption of net U.S. purchases in the final two months of 1998. Foreign net purchases of U.S. securities, which were substantial in the first half of the year, fell off markedly in the July–October period, but preliminary data suggest a significant recovery in November and December. Thus, there is some evidence that the contraction in gross capital flows seen in late summer and early fall waned somewhat in the fourth quarter.

Balance of payments data available through the first three quarters of 1998 show that total private foreign purchases of U.S. securities amounted to $194 billion, somewhat below the level in the first three quarters of 1997. Private foreign purchases of U.S. Treasury securities were only $22 billion in the first three quarters, compared with $147 billion for all of 1997. Private foreigners' purchases of other U.S. securities shifted away from equities and toward bonds, relative to 1997. U.S. purchases of foreign securities slowed markedly from their 1997 pace, totaling only $27 billion for the first three quarters of 1998 compared with $89 billion for all of the preceding year. The contraction in private portfolio capital flows, though large, was overshadowed by huge direct investment capital flows, which resulted in part from a number of very large cross-border mergers. The $72 billion in foreign direct investment into the United States in the first three quarters, together with several large mergers that occurred in the fourth quarter, are certain to bring the total for last year well above the record-high $93 billion posted in 1997. Merger activity also buoyed U.S. direct investment abroad: The pace of such investment in the first three quarters suggests that the annual total will be near the record-high $122 billion recorded in 1997.

The Labor Market

The rapid growth of output in 1998 was associated with both increased hiring and continued healthy growth in labor productivity. The number of jobs on nonfarm payrolls rose about 2¼ percent from the end of 1997 to the end of 1998, a net increase of 2.8 million. Manufacturers reduced employment over the year, but in other parts of the economy the demand for labor continued to rise rapidly. The construction industry boosted employment about 6 percent over the year, and both the services industries and the finance, insurance, and real estate sector posted increases of more than 3½ percent. Stores selling building materials and home furnishings expanded employment rapidly, as did firms involved in computer services, communications, and managerial services. In the first month of 1999, nonfarm payrolls increased an additional 245,000.

Output per hour in the nonfarm business sector rose 2½ percent in 1998 after having increased about 1¾ percent, on average, over the two previous years. By comparison, the average rate of rise during the 1980s and the first half of the 1990s was just over 1 percent per year. Because productivity often picks up to a pace above its long-run trend when economic growth accelerates, the results of the past three years might well be overstating the rate of efficiency gain that can be maintained in coming years. However, reasons for thinking that the trend might have picked up to some degree are becoming more compelling in view of the incoming data. The 1998 gain in output per hour was particularly impressive in this regard, in part because it came at a time when many businesses were diverting resources to correct the Y2K problem, a move that likely imposed a bit of drag on growth of output per hour. Higher rates of capital formation are raising the growth of capital per worker, and workers are likely becoming more skilled in employing the new technologies. Businesses not only are increasing their capital inputs but also are continuing to implement changes to their organizational structures and operating procedures that might enhance efficiency and bolster profit margins.

The rising demand for labor continued to strain supply in 1998. The civilian labor force rose just a touch more than 1 percent from the fourth quarter of 1997 to the fourth quarter of 1998, and with the number of persons holding jobs rising somewhat faster than the labor force, the civilian unemployment rate fell still further. The unemployment rate was 4.3 percent at the end of 1998; the average for the full year—4.5 percent—was the lowest of any year in almost three decades. In January of this year, the size of the labor force rose rapidly, but so did employment, and the unemployment rate remained at 4.3 percent. The percentage of the working age population that is outside the labor force and is interested in obtaining work but not actively seeking it edged down further this past year and has been in the lowest range since the collection of these data began in 1970. With the supply of labor as tight as it is, businesses are reaching further into the pool of individuals who do not have a history of strong attachment to the labor force; persons who are attempting to move from welfare to work are among the beneficiaries.

Workers have realized large increases in real wages and real hourly compensation over the past couple of years. The increases have come partly through faster gains in nominal pay than in the mid-1990s but also though reductions in the rate of price increase, which have been enhancing the real purchasing power of nominal earnings, perhaps to a greater degree than workers might have anticipated. According to the Labor Department's employment cost index, the hourly compensation of workers in private nonfarm industries rose 3½ percent in nominal terms during 1998, a touch more than in 1997 and ½ percentage point more than in 1996. Taking the consumer price index as the measure of price change, this increase in nominal hourly compensation translated into a 2 percent increase in real hourly pay, one of the largest on record in a series that goes back to the start of the 1980s; the gain was bigger still if the chain-type price index for personal consumption expenditures is used as the measure of consumer prices. Moreover, the employment cost index does not capture some of the forms of compensation that employers have been using to attract and retain workers—for example, stock options and signing bonuses.

Because of the rapid growth in labor productivity, unit labor costs have been rising much less rapidly than hourly compensation in recent years. The increase in unit labor costs in the nonfarm business sector was only 1½ percent in 1998. Businesses were unable to raise prices sufficiently to recoup even this small increase in costs, however. Labor gained a greater share of the income generated from production, and the profit share, though still high, fell back a little from its 1997 peak.

Prices

The broader measures of aggregate price change showed inflation continuing to slow in 1998. The consumer price index moved up 1½ percent over the four quarters of the year after having increased nearly 2 percent in 1997. A steep decline in energy prices in the CPI more than offset a small acceleration in the prices of other goods and services. Only part of the deceleration in the total CPI was attributable to technical changes in data collection and aggregation.[1]

Measures of aggregate price change from the national income and product accounts, which draw heavily on data from the CPI but also use data from other sources, showed a somewhat more pronounced deceleration of prices in 1998. The chain-type price index for personal consumption expenditures, the measure of consumer prices in the national accounts, rose ¾ percent after increasing 1½ percent in 1997. The chain-type price index for gross domestic purchases—the broadest measure of

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[1] Since the end of 1994, the Bureau of Labor Statistics has taken a number of steps to make the consumer price index a more accurate price measure. The agency also introduced new weights into the CPI at the start of 1998. In total, these changes probably reduced the 1998 rise in the CPI by slightly less than ½ percentage point, relative to the increase that would have been reported using the methodologies and weights in existence at the end of 1994. Without the changes that took effect in 1998, the deceleration in the CPI last year probably would have been about half as large as was reported.

prices paid by U.S. households, businesses, and governments—increased only ½ percent in 1998 after moving up 1¼ percent over the previous year. The rise in the chain-type price index for gross domestic product of slightly less than 1 percent was down from an increase of 1¾ percent in 1997.

Developments in the external sector helped to bring about the favorable inflation outcome of 1998. Consumers benefited directly from lower prices of finished goods purchased from abroad. Lower prices for imports probably also held down the prices charged by domestic producers, not only because businesses were concerned about losing market share to foreign competitors but also because declines in commodity prices in sluggish world markets helped reduce domestic production costs to some degree.

In manufacturing, one of the sectors most heavily affected by the softness in demand from abroad, the rate of plant capacity utilization fell noticeably over the year—even as the unemployment rate continued to decline. The divergence of these two key measures of resource use—the capacity utilization rate and the unemployment rate—is unusual: They typically have exhibited similar patterns of change over the course of the business cycle. Because the unemployment rate applies to the entire economy, it presumably should be a better indicator of the degree of pressure on resources in general. At present, however, slack in the goods-producing sector—a reflection of the sizable additions to capacity in this country and excess capacity abroad—seemingly has enforced a discipline of competitive price and cost control that has affected the economy more generally.

Alternative Measures of Price Change

Percent

Price measure	1997	1998
Fixed-weight		
Consumer price index	1.9	1.5
Excluding food and energy	2.2	2.4
Chain-type		
Gross domestic product	1.7	.9
Gross domestic purchases	1.3	.5
Personal consumption expenditures	1.5	.8
Excluding food and energy	1.6	1.2

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

Prices this past year tended to be weakest in the sectors most closely linked to the external economy. The price of oil fell almost 40 percent from December 1997 to December 1998. This drop triggered steep declines in the prices of petroleum products purchased directly by households. The retail price of motor fuel fell about 15 percent over the four quarters of the year, and the price of home heating fuel also plunged. With the prices of natural gas and electricity also falling, the CPI for energy was down about 9 percent over the year after having slipped 1 percent in 1997.

Large declines in the prices of internationally traded commodities other than oil pulled down the prices of many domestically produced primary inputs. The producer price index for crude materials other than energy, which reflects the prices charged by domestic producers of these goods, fell more than 10 percent over the year. However, because these non-oil commodities account for a small share of total production costs, the effect of their decline on inflation was much less visible further down the chain of production. Intermediate materials prices excluding food and energy fell about 1½ percent over the four quarters of the year, and the prices of finished goods excluding food and energy rose about 1½ percent. The latter index was boosted, in part, by an unusually large hike in tobacco prices that followed the settlement last fall of states' litigation against the tobacco companies. In the food sector as well, the effects of declining commodity prices became less visible further down the production chain; the PPI for finished foods was about unchanged, on net, over the year, and price increases at the retail level, though small, were somewhat larger than those of the preceding year.

Consumer prices excluding those of food and energy—the core CPI—continued to rise in 1998, but not very rapidly. As measured by the CPI, these prices increased nearly 2½ percent from the final quarter of 1997 to the final quarter of 1998, a shade more than in 1997. The chain-type price index for personal consumption expenditures excluding food and energy—the core PCE price index—decelerated a bit further, rising at roughly half the pace of the core CPI. Methodological differences between the two measures are numerous; some of the technical problems that have plagued the CPI are less pronounced in the PCE price measure, but the latter also depends partly on imputations of prices for which observations are not available. Both measures, however, seemed to suggest that the underlying trend of consumer price inflation remained low. A similar message came from surveys of consumers, which showed expectations of future price increases easing a bit further in 1998—although, as in other recent years, the expected increases remained somewhat higher than actual price increases.

U.S. Financial Markets

U.S. interest rates fluctuated in fairly narrow ranges over the first half of 1998, and most equity price indexes posted substantial gains. However, after the devaluation of the Russian ruble in August and subsequent difficulties in other emerging market economies, investors appeared to reassess the risks and uncertainties facing the U.S. economy and concluded that more cautious postures were in order. That sentiment was reinforced by the prospect of an unwinding of positions by some highly leveraged investors. The resulting shift toward safe, liquid investments led to a substantial widening of risk spreads on debt instruments and to volatile changes in the prices of many assets. Financial market volatility and many risk spreads returned to more normal levels later in the year and early this year, as lower interest rates and robust economic data seemed to reassure market participants that the economy would remain sound, even in the face of additional adverse shocks from abroad. However, lenders remained more cautious than they had been in the first part of last year, especially in the case of riskier credits.

Interest Rates

Over the first half of 1998, short-term Treasury rates moved in a narrow range, anchored by unchanged monetary policy, while yields on intermediate- and long-term Treasury securities varied in response to the market's shifting assessment of the likely impact of foreign economic difficulties on the U.S. economy. In late 1997 and into 1998, spreading financial crises in Asia were associated with declines in U.S. interest rates, as investors anticipated that weakness abroad would constrain U.S. economic growth and cushion the impact of tight U.S. labor markets on inflation. However, interest rates moved back up later in the first quarter of 1998, as the U.S. economy continued to expand at a healthy pace, fueled by hefty gains in domestic demand. After a couple of months of small changes, Treasury rates fell in May and June, when concerns about foreign economies, particularly in Asia, once again led some observers to expect weaker growth in the United States and may also have boosted the demand for safe Treasury securities relative to other instruments.

Treasury rates changed little, on net, in the early summer, but they slipped lower in August, reflecting increased concern about the Japanese economy and financial problems in Russia. The default by Russia on some government debt obligations and the devaluation of the ruble in mid-August not only resulted in sizable losses for some investors but also undermined confidence in other emerging market economies. The currencies of many of these economies came under substantial pressure, and the market value of the international debt obligations of some countries declined sharply. U.S. investors shared in the resulting losses, and U.S. economic growth and the profits of U.S. companies were perceived to be vulnerable. In these circumstances, many investors, both here and abroad, appeared to reassess the riskiness of various counterparties and investments and to become less willing to bear risk. The resulting shift of demand toward safety and liquidity led to declines of 40 to 75 basis points in Treasury coupon yields between mid-August and mid-September. In contrast, yields on higher-quality private securities fell much less, and those on issues of lower-rated firms increased sharply. As a result, spreads of private rates over Treasury rates rose substantially, reaching levels not seen for many years, and issuance of corporate securities dropped sharply.

The desire of investors to limit risk-taking as markets became troubled in the late summer showed up clearly in mutual fund flows. High-yield bond funds, which had posted net inflows of more than $1 billion each month from May to July, saw a $3.4 billion outflow in August and inflows of less than $400 million in September and October before rebounding sharply in November. By contrast, inflows to government bond funds jumped from less than $1 billion in July to more than $2 billion a month in August and September. Equity mutual funds posted net outflows totaling nearly $12 billion in August, the first monthly outflow since 1990, and inflows over the rest of the year were well below those earlier in the year.

In part, the foreign difficulties were transmitted to U.S. markets by losses incurred by leveraged investors—including banks, brokerage houses, and hedge funds—as the prospects for distress sales of riskier assets by such investors weighed on market sentiment, depressing prices. Many of these entities did reduce the scale of their operations and trim their risk exposures, responding to pressures from more cautious counterparties. As a result, liquidity in many markets declined sharply, with bid–asked spreads widening and large transactions becoming more difficult to complete. Even in the market for Treasury securities, investors showed an increased preference for the liquidity offered by the most recent issues at each maturity, and the yields on these more actively traded “on-the-run” securities fell noticeably relative to those available on “off-the-run” issues, the ones that had been outstanding longer.

Conditions in U.S. financial markets deteriorated further following revelations in mid-September of the magnitude of the positions and the extent of the losses of a major hedge fund, Long-Term Capital Management. LTCM indicated that it sought high rates of return primarily by identifying small discrepancies in the prices of different instruments relative to historical norms and then taking highly leveraged positions in those instruments in the expectation that market prices would revert to such norms over time. In pursuing its strategy, LTCM took very large positions, some of which were in relatively small and illiquid markets.

LTCM was quite successful between 1995 and 1997, but the shocks hitting world financial markets last August generated substantial losses for the firm. Losses mounted in September, and before new investors could be found, the firm encountered difficulties meeting liquidity demands arising from its collateral agreements with its creditors and counterparties. With world financial markets already suffering from heightened risk aversion and illiquidity, officials of the Federal Reserve Bank of New York judged that the precipitous unwinding of LTCM's portfolio that would follow the firm's default would significantly add to market problems, would distort market prices, and could impose large losses, not just on LTCM's creditors and counterparties, but also on other market participants not directly involved with LTCM.

In an effort to avoid these difficulties, the Federal Reserve Bank of New York contacted the major creditors and counterparties of LTCM to see if an alternative to forcing LTCM into bankruptcy could be found. At the same time, Reserve Bank officials informed some of their colleagues at the Federal Reserve Board, the Treasury, and other financial regulators of their activities. Subsequent discussions among LTCM's creditors and counterparties led to an agreement by the private-sector parties to provide an additional $3½ billion of capital to LTCM in return for a 90 percent equity stake in the firm.

Because of the potential for firms such as LTCM to have a large influence on U.S. financial markets, Treasury Secretary Robert Rubin asked the President's Working Group on Financial Markets to study the economic and regulatory implications of the operations of firms like LTCM and their relationships with their creditors. In addition, the extraordinary degree of leverage with which LTCM was able to operate has led the federal agencies responsible for the prudential oversight of the fund's creditors and counterparties to undertake reviews of the practices those firms employed in managing their risks. These reviews have suggested significant weaknesses in the risk-management practices of many firms in their dealings with LTCM and—albeit to a lesser degree—in their dealings with other highly leveraged entities. Few counterparties seem to have had a complete understanding of LTCM's risk profile, and their credit decisions were heavily influenced by the firm's reputation and strong past performance. Moreover, LTCM's counterparties did not impose sufficiently tight limits on their exposures to LTCM, in part because they relied on collateral agreements requiring frequent marking to market to limit the risk of their exposures. While these agreements generally provided for collateral with a value sufficient to cover current credit exposures, they did not deal adequately with the potential for future increases in exposures from changes in market values. This shortcoming was especially important in dealings with a firm like LTCM, which had such large positions in illiquid markets that its liquidation would likely have moved prices sharply against its creditors. In such cases, creditors need to take further steps to limit their potential future exposures, which might include requiring additional collateral or simply scaling back their activity with such firms.

The private-sector agreement to recapitalize LTCM allowed its positions to be reduced in an orderly manner over time, rather than in an abrupt fire sale. Nonetheless, the actual and anticipated unwinding of LTCM's portfolio, as well as actual and anticipated sales by other similarly placed leveraged investors, likely contributed materially to the tremendous volatility of financial markets in early October. Market expectations of asset price volatility going forward, as reflected in options prices, rose sharply, as bid–asked spreads and the premium for on-the-run securities widened. Long-term Treasury yields briefly dipped to their lowest levels in more than thirty years, in part because of large demand shifts resulting from concerns about the safety and liquidity of private and emerging market securities. Spreads of rates on corporate bonds over those on comparable Treasury securities rose considerably, and issuance of corporate bonds, especially by lower-rated firms, remained very low.

By mid-October, however, market conditions had stopped deteriorating, and they began to improve somewhat in the days and weeks following the cut in the federal funds rate on October 15, between Federal Open Market Committee meetings. Internationally coordinated efforts to help Brazil cope with its financial difficulties, culminating in the announcement of an IMF-led support package in mid-November, contributed to the easing of market strains. In the Treasury market, bid–asked spreads narrowed a bit and the premium for on-the-run issues declined. With the earlier flight to quality and liquidity unwinding, Treasury rates backed up considerably. Corporate bond spreads reversed a part of their earlier rise, and investment-grade bond issuance rebounded sharply. In the high-yield bond market, investors appeared to be more hesitant, especially for all but the best-known issuers, and the volume of junk bond issuance picked up less. In the commercial paper market, yields on higher-quality paper declined; yields on lower-quality paper remained elevated, however, and some lower-tier firms reportedly drew on their bank lines for funding, giving a further boost to bank business lending, which had begun to pick up during the summer.

Market conditions improved a bit further immediately after the Federal Reserve's November rate cut, but some measures of market stress rose again in late November and in December. In part, this deterioration reflected widespread warnings of lower-than-expected corporate profits, a weakening economic outlook for Europe, and renewed concerns about the situation in Brazil. In addition, with risk a greater-than-usual concern, some market participants were likely less willing to hold lower-rated securities over year-end, when they would have to be reported in annual financial statements. As a result, liquidity in some markets appeared to be curtailed, and price movements were exaggerated. These effects were particularly noticeable in the commercial paper market: The spread between rates on top-tier and lower-tier thirty-day paper jumped almost 40 basis points on December 2, when that maturity crossed year-end, and then reversed the rise late in the month.

By shortly after year-end, some measures of market stress had eased considerably from their levels in the fall, although markets remained somewhat illiquid relative to historical norms, and risk spreads on corporate bonds stayed quite elevated. Nonetheless, with Treasury yields very low, corporate bond rates were apparently perceived as advantageous, and—following a lull around year-end—many corporate borrowers brought new issues to market. The devaluation and subsequent floating of the Brazilian *real* in mid-January had a relatively small effect on U.S. financial markets. More recently, intermediate- and long-term Treasury rates have increased, as incoming data have continued to show the economy expanding briskly, and investors have come to believe that no further easing of Federal Reserve policy is likely.

Equity Prices

Most equity indexes rose strongly, on balance, in 1998, with the Nasdaq Composite Index up nearly 40 percent, the S&P 500 Composite Index rising more than 25 percent, and the Dow Jones Industrial Average and the NYSE Composite Index advancing more than 15 percent. Small capitalization stocks underperformed those of larger firms, with the Russell 2000 Index off 3 percent over the year. The variation in stock prices over the course of the year was extremely wide. Prices increased substantially over the first few months of 1998, as concerns eased that Asian economic problems could lead to a slowdown in the United States and to a consequent decline in profits. The major indexes declined, on balance, over the following couple of months before rising sharply, in some cases to new records, in late June and early July, on increasing confidence about the outlook for earnings. The main exception was the Russell 2000; small capitalization stocks fell more substantially in the spring, and their rise in July was relatively muted.

Rising concerns about the outlook for Japan and other Asian economies, as well as the deepening financial problems in Russia, caused stock prices to retrace their July gains by early August. After Russia devalued the ruble and defaulted on some debts in mid-August, prices fell further, reflecting the general turbulence in global financial markets. By the end of the month, most equity indexes had fallen back to roughly their levels at the start of the year. Commercial bank and investment bank stocks fell particularly sharply, as investors became concerned about the effect on these institutions' profits of emerging market difficulties and of substantial declines in the values of some assets. Equity prices rose for a time in September but then fell back by early October before rebounding as market dislocations eased and interest rates on many private obligations fell. By December, most major indexes were back near their July highs, although the Russell 2000 remained below its earlier peak.

In late December, and into the new year, stock prices continued to advance, with several indexes reaching new highs in January. The devaluation of the Brazilian *real* caused some firms' shares to drop as investors reevaluated prospective earnings from Latin American operations, but all the major stock indexes posted gains in January; the Nasdaq advanced nearly 15 percent over the month, driven by large advances in the stock prices of high-technology firms, especially those related to the Internet. More recently, however, stock prices fell back, as interest rates rose and some investors apparently concluded that prices had risen too far, given the outlook for earnings.

The increase in equity prices last year and early this year, coupled with the slowing of earnings growth, left many valuation measures beyond their historical ranges. After ticking higher in the late summer and early autumn, the ratio of consensus estimates of earnings over the coming twelve months to prices in the S&P 500 later fell back, dropping to a new low in January. In part, the decline in this measure over the past year likely reflected lower real long-term bond yields. For example, as measured by the difference between the ten-year nominal Treasury yield and inflation expectations reported in the Philadelphia Federal Reserve Bank's survey of professional forecasters, real yields fell appreciably between late 1997 and early 1999. (The yield on ten-year inflation-indexed Treasury securities actually rose somewhat last year. However, the increase may have reflected the securities' lack of liquidity and the substantial rise in the premium investors were willing to pay for liquidity.) Since mid-1998, the real interest rate has declined somewhat more than the forward earnings yield on stocks, and the spread between the two consequently increased a bit, perhaps reflecting the greater sense of risk in financial markets. Nonetheless, the spread has remained quite small relative to historical norms: Investors may be anticipating rapid long-term earnings growth—consistent with the expectations of securities analysts—and they may still be satisfied with a lower risk premium for holding stocks than they have demanded historically.

Debt and the Monetary Aggregates

Debt and Depository Intermediation

From the fourth quarter of 1997 to the fourth quarter of 1998, the total debt of the U.S. household, government, and nonfinancial business sectors increased about 6¼ percent, in the top half of its 3 percent to 7 percent range and considerably faster than nominal GDP. Buoyed by strong spending on durable goods, housing, and business investment, as well as by merger and acquisition activity that substituted debt for equity, nonfederal debt expanded about 9 percent last year, more than 2 percentage points faster than in 1997. By contrast, federal debt declined 1¼ percent, following a rise of ¾ percent the previous year.

Credit market instruments on the books of depository institutions rose at a somewhat slower pace than did the debt aggregate, posting a 5¾ percent rise in 1998, about half a percentage point less than in 1997. Growth in depository credit picked up in the second half of the year, as the turbulence in financial markets apparently led many firms to substitute bank loans for funds raised in the markets. Banks also added considerably to their holdings of securities in the third and fourth quarters, in part reflecting the attractive spreads available on non-Treasury debt instruments.

Financial firms also appeared to turn to banks for funding when the financial markets were volatile, and U.S. banks substantially expanded their lending to financial firms through repurchase agreements and loans to purchase and carry securities. As a result, growth of total bank credit, adjusted to remove the effects of mark-to-market accounting rules, accelerated to 10½ percent on a fourth-quarter to fourth-quarter basis, the largest annual increase in more than a decade.

The Monetary Aggregates

The broad monetary aggregates expanded very rapidly last year. From the fourth quarter of 1997 to the fourth quarter of 1998, M2 increased 8½ percent, placing it well above the upper bound of its 1 percent to 5 percent range. However, as the FOMC noted last February, this range was intended as a benchmark for money growth under conditions of stable prices, real economic growth near trend, and historical velocity relationships. Part of the excess of M2 above its range was the result of faster growth in nominal spending than would likely be consistent with sustained price stability. In addition, the velocity of M2 (defined as the ratio of nominal GDP to M2) fell 3 percent. Some of the decline resulted from the decrease in short-term market interest rates last year—as usual, rates on deposits fell more slowly than market rates, reducing the opportunity cost of holding M2 (defined as the difference between the rate on Treasury bills and the average return on M2 assets).

Growth of Money and Debt

Percent

Period	M1	M2	M3	Domestic non-financial debt
Annual[1]				
1988	4.2	5.6	6.4	9.1
1989	.6	5.2	4.1	7.5
1990	4.2	4.2	1.9	6.7
1991	8.0	3.1	1.2	4.5
1992	14.3	1.8	.6	4.5
1993	10.6	1.3	1.0	4.9
1994	2.5	.6	1.7	4.9
1995	–1.6	3.9	6.1	5.4
1996	–4.5	4.6	6.8	5.3
1997	–1.2	5.8	8.8	5.0
1998	1.8	8.5	11.0	6.3
Quarterly (annual rate)[2]				
1998:Q1	3.2	7.6	10.3	6.2
Q2	1.0	7.5	10.1	6.1
Q3	–2.0	6.9	8.6	6.0
Q4	5.0	11.0	13.2	6.4

NOTE. M1 consists of currency, travelers checks, demand deposits, and other checkable deposits. M2 consists of M1 plus savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds. M3 consists of M2 plus large-denomination time deposits, balances in institutional money market funds, RP liabilities (overnight and term), and Eurodollars (overnight and term). Debt consists of the outstanding credit market debt of the U.S. government, state and local governments, households and nonprofit organizations, nonfinancial businesses, and farms.

[1] From average for fourth quarter of preceding year to average for fourth quarter of year indicated.

[2] From average for preceding quarter to average for quarter indicated.

However, the bulk of the decline cannot be explained on the basis of the historical relationship between the velocity of M2 and this measure of its opportunity cost. Three factors not captured in that relationship likely contributed to the drop in velocity. First, households seem to have allocated an increased share of savings flows to monetary assets rather than equities following several years of outsized gains in stock market wealth. Second, some evidence suggests that in the 1990s the demand for M2 assets has become more sensitive to longer-term interest rates and to the slope of the yield curve, and so the decline in long-term Treasury yields last year, and the consequent flattening of the yield curve, may have increased the relative attractiveness of M2 assets. Finally, a critical source of the especially rapid M2 expansion in the fourth quarter likely was an increased demand for safe, liquid assets as investors responded to the heightened volatility in financial markets. With some of these safe-haven flows likely being reversed, growth in the broad monetary aggregates, while still brisk, has slowed appreciably early this year.

M3 expanded even faster than M2 in 1998, posting an 11 percent rise on a fourth-quarter to fourth-quarter basis. Last year's growth was the fastest since 1981 and left the aggregate well above the top end of its 2 percent to 6 percent growth range. As with M2, however, the FOMC established the M3 range as a benchmark for growth under conditions of stable prices, sustainable output growth, and the historical behavior of velocity. The rapid growth of M3 in part simply reflected the rise in M2. In addition, the non-M2 components of M3 increased 18½ percent over the year, following an even larger advance in 1997. The substantial rise in these components last year was partly the result of the funding of the robust growth in bank credit with managed liabilities, many of which are in M3. However, M3 growth was boosted to an even greater extent by flows into institution-only money funds, which have been expanding rapidly in recent years as they have increased their share of the corporate cash management business. Because investments in these funds substitute for business holdings of short-term assets that are not in M3, their rise has generated an increase in M3 growth. In addition, institution-only funds pay rates that tend to lag movements in market rates, and so their relative attractiveness was temporarily enhanced—and their growth rate boosted—by declines in short-term market interest rates late last year.

M1 increased 1¾ percent over the four quarters of 1998, its first annual increase since 1994. Currency expanded at an 8¼ percent pace, its largest rise since 1994. The increase apparently reflected continued strong foreign shipments, though at a slower pace than in 1997, and a sharp acceleration in domestic demand. Deposits in M1 declined further in 1998, reflecting the continued introduction of retail "sweep" programs. Growth of M1 deposits has been depressed for a number of years by these programs, which shift—or "sweep"—balances from household transactions accounts, which are subject to reserve requirements, into savings accounts, which are not. Because the funds are shifted back to transactions accounts when needed, depositors' access to their funds is not affected by these programs. However, banks benefit from the reduction in holdings of required reserves, which do not pay interest. Over 1998, sweep programs for demand deposit accounts became more popular, contributing to a 4¼ percent decline in such balances. By contrast, new sweep programs for other checkable deposits, which had driven double-digit declines in such deposits over the previous three years, were less important in 1998, and, with nominal spending strong and interest rates lower, other checkable deposits were about unchanged on the year.

As a result of the introduction of retail sweep accounts, the average level of required reserve balances (balances that must be held at Reserve Banks to meet reserve requirements) has trended lower over the past few years. The decline has been associated with an increase in banks' required clearing balances, which are balances that banks agree in advance to hold at their Federal Reserve Bank in order to facilitate the clearing of their payments. Unlike required reserve balances, banks earn credits on their required clearing balances that can be applied to the use of Federal Reserve priced services. Despite the increase in required clearing balances, required operating balances, which are the sum of required reserve balances and required clearing balances, have declined over the past few years and in late 1998 reached their lowest level in several decades.

The decline in required operating balances has generated concerns about a possible increase in the volatility of the federal funds rate. Because a bank's required level of operating balances must be met only on average over a two-week maintenance period, banks are free to allocate their reserve holdings across the days of a maintenance period in order to minimize their reserve costs. However, banks must also manage their reserves in order to avoid overdrafts, which the Federal Reserve discourages through administrative measures and financial penalties. Thus, as required operating balances decline toward the minimum level needed to clear banks' transactions, banks are less and less able to respond to fluctuations in the federal funds rate by lending funds when the rate is high and borrowing when the rate is low. As a result, when required operating balances are low, the federal funds rate is likely to rise further than it otherwise would when demands for reserves are unexpectedly strong or supplies weak; conversely, the federal funds rate is likely to fall more in the event of weaker-than-expected demand or stronger-than-expected supply. One way to ease this difficulty would be to pay interest on required reserve balances, which would reduce banks' incentives to expend resources on sweeps and other efforts to minimize these balances.

Despite the low level of required operating balances, the federal funds rate did not become noticeably more volatile over the spring and summer of 1998. In part, this result reflected more frequent overnight open market operations by the Federal Reserve to better match the daily demand for and supply of reserves. Also, banks likely improved the management of their accounts at the Federal Reserve Banks. Moreover, large banks apparently increased their willingness to borrow at the discount window. The Federal Reserve's decision to return to lagged reserve accounting at the end of July also likely contributed to reduced volatility in the federal funds market by enhancing somewhat the ability of both banks and the Federal Reserve to forecast reserve demand.

In the latter part of 1998 and into 1999, however, the federal funds rate was more volatile. The increase may have owed partly to further reductions in required operating balances resulting from new sweep programs, but other factors were probably more important, at least for a time. Market participants were scrutinizing borrowing banks more closely, and in some cases lenders pared or more tightly administered their counterparty credit limits, or shifted more of their placements from term to overnight maturities. The heightened attention to credit quality also made banks less willing to borrow at the discount window, because they were concerned that other market participants might detect their borrowing and interpret it as a sign of financial weakness. As a result, many banks that were net takers of funds in short-term markets attempted to lock in their funding earlier in the morning. On net, these forces boosted the demand for reserves and put upward pressure on the federal funds rate early in the day. To buffer the effect of these changes on volatility in the federal funds market, the Federal Reserve increased the supply of reserves and, at times, responded to the level of the federal funds rate early in the day when deciding on the need for market operations. Because demand had shifted to earlier in the day, however, the federal funds rate often fell appreciably below its target level by the end of the day.

At its November meeting, the FOMC amended the Authorization for Domestic Open Market Operations to extend the permitted maturity of System repurchase agreements from fifteen to sixty days. Over the remainder of 1998, the Domestic Trading Desk made use of this new authority on three occasions, arranging System repurchase agreements with maturities of thirty to forty-five days to meet anticipated seasonal reserve demands over year-end. While the Desk had in the past purchased inflation-indexed securities when rolling over holdings of maturing nominal securities, it undertook its first outright open market purchase devoted solely to inflation-indexed Treasury securities in 1998, thereby according those securities the same status in open market operations as other Treasury securities.

International Developments

In 1998, developments in international financial markets continued to be dominated by the unfolding crises in emerging markets that had begun in Thailand in 1997. Financial market turbulence spread to other emerging markets around the globe, spilling over from Korea, Indonesia, Malaysia, Singapore, the Philippines, and Hong Kong in late 1997 and in the first part of 1998 to Russia in the summer, and to Latin America, particularly Brazil, shortly thereafter. The Asian crisis contributed to a deepening recession in Japan last year, and as the year progressed, growth in several other major foreign industrial economies slowed as well.

At the beginning of 1998, many Asian currencies were declining or were under pressure. The Indonesian rupiah dropped sharply in January, amid widespread rioting and talk of a coup, and fell again in May and June, as the deepening recession prompted more social unrest and ultimately the ouster of President Suharto. Some of the rupiah's losses were reversed in the second half of the year, following the relatively orderly transition of power to President Habibie. Tighter Indonesian monetary policy, which pushed short-term interest rates as high as 70 percent by July, contributed to the rupiah's recovery. On balance, between December 1997 and December 1998, the rupiah depreciated more than 35 percent against the dollar.

In contrast, the Thai baht and Korean won, which had declined sharply in 1997, gained more than 20 percent against the dollar over the course of 1998. Policy reforms and stable political environments helped boost these currencies. Between these extremes, the currencies of the Philippines, Malaysia, Singapore, and Taiwan fluctuated in a narrower range and ended the period little changed against the dollar. In September, Malaysia imposed capital and exchange controls, fixing the ringgit's exchange rate against the dollar. The Hong Kong dollar came under pressure at times during the year, but its peg to the U.S. dollar remained intact, although at the cost of interest rates that were at times considerably elevated. Short-term interest rates in Asian economies other than Indonesia declined in 1998, and as some stability returned to Indonesian markets near the end of the year, short-term rates in that nation began to retreat from their highs.

As the year progressed, the financial storm moved from Asia to Russia. At first the Russian central bank was able to defend the ruble's peg to the dollar with interest rate increases and sporadic intervention. By midyear, however, the government's failure to reach a new assistance agreement with the International Monetary Fund, reported shortfalls in tax revenues, and the disruption of rail travel by striking coal miners protesting late wage payments brought to the fore the deep structural and political problems faced by Russia. In addition, declining oil prices were lowering government revenues and worsening the current account. As a result of these difficulties, the ruble came under renewed pressure, forcing Russian interest rates sharply higher, and Russian equity prices fell abruptly. A disbursement of $4.8 billion from the IMF in July was quickly spent to keep the currency near its level of 6.2 rubles per dollar, but the lack of progress on fiscal reform put the next IMF tranche in doubt.

On August 17, Russia announced a devaluation of the ruble and a moratorium on servicing official short-term debt. Subsequently, the ruble depreciated more than 70 percent against the dollar, the government imposed conditions on most of its foreign and domestic debt that implied substantial losses for creditors, and many Russian financial institutions became insolvent. The events in Russia precipitated a global increase in financial market turbulence, including a pullback of credit to highly leveraged investors and a widening of credit spreads in emerging market economies and in many industrial countries, which did not abate until after central banks in a number of industrial countries eased policy in the fall.

Latin American financial markets were only moderately disrupted by the Asian and Russian problems during the first half of 1998. The reaction to the Russian default, however, was swift and strong, and the prices of Latin American assets fell precipitously. The spreads between yields on Latin American Brady bonds and comparable U.S. Treasuries widened considerably (with increases ranging from 900 basis points in Argentina to 1500 basis points in Brazil) and peaked in early September before retracing part of the rise. Latin American equity prices plunged, ending the year down 25 percent or more. Several currencies came under pressure, despite sharp increases in short-term interest rates. The Mexican peso, which was also weakened by the effects of falling oil prices, depreciated 18 percent against the dollar over the year. The Colombian peso and the Ecuadorian sucre were devalued, but Argentina's currency board arrangement survived.

Brazil's central bank defended the *real*'s crawling peg until mid-January 1999 but is estimated to have used more than half of the $75 billion in foreign exchange reserves it had amassed as of last April. Anticipation of the IMF-led financial assistance package for Brazil helped spur a partial recovery in Latin American asset markets in late September and October. The details of the $41.5 billion loan package were announced in November, but after the package was approved by the IMF in early December, Brazil's Congress rejected a part of the government's fiscal austerity plan, sparking renewed financial turmoil. In mid-December, $9.3 billion of the loan package was disbursed, but as the year ended, the continuing pressure from investors seeking to take funds out of Brazil put the long-run viability of the crawling exchange rate peg in doubt. The *real* came under pressure again in early January after the state of Minas Gerais threatened not to pay its debt to the federal government. On January 13, the *real* was devalued 8 percent, and two days later it was allowed to float. Since the end of 1998, the *real* has depreciated nearly 38 percent against the dollar, and capital flight from Brazil has likely persisted. The collapse of the *real* exerted some downward pressure on the currencies of other Latin American countries. Thus far, however, contagion has been more limited than it was after the Russian devaluation; unlike Russia, Brazil has continued to meet debt service obligations, and investors apparently had an opportunity to adjust positions in advance of the devaluation and have drawn a distinction between Brazil's problems and those of other economies.

The fallout from the financial crises that hit several Asian emerging market economies in late 1997 triggered a further decline in output in the region in early 1998. In the countries most heavily affected—Thailand, Korea, Malaysia, and Indonesia—output dropped at double-digit annual rates in the first half of the year, as credit disruptions, widespread failures in the financial and corporate sectors, and a resulting high degree of economic uncertainty depressed activity severely. Output in Hong Kong also dropped in early 1998, as interest rates rose sharply amid pressure on its currency peg. Later in the year, with financial conditions in most of the Asian crisis countries stabilizing somewhat, output started to bottom out.

The Asian crisis had a relatively moderate effect on China, although it may have encouraged authorities in that country to move ahead more quickly with various financial sector reforms. Financial tensions mounted early this year as foreign investors have reacted with concern to the failure of the Guangdong International Trust and Investment Corporation. Chinese growth remained fairly strong throughout 1998, despite a dramatic slowdown in the growth of exports.

Inflation in the Asian developing economies rose only moderately on average in 1998, as the inflationary effects of currency depreciations in the region were largely offset by the deflationary influence of very weak domestic activity. The current account balances of the Asian crisis countries swung into substantial surplus last year, reflecting a sharp drop in imports resulting from the falloff in domestic demand as well as improvement in the countries' competitive positions associated with the substantial depreciations of their currencies in late 1997 and early 1998.

In Russia, economic activity declined last year as interest rates were pushed up in an attempt to fend off pressure on the ruble. After the August debt moratorium and ruble devaluation, output dropped sharply, ending the year down about 10 percent from its year-earlier level. The ruble collapse triggered a surge in inflation to a triple-digit annual rate during the latter part of the year.

In Latin America, the pace of economic activity slowed only moderately in the first half of 1998, as the spillover from the Asian financial turbulence was limited. The Russian financial crisis in August, in contrast, had a strong impact on real activity in Latin America, particularly Brazil and Argentina, where interest rates moved sharply higher in response to exchange rate pressures. Output in both countries is estimated to have declined in the second half of the year at annual rates of about 5 percent. Activity in Mexico and Venezuela was also depressed by lower oil export revenues. Inflation rates in Latin American countries were little changed in 1998 and ranged from 1 percent in Argentina and 3 percent in Brazil to 31 percent in Venezuela.

The dollar's value, measured on a trade-weighted basis against the currencies of a broad group of important U.S. trading partners, rose almost 7 percent during the first eight months of 1998, but it then fell, by December reaching a level about 2 percent above its year-earlier level. (When adjusted for changes in U.S. and foreign consumer price levels, the real value of the dollar in December 1998 was about 1 percent below its level in December 1997.) Before the Russian default, the dollar was supported by the robust pace of U.S. economic activity, which at times generated expectations that monetary policy would be tightened and which contrasted with weakening economic activity abroad, especially in Japan. Occasionally, however, the positive influence of the strong economy was countered by worries about growing U.S. external deficits. From August through October, in the aftermath of the Russian financial meltdown, concerns that increased difficulties in Latin America might affect the U.S. economy disproportionately, as well as expectations of lower U.S. interest rates, weighed on the value of the dollar, and it fell sharply. The broad index of the dollar's exchange value eased a bit further during the fourth quarter of the year. So far in 1999, the dollar has gained nearly 3 percent in terms of the broad index.

Against the currencies of the major foreign industrial countries, the dollar declined 2 percent in nominal terms over 1998, on balance, reversing some of its 10 percent appreciation the preceding year. Among these currencies, the dollar's value fluctuated most widely against the Japanese yen. The dollar rose against the yen during the first half of the year as a result of concerns about the effects of the Asian crisis on the already-weak Japanese economy and further signs of deepening recession and persistent banking system problems in that country. It reached a level of almost 147 yen per dollar in mid-June, prompting coordinated intervention by U.S. and Japanese authorities in foreign exchange markets that helped to contain further downward pressure on the yen. The dollar resumed its appreciation against the yen, albeit at a slower pace, in July and early August.

The turning point in the dollar–yen rate came after the Russian collapse, amid the global flight from risk that caused liquidity to dry up in the markets for many assets. During the first week of October, the dollar dropped nearly 14 percent against the yen in extremely illiquid trading conditions. Although fundamental factors in Japan, such as progress on bank reform, fiscal stimulus, and the widening trade surplus may have helped boost the yen against the dollar, market commentary at the time focused on reports that some international investors were buying large amounts of yen. These large purchases reportedly were needed to unwind positions in which investors had used yen loans to finance a variety of speculative investments. On balance, the dollar depreciated almost 10 percent against the yen in 1998, reversing most of its net gain during 1997. It depreciated further against the yen in early 1999, hitting a two-year low on January 11, but it then rebounded somewhat amid reports of intervention purchases of dollars by the Bank of Japan. More recently, the Bank of Japan has eased monetary policy further, and the dollar has strengthened against the yen. So far this year, the dollar has gained about 7 percent against the yen.

Japanese economic activity contracted in 1998, as the country remained in its most protracted recession of the postwar era. Business and residential investment plunged, and private consumption stagnated, more than offsetting positive contributions from government spending and net exports. Core consumer prices declined slightly, while wholesale prices fell almost 4½ percent. In April, the Japanese government announced a large fiscal stimulus package. During the final two months of the year, the government announced another set of fiscal measures slated for implementation during 1999, which included permanent personal and corporate income tax cuts, various incentives for investment, and further increases in public expenditures.

Against the German mark, the dollar depreciated about 6 percent, on net, during 1998. Late in the year the dollar moved up against the mark, as evidence of a European growth slowdown raised expectations of easier monetary conditions in Europe. In the event, monetary policy was eased sooner than market participants had expected, with a coordinated European interest rate cut coming in early December.

A major event at the turn of the year was the birth of the euro, which marked the beginning of Stage Three of European Economic and Monetary Union (EMU). On December 31, the rates locking the euro with the eleven legacy currencies were determined; based on these rates, the value of the euro at the moment of its creation was $1.16675. Trading in the euro opened on January 4, with the first trades reflecting a significant premium for the euro over its initial value. As the first week of trading progressed, however, the initial euphoria wore off, and so far this year the dollar has strengthened more than 5 percent against the euro, partly reflecting better-than-expected economic data in the United States, contrasted with weaker-than-expected data in the euro area.

In the eleven European countries whose currencies are now fixed against the euro, output growth slowed moderately over the course of 1998, as net exports weakened and business sentiment worsened. Unemployment rates came down slightly, but the average of these rates remained in the double-digit range. Consumer price inflation continued to slow, helped by lower oil prices. In December, the harmonized CPI for the eleven countries stood ¾ percent above its year-earlier level, meeting the European Central Bank's primary objective of inflation below 2 percent.

Between December 1997 and December 1998, the average value of the dollar changed little against the British pound but rose 8 percent against the Canadian dollar. Weakness in primary commodity prices, including oil, likely depressed the value of the Canadian dollar. The Bank of Canada raised official rates in January 1998 and again in August, in response to currency market pressures. The Bank of England raised official rates in June 1998 to counter inflation pressures. Tighter monetary conditions in both countries, as well as a decline in net exports associated with global difficulties, contributed to a slowing of output growth in the second half of the year. The deceleration was sharper in the United Kingdom than in Canada. U.K. inflation eased slightly to near its target rate, while Canadian inflation remained near the bottom of its target range. In response to weaker economic activity as well as to the expected effects of the global financial turmoil, both the Bank of Canada and the Bank of England have lowered official interest rates since September.

The general trend toward easier monetary conditions was reflected in declines in short-term interest rates in almost all the G-10 countries during the year. Interest rates in the euro area converged to relatively low German levels in anticipation of the launch of the third stage of EMU. Yields on ten-year government bonds in the major foreign industrial countries declined significantly over the course of the year, as economic activity slowed, inflation continued to moderate, and investors sought safer assets. Between December 1997 and December 1998, ten-year interest rates fell 180 basis points in the United Kingdom and 150 basis points in Germany. The ten-year rate fell only 30 basis points in Japan, on balance, declining about 90 basis points over the first ten months of the year but backing up in November and December. Market participants attributed the increase to concerns that the demand for bonds would be insufficient to meet the surge in debt issuance associated with the latest fiscal stimulus package.

Share prices on European stock exchanges posted another round of strong advances last year, with price indexes rising 8 percent in the United Kingdom, about 15 percent in Germany, nearly 29 percent in France, and 41 percent in Italy. In contrast, Japanese equity prices fell more than 9 percent in 1998, and Canadian share prices decreased 4 percent. After a considerable run-up earlier in the year, share prices around the globe fell sharply in August and September, but they rebounded in subsequent months as the Federal Reserve and central banks in many other industrial countries eased monetary policy.

On November 17, the FOMC voted unanimously to reauthorize Federal Reserve participation in the North American Framework Agreement (NAFA), established in 1994, and in the associated bilateral reciprocal currency swap arrangements with the Bank of Canada and the Bank of Mexico. On December 7, the Secretary of the Treasury authorized renewal of the Treasury's participation in the NAFA and of the associated Exchange Stabilization Agreement with Mexico. Other bilateral swap arrangements with the Federal Reserve—those with the Bank for International Settlements, the Bank of Japan, and many European central banks—were allowed to lapse in light of their disuse over the past fifteen years and in the presence of other well-established arrangements for international monetary cooperation. The swap arrangement between the Treasury's Exchange Stabilization Fund and the German Bundesbank was also allowed to lapse.

Report on July 22, 1999

Monetary Policy and the Economic Outlook

The U.S. economy has continued to perform well in 1999. The ongoing economic expansion has moved into a near-record ninth year, with real output expanding vigorously, the unemployment rate hovering around lows last seen in 1970, and underlying trends in inflation remaining subdued. Responding to the availability of new technologies at increasingly attractive prices, firms have been investing heavily in new capital equipment; this investment has boosted productivity and living standards while holding down the rise in costs and prices.

Two of the major threats faced by the economy in late 1998—economic downturns in many foreign nations and turmoil in financial markets around the world—receded over the first half of this year. Economic conditions overseas improved on a broad front. In Asia, activity picked up in the emerging-market economies that had been battered by the financial crises of 1997. The Brazilian economy—Latin America's largest—exhibited a great deal of resilience with support from the international community, in the wake of the devaluation and subsequent floating of the *real* in January. These developments, along with the considerable easing of monetary policy in late 1998 and early 1999 in a number of regions, including Europe, Japan, and the United States, fostered a markedly better tone in the world's financial markets. On balance, U.S. equity prices rose substantially, and in credit markets, risk spreads receded toward more typical levels. Issuance of private debt securities ballooned in late 1998 and early 1999, in part making up for borrowing that was postponed when markets were disrupted.

As these potentially contractionary forces dissipated, the risk of higher inflation in the United States resurfaced as the greatest concern for monetary policy. Although underlying inflation trends generally remained quiescent, oil prices rose sharply, other commodity prices trended up, and prices of non-oil imports fell less rapidly, raising overall inflation rates. Despite improvements in technology and business processes that have yielded striking gains in efficiency, the robust growth of aggregate demand, fueled by rising equity wealth and readily available credit, produced even tighter labor markets in the first half of 1999 than in the second half of 1998. If this trend were to continue, labor compensation would begin climbing increasingly faster than warranted by productivity growth and put upward pressure on prices. Moreover, the Federal Open Market Committee (FOMC) was concerned that as economic activity abroad strengthened, the firming of commodity and other prices might also foster a less favorable inflation environment. To gain some greater assurance that the good inflation performance of the economy would continue, the Committee decided at its June meeting to reverse a portion of the easing undertaken last fall when global financial markets were disrupted; the Committee's target for the overnight federal funds rate, a key indicator of money market conditions, was raised from 4¾ percent to 5 percent.

Monetary Policy, Financial Markets, and the Economy over the First Half of 1999

The FOMC met in February and March against the backdrop of continued rapid expansion of the U.S. economy. Demand was strong, employment growth was brisk, and labor markets were tight. Nonetheless, price inflation was still low, held in check by a substantial gain in productivity, ample manufacturing capacity, and low inflation expectations.

Activity was supported by a further settling down of financial markets in the first quarter after a period of considerable turmoil in the late summer and fall of 1998. In that earlier period, which followed Russia's moratorium on a substantial portion of its debt payments in mid-August, the normal functioning of U.S. financial markets had been impaired as investors cut back sharply their credit risk exposures and market liquidity dried up. The Federal Reserve responded to these developments by trimming its target for the overnight federal funds rate by 75 basis points in three steps. In early 1999, the devaluation and subsequent floating of the Brazilian *real* in mid-January heightened concerns for a while, but market conditions overall improved considerably.

At its February and March meetings, the FOMC left the stance of monetary policy unchanged. The Committee expected that the growth of output might well slow sufficiently to bring production into close enough alignment with the economy's enhanced potential to forestall the emergence of a trend of rising inflation. Although domestic demand was still increasing rapidly, it was anticipated to moderate over time in response to the buildup of large stocks of business equipment, housing units, and durable goods and more restrained expansion in wealth in the absence of appreciable further increases in equity prices. Furthermore, the FOMC, after taking account of the near-term effects of the rise in crude oil prices, saw few signs that cost and price inflation was in the process of picking up. The unusual combination of very high labor resource utilization and sustained low inflation suggested considerable uncertainty about the relationship between output and prices. In this environment, the Committee concluded that it could wait for additional information about the balance of risks to the economic expansion.

By the time of the May FOMC meeting, demand was still showing considerable forward momentum, and growth in economic activity still appeared to be running in excess of the rate of increase of the economy's long-run capacity to expand output. Borrowers' heavy demands for credit were being met on relatively favorable terms, and wealth was further boosted by rapidly rising equity prices. Also, the economic and financial outlook for many emerging-market countries was brighter. Trends in inflation were still subdued, although consumer prices—even apart from a big jump in energy prices—were reported to have registered a sizable rise in April.

At its May meeting, the FOMC believed that these developments tilted the risks toward further robust growth that would exert additional pressure on already taut labor markets and ultimately show through to inflation. Moreover, a turnaround in oil and other commodity markets meant that prices of these goods would no longer be holding down inflation, as they had over the past year. Yet, the economy to date had shown a remarkable ability to accommodate increases in demand without generating greater underlying inflation trends, as the continued growth of labor productivity had helped to contain cost pressures. The uncertainty about the prospects for prices, demand pressures, and productivity was large, and the Committee decided to defer any policy action. However, in light of its increased concern about the outlook for inflation, the Committee adopted an asymmetric directive tilted toward a possible firming of policy. The Committee also wanted to inform the public of this significant revision in its view, and it announced a change in the directive immediately after the meeting. The announcement was the first under the Committee's policy of announcing changes in the tilt of the domestic directive when it wants to communicate a major shift in its view about the balance of risks to the economy or the likely direction of its future actions.

In the time leading up to the FOMC's June meeting, economic activity in the United States continued to move forward at a brisk pace, and prospects in a number of foreign economies showed additional improvement. Labor markets tightened slightly further. The federal funds rate, however, remained at the lower level established in November 1998, when the Committee took its last of three steps to counter severe financial market strains. With those strains largely gone, the Committee believed that the time had come to reverse some of that accommodation, and it raised the targeted overnight federal funds rate 25 basis points, to 5 percent. Looking ahead, the Committee expected demand to remain strong, but it also noted the possibility that a further pickup in productivity could allow the economy to accommodate this demand for some time without added inflationary pressure. In light of these conflicting forces in the economy, the FOMC returned to a symmetric directive. Nonetheless, with labor markets already tight, the Committee recognized that it needed to stay especially alert to signs that inflationary forces were emerging that could prove inimical to the economic expansion.

Economic Projections for 1999 and 2000

The members of the Board of Governors and the Federal Reserve Bank presidents see good prospects for sustained, solid economic expansion through next year. For this year, the central tendency of their forecasts of growth of real gross domestic product is 3½ percent to 3¾ percent, measured as the change between the fourth quarters of 1998 and 1999. For 2000, the forecasts of real GDP are mainly in the 2½ percent to 3 percent range. With this pace of expansion, the civilian unemployment rate is expected to remain close to the recent 4¼ percent level over the next six quarters.

The increases in income and wealth that have bolstered consumer demand over the first half of this year and the desire to invest in new high-technology equipment that has boosted business demand during the same period should continue to stimulate spending over the quarters ahead. However, several factors are expected to exert some restraint on the economy's momentum by next year. With purchases of durable goods by both consumers and businesses having risen still further and running at high levels, the stocks of such goods probably are rising more rapidly than is likely to be desired in the longer run, and the growth of spending should moderate. The increase in market interest rates should help to damp spending as well. And unless the extraordinary gains in equity prices of the past few years are extended, the impetus to spending from increases in wealth will diminish.

Federal Reserve policymakers believe that this year's rise in the consumer price index (CPI) will be larger than that in 1998, largely because of the rebound in retail energy prices that has already occurred. Crude oil prices have moved up sharply, reversing the decline posted in 1998 and leading to a jump in the CPI this spring. For next year, the FOMC participants expect the increase in the CPI to remain around this year's pace, with a central tendency of 2 percent to 2½ percent. Futures market quotes suggest that the prevailing expectation is that the rebound in oil prices has run its course now, and ample industrial capac-

Economic Projections for 1999 and 2000

Percent

Indicator	Federal Reserve governors and Reserve Bank presidents		Administration[1]
	Range	Central tendency	
	1999		
Change, fourth quarter to fourth quarter[2]			
Nominal GDP	4¾–5½	5–5½	4.8
Real GDP	3¼–4	3½–3¾	3.2
Consumer price index[3]	1¾–2½	2¼–2½	2.4
Average level fourth quarter			
Civilian unemployment rate	4–4½	4–4¼	4.3
	2000		
Change, fourth quarter to fourth quarter[2]			
Nominal GDP	4–5¼	4–5	4.2
Real GDP	2–3½	2½–3	2.1
Consumer price index[3]	1½–2¾	2–2½	2.4
Average level, fourth quarter			
Civilian unemployment rate	4–4½	4¼–4½	4.7

1. From the Mid-Session Review of the budget.

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

3. All urban consumers.

ity and productivity gains may help limit inflationary pressures in coming months as well. With labor utilization very high, though, and demand still strong, significant risks remain even after the recent policy firming that economic and financial conditions may turn out to be inconsistent with keeping costs and prices from escalating.

Although interest rates currently are a bit higher than anticipated in the economic assumptions underlying the budget projections in the Administration's Mid-Session Review, there is no apparent tension between the Administration's plans and the Federal Reserve policymakers' views. In fact, Federal Reserve officials project somewhat faster growth in real GDP and slightly lower unemployment rates into 2000 than the Administration does, while the Administration's projections for inflation are within the Federal Reserve's central tendencies.

Money and Debt Ranges for 1999 and 2000

At its meeting in late June, the FOMC reaffirmed the ranges for 1999 growth of money and debt that it had established in February: 1 percent to 5 percent for M2, 2 percent to 6 percent for M3, and 3 percent to 7 percent for debt of the domestic nonfinancial sectors. The FOMC set the same ranges for 2000 on a provisional basis.

As has been the case since the mid-1990s, the FOMC views the ranges for money growth as benchmarks for growth under conditions of price stability and the historically typical relationship between money and nominal income. The disruption of the historically typical pattern of the velocities of M2 and M3 (the ratio of nominal GDP to the aggregates) during the 1990s implies that the Committee cannot establish, with any confidence, specific target ranges for expected money growth for a given year that will be consistent with the economic performance that it desires. However, persistently fast or slow money growth can accompany, or even precede, deviations from desirable economic outcomes. Thus, the behavior of the monetary aggregates, evaluated in the context of other financial and nonfinancial indicators, will continue to be of interest to Committee members in their policy deliberations.

The velocities of M2 and M3 declined again in the first half of this year, albeit more slowly than in 1998. The Committee's easing of monetary policy in the fall of 1998 contributed to the decline, but only to a modest extent. It is not clear what other factors led to the drop, although the considerable increase in wealth relative to income resulting from the substantial gains in equity prices over the past few years may have played a role. Investors could be rebalancing their portfolios, which have become skewed toward equities, by reallocating some wealth to other assets, including those in M2.

Even if the velocities of M2 and M3 were to return to their historically typical patterns over the balance of 1999 and in 2000, M2 and M3 likely would be at the upper bounds of, or above,

Ranges for Growth of Monetary and Debt Aggregates

Percent

Aggregate	1998	1999	Provisional for 2000
M2	1–5	1–5	1–5
M3	2–6	2–6	2–6
Debt	3–7	3–7	3–7

NOTE. Change from average for fourth quarter of preceding year to average for fourth quarter of year indicated.

their longer-term price-stability ranges in both years, given the Committee's projections of nominal GDP growth. This relatively rapid expansion in nominal income reflects faster expected growth in productivity than when the price-stability ranges were established in the mid-1990s and inflation that is still in excess of price stability. The more rapid increase in productivity, if it persists for a while and is sufficiently large, might in the future suggest an upward adjustment to the money ranges consistent with price stability. However, considerable uncertainty attends the trend in productivity, and the Committee chose not to adjust the ranges at its most recent meeting.

Debt of the nonfinancial sectors has expanded at roughly the same pace as nominal income this year—its typical pattern. Given the stability of this relationship, the Committee selected a growth range for the debt aggregate that encompasses its expectations for debt growth in both years. The Committee expects growth in nominal income to slow in 2000, and with it, debt growth. Nonetheless, growth of this aggregate is projected to remain within the range of 3 percent to 7 percent.

Economic and Financial Developments in 1999

The economy has continued to grow rapidly so far this year. Real gross domestic product rose more than 4 percent at an annual rate in the first quarter of 1999, and available data point to another significant gain in the second quarter.[2] The rise in activity has been brisk enough to produce further substantial growth of employment and a reduction in the unemployment rate to 4¼ percent. Growth in output has been driven by strong domestic demand, which in turn has been supported by further increases in equity prices, by the continuing salutary effects of government saving and inflows of foreign investment on the cost of capital, and by more smoothly functioning financial markets as the turbulence that marked the latter part of 1998 subsided. Against the background of the easing of monetary policy last fall and continuing robust economic activity, investors became more willing to advance funds to businesses; risk spreads have receded and corporate debt issuance has been brisk.

Inflation developments were mixed over the first half of the year. The consumer price index increased more rapidly owing to a sharp rebound in energy prices. Nevertheless, price inflation outside of the energy area generally remained subdued despite the slight further tightening of labor markets, as sizable gains in labor productivity and ample industrial capacity held down price increases.

The Household Sector

Consumer Spending

Real personal consumption expenditures surged 6¾ percent at an annual rate in the first quarter, and more recent data point to a sizable further advance in the second quarter. The underlying fundamentals for the household sector have remained extremely favorable. Real incomes have continued to rise briskly with strong growth of employment and real wages, and consumers have benefited from substantial gains in wealth. Not surprisingly, consumer confidence—as measured, for example,

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[2] All figures from the national income and product accounts cited here are subject to change in the quinquennial benchmark revisions slated for this fall.

by the University of Michigan Survey Research Center (SRC) and Conference Board surveys—has remained quite upbeat in this environment.

Growth of consumer spending in the first quarter was strong in all expenditure categories. Outlays for durable goods rose sharply, reflecting sizable increases in spending on electronic equipment (especially computers) and on a wide range of other goods, including household furnishings. Purchases of cars and light trucks remained at a high level, supported by declining relative prices as well as by the fundamentals that have buoyed consumer spending more generally. Outlays for nondurable goods were also robust, reflecting in part a sharp increase in expenditures for apparel. Finally, spending on services climbed steeply as well early this year, paced by sizable increases in spending on recreation and brokerage services. In the second quarter, consumers apparently boosted their purchases of motor vehicles further. In all, real personal consumption expenditures rose at more than a 4 percent annual rate in April and May, an increase that is below the first-quarter pace but is still quite rapid by historical standards.

Real disposable income increased at an annual rate of 3½ percent in the first quarter, with the strong labor market generating marked increases in wages and salaries. Even so, income grew less rapidly than expenditures, and the personal saving rate declined further; indeed, by May the saving rate had moved below negative 1 percent. Much of the decline in the saving rate in recent years can be explained by the sharp rise in household net worth relative to disposable income that is associated with the appreciation of households' stock market assets since 1995. This rise in wealth has given households the wherewithal to spend at levels beyond what current incomes would otherwise allow. As share values moved up further in the first half of this year, the wealth-to-income ratio continued to edge higher despite the absence of saving out of disposable income.

Residential Investment

Housing activity remained robust in the first half of this year. In the single-family sector, positive fundamentals and unseasonably good weather helped boost starts to a pace of 1.39 million units in the first quarter—the highest level of activity in twenty years. This extremely strong level of building activity strained the availability of labor and some materials; as a result, builders had trouble achieving the usual seasonal increase in the second quarter, and starts edged off to a still-high pace of 1.31 million units. Home sales moderated in the spring: Sales of both new and existing homes were off some in May from their earlier peaks, and consumers' perceptions of homebuying conditions as measured by the Michigan SRC survey have declined from the very high marks recorded in late 1998 and early this year. Nonetheless, demand has remained quite robust, even in the face of a backup in mortgage interest rates: Builders' evaluations of new home sales remained very high at midyear, and mortgage applications for home purchases showed strength into July.

With strong demand pushing up against limited capacity, home prices have risen substantially, although evidence is mixed as to whether the rate of increase is picking up. The quality-adjusted price of new homes rose 5 percent over the four quarters ended in the first quarter of 1999, up from 3¼ percent over the preceding four-quarter period. The repeat sales index of existing home prices also rose about 5 percent between the first quarter of 1998 and the first quarter of 1999, but this series posted even larger increases in the year-earlier period. On the cost side, tight supplies have led to rising prices for some building materials; prices of plywood, lumber, gypsum wallboard, and insulation have all moved up sharply over the past twelve months. In addition, hourly compensation costs have been rising relatively rapidly in the construction sector.

Starts of multifamily units surged to 384,000 at an annual rate in the first quarter and ran at a pace a bit under 300,000 units in the second quarter. As in the single-family sector, demand has been supported by strong fundamentals, builders have been faced with tight supplies of some materials, and prices have been rising briskly: Indeed, apartment property values have been increasing at around a 10 percent annual rate for three years now.

Household Finance

In addition to rising wealth and rapid income growth, the strong expenditures of households on housing and consumer goods over the first half of 1999 were encouraged by the decline in interest rates in the latter part of 1998. Households borrowed heavily to finance spending. Their debt expanded at a 9½ percent annual rate in the first quarter, up from the 8¾ percent pace over 1998, and preliminary data for the second quarter indicate continued robust growth. Mortgage borrowing, fueled by the vigorous housing market and favorable mortgage interest rates, was particularly brisk in the first quarter, with mortgage debt rising at an annual rate of 10 percent. In the second quarter, mortgage rates moved up considerably, but preliminary data indicate that borrowing was still substantial.

Consumer credit growth accelerated in the first half of 1999. It expanded at about an 8 percent annual rate compared with 5½ percent for all of 1998. The growth of nonrevolving credit picked up, reflecting brisk sales and attractive financing rates for automobiles and other consumer durable goods. The expansion of revolving credit, which includes credit card loans, slowed a bit from its pace in 1998.

Households apparently have not encountered added difficulties meeting the payments associated with their greater indebtedness, as measures of household financial stress improved a bit on balance in the first quarter. Personal bankruptcies dropped off considerably, although part of the decline may reflect the aftermath of a surge in filings in late 1998 that occurred in response to pending legislation that would limit the ability of certain debtors to obtain forgiveness of their obligations. Delinquency rates on several types of household loans edged lower. Delinquency and charge-off rates on credit card debt moved down from their 1997 peaks but remained at historically high rates. A number of banks continued to tighten credit card lending standards this year, as indicated by banks’ responses to Federal Reserve surveys.

The Business Sector

Fixed Investment

Real business fixed investment appears to have posted another huge increase over the first half of 1999. Investment spending continued to be driven by buoyant expectations of sales prospects as well as by rapidly declining prices of computers and other high-tech equipment. In recent quarters, spending also may have been boosted by the desire to upgrade computer equipment in advance of the rollover to the year 2000. Real investment has been rising rapidly for several years now; indeed, the average increase of 10 percent annually over the past five years represents the most rapid sustained expansion of investment in more than thirty years. Although a growing portion of this investment has gone to cover depreciation on purchases of short-lived equipment, the investment boom has led to a notable upgrading and expansion of the capital stock and in many cases has embodied new technologies. These factors likely have been important in the nation's improved productivity performance over the past few years.

Real outlays for producers' durable equipment increased at an annual rate of 9½ percent in the first quarter of the year, after having surged nearly 17 percent last year, and may well have re-accelerated in the second quarter. Outlays on communications equipment were especially robust in the first quarter, driven by the ongoing effort by telecommunications companies to upgrade their networks to provide a full range of voice and data transmission services. Purchases of computers and other information processing equipment were also up notably in the first quarter, albeit below last year's phenomenal spending pace, and shipments of computers surged again in April and May. Shipments of aircraft to domestic carriers apparently soared in the second quarter, and business spending on motor vehicles, including medium and heavy trucks as well as light vehicles, has remained extremely strong as well.

Real business spending for nonresidential structures has been much less robust than for equipment, and spending trends have varied greatly across sectors of the market. Real spending on office buildings and lodging facilities has been increasing impressively, while spending on institutional and industrial structures has been declining—the last reflecting ample capacity in the manufacturing sector. In the first quarter of this year, overall spending on structures was reported in the national income and product accounts to have moved up at a solid 5¾ percent annual rate, reflecting a further sharp increase in spending on office buildings and lodging facilities. However, revised source data indicate a somewhat smaller first-quarter increase in nonresidential construction and also point to a slowing in activity in April and May from the first-quarter pace.

Inventory Investment

Inventory–sales ratios in many industries dropped considerably early this year, as the pace of stockbuilding by nonfarm businesses, which had slowed notably over 1998, remained well below the surge of consumer and business spending in the first quarter. Although production picked up some in the spring, final demand remained quite strong, and available monthly data suggest that businesses accumulated inventories in April and May at a rate not much different from the modest first-quarter pace.

In the motor vehicle sector, makers geared up production in the latter part of 1998 to boost inventories from their low levels after last summer's strikes. Nevertheless, as with the business sector overall, motor vehicle inventories remained on the lean side by historical standards in the early part of this year as a result of surprisingly strong vehicle sales. As a consequence, manufacturers boosted the pace of assemblies in the second quarter to the highest level in twenty years. With no noticeable signs of a slowing in demand, producers have scheduled third-quarter output to remain at the lofty heights of the second quarter.

Corporate Profits and Business Finance

The economic profits of nonfinancial U.S. corporations rose considerably in the first quarter, even after allowing for the depressing effect in the fourth quarter of payments associated with the settlement between the tobacco companies and the states. Despite the growth of profits, capital expenditures by nonfinancial businesses continued to outstrip internal cash flow. Moreover, borrowing requirements were enlarged by the net reduction in equity outstanding, as the substantial volume of retirements from merger activity and share repurchase programs exceeded the considerable volume of gross issuance of both initial and seasoned public equities. As a result, businesses continued to borrow at a brisk pace: Aggregate debt of the nonfinancial business sector expanded at a 9½ percent annual rate in the first quarter. As financial market conditions improved after the turmoil of the fall, businesses returned to the corporate bond and commercial paper markets for funding, and corporate bond issuance reached a record high in March. Some of the proceeds were used to pay off bank loans, which had soared in the fall, and these repayments curbed the expansion of business loans at banks. Partial data for the second quarter indicate that borrowing by nonfinancial businesses slowed somewhat.

Risk spreads have receded on balance this year from their elevated levels in the latter part of 1998. From the end of December 1998 through mid-July, investment-grade corporate bond yields moved up from historically low levels, but by less than yields on comparable Treasury securities, and the spread between these yields narrowed to a level somewhat above that prevailing before the Russian crisis. The rise in investment-grade corporate bond yields was restrained by investors' apparently increased willingness to hold such debt, as growing optimism about the economy and favorable earnings reports gave investors more confidence about the prospective financial health of private borrowers. Yield spreads on below-investment-grade corporate debt over comparable Treasury securities, which had risen considerably in the latter part of 1998, also retreated. But in mid-July, these spreads were still well above the thin levels prevailing before the period of financial turmoil but in line with their historical averages.

In contrast to securities market participants, banks' attitudes toward business lending apparently became somewhat more cautious over the first half of the year, according to Federal Reserve surveys. The average spread of bank lending rates over the FOMC's target federal funds rate remained elevated. On net, banks continued to tighten lending terms and standards this year, although the percentage that reported tightening was much smaller than in the fall.

The overall financial condition of nonfinancial businesses was strong over the first half of the year, although a few indicators suggested a slight deterioration. In the first quarter, the ratio of net interest payments to corporate cash flow remained close to the modest levels of 1998, as low interest rates continued to hold down interest payments. Delinquency rates for commercial and industrial loans from banks ticked up, but they were still modest by historical standards. Similarly, over the first half of the year, business failures—measured as the ratio of liabilities of failed businesses to total liabilities—stepped up from the record low in 1998. The default rate on below-investment-grade bonds rose to its highest level in several years, an increase stemming in part from defaults by companies whose earnings were impaired by the drop in oil and other commodity prices last year. The total volume of business debt that was downgraded exceeded slightly the volume of debt that was upgraded.

The Government Sector

Federal Government

The incoming news on the federal budget continues to be quite favorable. Over the first eight months of fiscal year 1999—the period from October through May—the unified budget registered a surplus of about $41 billion, compared with $16 billion during the comparable period of fiscal 1998. If the latest projections from the Office of Management and Budget and the Congressional Budget Office are realized, the unified budget for fiscal 1999 as a whole will show a surplus of around $100 billion to $120 billion, or more than 1 percent of GDP—a striking turnaround from the outsized budget deficits of previous years, which approached 5 percent of GDP in the early 1990s.

As a result of this turnaround, the federal government is now contributing positively to the pool of national saving. In fact, despite the recent drop in the personal saving rate, gross saving by households, businesses, and governments has remained above 17 percent of GDP in recent quarters—up from the 14 percent range that prevailed in the early 1990s. This well-maintained pool of national savings, together with the continued willingness of foreigners to finance our current account deficits, has helped hold down the cost of capital, thus contributing to our nation's investment boom.

This year's increase in the federal surplus has reflected continued rapid growth of receipts in combination with a modest increase in outlays. Federal receipts were 5 percent higher in the first eight months of fiscal 1999 than in the year-earlier period. With profits leveling off from last year, receipts of corporate taxes have stagnated so far this fiscal year. However, individual income tax payments are up appreciably, reflecting the solid gains in household incomes and perhaps also a rise in capital gains realizations large enough to offset last year's reduction in capital gains tax rates. At the same time, federal outlays increased only 2½ percent in nominal terms and barely at all in real terms during the first eight months of the fiscal year, relative to the comparable year-earlier period. Spending growth has been restrained in major portions of both the discretionary (notably, defense) and nondiscretionary (notably, net interest, social security, and Medicare) categories—although this year's emergency supplemental spending bill, at about $14 billion, was somewhat larger than similar bills in recent years.

As for the part of federal spending that is counted in GDP, real federal outlays for consumption and gross investment, which had changed little over the past few years, declined at a 2 percent annual rate in the first quarter of 1999. A drop in real defense outlays more than offset a rise in nondefense expenditures in the first quarter. And despite the military action in the Balkans and the recent emergency spending bill, defense spending appears to have declined in the second quarter as well.

The budget surpluses of the past two years have led to a notable decline in the stock of federal debt held by private investors as a share of GDP. Since its peak in March 1997, the total volume of Treasury debt held by private investors has fallen by nearly $130 billion. The Treasury has reduced its issuance of interest-bearing marketable debt in fiscal 1999. The decrease has been concentrated in nominal coupon issues; in 1998, by contrast, the Treasury retired both bill and coupon issues in roughly equal measure. Offerings of inflation-indexed securities have remained an important part of the Treasury's overall borrowing program: Since the beginning of fiscal 1999, the Treasury has sold nearly $31 billion of such securities.

State and Local Governments

The fiscal condition of state and local governments has remained quite positive as well. Revenues have been boosted by increases in tax collections due to strong growth of private-sector incomes and expenditures—increases that were enough to offset an ongoing trend of tax cuts. Meanwhile, outlays have continued to be restrained. In all, at the state level, fiscal 1999 looks to have been the seventh consecutive year of improving fiscal positions; of the forty-six states whose fiscal years ended on June 30, all appear to have run surpluses in their general funds.

Real expenditures for consumption and gross investment by states and localities, which had been rising only moderately through most of 1998, jumped at a 7¾ percent annual rate in the first quarter of this year. This increase was driven by a surge in construction expenditures that was helped along by unseasonably favorable weather, and spending data for April and May suggest that much of this rise in construction spending was offset in the second quarter. As for employment, state and local governments added jobs over the first half of the year at about the same pace as they did last year.

Debt of state and local governments expanded at a 5½ percent rate in the first quarter. The low interest rate environment and strong economy encouraged the financing of new projects and the refunding of outstanding higher-rate debt. Borrowing slowed to a more modest pace in the second quarter, as yields on long-dated municipal bonds moved up, but by less than those on comparable Treasury securities. The credit quality of municipal securities improved further over the first half of the year, with more issues being upgraded than downgraded.

External Sector

Trade and the Current Account

The current account deficit reached $274 billion at an annual rate in the first quarter of 1999, a bit more than 3 percent of GDP, compared with $221 billion and 2½ percent of GDP for 1998. A widening of the deficit on trade in goods and services, to $215 billion at an annual rate in the first quarter from $173 billion in the fourth quarter of 1998, accounted for the deterioration in the current account balance. Data for April and May indicate that the trade deficit increased further in the second quarter.

The quantity of imports of goods and services again grew vigorously in the first quarter. The annual rate of growth of imports, at 13½ percent, continued the rapid pace seen over 1998 and reflected the strength of U.S. domestic demand and the effects of past dollar appreciation. Imports of consumer goods, automotive products, computers, and semiconductors were particularly robust. Preliminary data for April and May suggest that real import growth remained strong, as nominal imports rose steadily and non-oil import prices posted a moderate decline.

The volume of exports of goods and services declined at an annual rate of 5 percent in the first quarter. The decline partially reversed the strong increase in the fourth quarter of last year. The weakness of economic activity in a number of U.S. trading partners and the strength of the dollar damped demand for U.S. exports. Declines were registered in aircraft, machinery, industrial supplies, and agricultural products. Exports to Asia generally turned down in the first quarter from the elevated levels recorded in the fourth quarter, when they were boosted by record deliveries of aircraft to the region. Preliminary data for April and May suggest that real exports advanced slightly.

Capital Account

Foreign direct investment in the United States and U.S. direct investment abroad remained robust in the first quarter, reflecting brisk cross-border merger and acquisition activity. On balance, net capital flows through direct investment registered a modest outflow in the first quarter compared with a huge net inflow in the fourth quarter. Fourth-quarter inflows were swollen by several large mergers. Net foreign purchases of U.S. securities also continued to be quite sizable but again were well below the extraordinary pace of the fourth quarter. Most of the slowdown in the first quarter is attributable to a reduced demand for Treasury securities on the part of private investors abroad. But capital inflows from foreign official sources also slowed in the first quarter. U.S. residents on net sold foreign securities in the first quarter, but at a slower rate than in the previous quarter.

The Labor Market

Employment and Labor Supply

Labor demand remained very strong during the first half of 1999. Payroll employment increased about 200,000 per month on average, which, although less rapid than the 244,000 pace registered over 1998, is faster than the growth of the working-age population. With the labor force participation rate remaining about flat at just over 67 percent, the unemployment rate edged down further from an average of 4½ percent in 1998 to 4¼ percent in the first half of this year—the lowest unemployment rate seen in the United States in almost thirty years. Furthermore, the pool of potential workers, including not just the unemployed but also individuals who are out of the labor force but report that they want a job, declined late last year to the lowest share of the labor force since collection of these data began in 1970—and it has remained near that low this year. Not surprisingly, businesses in many parts of the country have perceived workers to be in very short supply, as evidenced by high levels of help-wanted advertising and surveys showing substantial difficulties in filling job openings.

Employment gains in the private service-producing sector remained sizable in the first six months of the year and more than accounted for the rise in nonfarm payrolls over this period. Payrolls continued to rise briskly in the services industry, with firms providing business services (such as help supply services and computer services) adding jobs especially rapidly. Job gains were quite sizable in retail trade as well. Within the service-producing sector, only the finance, insurance, and real estate industry has slowed the pace of net hiring from last year's rate, reflecting, in part, a slower rate of job gains in the mortgage banking industry as the refinancing wave has ebbed.

Within the goods-producing sector, the boom in construction activity pushed payrolls in that industry higher in the first six months of this year. But in manufacturing, where employment began declining more than a year ago in the wake of a drop in export demand, payrolls continued to fall in the first half of 1999; in all, nearly half a million factory jobs have been shed since March 1998. Despite these job losses, manufacturing output continued to rise in the first half of this year, reflecting large gains in labor productivity.

Labor Costs and Productivity

Growth in hourly compensation, which had been on an upward trend since 1995, appears to have leveled off and, by some measures, has slowed in the past year. According to the employment cost index (ECI), hourly compensation costs increased 3 percent over the twelve months ended in March, down from 3½ percent over the preceding twelve-month period. Part of both the earlier acceleration and more recent deceleration in the ECI apparently reflected swings in commissions, bonuses, and other types of ''variable'' compensation, especially in the finance, insurance, and real estate industry. But in addition, part of the recent deceleration probably reflects the influence of restrained price inflation in tempering nominal wage increases. Although down from earlier increases, the 3 percent rise in the ECI over the twelve months ended in March was well above the rise in prices over this period and therefore was enough to generate solid gains in workers' real pay.

The deceleration in the ECI through March has been most pronounced in the wages and salaries component, whose twelve-month change slowed ¾ percentage point from a year earlier. More recently, data on average hourly earnings of production or nonsupervisory workers may point to a leveling off, but no further slowing, of wage growth: This series was up at about a 4 percent annual rate over the first six months of this year, about the same as the increase over 1998. Growth in the benefits component of the ECI slowed somewhat as well in the year ended in March, to a 2¼ percent increase. However, employers' costs for health insurance are one component of benefits that has been rising more rapidly of late. After showing essentially no change from 1994 through 1996, the ECI for health insurance accelerated to a 3¾ percent pace over the twelve months ended in March.

A second measure of hourly compensation—the Bureau of Labor Statistics' measure of compensation per hour in the nonfarm business sector, which is derived from compensation information from the national accounts—has been rising more rapidly than the ECI in the past few years and has also decelerated less so far this year. Nonfarm compensation per hour increased 4 percent over the four quarters ended in the first quarter of 1999, 1 percentage point more than the rise in the ECI over this period. One reason these two compensation measures may diverge is that the ECI does not capture certain forms of compensation, such as stock options and hiring, retention, and referral bonuses, whereas nonfarm compensation per hour does measure these payments.[3] Although the two compensation measures differ in numerous other respects as well, the series' divergence may lend support to anecdotal evidence that these alternative forms of compensation have been increasing especially rapidly in recent years. However,

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[3] However, nonfarm compensation per hour captures the gains from the actual *exercise* of stock options, whereas for analyzing compensation trends, one might prefer to measure the value of the options at the time they are *granted*.

because nonfarm compensation per hour can be revised substantially, one must be cautious in putting much weight on the most recent quarterly figures from this series.

Rapid productivity growth has made it possible to sustain these increases in workers' compensation without placing great pressure on businesses' costs. Labor productivity in the nonfarm business sector posted another sizable gain in the first quarter of 1999, and the increase over the four quarters ended in the first quarter of 1999 was 2½ percent. Indeed, productivity has increased at a 2 percent pace since 1995—well above the trend of roughly 1 percent per year that had prevailed over the preceding two decades.[4] This recent productivity performance is all the more impressive given that businesses are reported to have had to divert considerable resources toward avoiding computer problems associated with the century date change, and given as well that businesses may have had to hire less-skilled workers than were available earlier in the expansion when the pool of potential workers was not so shallow. Part of the strength in productivity growth over the past few years may have been a cyclical response to the rapid growth of output over this period. But productivity may also be reaping a more persistent payoff from the boom in business investment and the accompanying introduction of newer technologies that have occurred over the past several years.

Even these impressive gains in labor productivity may not have kept up fully with increases in firms' real compensation costs of late. Over the past two years, real compensation, measured by the ECI relative to the price of nonfarm business output, has increased the same hefty 2½ percent per year as labor productivity; however, measured instead using nonfarm compensation per hour, real compensation has increased somewhat more than productivity over this period, implying a rising share of compensation in total national income. A persistent period of real compensation increases in excess of productivity growth would reduce firms' capacity to absorb further wage gains without putting upward pressure on prices.

Prices

Price inflation moved up in early 1999 from a level in 1998 that was depressed by a transitory drop in energy and other commodity prices. After increasing only about 1½ percent over 1998, the consumer price index rose at a 2¼ percent annual rate over the first six months of this year, driven by a sharp turnaround in prices of gasoline and heating oil. However, the so-called "core" CPI, which excludes food and energy items, rose at an annual rate of only 1.6 percent over this period—a somewhat smaller increase than that registered over 1998 once adjustment is made for the effects of changes in CPI methodology: According to a new research series from the Bureau of Labor Statistics (BLS), the core CPI would have increased 2.2 percent over 1998

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[4] About ¼ percentage point of the improvement in productivity growth since 1995 can be attributed to changes in price measurement. The measure of real output underlying the productivity figures since 1995 is deflated using CPI components that have been constructed using a geometric-means formula; these components tend to rise less rapidly than the CPI components that had been used in the output and productivity data before 1995. These smaller CPI increases translate into more rapid growth of output and productivity in the later period.

had 1999 methods been in place in that year.[5]

The moderation of the core CPI in recent years has reflected a variety of factors that have helped hold inflation in check despite what has been by all accounts a very tight labor market. Price increases have been damped by substantial growth in manufacturing capacity, which has held plant utilization rates in most industries at moderate (and in some cases subpar) levels, thereby reinforcing competitive pressures in product markets. Furthermore, rapid productivity growth helped hold increases in unit labor costs to low levels even as compensation growth was picking up last year. The rise in compensation itself has been constrained by moderate expectations of inflation, which have been relatively stable. According to the Michigan SRC survey, the median of one year-ahead inflation expectations, which was about 2½ percent late last year, averaged 2¾ percent in the first half of this year.

The quiescence of inflation expectations, at least through the early part of this year, in turn may have come in part from the downward movement in overall inflation last year resulting from declines in prices of imports and of oil and other commodities. These price declines have not been repeated more recently. This year's rise in energy prices is the clearest example, but commodity prices more generally have been turning up of late. The Journal of Commerce industrial price index has moved up about 6 percent so far this year after having declined about 10 percent last year, with especially large increases posted for prices of lumber, plywood, and steel. These price movements are starting to be seen at later stages of processing as well: The producer price index for intermediate materials excluding food and energy, which gradually declined about 2 percent over the fifteen months through February 1999, retraced about half of that decrease by June. Furthermore, non-oil import prices,

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[5] The most important change this year was the introduction of the geometric-means formula to aggregate price quotes within most of the detailed item categories. (The Laspeyres formula continues to be used in constructing higher-level aggregates.) Although these geometric-means CPIs were introduced into the official CPI only in January of this year, the BLS generated the series on an experimental basis going back several years, allowing them to be built into the national income and product accounts back to 1995.

Alternative Measures of Price Change

Percent, annual rate

Price measure	1996:Q4 to 1997:Q4	1997:Q4 to 1998:Q4	1998:Q4 to 1999:Q1
Fixed-weight			
Consumer price index	1.9	1.5	1.5
Excluding food and energy	2.2	2.4	1.6
Chain-type			
Gross domestic product	1.7	.9	1.6
Gross domestic purchases	1.3	.4	1.2
Personal consumption expenditures	1.5	.7	1.2
Excluding food and energy	1.6	1.2	1.3

NOTE. A fixed-weight index uses quantity weights from the base year to aggregate prices from each distinct item category. A chain-type index is the geometric average of two fixed-weight indexes and allows the weights to change each year. Changes are based on quarterly averages.

although continuing to fall this year, have moved down at a slower rate than that of the past couple of years when the dollar was rising sharply in foreign exchange markets. Non-oil import prices declined at a 1¼ percent annual rate over the first half of 1999, after having fallen at a 3 percent rate, on average, over 1997 and 1998.

Some other broad measures of prices also showed evidence of acceleration early this year. The chain-type price index for GDP—which covers prices of all goods and services produced in the United States—rose at about a 1½ percent annual rate in the first quarter, up from an increase of about 1 percent last year. A portion of this acceleration reflected movements in the chain-type price index for personal consumption expenditures (PCE) that differed from movements in the CPI.

Although the components of the CPI are key inputs into the PCE price index, the two price measures differ in a variety of respects: They use different aggregation formulas; the weights are derived from different sources; the PCE measure does not utilize all components of the CPI; and the PCE measure is broader in scope, including not just the out-of-pocket expenditures by households that are captured by the CPI, but also the portion of expenditures on items such as medical care and education that are paid by insurers or governments, consumption of items such as banks' checking services that are provided without explicit charge, and expenditures made by nonprofit institutions. Although PCE prices typically rise a bit less rapidly than the CPI, the PCE price measure was unusually restrained relative to the CPI in the few years through 1998, reflecting a combination of the above factors.

Last year's sharp drop in retail energy prices and the subsequent rebound this spring reflected movements in the price of crude oil. The spot price of West Texas intermediate (WTI) crude oil, which had stood at about $20 per barrel through most of 1997, dropped sharply over 1998 and reached $11 per barrel by the end of the year, reflecting in part a weakening in demand for oil from the distressed Asian nations and increases in supply from Iraq and other countries. But oil prices jumped this year as the OPEC nations agreed on production restraints aimed at firming prices, and the WTI spot price reached $18 per barrel in April and has moved still higher more recently. As a result, gasoline prices, which dropped 15 percent over 1998, reversed almost all of that decline over the first six months of this year. Prices of heating fuel also rebounded after dropping in 1998. In all, the CPI for energy rose at a 10 percent annual rate over the December-to-June period.

Consumer food prices increased moderately over the first six months of the year, rising at a 1¾ percent annual rate. Despite the upturn in commodity prices generally, farm prices have remained quite low and have helped to hold down food price increases. Spot prices of wheat, soybeans, and sugar have moved down further this year from already depressed levels at the end of 1998, and prices of corn and coffee have remained low as well.

The CPI for goods other than food and energy declined at about a ½ percent annual rate over the first six months of 1999, after having risen 1¼ percent over 1998. The 1998 increase reflected a sharp rise in tobacco prices in December associated with the settlement of litigation between the tobacco companies and the states; excluding tobacco, the CPI for core goods was about flat last year. The decline in the first half of this year was concentrated in durable goods, where prices softened for a wide range of items, including motor vehicles. The CPI for non-energy services increased about 2½ percent at an annual rate in the first half, down a little from the increase over 1998. Increases in the CPI for rent of shelter have slowed thus far in 1999, rising at a 2½ percent annual rate versus a 3¼ percent rise last year. However, airfares and prices of medical services have been rising more rapidly so far this year.

Debt and the Monetary Aggregates

Debt and Depository Intermediation

The total debt of the U.S. household, government, and nonfinancial business sectors increased at about a 6 percent annual rate from the fourth quarter of 1998 through May, a little above the midpoint of its growth range of 3 percent to 7 percent. Nonfederal debt expanded briskly at about a 9 percent annual pace, in association with continued strong private domestic spending on consumer durable goods, housing, and business investment. By contrast, federal debt contracted at a 3 percent annual rate, as budget surpluses reined in federal government financing needs.

Credit extended by depository institutions slumped over the first half of 1999, after having expanded quite briskly in 1998. A fair-sized portion of the expansion in 1998 came in the fourth quarter and stemmed from the turmoil in financial markets. In that turbulent environment, depository institutions postponed securitization of mortgages, and businesses shifted their funding demand from securities markets to depository institutions, where borrowing costs in some cases were governed by pre-existing lending commitments. Depository institutions also acquired mortgage-backed securities and other private debt instruments in volume, as their yields evidently rose relative to depository funding costs. As financial stresses unwound, securitization resumed, business borrowers returned to securities markets, and net purchases of securities slowed. From the fourth quarter of 1998 through June, bank credit rose at a 3 percent annualized pace, after adjusting for the estimated effects of mark-to-market accounting rules.

Monetary Aggregates

The growth of M3, the broadest monetary aggregate, slowed appreciably over the first half of 1999. M3 expanded at a 6 percent annual pace from the fourth quarter of 1998 through June of this year, placing this aggregate at the top of the 2 percent to 6 percent price-stability growth range set by the FOMC at its February meeting. With depository credit growing modestly, depository institutions trimmed the managed liabilities included in M3, such as large time deposits. Growth of institutional money market mutual funds also moderated from its rapid pace in 1998. Rates on money market funds tend to lag the movements in market rates because the average rate of return on the portfolio of securities held by the fund changes more slowly than market rates. In the fall, rates on institutional money market funds did not decline as fast as market rates after the Federal Reserve eased monetary policy, and the growth of these funds soared. As rates on these funds moved back into alignment with market rates this year, growth of these funds ebbed.

M2 advanced at a 6¼ percent annual rate from the fourth quarter of 1998 through June. M2 growth had been elevated in late 1998 by unsettled financial conditions, which raised the demand

Growth of Money and Debt

Percent

Period	M1	M2	M3	Domestic non-financial debt
Annual[1]				
1989	.6	5.2	4.1	7.5
1990	4.2	4.2	1.9	6.7
1991	8.0	3.1	1.2	4.5
1992	14.3	1.8	.6	4.5
1993	10.6	1.3	1.0	4.9
1994	2.5	.6	1.7	4.9
1995	–1.6	3.9	6.1	5.4
1996	–4.5	4.6	6.8	5.1
1997	–1.2	5.8	8.8	4.8
1998	1.8	8.5	10.9	6.1
Quarterly (annual rate)[2]				
1999:Q1	2.8	7.2	7.3	5.9
Q2	3.4	5.7	5.0	n.a.
Year-to-date[3]				
1999	2.0	6.2	6.0	6.1

NOTE. M1 consists of currency, travelers checks, demand deposits, and other checkable deposits. M2 consists of M1 plus savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds. M3 consists of M2 plus large-denomination time deposits, balances in institutional money market funds, RP liabilities (overnight and term), and Eurodollars (overnight and term). Debt consists of the outstanding credit market debt of the U.S. government, state and local governments, households and nonprofit organizations, nonfinancial businesses, and farms.

1. From average for fourth quarter of preceding year to average for fourth quarter of year indicated.

2. From average for preceding quarter to average for quarter indicated.

3. From average for fourth quarter of 1998 to average for June (May in the case of domestic nonfinancial debt).

n.a. Not available.

for liquid money balances, and by the easing of monetary policy, which reduced the opportunity costs of holding the assets included in the monetary aggregates. M2 growth moderated over the first half of 1999, as the heightened demand for money waned; in June this aggregate was above its 1 percent to 5 percent price-stability growth range. The growth in M2 over the first half of the year again outpaced that of nominal income, although the decline in M2 velocity—the ratio of nominal income to M2—was at a slower rate than in 1998. The decline this year reflected in part a continuing lagged response to the policy easing in the fall; however, the drop in M2 velocity was again larger than predicted on the basis of the historical relationship between the velocity of M2 and the opportunity costs of holding M2—measured as the difference between the rate on three-month Treasury bills and the average return on M2 assets. The reasons for the decline of M2 velocity this year are not clear; the drop extends a trend in velocity evident since mid-1997 and may in part owe to households' efforts to allocate some wealth to the assets included in M2, such as deposits and money market mutual fund shares, after several years of substantial gains in equity prices that greatly raised the share of wealth held in equities.

M1 increased at a 2 percent annualized pace from the fourth quarter of 1998 through June, in line with its advance in 1998. The currency component of M1 expanded quite rapidly. The strength appeared to stem from domestic, rather than foreign, demand, perhaps reflecting vigorous consumer spending, although currency growth was more robust than might be expected for the rise in spending. The deposits in M1—demand deposits and other checkable deposits—contracted further, as retail sweep programs continued to be introduced. These programs, which first began in 1994, shift funds from a depositor's checking account, which is subject to reserve requirements, to a special-purpose money market deposit account, which is not. Funds are then shifted back to the checking account when the depositor's account balance falls below a given level. The depository institution benefits from a retail sweep program because the program cuts its reserve requirement and thus the amount of non-interest-bearing reserve balances that it must hold at its Federal Reserve Bank. New sweep programs depressed the growth of M1 by about 5¼ percentage points over the first half of 1999, somewhat less than in previous years because most of the depository institutions that would benefit from such programs had already implemented them.

As a consequence of retail sweep programs, the balances that depository institutions are required to hold at the Federal Reserve have fallen about 60 percent since 1994. This development has the potential to complicate reserve management by the Federal Reserve and depository institutions and thus raise the volatility of the federal funds rate. It would do so by making the demand for balances at the Federal Reserve more variable and less predictable. Before the introduction of sweeps, the demand for balances was high and stable because reserve balance requirements were large, and the requirements were satisfied by the average of daily balances held over a maintenance period. With sweep programs reducing required balances to low levels, depository institutions have found that they target balances in excess of their required balances in order to gain sufficient protection against unanticipated debits that could leave their accounts overdrawn at the end of the day. This payment-related demand for balances varies more from day to day than the requirement-related demand. Thus far, the greater variation in the demand for balances has not made the federal funds rate appreciably more volatile, in part reflecting the successful efforts of depository institutions and the Federal Reserve to adapt to lower balances. For its part, the Federal Reserve has conducted more open market operations that mature the next business day to better align daily supply with demand. Nonetheless, required balances at the Federal Reserve could drop to levels at which the volatility of the funds rate becomes pronounced. One way to address the problem of declining required balances would be to permit the Federal Reserve to pay interest on the reserve balances that depository institutions hold. Paying interest on reserve balances would reduce considerably the incentives of depository institutions to develop reserve-avoidance practices that may complicate the implementation of monetary policy.

U.S. Financial Markets

Yields on Treasury securities have risen this year in response to the ebbing of the financial market strains of late 1998, surprisingly strong economic activity, concerns about the potential for increasing inflation, and the consequent anticipation of tighter monetary policy. In January, yields on Treasury securities moved in a narrow range, as lingering safe-haven demands for dollar-denominated assets, owing in part to the devaluation and subsequent floating of the Brazilian *real*, about offset the effect on yields of stronger-than-expected economic data. Over subsequent months, however, yields on Treasury securities, especially at intermediate and long maturities, moved up substantially. The demand for the safest and most liquid assets, which had pulled down Treasury yields in the fall, abated as the strength in economic activity and favorable earnings reports engendered optimism about the financial condition of private borrowers and encouraged investors to buy private securities. In addition, rising commodity prices, tight labor markets, and robust economic activity led market participants to conclude that monetary policy would need to be tightened, perhaps in a series of steps. This view, accentuated by the FOMC's announcement after its May meeting that it had adopted a directive tilted toward tightening policy, also boosted yields. Between the end of 1998 and mid-July, Treasury yields added about 80 basis points to 110 basis points, on balance, with the larger increases in the intermediate maturities. The rise in Treasury bill rates, anchored by the modest upward move in the FOMC's target federal funds rate, was much less, about 10 basis points to 40 basis points.

The recovery in fixed-income markets over the first half of the year was evident in a number of indicators of market conditions. Market liquidity was generally better, and volatility was lower. The relative demand for the most liquid Treasury securities—the most recently auctioned security at each maturity—was not so acute, and yields on these securities were in somewhat closer alignment with yields on issues that had been outstanding longer. Dealers were more willing to put capital at risk to make markets, and bid–asked spreads in Treasury securities narrowed somewhat, though, in June they were still a bit wider than had been typical. Market expectations of asset price volatility, as reflected in prices on Treasury bond options contracts, receded on balance. The implied volatility of bond prices dropped off until April and then turned back up, as uncertainty about the timing and extent of a possible tightening of monetary policy increased.

Yields on inflation-indexed Treasury securities have only edged up this year, and the spreads between yields on nominal Treasury securities and those on comparable inflation-indexed securities have widened considerably. Yields on inflation-indexed securities did not decline in late 1998 like those of their nominal counterparts, in part because these securities were not perceived as being as liquid as nominal Treasury securities. Thus, as the safe-haven demand for nominal Treasury securities unwound and nominal yields rose, yields on inflation-indexed securities did not move up concomitantly. Moreover, these yields were held down by some improvement in the liquidity of the market for inflation-indexed securities, as suggested by reports of narrower bid–asked spreads, which provided additional impetus for investors to acquire these securities. Because of such considerations, the value of the yield spread between nominal and inflation-indexed Treasury securities as an indicator of inflation expectations is limited. Nonetheless, the widening of the spread this year may have reflected some rise in inflation expectations.

Equity prices have climbed this year. Major equity price indexes posted gains of 10 percent to 31 percent, on balance, between the end of 1998 and July 16, when most of them established record highs. The lift to prices from stronger-than-anticipated economic activity and corporate profits apparently has offset the damping effect of rising bond yields. Prices of technology issues, especially Internet stocks, have risen considerably on net, despite some wide swings in sentiment. Share prices of firms producing primary commodities, which tumbled in the fall, rebounded to post large price gains, perhaps because of the firming of commodity prices amid perceptions that Asian economies were improving. Consensus estimates of earnings over the coming twelve months have strengthened, but in June the ratio of these estimates to prices, as measured by the S&P 500 index, was near the record low established in May. Meanwhile, real interest rates, measured as the difference between the yield on the nominal ten-year Treasury note and a survey-based measure of inflation expectations, moved up. Consequently, the risk premium for holding equities remained quite small by historical standards.

Year 2000 Preparedness

The Federal Reserve and the banking system have largely completed preparing technical systems to ensure that they will function at the century date change and are taking steps to deal with potential contingencies. The Federal Reserve successfully completed testing all of its mission-critical computer systems for year 2000 compliance, including its securities and funds transfer systems. As a precaution to assure the public that sufficient cash will be available in the event that demand for U.S. currency rises in advance of the century date change, the Federal Reserve will increase considerably its inventory of currency by late 1999. In addition, the Federal Reserve established a Century Date Change Special Liquidity Facility to supply collateralized credit freely to depository institutions at a modest penalty to market interest rates in the months surrounding the rollover. This funding should help financially sound depository institutions commit more confidently to supplying loans to other financial institutions and businesses in the closing months of 1999 and early months of 2000.

All depository institutions have been subject to special year 2000 examinations by their banking supervisors to ensure their readiness. Banks, in turn, have worked with their customers to encourage year 2000 preparedness by including a review of a customer's year 2000 preparedness in their underwriting or loan-review standards and documentation. According to the Federal Reserve's May 1999 Senior Loan Officer Opinion Survey, a substantial majority of the respondent banks have largely completed year 2000 preparedness reviews of their material customers. Most banks reported that only a small portion of their customers have not made satisfactory progress.

Banks in the Federal Reserve's survey reported little demand from their clients for special contingency lines of credit related to the century date change, although many expect demand for such lines to increase somewhat as the year progresses. Almost all domestic respondents reported that they are willing to extend such credit lines, although in some cases with tighter standards or terms.

International Developments

Global economic prospects look considerably brighter than they did only a few months ago. To an important degree, this improvement owes to the rebound in the Brazilian economy from the turmoil experienced in January and February and to the fact that the fallout from Brazil on other countries was much less than it might have been. The fear was that the collapse of the Brazilian *real* last January would unleash a spiral of inflation and further devaluation and lead to a default on government domestic debt, destabilizing financial markets and triggering an intensified flight of capital from Brazil. In light of events following the Russian debt moratorium and collapse of the ruble last year, concern existed that a collapse of the *real* could also have negative repercussions in Latin America more broadly, and possibly even in global financial markets.

Developments in Brazil turned out better than expected over the weeks after the floating of the *real* in January. Between mid-January and early March, the *real* lost 45 percent of its value against the dollar, reaching a low of 2.2 per dollar, but then started to recover after the Brazilian central bank raised the overnight interest rate from 39 percent to 45 percent and made clear that it gave a high priority to fighting inflation. By mid-May, the *real* had strengthened to 1.65 per dollar, even while the overnight rate had been cut, in steps, from its March high. The overnight rate was reduced further, to 21 percent by the end of June, but the *real* fell back only modestly and stood at about 1.80 per dollar in mid-July. Brazil's stock market also rose sharply and was up by about 65 percent in the year to date.

Several favorable developments have worked to support the *real* and equity prices over the past few months. Inflation has been lower than expected, with consumer price inflation at an annual rate of around 8 percent for the first half of the year. Greater-than-expected real GDP growth in the first quarter, though attributable in part to temporary factors, provided some evidence of a bottoming out, and possible recovery, in economic activity over the first part of this year. And in the fiscal arena, the government posted a primary surplus of more than 4 percent of GDP in the first quarter—well above the goal in the International Monetary Fund program. The positive turn of events has facilitated a return of the Brazilian government and private-sector borrowers to international bond markets, albeit on more restrictive terms than those of a year ago.

Since the middle of May, however, the road to recovery in Brazil has become bumpier. The central government posted a fiscal deficit in May that was bigger than had been expected. In addition, court challenges have called into question fiscal reforms enacted earlier this year that were expected to improve the government's fiscal balance by about 1 percent of GDP. In May, the rise in U.S. interest rates associated with the anticipated tightening in the stance of U.S. monetary policy helped push Brady bond yield spreads up more than 200 basis points. Although they narrowed some in June, they widened recently on concerns about Argentina's economic situation.

The Brazilian crisis did trigger renewed financial stress throughout Latin America, as domestic interest rates and Brady bond yield spreads increased sharply in January from levels that had already been elevated by the Russian crisis. Nonetheless, these increases were generally smaller than those that had followed the Russian crisis, and as developments in Brazil proved more positive than expected, financial conditions in the rest of the region stabilized rapidly. Even so, the combination of elevated risk premiums and diminished access to international credit markets, as well as sharp declines in the prices of commodity exports, had significant consequences for GDP growth, which began to slow or turn negative throughout the region in late 1998 and early 1999.

Mexico appears to have experienced the least diminution in economic growth, likely because of its strong trade links with the United States, where growth has been robust. A flattening in Mexican GDP in the final quarter of 1998 has given way to renewed, but moderate, growth more recently, and the Mexican peso has appreciated by about 5½ percent relative to the dollar since the start of the year. By contrast, economic activity in Argentina declined sharply in the first quarter, in part because of the devaluation and relatively weak economic activity in Brazil, Argentina's major trading partner. More recently the earlier recovery in

Argentina's financial markets appears to have backtracked as concern has increased about the medium- to long-run viability of the currency peg to the dollar. Several countries in the region, including Venezuela, Chile, and Colombia, also experienced sharp declines in output in the first quarter, stemming in part from earlier declines in oil and other commodity prices.

In emerging Asia, signs of recovery in financial markets and in real activity are visible in most of the countries that experienced financial crises in late 1997. However, the pace and extent of recovery is uneven across countries. The strongest recovery has been in Korea. In 1998, the Korean won reversed nearly half of its sharp depreciation of late 1997. It has been little changed on balance this year, as Korean monetary authorities have intervened to moderate its further appreciation. Korean stock prices have also staged an impressive recovery—moving up about 75 percent so far in 1999. In the wake of its financial crisis, output in Korea fell sharply, with industrial production down about 15 percent by the middle of last year. Since then, however, production has bounced back. With the pace of the recovery accelerating this year, all of the post-crisis drop in production has been reversed. This turnaround reflects both the improvement in Korea's external position, as the trade balance has swung into substantial surplus, and the government's progress in addressing the structural problems in the financial and corporate sectors that contributed to the crisis.

Financial markets in the Southeast Asian countries that experienced crises in 1997 (Thailand, Singapore, Malaysia, Indonesia, and the Philippines) apparently were little affected by spillover from Brazil's troubles earlier this year and have recovered on balance over the past year, with exchange rates stabilizing and stock prices moving higher. Financial conditions have been weakest in Indonesia, in large part a result of political uncertainty; but even so, domestic interest rates have dropped sharply, and the stock market has staged an impressive rebound since April. The recovery of economic activity in these countries has been slower and less robust than in Korea, possibly reflecting slower progress in addressing structural weaknesses in the financial and corporate sectors. However, activity appears to have bottomed out and has recently shown signs of starting to move up in these countries.

Financial markets in China and Hong Kong experienced some turbulence at the start of the year when Chinese authorities put the Guangdong International Trust and Investment Corporation (GITIC) into bankruptcy, leading to rating downgrades for some Chinese financial institutions, including the major state commercial banks. The GITIC bankruptcy also raised concerns about Hong Kong financial institutions, which are heavy creditors to Chinese entities. These concerns contributed to a substantial increase in yield spreads between Hong Kong government debt and U.S. Treasury securities and to a fall in the Hong Kong stock market of about 15 percent. Spreads have narrowed since, falling from about 330 basis points on one-year debt in late January to about 80 basis points by mid-May, and have remained relatively stable since then. Equity prices also rebounded sharply, rising nearly 50 percent between mid-February and early May. Despite sizable volatility in May and June, they are now roughly unchanged from early May levels.

In Japan, a few indicators suggest that recovery from a prolonged recession may be occurring. Principally, first-quarter GDP growth at an annual rate of 7.9 percent was recorded—the first positive growth in six quarters. This improvement reflects in part a shift toward more stimulative fiscal and monetary policies. On the fiscal front, the government announced a set of measures at the end of last year that were slated for implementation during 1999 and included permanent cuts in personal and corporate income taxes, various investment incentives, and increases in public expenditures. The large-scale fiscal expansion and concern about increases in the supply of government bonds caused bond yields to more than double late last year and early this year, to a level of about 2 percent on the ten-year bond.

In mid-February, primarily because of concern about the prolonged weakness in economic activity and pronounced deflationary pressures but also in response to the rising bond yields, the Bank of Japan announced a reduction in the target for the overnight call-money rate and subsequently guided the rate to its present level of 3 basis points by early March. This easing of monetary policy had a stimulative effect on Japanese financial markets, with the yield on the ten-year government bond falling more than 75 basis points, to 1.25 percent by mid-May. More recently, the yield has risen to about 1.8 percent, partially in response to the release of unexpectedly strong first-quarter GDP growth. Supportive monetary conditions, coupled with restructuring announcements from a number of large Japanese firms and growing optimism about the economic outlook, have fueled a rise in the Nikkei from around 14,400 over the first two months of the year to over 18,500 in mid-July.

The improved economic performance in Japan also reflects some progress on addressing persistent problems in the financial sector. In March the authorities injected 7½ trillion yen of public funds into large financial institutions and began to require increased provisioning against bad loans as well as improved financial disclosure. Although much remains to be done, these actions appear to have stabilized conditions, at least temporarily, in the banking system, and the premium on borrowing rates paid by leading Japanese banks declined to zero by March.

The yen strengthened in early January, supported by the runup in long-term Japanese interest rates, reaching about 110 per dollar—its highest level in more than two years. However, amid apparent intervention by the Japanese authorities, the yen retreated to a level above 116 per dollar, and it remained near that level until the mid-February easing of monetary policy and the subsequent decline of interest rates when it depreciated to about 120 per dollar. In mid-June, the Japanese authorities intervened in the foreign exchange market in an effort to limit appreciation of the yen after the surprisingly strong first-quarter GDP release increased market enthusiasm for that currency. The authorities noted that a premature strengthening of the yen was undesirable and would weigh adversely on economic recovery.

In the other major industrial countries, the pace of economic growth this year has been mixed. Economic developments in Canada have been quite favorable. GDP rose 4¼ percent at an annual rate in the first quarter after a fourth-quarter gain of 4¾ percent, with production fueled by strong demand for Canadian products from the United States. Core inflation remains low, near the lower end of the Bank of Canada's target range of 1 percent to 3 percent, although overall inflation rose some in April and May. Oil prices and other commodity prices have risen, and the current account deficit has narrowed considerably. These factors have helped the Canadian dollar appreciate relative to the U.S. dollar by about 4 percent this year and have facilitated a cut in short-term interest rates of 50 basis points by the Bank of Canada. Along with rising long-term interest rates elsewhere, long rates have increased in Canada by about 30 basis points over the course of this year. Even so, equity prices have risen about 12 percent since the start of the year, although the rise in long-term rates has undercut some of the momentum in the stock market.

In the United Kingdom, output was flat in the first quarter, coming off a year in which GDP growth had already slowed markedly. However, the effects of aggressive interest rate reductions undertaken by the Bank of England in late 1998 and earlier this year appear to have emerged in the second quarter, with gains in industrial production, retail sales volume, and business confidence. Inflationary pressures have been well contained, benefiting in part from the continued strength in sterling; the Bank of England cut interest rates, most recently in June, to reduce the likelihood of inflation undershooting its target of 2½ percent. Consistent with expectations of an upturn in growth, equity prices have risen more than 15 percent, and long-term bond yields have climbed nearly 80 basis points since the end of last year.

First-quarter growth in the European countries that have adopted a common currency (euro area) regained some momentum from its slow pace in late 1998 but was nevertheless below potential, as production continued to react to the decline in export orders registered over the course of 1998 and in early 1999. Still, the drag on overall production from weak export demand from Asia and eastern Europe appears to have lifted a bit in the past few months, although the signs of a pickup in growth were both tentative and uneven across the euro area. In Germany, industrial production was higher in April and May than in the preceding two months, and export orders were markedly higher in those months than they had been at any time since the spring of 1998. But in France, which had been the strongest of the three largest euro-area economies in 1998, GDP growth was a meager 1¼ percent at an annual rate in the first quarter, and industrial production slipped in April.

On average in the euro area, inflation has remained quite tame, even as rising oil prices, a declining euro, and, at least in Germany, an acceleration in wage rates have raised inflationary pressures this year. The low average rate of inflation as well as the still sluggish pace of real activity in some of the euro-area countries led the European Central Bank to lower the overnight policy rate by 50 basis points in April, on top of cuts in short-term policy rates made by the national central banks late last year that, on average, were worth about 60 basis points.

Notwithstanding the easing of the policy stance, long-term government bond yields have risen substantially from their January lows in the largest economies of the euro area. Ten-year rates spiked in early March along with U.S. rates, fell back some through mid-May, and then resumed an upward course around the time the FOMC adopted a tightening bias in mid-May. Since the middle of June, a relatively sharp increase in yields has pushed them to about 100 basis points above their values at the start of the year and has narrowed what had been a growing interest rate differential between U.S. and European bonds. In addition to the pressure provided by the increase in U.S. rates, the runup in European yields likely reflects the belief that short-term rates have troughed, as the incipient recovery in Asia not only reduces the drag on European exports but also attenuates deflationary pressures on European import prices. Concern about the fall in the exchange value of the euro may also have contributed to an assessment that the next move in short-term rates would be up. Gains in equity prices so far this year—averaging about 12½ percent—are also suggestive of the belief that economic activity may be picking up, although the range in share price movements is fairly broad, even considering only the largest economies: French equity prices have risen about 20 percent, German prices are up 13 percent, and Italian prices are up only 5 percent.

The new European currency, the euro, came into operation at the start of the year, marking the beginning of Stage Three of European Economic and Monetary Union. The rates of exchange between the euro and the currencies of the eleven countries adopting the euro were set on December 31; based on these rates, the value of the euro at the moment of its creation was $1.16675. Trading in the euro opened on January 4, and after jumping on the first trading day, its value has declined relative to the dollar almost steadily and is now about 13 percent below its initial value. The course of the euro–dollar exchange rate likely has reflected in part the growing divergence in both the cyclical positions and, until recently, long-term bond yields of the euro-area economies and the United States. Concerns about fiscal discipline in Italy—the government raised its 1999 deficit-to-GDP target from 2.0 percent to 2.4 percent—and about progress on structural reforms in Germany and France have also been cited as contributing to weakness in the euro, with the European Central Bank recently characterizing national governments' fiscal policy plans as "unambitious."

On balance the dollar has appreciated more than 4½ percent against an index of the major currencies since the end of last year, owing mainly to its strengthening relative to the euro. Nevertheless, it remains below its recent peak in August of last year when the Russian debt moratorium and subsequent financial market turmoil sent the dollar on a two-month downward slide. ■

Federal Reserve Operations

Consumer and Community Affairs

The consumer and community affairs function of the Board of Governors focused on activities in two key areas in 1999—providing information to a variety of audiences, including consumers, community groups, financial institutions, and the small business community; and improving the process for supervising state member banks for compliance with federal consumer banking and civil rights laws. The Board also reviewed several large bank holding company applications; strengthened regulatory guidance on disclosures and other matters; referred two cases reflecting possible patterns or practices of discrimination to the U.S. Department of Justice; and investigated and responded to issues raised in consumer complaints.

Community Development

The Federal Reserve promotes the economic viability of underserved populations and markets through its community affairs program, which provides technical assistance and conducts outreach to advise lenders, community developers, and government officials on innovative approaches for funding community-based economic development activities. Capitalizing on their access to information on financial intermediaries, the Community Affairs Officers at the twelve Reserve Banks design programs tailored to the information and development needs of their Districts. The Board's Division of Consumer and Community Affairs offers a national perspective and provides oversight and guidance, engaging in projects that have broad implications for public policy or that present issues industrywide in scope. This organizational structure supports a program that is both cohesive and diverse.

During 1999, the Board adopted a strategic plan and a revised mission statement for the community affairs function to take account of the significant changes occurring in the banking and community development industries. With an updated focus, the Federal Reserve System is positioned to apply its resources and expertise to projects promoting community-based economic development efforts throughout the country. In working toward this objective, the Reserve Banks hosted 284 conferences, conducted 1,689 outreach meetings, provided technical assistance on 878 occasions, delivered 280 speeches, and distributed 170,000 copies of newsletters during 1999. These activities are featured in *Capital Connections*, a newsletter begun in 1999 by the Board that highlights innovative and important projects undertaken by the Reserve Banks.

Many of the Division's community affairs efforts during 1999 were undertaken in cooperation with the Reserve Banks. For example, the Board and the Reserve Banks cosponsored a major research conference on small-business financing and development (see box). The Federal Reserve assisted the U.S. Small Business Administration (SBA) in its effort to increase awareness of the venture capital available to entrepreneurs through its small-business investment company (SBIC) program, a funding resource that leverages private investment with SBA guarantees. The Board coordinated the sponsorship of six seminars on SBICs by the Reserve

The Business of Small Business Access to Capital and Credit

> *The availability of business capital and credit is an essential component of healthy communities. Research on the relationship between small business and credit providers can provide information that is critical for dynamic markets.*
>
> Alan Greenspan, *Chairman*, Board of Governors

Small business is often referred to as the ‘‘engine of our economy.’’ Accordingly, the Federal Reserve System has a keen interest in its significance in financial markets. In 1999, the System’s community affairs officers demonstrated this interest by partnering with their research colleagues to sponsor an academic conference on the availability of funding resources for small businesses.

The two-day conference, ‘‘Business Access to Capital and Credit,’’ was the first national research conference of its kind for the Federal Reserve System. It provided a forum for economists, scholars, and advocates to present research findings, and it served as a foundation for continued research and discussion. Topics addressed included lending relationships, access to credit for minority-owned businesses, microenterprise lending, and credit scoring. The conference drew nearly 400 lenders, community developers, researchers, and government officials.

Small Business as an Economic Force

Small businesses provide jobs to more than half the private-sector workforce and generate more than half the nation’s sales and private gross domestic product. More agile than their ‘‘big business’’ counterparts, small firms can react quickly to customer demands and market changes. It is frequently because of their size, rather than in spite of it, that these small businesses are successful and often lead their industries in innovation. However, these entrepreneurial firms typically lack sufficient business experience and capital—factors that represent credit risk to lenders. This risk, whether perceived or real, has been cited as the reason small businesses, particularly those owned by minorities or located in low-income neighborhoods, have historically found it difficult to obtain the funding vital to their operation and growth.

Small Business and Community Development

In the course of their outreach and technical assistance activities, the System’s community affairs officers have over the years gathered anecdotal evidence of the credit gap that small enterprises continually struggle with. The lack of access to capital is viewed as particularly detrimental to the

Banks of New York, Atlanta, Chicago, Kansas City, Dallas, and San Francisco for a target audience of bankers, investors, and small-business developers.

The Board also played a role in the BusinessLINC Initiative, an interagency project headed by the SBA and the U.S. Department of the Treasury that seeks to stimulate business-to-business relationships, with larger companies mentoring small firms. Among other things, the Board assisted in the development of a national conference promoting BusinessLINC.

revitalization of low-income areas, given that these communities rely heavily on small firms for the economic stability and services that are critical to initiating and sustaining redevelopment. Without sufficient funding, these firms have difficulty remaining in business.

> *Small-business owners must contend with lenders with varying underwriting standards, varying appetites for risk, and varying expected rates or return for loans they may approve. The vagaries of local economies may also influence the likelihood that a small firm gets approved for credit.*
>
> Edward M. Gramlich, *Member*
> Board of Governors

In 1998, Board and Reserve Bank community affairs and research officers concluded that a research conference would foster better understanding of small business lending and credit issues and would encourage ongoing research and discussion. Scholars, practitioners, and policymakers nationwide responded to the call for papers. Seventeen studies identified as the most germane to the conference's objectives provided the framework for the conference, which was held in Arlington, Virginia, on March 8–9, 1999. Remarks by Federal Reserve Board Chairman Alan Greenspan and Governor Edward Gramlich reinforced the importance of understanding the challenges and opportunities involved in funding small businesses.

The Research

The conference focused on six topics:

- *CRA data on small-business lending*—The flow of credit to small businesses in low- and moderate-income communities, and ways to finance the operation of small farms
- *Access to credit for minority-owned businesses*—Differences in credit extensions to businesses owned by African Americans
- *The small business–small lender relationship*—The effect of banking consolidation and bank size on the relationship between business owners and lenders
- *Microenterprise lending*—Increasing the probability of repayment of micro-loans, and the efficacy of such programs in promoting self-sufficiency, providing training, and predicting success
- *Credit scoring and securitization of small-business loans*—The effect of credit scoring and securitization of small business loans on the availability of credit to small businesses in general and in low- and moderate-income communities.

Conference proceedings are available at www.federalreserve.gov/community.htm.

The success of the conference gave evidence of a desire for continued research on community economic development issues. System community affairs officers and their research colleagues are now collaborating on a second conference, to be held in spring 2001. This one will focus on the effect of changing financial markets on community development.

To support a presidential initiative on microenterprise development, the Board helped compile and disseminate information on existing federal programs that provide funding and technical support to very small firms. It also helped design and develop content for a centralized, Internet-based database of resources available to these businesses.

In 1999 the Federal Reserve System dedicated resources to several national home ownership initiatives. One was an interagency effort to increase home ownership in rural America; the community affairs function supported the Rural Home Loan Partnership by promoting the availability of a new financing vehicle offered by the U.S. Department of Agriculture, the Federal Home Loan Bank System, and the Rural Local Initiatives Support Corporation. The Reserve Banks of Boston, Richmond, St. Louis, and San Francisco convened bankers and community developers in their Districts to discuss the program and the availability of mortgage guarantees. The community affairs function also provided leadership and technical expertise in connection with the One-Stop Mortgage Initiative, a project initiated by the White House to create home ownership opportunities among Native Americans residing in Indian country. A work group for this initiative—made up of representatives of numerous other government agencies and the Minneapolis, Kansas City, and San Francisco Reserve Banks—identified specific actions needed to improve financial literacy and homebuyer preparation among the target market, critical elements in ensuring the success of any affordable housing program.

The Board and the Federal Reserve Bank of Richmond worked to promote economic development in the District of Columbia through a partnership among community groups, government agencies, financial institutions, and corporate businesses. Key representatives of these groups addressed issues that hamper growth, and proposed remedial actions at meetings convened by the Federal Reserve. Expertise in structuring and facilitating this partnership was provided by the Cleveland Reserve Bank, which offered recommendations on the basis of its experiences with a similar initiative.

In addition to participating directly in such collaborative efforts, the Federal Reserve's Community Affairs Offices sponsored conferences on new community development funding strategies and resources. The Federal Reserve Bank of New York sponsored a three-part series on innovative financing mechanisms for preserving low- and moderate-income communities. The series, which targeted community developers and investors, included seminars on real estate investment trusts, venture capital, and the securitization of community development loans. The San Francisco Reserve Bank also hosted a conference on the securitization of small-business and community development loans. Securitization could lead to the creation of a secondary market for these loans, which would, in turn, expand creditors' lending capacity.

The Community Affairs Offices also stressed the mutual benefits that can be achieved through creative partnerships among community stakeholders. The Federal Reserve Bank of Boston sponsored a conference highlighting the special resources that local universities can provide and the leadership and funding roles they can play in community development collaborations. The New York Reserve Bank spearheaded efforts to promote school-to-work programs and other work-training initiatives for low-income youth as qualified community reinvestment activities for financial institutions.

To give the public ready access to community development information, the Federal Reserve launched two web-based databases in 1999. The Federal Reserve Bank of Kansas City unveiled 1st Source, an interactive database of government funding and other community development support programs available through federal agencies. The Chicago Reserve Bank posted the Consumer and Economic Development Research and Information Center, a one-stop site for research and information on upcoming events related to community development.

Consumer Advisory Council

The Board's Consumer Advisory Council convened in March, June, and October 1999 to advise the Board on matters concerning laws that the Board administers and on other issues related to consumer financial services. The council's thirty members come from consumer and community organizations, the financial services industry, academic institutions, and state agencies. Council meetings are open to the public.

During the year, the council focused on numerous issues, including the Community Reinvestment Act (CRA), financial privacy, electronic disclosures, and subprime lending. Council members' diverse views provided valuable insight on consumer issues. Highlights of a few of the discussion topics follow.

The CRA was a major topic at the March and June meetings. Issues discussed included the banking agencies' collection and use of data related to small-business lending, the limitations of these data, and the feasibility of conducting a comprehensive study of small-business lending. Also discussed were lending agreements between financial institutions and community groups and the ways these agreements facilitate successful partnerships.

Privacy issues were another topic at the March and June meetings. In March, council members provided views on appropriate privacy protections for consumers and discussed the use of either mandatory directives or voluntary principles to address privacy concerns. Although they held differing views on whether mandatory or voluntary privacy protections would work best, council members agreed on the need for consumer privacy protections. In June, the group reviewed the growing number of privacy initiatives and expressed general support for a uniform approach to privacy to avoid proliferation of rules by state courts and regulators.

Electronic disclosures were a key topic at the June and October meetings. Council members discussed proposed rules for providing electronic disclosures under five of the Board's consumer protection regulations: B (Equal Credit Opportunity), E (Electronic Fund Transfers), M (Consumer Leasing), Z (Truth in Lending), and DD (Truth in Savings). Although members had differing views on suggested changes to the content and format of the proposed disclosure forms, they supported adding more consumer protections to the proposals, at least initially.

In October, the council discussed proposed changes to Regulation B concerning the removal of the general prohibition against noting information about an applicant's race, color, religion, national origin, and sex in transactions for nonmortgage credit. Members generally favored the removal of the prohibition, but opinions differed on whether data collection should be voluntary (as proposed) or mandatory.

In October, the council also addressed subprime lending—the extension of ‘‘nonconforming’’ loans to borrowers who may not qualify for conventional rates. Although subprime lending in many instances meets the credit needs of individuals who have impaired credit histories, some borrowers are subject to predatory, or abusive, practices by lenders. Council members emphasized the need to strengthen education, particularly for the most vulnerable population of borrowers, so that they do not become victims of abusive lending practices.

Fair Lending

In 1999 the Board implemented new, risk-based procedures for examinations to ensure compliance with the federal fair lending laws and regulations. These procedures were also adopted by other member agencies of the Federal Financial Institutions Examination Council. The new examination procedures are intended to facilitate more sophisticated analysis than was previously reflected in agency procedures and to give examiners the flexibility to tailor the fair lending focus of an examination to the institution being reviewed.

To educate examiners about the new procedures, the Federal Reserve carried out an extensive training program. In 1999, a comprehensive two-week course for less-experienced examiners was conducted on four occasions and an intensive one-week course for experienced examiners was conducted on six occasions. The two-week course will be offered on each ongoing basis three times a year.

Training in the fair lending examination procedures was also offered outside the Federal Reserve System. The Reserve Banks developed and presented outreach programs to bankers during the first half of 1999. And at the request of bank trade associations, federal and state banking and law enforcement agencies, and other interested parties, the Board gave fifteen presentations on the new procedures in ten cities during the year.

Since 1994, the Federal Reserve has used a two-stage statistical regression program in its assessment of fair lending compliance by large-volume mortgage lenders. The program identifies—on the basis of an initial analysis of reported HMDA (Home Mortgage Disclosure Act) data—banks that show significant disparities in rates of loan denial for minority and nonminority applicants; it then subjects the banks' records to a supplemental analysis that is based on additional information from a sample of the banks' loan files. In 1999, the Board issued updated guidance to examiners on the use of the regression program in conjunction with the new fair lending examination procedures. The Board also hosted a conference at which Reserve Banks discussed their program-related experiences. A number of program improvements were adopted, including several that will help in the identification of banks that merit more intensive review.

In accordance with the Equal Credit Opportunity Act, the Board refers violations of Regulation B that it has reason to believe constitute a ‘‘pattern or practice’’ of discrimination to the U.S. Department of Justice. During 1999 the Board reviewed nineteen potential referrals, including four carried over from 1998. All had been detected during Reserve Bank compliance examinations. Of the nineteen cases, fourteen involved possible discrimination in underwriting and the remaining five involved potential discrimination in pricing, including three instances of possible violations in setting prices of ‘‘indirect,’’ or brokered, loans.

The Board referred two of the nineteen cases to the Justice Department, and three matters were still under review at year's end. One of the two referred cases involved discrimination on the prohibited basis of marital status; the bank combined the incomes of married joint applicants for purposes of evaluating the applications, but did not do so for unmarried joint applicants. The second referral involved allegations that female and minority applicants had been charged higher rates on direct and indirect loans than had white and male applicants and that bank personnel had full knowledge of the discriminatory pricing.

During 1999, certain lending practices described as abusive, or ‘‘predatory,’’ came under increasing criticism by private and government organizations and by the media. Predatory lending generally targets—for high-cost mortgage loans—financially unsophisticated elderly, minority, and lower-income homeowners who have substantial equity in their property and possibly have experienced some credit imperfections. The practices may involve fair lending violations as well as violations of the Truth in Lending Act, the Real Estate Settlement Procedures Act, and state and federal laws prohibiting fraud and deceptive practices. In October 1999 the Federal Reserve and representatives of nine federal agencies established a working group to define practices that constitute predatory lending and to propose steps that the agencies could take to address the practices.

Risk-Focused Compliance Examinations

In January 1999 the Board implemented a risk-focused supervision program that represents a fundamental change in the way the Federal Reserve System conducts examinations for compliance with the consumer banking laws and regulations. The program tailors the examination to the individual bank under review. To focus examination resources on the areas of greatest risk to banks and their customers, the program requires an in-depth preliminary review of such things as the bank’s compliance history, new products, and management changes. Using the results of this review, the examining Reserve Bank identifies the areas of highest risk and develops an examination plan that covers all consumer compliance areas, with special emphasis on those reflecting the highest risk. The program also has outreach and monitoring components.

Both the risk-focused compliance examination procedures and the fair lending examination procedures, described in the preceding section, rely heavily on examiner judgment about the appropriate level of review and supervision for a particular bank. To determine the extent of implementation of these procedures Systemwide, and to identify best practices for implementing the risk-focused program, teams of Reserve Bank and Board staff members in 1999 conducted a review of each Reserve Bank. The findings helped in refining the examination procedures and the overall risk-focused supervision process.

The Gramm–Leach–Bliley Act

On November 12, 1999, President Clinton signed the Gramm–Leach–Bliley Act into law. Two areas covered by the act—CRA examinations and the creation of ‘‘financial holding companies’’—have implications for both the Board’s compliance examination function and its applications processing function. Among other things, the act extends the length of time between CRA examinations for financial institutions that have assets of not more than $250 million and a CRA rating of ‘‘satisfactory’’ or ‘‘outstanding.’’ With few exceptions, banks rated satisfactory for CRA performance are to be examined no more than once every forty-eight months and banks rated outstanding, no more than once every sixty months. Previously, state member banks rated satisfactory or outstanding for CRA and with satisfactory compliance ratings were examined once every twenty-four or thirty-six months.

The act also repeals those provisions of the Glass–Steagall Act of 1933 and the Bank Holding Company Act of 1956 that restricted the affiliation of bank holding companies with securities firms and insurance companies. The legislation creates ‘‘financial holding companies,’’ which may conduct a broad range of financial activities, including insurance and securities underwriting, and merchant banking. It also bars a bank holding company from becoming a financial holding company if any of its depository subsidiaries received a rating lower than satisfactory at its most recent CRA examination, and bars an existing financial holding company from taking on additional powers or making acquisitions if the CRA rating of one of its depository subsidiaries falls below satisfactory.

In addition, the act requires the federal banking agencies to issue customer-protection regulations governing the sale and marketing of insurance products by depository institutions. These regulations are to prohibit depository institutions from engaging in coercive sales practices, such as conditioning the extension of credit on the purchase of an insurance product from the institution or one of its affiliates. They are also to ensure that consumers are given disclosures clarifying that insurance products sold by a depository institution involve an investment risk and are not insured by the Federal Deposit Insurance Corporation. In addition, the act requires the federal banking agencies to establish a mechanism for addressing consumer complaints that allege violations of the regulations.

Privacy issues are also part of the act’s provisions. For example, the act requires the federal regulatory agencies to establish standards for the security, confidentiality, and integrity of customer records and information, including protection against unauthorized access. Financial institutions must notify consumers about the institution’s privacy policies and must give consumers a means of ‘‘opting out’’ of disclosures to nonaffiliated third parties. The Board is working with the other agencies to develop substantially similar regulations implementing these privacy requirements. The agencies are also working together to develop regulations implementing the act’s ‘‘sunshine’’ provisions applicable to CRA-related agreements between insured depository institutions or their affiliates and nongovernmental entities or persons. The act requires that the agencies draft rules for disclosing the agreements and rules requiring the parties to the agreements to report on them annually.

Consumer Policies

Through its consumer policies program, the Board conducts research and explores ways other than by regulation to protect consumers in the area of retail financial services. In 1999 the Board worked with other agencies, as well as with public- and private-sector organizations, to develop consumer-related educational materials.

Two significant interagency education efforts involved electronic bank accounts and mortgage shopping. New fact sheets for low- and moderate-income households on managing electronic bank accounts (scheduled for publication in March 2000) were developed to complement the U.S. Department of the Treasury’s initiatives to provide government payments electronically. Also, the consumer brochure *Looking for the Best Mortgage: Shop, Compare, Negotiate*, developd by an interagency fair lending task force, was released. By the end of 1999, more than 380,000 copies of the brochure, which identifies key considerations for persons shopping for a mortgage, had been distributed; information from the brochure is also available on the Board's public web site.

Working with a broad-based coalition of agencies and organizations from the private and public sectors, the Board also continued its initiative on vehicle leasing education. Materials developed by the leasing education team include a comprehensive computer-based program entitled *Keys to Vehicle Leasing—A Consumer Resource*, which is scheduled for release in early 2000, and a Spanish-language version of the brochure *Keys to Vehicle Leasing—A Consumer Guide*. During 1999, the Federal Reserve distributed more than 800,000 copies of the brochure and received approximately 190,000 visits to the Board's public web site.

Electronic banking and leasing were also the topics of research projects. Using data from the University of Michigan Survey Research Center's monthly Surveys of Consumers, for example, the Board analyzed consumers' credit shopping practices, leasing experiences, and attitudes toward the use of electronic banking services. Results of the research were shared with other agencies and the public through meetings, conferences, and journal articles.

Civil Money Penalty for Flood Insurance Violations

In June 1999 the Board assessed a civil money penalty against a state member bank for flood insurance violations. Without admitting to any of the allegations, the bank consented to the Board's order in connection with an alleged pattern or practice of violations of the Board's regulations implementing the National Flood Insurance Act. The order required the bank to pay a civil money penalty of $10,000. This was the first time the Board has imposed a monetary penalty for flood insurance violations.

Regulatory Matters

The Board has responsibility for implementing a wide range of federal laws concerning consumer financial services and fair lending. In August 1999, the Board took the following actions:

- Published proposed rules and official staff commentary as part of a comprehensive review of Regulation B (Equal Credit Opportunity). The Board proposed removing the general prohibition against creditors' noting characteristics such as the race, sex, and national origin of applicants for nonmortgage credit; requiring creditors to retain certain records in connection with preapproved credit solicitations; and expanding the record-retention period for most business credit applications from twelve to twenty-five months. The Board is reviewing more than 700 letters from members of Congress, local governments, community organizations, businesses, and consumers in response to the proposal.
- Issued revised proposals to permit the electronic delivery of federally mandated disclosures under five consumer protection regulations: Regulations B, E (Electronic Fund Transfers), M (Consumer Leasing), Z (Truth in Lending), and DD (Truth in Savings). The Board had received and considered more than 200 letters responding to earlier proposals issued in 1998. The revised proposals generally allow delivery of disclosures by electronic mail or other means, such as posting them on a web site, if the consumer consents. They also specify what information must be given to consumers before they consent; this

information would be provided on a standardized form. The Board has received letters from more than 100 commenters and also obtained the views of individual consumers by conducting focus group interviews.

- Issued an interim rule for deposit accounts that allows institutions to deliver Regulation DD disclosures for periodic statements electronically if the consumer agrees. The Regulation DD rule is consistent with an interim rule issued in 1998 under Regulation E, and makes it possible for institutions to deliver deposit account statements electronically under a single set of procedures.

In addition, the Board took the following regulatory actions during the year:

- Revised the official staff commentary to Regulation Z to give guidance on the rules prohibiting the issuance of unsolicited credit cards; calculating payment schedules for loans involving mortgage insurance; and disclosing credit sale transactions for which the down payment includes cash and property used as a trade-in
- Adopted revisions to the official staff commentary to Regulation M to provide guidance on disclosures for lease renegotiations and extensions, official fees and taxes, multiple-item leases, and advertisements
- Proposed revisions to the official staff commentary to Regulation Z to clarify that those cash advances commonly called ‘‘payday loans’’ are credit transactions covered by the regulation
- Adjusted the dollar amount that triggers additional disclosure requirements for certain mortgage loans under the Home Ownership and Equity Protection Act of 1994
- Increased to $30 million the exemption threshold for depository institutions required to report data under the Home Mortgage Disclosure Act.

Testimony and Legislative Recommendations

In March 1999 the Board testified before the Senate Committee on Banking, Housing, and Urban Affairs on consumer protection issues raised by the conference report on H.R. 3150, the Bankruptcy Reform Act of 1998. The Board’s testimony centered on proposed legislation in two areas—amendments to the Truth in Lending Act and requirements that the Board conduct three consumer-related studies. In general, the proposed TILA amendments involved new disclosures describing the effect of making only minimum payments on open-end credit plans. The proposed studies concerned the adequacy of existing disclosures and protections for debit cards that can be used without personal identification numbers; certain home-secured loans for which the total amount of the credit extended exceeds the fair market value of the dwelling; and specific consumer borrowing practices.

In July the Board testified on consumer financial privacy before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Services. The Board’s testimony focused on proposed legislation to place additional limitations on financial institutions’ disclosure of customer information and stressed the need for Congress to balance personal privacy concerns with economic efficiency. In addition, the testimony emphasized the need for consistency across markets to ensure that any limitations imposed on one industry, such as financial services, do not place that industry at a competitive disadvantage.

Economic Effects of the Electronic Fund Transfer Act

As required by statute, the Board monitors the effects of the Electronic Fund Transfer Act (EFTA) on the compliance costs and consumer benefits related to electronic fund transfer (EFT) services. The economic effects of the EFTA likely continued to increase in 1999 because of the continued growth of EFT services.

Results of consumer surveys indicate that during this decade the proportion of U.S. households using EFT services grew at an annual rate of about 2 percent. Approximately 85 percent of households have one or more EFT features on their accounts at financial institutions. Automated teller machines (ATMs) remain the most widely used EFT service. During 1999, the number of ATM transactions decreased somewhat, to about 907 million a month from 930 million a month in 1998, probably in part because of higher average ATM fees. Over the same period, the number of installed ATMs rose more than 20 percent, to 227,000. Direct deposit is another widely used EFT service: More than half of U.S. households have funds deposited directly into their accounts. Use of the service is particularly common in the public sector, accounting for 76 percent of social security payments and 91 percent of federal salary and retirement payments. About one-third of U.S. households have debit cards, which consumers use at merchant terminals to debit their transaction accounts. Although these point-of-sale (POS) systems still account for a fairly small share of electronic transactions, their use continued to grow rapidly in 1999. The number of POS transactions rose a third, from about 150 million a month in 1998 to 202.3 million a month in 1999, and the number of POS terminals rose 38 percent, to 2.35 million.

The incremental costs associated with the EFTA 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, as 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 EFT at present. (See “Agency Reports on Compliance with Consumer Regulations.”)

Compliance Activities

The Federal Reserve System’s compliance activities in 1999 included conducting and overseeing examinations of state member banks, training System compliance examiners, and participating in the compliance activities of the Federal Financial Institutions Examination Council (FFIEC). As noted in earlier sections, the System also worked to develop and implement new risk-focused examination procedures.

Compliance Examinations

Since 1977 the Federal Reserve System’s compliance examination program has ensured that state member banks and foreign banking organizations subject to Federal Reserve examination comply with federal laws protecting consumers in the provision of financial services. During the 1999 reporting period (July 1, 1998, through June 30, 1999), the Federal Reserve conducted 487 examinations for compliance with consumer protection laws: 344 examinations of state member banks and 143 of foreign banking organizations.[1]

Examiner Training

Examiners well versed in the consumer protection laws, fair lending laws, and the Community Reinvestment Act (CRA) are essential to the Board's compliance program. Therefore, the type and timeliness of training opportunities are important. New Reserve Bank examiners attend a two-week basic compliance course; and examiners with six to twelve months of field experience attend a two-week advanced course, a two-week course in techniques for fair lending examinations, and a one-week course in CRA examination techniques. During the 1999 reporting period, eleven sessions attended by a total of 197 individuals were held—two sessions of the basic compliance course, two of the advanced compliance course, four in fair lending examination techniques, and three in CRA examination techniques.

Participation in FFIEC Activities

Through the cooperation of its five member agencies—the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA)—the Federal Financial Institutions Examination Council develops uniform examination principles, standards, and report forms. In 1999 the member agencies continued working to improve coordination of consumer compliance and CRA examination activities. Actions to promote uniformity among the federal supervisors of financial institutions included issuing new interagency fair lending examination procedures; amending Interagency Questions and Answers for the CRA; revising the Interagency Questions and Answers on the Policy Guide on Administrative Enforcement of the Truth in Lending Act; and approving interagency examination procedures for the Fair Credit Reporting Act. The FFIEC is currently developing interagency examination procedures for the Homeowners Protection Act of 1998, which requires that lenders or servicers provide information on private mortgage insurance on loans secured by the consumer's primary residence.

Agency Reports on Compliance with Consumer Regulations

The Board is required to report annually on compliance with Regulation B (which implements the Equal Credit Opportunity Act, ECOA); Regulation E (Electronic Fund Transfer Act, EFTA); Regulation M (Consumer Leasing Act, CLA); Regulation Z (Truth in Lending Act, TILA); Regulation CC (Expedited Funds Availability Act, EFTA); Regulation DD (Truth in Savings Act, TISA); and Regulation AA (Unfair or Deceptive Acts or Practices Act). The Board assembles compliance data from the Reserve Banks and also collects data from the FFIEC agencies and from other federal supervisory agencies.[2]

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[1] 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, compared with state member banks, they engage in relatively few activities that are covered by consumer protection laws.

[2] The agencies use different methods to compile compliance data. Accordingly, the data—which are presented here in terms of percentages of financial institutions supervised or examined—support only general conclusions.

A summary of the reported compliance data for the 1999 reporting period (July 1, 1998, through June 30, 1999) follows. In general, the overall level of compliance in 1999 was similar to that in 1998. As in past years, the level of compliance varied considerably from regulation to regulation.

Regulation B (Equal Credit Opportunity)

The FFIEC agencies reported that 78 percent of the institutions examined during the 1999 reporting period were in compliance with Regulation B, compared with 79 percent for the 1998 reporting period. Of the institutions not in compliance, 68 percent had one to five violations. The most frequent violations involved the 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 under Regulation B, and the name and address of the federal agency that enforces compliance
- Collect information for monitoring purposes about the race or national origin, sex, marital status, and age of 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
- Provide a statement of reasons for credit denial or other adverse action that is specific and indicates the principal reasons for the credit denial or other adverse action
- Take a written credit application for the purchase or refinancing of a principal residence
- Refrain from requesting the race, color, religion, national origin, or sex of an applicant in transactions not covered by the data collection requirements.

The OTS issued three formal enforcement actions that contained provisions relating to Regulation B.

The Federal Trade Commission (FTC) obtained consent decrees against two vehicle finance companies for violations of the ECOA. The violations included, among others, providing inadequate notices of adverse action to loan applicants and discriminating against applicants on the basis of sex, marital status, or the fact that an applicant's income derived from public assistance sources. Under the consent decrees, the defendants agreed to civil money penalties and to the entry of a permanent injunction.

The FTC also continued litigation against a mortgage lender for violations of the ECOA. The allegations included, among others, failing to take written applications for mortgage loans, failing to collect monitoring information on mortgage loan applicants, and providing inadequate notices of adverse action to loan applicants. The FTC is seeking civil money penalties and injunctive relief in connection with the case.

The FTC is continuing its work with other government agencies and with creditor and consumer organizations to increase awareness of and compliance with the ECOA.

The other agencies that enforce the ECOA—the Farm Credit Administration (FCA), the Department of Transportation (DOT), the Securities and Exchange Commission (SEC), 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 certain violations of the ECOA, most of them due to creditors' failure to collect information for monitoring purposes and to comply with rules regarding adverse action notices; however, no formal actions were initiated.

Regulation E (Electronic Fund Transfers)

The FFIEC agencies reported that approximately 95 percent of the institutions examined during the 1999 reporting period were in compliance with Regulation E, compared with 96 percent for the 1998 reporting period. Financial institutions most frequently failed to comply with the following requirements:

- Investigate an alleged error promptly after receiving a notice of error
- Determine whether an error was actually made, and transmit the results of the investigation and determination to the consumer within ten business days
- Provide customers with a periodic statement of all required information at least quarterly (or monthly, if an electronic funds transfer occurred).

The OTS issued two formal enforcement actions that contained provisions relating to Regulation E.

The FTC issued a brochure, "Guide to Online Payments," that gives consumers information about different types of online payment systems and security features. The SEC reported that no violations of Regulation E were detected in examinations of registered broker–dealers conducted by self-regulatory organizations.

Regulation M (Consumer Leasing)

The FFIEC agencies reported substantial compliance with Regulation M for the 1999 reporting period. As in 1998, more than 99 percent of the institutions examined were in compliance. The few violations noted involved failure to adhere to specific disclosure requirements.

The FTC issued one consent decree against a vehicle manufacturer and one consent decree against two related vehicle dealerships and their owner. These decrees, which provided for civil penalties and other relief for allegedly deceptive lease or credit advertising, involved the failure to disclose important lease or credit terms clearly and conspicuously, in violation of the CLA or the TILA. The FCA reported that it identified no violations of the CLA during its examinations.

Regulation Z (Truth in Lending)

The FFIEC agencies reported that 74 percent of the institutions examined during the 1999 reporting period were in compliance with Regulation Z, the same percentage as in 1998. The Board and the FDIC reported an increase in compliance, the OTS and the NCUA reported a decrease, and the OCC reported an unchanged level of compliance. The FFIEC agencies indicated that of the institutions not in compliance, 63 percent were in the lowest-frequency category (one to five violations), compared with 62 percent in 1998. The violations of Regulation Z most often observed were failure to take these actions:

- Accurately disclose the finance charge, payment schedule, annual per-

centage rate, security interest in collateral, and amount financed
- Accurately itemize the amount financed upon request
- Provide disclosures within three business days of application for RESPA-related residential mortgage applications
- Redisclose the annual percentage rate when a change occurred before consummation or settlement
- Withhold loan funds until the end of the rescission period
- Ensure that disclosures reflect the terms of the legal obligation between the parties.

The OTS issued three formal enforcement actions subject to provisions of Regulation Z. Altogether, a total of 342 institutions supervised by the Federal Reserve, the FDIC, or the OTS were required, under the Interagency Enforcement Policy on Regulation Z, to refund $2.1 million to consumers in 1999 because of improper disclosures.

The FTC obtained consent judgments against seven subprime lenders and their owners for alleged violations of the Home Ownership and Equity Protection Act and the TILA. That agency also issued a final decision and order against a nationwide mortgage company for violating the TILA. This judgment involved allegedly deceptive cost information and practices. In addition, the FTC continued to litigate a complaint it had filed in federal district court in 1998. The complaint charged a mortgage lender in the Washington, D.C., area and its owner with violating the TILA in connection with alleged deceptive and unfair practices in home mortgage lending. As previously discussed under Regulation M, the FTC also issued a consent decree against two vehicle dealerships and their owner for violation of the CLA and the TILA.

In response to concerns about home equity fraud, the FTC issued ‘‘Need a Loan? Think Twice about Using Your Home as Collateral,’’ a consumer publication that provides information to consumers considering home equity loans. In addition, the FTC continued to participate in interagency efforts to educate consumers.

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 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 DOT is currently in negotiations to settle this litigation.

Regulation AA (Unfair or Deceptive Acts or Practices)

The three bank regulators with responsibility for enforcing Regulation AA’s Credit Practices Rule—the Federal Reserve, the OCC, and the FDIC—reported that 98 percent of the institutions examined during the 1999 reporting period were in compliance. The most frequent violation was failure to provide a clear, conspicuous disclosure regarding a cosigner’s liability for a debt. No formal enforcement actions for violations of the regulation were issued during the period.

Regulation CC (Availability of Funds and Collection of Checks)

The FFIEC agencies reported that 91 percent of institutions examined during the 1999 reporting period were in compliance with Regulation CC, compared with 89 percent for the 1998 reporting period. Of the institutions not in compliance, 66 percent had one to five violations. Institutions most frequently failed to comply with the following requirements:

- Follow special procedures for large-dollar deposits
- Provide immediate availability of amounts up to $100, for deposits not subject to next-day availability
- Make funds from certain checks, both local and nonlocal, available for withdrawal within the times prescribed by the regulation
- Provide exception notices about funds availability, including all required information.

The OTS issued two formal enforcement actions that contained provisions relating to Regulation CC.

Regulation DD (Truth in Savings)

The FFIEC agencies reported that 87 percent of institutions examined during the 1999 reporting period were in full compliance with Regulation DD. Institutions most frequently failed to comply with the following requirements:

- State the rate of return as an annual percentage yield in an advertisement
- Provide appropriate maturity notices for certificates of deposit maturing in more than one year
- State required additional information in advertisements containing the annual percentage yield
- Provide all applicable information on account disclosures. Community Reinvestment Act

Community Reinvestment Act

The Federal Reserve assesses the Community Reinvestment Act (CRA) performance of state member banks during regular compliance examinations. In addition, the Board considers CRA ratings (as well as other factors) when acting on applications from state member banks and bank holding companies for mergers, acquisitions, and certain other actions. The Federal Reserve has a three-faceted program for fostering better bank performance under the CRA. The program includes the following:

- Examining institutions to assess compliance with the CRA
- Disseminating information on community development techniques to bankers and the public through Community Affairs Offices at the Reserve Banks
- Performing CRA analyses in connection with applications from banks and bank holding companies.

During the 1999 reporting period, the Federal Reserve conducted 338 CRA examinations. Of the banks examined, 63 were rated outstanding in meeting community credit needs, 269 were rated satisfactory, 4 were rated needs to improve, and 2 were rated as being in substantial noncompliance.

Applications

During 1999, the number of megamergers declined considerably from the previous year. Still, the Board of Governors considered applications for several very large banking mergers.

- In May the Board approved the application by Deutsche Bank, Frankfurt, Germany, to acquire Bankers Trust Corporation, New York, New York, a transaction creating the largest commercial banking organization in the world.

- In September the Board approved the application by Fleet Financial Group, Inc., to acquire BankBoston Corporation, both of Boston, Massachusetts. Because of the considerable public interest in the proposal, the Board held a public meeting to give interested persons a chance to present oral testimony.
- In December the Board approved the application by HSBC Holdings plc, London, England, to acquire Republic New York Corporation, New York, New York. HSBC was the eighth largest banking organization in the world and Republic was the nineteenth largest commercial banking organization in the United States at the time of the application.
- Also in December the Board approved the application by First Security Corporation to acquire Zions Bancorporation, both of Salt Lake City, Utah. Had the transaction been consummated, it would have created the twenty-fourth largest commercial banking organization in the nation.

In each of these applications, the Board found that the CRA records of the organizations involved were consistent with approval. In two of the three cases involving anticipated branch closures (Fleet and First Security), the Board required that the merged organizations report, for a two-year period, all branch closings and consolidations occurring as a result of the mergers.

In addition to these large transactions, the Federal Reserve System in 1999 acted on ten bank and bank holding company applications that involved protests by members of the public concerning insured depository institutions' performance under the CRA and acted on two applications that involved depository institutions having less than satisfactory CRA ratings. The Federal Reserve reviewed another twenty-nine applications involving fair lending and other issues related to compliance with consumer protection laws.[3]

HMDA Data and Mortgage Lending Patterns

The Home Mortgage Disclosure Act requires mortgage lenders covered by the act to collect and make public certain data about their home purchase, home improvement, and refinancing loan transactions. Depository institutions generally are covered if they were located in metropolitan areas and met the asset threshold at the end of the preceding year; the asset threshold for the data reported in 1999 was $29 million. Mortgage companies are covered if they were located in or made loans in metropolitan areas and had assets of more than $10 million (when combined with the assets of any parent company) at the end of the preceding year. These entities are also covered, regardless of asset size, if they originated 100 or more home purchase loans in the preceding year.

In 1999, 6,707 depository institutions and affiliated mortgage companies and 1,130 independent mortgage companies reported to their supervisory agencies HMDA data for calendar year 1998. These lenders submitted information about the geographic location of the properties related to their loans and applications, the disposition of loan applications, and, in most cases, the race or national origin, income, and sex of applicants and borrowers. The Federal Financial Institutions Examination Council processed the data and pro-

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[3] In addition, one application (involving a CRA protest) was withdrawn in 1999.

duced disclosure statements on behalf of the U.S. Department of Housing and Urban Development and the FFIEC member agencies.

Individual disclosure statements are prepared for each lender that reported data—one statement for each metropolitan area in which the lender had offices and reported loan activity; in 1999 the FFIEC prepared 57,294 statements based on the 1998 data. In July, each institution made its disclosure statement public, and reports containing aggregate data for all lenders in a given metropolitan area were made available at central depositories in the nation's approximately 330 metropolitan areas. These data are used not only by the FFIEC member agencies, the reporting institutions, and the public, but also by HUD in its oversight of Fannie Mae and Freddie Mac and by HUD and the Department of Justice as one component of fair lending reviews. The data also assist HUD, the Department of Justice, and state and local agencies in responding to allegations of lending discrimination and in targeting lenders for further inquiry.[4]

The data reported in 1999 for the preceding year covered 24.7 million loans and applications, an increase of about 51 percent over 1998 that was due primarily to increased refinancing activity. The number of home purchase loans extended in 1998 compared with 1997 increased 13 percent for Asians and whites, 9 percent for blacks, 16 percent for Hispanics, and 21 percent for Native Americans. Over the six years 1993 through 1998, the number of home purchase loans extended increased 46 percent for Asians, 72 percent for blacks, 87 percent for Hispanics, 52 percent for Native Americans, and 31 percent for whites.

The number of home purchase loans extended to applicants in all income categories increased in 1998 compared with the preceding year. The number of such loans extended to lower-income applicants increased 19 percent, and the number extended to upper-income applicants increased 14 percent. Over the six years 1993 through 1998, the number of home purchase loans extended to lower-income and upper-income applicants increased 64 percent and 45 percent respectively.

In 1998, 31 percent of Hispanic applicants and 23 percent of black applicants for home purchase loans sought government-backed mortgages; the comparable figures for white, Asian, and Native American applicants were 14 percent, 10 percent, and 12 percent respectively. Twenty-four percent of lower-income applicants for home purchase loans, compared with 10 percent of upper-income applicants, applied for government-backed loans in 1998.

Denial rates for conventional (non-government-backed) home purchase loans in 1998 were 12 percent for Asian applicants, 54 percent for black applicants, 39 percent for Hispanic applicants, 53 percent for Native American applicants, and 26 percent for white applicants. Except for Asian applicants, each of these rates exceeded, by a small measure, the comparable rate for 1997.

Overall, the denial rate for conventional loans was 29 percent in 1998. This rate has increased in each of the past several years, reflecting in part the increasing share of applications for conventional loans filed by lower-income applicants. The increase in denial rates also reflects the growing share of applications reported under HMDA that are filed with lenders that specialize in

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[4] On behalf of the nation's eight active private mortgage insurance (PMI) companies, the FFIEC also compiles information on applications for PMI similar to the information on home mortgage lending collected under HMDA. Lenders typically require PMI for conventional mortgages that involve small down payments.

manufactured home and subprime lending.[5] In 1998, these 260 lenders denied 55 percent of all applications for conventional home purchase loans they received, compared with 16 percent for other lenders. If the activities of these specialty lenders are excluded from the calculations, denial rates for the remaining institutions show little change since 1993.

Consumer Complaints

The Federal Reserve investigates complaints against state member banks and forwards to the appropriate enforcement agencies complaints that involve other creditors and businesses (see table). The Federal Reserve also monitors and analyzes complaints about unregulated practices.

In 1999 the Board implemented a new PC-based database system, CAESAR (Complaint Analysis Evaluation System and Reports). For both the Board and the Reserve Banks, CAESAR facilitates access to information on the status and resolution of complaints and inquiries as well as any supervisory actions taken as a result of complaint investigations. It also facilitates analysis of the type of discrimination complaints received, and produces reports used to identify patterns and trends in complaints and inquiries.

During 1999, the Board also revised its *Consumer Complaint Manual.* The revised manual includes updated policies and procedures for the Systemwide consumer complaint program, a new chapter on Board evaluation of Reserve Bank complaint program performance, a checklist for Reserve Banks to use when investigating complaints alleging illegal credit discrimination, and information about CAESAR.

Complaints against State Member Banks

In 1999 the Federal Reserve received a total of 4,697 complaints—3,782 by mail, 885 by telephone, and 30 in

Consumer Complaints against State Member Banks and Other Institutions Received by the Federal Reserve System, 1999

Subject	State member banks	Other institutions[1]	Total
Regulation B (Equal Credit Opportunity)	70	43	113
Regulation E (Electronic Fund Transfers)	34	69	103
Regulation M (Consumer Leasing)	23	22	45
Regulation Q (Payment of Interest)	1	0	1
Regulation Z (Truth in Lending)	375	531	906
Regulation BB (Community Reinvestment)	3	3	6
Regulation CC (Expedited Funds Availability)	19	47	66
Regulation DD (Truth in Savings)	48	54	102
Fair Credit Reporting Act	110	314	424
Fair Debt Collection Practices Act	10	21	31
Fair Housing Act	0	0	0
Flood insurance	2	3	5
Regulations T, U, and X	0	1	1
Real Estate Settlement Procedures Act	6	45	51
Unregulated practices	1,278	1,565	2,843
Total	**1,979**	**2,718**	**4,697**

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

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[5] See Glenn B. Canner and Wayne Passmore, “The Role of Specialized Lenders in Extending Mortgages to Lower-Income and Minority Homebuyers,” *Federal Reserve Bulletin*, vol. 85 (November 1999), pp. 709–23.

Consumer Complaints Received by the Federal Reserve System,
by Subject of Complaint, 1999

Subject of complaint	Complaints against state member banks					
	Total		Not investigated		Investigated	
					Bank legally correct	
	Number	Percent	Unable to obtain sufficient information from consumer	Explanation of law provided to consumer	No reimbursement or other accommodation	Goodwill reimbursement or other accommodation
Loans						
Discrimination alleged						
Real estate loans	18	1	0	1	8	0
Credit cards	31	1	3	2	8	4
Other loans	21	1	1	3	8	1
Other type of complaint						
Real estate loans	153	8	4	26	39	25
Credit cards	996	50	27	81	173	475
Other loans	214	11	7	57	69	25
Deposits	394	20	11	101	94	65
Electronic fund transfers	34	2	0	6	8	2
Trust services	22	1	3	6	7	1
Other	96	5	15	10	11	15
Total	**1,979**	**100**	**71**	**293**	**425**	**613**

person. Of the complaints, 1,979 were against state member banks (see tables). Of the complaints against state member banks, about 75 percent involved loan functions: 3 percent alleged discrimination on a prohibited basis, and 69 percent addressed a variety of other practices, such as credit denial on a basis not prohibited by law (credit history or length of residence, for example) and miscellaneous other practices (release or use of credit information, for example). Another 20 percent of the complaints involved disputes about interest on deposits and general deposit account practices; the remaining 8 percent concerned disputes about electronic fund transfers, trust services, or other practices.

During 1999, investigations were also completed in connection with 159 state member bank complaints pending at year-end 1998. Investigations revealed that in the vast majority of the cases, the banks were legally correct. Notwithstanding, in nearly half of these cases the banks chose to reimburse or otherwise accommodate the consumer. Only two of these complaints concerned violations of regulations.

The Federal Reserve also received more than 2,000 inquiries about consumer credit and banking policies and practices. In responding to these inquiries, the Board and the Federal 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 continued to monitor complaints about banking practices that are not subject

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 courts	Possible bank violation—bank took corrective action	Matter in litigation			
0	0	0	0	0	9	28	46
0	1	1	0	1	11	9	40
0	0	1	0	0	7	6	27
4	36	10	1	0	8	383	536
3	121	16	1	0	99	953	1,949
0	36	2	1	3	14	283	497
3	64	13	0	13	30	621	1,015
0	6	3	1	1	7	69	103
0	1	1	0	0	3	30	52
1	21	4	0	1	18	336	432
11	**286**	**51**	**4**	**19**	**206**	**2,718**	**4,697**

to existing regulations and to focus on those that concern possibly unfair or deceptive practices. Of the 2,843 complaints about unregulated practices received in 1999, four of the five categories that received the most complaints involved credit cards: miscellaneous problems involving credit cards (216 complaints); penalty charges on accounts (159); customer service problems (115); and interest rates and terms (113). Among the issues raised by the customer service complaints were the failure to close accounts as requested; the failure to provide account information; and the imposition of an annual fee after an account was closed. The remaining category, miscellaneous unregulated practices (167 complaints), covered a wide range of issues, including check-cashing problems and release of liens. Each of these five complaint categories accounted for a small portion (5 percent or less) of all consumer complaints received.

Complaint Referrals to HUD

The Federal Reserve in 1999 continued to refer to the Department of Housing and Urban Development complaints alleging violations of the Fair Housing Act, in accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies. Nine such complaints about state member banks were referred during the year. Investigations of seven of the nine revealed no evidence of illegal discrimination; the remaining complaints were pending at year-end. ■

Banking Supervision and Regulation

The U.S. banking system reported strong performance in 1999, as earnings continued to set new records, capital ratios rose, and problem assets increased only moderately from below-average levels. That performance was achieved as the U.S. economy continued to expand at a strong pace and emerging-market economies that had experienced considerable turmoil in the preceding year stabilized. Fee and other noninterest revenues grew at a faster pace than bank balance sheets, with banks relying to a greater extent on revenues from trust, securitization, loan servicing, asset management, trading, venture capital, and other activities. Growth of noninterest revenues made up for flat, and in some cases narrowing, interest margins that reflected the industry's growing reliance on wholesale sources of funds as well as the gradual decline of lower-cost, retail deposits. At the same time, provisioning for credit losses declined and noninterest expenses moderated, resulting in stronger operating earnings.

The rapid pace of industry consolidation among the largest firms subsided somewhat during 1999 as many firms prepared for the century date change and worked to digest the significant mergers already undertaken. Competition among banking firms remained intense, amid signs that loan terms and conditions were continuing to weaken and that banking organizations were extending credit to some borrowers largely on the expectation that the borrower's current strong financial performance would continue indefinitely. Federal Reserve supervisory staff identified several instances in which meaningful stress-testing had not been performed. These trends prompted the issuance of guidance to Federal Reserve examiners and the industry regarding the potential consequences of banks departing from accepted sound lending standards. The rise in adverse examiner classifications over the year provided some evidence that such weakening standards were affecting credit-quality conditions and raised questions about the greater vulnerability of weakly underwritten credits if economic conditions were to deteriorate.

The final year of the 1990s witnessed two significant legislative and regulatory events: (1) modernization of the U.S. financial system through the Gramm–Leach–Bliley Act, which repealed depression-era banking laws and provides for the affiliation of banks with securities and insurance firms within financial holding companies, and (2) the first steps toward a comprehensive revision of the 1988 Basel Capital Accord. Under the financial modernization act, the Federal Reserve will play an important role as umbrella supervisor of financial holding companies. To a great extent, the Federal Reserve will rely on information and analysis provided by functional regulators of the bank and securities or insurance firms. The focus of the Federal Reserve's review will be the holding company's risk profile and managerial strength on a fully consolidated basis, with emphasis on whether any weaknesses might adversely affect the insured depository institution.

While U.S. lawmakers were modernizing banking laws, the Basel Committee on Banking Supervision announced that it would modernize international capital standards by undertaking the

The Implications of Financial Modernization Legislation for Bank Supervision

> *Now the financial services industry faces the challenge of how best to take advantage of the new opportunities provided by the financial modernization law, and their regulators face the challenge of implementing the framework for regulating and supervising the more diversified financial holding companies allowed under the new legislation.*
>
> Laurence H. Meyer, *Member*, Board of Governors

The Gramm–Leach–Bliley Act, signed by the President in November 1999, provides long-needed reform of the U.S. financial regulatory system. It permits traditional bank holding companies and foreign banks to expand into new insurance and securities activities, and insurance and securities firms to enter commercial banking. Moreover, it does so in a relatively expeditious way, avoiding many regulatory procedures that would have been required in the past. (For a description of the act's provisions, see the section on the Bank Holding Company Act in this chapter and also the chapter "Federal Legislative Developments.")

The Gramm–Leach–Bliley Act, along with the implementing regulations and associated supervisory policies, promises to transform the U.S. financial system. By validating affiliations between banks and diversified financial services firms, through "financial holding companies," the legislation should improve the competitiveness and efficiency of financial markets and provide a broader array of financial products to consumers. With the flexibility it introduces—together with the workings of time, technology, and innovation—world financial markets and institutions undoubtedly will look much different a decade from now than they do today. Whether the new landscape will be fruitful for institutions and consumers depends a great deal on how well government develops regula-

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first wholesale review of the Basel Capital Accord. The committee's consultative document called for comment on a revised capital framework that would rely on three pillars: (1) capital standards that better align minimum requirements with the actual level of bank risk-taking, (2) supervisory review of a banking organization's positions and risk management capabilities as well as their effect on capital adequacy, and (3) improved market discipline of bank risk-taking activities through greater disclosure of risk positions and capital.

Federal Reserve staff members are involved in this review. In particular, they are exploring the use of bank internal risk grades in setting minimum requirements for credit risk. Staff are also exploring techniques for applying capital charges for operating risk and for interest rate risk when institutions take on significantly high levels of interest rate risk, so called "outliers." Work is also under way in connection with the supervisory component of the framework (the second pillar) as well as the disclosure elements of the third pillar. Development and implementation of tions and industry defines new strategies for competing effectively in the years ahead.

The Federal Reserve's challenge will be to avoid extending the federal safety net to more institutions as it constructs supervisory and regulatory policies under financial reform. The federal safety net gives banks the special benefits of access to federal deposit insurance and to the Federal Reserve's clearing process and discount window. Extending that access could result in relaxed market discipline and could thereby expose U.S. taxpayers to the kind of dangers experienced more than a decade ago during the savings and loan crisis.

The Federal Reserve has sought to address the risks associated with any extension of the safety net by separating the conduct of new activities as much as reasonably possible from insured depositories and by providing a framework for adequate supervision of financial holding companies. Such efforts will contribute to the market discipline necessary to make supervision most effective.

Determining the right mix of active government oversight and market discipline has become more difficult as financial markets and institutions have grown larger and more complex. In fulfilling its role as umbrella supervisor, the Federal Reserve must look across the entire financial holding company to adequately assess its risk-management process and its financial condition. Fortunately, the diversification that comes with the greater size and range of activities of today's large financial institutions has improved these firms' ability to withstand shocks and has probably reduced the likelihood that one or more of them will fail. At the same time, the larger size of these institutions means greater damage to the entire financial system should just one of them fail.

Financial institutions and their regulators must remain flexible and innovative in dealing with rapidly changing markets and financial products. Large banking organizations and financial holding companies, in particular, must be willing to meet high standards of soundness and disclosure and improve their ability to assess risk in step with the burgeoning complexity of the marketplace. The potential benefits from financial reform should be substantial, but they will be so only if both government and industry work together to keep the system sound.

this challenging initiative is expected to take a considerable amount of time.

To ensure that its supervisory program adequately takes account of the risks assumed by more complex organizations that undertake innovative activities, the Federal Reserve has increasingly relied on information and analysis provided by banks' own risk-management systems for evaluating capital adequacy. After identifying areas in which the organizations' practices could be improved, the Federal Reserve has issued guidance on sound practices for evaluating capital adequacy. The guidance to larger institutions with complex risk profiles enumerated the fundamental elements of a sound internal capital-adequacy analysis and encouraged the institutions to strengthen their risk-measurement capabilities as well as to integrate these capabilities more fully into evaluations of their own capital adequacy.

The Federal Reserve's approach to assessing capital adequacy is an important aspect of a program for large, complex banking organizations (LCBOs) that was formalized during 1999. That program involves more continuous, risk-focused supervisory oversight of these institutions as well as greater use of horizontal comparative analysis of these companies' business lines and other activities. This approach to supervision is intended not only to improve the Federal Reserve's hands-on knowledge of these organizations but also to improve its ability to identify sound practices. The program will be supported by improved information technology that will provide supervisory staff and examiners with more up-to-date information on and analysis of banking organizations and will facilitate the sharing and coordination of information among the banking agencies and other authorities. The Federal Reserve's approach to LCBOs and the supporting technology will be a solid foundation for efforts to supervise financial holding companies, which require more continuous information and greater collaboration among authorities.

Another area of note during 1999 was the culmination of the Federal Reserve's multiyear effort to ensure that U.S. banks recognized their responsibility to be prepared for the century date change. During the rollover period, only minor problems were reported domestically and abroad. Potentially large costs to the financial system and the public were avoided because of these efforts and the work of domestic and international banking regulators, and the banks themselves, to ensure a smooth transition to the year 2000.

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, certain securities law provisions applicable to banks, and consumer and civil rights laws.[1] In examining these activities it relies to the greatest extent possible on reports and information provided by the functional regulator of the activities, if other than the Federal Reserve.

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 organizations in the United States.

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

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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 and civil rights laws. To carry out this responsibility, the Federal Reserve trains a number of its bank examiners to evaluate institutions with regard to such compliance. The chapter of this REPORT covering consumer and community affairs describes these regulatory responsibilities.

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, branches and agencies of foreign banks, Edge Act corporations, and agreement corporations; it conducts *inspections* of holding companies and their nonbank subsidiaries, as many aspects of the reviews at bank holding companies and their nonbank subsidiaries differ from bank examinations. Pre-examination planning and on-site review of operations are integral parts of ensuring the safety and soundness of financial institutions. In both examinations and inspections, 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 regulations.

State Member Banks

At the end of 1999, 1,010 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented about 11.8 percent of all insured U.S. commercial banks and held about 23.5 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. For most of these banks, a full-scope, on-site examination is required at least once a year; certain well-capitalized, well-managed institutions having assets of less than $250 million may be examined every eighteen months.

During 1999, the Federal Reserve Banks conducted 517 examinations of state member banks (some of them jointly with the state agencies), and state banking departments conducted 248 independent examinations of state member banks.

Bank Holding Companies

At year-end 1999, the number of U.S. bank holding companies totaled 5,941. These organizations controlled 6,774 insured commercial banks and held approximately 95 percent of all insured commercial bank assets.

Federal Reserve guidelines call for annual inspection of large bank holding companies as well as smaller companies that have significant nonbank assets. In judging the financial condition of subsidiary banks, Federal Reserve examiners consult the examination reports of the federal and state banking authorities that have primary responsibility for the supervision of these banks, thereby minimizing duplication of effort and reducing the burden on banking organizations. In 1999, Federal Reserve examiners conducted 1,427 bank holding company inspections, of which 980 were on site and 447 were off site, and state examiners conducted 70 independent inspections. These inspections were conducted at 1,218 bank holding companies.

Small, noncomplex bank holding companies—those that have less than $1 billion in consolidated assets, do not have debt outstanding to the public, and do not engage in significant nonbank activities—are subject to a special supervisory program that became effective in 1997. The program permits a more flexible approach to supervising those entities in a risk-focused environment and is designed to improve the overall effectiveness and efficiency of the Federal Reserve's bank supervisory efforts. Each such holding company is subject to off-site review once during each supervisory cycle, which corresponds to the mandated examination cycle for the company's lead bank. In 1999, the Federal Reserve conducted 2,058 reviews of these companies.

Specialized Examinations

The Federal Reserve conducts specialized examinations of banking organizations in the areas of information technology; fiduciary activities; transfer agent activities; government and municipal securities broker and dealer activities; and securities underwriting and dealing through so-called section 20 subsidiaries of bank holding companies. As part of the technology review, examiners in 1999 also conducted targeted reviews of preparedness for the century date change.

Information Technology

The Federal Reserve examines the information technology activities of state member banks, U.S. branches and agencies of foreign banks, Edge Act and agreement corporations, and independent data centers that provide electronic data processing services to these institutions. These examinations are conducted in recognition of the importance of information technology to the financial services industry and help ensure that banking organizations conduct their operations in a safe and sound manner. During 1999, the Federal Reserve conducted 178 examinations that focused on the safety and soundness of information technology and electronic data processing systems. The Federal Reserve was also the lead agency in four examinations of large, multiregional data processing servicers examined in cooperation with the other federal banking agencies.

Year 2000 Compliance

The Federal Reserve conducted reviews of the Year 2000 readiness of supervised institutions. These focused on the successful completion of testing and implementation of mission-critical systems by June 30, 1999, and the progress being made by those that were unable to meet that target. In much of the second half of the year, the focus was on the completion of contingency plans for business resumption and event management at the century rollover.

When necessary, supervisors initiated enforcement actions against individual institutions. The severity of the actions was scaled to the severity of the Year 2000 problems faced by the institution. In the most serious cases, the actions were made public so that affected consumers and counterparties could evaluate their own actions relative to the institution's problems.

Fiduciary Activities

The Federal Reserve has supervisory responsibility for institutions that together hold more than $12 trillion of assets in various fiduciary capacities. During on-site examination of an institution's fiduciary activities, examiners evaluate the institution's management and operations, including its asset and account management, risk management, and audit and control procedures, and review its compliance with laws, regulations, general fiduciary principles, and potential conflicts of interest. In 1999, Federal Reserve examiners conducted 191 on-site examinations of fiduciary activities.

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 transfer agent operations and compliance with relevant securities regulations. During 1999 Federal Reserve examiners conducted on-site examinations at 44 of the 127 state member banks and bank holding companies that were registered as transfer agents.

Also during the year the Federal Reserve examined one state-member limited-purpose trust company that acted as a national securities depository to ensure the safety and soundness of its operations and its compliance with applicable laws and regulations.

Government and Municipal Securities Dealers and Brokers

The Federal Reserve is responsible for examining the government securities dealer and broker activities of state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with Department of the Treasury regulations. Thirty-eight state member banks and eight state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 1999 the Federal Reserve conducted twelve examinations of broker–dealer activities in government securities at these institutions.

Under the Securities Act Amendments of 1975, the Federal Reserve is also responsible for the supervision of state member banks and bank holding companies that act as municipal securities dealers. The Federal Reserve supervises thirty-two banks that act as municipal securities dealers. In 1999, ten of these institutions were examined.

Securities Subsidiaries of Bank Holding Companies

Before enactment of the Gramm–Leach–Bliley Act, all subsidiaries of bank holding companies established pursuant to section 20 of the Banking Act of 1933 (so-called section 20 firms or subsidiaries) were required to conduct business subject to uniform operating standards, consistent with safe and sound operations. To ensure that section 20 firms were not engaged principally in underwriting and dealing in securities, the Board limited revenues derived from such activities to less than 25 percent of the total revenues of the section 20 subsidiary.

At year-end 1999, forty-five bank holding companies and foreign banking organizations owned a total of fifty-two section 20 subsidiaries authorized to underwrite and deal in ineligible securities; largely because of mergers and acquisitions, seven of these institutions owned more than one section 20 subsidiary. Of the fifty-two authorized section 20 subsidiaries, forty-four were permitted to underwrite any debt or equity security, three were permitted to underwrite any debt security, and five were permitted to underwrite only the limited types of debt securities first approved by the Board in 1987. The Federal Reserve follows specialized inspection procedures to review the operations of these securities subsidiaries; it conducted fifty such inspections in 1999.

The section 20 inspection program is currently being revised in light of the provisions of the Gramm–Leach–Bliley Act.

Enforcement Actions, Civil Money Penalties, and Suspicious Activity Reporting

In 1999 the Federal Reserve Banks recommended, and members of the Board's staff initiated and worked on, twenty-seven enforcement cases involving fifty-one separate actions, such as cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalties.

In other significant matters, the Board of Governors assessed civil money penalties totaling more than $595,000. The Board also terminated all outstanding enforcement actions related to Year 2000 deficiencies because the affected organizations had taken appropriate actions to address the deficiencies.

All final enforcement orders issued by the Board of Governors and all written agreements executed by the Federal Reserve Banks in 1999 are available to the public and can be accessed from the Board's public web site.

In addition to formal enforcement actions, the Federal Reserve Banks in 1999 completed 107 informal enforcement actions, such as memorandums of understanding and board resolutions.

Risk-Focused Supervision

Over the past several years the Federal Reserve has initiated a number of 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 their risks.

Risk-Focused Supervision of Community Banks

The risk-focused supervision program for community banks emphasizes that certain elements are key to the risk-focused supervision process. These elements include adequate planning time, 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 of the examination.

Risk-Focused Supervision of Large, Complex Banking Organizations

Large, complex banking organizations are supervised under the Federal Reserve's Framework for Risk-Focused Supervision of Large, Complex Financial Institutions. In 1999, more-specific guidance on the applicability of this program to the larger and more complex banking organizations was developed. The key features of the LCBO supervision program are (1) identifying those LCBOs that, based on their shared risk characteristics, 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) instituting a defined, stable team to supervise each LCBO, a team composed of Reserve Bank staff who have skills appropriate for the organization's unique risk profile, led by a Reserve Bank central point of contact who has responsibility for only one LCBO, and supported by specialists skilled in evaluating the risks of highly complex LCBO business activities and functions, and (4) promoting Systemwide and interagency information-sharing through an automated system.

An important element of the program is the sharing of resources across the System. Several initiatives are under way to better utilize supervisory resources Systemwide in order to facilitate comprehensive reviews of institutions and to assist in horizontal risk assessments across groups of institutions to identify emerging trends.

Risk-Focused Supervision of Small Shell Bank Holding Companies

The Federal Reserve uses automated screening systems for small shell bank holding companies to identify trends that may adversely affect individual companies. These screens support the risk-focused supervision program for these companies, which tailors supervisory activities to an assessment of each company's reported condition and activities and the condition of its subsidiary banks. Under the program, Reserve Banks are expected to perform a risk assessment of each small shell bank holding company at least once during each supervisory cycle, which depends on the examination frequency for the holding company's lead bank. If a preliminary assessment identifies no unusual supervisory issues or concerns, no special follow-up with the company is necessary. However, if it supports the assignment of a supervisory rating (that is, a BOPEC rating) of 3 or worse or a management rating of less than satisfactory, a full-scope, on-site inspection is expected to be performed. New companies are subject to a full-scope, on-site inspection within the first twelve to eighteen months of operation.

Technology Initiatives for the Risk-Focused Supervision Program

Work continued during 1999 toward the implementation of phase I of the Banking Organization National Desktop (BOND) application, which is scheduled for release in 2000. This information technology initiative is designed to facilitate the high degree of information-sharing and collaboration necessary to support risk-focused supervision of the largest, most complex U.S and foreign banking organizations by providing immediate, user-friendly access to a full range of internal and third-party information. It will also facilitate the analysis of trends across similar organizations and improve the Federal Reserve's ability to identify and manage the risks posed by these diversified banking organizations.

Surveillance and Risk Assessment

To supplement on-site examinations, the Federal Reserve routinely monitors the financial condition and performance of banking organizations using automated screening systems. In these surveillance systems, data from regulatory financial reports are analyzed to identify companies that appear to be deteriorating or to be weaker than current supervisory ratings suggest. The analysis helps to direct examination resources to potentially troubled institutions. Surveillance systems also identify companies that are engaging in new or complex activities to assist in planning examinations. Currently, separate surveillance programs are run quarterly for state member banks; large, complex bank holding companies; and small shell bank holding companies. The Federal Reserve also produces and distributes the quarterly Bank Holding Company Performance Report (BHCPR) to assist supervisory staff in evaluating individual bank holding companies.

During 1999 the Federal Reserve initiated development of surveillance programs for U.S. branches and agencies of foreign banking organizations and for changes in cross-border exposures of banking holding companies. Staff members also adapted a number of surveillance screens to be used in the BOND application.

To facilitate access to data from regulatory reports and to surveillance program results, the Federal Reserve maintains a PC-based application that accesses data housed in the National Information Center (NIC) and electronically distributes surveillance screen results. During the year, staff members expanded the capabilities of this application—the Performance Report Information and Surveillance Monitoring application (PRISM)—to include financial information on U.S. nonbank subsidiaries and data on institution structure.

The Federal Reserve works with the other federal banking agencies to enhance and coordinate surveillance activities through representation on the Federal Financial Institutions Examination Council's Task Force on Surveillance Systems.

International Activities

The Federal Reserve plays a critical role in the supervision of the international activities of U.S. banking organizations and the U.S. activities of foreign banking organizations. It supervises foreign branches of member banks; overseas investments by member banks, Edge Act corporations and agreement corporations, and bank holding companies; and investments by bank holding companies in export trading companies. It also supervises the U.S. activities of foreign banking organizations, including U.S. branches, agencies, and representative offices, U.S. bank subsidiaries, and commercial lending company subsidiaries and nonbanking subsidiaries.

Foreign Office 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 1999 the Federal Reserve conducted examinations of five foreign branches of state member banks and twenty 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. Also, examiners made three visits to the overseas offices of U.S. banks to obtain financial and operating information and, in some instances, to evaluate their compliance with corrective measures or to test their adherence to safe and sound banking practices.

Foreign Branches of Member Banks

At the end of 1999, eighty-two member banks were operating 921 branches in foreign countries and overseas areas of the United States; fifty-one national banks were operating 717 of these branches, and thirty-one state member banks were operating the remaining 204 branches. In addition, twenty nonmember banks were operating 45 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. Agreement corporations are similar organizations, state chartered or federally chartered, that enter into agreements with the Board not to exercise any power that is not permissible for an Edge Act corporation.

Under sections 25 and 25(A) of the Federal Reserve Act, Edge Act and agreement corporations may engage in international banking and foreign financial transactions. These corporations, which in most cases 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 in companies such as finance and leasing companies, as well as in foreign banks.

At year-end 1999, there were eighty-three Edge Act and agreement corporations with twenty-nine branches. During the year, the Federal Reserve examined all of these corporations.

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 1999, 230 foreign banks from 58 countries operated 317 state-licensed branches and agencies (of which 15 were insured by the Federal Deposit Insurance Corporation) as well as 57 branches licensed by the Office of the Comptroller of the Currency (of which 6 had FDIC insurance). These foreign banks also directly owned 17 Edge Act corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 82 U.S. commercial banks. Altogether, these U.S. offices of foreign banks at the end of 1999 controlled approximately 19 percent of U.S. commercial banking assets. These foreign banks also operated 115 representative offices; an additional 84 foreign banks operated in the United States solely through a representative office.

The Federal Reserve has acted to ensure that all state-licensed and federally licensed branches and agencies 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 conducted or participated with state and federal regulatory authorities in 274 examinations during 1999.

Joint Program for Supervising the U.S. Operations of Foreign Banking Organizations

In 1995 the Federal Reserve, in cooperation with the other federal and state banking supervisory agencies, formally adopted a joint program for supervising the U.S. operations of foreign banking organizations (FBOs). The program has two main parts. One part focuses on the examination process for those FBOs 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 FBO to assess its general ability to support its U.S. operations and to determine what risks, if any, the FBO poses through its U.S. operations. Together, these two processes provide critical information to U.S. supervisors in a logical, uniform, and timely manner. During 1999 the Federal Reserve continued to implement program goals through coordination with other supervisory agencies and the development of financial and risk assessments of foreign banking organizations and their U.S. operations.

Technical Assistance

In 1999 the Federal Reserve System continued to provide staff for technical assistance missions covering bank supervisory matters to an increasing number of central banks and supervisory authorities around the world. Technical assistance takes a variety of forms ranging from official visits by foreign supervisors to the Board and Reserve Banks for the purpose of learning about U.S. supervisory practices and procedures to secondments of Federal Reserve System staff to overseas supervisory authorities for the purpose of advising on strengthening the bank supervisory process in a foreign country. In 1999, technical assistance was concentrated in Latin America, the Far East, and former Soviet bloc countries. During the year, the Federal Reserve offered supervision training courses in Washington, D.C., and on site in a number of foreign jurisdictions exclusively for the staff of foreign supervisory authorities. System staff members 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, and the Basel Committee on Banking Supervision.

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 FFIEC.

Capital Adequacy Standards

During 1999 the Federal Reserve, together with the other federal banking agencies, issued two final rules that amended their capital standards for market risk and implemented technical modifications.

Market Risk/Specific Risk

On April 19 the Federal Reserve, together with the FDIC and the OCC, issued a final rule amending their respective risk-based capital standards for market risk applicable to certain institutions having significant trading activities. The final rule permits institutions to use qualifying internal models to determine their capital requirements in relation to specific risk (an element of market risk) without comparing the requirements generated by their internal models with the so-called standardized specific-risk capital requirement.

Technical Modifications

On March 2 the federal banking agencies issued a final rule amending their capital adequacy standards to eliminate differences among the agencies. The final rule revises and makes consistent among the agencies the risk-based capital treatment of construction loans for presold one- to four-family residential properties, junior liens on one- to four-family residential properties, and investments in mutual funds and simplifies the agencies' leverage capital rules for banks and thrift institutions.

The final rule permits a 50 percent risk weight for all qualifying construction loans on presold one- to four-family residential properties. It also requires that a lending institution holding the first and junior liens on a one- to four-family residential property, with no other intervening liens, treat the loans on a combined basis as a single extension of credit for loan-to-value and risk-weighting purposes. The institution's combined loan amount is then assigned in its entirety to either the 50 percent or 100 percent risk category, depending on underwriting and performance criteria. In addition, the final rule gives institutions the option of assigning a mutual fund investment on a pro rata basis among the risk categories according to the investment limits in the mutual fund prospectus. Finally, with regard to the leverage capital standards, the final rule clarifies that certain institutions having the highest supervisory rating must have a minimum leverage ratio of 3.0 percent; all other banks and thrift institutions must have a minimum leverage ratio of 4.0 percent.

Trading and Capital Markets Activities

In 1999 the Board's Division of Banking Supervision and Regulation updated its *Trading and Capital Markets Activities Manual*, which provides examiners with guidance for reviewing capital markets and trading activities at financial institutions of all types and sizes. The manual discusses the risks involved in various activities, risk-management and risk-measurement techniques, appropriate internal controls, and examination objectives and procedures. It takes a functional approach to activities, as opposed to a legal-entity approach. In the 1999 update, chapters on counterparty credit risk, capital adequacy, and accounting were revised to reflect new regulatory guidance and best practices.

Recourse

During 1999 the Federal Financial Institution Examination Council recommended that the Federal Reserve, together with the OCC, FDIC, and OTS (Office of Thrift Supervision), adopt the interagency proposal that would amend the risk-based capital standards to address the regulatory capital treatment of recourse obligations and direct credit substitutes that expose banks, bank holding companies, and thrift institutions to credit risk. The proposed revisions would use credit ratings to match the risk-based capital assessment more closely to an institution's relative risk of loss in certain asset securitizations. It is expected that the proposal will be issued for public comment in the first quarter of 2000.

Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations

In July the Federal Reserve issued supervisory guidance that emphasizes the growing need for banking organizations to ensure that their capital not only is adequate to meet formal regulatory standards but also is sufficient to support their underlying risk positions. The guidance suggests that internal capital management processes at several large, complex banking organizations could be improved and better integrated with internal risk measurement and analysis. In coming months, the Federal Reserve will evaluate internal capital management processes to judge whether they meaningfully tie the identification, monitoring, and evaluation of risk to the determination of an institution's capital needs.

Loan Write-Up Standards

The Federal Reserve amended its loan write-up standards for criticized assets in 1999 to bring them into conformity with the risk-focused examination approach. In the case of a majority of adversely classified assets, the new standards allow the examiner to omit details that are of little benefit to the banking organization and supervision staff. The new approach, which uses asset-classification write-ups to illustrate loan administration weaknesses, encourages a cooperative effort between examiners and bank management. Full loan write-ups are still required for certain criticized assets in situations in which bank management disagrees with the disposition accorded by the examiner and when the institution is viewed as a problem bank. Abbreviated write-ups are appropriate to formalize certain decisions and to clarify actions by management.

Real Estate Lending Standards

In October the Federal Reserve, together with the other federal banking agencies, issued guidance on high loan-to-value (LTV) residential real estate loans as a clarification of the agencies' real estate lending regulations. The guidance describes some of the risks inherent in high LTV lending and the controls that institutions should have in place to manage these risks. It also reminds institutions about the 100 percent capital limitations on this type of lending.

Synthetic Securitizations

On November 17 the Federal Reserve, together with the OCC, issued guidance on the way synthetic securitizations should be treated under the current leverage and risk-based capital guidelines. The guidance permits a banking organization sponsoring a leveraged synthetic securitization to reduce its capital requirement against certain retained exposures if the institution has eliminated virtually all of its credit risk exposure to the specified portfolio being synthetically securitized. The guidance specifies minimum requirements that the sponsoring institution must meet to ensure that it has eliminated virtually all of its credit exposure; it also specifies disclosure requirements regarding the transaction.

Retained Interests

On December 13 the Federal Reserve, together with the OCC, FDIC and the OTS, issued guidance emphasizing the importance of fundamental risk-management practices in connection with securitization activities. The guidance stresses the specific expectation that any securitization-related retained interest claimed and booked by a financial institution should be supported by documentation of the interest's fair value, determined by using reasonable, conservative valuation assumptions that can be objectively verified. Retained interests that lack such objectively verifiable support or that fail to meet the supervisory standards set forth in the guidance are to be classified as a loss and disallowed as assets of the institution for regulatory capital purposes.

Examination-Frequency Guidelines

In October the Federal Reserve and the other federal banking agencies issued a final rule revising their examination-frequency guidelines to address provisions in the Riegle Community Development and Regulatory Improvement Act of 1994 and the Economic Growth and Regulatory Paperwork Reduction Act of 1996. As a result of the revision, certain U.S. branches and agencies of foreign banking organizations may qualify for an eighteen-month examination cycle rather than a twelve-month cycle.

To qualify for consideration for less-frequent examination, a U.S. branch or agency must have total assets of $250 million or less, must have received a composite supervisory rating of 1 or 2 at its most recent examination, and must not be subject to a formal enforcement action. In addition, the U.S. branch or agency must have satisfied the requirements that either (1) the foreign bank's most recently reported capital adequacy position consists of, or is equivalent to, tier 1 and total risk-based capital ratios of at least 6 percent and 10 percent respectively, on a consolidated basis, or (2) the office has maintained, on a daily basis over the past three quarters, eligible assets (determined in accordance with applicable federal and state laws) in an amount not less than 108 percent of the preceding quarter's average third-party liabilities and sufficient liquidity is currently available to meet its obligations to third parties. Finally, the foreign bank must not have experienced a change in control during the preceding twelve months.

Guide to the Interagency Country Exposure Review Committee (ICERC) Process

In November the Federal Reserve, together with the OCC and the FDIC, issued a document, "Guide to the Interagency Country Exposure Review Committee Process," that clarifies and makes more transparent for financial institutions and examiners the ICERC's functions and operating procedures. The ICERC is responsible for assessing the degree of transfer risk (that is, the possibility that an asset cannot be serviced in the currency of payment because of a lack of, or restraints on the availability of, needed foreign exchange in the country of the obligor) inherent in the cross-border and cross-currency exposures of U.S. banks.

Interagency Guidance on Subprime Lending

In March the Federal Reserve, together with the other federal banking agencies, issued interagency guidance on subprime lending. The guidance was developed to bring greater attention to the supervisory issues related to banks' and thrifts' involvement in subprime lending and to how these institutions should manage the unique risks associated with this activity. The guidance notes that the agencies consider subprime lending to be a high-risk activity that is unsafe and unsound if the risks associated with subprime loans are not properly controlled. It advances sound practices for managing the risks involved in subprime lending. Institutions are expected to have policies and procedures in place to measure, monitor, and control the additional risks associated with this activity.

Joint Policy Statement Regarding Branch Closings by Insured Depository Institutions

On June 29 the federal banking agencies issued a revised joint policy statement regarding branch closings by insured depository institutions. The statement incorporates changes in the underlying statute made by section 106 of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 and section 2213 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996. It clarifies the steps that interstate banks should take regarding notice and consultation for proposed branch closings in low- or moderate-income areas. It also clarifies the status of automated teller machines, relocations and consolidations, and branch closings in connection with emergency acquisitions or assistance by the FDIC.

Interagency Guidance on the Allowance for Loan Losses

During 1999 the Federal Reserve, the Securities and Exchange Commission, and the other federal banking agencies continued to develop guidance regarding the allowance for loan losses. In March the agencies issued a joint statement outlining initiatives the agencies and the accounting profession are undertaking to develop enhanced guidance on appropriate methodologies, disclosures, and supporting documentation for loan loss allowances and other issues. In May the Federal Reserve issued guidance addressing the need for banking organizations to maintain conservative allowances for loan losses in the context of existing accounting standards; the guidance is now a part of generally accepted accounting principles (GAAP). In July the agencies issued a joint statement emphasizing a number of factors that should be considered when establishing appropriate allowance levels, consistent with the May Federal Reserve guidance. As part of an interagency statement also issued in July, the SEC agreed to consult with the banking regulators when determining whether to take a significant action against financial institutions with respect to their loan loss allowance.

Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations

In September the Federal Reserve and the other federal banking agencies issued a joint policy statement regarding the external auditing programs of banks and savings associations. The statement encourages banks and savings associations with less than $500 million in total assets to adopt an external auditing program as a part of their overall risk-management process. It reflects the agencies’ view that higher-risk areas of an institution’s business should be subjected to regular independent testing and evaluation to ensure that the institution’s financial statements and regulatory reports are accurately and reliably prepared. The statement also encourages the board of directors of each institution to establish an audit committee made up entirely of outside directors. The statement is effective for fiscal years beginning on or after January 1, 2000.

International Guidance on Internal Control, Accounting, and Disclosure

As a member of the Basel Committee on Banking Supervision, the Federal Reserve plays a key role in the development of supervisory guidance on internal control, accounting, and reporting practices among banking organizations.

The objectives of this guidance are to promote market discipline through greater transparency in financial statements, to encourage sound risk management, and to improve disclosures of qualitative and quantitative information on bank risk exposures and risk-management policies and practices. During 1999 the Federal Reserve contributed to several papers and reports that were issued by the Basel Committee, including the following:

- ‘‘Sound Practices for Loan Accounting and Disclosure’’ (July) provides guidance to banks, banking supervisors, and those who set accounting standards on recognition and measurement of loans, establishment of loan loss allowances, disclosure of credit risk, and related matters. The paper sets out banking supervisors’ views on sound loan accounting and loan-disclosure practices for banks. It also serves as a framework for supervisory evaluation of banks’ policies and practices in these areas.
- ‘‘Best Practices for Credit Risk Disclosure’’ (July) provides guidance on best practices in public disclosure of credit risk by banking institutions. Banks are encouraged to provide market participants and the public with the information they need to make meaningful assessments of their credit risk profile. The paper is part of the Basel Committee’s ongoing efforts to promote transparency and effective market discipline.
- ‘‘Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms’’ (October) presents recommendations for public disclosure of the trading and derivatives activities of banks and securities firms. The recommendations complement the annual survey of trading and derivatives disclosures by large, internationally active banks and securities firms.
- ‘‘Trading and Derivatives Disclosures of Banks and Securities Firms: Results of the Survey of Public Disclosures in 1998 Annual Reports’’ (December) is a report of the fifth annual joint survey by the Basel Committee and the IOSCO on the public disclosure of trading and derivatives activities of banks and securities firms worldwide. The report provides an overview and analysis of the disclosures about trading and derivatives activities presented in the 1998 annual reports of a sample of the largest internationally active banks and securities firms in the G–10 countries and notes improvements since 1993.
- ‘‘Working Paper on Capital Requirements and Bank Behavior: The Impact of the Basel Accord’’ (April) reviews the empirical evidence on the effect of the 1988 Basel Accord on banks. The paper addresses whether the adoption of fixed minimum capital requirements led some banks to maintain higher capital ratios than they would have otherwise and whether these requirements have been successful in limiting risk-taking by banks.
- ‘‘Working Paper on Supervisory Lessons to be Drawn from the Asian Crisis’’ (June) makes recommendations for G–10 creditor banks and their supervisors in the wake of the 1997–98 Asian financial crisis. Recommendations address revisions to the Basel Accord and the use of rating-agency ratings, large-exposure guidance, country-risk assessments, and country-risk-management practices.
- ‘‘Banks’ Interactions with Highly Leveraged Institutions and Sound Practices for Banks’ Interactions with Highly Leveraged Institutions’’ (January) evaluates the potential risks resulting from banks’ interactions

with highly leveraged institutions, assesses the deficiencies in banks' risk-management practices, and evaluates alternative policy responses, including encouraging the use of sound practices by banks. It sets forth sound practices standards for the management of counterparty credit risk in banks' trading and derivatives activities with highly leveraged institutions.

- ''Performance of Models-Based Capital Charges for Market Risk: 1 July–31 December 1998'' (September) reports on a survey of more than forty banks in nine countries subject to the market-risk amendment to the Basel Accord during the third and fourth quarters of 1998, a period of high market volatility. The survey found that the capital charge for market risk under the internal-models approach provided an adequate buffer against trading losses at the surveyed institutions over the period reviewed. The survey encouraged banks to continue to reassess the performance of internal models and to complement those models with robust stress-testing.

In addition to serving on the Basel Committee on Banking Supervision, Federal Reserve staff members participate in meetings of the Financial Accounting Standards Board's (FASB) Financial Instruments Task Force. The task force was created to help the FASB address issues related to the accounting and disclosure standards for financial instruments. Staff members also participate in meetings of the International Accounting Standards Committee (IASC) on behalf of the Basel Committee's Task Force on Accounting Issues. The IASC's objectives are to formulate and publish international accounting standards and to promote their worldwide acceptance and observance.

Bank Holding Company Reports

As the federal supervisor and regulator of U.S. bank holding companies, the Federal Reserve requires periodic regulatory reports from these organizations. These reports, which are revised periodically, provide essential information to assist the Federal Reserve in the supervision of these banking organizations and in the formulation of regulations and supervisory policies. The reports are also used by the Federal Reserve to respond 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 (FR Y–9C, FR Y–9LP, and FR Y–9SP) provides standardized financial statements for the consolidated bank holding company and its parent. The Federal Reserve uses these reports to detect emerging financial problems, to review performance and conduct pre-inspection analysis, to monitor and evaluate risk profiles and capital adequacy, to evaluate proposals for bank holding company mergers and acquisitions, and to analyze a bank holding company's overall financial condition to ensure safe and sound operations. The FR Y–11 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.

Most of the revisions made to the FR Y–9C during 1999 paralleled revisions made to the FFIEC 031 Call Report. They included the elimination of detailed items for ''high-risk mortgage securities;'' implementation of the disclosure requirements of Statement of Financial Accounting Standard No. 133 (FAS 133), Accounting for Derivative Instruments and Hedging Activities, for cash-flow hedges; and implementation of items for monitoring risk-based capital. The revisions to the other FR Y–9 reports and to the FR Y–11 series consisted primarily of implementation of the FAS 133 disclosure requirements for cash-flow hedges. A section for ‘‘Notes to the Financial Statements’’ was also added to the FR Y–11 reports, but otherwise there were no substantive revisions to the FR Y–11 series.

Federal Financial Institutions Examination Council

Uniform Retail Credit Classification and Account Management Policy

On February 10, the FFIEC issued the Uniform Retail Credit Classification and Account Management Policy, which updates and expands the guidelines for classifying consumer loans that were first issued in 1980. The policy, among other things, adds guidance on the treatment of loans to bankrupt borrowers, fraudulent loans, loans to deceased borrowers, and delinquent residential real estate and home equity loans and on the treatment of partial payments. It also sets forth the criteria that must be satisfied before a depository institution may consider a delinquent account current. The policy statement becomes effective on December 31, 2000.

Revisions to the Call Report

The FFIEC implemented a few changes to the bank Reports of Condition and Income (Call Reports), effective with the March 1999 report, to improve the banking agencies’ ability to monitor the safety and soundness of financial institutions. The changes included new items to conform with GAAP, specifically, items necessary to implement FAS 133. Certain detailed items on bank investment portfolios were eliminated, and instructions for reporting securities activities, risk-based capital, and intangible assets were clarified. The FFIEC also revised the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002), effective with the March 1999 report, to maintain consistency with the bank Call Reports. In September, the FFIEC announced that no new items would be added to the Call Report for the March 31, 2000 report.

Year 2000 Supervision Program

Throughout 1999 the FFIEC agencies continued their efforts to ensure the readiness of supervised financial institutions’ automated information systems, and those of their customers, for the century date change. The final phase of the supervisory program undertaken by the agencies was extensive and included the issuance of additional policy guidance, the conduct of on-site examinations and intensive monitoring of financial institutions and markets, contingency planning to respond to disruptions that could occur, and event management for the year-end rollover period. The program focused on promoting industry and consumer awareness; establishing targets for completion of testing; developing implementation and contingency plans; and providing feedback, in part through examinations, to institutions in their attempts to assess their progress and to identify outstanding issues.

The FFIEC worked rigorously to ensure broad awareness of the importance and scope of the problem, both domestically and internationally, and joined with the private sector in a coordinated effort to successfully address the Year 2000. The agencies made significant contributions to the financial industry’s successful transition into the new millennium without serious disruption to the financial services provided to the industry and the public.

Supervisory Information Technology

The Supervisory Information Technology (SIT) function within the Board's Division of Banking Supervision and Regulation facilitates management of the diverse information technology requirements of 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 takes advantage of the systems and expertise available more broadly within the Federal Reserve System.

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

Large Bank Supervision

During 1999 significant progress was made in developing a new information system to support the supervision of large, complex banking organizations. Known as BOND (Banking Organization National Desktop), the system, which is scheduled for implementation in 2000, will provide collaboration, messaging, and document-management capabilities as well as access to regulatory and market data.

Community Bank Supervision

For several years the Federal Reserve has worked closely with the FDIC, the Conference of State Bank Supervisors, and several state banking authorities to automate the examination process for community banks. The agencies now have a common set of automated examination tools that support the risk-focused supervision process (ED), loan analysis (ALERT), and report preparation (GENESYS). These tools are continually evaluated and enhanced. A major rewrite of the GENESYS application that will enable broader implementation among the agencies is scheduled for completion in June 2000.

National Information Center

The National Information Center (NIC) is the Federal Reserve's comprehensive repository for supervisory, financial, and banking structure data. Also included under the NIC management structure is the National Examination Database (NED), a major application that gives supervisory personnel throughout the Federal Reserve System, as well as state banking authorities and the other federal regulators, access to NIC data. Several enhancements to the NIC and NED are under way.

The NED system was enhanced in February to capture large banking organization risk-assessment information. A web-enabled user access interface is being developed, and the application will be enhanced to reflect further changes in the supervision business model to address a continuous supervisory program and financial modernization.

In June the final phase of the NIC banking structure updating system was implemented. Completion of the final phase brings all structure-updating functions to the client/server platform. This new architecture for processing and analyzing NIC data ensures easier access to banking structure data as well as a more cost-effective approach to applying system modifications. Work is also continuing on a project for the electronic submission of data on changes in investments and activities of bank holding companies. The web-based application will offer respondents the same level of state-of-the-art tools used by NIC's structure-updating functions in order to enhance the respondent's ability to submit data more quickly and with greater accuracy.

In conjunction with the BOND project, the NIC is being enhanced to include a repository for supervisory documents. Called the Central Document and Text Repository (CDTR), the repository will initially house those supervisory products that are associated with the framework for risk-focused supervision of large, complex banking organizations. Broad categories of documents to be housed in the CDTR are examination and inspection documents, enforcement-event documents, and other products associated with a region of the United States or a Federal Reserve District (for domestic bank holding companies), a country (for foreign banking organizations), or risk profiles. In addition, staff members are exploring the expansion of the CDTR to serve broader document-management needs within the supervision function and with other regulatory agencies.

The NIC public web site was also enhanced during the year. The site (http://www.ffiec.gov/nic/) makes available bank holding company performance ratios, NIC banking structure and financial data, and, since December 1999, all consolidated and large parent financial statement schedules for bank holding companies.

Strategic Planning

With Board and Reserve Bank participation, SIT is developing a vision statement and a multiyear strategic plan to guide the information technology direction and investments of the supervision and regulation function. A work group is developing a current-period operating plan that emphasizes national projects, supporting budgets, and appropriate documentation for senior level review. Each of these endeavors will use a ''repeatable process'' to outline the approach for future efforts. The work group is also evaluating alternatives to track national IT development and projects costs for the supervision and regulation function.

S&R Enterprise Information Architecture (EIA)

SIT established a work group of Reserve Bank and Board staff to begin the process of documenting the Systemwide enterprise information architecture (EIA) for the supervision and regulation function. Using a business-centered, top-down approach, the work group is defining the business processes, information, data, applications/information systems, and systems infrastructure that make up the EIA. It will prepare a technical reference manual that documents the EIA and describes maintenance procedures. Documentation will enhance the effectiveness of the supervision and regulation function, help guide IT development and acquisition efforts, and increase return on information technology investments by improving interoperability between systems.

IT Project Management

To draw on the best practices for managing IT projects in private industry and

Number of Sessions of Training Programs for Banking Supervision and Regulation, 1999

Program	Total	Regional
Schools or seminars conducted by the Federal Reserve		
Core schools		
Banking and supervision elements	10	8
Operations and analysis	6	3
Bank management	4	1
Report writing	17	17
Management skills	11	9
Conducting meetings with management	15	15
Other schools		
Loan analysis	5	5
Examination management	1	. . .
Real estate lending seminar	4	4
Specialized lending seminar	3	2
Senior forum for current banking and regulatory issues	2	2
Banking applications	1	. . .
Basic entry-level trust	2	. . .
Advanced trust	1	. . .
Consumer compliance examinations I	2	. . .
Consumer compliance examinations II	2	1
CRA examination techniques	3	3
Fair lending examination techniques	4	2
Foreign banking organizations	3	3
Information systems and emerging technology risk management	5	5
Information systems continuing education	2	. . .
Intermediate information systems examination	1	1
Capital markets seminars	18	12
Section 20 securities seminar	3	1
Internal controls	1	. . .
Leadership dynamics	7	6
Seminar for senior supervisors of foreign central banks[1]	1	. . .
Other agencies conducting courses[2]		
Federal Financial Institutions Examination Council	45	5
The Options Institute	2	2

1. Conducted jointly with the World Bank.
2. Open to Federal Reserve employees.

. . . Not applicable.

the government, SIT is studying those practices and developing a project manager's handbook. The handbook will be included in the EIA technical reference manual and will be available to project managers, team members, and stakeholders. In addition to producing the handbook, SIT is working to identify project management training opportunities for Reserve Bank and Board staff and will propose a project management training curriculum and certification program.

Staff Training

The Supervisory Education Program trains staff members that have supervisory or regulatory responsibilities at the Reserve Banks, at the Board of Governors, and at state banking departments. Students from supervisory counterparts in foreign countries attend the training sessions on a space-available basis. The program provides training at the basic, intermediate, and advanced levels for 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., or at regional locations and may be held jointly with regulators of other financial institutions. The program is designed to increase a student's knowledge of the entire supervisory and regu-

Status of Students Registered for the Core Proficiency Examination, 1999

Student status	Core examination	Specialty area[1]			
		Safety and soundness	Consumer affairs	Trust	Information technology
In queue, year-end 1998	33	22	10	1	0
Test taken, 1999	108	63	38	1	0
Passed	94	55	24	1	0
Failed	14	8	14	0	0
In queue, year-end 1999	15	9	6	0	0

1. Students are examined in one specialty area of their choice.

latory process and thereby provide a higher degree of cross-training among staff members.

The Federal Reserve System also participates in training offered by the Federal Financial Institutions Examination Council and by certain other regulatory agencies. The System's involvement includes developing and implementing basic and advanced training in various emerging issues as well as in such specialized areas as trust activities, international banking, information technology, municipal securities dealer activities, 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 1999 the Federal Reserve conducted numerous schools and seminars, and staff members participated in several courses offered by or cosponsored with other agencies, as shown in the accompanying table. Over the year the Federal Reserve trained 2,719 students in System schools, 856 in schools sponsored by the FFIEC, and 42 in other schools, for a total of 3,617 students, including 290 representatives from foreign central banks. The number of training days in 1999 totaled 18,729.

The Federal Reserve System also gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program 451 state examiners were trained—247 in Federal Reserve courses, 196 in FFIEC programs, and 8 in other courses.

The Federal Reserve System continued in 1999 to make revisions initiated in 1997 to the core training program that leads to the commissioning of assistant examiners. The project was undertaken to give assistant examiners a greater understanding of risk-focused examination concepts, the components of sound internal controls, the importance of management information systems, the concept of risk as it applies to banking, and the key supervisory issues related to integrated supervision. These changes, which resulted in a new curriculum, will be completed by the end of 2000.

Depending on their hire date, staff members seeking an examiner's commission follow one of two training tracks. One track is for examiners hired before February 28, 1998, who must take the ‘‘core proficiency examination’’ as well as an examination in a specialty area of the student's choice—safety and soundness, consumer affairs, trust, or information technology. Examiners on this track should complete their commissioning requirements by the end of 2001. In 1999, 108 examiners completed the core proficiency examination (see table).

Status of Students Registered for the First Proficiency Examination, 1999

Student status	First examination	Specialty area[1]
Test taken	205	1
Passed	204	1
Failed	1	0
In queue, year-end 1999	9	0

1. As is the case for the core proficiency examination, students will be examined in one of four specialty areas of their choice. In 1999, the only specialty examination available was for the consumer affairs area.

The other track is for examiners hired after February 28, 1998, who must take the ‘‘first proficiency examination’’ as well as a ‘‘specialty proficiency examination’’ in one of the four specialty areas. By the end of 1999, 205 examiners had completed the first proficiency examination. The only specialty examination available in 1999 was for consumer affairs (see table); the other specialty examinations will be developed in the first quarter of 2000.

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 in relation to bank 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 company must obtain the Federal Reserve’s approval before forming a bank holding company by acquiring control 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 a bank holding company, which depending on the circumstances may or may not be commenced without prior Federal Reserve approval.

The Bank Holding Company Act and various related statutes were significantly amended in November 1999 by passage of the Gramm–Leach–Bliley Act. Title I of the latter act, which becomes effective in March 2000, authorizes those bank holding companies that meet applicable statutory requirements to become financial holding companies and to engage without prior Federal Reserve approval in a broad array of financially related activities, including securities underwriting and dealing, insurance agency and insurance underwriting, and merchant banking. All bank holding companies will continue to need prior Federal Reserve approval to acquire or establish additional banks.

Bank holding companies that do not become financial holding companies will be more restricted in the types of nonbank activities in which they may engage, and they may need prior Federal Reserve approval to conduct those activities. However, various streamlined application processes remain available to these companies. Since 1996, the act has permitted well-run bank holding companies that satisfy certain criteria to commence certain nonbank activities on a de novo basis without prior Federal Reserve approval and has provided an expedited prior-notice procedure for other nonbank activities and for small bank and nonbank acquisitions.

When reviewing an application or notice that requires prior approval, the Federal Reserve must consider several factors, including 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.

In 1999 the Federal Reserve approved 302 proposals by foreign or domestic companies to become bank holding companies, 98 proposals by existing bank holding companies to merge with other bank holding companies, 231 proposals by existing bank holding companies to acquire or retain banks, 450 requests by existing bank holding companies to acquire or establish nonbank firms engaged in activities closely related to banking, and 173 other bank holding company-related applications or notices. Data on these and all other decisions are shown in the accompanying table.

Bank Merger Act

The Bank Merger Act requires that all proposed mergers 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

Decisions by the Federal Reserve on Domestic and International Applications, 1999

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	15	0	0	0	0	1	218	68	302
Merger of bank holding company	11	0	0	0	0	8	47	32	98
Acquisition or retention of bank	21	0	0	0	0	6	134	70	231
Acquisition of nonbank	0	0	146	0	0	26	0	278	450
Merger of bank	34	0	0	0	0	16	122	0	172
Change in control	0	1	2	0	0	0	0	138	141
Establishment of a branch, agency, or representative office by a foreign bank	17	0	0	0	0	0	9	0	26
Other	508	0	41	29	0	600	1,123	153	2,454
Total	**606**	**1**	**189**	**29**	**0**	**657**	**1,653**	**739**	**3,874**

primary jurisdiction. Before acting on a proposed merger, the Federal Reserve considers factors relating to 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 proposal. It also considers the views of certain other agencies regarding the competitive factors involved in the transaction.

During 1999 the Federal Reserve approved 172 merger applications. As required by law, each merger is described in this Report (in table 15 of the ‘‘Statistical Tables’’ section).

When the FDIC, the OCC, or the OTS has jurisdiction over a merger, the Federal Reserve is asked to comment on the competitive factors to ensure comparable enforcement of the antitrust provisions of the Bank Merger Act. The Federal Reserve and those agencies have adopted standard terminology for assessing competitive factors in merger cases to ensure consistency in administering the act. The Federal Reserve submitted 635 reports on competitive factors to the other federal banking agencies in 1999.

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 of bank holding companies. In doing so, the Federal Reserve reviews the financial position, competence, experience, and integrity of the acquiring person; considers the effect of the proposal on the financial condition of the bank or bank holding company to be acquired; determines the effect of the proposal on competition in any relevant market; assesses the completeness of information submitted by the acquiring person; and considers whether the proposal would have an adverse effect on the federal deposit insurance funds. As part of this process, the Federal Reserve may conduct name checks on each acquiring person.

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 1999 the Federal Reserve approved 140 proposed changes in control of state member banks and bank holding companies and denied 1.

International Banking Act

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

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. The System may also take into account 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; and the record of the foreign bank with respect to compliance with U.S. law.

In 1999 the Federal Reserve approved applications by nineteen foreign banks from thirteen foreign countries to establish branches, agencies, and representative offices in the United States.

Overseas Investments by U.S. Banking Organizations

U.S. banking organizations, with the authorization of the Federal Reserve, may engage in a broad range of activities overseas. Most foreign investments may be made under general consent procedures that involve only an after-the-fact notification to the Board; significant investments must be reviewed in advance by the Board. In 1999 the Board approved fifty-eight proposals (excluding those relating to recent large domestic mergers) by U.S. banking organizations to make significant investments overseas.

The Federal Reserve also has authority to act on proposals involving Edge Act and agreement corporations, which are established by banking organizations to provide a means of engaging in international business. In 1999 the Federal Reserve approved two applications to establish new Edge corporations (one of which proposed to engage in foreign exchange settlement activities) and one application by a member bank to increase its total investment in its Edge corporation subsidiaries to more than 10 percent, but less than 20 percent, of the bank's capital and surplus. In addition, the Federal Reserve approved one application to establish a new agreement corporation.

Applications by Member Banks

State member banks must obtain Federal Reserve approval to establish domestic branches, and member banks (including national banks) must obtain Federal Reserve approval to establish foreign branches. When reviewing proposals for domestic branches, the Federal Reserve considers the scope and character of the proposed 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. Once a member bank has received authority to open a branch in a particular foreign country, the member bank may open additional branches in that country without prior Federal Reserve approval. In 1999 the Federal Reserve acted on new and merger-related branch proposals for 2,042 domestic branches and granted prior approval for the establishment of 12 foreign branches (excluding those relating to recent large domestic mergers).

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 its debt and decreases its equity. Relatively larger repurchases may undermine the financial condition of a bank holding company and its bank subsidiaries. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's capital guidelines. In 1999 the Federal Reserve reviewed eighteen proposed stock repurchases by bank holding companies, all of which were approved, under delegated authority, by either a Reserve Bank or the Secretary of the Board.

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 1999 the Board's public web site was expanded to include more information relevant to the applications process.

Timely Processing of Applications

The Federal Reserve maintains internal target dates and procedures for the processing of applications. The setting of target dates promotes efficiency at the Board and the Reserve Banks and reduces the burden on applicants. The time frame for final action ranges from twelve to sixty days, depending on the type of application or notice. In 1999, 82 percent of decisions met this standard.[2]

Delegation of Applications

Historically, the Board of Governors has delegated certain regulatory functions, including the authority to approve, but not to deny, certain types of applications, to the Reserve Banks, to the Director of the Board's Division of Banking Supervision and Regulation, and to the Secretary of the Board. In 1999, 79 percent of the applications processed were acted on under delegated authority.

Banking and Nonbanking Proposals

Some of the largest U.S. banking organizations were party to significant banking proposals in 1999. The Board approved two proposals by foreign banking organizations to acquire large U.S. banking organizations. It also approved one merger proposal by two bank holding companies operating in the same markets that required the largest level of branch divestitures ever considered by the Board. As with other large banking proposals, the Board received many comments, particularly with respect to Community Reinvestment Act, fair lending, and competitive issues. The Federal Reserve also continued to act on proposals involving mutual bank holding companies.

The Board approved two proposals involving new nonbank activities during the year. One proposal was by two institutions to own and operate an electronic securities exchange. The other was by a group of foreign and domestic bank

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[2] If the data were adjusted for multiple related applications filed in connection with several larger merger proposals, the percentage would be 94 percent.

holding companies that sought to engage in digital certification activities. The Federal Reserve also approved various other securities-related proposals involving section 20 companies.

Enforcement of Other Laws and Regulations

Financial Disclosure 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 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 1999, twenty state member banks, most of them small or medium size, were registered with the Board under the Securities Exchange Act.

Securities Credit

Under the Securities Exchange Act of 1934, 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 compliance with the Board's securities credit regulations. The Securities and Exchange Commission, the National Association of Securities Dealers, and the national securities exchanges examine brokers and dealers for compliance with Regulation T. The federal banking agencies examine banks under their respective jurisdictions for compliance with Regulation U. The Farm Credit Administration, the National Credit Union Administration, and the Office of Thrift Supervision examine lenders under their respective jurisdictions for compliance with Regulation U; the Federal Reserve examines other Regulation U lenders.

Since 1990 the Board has published a list of foreign stocks that are eligible for margin treatment at broker–dealers on the same basis as domestic margin securities. In 1999, the foreign list was revised in March and September.

At the end of 1999, 839 lenders other than banks, brokers, or dealers were registered with the Federal Reserve; of these, 577 were under the Federal Reserve's supervision. The Federal Reserve regularly inspects 262 of these lenders either biennially or triennially, according to the type of credit they extend; 70 of the 262 were inspected in 1999 for compliance with Regulation U. The remaining 315 lenders were exempt from periodic on-site inspections by the Federal Reserve but were monitored through the filing of periodic regulatory reports.

Bank Secrecy Act/ Anti–Money Laundering

The regulation (31 CFR Part 103) implementing the Currency and Foreign Transactions Reporting Act, also known as the Bank Secrecy Act, requires banks and other types of financial institutions to file certain reports and maintain certain records. These reports and records include information concerning persons involved in large currency transactions as well as suspicious activity related to possible violations of federal law, including money laundering and other financial crimes. The act is regarded as a primary tool in the fight against money laundering, and its requirements deter 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, pursuant to Regulation H, section 208.63, each banking organization supervised by the Federal Reserve must develop a written Bank Secrecy Act compliance program 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 appropriate personnel. Through its examination process, training, and other off-site measures, the Federal Reserve monitors compliance with the Bank Secrecy Act and Regulation H by the banking organizations under its supervision.

In 1999 the Federal Reserve continued to provide expertise and guidance to the Bank Secrecy Act Advisory Group, a committee established at the Department of the Treasury by congressional mandate to seek measures to reduce unnecessary Bank Secrecy Act burdens and to increase the utility of data gathered under the act to regulators and law enforcement. In addition, the Federal Reserve is continuing to participate in the governmentwide effort to deter money laundering as announced by the Department of the Treasury in the National Money Laundering Strategy for 1999. The Federal Reserve also led an interagency group that revised the Suspicious Activity Report to make it less burdensome for filers, more useful to law enforcement, and Year 2000 compliant. An interim form that is Year 2000 compliant was released midyear, and a new form incorporating all the enhancements will be released in the first quarter of 2000.

In December 1998 the Federal Reserve, along with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, issued proposed rules that would have required domestic and foreign banking organizations to develop and maintain Know Your Customer programs. The proposed rules were intended to provide guidance to banks to facilitate and ensure their compliance with existing federal reporting and recordkeeping requirements, such as those found in the Bank Secrecy Act. It was intended to help protect the integrity and reputation of the financial services industry and assist the government in its efforts to combat money laundering and other illegal activities that might be occurring through financial institutions. After receiving more than 15,000 comments from community, regional and multinational banks, members of Congress, trade and industry groups, and the public that viewed the proposed regulations as an invasion of personal privacy, among other issues, the Federal Reserve, along with the other agencies, withdrew the proposal.

Through the Special Investigations Section of the Division of Banking Supervision and Regulation, the Federal Reserve has assisted in the investigation of money laundering activities, including Operation Casablanca, which

Loans by State Member Banks to their Executive Officers, 1998 and 1999

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
1998			
October 1–December 31	753	45,385,000	4.0–19.8
1999			
January 1–March 31	764	51,396,000	4.0–18.0
April 1–June 30	752	63,852,000	4.9–19.8
July 1–September 30	722	157,568,000	2.0–18.0

SOURCE. Call Reports.

involved a number of foreign banking organizations. The section has also provided anti-money-laundering training to designated staff members at each Reserve Bank, to the domestic banking sector through trade association conferences and seminars, and to representatives of law enforcement agencies.

Internationally, the section has assisted the State Department by providing anti-money-laundering training and technical assistance to countries in Asia, eastern Europe and the newly independent states, South and Central America, and the Caribbean. Federal Reserve staff members have also participated in numerous multilateral international anti-money-laundering initiatives sponsored by such groups as the G–7, the Financial Action Task Force, and the Asia Pacific Working Group on Money Laundering.

Loans 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.

Federal Reserve Membership

At the end of 1999, 3,478 banks were members of the Federal Reserve System. At that time, member banks were operating 47,673 branches and accounted for 41 percent of all commercial banks in the United States and for 74 percent of all commercial banking offices. ■

Federal Reserve Banks

The Federal Reserve Banks devoted significant attention in 1999 to preparing for the century date change. Efforts in that area as well as other activities affecting the Reserve Banks are described in this chapter.

Century Date Change

The Federal Reserve was fully prepared for the year 2000 rollover and on the days before, during, and after the event experienced only minor problems related to the date change. The extensive work of testing and preparing the critical components and operational entities that took place prior to the rollover prevented major disruptions in Federal Reserve services to the nation's banking and financial markets. All mission-critical components were tested for year 2000 compliance and put into production during 1999. The Reserve Banks continued to support extensive year 2000 testing by depository institutions throughout the year. The Federal Reserve also took steps to ensure an adequate supply of currency for the century rollover.

By year-end 1999, more than 9,000 financial institutions had tested the services they use with the Federal Reserve. These institutions included all of the System's major customers in terms of volume and dollar amount of the transactions processed through the Federal Reserve. The Federal Reserve also tested the automated payment services it provides to federal agencies, such as the Social Security Administration, to ensure that banks could receive government payments. In 1999, the Joint Year 2000 Council, sponsored by the Bank for International Settlements, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions and chaired by Federal Reserve Vice Chairman Roger Ferguson, served as the key forum for Y2K communications among financial market authorities around the globe. Representatives from more than 100 countries participated in the council's activities, including developing guidance papers to assist regulators, issuing bulletins to share information, and attending regional meetings throughout the world.

In 1999, the Federal Reserve focused on event management and contingency planning for the Y2K rollover. System Communication Centers were established at the Federal Reserve Bank of Boston and the Board of Governors, with supporting Local Communication Centers in each Reserve Bank to manage information concerning the status of Federal Reserve systems during the rollover event. The Federal Reserve tested contingency scenarios to exercise all lines of communication and tested responses to the scenarios to prepare for the event. As the year came to an end, the Federal Reserve met increased demands for currency.

As in 1998, the Federal Reserve continued to inform the public about plans for addressing the year 2000 problem and continued to advise depository institutions of the Federal Reserve's plans and schedules. The Federal Reserve provided extensive information concerning its year 2000 activities to government oversight organizations, including the U.S. General Accounting Office, the House and Senate Banking Committees, and the Office of Management and Budget. The Federal Reserve provided leadership to the financial community, domestically and internationally, and participated in the President's Y2K Council activities.

The Benefits of the Federal Reserve's Year 2000 Preparations

> *As a result of Y2K preparations, we have vividly seen how complex and interdependent our economic affairs have become, and this new awareness is already beginning to pay off in higher levels of efficiency and effectiveness.*
>
> Edward W. Kelley, Jr., *Member*, Board of Governors

In the three years leading to the rollover to the new century, U.S. banking organizations devoted considerable time, talent, and money to protecting their computer systems from date-related glitches. They also measured and managed potential customer and counterparty risk and planned their responses to possible internal and external disruptions or other unexpected events.

Was the enormous effort worth it? U.S. Representative James Leach, chairman of the House Committee on Banking and Financial Services, answered that question with a definite "yes." In a letter to Board Chairman Alan Greenspan, Leach expressed Congress's gratitude to the Federal Reserve for its leadership, both domestically and internationally, in preparing the banking industry and financial system for the century date change. Now, having come smoothly through the date change, both the Federal Reserve and private-sector banking organizations are finding that their preparations are yielding benefits that extend far beyond the absence of disruption on New Year's Day.

Greater Efficiency and Better Management

For the Federal Reserve System, Y2K preparations have yielded greater productivity, better management of information technology, and enhanced communication with and services to customers. Productivity improvements include the elimination of redundant applications, the standardization of operating environments, and the adoption of better security procedures and better processes for implementing system upgrades. Improved processes for adopting changes ensure that changes are well tested and that controls provide assurance that the compiled application and source code are the same. Applications are running with fewer bugs and fewer end-of-year or other operating problems.

Senior managers involved in the development of year 2000 programs for information systems now better understand the critical roles automated systems play in the success of business lines. And line managers, because they had to become more involved in meeting the technology needs of their operations, now more fully appreciate the use of information technology as a business opportunity rather than a cost. This knowledge will be used to further improve services.

For example, century change preparations improved risk-management structures that can be used to monitor and control operational risk in the future. Similarly, experience in monitoring risks to customers and counterparties and in assessing

The Federal Reserve undertook three major initiatives to prepare for cash interdependencies with service providers will yield incremental efficiencies and improved reliability. Finally, review and extensive testing of business-resumption contingency plans resulted in contingency procedures that are more comprehensive, more up-to-date, and more effective.

Other Long-Term Benefits

Federal Reserve customers, counterparties, and the public also benefited from year 2000 preparations. Communication efforts to ease the public's concern about potential problems contributed to responsible public behavior during the century rollover. And close collaboration with banking organizations ensured that cash supplies were adequate to meet customer demand and that liquidity needs could be met quickly through discount window operations. As a result, the public and the financial community retained a high level of confidence in the banking system, and there was neither an abnormal demand for cash nor volatility in payment systems. A spirit of cooperation and the ability to develop an effective communication strategy will be crucial tools for future initiatives.

Because of the close coordination with suppliers and service providers during year 2000 preparations, technology vendors and telecommunications, electric utility, and city services providers have a better understanding of their critical role in maintaining the continuity of central bank operations. The stronger relationships with these firms should ensure that coordination of disaster recovery plans will continue and that recovery of services to the central bank will remain a high priority for suppliers.

Plans for Technology

The improvements that resulted from year 2000 preparations—improved risk assessment and contingency procedures, better management of information technology for efficiencies and customer service, and enhanced communication—will also prove useful as the Federal Reserve broadens its use of information technology across business lines in order to identify opportunities and control activities more closely. Internet and e-commerce activities will expand significantly in the future; emphasis will shift away from the simple on-line delivery of existing services and toward redefining business lines to take full advantage of technology. Strengthening lines of communication internally and with the banking community, with a special focus on enhancing customer service, will be an important part of the Federal Reserve's business strategy.

Overall, preparations for the century date change enhanced the Federal Reserve's ability to respond to the needs of the banking community and the public and to deliver new services. The greater public trust in the banking system and in the Federal Reserve's ability to manage the century rollover and continue operations suggests confidence that future challenges will be met with a similar level of expertise.

demand associated with the year 2000 rollover. First, the fiscal year 1999 new-currency print order was larger and more concentrated in the higher denominations than usual, so that there would be ample cash if the public chose to withdraw more currency in anticipation of Y2K problems. Second, in an effort to address the possibility that remote locations might need extra currency quickly, the Federal Reserve established strategic inventory locations. The Federal Reserve contracted with depository institutions and armored carriers in locations far from Reserve Bank offices to hold Federal Reserve notes for potential emergency cash orders. Finally, the Federal Reserve increased its communication with several industries on the Y2K problem. Meetings, conference calls, surveys, and general exchanges of information were common between the Federal Reserve and depository institutions, foreign central banks, armored carriers, retail industries, and the public.

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 pretax 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).[1]

Overall, fees charged in 1999 for priced services were lowered approximately 1.2 percent from 1998.[2] Revenue from priced services was $835.9 million, other income related to priced services was $31.7 million, and costs related to priced services were $775.7 million, including costs other than profit imputed in the PSAF, resulting in net income of $92.0 million. Priced services recovered 104.2 percent of total costs, including $57.2 million of targeted return on equity associated with the PSAF. Over the past ten years, the Reserve Banks have recovered 101.1 percent of their priced services costs, including the PSAF (table).[3]

Check Collection

Federal Reserve Bank operating expenses and imputed costs for commercial check services in 1999 totaled $649.8 million. Revenue from check operations totaled $681.0 million, and other income amounted to $26.3 million, resulting in net income of $57.5 million.

The Reserve Banks handled 17.1 billion checks in 1999, an increase of 3.0 percent from 1998 (see table). The volume of fine-sort checks, which are presorted by the depositing banks according to paying bank, declined 6.8 percent, compared with a 3.6 percent decrease in 1998. The volume of checks deposited that required processing by the Reserve Banks increased 4.4 percent.

The Reserve Banks continued to encourage electronic innovations that make the collection system more effi-

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[1] In addition to income taxes and targeted return on equity, the PSAF is made up of three imputed costs: interest on debt, sales taxes, and assessments for deposit insurance from 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 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 income, and targeted return on equity—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. *Net income* is revenue plus net income on clearing balances minus total cost.

Priced Services Cost Recovery, 1990–99

Millions of dollars, except as noted

Year	Revenue from services[1]	Operating expenses and imputed costs[2]	Targeted return on equity	Total expenses	Cost recovery (percent)
1990	746.5	684.3	33.6	717.9	104.0
1991	750.2	692.0	32.5	724.5	103.5
1992	760.8	710.7	24.9	735.6	103.4
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	832.9	104.2
1990–99	**7,906.5**	**7,438.2**	**382.2**	**7,820.4**	**101.1**

1. Includes revenue from services of $7,684.8 million and other income and expense (net) of $221.7 million for the ten-year period.

2. Includes operating expenses of $6,539.0 million, imputed costs of $556.4 million, and imputed income taxes of $249.3 million for the ten-year period. Also, the effect of one-time accounting changes of $74.1 million and $19.4 million is included for 1993 and 1995 respectively.

cient. In 1999, 26.9 percent of all checks presented by the Reserve Banks to paying banks were presented electronically (approximately 3.2 billion), an increase of 13.4 percent from 1998. Images of 5.2 percent of checks presented by Reserve Banks were captured, compared with 3.9 percent in 1998. Check-imaging pilot programs at the Utica, New York, and Helena, Montana, offices began evaluating the efficiency of the environments for image-enhanced check processing.

In 1999, the Reserve Banks decided to standardize their check-processing platforms across all forty-five check-processing offices. The Reserve Banks believe that, over the long run, standardized platforms will enable them to increase operating efficiency, reduce

Activity in Federal Reserve Priced Services, 1999, 1998, and 1997

Thousands of items

Service	1999	1998	1997	Percent change	
				1998 to 1999	1997 to 1998
Commercial checks	17,075,008	16,573,463	15,949,152	3.0	3.9
Funds transfers	105,408	100,609	91,800	4.8	9.6
Securities transfers	5,147	5,115	4,136	.6	23.7
Commercial ACH	3,343,615	2,965,739	2,602,892	12.7	13.9
Noncash collection	613	755	887	–18.8	–14.8
Cash transportation	18	18	27[1]	1.0	–32.6

NOTE. Components may not yield percentages shown because of rounding. 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 collection*, the number of items on which fees are assessed; and in *cash transportation*, the number of registered mail shipments and FRB-arranged armored carrier stops.

1. Restatement resulting from a change in definition or to correct a previously reported error.

costs, and improve the quality of service provided to depository institutions. The Reserve Banks' Retail Payments Product Office will continue to manage this long-term initiative.

Fedwire Funds Transfer and Net Settlement

Reserve Bank operating expenses and imputed costs for Fedwire funds transfer and net settlement services totaled $61.3 million in 1999. Revenue from these operations totaled $66.8 million, and other income amounted to $2.3 million, resulting in net income of $7.8 million.

Funds Transfer

The number of Fedwire funds transfers originated by depository institutions increased 4.8 percent in 1999, to 105.4 million.

Fees for Fedwire funds transfers have declined nearly 50 percent since 1996. In January 1999, the Reserve Banks reduced the basic transfer fee from $0.40 to $0.34. In February, the Banks introduced a volume-based pricing structure for the funds transfer service that takes into account the scale economies achieved by centralized processing and recognizes differences in demand for large-value transfers. The pricing structure is similar to those used by other domestic and international large-value transfer systems. In 1999, the basic per-transfer fee of $0.34 was charged for the first 2,500 funds transfers originated and received by a depository institution each month; a per-transfer fee of $0.27 was charged for additional transactions up to 80,000 transfers each month; and a per-transfer fee of $0.21 was assessed for every transaction after 80,000 transfers each month.

Depository institutions that do not have an electronic connection to the Fedwire funds transfer system can originate transfers via ''off-line'' telephone instructions. The volume of off-line Fedwire funds transfers has been declining substantially in recent years. Because of the decline and the small percentage of transfers that are originated off line (0.03 percent in 1999), the Federal Reserve began in 1998 to consolidate its Fedwire off-line funds transfer operations at the Federal Reserve Banks of Boston and Kansas City. The consolidation, completed in March 1999, has made it possible to streamline service and ensures uniform service nationwide. To reflect more fully the costs of processing off-line transfers and to encourage off-line customers having higher transfer volume to install electronic connections, the off-line transaction surcharge was increased in February from $12.00 to $13.00.

Net Settlement

The Reserve Banks provide settlement services to approximately 100 local and national private-sector clearing and settlement arrangements. In 1999, the Reserve Banks processed about 361,000 settlement entries for these arrangements.

The Federal Reserve offers three types of settlement services. In the ''settlement sheet'' service, the settlement agent for a clearinghouse provides a settlement sheet to a Reserve Bank. The Reserve Bank posts net debit and credit entries to the accounts of the settling participants. The entries are provisional until the banking day after settlement. In the Fedwire-based settlement service, the clearinghouse uses a zero-balance settlement account to receive and send Fedwire funds transfers to settle participants' obligations. Fedwire funds transfers are final and irrevocable when processed. In March 1999, the Reserve Banks implemented an enhanced settlement service that offers finality characteristics similar to those of the Fedwire funds transfer service and provides settlement arrangements that include an automated mechanism for submitting settlement files to the Reserve Banks. This enhanced settlement service improves operational efficiency and reduces settlement risk to participants by granting settlement finality on the settlement day. It also enables the Reserve Banks to manage and limit risk by incorporating risk controls that are as robust as those used in the Fedwire funds transfer service. The Reserve Banks will continue to offer the Fedwire-based settlement service. The settlement sheet service, however, will be phased out gradually, and all participating arrangements will need to move to the enhanced service by year-end 2001.

In 1999, the fees and fee structure for the settlement sheet and the enhanced settlement services were revised by lowering the per-entry fee from $1.00 to $0.95, introducing a settlement file fee of $12.00, increasing both the off-line surcharge and the telephone notification surcharge from $10.00 to $13.00, and introducing a minimum monthly fee of $60. Fees for the Fedwire-based settlement service were not changed.

Fedwire Book-Entry Securities

Reserve Bank operating expenses and imputed costs for the Fedwire book-entry securities service totaled $13.9 million in 1999. Revenue from these operations totaled $16.7 million, and other income amounted to $0.6 million, resulting in net income of $3.4 million.

The Reserve Banks processed 5.1 million transfers of government agency securities on the Fedwire book-entry securities transfer system during the year, an increase of 1.2 percent from 1998.[4]

In February, the Reserve Banks implemented a fee structure for the book-entry service that splits the basic transfer fee equally between the originator and the receiver of a securities transfer (rather than charge the entire transfer fee to the originator). The fee for an on-line Fedwire book-entry securities transfer was reduced to $0.85, a 24 percent reduction from 1998. Changing the on-line transfer fee to a fee assessed on both senders and receivers more accurately aligns the costs and benefits to participants in a transfer. In July, the Reserve Banks began applying an account-maintenance fee of $15 to each joint-custody securities account held by a customer, rather than to just the customer's master account.[5]

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[4] The revenues, expenses, and volumes reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and international institutions such as the World Bank. The Fedwire book-entry securities service also provides custody, transfer, and settlement services for U.S Treasury securities. The Reserve Banks act as fiscal agents of the United States when they provide transfer and safekeeping of U.S. Treasury securities, and the Treasury Department assesses fees on depository institutions for some of these services. For more details, see the section ‘‘Fiscal Agency Services’’ later in this chapter.

[5] Before the conversion of all Reserve Banks to the National Book-Entry System (NBES), account maintenance fees for joint custody securities accounts were different across the Reserve Banks. During the transition to NBES, the interim pricing practice for these accounts was standardized to charge one account-maintenance fee per customer regardless of the number of pledgees. This interim practice achieved consistency and minimized the effect on customers converting to the new system but resulted in reduced revenue and incomplete recovery of processing costs.

Depository institutions that do not have an electronic connection to the Fedwire securities transfer system can originate transfers via ''off-line'' telephone instructions. The volume of off-line Fedwire securities transfers has been declining substantially in recent years. Because of the decline and the small percentage of transfers that are originated off line (0.19 percent in 1999), the Federal Reserve began in 1998 to consolidate its Fedwire off-line securities transfer operations at the Federal Reserve Banks of Boston and Kansas City. The consolidation, completed in March 1999, has made it possible to streamline service and ensures uniform service nationwide. In 1999, the $10 off-line securities transfer fee was converted to an off-line surcharge and was increased to $13 to be consistent with the off-line surcharge in the Fedwire funds transfer and net settlement services.

Automated Clearinghouse

Reserve Bank operating expenses and imputed costs for commercial automated clearinghouse (ACH) services totaled $55.9 million in 1999. Revenue from ACH operations totaled $65.5 million, and other income amounted to $2.3 million, resulting in net income of $11.9 million. The Reserve Banks processed 3.3 billion ACH transactions, an increase of 12.7 percent from 1998.

Fees for originating ACH transactions were reduced $0.0005 per transaction in August. The reduction amounted to a decrease of 8.5 percent for originating a large file and 7.1 percent for originating a small file.

The Reserve Banks continued to encourage the growth of electronic payments by participating during 1999 in an ACH cross-border pilot program between the United States and Canada.

In May, the Board requested comments on the effect of modifying the Reserve Banks' pricing practices and deposit deadlines for ACH transactions they exchange with private-sector operators. Board staff members met with commenters in December to further discuss private-sector-operator issues.

In November, the Board approved modifications to the settlement finality for ACH credit transactions processed by the Reserve Banks. This approval, which will become effective in early 2001, makes settlement final when posted to depository institutions' accounts. To lower settlement risk, prefunding will be required for those ACH credit transactions that are settled through a Federal Reserve account that is monitored in real time.

Noncash Collection

Reserve Bank operating expenses and imputed costs for noncash collection services totaled $2.0 million in 1999. Revenue from noncash operations totaled $2.9 million, and other income amounted to $0.1 million, resulting in net income of $1.0 million. The Jacksonville Branch of the Federal Reserve Bank of Atlanta, which is the Reserve Banks' centralized processing site for this service, processed 613,000 noncash collection items (coupons and bonds), a decrease of 18.8 percent from 1998.

Cash Services

Because providing high-quality currency and coin is a basic responsibility of the Federal Reserve, the Reserve Banks charge fees only for special cash services and nonstandard access.[6] Special cash services represent a very small

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[6] Nonstandard access is not treated as a priced service; instead, fees for nonstandard access are treated as a recovery of expenses.

portion (less than 1 percent) of the cost of overall cash services provided by the Reserve Banks to depository institutions; these services include the provision of wrapped coin, packaging of nonstandard currency orders and deposits as well as coin deposits, and shipping of currency and coin by registered mail.

The Cleveland District and the Helena Branch of the Minneapolis Reserve Bank provide wrapped coin as a priced service. The Chicago District provides currency in nonstandard packages, the Helena Branch provides coin in nonstandard packages, and the El Paso Branch provides nonstandard packaging of same-day express cash orders. In addition, five Districts provide cash transportation by registered mail. Reserve Bank operating expenses and imputed costs for special cash services totaled $2.8 million in 1999. Revenue from cash operations totaled $2.9 million, and other income amounted to $0.1 million, resulting in net income of $0.2 million.

Float

Federal Reserve float decreased in 1999 to a daily average of $584.4 million, from a daily average of $632.7 million in 1998.[7] The Federal Reserve recovers the cost of float associated with priced services as part of the fees for those services.

Developments in Currency and Coin

The Federal Reserve experienced unprecedented demand for coin in 1999, when the Mint and the Federal Reserve paid out more than $5.8 billion in coin, an 8.1 percent increase from 1998 and a 20.0 percent increase from 1997. The Federal Reserve worked closely with the Mint to move coin inventories around the System, replenishing low stocks at certain Reserve Bank offices. Rather than have each office maintain its own coin inventories, the Reserve Banks' Cash Fiscal Product Office, located at the Federal Reserve Bank of Philadelphia, began the centralized management of coin. This effort will ensure an equitable supply of coin among the twelve Reserve Banks.

Contributing to the greater demand for coin in 1999 was the beginning of the Mint's 50 State Quarters program. The Mint produced five different quarters in 1999, and the quarters were very popular with the public. Historically, the Mint produces about 1.5 billion quarters every year. The original forecast of need in 1999 was 3.5 billion, but the Mint had to increase production to 5 billion because of the extraordinarily high demand.

Strong economic growth and robust retail sales in 1999 were probably also factors in the increase in demand for all denominations of coin. Because of continued prosperity, consumers may not feel the need to spend the extra coin they hold, thus reducing the amount of coin in circulation.

In fiscal year 1999, the Federal Reserve directed the Bureau of Engraving and Printing to print 11.4 billion notes, an increase of nearly 24 percent from its fiscal 1998 order. As part of the Federal Reserve's preparations for the century date change, each Reserve Bank

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[7] The measure of Federal Reserve float used here is different from that used in previous years; it has been changed to make the figures more comparable to those reported in the Board's weekly statistical releases. In previous years, daily average float was shown net of float recovered through deposit adjustments; if the data here were calculated as in previous years, the figures for float in 1999 and 1998 would be $199.1 million and $323.6 million respectively. See footnote 6 of the pro forma financial statements at the end of this chapter for detailed information on Federal Reserve float.

office increased its volume of currency available for potential increased payments to depository institutions.

Developments in Fiscal Agency and Government Depository Services

The Federal Reserve Act provides that when required by the Secretary of the Treasury, Reserve Banks will act as fiscal agents and depositories of the United States. As fiscal agents, Reserve Banks provide the Department of the Treasury with 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. As depositories, Reserve Banks collect and disburse funds on behalf of the federal government. They also provide fiscal agency services on behalf of several domestic and international government agencies.

The Reserve Banks spent much of 1999 preparing for a smooth transition into the year 2000. They worked with the Treasury and other government agencies, including the Department of Defense, the Social Security Administration, and the Department of Veterans Affairs, to ensure the payment of government benefits into the new year and to support the Treasury's debt-management program. These efforts were part of the extensive planning process that contributed to the successful transition into the new century.

The total cost of providing fiscal agency and depository services to the Treasury in 1999 amounted to $255.6 million, compared with $250.9 million in 1998 (table). The cost of providing services to other government agencies was $39.3 million, compared with $46.6 million in 1998.

The Reserve Banks establish uniform and consistent practices for accounting for, reporting of, and billing for the full costs of providing fiscal agency and depository services to the U.S. government. In 1999, the Reserve Banks requested reimbursement by the Treasury and other government agencies of $294.8 million in fiscal agency and depository expenses, a decrease of $2.7 million from 1998.

The Reserve Banks also worked with federal agencies to restructure certain Federal Reserve services. The objective was to assess services that are conducted at more than one location, such as the redemption of Treasury and agency interest coupons, and to centralize these operations to reduce expenses. Some of these projects will be implemented in 2000.

Fiscal Agency Services

The Reserve Banks handle marketable Treasury securities and savings bonds and monitor the collateral pledged by depository institutions to the federal government.

Marketable Treasury Securities

Reserve Bank 1999 operating expenses for activities related to marketable Treasury securities totaled $74.8 million, a 2.5 percent increase from 1998. The Banks processed nearly 253,000 commercial tenders for government securities in Treasury auctions, a 20.1 percent decline from 1998. Commercial tenders are processed at the New York, Chicago, and San Francisco Reserve Banks using a common automated application known as the Treasury Automated Auction Processing System.

The Reserve Banks operate two book-entry securities systems for Treasury securities: the Fedwire book-entry secu-

Expenses of Federal Reserve Banks for Fiscal Agency and Depository Services, 1999, 1998, and 1997

Thousands of dollars

Agency and service	1999	1998	1997
DEPARTMENT OF THE TREASURY			
Bureau of the Public Debt			
Savings bonds	70,285.8	71,401.8	70,340.4
Treasury Direct	40,446.2	35,859.1	35,440.4
Commercial book entry	15,744.2	17,880.4	26,809.4
Marketable Treasury issues	13,715.1	15,530.5	14,855.4
Definitive securities and Treasury coupons	4,886.7	3,734.2	3,618.9
Other services	100.4	83.7	n.a.
Total	145,178.4	144,489.7	151,064.5
Financial Management Service			
Treasury tax and loan and Treasury general account	34,971.0	35,428.2	35,265.9
Government check processing	33,365.4	34,096.4	26,548.0
Automated clearinghouse	11,263.4	11,716.0	14,477.3
Government agency check deposits	2,422.7	2,731.0	2,795.3
Fedwire funds transfers	187.7	186.3	422.0
Other services	20,423.5	16,045.2	20,994.2
Total	102,633.7	100,203.1	100,502.7
Other Treasury			
Total	7,786.8	6,237.6	3,840.0
Total, Treasury	255,598.9	250,930.4	255,407.2
OTHER FEDERAL AGENCIES			
Department of Agriculture			
Food coupons	18,643.9	24,452.4	25,495.7
U.S. Postal Service			
Postal money orders	6,623.3	5,275.3	6,108.7
Miscellaneous agencies			
Other services	13,983.0	16,850.6	17,042.1
Total, other agencies	39,250.2	46,578.3	48,646.5
Total reimbursable expenses	**294,849.1**	**297,508.7**	**304,053.7**

n.a. Not available.

rities system, which provides custody and transfer, and Treasury Direct, which provides custody services only.[8] Almost all book-entry Treasury securities, 97.4 percent of the total par value outstanding at year-end 1999, were maintained on Fedwire; the remainder were maintained on Treasury Direct.

The Reserve Banks in 1999 processed 8.1 million Fedwire transfers of Treasury securities, a 9.0 percent decline from 1998. They also processed 26.6 million interest and principal payments for Treasury and government agency securities, a decrease of 0.2 percent from 1998.

Treasury Direct, operated by the Philadelphia Reserve Bank, is a system of book-entry securities accounts for institutions and individuals planning to hold their Treasury securities to maturity. The Treasury Direct system holds more than 721,000 accounts. During 1999, the Reserve Banks processed nearly 239,000 tenders for Treasury Direct customers seeking to purchase Treasury securities at Treasury auctions and handled 0.6 million reinvestment requests; the number of tenders was

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[8] The Fedwire book-entry securities mechanism is also used for safekeeping and transfer of securities issued by federal government agencies, government-sponsored enterprises, and international institutions. For more details, see the section ‘‘Fedwire Book-Entry Securities’’ earlier in this chapter.

22.7 percent lower than in 1998, and the number of reinvestment requests was 45.5 percent lower. The Philadelphia Reserve Bank issued 6.4 million payments for discounts, interest, and redemption proceeds; the Treasury Direct facility was also used to originate 2.8 million payments for savings bonds and more than 41,000 interest payments for definitive (paper) Treasury issues.

In May, the Reserve Banks started working with Treasury to reduce the number of sites that provide Treasury Direct customer service from thirty-seven to three—Boston, Minneapolis, and Dallas—and to enhance customer service for Treasury Direct investors. A few Treasury Direct offices moved their investors' accounts to new servicing locations in 1999, but the majority will move sometime in 2000. By 2001, all applications to purchase, reinvest, and redeem Treasury securities will go to one of the three consolidated sites, where they will receive the same quality and type of service as before. The Philadelphia Reserve Bank will continue to operate the Treasury Direct application.

As part of the Treasury Direct consolidation, the Reserve Banks began to design automation support for a toll-free customer contact center for Treasury Direct customers. The center will route calls to a variety of electronic services available from the Treasury or connect the investor to the next available agent at one of the three Reserve Banks, regardless of the caller's location.

At the Treasury's direction, the Reserve Banks eliminated walk-in services for Treasury securities and savings bond investors in September. Only a few customers were using this costly service, and the number of Federal Reserve offices that processed these transactions was declining as a result of consolidation. In 1998, the Treasury started to expand the services offered to investors electronically; for example, individuals can purchase Treasury securities and savings bonds on the Treasury's web site, and investors can use a touch-tone telephone to reinvest their maturing Treasury securities or to request statements of account. Throughout the summer, the Reserve Banks conducted an extensive information program to reduce the effect on walk-in customers.

As a service to Treasury Direct investors, the Chicago Reserve Bank, through the Sell Direct program, continued to sell investors' Treasury securities on the secondary market for a fee. In Sell Direct's second full year, the Bank sold nearly 16,000 securities worth $581.2 million, compared with more than 16,000 securities worth $510.6 million in 1998. The Bank collected almost $535,000 in fees on behalf of the Treasury, a decrease of 2.7 percent from the $550,000 in fees collected in 1998.

Savings Bonds

Reserve Bank operating expenses for savings bond activities totaled $70.3 million in 1999, a decrease of 1.5 percent from 1998. The Banks printed and mailed 40.5 million savings bonds on behalf of the Treasury's Bureau of the Public Debt, a 10.3 percent decline from 1998. In the first full year that the inflation-indexed Series I savings bond was offered, the Reserve Banks processed nearly 160,000 original-issue transactions for the Series I savings bond and 7.0 million original-issue transactions for the Series EE savings bond. They also processed approximately 550,000 redemption, reissue, and exchange transactions, a 9.0 percent decrease from 1998. The Reserve Banks responded to 1.6 million service calls from owners of savings bonds, approximately the same number as in 1998.

The Reserve Banks continued to enhance the automation aspects of savings bond processing. Following a successful pilot program in 1998, all savings bond processing sites implemented digital scanning software, which converts paper applications submitted by banks across the country into an electronic medium. Work also continued on a distributed processing automation platform for savings bonds to replace several current mainframe applications.

Savings bond operations are conducted at five Reserve Bank offices: Buffalo, Pittsburgh, Richmond, Minneapolis, and Kansas City. All five offices process transactions, but only the Pittsburgh and Kansas City offices print and mail savings bonds.

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 payment activities in 1999 totaled $35.0 million. The Banks processed approximately 44,000 paper and 4.8 million electronic advices of credit from depository institutions handling tax payments for businesses and individuals. Advices of credit are notices from depository institutions to the Federal Reserve and the Treasury that summarize taxes collected on a given day. The volume of paper advices of credit declined 80.9 percent from 1998 to 1999, and the volume of tax payments submitted electronically decreased 4.0 percent. The Reserve Banks also received a small number of tax payments directly.

Depository institutions that receive tax payments may either place the funds in a Treasury tax and loan (TT&L) account or remit the funds to a Reserve Bank. The Federal Reserve controls the collateral pledged to secure federal tax payment deposits held by depository institutions. The Minneapolis Reserve Bank operates an automated system through which businesses pay taxes that are due on the same day the tax liability is determined. These electronic tax payments, a part of the Treasury's Electronic Federal Tax Payment System (EFTPS), are invested in depository institutions' TT&L balances via the Federal Reserve's TT&L mechanism. In 1999, this electronic tax application processed approximately 164,000 tax payments from 7.8 million taxpayers totaling $201.0 billion. Approximately 93.6 percent of business taxes are collected electronically. Most EFTPS payments are made via ACH to accounts maintained by two commercial banks as Treasury's financial agents.

In 1999, work continued on a new automated program to be implemented in mid-2000, the Treasury Investment Program (TIP), which will replace the twelve existing TT&L applications with a single application and database. Besides centralizing this function, TIP also provides the Treasury with investment capabilities. The new program will process only electronic tax payments, which constitute most business tax payments today. A separate application, called Patax (paper tax processing system), will automate the handling of paper tax payments. The St. Louis Reserve Bank, acting on behalf of all the Reserve Banks, will truncate paper tax coupons when the TIP application is implemented.

Payments Processed for the Treasury

Reserve Bank operating expenses related to government payment operations in 1999 amounted to $47.2 million. The Treasury continued to encourage electronic payments: ACH transactions processed for the Treasury amounted to 823.6 million, an increase of 9.4 percent from 1998. Most government payments made via the ACH are social security, pension, and salary payments; some are payments to vendors. All recurring Treasury Direct payments and many definitive securities interest payments are made via the ACH.

In support of the Treasury's effort to make payments electronically, the Federal Reserve Bank of Dallas implemented Electronic Transfer Accounts in 1999. The accounts give beneficiaries of federal payments who do not have bank accounts access to low-cost transaction accounts at federally insured depository institutions. The Dallas Bank will manage enrollment of depository institutions that want to provide these accounts and will help payment recipients and others locate institutions that are authorized to offer the accounts.

The Treasury continues to reduce the number of payments it makes by paper check. The Reserve Banks processed 288.2 million paper government checks in 1999, a decrease of 10.3 percent from 1998. The Banks also issued nearly 609,000 paper fiscal agency checks, a decrease of 22.5 percent from 1998. Fiscal agency checks were used primarily to pay semiannual interest on registered, definitive Treasury notes and bonds and on Series H and HH savings bonds; some were used to pay the principal of matured securities and coupons and to make discount payments to first-time purchasers of government securities through Treasury Direct.

In 1999, the Reserve Banks continued to operate the check-imaging system, implemented in 1998, that captures and stores digital images of all U.S. government checks for the Treasury's Financial Management Service. This service improves processing efficiency for the U.S. Treasury and lowers its operating costs. In 1999, the Reserve Banks imaged 80.1 percent of all the U.S. government checks they processed, compared with 42.3 percent in 1998.

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. Depending on the authority under which the services are provided, the Reserve Banks may (1) maintain book-entry accounts of government agency securities and handle their transfer,[9] (2) provide custody for the stock of unissued definitive securities, (3) maintain and update balances of outstanding book-entry and definitive securities for issuers, (4) perform various other securities-servicing activities, (5) maintain funds accounts for some government agencies, and (6) provide various payments services.

One such service is the provision of food coupon services for the U.S. Department of Agriculture. Reserve Bank operating expenses for food coupon services in 1999 totaled $18.6 million, 24.1 percent lower than in 1998.

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[9] The Federal Reserve tracks the transfer and account maintenance of agency securities as a priced service to depository institutions. No expenses of providing these services to depository institutions are charged to the agencies.

The Banks redeemed 1.2 billion food coupons, a decrease of 33.3 percent from 1998. As a result of the Department of Agriculture's program to provide benefits electronically, the volume of paper food coupons redeemed by the Reserve Banks is expected to continue to decline. In 1999, the Richmond Reserve Bank helped facilitate the elimination of paper food coupons through its Account Management Agent software, which monitors funding requests for electronic benefit transfer and reports payment activity.

As fiscal agents of the United States, the Reserve Banks also process all postal money orders deposited by banks for collection. The Reserve Banks processed 225.9 million postal money orders in 1999, 6.2 percent more than in 1998. Much of this work is centralized at the St. Louis Reserve Bank. In 1999, that Bank worked with the U.S. Postal Service to design an image-capture service for postal money orders, similar to the service provided for Treasury checks. When the Bank implements this service in 2000, the digital files of paid money orders will facilitate the Postal Service's accounting, reconcilement, and claims processes.

Information Technology

Although year 2000 preparations dominated Federal Reserve information technology activities in 1999, a number of strategic initiatives were undertaken to improve the IT infrastructure over the next several years. In 1999, the Federal Reserve initiated a plan to modernize the current telecommunications network, Fednet, that supports both external electronic connections between the Federal Reserve and depository institutions and internal communications among Reserve Banks: Fednet will be upgraded with frame relay technology. The new network will improve the speed, reliability, and performance of depository institutions' electronic connections during contingencies and will provide the capacity and flexibility to support new electronic services that will use web-based technologies. The new network will also enable the Federal Reserve to introduce efficiencies into its internal IT operations by facilitating further standardization and consolidation of processing resources.

In 1999, the Federal Reserve completed installation of Triple DES, an advanced application of the Data Encryption Standard (DES), on its internal network and deployed Triple DES to approximately 12,000 Fedline connections, which give depository institutions access to a variety of Federal Reserve services. The Federal Reserve adopted Triple DES as its encryption method in 1998 to strengthen protection of information transmitted electronically among Reserve Banks and to depository institutions. As part of the frame relay network conversion, those depository institutions that connect to the Federal Reserve via computer interface will be converted to Triple DES.

During 1999, several depository institutions participated in a successful pilot program of Fedline for Windows (FLW). Concurrent with application testing, a significant effort was undertaken to improve the security of the new FLW platform. The security enhancements are directed at authenticating FLW operators, encrypting information, and interconnecting FLW with the administrative systems of depository institutions. Conversion of dial customers from the Federal Reserve's current DOS Fedline platform to the new FLW platform is expected to begin in late 2000. Deployment of FLW will also enable the Federal Reserve to complete its Triple DES initiative.

Reserve Banks continue to make significant progress in using the World Wide Web as a service-delivery channel. The Federal Reserve is developing an overall strategy for providing access to services through web browser interfaces. In 1999, the Federal Reserve planned the implementation of a public key infrastructure strategy to secure external access to its services. Depository institutions are currently conducting pilot programs of check-imaging, cash services, Treasury auction, and statistical-reporting web-based applications.

Financial Examinations of 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 assigns this responsibility to its Division of Reserve Bank Operations and Payment Systems. 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 annually provides an assertion letter to its board of directors 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.

In 1999, the division's attentions at the Reserve Banks focused on rendering an opinion, using a format consistent with the integrated COSO framework, on each District's internal control system. The scope of these examinations included comprehensive reviews of each Bank's internal control system in terms of the five COSO control components: control environment, risk assessment, control activities, information and communication, and monitoring.

Each year, to assess compliance with the policies established by the Federal Reserve's Federal Open Market Committee (FOMC), the division 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 distribution of net earnings of the Federal Reserve Banks for 1998 and 1999.

Total income in 1999 was $29,347 million, compared with $28,149 million in 1998. In 1999, total income included revenue from fees for the provision of priced services of $836 million. Total expenses were $2,552 million ($1,532 million in operating expenses, $321 million in earnings credits granted to depository institutions, $485 million in assessments for the cost of new currency, and $214 million in assessments for other expenditures by

Income, Expenses, and Distribution of Net Earnings of Federal Reserve Banks, 1999 and 1998

Millions of dollars

Item	1999	1998
Current income	29,347	28,149
Current expenses	1,852	1,833
Operating expenses[1]	1,532	1,487
Earnings credits granted	321	346
Current net income	27,495	26,316
Net additions to (deductions from, –) current net income	–526	1,914
Cost of unreimbursed services to Treasury	8	8
Assessments by the Board of Governors	699	587
For expenditures of Board	214	178
For cost of currency	485	409
Net income before payments to Treasury	26,262	27,636
Dividends paid	374	343
Transferred to surplus	479	732
Payments to Treasury[2]	25,410	26,561

NOTE. In this and the following table, components may not sum to totals because of rounding.

1. Includes a net periodic credit for pension costs of $367 million in 1999 and $288 million in 1998.

2. Interest on Federal Reserve notes.

the Board of Governors). Unreimbursed expenses for services provided to the Treasury and other government entities amounted to $8 million.[10]

The profit and loss account showed a net loss of $526 million. The loss was due primarily to unrealized losses on assets denominated in foreign currencies revalued to reflect current market exchange rates. Statutory dividends paid to member banks totaled $374 million, $31 million more than in 1998; 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 Treasury in the form of interest on Federal Reserve notes totaled $25,410 million in 1999, down from $26,561 million in 1998; 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 REPORT, table 5 details the income and expenses of each Reserve Bank for 1999, and table 6 shows a condensed statement for each Bank for 1914–99. 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 1999 amounted to $495,606 million, an increase of $48,511 million from 1998 (see table). Holdings of U.S. government securities increased $48,451 million, and holdings of loans increased $60 million.

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[10] The Reserve Banks bill the Treasury and other government entities for the cost of certain services, and the portions of the bills that are not paid are reported as unreimbursed expenses.

Securities and Loans of Federal Reserve Banks, 1997–99

Millions of dollars, except as noted

Item and year	Total	U.S. government securities[1]	Loans[2]
Average daily holdings[3]			
1997	417,805	417,529	277
1998	447,095	446,933	161
1999	495,606	495,384	221
Earnings			
1997	25,714	25,699	15
1998	26,851	26,842	9
1999	28,227	28,216	11
Average interest rate (percent)			
1997	6.15	6.16	5.27
1998	6.01	6.01	5.44
1999	5.70	5.70	5.02

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.

The average rate of interest earned on the Reserve Banks' holdings of government securities declined to 5.70 percent from 6.01 percent in 1998, and the average rate of interest earned on loans declined to 5.02 percent from 5.44 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 1995 through 1999.

Federal Reserve Bank Premises

In 1999, the design of the Atlanta Reserve Bank's new headquarters building was completed and construction began, and construction of the Bank's new Birmingham Branch building continued. Multiyear renovation programs were completed at the Kansas City Bank's Oklahoma City Branch and at the San Francisco Bank's Portland and Salt Lake City Branches. Other multiyear renovation programs continued at the New York Bank's headquarters building and the San Francisco Bank's Seattle Branch.

The multiyear leasehold improvements program continued for the New York Reserve Bank's new leased office facility in New York City, and some staff members have moved into the new offices. The Kansas City Bank continued to analyze options for expanding its headquarters parking facility.

The Board of Governors approved the installation of exterior security enhancements for the Richmond Reserve Bank's headquarters building. It also approved the selection of the site for the San Francisco Bank's new currency-processing facility in Phoenix; the facility's design was completed, and construction is planned to begin in 2000. Finally, the Board approved the Dallas Bank's request to begin a new building program for its Houston Branch and approved the selection of a site. Analysis of options for developing the site is continuing. ■

Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 1999 and 1998

Millions of dollars

Item	1999		1998	
Short-term assets (Note 1)				
Imputed reserve requirements on clearing balances	777.2		725.3	
Investment in marketable securities	6,994.8		6,527.7	
Receivables	78.2		76.8	
Materials and supplies	4.2		4.4	
Prepaid expenses	24.4		20.4	
Items in process of collection	3,747.8		4,272.5	
Total short-term assets		11,626.5		11,626.9
Long-term assets (Note 2)				
Premises	431.7		398.6	
Furniture and equipment	146.5		127.6	
Leases and leasehold improvements	59.5		26.8	
Prepaid pension costs	542.8		437.3	
Total long-term assets		1,180.5		990.4
Total assets		**12,807.0**		**12,617.3**
Short-term liabilities				
Clearing balances and balances arising from early credit of uncollected items	7,996.3		8,011.8	
Deferred-availability items	3,523.5		3,513.7	
Short-term debt	106.7		101.5	
Total short-term liabilities		11,626.5		11,626.9
Long-term liabilities				
Obligations under capital leases	.0		.0	
Long-term debt	237.2		193.6	
Postretirement/postemployment benefits obligation	231.2		217.4	
Total long-term liabilities		468.5		411.0
Total liabilities		**12,095.0**		**12,037.9**
Equity		712.0		579.4
Total liabilities and equity (Note 3)		**12,807.0**		**12,617.3**

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, 1999 and 1998

Millions of dollars

Item	1999		1998	
Revenue from services provided to depository institutions (Note 4)		835.9		816.0
Operating expenses (Note 5)		692.7		654.1
Income from operations		143.2		161.9
Imputed costs (Note 6)				
Interest on float	8.7		16.2	
Interest on debt	18.5		17.0	
Sales taxes	9.8		8.7	
FDIC insurance	2.7	39.7	1.4	43.4
Income from operations after imputed costs		103.5		118.5
Other income and expenses (Note 7)				
Investment income	337.3		352.0	
Earnings credits	–305.5	31.7	–328.2	23.7
Income before income taxes		135.3		142.3
Imputed income taxes (Note 8)		43.3		45.7
Net income (Note 9)		**92.0**		**96.6**
MEMO: Targeted return on equity (Note 10)		57.2		66.8

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, 1999

Millions of dollars

Item	Total	Commercial check collection	Funds transfer and net settlement	Book-entry securities	Commercial ACH	Noncash collection	Cash services
Revenue from services (Note 4)	835.9	681.0	66.8	16.7	65.5	2.9	2.9
Operating expenses (Note 5)	692.7	589.2	54.8	11.8	47.8	1.4	2.7
Income from operations	143.2	91.7	12.1	5.0	17.7	1.5	.2
Imputed costs (Note 6)	39.7	33.5	2.9	.6	2.5	.1	.0
Income from operations after imputed costs	103.5	58.2	9.2	4.4	15.2	1.4	.1
Other income and expenses, net (Note 7)	31.7	26.3	2.3	.6	2.3	.1	.1
Income before income taxes	135.3	84.6	11.5	5.0	17.4	1.5	.2
Imputed income taxes (Note 8)	43.3	27.1	3.7	1.6	5.6	.5	.1
Net income (Note 9)	**92.0**	**57.5**	**7.8**	**3.4**	**11.9**	**1.0**	**.2**
MEMO: Targeted return on equity (Note 10)	57.2	46.1	5.3	1.0	4.6	.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 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. 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 $105.5 million in 1999 and $87.1 million in 1998 and corresponding increases in this asset account.

(3) LIABILITIES AND EQUITY

Under the matched-book capital structure for assets that are not "self-financing," short-term assets are financed with short-term debt. Long-term assets are financed 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 adjustment 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 $3.4 million in 1999 and $2.8 million in 1998. 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 1999 and 1998 as follows (in millions):

	1999	1998
Check	.0	27.1
ACH	.0	.0
Funds transfer	1.7	19.6
Book entry	.0	.0
Noncash collection	.0	.1
Special cash services	.0	.1
Total	**1.7**	**46.9**

Total operating expense on the income statement by service does not equal the sum of operating expenses for each service because of the effect of SFAS 87. Although the portion of the SFAS 87 credit related to the current year is allocated to individual services, the amortization of the initial effect of implementation is reflected only at the System level.

(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. 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 costs are 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 service 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 1999 in millions of dollars:

Total float	584.4
Unrecovered float	21.3
Float subject to recovery	563.1
Sources of recovery of float	
Income on clearing balances	56.2
As-of adjustments	385.3
Direct charges	209.5
Per-item fees	(87.9)

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; float recovered through per-item fees has been added to the cost base subject to recovery in 1999.

(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.

Because clearing balances relate directly to the Federal Reserve's offering of priced services, the income and cost associated with these balances are allocated to each service based on each service's ratio of income to total income.

(8) INCOME TAXES

Imputed income taxes are calculated at the effective tax rate derived from the PSAF model (see note 3).

(9) ADJUSTMENTS TO NET INCOME FOR PRICE SETTING

In setting fees, certain costs are excluded in accordance with the System's overage and shortfalls policy and its automation consolidation policy. Accordingly, to compare the financial results reported in this table with the projections used to set prices, adjust net income as follows (amounts shown are net of tax):

	1999	1998
Net income	91.8	96.6
Amortization of the initial effect of implementing SFAS 87	−10.2	−10.2
Deferred costs of automation consolidation	−1.2	−14.5
Adjusted net income	80.4	71.9

(10) 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). This amount is adjusted to reflect the recovery of $1.2 million of automation consolidation costs for 1999 and $14.5 million for 1998. The Reserve Banks recovered these amounts, along with a finance charge, by the end of 1999.

The Board of Governors and the Government Performance and Results Act

Under the Government Performance and Results Act of 1993, federal agencies are required, in consultation with the Congress and outside stakeholders, to prepare a strategic plan covering a multiyear period and to submit annual performance plans and performance reports. Though not required to do so, the Board of Governors is voluntarily complying with the act's requirements.

Strategic and Performance Plans

The Board sent its strategic plan for the period 1997–2002 to the Congress in October 1997. The document states the Board's mission, articulates major goals for the period, outlines strategies for achieving those goals, and discusses the environment and other factors that could affect their achievement. It also addresses issues that cut across agency jurisdictional lines, identifies key quantitative measures of performance, and discusses performance evaluation. The strategic plan for the period 2000–05 is being prepared; the mission, goals, and other elements of the plan will remain essentially unchanged.

In September 1998, the Board sent to the Congress a performance plan for its 1998–99 budget.[1] Except for the monetary policy function, the plan set forth specific targets for some of the performance measures identified in the strategic plan. It also described the operational processes and resources needed to meet those targets and discussed validation and verification of results.

The strategic and performance plans are available on the Board's public web site (www.federalreserve.gov/boarddocs/rptcongress). A summary of the goals and objectives set forth in those plans is given in the next section.

Goals and Objectives

The Federal Reserve has three interrelated and mutually reinforcing goals, with supporting objectives:

Goal

To conduct monetary policy toward the achievement of maximum sustainable long-term growth and stable prices

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

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[1] The act requires that a performance plan be submitted for each fiscal year beginning with fiscal 1999. The Board budgets over a calendar year, and its budget covers a two-year period. The budget for 2000–01 was approved in September 1999. The performance plan for the 2000–01 budget is being prepared for publication in the second half of 2000. A report on the results of the performance plan for the 1998–99 budget is being prepared for release at about the same time.

- 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 through supervision and regulation of the nation's banking and financial systems, through its function as the lender of last resort, and through effective implementation of statutes designed to inform and protect the consumer

Objectives

- Maintain ability and capacity as a bank supervisor and central bank to ensure that emerging financial threats can be identified early and successfully resolved
- Provide comprehensive and effective supervision of U.S. banks, bank holding companies, U.S. operations of foreign banking organizations, and related entities by focusing supervisory efforts and resources on areas of highest risk to individual organizations and the financial system as a whole, and by developing effective regulations to promote a safe and sound banking environment
- Promote sound practices for managing risk at banking organizations in order to provide for strong internal controls, active boards of directors, and senior management oversight and accountability
- Promote sound banking and effective supervisory practices among developed and emerging countries through ongoing coordination with international supervisory bodies and through training programs for international supervisors and bankers
- Heighten the positive effect of market discipline on banking organizations by encouraging improved disclosures, accounting standards, risk measurement, and overall market transparency
- Harness benefits of technology in carrying out responsibilities to improve supervisory efficiency and to reduce burden on banking organizations
- Maintain an understanding of the effect of financial innovation and technology (for example, new powers and products, new risk management and measurement methodologies, and electronic banking) on the operations and risk profile of banking organizations and the payment system; ensure that supervisory programs accommodate prudent advances that benefit consumers and businesses or improve risk management
- Remove unnecessary banking restrictions, consistent with safety and soundness. Refine or eliminate unnecessary or ineffective policies, procedures, regulations, or restrictions to ensure that reforms are effectively implemented, consistent with safety and soundness of banking organizations
- Assure fair access to financial services for all Americans through vigorous enforcement of the Equal Credit Opportunity, Fair Housing, Community Reinvestment, and Home Mortgage Disclosure Acts and by encouraging state member bank involvement in community development activities
- Administer and ensure compliance with consumer protection statutes relating to consumer financial transactions (such as the Truth in Lending,

Truth in Savings, Consumer Leasing, and Electronic Fund Transfer Acts) to carry out congressional intent, striking the proper balance between protection of consumers and regulatory burden to the industry.
- Implement appropriate rules, regulations, and policies to comply with the Gramm–Leach–Bliley Act, which was enacted in November 1999.

Goal

To foster the integrity, efficiency, and accessibility of U.S. dollar payment and settlement systems, issue currency, and act as the fiscal agent and depository of the U.S. government

Objectives

- Provide Federal Reserve Bank priced payment services that maintain and improve the efficiency and integrity of the U.S. dollar payment mechanism
- Meet public demand for U.S. currency in the United States and abroad, work with Treasury to implement effective counterfeit-deterrence and detection features in U.S. currency, and provide for the smooth introduction of new-design currency
- Provide efficient and effective fiscal agency and depository services on behalf of Treasury and other government agencies
- Study and monitor U.S. dollar payment, clearing, and settlement systems and the risk issues pertaining to these systems to facilitate sound policy decisions that foster the integrity of the nation's payment systems.

Interagency Coordination

Interagency coordination helps focus efforts to eliminate redundancy and lower costs. As required 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 cross jurisdictional lines. In particular, 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.[2] In addition, a coordinating committee of the chief financial officers of the five agencies has been created to address and report on strategic planning issues of mutual concern. This working group has been meeting since June 1997 and has established four subgroups to focus on examinations, outreach, performance planning, and planning/budget linkage. These and similar planning efforts can significantly lower data processing and other costs for the government and the costs for depository institutions of compliance with federal regulations. ■

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[2] The FFIEC member agencies are the Board of Governors, 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 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.

Federal Legislative Developments

The following federal legislation enacted during 1999 significantly affects the Federal Reserve System and the institutions it supervises: the Gramm–Leach–Bliley Act; the Federal Reserve Retirement Portability Act; the consolidated appropriation for fiscal year 2000; and an amendment to the Federal Reserve Act to broaden the range of discount window loans.

Gramm–Leach–Bliley Act

The Gramm–Leach–Bliley Act (GLB Act), Public Law 106-102, enacted on November 12, 1999, amends the Bank Holding Company Act of 1956 (BHC Act), the Federal Reserve Act, and other federal banking laws. It allows banks to affiliate with securities broker–dealers, insurance companies and agents, and other entities engaged in a wide range of financial activities and establishes a prudential framework for the supervision of holding companies engaged in banking and other financial activities. The following sections summarize the GLB Act's seven titles and describe the portions that bear significantly on the Federal Reserve System and the institutions it supervises.

Title I

Title I revises the BHC Act to expand the ability of qualifying bank holding companies to engage in, or affiliate with companies engaged in, financial activities; establishes a prudential framework for the Board's supervision of bank holding companies and their subsidiaries; and establishes the conditions under which an insured bank may control a subsidiary engaged in activities that the parent bank is not allowed to conduct directly. It also makes other revisions to the BHC Act and other federal banking laws.

Expanded Activities for Financial Holding Companies

Title I repeals the provisions of the Glass–Steagall Act and the BHC Act that restricted the affiliation of bank holding companies with securities firms and insurance companies and agents. It also authorizes bank holding companies that qualify as financial holding companies (FHCs) to engage in, or affiliate with companies engaged in, a wide array of financial activities, including securities underwriting and dealing; insurance agency and underwriting activities; merchant banking activities; and any other activity that the Federal Reserve Board, in conjunction with the Secretary of the Treasury, determines to be financial in nature or incidental to financial activities. FHCs may also engage in nonfinancial activities that the Board determines are complementary to a financial activity and do not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

To become an FHC, a bank holding company must file a declaration with the Board certifying that all of its depository institution subsidiaries are well managed and well capitalized. Title I provides that a bank holding company's certification is not effective if any of the company's insured depository institution subsidiaries received less than a ‘‘satisfactory’’ rating at its most recent examination under the Community Reinvestment Act of 1977. It also requires that the Board establish comparable capital and managerial standards for foreign banks that seek to become an FHC.

Umbrella Supervision and Functional Regulation

Title I preserves the Board's role as the umbrella supervisor for all bank holding companies, including FHCs, and the Board's ability to establish consolidated capital requirements for bank holding companies and to obtain reports from and examine any bank holding company or subsidiary. In exercising its supervisory authority, the Board must rely, to the fullest extent possible, on publicly available information, externally audited financial statements, and reports that a bank holding company or subsidiary is required to provide to other supervisory authorities. In addition, the Board must focus its examination efforts, to the maximum extent possible, on bank holding companies and on those of the companies' subsidiaries that may have a materially adverse effect on an affiliated depository institution.

To reduce unnecessary regulatory burden and enhance functional regulation, Title I places certain additional limits on the Board's ability to obtain reports from, examine, establish capital requirements for, require a capital transfer from, or take enforcement action against a ‘‘functionally regulated subsidiary'' of a bank holding company. The GLB Act places similar limits on the supervisory authority of the other federal banking agencies with respect to a functionally regulated subsidiary of an insured depository institution.

Title I authorizes the Board to adopt rules governing relationships and transactions between state member banks and their subsidiaries, between depository institutions and their holding company affiliates, and between the U.S. branches, agencies, and commercial lending subsidiaries of foreign banks and their U.S. affiliates.

Financial Subsidiaries of Banks

Title I establishes the criteria under which a national bank may own or control a subsidiary engaged in activities that national banks are not allowed to conduct directly (a ‘‘financial subsidiary'') and establishes prudential requirements for national banks that have financial subsidiaries. A financial subsidiary does not include a subsidiary that national banks are expressly authorized by federal law (other than the GLB Act) to own or control, such as an Edge or agreement subsidiary controlled pursuant to sections 25 or 25A of the Federal Reserve Act.

Title I provides that financial subsidiaries of national banks may engage only in those activities that are determined to be financial in nature (or incidental to such activities) and other activities permissible for national banks to conduct directly. They are prohibited from engaging as principal in underwriting insurance (other than credit-related insurance); providing or issuing annuities; real estate investment or development activities (unless expressly authorized by law); and merchant banking activities. The Board and the Secretary of the Treasury may jointly remove the restrictions on the conduct of merchant banking activities by financial subsidiaries, but no earlier than five years after the date of enactment of the GLB Act.

Insured state banks may own or control a subsidiary that engages as principal in activities that national banks may conduct only through a financial subsidiary (for example, securities underwriting and dealing) only if the state bank complies with many of the same requirements applicable to national banks that have a financial subsidiary.

Derivatives Transactions and Intra-Day Credit under Section 23A

Title I amends section 23A of the Federal Reserve Act to require that the Board promulgate rules to address as ‘‘covered transactions’’ (1) the credit exposure arising from derivatives transactions between banks and their affiliates and (2) intra-day extensions of credit by banks to their affiliates.

Title II

Title II addresses the regulation of the securities, investment advisory, and investment company activities of banks and requires the Securities and Exchange Commission (SEC) to consult with the appropriate federal banking agency before taking any action with respect to the loan loss reserves of an insured depository institution or the holding company of an insured depository institution. It also permits companies that control a registered broker–dealer (but do not control an insured depository institution other than limited-purpose institutions) to voluntarily elect to be supervised by the SEC on a consolidated basis and establishes the framework for SEC supervision.

Bank Securities Activities

Title II amends the Securities Exchange Act of 1934, effective in May 2001, to repeal the blanket exemption for banks from the definitions of ‘‘broker’’ and ‘‘dealer.’’ It replaces those exemptions with a set of specific exemptions for banks engaged in traditional bank securities activities. Under Title II, a bank may avoid registering as a broker or dealer with the SEC only if it limits its securities activities to those specifically exempted by the GLB Act.

The specific exemptions would, among other things, allow banks to do the following subject to restrictions specified in the GLB Act: effect securities transactions in connection with their trust, custody, and safekeeping operations; privately place securities; purchase and sell traditional banking products, such as certificates of deposit, loan participations, and interest rate, currency, credit and equity swaps; and broker securities in up to 500 transactions per year that are not otherwise exempt.

Title II also allows banks to offer and sell, without registering as a broker or dealer, any financial product developed in the future unless the SEC determines, through a formal rulemaking process, that the new product is a security and that the registration of banks selling such products is in the public interest and necessary or appropriate to protect investors. In making this determination, the SEC is required to consider the views of the Board and the regulation of the product under the federal banking laws. The Board may challenge a determination by the SEC on a newly developed product area in federal court.

Consultation Concerning Loan Loss Reserves

Title II requires the SEC to consult with the appropriate federal banking agency before taking any action or rendering an opinion on the manner in which an insured depository institution or a depository institution holding company reports its loan loss reserves in its financial statements.

Title III

Title III addresses insurance-related issues, including the ability of national banks (and their subsidiaries) to provide insurance as principal and the regulation of the retail sale of insurance products by, or on the premises of, insured depository institutions. It also addresses the circumstances under which a mutual insurance company may change its state of incorporation for the purpose of reorganizing into a stock insurer controlled by a mutual holding company. In addition, Title III authorizes the creation of a new self-regulatory organization—the National Association of Registered Agents and Brokers—to establish uniform criteria for the qualification, training, and continuing education of insurance agents and brokers.

Insurance Underwriting Activities of National Banks

Title III generally prohibits national banks and their subsidiaries from underwriting insurance and providing or issuing annuities. National banks and their subsidiaries may continue to underwrite only those types of insurance that national banks were permitted to underwrite as of January 1, 1999. Title III establishes a procedure for determining whether financial products first offered after January 1, 1999, are banking products that national banks may provide as principal or are insurance products that they may not provide as principal. Special rules govern the ability of national banks (and their subsidiaries) to underwrite and sell title insurance.

Consumer Protection Regulations for Retail Insurance Sales

Title III amends the Federal Deposit Insurance Act to require the federal banking agencies to issue (to the extent they deem appropriate) consumer protection regulations governing the retail sale of insurance products by, or on the premises of, insured depository institutions and their subsidiaries. The regulations must prohibit the illegal tying of bank and insurance products; require certain disclosures; prohibit misleading advertising; require, to the extent practicable, the separation of insurance sales and deposit-taking activities; and establish a process for receiving and processing consumer complaints alleging a violation of the regulations.

Title IV

Title IV amends the Home Owners' Loan Act to close the unitary thrift loophole, which allowed commercial firms to control a federally insured savings association. It prohibits any company that acquired control of a savings association after May 4, 1999, from engaging in commercial activities. Companies that controlled only a single savings association before May 4, 1999 (or pursuant to an application filed before that date), may continue to engage in any type of financial or commercial activity.

Title V

Title V requires that financial institutions (as defined in the GLB Act) disclose to their customers, at the time a customer relationship is established, the institution's policies regarding the disclosure of confidential customer information to affiliates and third parties. It also generally prohibits a financial institution from disclosing any nonpublic personal information about a consumer to an unaffiliated third party unless the institution informs the consumer that such information may be shared with third parties and allows the consumer to ‘‘opt out’’ of such sharing arrangements. In addition, Title V prohibits financial institutions from disclosing a customer's account number or access code for a deposit, transaction, or credit card account to unaffiliated third parties for use in marketing programs.

Title V also prohibits persons, with certain exceptions, from obtaining customer information from a financial institution (as defined in the GLB Act), or from a customer of a financial institution, through the use of false, fictitious, or fraudulent statements or representations.

Title VI

Title VI effects a number of changes in the organization, membership, and powers of the Federal Home Loan Bank (FHLB) System. For example, Title VI amends the Federal Home Loan Act to permit insured depository institutions having less than $500 million in assets to become a member of the FHLB System without satisfying the qualified thrift lender test. It also amends that act to allow the FHLB System to make long-term advances to insured depository institutions having less than $500 million in assets for purposes of funding small businesses, small farms, and small agribusinesses.

Title VII

Title VII makes a number of miscellaneous amendments to the federal banking laws and mandates a number of studies.

CRA Sunshine Provisions

Title VII amends the Federal Deposit Insurance Act to require that the parties to certain agreements related to the Community Reinvestment Act (CRA) disclose the agreement to the public and the appropriate federal banking agency, and report annually to the appropriate federal banking agency on any payments made or actions taken pursuant to the agreement. It exempts certain types of agreements from coverage as a CRA-related agreement, including individual mortgage loans and agreements entered into by an insured depository institution (or affiliate) with an entity or person that has not commented or testified on the CRA or discussed or contacted the institution or affiliate concerning the CRA.

Small Bank CRA Examination Cycle

Title VII establishes a four-year CRA examination cycle for small insured depository institutions ($250 million or less in total assets) that received a ‘‘satisfactory’’ rating at their most recent CRA examination, and a five-year cycle for small institutions that received an ‘‘outstanding’’ rating at their most recent examination. However, the Board and the other federal banking agencies may conduct a CRA examination of a small insured depository institution at any time for reasonable cause or in connection with an application by the institution to establish a deposit facility.

Federal Reserve CRA Study

Title VII directs the Board to conduct a comprehensive study of the Community Reinvestment Act, focusing on the default, delinquency, and profitability of loans made in conformity with that act. In conducting the study, the Board must consult with the chairmen of and ranking members of the House Committee on Banking and Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs.

ATM Fee Disclosure

Title VII amends the Electronic Funds Transfer Act to require that automatic teller machine (ATM) operators imposing an ATM surcharge prominently post a notice to that effect on or at the ATM and inform consumers (through an on-screen message or paper receipt) of the surcharge amount before the consumer is irrevocably committed to completing the transaction. Issuers of ATM cards must also inform consumers at the time a card is issued that a surcharge may be imposed by a third party.

Plain Language Requirement

Title VII requires that the federal banking agencies use ‘‘plain language’’ in drafting all proposed and final rules to be published in the *Federal Register* .

Audits of the Federal Reserve Banks and the Board

Title VII amends the Federal Reserve Act to require that the Board obtain an annual independent audit of the financial statements of the Board and each Federal Reserve Bank.

Authorization to Release Reports

Title VII amends the Federal Reserve Act to allow the Board to release confidential supervisory information concerning any entity subject to examination by the Board to any other federal or state agency with supervisory authority over the entity; any officer, director or receiver of the entity; and any other person that the Board determines to be proper.

Federal Reserve Retirement Portability Act

On December 12, 1999, the President signed the Federal Reserve Retirement Portability Act, Public Law 106-168, which amends the Federal Employee Retirement System Act of 1986. Under the amendment, employees who worked for the Board of Governors after 1988 and participated in the ‘‘Bank’’ Benefit Structure of the Retirement Plan for Employees of the Federal Reserve System may transfer retirement credit for this service to the Federal Employees Retirement System if they later work for a federal government agency. The act also allows employees transferring to the Board from other federal agencies to withdraw their funds from the Federal Thrift Savings Plan and roll the funds over to the Board’s Thrift Plan.

Consolidated Appropriation for Fiscal Year 2000

The Consolidated Appropriation for Fiscal Year 2000, Public Law 106-168, was enacted on December 12, 1999. A section of the act amends the Federal Reserve Act to require the Federal Reserve Banks to transfer $3,752,000,000 from their surplus funds to the Board for transfer to the general fund of the Treasury. The amendment authorizes the Board to determine the amount that each Federal Reserve Bank must pay in fiscal year 2000. It also prohibits any Federal Reserve Bank from replenishing its surplus fund by the amount of any transfer it makes under this section.

Act to Amend the Federal Reserve Act

On December 6, 1999, the President signed Public Law 106-122, which amends the Federal Reserve Act to expand the types of instruments a Federal Reserve Bank may tender as collateral security to obtain Federal Reserve notes. Under this amendment, acceptable forms of collateral are expanded to include loans made under section 10B of the Federal Reserve Act. This amendment increases the Federal Reserve System’s flexibility in providing discount window credit while continuing to meet its obligations to collateralize Federal Reserve notes. ■

Regulatory Simplification

In 1978 the Board of Governors established a program of regulatory review to help minimize the burden of regulation on banking organizations. The objectives of the program are to ensure that all regulations, existing and proposed, represent the best course of action; to afford interested parties the opportunity to participate in the design of regulations and to comment on them; and to ensure that regulations are written in simple, clear language. Staff members regularly review Federal Reserve regulations for their adherence to these objectives and their consistency with the Regulatory Flexibility Act, which also requires that consideration be given to the economic consequences of regulation on small business. In its review process, the Board also follows the mandates of section 303 of the Riegle Community Development and Regulatory Improvement Act.

In 1999 the Board, as part of this review process, proposed revisions to Regulation B. It also proposed revisions to several consumer protection regulations to permit the electronic delivery of disclosures that are required to be given in writing. In addition, it amended Regulation A to establish a special lending program to accommodate liquidity needs during the century data change period.

Comprehensive Revisions Proposed

Regulation B

In August the Board published proposed revisions to Regulation B, which implements the Equal Credit Opportunity Act. The act makes it unlawful for creditors to discriminate against applicants on the basis of race, color, religion, national origin, marital status, sex, age, and other specified bases. The Board began the process of reviewing the regulation by issuing an advance notice of proposed rulemaking in March 1998; the proposed revisions take into account comments received at that time.

The proposed revisions would remove the general prohibition against creditors noting characteristics of applicants for nonmortgage credit such as race, sex, and national origin; they would not remove the prohibition against taking such information into account when extending credit. Creditors that choose to collect such information would be required to disclose that fact to applicants, and the proposal includes a model disclosure form. The revisions would require creditors to retain certain records concerning preapproved credit solicitations and would lengthen from twelve to twenty-five months the record-retention period for most applications for business credit.

Other Regulatory Activity

Electronic Disclosure

In August the Board issued for comment proposals that would permit financial institutions and others to provide federally mandated disclosures to consumers by electronic communication if the consumer consents. The proposals are modified from proposed rules (and an interim rule under Regulation E) issued in March 1998. They would authorize the electronic delivery of disclosures that under Regulations B (Equal Credit Opportunity), E (Electronic Fund Transfers), M (Consumer Leasing), Z (Truth in Lending), and DD (Truth in Savings) must be given in writing.

The proposals are an outgrowth of the 1996 comprehensive review of Regulation E, during which the Board determined that electronic communication of information required by federal laws governing financial services could reduce compliance costs without adversely affecting consumer protections.

With some exceptions, before obtaining a consumer's consent, financial institutions and others would have to provide to the consumer—through a standardized disclosure statement—certain information about electronic disclosures, including what type of disclosures would be provided electronically and how the consumer could receive and retain the disclosures.

Electronic disclosures could be delivered to a consumer's e-mail address or made available at another location such as an institution's web site. If an institution chooses to make disclosures available at a web site, it must notify a consumer when the information has been posted.

The proposals generally would require that when business is transacted in person, as is typical for mortgage loan closings, automobile loans and leases, and door-to-door sales involving credit, disclosures be made on paper. Most other disclosures could be delivered electronically, if the institution provides the disclosure statement about electronic delivery and obtains both the consumer's consent and the consumer's confirmation that his or her computer equipment meets the technical requirements necessary to receive and retain electronic disclosures.

Century Date Change Special Liquidity Facility

In July the Board amended Regulation A (Extensions of Credit by Federal Reserve Banks) to establish a special lending program to be in effect from October 1, 1999, through April 7, 2000. Under the program, Federal Reserve Banks could extend credit at a rate 150 basis points above the Federal Open Market Committee's targeted federal funds rate to eligible depository institutions to accommodate liquidity needs during the century date change period.

The special credit facility was designed to ensure that depository institutions would have adequate liquidity to meet any unusual demands during the period around the century date change. Among other things, it was intended to increase institutions' confidence in committing to supplying loans to other financial institutions and businesses through the rollover period.

In setting the interest rate on the loans at 150 basis points above the federal funds rate target, the Board judged that the spread was high enough to ensure that depository institutions would still have an incentive to seek funds in the private sector but low enough to provide a reasonable backstop should strains develop in funding and credit markets. The Board imposed no restrictions on the use and duration of the loans and applied the same collateral requirements as those for regular discount window loans. ■

Records

Record of Policy Actions of the Board of Governors

Regulation A
Extensions of Credit by Federal Reserve Banks

July 20, 1999—Amendments

The Board amended Regulation A to create a Century Date Change Special Liquidity Facility, a program for lending to depository institutions from October 1, 1999, through April 7, 2000.

> Votes for this action: Messrs. Greenspan, Kelley, Meyer, Ferguson, and Gramlich.[1]

The Board established the facility to help ensure that depository institutions have adequate liquidity to meet any unusual demands in the period around the century date change. The interest rate charged on loans from the special facility is 150 basis points higher than the Federal Open Market Committee's targeted federal funds rate. Although the collateral requirements are the same as for regular discount window loans, there are no restrictions on the use and duration of loans from the special facility while it is in operation, and borrowers are not required to seek funds elsewhere first.

Regulation D
Reserve Requirements of Depository Institutions

September 27, 1999—Amendments

The Board amended Regulation D to decrease the amount of net transaction accounts at depository institutions to which a lower reserve requirement applies and to increase the amount of reservable liabilities that is exempt from reserve requirements for 2000, effective for the reserve computation period beginning November 30, 1999, for institutions reporting weekly.

> Votes for this action: Messrs. Greenspan, Kelley, Meyer, Ferguson, and Gramlich.[1]

Under the Monetary Control Act of 1980, depository institutions, Edge Act corporations, 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 subject to the lower reserve requirement to reflect changes in net transaction accounts at depository institutions. Recent declines in net transaction accounts warranted a decrease to $44.3 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 increases in reservable liabilities at depository institutions. Recent growth in reservable liabilities warranted an increase in the amount exempted from reserve requirements to $5 million, and the Board amended Regulation D accordingly.

NOTE. In voting records throughout this chapter, Board members, except the Chairman and Vice Chairman, are listed in order of seniority.

[1] Throughout this chapter, note 1 indicates that two vacancies existed on the Board when the action was taken.

For institutions reporting weekly, the amendments are effective with the reserve computation period beginning November 30, 1999, and the corresponding reserve maintenance period beginning December 30, 1999. For institutions reporting quarterly, the amendments are effective with the reserve computation period beginning December 21, 1999, and the corresponding reserve maintenance period beginning January 20, 2000.

To reduce the reporting burden on small institutions, depository institutions having total deposits below specified levels are required to report their deposits and reservable liabilities quarterly or less frequently, while larger institutions must report weekly. To reflect increases in the growth rate of total deposits at all depository institutions, the Board increased the deposit cutoff levels used in determining the frequency and detail of depository reporting to $84.5 million for nonexempt depository institutions and to $54.3 million for exempt depository institutions, beginning in September 2000.

Regulation H
Membership of State Banking Institutions in the Federal Reserve System

October 21, 1999—Year 2000 Standards for Safety and Soundness

The Board made final the interim guidelines establishing Year 2000 standards for insured depository institutions, effective November 29, 1999.

> Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.[1]

The Board, jointly with the other federal banking and thrift agencies, made final the Interagency Guidelines Establishing Year 2000 Standards for Safety and Soundness for insured depository institutions that had been approved by the agencies as interim guidelines, effective October 15, 1998. The guidelines address project planning, renovation, testing, contingency planning, the role of management, risk assessment, and essential steps in each phase of Year 2000 readiness. The final guidelines make clarifying changes to the interim guidelines.

Regulation H
Membership of State Banking Institutions in the Federal Reserve System

Regulation K
International Banking Operations

Regulation Y
Bank Holding Companies and Change in Bank Control

March 23, 1999—Termination of Proposed Rulemaking

The Board withdrew a proposed rule that would have required the domestic and foreign banking organizations it supervises to develop and maintain ‘‘Know Your Customer’’ programs.

> Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

In December 1998, the Board and the other federal banking and thrift agencies requested comment on substantially similar ‘‘Know Your Customer’’ rules that would have required domestic and foreign depository institutions to de-

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[2] Throughout this chapter, note 2 indicates that one vacancy existed on the Board when the action was taken.

velop policies and procedures designed to identify customers and their normal and expected transactions, to monitor account activity, and to use this information to identify and report suspicious transactions. The Board and the other agencies withdrew the proposal on the basis of an analysis of the comments received.

Regulation H
Membership of State Banking Institutions in the Federal Reserve System

Regulation Y
Bank Holding Companies and Change in Bank Control

February 17, 1999—Amendment

The Board made final an interim rule amending Regulations H and Y to reduce regulatory burden on certain banking organizations having significant trading activities under the risk-based capital standards, effective July 1, 1999.

> Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

The Board, jointly with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, made final an interim rule adopted in December 1997 by amending the risk-based capital standards for market risk applicable to certain banks and bank holding companies that have significant trading activities. If an institution's internal model adequately measures specific risk, the amendment eliminates the requirement that when using an internal model, the total capital charges for specific risk must equal at least 50 percent of the standard specific risk capital charge. The rule reduces regulatory burden for institutions having qualifying internal models by eliminating the calculation of a standard specific risk capital charge.

February 24, 1999—Amendments

The Board amended Regulation H to revise the risk-based and leverage capital standards for banks to make the capital treatment for certain transactions more consistent among the federal banking and thrift agencies and amended Regulation Y to apply the same standards to bank holding companies, effective April 1, 1999.

> Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

The amendments, adopted by the Board jointly with the other federal banking and thrift agencies, revise the risk-based and leverage capital standards for state member banks, consistent with provisions of the Riegle Community Development and Regulatory Improvement Act of 1994. The amendments conform the risk-based capital treatments among the agencies for certain construction and real estate loans and investments in mutual funds, and simplify and make uniform the agencies' tier 1 leverage capital standards. The amendments to Regulation Y apply the same revisions to the risk-based capital standards for bank holding companies.

Regulation K
International Banking Operations

May 17, 1999—Amendment

The Board approved an amendment to Regulation K that makes final an interim rule extending the examination-frequency cycle for certain U.S. branches and agencies of foreign banks, effective October 22, 1999.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

The amendment, which was issued jointly with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, implements provisions of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 by making U.S. branches and agencies of foreign banks having assets of $250 million or less eligible for an eighteen-month examination cycle rather than a twelve-month cycle if they meet the qualifying criteria set out in the rule.

Regulation L
Management Official Interlocks

September 7, 1999—Amendments

The Board amended Regulation L to conform with recent statutory changes and to simplify compliance with the rule's requirements, effective January 1, 2000.

Votes for this action: Messrs. Greenspan, Kelley, Meyer, Ferguson, and Gramlich.[1]

Regulation L implements the Depository Institution Management Interlocks Act by prohibiting management officials from serving simultaneously with two unaffiliated depository institutions or their holding companies based on the depository organizations' asset size and the location of their offices. The Economic Growth and Regulatory Paperwork Reduction Act of 1996 amended three principal provisions of the Interlocks Act. It (1) increased the asset threshold for prohibiting management official interlocks between two unaffiliated depository organizations, regardless of office location, to interlocks involving organizations having total assets exceeding $2.5 billion and $1.5 billion respectively; (2) permanently exempted management officials whose service began before November 10, 1978; and (3) authorized exemptions from the Interlocks Act by regulation if the interlocking service would not result in a monopoly or substantially lessen competition. The Board, jointly with the other federal banking and thrift agencies, amended its management interlocks rules to comply with the new statutory provisions and to make other changes to simplify compliance with the rule's requirements.

Regulation CC
Availability of Funds and Collection of Checks

March 17, 1999—Amendment

The Board amended Regulation CC to allow banks that consummate a merger on or after July 1, 1998, and before March 1, 2000, to treat themselves as separate banks for purposes of the regulation until March 1, 2001, in order to provide them greater time to implement software changes related to the merger.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

Under the amendment, banks that consummate a merger within the specified time period will be treated as separate banks until March 1, 2001. The amendment is designed to provide relief to banks that are dedicating their automation resources primarily to renovating and testing software and replacing systems to address Year 2000 and leap year computer problems.

June 28, 1999—Termination of Proposed Rulemaking

The Board decided not to propose regulatory changes at this time to reduce the availability schedule for nonlocal checks.

> Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

In December 1998, the Board requested comment on an advance notice of proposed rulemaking to modify the availability schedule in Regulation CC for nonlocal checks. The proposal would have reduced the maximum hold for nonlocal checks from five to four business days, except for subcategories of nonlocal checks for which a depositary bank certifies that it does not receive a sufficient proportion of returns within four business days. After further analysis, the Board concluded that return times do not support a reduced availability schedule for nonlocal checks in the aggregate. The Board also determined that the costs and potential risks would outweigh the likely benefits of establishing subcategories of nonlocal checks for availability purposes.

October 26, 1999—Amendments

The Board amended Regulation CC to clarify the extent to which depository institutions and others may vary the terms of the regulation by agreement for the purpose of instituting electronic return of checks, effective December 15, 1999.

> Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.[1]

In February 1999, the Board requested comment on options for amending Regulation CC, which governs when paying or returning banks may send notices instead of returning the original checks, to consider whether more flexibility would enable check system participants to experiment with methods to return checks electronically. Rather than adopting any of the proposed options, the Board revised the Commentary to Regulation CC to add examples of interbank agreements on electronic presentment and return of checks.

Regulation DD
Truth in Savings

August 18, 1999—Interim Amendment

The Board approved an interim amendment to Regulation DD to permit depository institutions to provide certain disclosures electronically if the customer agrees, effective September 1, 1999.

> Votes for this action: Messrs. Greenspan, Kelley, Meyer, Ferguson, and Gramlich.[1]

Regulation DD, which implements the Truth in Savings Act, generally requires depository institutions to provide consumers with written disclosures of the yields, fees, and other terms for deposit accounts on request, when an account is opened, when changes in terms occur, and in periodic statements. The interim amendment permits depository institutions to provide Regulation DD's disclosures on periodic statements electronically if the customer agrees. The interim rule was adopted in response to comments received on a proposed rule issued in March 1998. Along with the interim amendment, the Board published for comment revised proposals to permit electronic disclosures under Regulations B (Equal Credit

Opportunity), E (Electronic Fund Transfers), M (Consumer Leasing), Z (Truth in Lending), and DD (Truth in Savings).

Miscellaneous Interpretations

Regulation K

International Banking Operations

October 25, 1999—Interpretation

The Board clarified that the scope of permissible data processing activities under Regulation K encompasses all those activities permissible for bank holding companies under Regulation Y (Bank Holding Companies and Change in Bank Control), effective November 1, 1999.

Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.[1]

Regulation K provides that a bank holding company or Edge Act corporation may control a foreign company that engages in activities that are usual in connection with the transaction of banking or other financial operations abroad, including data processing, but does not specify the scope of permissible data processing activities. Amendments to Regulation Y have expanded the scope of permissible data processing activities for bank holding companies in the United States, and those activities are equal to, and in some respects broader than, the data processing activities that were authorized by the adoption of Regulation K in 1979. The interpretation clarifies that the data processing provision of Regulation K encompasses the same data processing activities as described in Regulation Y under the same limitations. Banking organizations seeking to engage abroad in data processing or data transmission activities that are not authorized by Regulation Y must apply for the Board's prior consent under Regulation K.

Policy Statements and Other Actions

February 19, 1999—Policy Statement on Payments System Risk

The Board approved a modification to the procedures for measuring daylight overdrafts to include the posting time for settlement entries processed through the enhanced settlement service. The modification became effective on March 29, 1999, to coincide with the implementation of the enhanced settlement service.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

In 1998, the Board approved an enhanced settlement service that combines and improves selected features of the Reserve Banks' existing net settlement services and may be used for either gross or net multilateral settlements. The service provides same-day, intraday settlement finality to participants in clearing arrangements using the service. Settlement entries processed by the enhanced settlement service will be posted on a flow basis as they are processed and are final and irrevocable.

May 20, 1999—Delegation of Authority

The Board delegated to its General Counsel the authority to return applications filed under the International Banking Act that are informationally incomplete, effective May 20, 1999.

Votes for this action: Mr. Greenspan and Messrs. Kelley, Meyer, Ferguson, and Gramlich. Absent and not voting: Ms. Rivlin.[2]

Under the International Banking Act, the Board may not approve an application by a foreign bank to establish a branch, agency, commercial lending company, or representative office unless the bank provides the Board with information needed to adequately evaluate the application. The Board delegated to the General Counsel, with the concurrence of the director of the Division of Banking Supervision and Regulation, the authority to return an application if material informational deficiencies are not corrected within a reasonable period of time.

June 22, 1999—Policy Statement Concerning Branch Closing Notices and Policies

The Board approved a revised policy statement on branch closings by insured depository institutions to incorporate changes in the law, effective June 29, 1999.

> Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

The Board, jointly with the other federal banking and thrift agencies, approved a revised policy statement on branch closings by insured depository institutions to incorporate changes enacted by the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 and the Economic Growth and Regulatory Paperwork Reduction Act of 1996. The policy statement gives guidance on the procedure for branch closings in low- or moderate-income areas by an interstate bank and for convening a meeting with the appropriate parties if requested by a person from the affected area. The revised statement also provides that the prior-notice requirements for branch closings do not apply to automated teller machines, certain types of relocations and consolidations, and branches closed in connection with emergency acquisitions or assistance by the Federal Deposit Insurance Corporation.

July 14, 1999—Notice of Modification of Procedures for Deposit Reporting Frequency

The Board amended its requirements that depository institutions switch to new reporting categories for September 1999 in light of the century date change, effective August 1, 1999.

> Votes for this action: Messrs. Greenspan, Kelley, Meyer, Ferguson, and Gramlich.[1]

Depository institutions may be required to switch to new reporting categories each September. Assignment to these reporting categories determines the frequency and detail of deposit-reporting over the subsequent year and depends on increases or decreases in the level of deposits and reservable liabilities. The Board suspended some shifts in reporting categories for September 1999, thereby reducing the need for depository institutions to modify their data processing systems before the impending century date change. Normal category shift procedures will apply in September 2000.

November 10, 1999—Settlement Day Finality for Automated Clearinghouse Credit Transactions

The Board approved modifications to the time when settlement becomes final for automated clearinghouse (ACH) credit transactions processed by Federal Reserve Banks and required prefunding for ACH credit transactions in certain Federal Reserve accounts. The effective date will be announced three months before implementation in 2001.

> Votes for this action Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich.[1]

The Board made settlement for ACH credit transactions processed by the Federal Reserve final when posted, currently 8:30 a.m. eastern time on the day of settlement, and adopted a prefunding requirement for any ACH credit originations settled through a Federal Reserve account that is monitored in real time. The modifications are designed to reduce risk to receiving depository financial institutions in credit transactions and to manage settlement risks in credit originations in a manner comparable to other Federal Reserve services that have similar finality characteristics. To allow sufficient time for software modifications, the effective date for settlement-day finality for credit ACH transactions will be announced three months before implementation in 2001.

1999 Discount Rates

During 1999, the Board of Governors approved two increases of ¼ percentage point in the basic discount rate charged by the Federal Reserve Banks. These actions, taken in August and November, raised the basic rate from 4½ percent to 5 percent. The rates for seasonal and extended credit, which are set on the basis of market-related formulas, were changed more frequently, and they exceeded the basic rate by varying amounts during the year. In July, the Board announced the establishment of a temporary program, the Century Date Change Special Liquidity Facility (SLF), whose purpose was to lend to depository institutions to help them meet any unusual liquidity needs in the period around the century date change.

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 in 1999, which also appear in this REPORT.

January through Mid-August: No Changes in the Basic Rate

Economic activity expanded at a vigorous pace during the early months of the year, underpinned by notable further strength in consumer spending, but the recovery of financial markets in the United States and abroad and of foreign economies from the severe disruptions of the fall of 1998 was still tentative. Moreover, in an environment of robust improvements in productivity, inflation trends remained generally subdued despite very tight labor markets. Against this background, a majority of the Federal Reserve Banks favored an unchanged basic discount rate of 4½ percent, its level since mid-November 1998. However, two Banks particularly concerned about the mounting risks of higher inflation requested an increase of ¼ percentage point during March and April, and three other Banks joined them during the period from May through July. The Board took no action on these requests, but the Board members recognized the need to monitor carefully developments bearing on the outlook for rising inflation, notably, evidence of further tightening of labor markets in the context of continuing rapid growth of the economy.

Mid-August and Mid-November: Basic Rate Increased

In August a growing number of Federal Reserve Banks joined those requesting a ¼ percentage point increase in the basic rate—a total of ten by the third week of August—amid indications that recent wage and price increases had been a little larger on balance, though price inflation was still subdued. On August 24, the Board approved these pending actions in concert with a similar action by the FOMC to increase its intended level of the federal funds rate. These policy actions took account of the more normal functioning of the financial markets following the period of some unsettlement during the fall of 1998 and of the ongoing strength in domestic demand augmented by rising exports at a time when labor markets were already very tight. Against this background, the Board and the FOMC concluded that the degree of monetary ease that had been implemented during the autumn of 1998 to address the domestic effects of global financial turmoil was no longer consistent with sustained, noninflationary economic expansion.

In mid-October, two Federal Reserve Banks requested a further increase of ¼ percentage point in the basic rate, and by mid-November two additional Banks had joined them. On November 16, again in conjunction with a similar increase by the FOMC in the intended federal funds rate, the Board approved the pending actions, thereby raising the basic discount rate to 5 percent. Both actions reflected concerns that despite tentative evidence of some slowing in certain interest-sensitive sectors of the economy and of accelerating productivity, prevailing conditions in financial markets seemed likely to foster continued expansion in aggregate demand at a pace that would exceed the growth of potential output, with attendant risks of rising inflation over time. In light of market uncertainties associated with the century date change, no further changes in the discount rate were requested over the balance of the year despite ongoing concerns about the outlook for inflation.

Structure of Discount Rates

The basic discount rate is the rate normally charged on loans to depository institutions for short-term adjustment credit, while flexible, market-related rates generally apply on seasonal and extended credit. These flexible rates are calculated every two weeks in accordance with formulas that are approved by the Board. The rate on loans from the Special Liquidity Facility during the century date rollover period was set at 150 basis points above the intended federal funds rate established by the FOMC.

The objective of the seasonal program is to help smaller institutions meet liquidity needs arising from a clear pattern of intra-yearly movements in their deposits and loans. Funds may be provided for periods longer than those permitted under adjustment credit. Since its introduction in early 1992, the flexible rate charged on seasonal credit has been closely aligned with short-term market rates; it is never less than the basic rate applicable to adjustment credit.

The purpose of extended credit is to assist depository institutions that are under sustained liquidity pressure and are not able to obtain funds from other sources. The rate for extended credit is 50 basis points higher than the rate for seasonal credit and is at least 50 basis points above the basic rate. In appropriate circumstances, the basic rate may be applied to extended-credit loans for up to thirty days, but any further borrowings would be charged the flexible, market-related rate.

The Special Liquidity Facility was established as a temporary program for lending to depository institutions during the period October 1, 1999, through April 7, 2000. This facility was intended to help ensure that depository institutions would have adequate liquidity in the period surrounding the century date change.

Exceptionally large adjustment-credit loans that arise from computer breakdowns or other operating problems not clearly beyond the reasonable control of the borrowing institution are assessed the highest rate applicable to any credit extended to depository institutions; under the current structure, that is the rate on SLF credit.

At the end of 1999, the structure of discount rates was as follows: a basic rate of 5 percent for short-term adjustment credit and rates of 5.70 percent for seasonal credit, 6.20 percent for extended credit, and 7 percent for credit from the Special Liquidity Facility. During 1999, the rate for seasonal credit ranged from a low of 4.75 percent to a high of 5.75 percent, that for extended credit from a low of 5.25 percent to a high of 6.25 percent, and that for SLF credit from a low of 6.75 percent to a high of 7 percent.

Board Votes

Under the Federal Reserve Act, the boards of directors of the Federal Reserve Banks must establish rates on loans to depository institutions at least every fourteen days and must submit such rates to the Board of Governors for review and determination. The Reserve Banks are also required to submit requests on the same schedule to renew the formulas for calculating the rates on seasonal, extended, and SLF 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 1999 were unanimous.

Votes on the Basic Discount Rate

August 24, 1999. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Kansas City, and San Francisco to increase the basic discount rate ¼ percentage point, to 4¾ percent.

> Votes for this action: Messrs. Greenspan, Kelley, Meyer, Ferguson, and Gramlich. Votes against this action: None.

The Board subsequently approved similar actions taken by the directors of the Federal Reserve Banks of Minneapolis and Dallas, effective August 25 and 26, 1999, respectively.

November 16, 1999. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, Cleveland, Richmond, Kansas City, and San Francisco to increase the basic discount rate ¼ percentage point, to 5 percent.

> Votes for this action: Messrs. Greenspan, Ferguson, Kelley, Meyer, and Gramlich. Votes against this action: None.

The Board subsequently approved similar actions taken by the directors of the Federal Reserve Banks of Atlanta and Dallas, effective November 17, 1999, and by the directors of the Federal Reserve Banks of New York, Philadelphia, Chicago, St. Louis, and Minneapolis, effective November 18, 1999. ■

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 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 along with a summary of the reasons for their dissent.

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 two sets of instructions from the Federal Open Market Committee: an Authorization for Domestic Open Market Operations 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 1999. 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, 1999

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, 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 60 calendar 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.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the Committee may specify from time to time.

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 60 calendar days 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.

Domestic Policy Directive

In Effect January 1, 1999[1]

The information reviewed at this meeting suggests that the economy has continued to expand at a brisk pace in recent months. Growth in nonfarm payroll employment was strong in November, after more moderate gains in September and October, and the civilian unemployment rate fell to 4.4 percent. Total industrial production declined somewhat in November, but manufacturing output was stable and up considerably from the third-quarter pace. Business inventory accumulation slowed appreciably in October after a sizable rise in the third quarter. The nominal deficit on U.S. trade in goods and services narrowed slightly in October from its third-quarter average. Total retail sales rose sharply in October and November, and housing starts were strong as well. Available indicators point to a considerable pickup in

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[1] Adopted by the Committee at its meeting on December 22, 1998.

business capital spending after a lull in the third quarter. Trends in various measures of wages and prices have been mixed in recent months.

Most short-term interest rates have changed little on balance since the meeting on November 17, but longer-term rates have declined somewhat. Share prices in equity markets have remained volatile and have posted sizable gains on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar has declined slightly over the period in relation to other major currencies and in terms of an index of the currencies of other countries that are important trading partners of the United States.

M2 and M3 have posted very large increases in recent months. For the year through November, both aggregates rose at rates well above the Committee's annual ranges. Total domestic nonfinancial debt has expanded in recent months at a pace somewhat above the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting on June 30–July 1 the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on a tentative basis to set the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 4¾ percent. In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period.

Authorization for Foreign Currency Operations

In Effect January 1, 1999

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:

Austrian schillings
Belgian francs
Canadian dollars
Danish kroner
euro
Pounds sterling
French francs
German marks
Italian lire
Japanese yen
Mexican pesos
Netherlands guilders
Norwegian kroner
Swedish kronor
Swiss francs

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 (millions of dollars equivalent)
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	3,000
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,250

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 non–market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. 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.

Foreign Currency Directive

In Effect January 1, 1999

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 and with the Bank for International Settlements.

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, 1999

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 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 February 2–3, 1999

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, February 2, 1999, at 2:30 p.m. and continued on Wednesday, February 3, 1999, at 9:00 a.m.

Present:
Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehn
Mr. Ferguson
Mr. Gramlich
Mr. Kelley
Mr. McTeer
Mr. Meyer
Mr. Moskow
Ms. Rivlin
Mr. Stern

Messrs. Broaddus, Guynn, Jordan, and Parry, Alternate Members of the Federal Open Market Committee

Ms. Minehan, Messrs. Poole, and Hoenig, Presidents of the Federal Reserve Banks of Boston, St.Louis, and Kansas City respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist

Messrs. Alexander, Cecchetti, Hooper, Hunter, Lang, Lindsey, Rolnick, Rosenblum, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Mr. Winn,[2] Assistant to the Board, Office of Board Members, Board of Governors

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Dennis,[3] Assistant Director, Division of Reserve Bank Operations and Payment Systems, Board of Governors

Messrs. Reifschneider[4] and Small,[4] Section Chiefs, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

Ms. Kole,[5] Messrs. English[5] and Rosine,[5] Senior Economists, Divisions of International Finance, Monetary Affairs, and Research and Statistics respectively

Ms. Garrett, Economist, Division of Monetary Affairs, Board of Governors

Mr. Evans,[3] Manager, Division of Reserve Bank Operations and Payment Systems, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Conrad, First Vice President, Federal Reserve Bank of Chicago

Messrs. Beebe, Eisenbeis, Goodfriend, Hakkio, and Rasche, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, Kansas City, and St. Louis respectively

Messrs. Altig, Bentley, and Rosengren, Vice Presidents, Federal Reserve Banks of Cleveland, New York, and Boston 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, 1999, and ending December 31, 1999, 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.[6]

Edward G. Boehne, President of the Federal Reserve Bank of Philadelphia, with J. Alfred Broaddus, Jr., President of the Federal Reserve Bank of Richmond, as alternate.

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[2] Attended Wednesday's session only.

[3] Attended portions of meeting relating to the examination of the System Open Market Account and changes to the domestic securities lending program.

[4] Attended portions of meeting relating to the discussion of the Committee's consideration of its monetary and debt ranges for 1999.

[5] Attended portion of meeting relating to the Committee's review of the economic outlook and consideration of its monetary and debt ranges for 1999.

[6] Mr. Jamie B. Stewart, Jr., incoming First Vice President of the Federal Reserve Bank of New York, took his oath of office as alternate member for Mr. McDonough on February 18, 1999.

Michael H. Moskow, President of the Federal Reserve Bank of Chicago, with Jerry L. Jordan, President of the Federal Reserve Bank of Cleveland, 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.

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 meeting of the Committee after December 31, 1999, 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
Lynn S. Fox	Assistant Secretary
Gary P. Gillum	Assistant Secretary
J. Virgil Mattingly, Jr.	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Michael J. Prell	Economist
Karen H. Johnson	Economist

Lewis S. Alexander, Stephen G. Cecchetti, Peter Hooper, III, William C. Hunter, Richard W. Lang, David E. Lindsey, Arthur J. Rolnick, Harvey Rosenblum, Larry Slifman, and David J. Stockton, 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 meeting of the Committee after December 31, 1999.

By unanimous vote, Peter R. Fisher 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. Fisher as Manager was satisfactory to the board of directors of the Federal Reserve Bank of New York.

The Report of Examination of the System Open Market Account, conducted by the Board's Division of Reserve Bank Operations and Payment Systems as of the close of business on November 5, 1998, was accepted.

On the recommendation of the Manager of the System Open Market Account, the Committee amended paragraph 2 of the Authorization for Domestic Open Market Operations relating to the Treasury securities lending program. The revised facility introduces the auction technique for awarding borrowed securities to dealer firms on a competitive basis. The new facility is designed to implement more effectively the objective of providing a short-term ‘‘last resort’’ source of Treasury securities to the dealer market and thereby to facilitate the smooth clearing of Treasury securities and to ease liquidity strains in the market as they arise. The amended Authorization for Domestic Open Market Operations was approved unanimously in the form shown below:

Authorization for Domestic Open Market Operations

Amended February 2, 1999

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 60 calendar 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.

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 60 calendar days 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.

On the Manager's recommendation, the Committee also amended the Foreign Currency Authorization and the Foreign Currency Directive to reflect changes triggered by the launch of the euro. Specifically, it dropped from the Authorization those European currencies that now exist as denominations of the euro (Austrian schillings, Belgian francs, French francs, Italian lire, Netherlands guilders, and German marks). The amendments also removed the central banks of Austria, Belgium, Denmark, England, France, Germany, Italy, Japan, Netherlands, Norway, Sweden, and Switzerland, and the Bank for International Settlements from the list of institutions with which the Federal Reserve Bank of New York was authorized to maintain reciprocal currency arrangements (swap facilities). In keeping with the Committee's decision at the November 1998 meeting and after consultations with officials at the foreign institutions, the reciprocal currency arrangements in question were not renewed after they matured on various dates in December.

Accordingly, the amended Authorization for Foreign Currency Operations and the Foreign Currency Directive were unanimously approved in the forms shown below:

Authorization for Foreign Currency Operations

Amended February 2, 1999

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
Danish kroner
Euro
Pounds sterling
Japanese yen

Mexican pesos
Norwegian kroner
Swedish kronor
Swiss francs

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 1A. 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 non-market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. 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.

Foreign Currency Directive

Amended February 2, 1999

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 shown below were reaffirmed.

Procedural Instructions with Respect to Foreign Currency Operations

Reaffirmed February 2, 1999

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 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.

On January 27, 1999, 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 February 2–3 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. The Committee discussed proposed changes to the Program for Security of FOMC Information to update the document with regard to certain security classifications and access to confidential FOMC information. The Committee decided to continue its discussion at a later meeting.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on December 22, 1998, 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, and thus no vote was required 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 22, 1998 through February 2, 1999. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the economy expanded rapidly in the closing months of 1998. Widespread strength in domestic final demand and a diminished drag from net exports underpinned further solid gains in production, employment, and income. Inflation remained subdued despite very tight labor markets.

Nonfarm payroll employment recorded robust increases in November and December. Although manufacturing experienced further sizable job losses over the two months, strong employment gains were achieved in construction, retail trade, and the services industries. The civilian unemployment rate fell to 4.3 percent in December, and other measures of labor conditions also indicated that labor markets remained quite tight through year-end.

Industrial production rebounded in December from a small November decline. Industrial output strengthened for the fourth quarter as a whole, largely reflecting a surge in the production of motor vehicles and parts that more than offset sizable reductions in mining and utility output. The manufacture of high-tech equipment surged further and the production of construction supplies stayed on a brisk upward trend while activity in other manufacturing categories remained weak. On balance, output in manufacturing expanded at about the same pace as capacity, leaving the factory operating rate unchanged at a relatively low level.

Consumer spending, supported by further sizable gains in income and net worth, remained robust through year-end. Retail sales rose sharply in the fourth quarter. Expenditures for durable goods, particularly motor vehicles, were very strong. Outlays for nondurable goods were brisk despite sluggish growth in spending for apparel. Unseasonably mild weather held down spending for energy services in November and December, but purchases of other types of services recorded moderate increases. Surveys in early 1999 indicated buoyant consumer sentiment, reflecting optimism about personal finances and the employment outlook.

Residential housing activity continued to display substantial strength in the fourth quarter. Single-family housing starts remained at a very high level in December, and sales of new homes in that month were only slightly below the record established in November. Sales of existing homes hit a record high in December. Unseasonably favorable weather extended the construction season in some areas of the country, but low mortgage rates, rapid employment growth, rising net worth, and special financing programs designed to broaden opportunities for homeownership were important factors in the strength of home sales. Multifamily housing starts edged lower in the fourth quarter as a December increase partially reversed a November decline; rents have continued to rise in real terms over the last several years, but vacancy rates have changed little.

Business fixed investment picked up markedly in the fourth quarter after the small decline of the previous quarter. Much of the surge in spending on producers' durable equipment was attributable to a pickup in purchases of motor vehicles and aircraft. Elsewhere, investment in high-tech equipment expanded rapidly further, while spending for other types of durable equipment decelerated somewhat. Nonresidential construction activity apparently rose moderately in the fourth quarter. Office construction picked up further in an environment of falling vacancy rates and rising rental costs, but other building activity remained sluggish.

The pace of business inventory investment in October and November was slightly above that of the third quarter, but in comparison with strong sales inventory positions were relatively lean in most industries. In manufacturing, stocks increased moderately in the October–November period, and the aggregate stock–shipments ratio was in the middle of its narrow range for the past year. Inventory investment in the wholesale sector slowed considerably, but much of the swing reflected the unusually early harvest of farm products. The inventory–sales ratio for this sector was still at the top of its range for the last year, and inventory overhangs persisted in metals and minerals, machinery, and chemicals. Retailers stepped up their inventory accumulation in the October–November period. However, sales were robust and the inventory–sales ratio for this sector continued to trend downward.

The average deficit on U.S. trade in goods and services for October and November was a little smaller than the rate for the third quarter. The value of exports for the two-month period rose considerably, with the largest gains occurring in automotive products shipped to Canada, aircraft, machinery, agricultural products, and services. The value of imports also moved up, but by less than the value of exports. While the increases in imports were widespread across trade categories, particularly large advances were recorded for automotive products from Canada and Mexico and for computers. The available data suggested a weaker economic performance in most of the major foreign industrial countries in the fourth quarter; economic activity likely fell further in Japan, and economic growth apparently slowed in most countries of the euro bloc. Activity in most Asian developing countries remained depressed, though some seemed to be approaching a trough and Korea appeared to be in the early stages of a recovery. Moreover, economic conditions worsened in most Latin American economies.

Inflation remained low in 1998. Consumer prices changed little in December, reflecting a sizable drop in energy prices that offset the large increase in tobacco prices put in place after a settlement was reached between states and the tobacco makers. For 1998 as a whole, CPI inflation was slightly lower than in 1997; a substantial decline in energy prices more than offset a sizable pickup in food inflation and a small increase in core inflation. At the producer level, prices of finished goods edged down in 1998 following an appreciable decline in 1997. While finished energy prices fell by more in 1998, finished food prices were down only slightly and prices of core finished goods turned up after having been unchanged in 1997. Growth of hourly compensation of private industry workers slowed considerably in the fourth quarter of 1998, and the increase in hourly compensation for the year was little changed from that of 1997.

At its meeting on December 22, 1998, the Committee adopted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 4¾ percent and that did not contain any bias with regard to the direction of possible adjustments to policy during the intermeeting period. In the Committee's view, the stance of policy appeared to be consistent with its objectives of fostering sustained low inflation and high employment, and the risks to this outlook were reasonably well balanced over the near term.

Open market operations during the intermeeting period were directed toward maintaining the federal funds rate at the Committee's desired level. In the event, however, the rate averaged a little below its intended level, largely reflecting the efforts of the Trading Desk to keep reserve pressures around year-end to a minimum. Other short-term market rates declined somewhat on balance, partly owing to the disappearance of year-end pressures. Most long-term interest rates changed little over the intermeeting period, but Treasury bond yields moved up slightly on balance, apparently in response to incoming data suggesting stronger-than-expected economic growth.

In foreign exchange markets, the trade-weighted value of the dollar appreciated slightly on balance over the period. A small decline in the dollar relative to other major currencies was more than offset by the dollar's appreciation in terms of the currencies of a broader group of countries that also are important trading partners of the United States. The dollar appreciated against the euro following the release of data confirming a slowdown of economic growth in much of the euro area and the absence of inflationary pressures, and it rose against the British pound after the Bank of England unexpectedly cut its repo rate. Moreover, the economic crisis in Brazil apparently contributed to an increase in the dollar relative to some emerging market currencies. Against the yen, however, the dollar fell in early January to its lowest level in more than two years, evidently in response to sharp increases in yields on Japanese bonds, but the decline was partially reversed subsequently.

M2 and M3 continued to expand rapidly in December, with their liquid components, especially money market funds, registering particularly large increases. The effects of recent monetary policy easings in reducing the opportunity costs of these components, strong growth in GDP, and perhaps continued heightened demands for liquid and safe assets seemed to have contributed to this performance. Available data for January pointed to appreciable moderation in the growth of both aggregates. From the fourth quarter of 1997 to the fourth quarter of 1998, M2 and M3 rose at rates well above their annual ranges, while total domestic nonfinancial debt expanded at a pace somewhat above the middle of its range.

The staff forecast prepared for this meeting pointed to a substantial moderation in the expansion to a rate commensurate with the growth of the economy's potential. Growth of private final demand would be damped by the anticipated waning of positive wealth effects stemming from earlier large increases in equity prices and by slow growth of spending on consumer durables, housing units, and business capital goods after the earlier buildup in the stocks of these items. Subdued expansion of foreign economic activity and the lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place continuing, though diminishing, restraint on the demand for U.S. exports for some period ahead and to lead to further substitution of imports for domestic products. Pressures on labor resources were likely to remain near current levels and inflation was projected to rise somewhat over the projection horizon, largely as a result of an expected upturn in energy prices.

In the Committee's discussion of current and prospective economic conditions, members referred to continuing indications of an exceptional economic performance that was characterized by the persistence of quite low inflation despite very high and rapidly rising levels of overall output and employment. The members currently saw few signs that the economic expansion had moderated to a more sustainable rate, but most continued to anticipate substantial slowing over the year ahead to a pace close to or somewhat above that of the economy's long-run potential. While many agreed that such an outlook was subject to greater upside risk than they had anticipated a few months ago—given the abatement of market turmoil and positive business and consumer sentiment—such factors as the waning effects of the earlier increases in stock market wealth on consumer spending and some slowing in the extraordinary growth in business expenditures for equipment were likely to exert a moderating effect on the expansion. Moreover, potentially greater weakness in foreign economies and possible disruption to foreign financial markets remained a downside risk to the outlook. Against this background, the members generally anticipated some pickup in inflation, though to a still relatively low rate, primarily as last year's declines in oil and other import prices were not repeated. A number referred, however, to the experience of recent years, which suggested that the inflation process was not well understood and that inflation forecasts were subject to a wide range of uncertainty.

In keeping with the practice at meetings just before the Federal Reserve's semiannual monetary policy report to Congress and the Chairman’s associated testimony, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members had provided individual projections of the growth in real and nominal GDP, the rate of unemployment, and the rate of inflation for the year 1999. Their forecasts of the rate of expansion in real GDP in 1999 had a central tendency of 2½ to 3 percent and a full range of 2 to 3½ percent. Such growth was expected to be associated with a civilian unemployment rate in a range centering on 4¼ to 4½ percent in the fourth quarter of this year, implying little or no change from the current level. With regard to nominal GDP growth in 1999, the forecasts were mainly in a range of 4 to 4½ percent, with an overall range of 3¾ to 5 percent. Projections of the rate of inflation, as measured by the consumer price index, had a central tendency of 2 to 2½ percent, somewhat above the outcome for 1998 when the rise in the index was held down by a marked decline in energy prices and reduced prices of non-oil imports.

In their review of developments across the nation, members reported a mix of high overall levels of economic activity in every region but softness in a number of specific business activities, notably those affected by foreign competition. In particular, many manufacturing firms along with businesses engaged in agriculture, mining, and energy were being adversely affected by weak demand in foreign markets, strong import competition, and depressed oil and other commodity prices in world markets. Foreign developments were seen as a continuing element of weakness for the U.S. economy and also as a major source of uncertainty in the outlook for the year ahead. In this regard many members referred in particular to the problems facing Brazil and the risk that further financial and economic instability in that nation would spread to other Latin American countries, with repercussions on the U.S. economy. Markets in the major trading nations around the world were likely to remain on the soft side, with Japan struggling to recover from its ongoing recession and economic growth in Europe showing signs of becoming more sluggish.

Robust domestic demand clearly had offset weakness in net exports by a large margin in 1998, and while the growth in such demand was projected to slow this year it was expected to remain sufficient to support appreciable further expansion in overall economic activity. Consumer spending had exhibited considerable vigor during the recent holiday season and anecdotal reports from several regions suggested that the momentum in such spending had carried into the opening weeks of this year. Further, though prospectively moderating, growth in jobs and incomes, supportive credit conditions, and upbeat consumer sentiment suggested that consumer expenditures were likely to be well maintained over coming quarters. Even so, members anticipated at least some moderation in the growth of consumption after an extended period of sizable accumulation of consumer durable goods. Among other factors, the positive effects on consumer spending of the large accumulation of stock market wealth in recent years were likely to abate over time in the absence of a further and unanticipated surge in stock market prices.

Growth in business capital spending also was expected to moderate as the year progressed to a pace well below that experienced in recent years. Members commented in this regard that slowing growth in overall spending normally fostered reduced capital investment, and indeed developments in the second half of 1998 suggested that such investment might already be on a less strong uptrend. Moreover, the prospects of reduced growth in profits and a less ebullient stock market could also be expected to damp business fixed investment. Nonetheless, growth in such investment likely would continue to exceed that of overall spending, reflecting ongoing efforts to improve efficiency and hold down labor costs in highly competitive markets and more generally to take advantage of the declining costs of business equipment and the rapid pace of technological innovation. Members also cited reports from contacts in various sectors of the economy and areas of the country that business plans continued to call for substantial outlays for business equipment. Nonresidential building activity remained robust in several regions, but given already ample capacity in many sectors, the prospects for such construction were relatively weak.

Housing activity had continued to display impressive strength in many parts of the country, evidently reflecting rapid growth in employment and incomes, rising household net worth, and low mortgage interest rates. With the affordability of new homes expected to remain unusually attractive, the members anticipated that housing activity would be sustained at a high level. Some moderation in housing starts from recent peak levels appeared likely, however, in the context of the slowing in job and income gains associated with the members' overall forecasts.

With regard to the outlook for inflation, the members saw no evidence of accelerating price inflation despite high levels of business activity and very tight labor markets across most of the nation. Indeed, the conjuncture over an extended period of strong economic growth, very low rates of unemployment, and the absence of any buildup of inflation could not be explained in terms of normal historical relationships. While temporary factors, such as declining oil prices, had played a role in depressing inflation, the persistence of very low inflation under these conditions most likely also resulted from more lasting changes in economic relationships. These were perhaps best evidenced by the widespread inability of business firms to raise prices because of strong competitive pressures in domestic and global markets and the related efforts to hold down costs, including labor costs. Contributing importantly to the success of those cost-saving efforts were the continued rapid growth of increasingly efficient business capital. The accumulation of such capital evidently had greatly enhanced productivity in a broad range of economic activities. In this regard, available indicators suggested that productivity gains had essentially matched increases in labor costs for nonfinancial corporations over the past year. Members also cited widespread expectations of low inflation as an important underlying factor in moderating wage and price increases.

Looking ahead, an abatement or reversal of some of the temporary factors reducing prices was likely to raise measured inflation. The course of underlying inflation pressures was more difficult to gauge, however. If growth slowed to trend, as many expected, uncertainty about evolving relationships among economic activity, productivity growth, and wages made it unclear whether the enhanced competitiveness in many markets and greater cost reducing efforts of businesses would be sufficient to continue to hold price increases in check at the current degree of tautness in labor markets. Members generally agreed that if labor markets continued to tighten, cost and price pressures would begin to pick up. Some members also expressed concern that rapid money growth, should it persist, would suggest that monetary policy was too accommodative to contain inflation pressures. On balance, while a somewhat less favorable inflation performance was viewed as likely over the year ahead, the members did not anticipate any substantial deterioration in the inflation climate if growth in economic activity approximated the central tendency of their forecasts.

In keeping with the requirements of the Full Employment and Balanced Growth Act of 1978 (the Humphrey–Hawkins Act), the Committee reviewed the ranges for growth of the monetary and debt aggregates in 1999 that it had established on a tentative basis in early July 1998. Those ranges included expansion of 1 to 5 percent for M2 and 2 to 6 percent for M3, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The associated range for growth of total domestic nonfinancial sector debt was provisionally set at 3 to 7 percent for 1999. The tentative ranges for 1999 were unchanged from the ranges that had been adopted for the past several years.

All the members endorsed a proposal to adopt the growth ranges for M2 and M3 in 1999 that had been established on a provisional basis in July of last year. According to a staff analysis, growth of these aggregates would moderate considerably this year but was likely to remain above the tentative ranges, especially in the case of M3. The rapid growth of M2 and M3 in 1998 was associated with outsized declines in their velocities that appeared to have resulted in part from the turbulent behavior of financial markets and related efforts by the public to move funds to relatively safe and liquid assets and to turn to banks for credit. Other factors appear to have included some rechanneling of financial flows into money-type balances after an extended period of surging stock market prices and the drop in the opportunity cost of holding money as market interest rates fell over the latter part of the year. The expansion of M3 was further stimulated by the ongoing strength in institution-only money market funds whose popularity as a cash management tool continued to grow.

The calming of financial markets and forecasts of moderating nominal GDP growth pointed to reduced growth in the broad monetary aggregates this year. However, it was clear that substantial uncertainty still surrounded any projection of monetary expansion and the linkage between particular rates of money growth over a year and the basic objectives of monetary policy. In these circumstances, the members did not see any firm basis for deviating from the practice in recent years of setting ranges that, assuming velocity behavior consistent with average historical patterns, would serve as benchmarks for monetary expansion consistent with longer-run price stability and a sustainable rate of real economic growth.

Domestic nonfinancial debt, which had grown at a rate in the upper part of its 3 to 7 percent range in 1998, was thought likely to remain within that range this year, indeed near the midpoint of the range according to a staff analysis. Outstanding federal debt was expected to contract by a larger amount this year and, given current economic forecasts, the debt of the major nonfinancial sectors of the economy seemed likely to grow a bit more slowly. Thus, the members saw no reason to depart from the tentative range for nonfinancial debt, which was expected to readily encompass the likely rate of growth in this aggregate.

At the conclusion of this review, the Committee voted to approve without change the ranges for 1999 that it had established on a tentative basis on July 1, 1998. Accordingly, the following statement of longer-run policy and growth ranges for 1999 was approved for inclusion in the domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at this meeting established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

> Votes for this action: Messrs. Greenspan, McDonough, Boehne, Ferguson, Gramlich, Kelley, McTeer, Meyer, Moskow, Ms. Rivlin, and Mr. Stern. Votes against this action: None.

In the Committee's discussion of policy for the intermeeting period ahead, all the members favored an unchanged policy stance. Many were concerned that the odds were tilted toward rising inflation over time, especially if the expansion did not slow to a more sustainable rate. Members commented that the market unsettlement that had in large measure prompted the Committee's easing actions during the fall had now lessened appreciably. In the view of some, those actions might need to be reversed, at least in part, to restore what they regarded as a policy stance that seemed most likely to prove consistent with desirable economic trends. Still, the persistence of subdued inflation and the absence of current evidence of accelerating inflation were seen as arguing against a policy tightening move at this point. Moreover, it was clear that the outlook for economic activity was subject to considerable uncertainty and that some shortfall from current forecasts, perhaps in conjunction with unexpectedly adverse trade and financial influences stemming from developments abroad, might materialize and damp inflationary demand pressures. Even in the absence of greater-than-anticipated slowing in the economic expansion, the experience of recent years had amply demonstrated that the relationship between demand pressures on resources and inflation was not following historical patterns, and developments exerting a more lasting moderating effect on inflation, such as more productive capital investment and effective access to spare capacity overseas, could help to contain inflation for some time. Against this background, the members agreed on the need to continue to monitor the economy with care for signs either of a potential upturn in inflation or greater softness in the expansion than they were currently forecasting and to be prepared to respond promptly in either direction.

In light of the uncertainties and diversity of risks surrounding the economic outlook, most members were in favor of retaining the existing symmetry of the directive. In one view, however, the risks of rising inflation were strong enough to warrant consideration of an asymmetrical directive that was tilted toward restraint. Nonetheless, since inflation was difficult to predict and any needed adjustment to policy in the period ahead could readily be implemented even with a symmetrical directive, all the members indicated that they could accept such a directive.

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 information reviewed at this meeting suggests that the economy expanded rapidly in the closing months of 1998. Nonfarm payroll employment posted strong gains in November and December, and the civilian unemployment rate fell to 4.3 percent in December. Total industrial production strengthened in the fourth quarter, owing in large measure to a surge in the production of motor vehicles and parts. Total retail sales rose sharply in the fourth quarter, and home sales and housing starts increased appreciably. Available indicators suggest that business capital spending picked up markedly in the fourth quarter after a lull in the third. In November, the nominal deficit on U.S. trade in goods and services was somewhat larger than in October, but the combined October–November deficit was slightly smaller than its third-quarter average. Inflation has remained subdued despite very tight labor markets.
>
> Most short-term interest rates have declined somewhat on balance since the meeting on December 22, while longer-term rates have changed little. Share prices in equity markets have posted further sizable gains on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar has depreciated slightly over the period in relation to other major currencies but it has appreciated somewhat in terms of the currencies of a broader group that also includes other important trading partners of the United States. M2 and M3 continued to record very large increases in late 1998, but available data pointed to some moderation in January. From the fourth quarter of 1997 to the fourth quarter of 1998, both aggregates rose at rates well above the Committee's annual ranges. Total domestic nonfinancial debt expanded at a pace somewhat above the middle of its range in 1998.
>
> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at this meeting established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.
>
> To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 4¾ percent. In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period.

Votes for this action: Messrs. Greenspan, McDonough, Boehne, Ferguson, Gramlich, Kelley, McTeer, Meyer, Moskow, Ms. Rivlin, and Mr. Stern. Votes against this action: None.

Sunset Legislation Relating to Humphrey–Hawkins Reports

The Committee discussed the Federal Reports Elimination and Sunset Act of 1995 which provides for the termination of the legal requirements for semiannual Humphrey–Hawkins reports to Congress after 1999. At this meeting, the members agreed that the semiannual reports and associated Congressional hearings had been quite useful and should be continued. They had given the Committee an effective means to explain its policies and communicate its views on a variety of issues and had enhanced its accountability to the public and the Congress.

Sale of Euro Reserves

In a notation vote completed on March 22, 1999, the Committee unanimously approved an off-market sale of approximately $4.8 billion equivalent of the System's euro reserves to the Exchange Stabilization Fund (ESF). In return, the System received $3.4 billion in dollars and $1.4 billion equivalent of Japanese yen from the ESF. The transaction reduced the System's overall holdings of foreign currencies to the level of those held by the ESF and left the resulting balances of euro and yen equal in both the System and ESF accounts.

It was agreed that the next meeting of the Committee would be held on Tuesday, March 30, 1999.

The meeting adjourned at 11:40 a.m. on February 3, 1999.

Donald L. Kohn
Secretary

Meeting Held on March 30, 1999

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 30, 1999, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Ferguson
Mr. Gramlich
Mr. Kelley
Mr. McTeer
Mr. Meyer
Mr. Moskow
Ms. Rivlin
Mr. Stern

Messrs. Broaddus, Guynn, Jordan, 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
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Prell, Economist
Ms. Johnson, Economist

Messrs. Cecchetti, Hooper, Hunter, Lang, Lindsey, Slifman, Stockton, and Rosenblum, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Ms. Pianalto, First Vice President, Federal Reserve Bank of Cleveland

Ms. Browne, Messrs. Eisenbeis, Goodfriend, Hakkio, Kos, Rasche, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Boston, Atlanta, Richmond, Kansas City, New York, St. Louis, and Cleveland respectively

Messrs. Judd and Weber, Vice Presidents, Federal Reserve Banks of San Francisco and Minneapolis respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on February 2–3, 1999, 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, and thus no vote was required 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 February 3, 1999, through March 29, 1999. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below. The domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York follows the summary.

The information reviewed at this meeting suggested that the economic expansion remained robust early in the year. Consumer spending was particularly strong, and housing starts climbed higher. While growth of business capital spending moderated somewhat after a fourth-quarter surge, it was still quite rapid. Heavy competition from imports damped the rise of industrial production; however, employment expansion remained brisk and labor markets tight. Price inflation was still low.

Nonfarm payroll employment posted sizable further gains in January and February. Hiring in construction and retail trade was notably strong, and employment in the service industries continued to trend higher. By contrast, manufacturing suffered further job losses. The civilian unemployment rate, at 4.4 percent in February, stayed in the narrow 4¼ to 4½ percent range that had prevailed since spring 1998.

Total industrial production was unchanged in January and rose slightly in February. Gas and oil extraction slumped in January, and mild weather restrained utility output in February. Manufacturing production increased modestly in both months, reflecting strong increases in the output of high-tech industries that more than offset declines in the production of aircraft and of motor vehicles and parts. The factory operating rate fell further in the January–February period, as the growth in manufacturing capacity continued to outpace the rise in production.

Consumer spending surged in the early months of 1999, supported by rapidly rising disposable personal income, soaring household net worth, and buoyant consumer sentiment. Attractive pricing and the favorable trends in income and wealth contributed to strong underlying demand for motor vehicles, and substantial gains were recorded in most other categories of retail sales as well. Expenditures on services in January (latest available data) also exhibited strength, most notably in spending for energy services, which picked up after an unseasonably warm December.

Housing demand remained elevated. Single-family home sales were still at a very strong level in January (latest data), despite a drop from their recent record high. Housing starts increased appreciably in the January–February period as builders took advantage of good weather to try to catch up with backlogged demand.

Business fixed investment appeared to have decelerated noticeably from the very fast pace of the fourth quarter. Data on shipments of nondefense capital goods in January and February suggested that business outlays for computers and motor vehicles were growing less rapidly, and purchases of most other types of durable equipment seemed to be slowing somewhat. Nonresidential construction activity was down on balance in January, though the construction of office buildings trended still higher and the building of lodging facilities picked up.

Total business inventories changed little in January and stocks generally were at comfortable levels, though conditions varied across industries. Manufacturing stocks fell in January, largely reflecting further reductions in inventories of aircraft and parts, and the aggregate stock–sales ratio for the sector was at the bottom of its range over the past twelve months. In the wholesale sector, a reduction in inventories in January was concentrated in motor vehicles. The decline in stocks was closely paralleled by a drop in sales, and the aggregate inventory–sales ratio for the sector stayed around the top of its range over the past twelve months. Retail inventories increased considerably in January, but with sales growing rapidly, the aggregate inventory–sales ratio remained at the bottom of its range over the past year.

The U.S. trade deficit in goods and services widened substantially in January from its fourth-quarter average. The value of exports fell for a third straight month and reached its lowest level since last August; half of the drop was in agricultural products. The value of imports retraced in January most of its December decline, with sizable increases recorded for imported consumer goods, computers, and motor vehicles from Canada. The economies of many of the major foreign industrial countries faltered in the fourth quarter. Japan recorded a fifth straight quarterly decline in economic activity, and growth in real output weakened in the euro area and remained sluggish in the United Kingdom. By contrast, economic activity rebounded in Canada. Elsewhere, while economic activity continued to decline in Latin America and Russia, there were indications that some Asian economies might be bottoming out and that recovery might be under way in Korea.

Inflation remained subdued in early 1999. Both the total and core measures of consumer prices increased only slightly in January and February, and core inflation for the twelve months ended in February was somewhat lower than for the year-earlier period. At the producer level, prices of finished goods other than food and energy changed little over January and February. For the twelve months ended in February, core producer price inflation was somewhat higher than for the year-earlier period, but the pickup partly reflected the large increase in tobacco prices that resulted from the settlement of the lawsuit brought by state attorneys general. Average hourly earnings of private production or nonsupervisory workers increased moderately on balance over the January–February period. The rise in average hourly earnings for the year ended in February was noticeably smaller than that for the year-earlier period.

At its meeting on February 2–3, 1999, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with an unchanged federal funds rate of about 4¾ percent and that did not contain any bias relating to the direction of possible adjustments to policy during the intermeeting period. The Committee judged this policy stance to be consistent with its objectives of fostering high employment and sustained low inflation and, over the near term at least, viewed the risks to this outlook as reasonably well balanced.

Open market operations throughout the intermeeting period were directed toward maintaining the federal funds rate at around 4¾ percent. Market interest rates changed little immediately after the February meeting because market participants had expected the Committee's decision. Subsequently, however, Treasury yields moved up significantly in response to incoming data suggesting further robust growth in aggregate spending, and then retraced much of the rise after the receipt of favorable news on inflation. Short-term interest rates changed little on balance over the intermeeting interval, and longer-term rates rose somewhat. Key indexes of stock market prices recorded mixed changes.

The trade-weighted value of the dollar in foreign exchange markets increased somewhat over the intermeeting period in relation to the currencies of a broad group of important U.S. trading partners. Much of the dollar's upward movement came against a subset of major currencies. A large rise in terms of the yen occurred in response to an easing of monetary policy by the Bank of Japan that reduced the overnight call rate to an extremely low level and fostered a considerable decline in Japanese bond yields. The dollar also rose substantially against the euro, which was weighed down by signs of continued weakness in Germany and, late in the period, by the outbreak of hostilities in the Balkans. Among the emerging countries, the Brazilian *real* depreciated on balance against the dollar, although it firmed late in the period as overall financial conditions in that country stabilized somewhat, and the Mexican peso appreciated against the dollar in association with a rebound in oil prices.

Expansion of M2 and M3 moderated considerably on balance in the early months of 1999 from the rapid increases of the fourth quarter. The deceleration of these aggregates apparently reflected the waning effects of the policy easings of last autumn in narrowing the opportunity cost of holding M2 assets, a slowdown in mortgage refinancing activity, and a bounceback in household purchases of stock mutual funds as conditions in financial markets brightened. Both aggregates were estimated to have increased over the first quarter at rates somewhat above the Committee's annual ranges. Total domestic nonfinancial debt continued to expand at a pace somewhat above the middle of its range.

The staff forecast prepared for this meeting suggested that the expansion would gradually moderate to a rate commensurate with the growth of the economy's estimated potential. Growth of private final demand would be damped by the anticipated waning of positive wealth effects stemming from earlier large increases in equity prices and by slower growth of spending on consumer durables, housing units, and business equipment after the earlier buildup in the stocks of these items. The lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place continuing, though diminishing, restraint on the demand for U.S. exports for some period ahead and to lead to further substitution of imports for domestic products. Pressures on labor resources were likely to remain substantial. Price inflation was projected to rise somewhat over the projection horizon, largely as a result of an expected upward trend in energy prices.

In the Committee's discussion of current and prospective economic developments, members commented that for an extended period most forecasters had been projecting slower economic growth and higher inflation than actually had materialized. With regard to output, current indicators provided little evidence of any moderation in the pace of the expansion from the robust growth experienced on average over the last few years. Even so, most members viewed a slowing to a rate closer to most estimates of the growth of the economy's potential as a reasonable expectation. They agreed, however, that the timing and extent of such moderation were subject to a wide range of uncertainty. Factors expected to foster slower growth in key demand sectors of the economy included the buildup of large stocks of business equipment, housing units, and durable goods by households and an assumption that the stock market would play a more neutral role than in recent years. The effects of domestic demand on domestic production would continue to be damped by further increases in the trade deficit, though the offset from this source might well diminish if financial markets and economies in key developing nations were to exhibit more signs of stabilization or improvement. Given the persistence of robust growth in domestic demand and the continuing forward momentum in U.S. economic activity, many of the members commented that the risks to their forecasts were tilted toward the eventual emergence of somewhat greater inflation pressures. Despite the persistence of very tight labor markets across the nation, however, there currently were only scattered indications of more rapid increases in wages and no evidence of rising price inflation. The reasons underlying this remarkable economic performance were potentially transitory but also possibly of a longer-term nature. Lower oil and other input prices had played a role. However, it also seemed likely that accelerating productivity helped to account for the economy's ability to sustain not only higher rates of growth of output but also relatively low levels of unemployment, at least for a time, without generating higher inflation.

In their review of developments across the nation, the members reported sustained, and in some areas rising, overall growth in regional economic activity. At the same time, some sectors were continuing to experience varying degrees of softness, notably those most affected by developments abroad such as manufacturing, agriculture, and energy. A number of members referred, however, to signs of recent improvement in manufacturing that appeared to be associated primarily with the strength of domestic demand but to some extent also with increased demand from some developing countries.

With regard to developments in key expenditure sectors of the economy, the members anticipated that growth in consumer spending would retain considerable upward momentum, given their expectations of favorable fundamentals such as further expansion in employment and incomes, the rise in financial wealth that had continued through the first quarter, and ready access to consumer credit. Some also referred to the currently elevated level of consumer confidence. As time went on, however, it seemed unlikely that growth in consumer spending would be sustained at its recent exceptional pace. The accumulation of durable goods by consumers in recent years should at some point inhibit further large increases in spending for such goods. Moreover, the favorable effect of the extended run-up in stock market wealth evidently had been a factor in bolstering consumer confidence and willingness to spend. While the course of stock market prices could not reliably be predicted, the market's stimulative effect on spending was likely to wane over time in the absence of further appreciable advances in prices. Current indications of some softening in home sales and reduced mortgage refinancing activity, should they persist, also augured less stimulus to consumer spending in coming quarters.

The extraordinary expansion in business fixed investment in recent years, fueled to a major extent by purchases of new equipment, was also expected to moderate over time as a result of the large buildup and reduced utilization of capacity and the forecasted slower growth in final sales. While the prospect of further declines in the prices of some equipment would encourage continued growth in spending, the lower prices were not expected to outweigh the effects of relatively low capacity usage and more moderate growth in overall demand in coming quarters. In this regard, some signs of deceleration could be detected in the currently available data, though from extremely rapid rates of growth. With respect to commercial building, members reported strong construction activity in many areas, but some also noted that such construction appeared to have reached a peak, as evidenced in part by signs of overbuilding in a few areas. Moreover, current data suggested little or no growth in overall expenditures on nonresidential structures.

Residential sales and construction were described as very strong in many parts of the country and indeed were being held down in some areas by low inventories of housing available for sale and a limited supply of qualified construction workers. Some members commented that housing construction backlogs and unusually mild winter weather in many areas had sustained a high level of housing construction in recent months. Looking ahead, however, members observed that residential building activity appeared to have peaked in some areas and an oversupply of apartments was reported in a few major cities. More generally, the rise in mortgage rates since last fall and some softening of demand indicators pointed to less strength in the housing sector. Even so, the outlook for jobs and income and the buildup of financial wealth constituted favorable home affordability factors that appeared likely to support a continuing high level of housing demand, especially in the single-family sector.

Relatively heavy spending on imports owing to strong domestic demand and low prices likely would exert a continuing negative effect on net exports over the next several quarters. Nevertheless, demand for U.S. exports could begin to pick up, given what now appeared to be improved prospects for economic activity in several emerging market economies. Financial market conditions had become more settled in a number of these economies, and contagion from developments in Brazil now seemed to present a reduced threat to that nation's trading partners. Even so, foreign-sector forecasts—for industrial as well as emerging market economies—remained subject to considerable downside risk, including uncertainties stemming from the recent flare-up of hostilities in the Balkans.

In the Committee's discussion of the outlook for inflation, members commented that they saw no evidence of any acceleration in price inflation despite the continuing strength of the economic expansion and the tightness of labor markets. Anecdotal reports from around the nation continued to underscore the difficulty or inability of most business firms to raise prices in highly competitive markets. There were a limited number of reports of relatively sizable increases in wages paid to workers with skills in especially short supply, but on the whole employers were successful in holding down increases in labor compensation and offsetting them through improvements in productivity. Indeed, increases in unit labor costs, at least in the nonfinancial corporate sector and perhaps more widely as well, had declined to a very low rate over the past year.

The members saw little reason to anticipate any significant, continuing increase in inflation in the near term. Inflation was expected to rise, owing to the recent hikes in oil prices, but the increase should be limited. And with little evidence of rising pressures on prices at early stages of production or on nominal wages, inflation should remain contained for a time. However, some members were concerned about the risk that sustained rapid growth in aggregate demand would stretch markets even more. Even presuming that growth in economic activity would moderate to a pace close to the economy's potential, labor markets would remain relatively taut and at some point could trigger faster increases in labor compensation and, in turn, rising price inflation. Moreover, the dissipation or reversal of favorable supply factors—including, for example, in addition to energy prices the waning effects of the dollar's earlier appreciation, could contribute to higher inflation expectations and faster nominal compensation increases. In the view of some others, though, the impact on prices of the unwinding of the favorable factors might well be muted or offset by a possible further uptick in productivity growth. Accelerating productivity had been spurring investment in capacity and intense competition among businesses, and had been holding down labor costs. Furthermore, optimism about improving productivity was evident in projections of business profits and the high level of equity prices. In any event, it was clear that forecasts in recent years typically had overstated the rise in inflation, and a great deal of uncertainty surrounded the extent to which productivity gains and other factors, some unspecified, might continue to hold down inflation in a period of robust economic growth and relatively tight labor markets.

In the Committee's discussion of policy for the intermeeting period ahead, all the members indicated that they favored an unchanged policy stance. Several commented that they saw no significant changes in the tenor of recent statistical and anecdotal reports that would constitute the basis for an adjustment to policy or a greater presumption that policy might need to be changed soon. Many referred in particular to the absence of any warning signs of accelerating inflation over the near term as a major consideration in support of a steady policy at this time. In the view of some, however, the next policy action was more likely to be a firming than an easing. They saw a greater likelihood that tight—and perhaps tightening—labor markets would add to price pressures than that demand would falter or that inflation would decrease further. Yet they recognized that such forecasts were subject to a substantial degree of uncertainty. This argued for a cautious approach to any policy change, especially in light of an economic performance that had not conformed to historical patterns in recent years. While a number of members noted that a case might be made for unwinding part of the Committee's easing actions during the fall of last year, given the recovery in financial markets and the improvement in the economic outlook since then, they argued that the incoming data and prospects for sustained favorable economic performance did not support such an action. The members concluded that the Committee was in a position to wait for developments to unfold, especially given the absence of any evidence of an impending acceleration of underlying inflation. If the risks of higher inflation intensified, it would still have time to take action to head off price pressures in order to foster sustained economic growth and a high level of employment. Many of the members emphasized, however, that in such circumstances the Committee might need to act promptly to forestall a buildup of inflationary forces that could destabilize the expansion.

All the members endorsed a proposal to retain the existing symmetry of the directive with respect to possible adjustments to policy during the intermeeting period. While many believed that the next policy move likely would be in the direction of some tightening, such an outcome was not a foregone conclusion, and in any event the timing of the next policy action was highly uncertain. It also was noted that a biased directive would not be consistent with the members' view that a policy adjustment was unlikely in the period just ahead. Moreover, while the Committee's disclosure procedures do not always require the immediate announcement of a shift in symmetry, the members agreed that were they to announce a shift to a tightening bias, it would likely have in current circumstances a relatively pronounced and undesired effect on financial markets. In particular, the markets might well build in higher odds of a policy tightening move at the May or June meetings than currently was consistent with the members' thinking. It also seemed desirable to defer any change in the directive and await further developments relating to the hostilities in the Balkans.

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 information reviewed at this meeting suggests that the expansion in economic activity is still robust. Nonfarm payroll employment posted sizable further gains in January and February, and the civilian unemployment rate remained below 4½ percent. Total industrial production edged higher over the first two months of the year. Total retail sales rose sharply further over the two months, and housing starts increased appreciably from an already elevated level. Available indicators suggest that business capital spending decelerated in early 1999 but growth was still relatively rapid. The nominal deficit on U.S. trade in goods and services widened substantially in January from its fourth-quarter average. Inflation has remained subdued despite very tight labor markets.

Short-term interest rates have changed little since the meeting on February 2–3, 1999, while longer-term rates have risen somewhat on balance. Key measures of share prices in equity markets have registered mixed changes over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar has risen somewhat over the period in relation to the currencies of a broad group of important U.S. trading partners, and the appreciation has been a bit larger against a subset of major currencies.

M2 and M3 continued to record large increases in January and February, but available data pointed to substantial moderation in March. Both aggregates are estimated to have increased over the first quarter at rates somewhat above the Committee's annual ranges. Total domestic nonfinancial debt has continued to expand at a pace somewhat above the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in February established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 4¾ percent. In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period.

> Votes for this action: Messrs. Greenspan, McDonough, Boehne, Ferguson, Gramlich, Kelley, McTeer, Meyer, Moskow, Ms. Rivlin, and Mr. Stern. Votes against this action: None

It was agreed that the next meeting of the Committee would be held on Tuesday, May 18, 1999.

The meeting adjourned at 12:35 p.m.

Donald L. Kohn
Secretary

Meeting Held on May 18, 1999

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 18, 1999, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Ferguson
Mr. Gramlich
Mr. Kelley
Mr. McTeer
Mr. Meyer
Mr. Moskow
Ms. Rivlin
Mr. Stern

Messrs. Broaddus, Guynn, Jordan, 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
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Ms. Johnson, Economist

Messrs. Alexander, Cecchetti, Hooper, Hunter, Lang, Lindsey, Rolnick, Rosenblum, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Connolly, First Vice President, Federal Reserve Bank of Boston

Ms. Browne, Messrs. Goodfriend, Hakkio, Ms. Krieger, and Mr. Sniderman, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, Kansas City, New York, and Cleveland respectively

Messrs. Cunningham and Gavin, Vice Presidents, Federal Reserve Bank of Atlanta and St. Louis respectively

Mr. Trehan, Research Officer, Federal Reserve Bank of San Francisco

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 30, 1999, 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, and thus no vote was required 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 March 30, 1999, through May 17, 1999. By unanimous vote, the Committee ratified these transactions.

The Committee voted unanimously to extend for one year beginning in mid-December 1999 the 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, which was established in 1994. The vote to renew was taken at this meeting rather than later in the year to give the Committee members a timely opportunity to discuss whether or not they wanted to extend the maturity of the agreements; the terms of the agreements require that any decision not to renew be communicated to swap line partners at least 6 months in advance of the swap maturities.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below. The domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York follows the summary.

The information reviewed at this meeting suggested that economic activity had continued to expand vigorously. Consumer spending had maintained its strong forward momentum, and housing activity generally had remained at a high level. Growth of business capital spending had slowed appreciably but was still quite rapid. The expansion in industrial production had quickened recently while gains in employment had moderated somewhat. Inflation had remained low, although consumer prices registered a sizable rise in April; labor costs were still quiescent despite very tight labor markets.

Growth in nonfarm payroll employment slowed on balance over March and April, but hiring was still relatively rapid. Employment gains were concentrated in the services, retail trade, and finance, insurance, and real estate categories. By contrast, manufacturing experienced further job losses, and construction employment fell on balance over the March–April period after having expanded briskly since last fall. The civilian unemployment rate in April, at 4.3 percent, matched its first-quarter average.

Industrial production increased substantially in March and April after a period of sluggish growth. In manufacturing, the production of durable goods rose rapidly in both months, paced by sharp increases in the output of semiconductors and motor vehicles and parts. The production of office automation equipment picked up from an already rapid pace in the March–April period, and the manufacture of communications equipment surged in April. Although growth in the output of nondurable goods had increased somewhat in recent months, the level of production was still below its year-earlier level. The step-up in industrial production in recent months had lifted the rate of utilization of manufacturing capacity, but it remained below its long-term average.

Consumer spending has been very strong this year, supported by rapid income growth, soaring household net worth, and buoyant consumer sentiment. Retail sales edged still higher in April after recording large gains earlier in the year. Sales of motor vehicles in April again were exceptionally high, and outlays for non-auto goods remained robust. In addition, spending on services grew briskly in the first quarter (latest data available), paced by sharply increased outlays for energy, bank and brokerage services, and recreation.

Total housing starts fell in April after several months of unusually favorable weather conditions that had allowed builders to maintain a relatively high level of construction activity. Some of the decline in starts apparently reflected shortages of labor and some types of building materials. However, sales of new homes had fallen somewhat on balance thus far this year, and applications for mortgages to finance purchases of homes remained below their 1998 peak despite a recent turn upward.

Business capital spending decelerated in the first quarter, though to a still relatively rapid pace. Growth of spending on durable equipment was boosted by a surge in outlays for communications equipment, brisk expenditures for motor vehicles, and continuing though lessened strength in purchases of computers. Nonresidential building activity advanced moderately in the first quarter, reflecting significant further increases in the construction of office buildings and lodging facilities. Building activity in other nonresidential categories changed little.

Total business inventories rose considerably in March, mostly reflecting a huge run-up in inventories at automotive dealerships. For the first quarter as a whole, inventory accumulation exclusive of motor vehicles was near the subdued pace of late 1998, and stocks generally appeared to be at fairly low levels relative to sales. In the manufacturing sector, inventories fell further in the first quarter, largely reflecting reductions of stocks of aircraft and parts, and the aggregate inventory–sales ratio for the sector in March was somewhat below the bottom of its range over the previous twelve months. The first-quarter rise in non-auto wholesale inventories was nearly the same as the fourth-quarter increase. With sales up appreciably, however, the inventory–sales ratio for the sector dropped sharply and was near the bottom of its range for the past year. Non-auto retail inventories increased considerably in the first quarter, but sales grew by even more and the aggregate inventory–sales ratio was near the bottom of its range over the last year.

The U.S. trade deficit in goods and services widened substantially in January and February from its fourth-quarter average, with exports falling sharply and imports rising strongly. The drop in exports in the January–February period nearly reversed the large fourth-quarter increase, with substantial declines occurring in aircraft, machinery, industrial supplies, and agricultural products. The jump in imports was concentrated in consumer goods, automotive products, computers, and semiconductors. Economic growth continued to be sluggish in many of the major foreign industrial countries, according to the limited information available for the first quarter. Growth was weak on balance in the euro zone and the United Kingdom, and there were few signs of economic recovery in Japan. However, the expansion in Canada appeared to have remained strong. Elsewhere, the Korean economy grew vigorously in the first quarter, and there were indications that the slowdown in economic activity in Southeast Asia and Latin America might have bottomed out, with some countries beginning to recover.

Consumer prices rose substantially in April. Energy prices increased sharply, food prices edged up, and the prices of consumer items other than food and energy rose appreciably. For the twelve months ended in April, core consumer inflation was slightly higher than for the year-earlier period. Producer prices of finished goods also increased in April, but by less than consumer prices. Finished energy prices were up sharply, but prices of finished foods declined appreciably, and prices of core producer goods advanced only slightly. For the twelve months ended in April, core producer inflation was up noticeably over that for the year-earlier period, reflecting importantly the sharp increase in prices of tobacco products. In contrast to price inflation, labor costs appeared to have remained quiescent. The increase in average hourly earnings was the same in April as in March, and the rise for the twelve months ended in April was significantly smaller than that for the year-earlier period.

At its meeting on March 30, 1999, the Committee adopted a directive that called for maintaining conditions in reserve markets that would be consistent with an unchanged federal funds rate of about 4¾ percent and that did not contain any bias relating to the direction of possible adjustments to policy during the intermeeting period. The Committee judged this policy stance to be consistent with its objectives of fostering high employment and sustained low inflation, with the risks of different outcomes being reasonably well balanced, at least for the near term.

Open market operations throughout the intermeeting period were directed toward maintaining the federal funds rate at around 4¾ percent. The average rate for the period was in line with the Committee's target level; however, substantial fluctuations in the rate associated with tax-season uncertainties complicated reserve management. Yields on Treasury securities rose appreciably on balance, with the largest increases occurring in intermediate- and longer-term maturities. The climb in rates reflected not only the strength of incoming data on the U.S. economy but also improved economic prospects in many foreign countries and higher world commodity prices. Increasing optimism about economic conditions in the United States and abroad apparently eased concerns about the creditworthiness of business borrowers, especially firms of relatively low credit standing, and rates on private obligations registered mixed changes over the period. Most key measures of share prices in equity markets recorded sizable gains over the intermeeting period.

The trade-weighted value of the dollar in foreign exchange markets depreciated somewhat over the intermeeting period in relation to the currencies of a broad group of important U.S. trading partners. The dollar's decline partly reflected improvements in the economic and financial outlook for many emerging market economies. The dollar also depreciated significantly against the Canadian and Australian currencies as the prices of metals, oil, and lumber moved higher. By contrast, the dollar moved up on balance in terms of the euro and the Japanese yen. A reduction in the European Central Bank's refinance rate and the diminished prospects for a near-term resolution of hostilities in the Balkans weighed on the euro. The dollar's rise against the yen evidently was partly a response to a decline in the yield on ten-year Japanese government bonds while dollar yields moved higher.

M2 and M3 recorded sizable increases in April, apparently arising from a buildup of liquid accounts by households to make larger-than-usual final tax payments. For the year through April, M2 and M3 had grown less rapidly than in 1998; even so, M2 was estimated to have grown this year at a rate somewhat above the Committee's annual range, and M3 at a rate slightly above its range. Total domestic nonfinancial debt continued to expand at a pace somewhat above the middle of its range.

The staff forecast prepared for this meeting suggested that the expansion would gradually moderate to a rate commensurate with the rise in the economy's estimated potential. Growth of private final demand would be damped by the anticipated waning of positive wealth effects stemming from large increases in equity prices and by slower growth of spending on consumer durables, houses, and business equipment after the earlier buildup in the stocks of these items. The lagged effects of the rise that had occurred in the foreign exchange value of the dollar were expected to place continuing, though diminishing, restraint on the demand for U.S. exports for some period ahead. Labor markets were anticipated to remain tight, and inflation was projected to increase somewhat on balance over the projection period, partly as a result of some firming of import prices that, in turn, would give domestic firms somewhat more leeway to raise their prices.

In the Committee's discussion of current and prospective economic developments, members commented that they saw few signs of any moderation in the expansion of economic activity from the rapid pace that had prevailed in recent quarters—a pace greater than the growth in the economy's potential, even though the growth of potential was rising as a result of accelerating productivity. For a number of reasons, they still viewed some slowing in the expansion to a growth rate more in line with that of potential as a reasonable expectation. However, the timing and extent of the moderation remained subject to substantial uncertainty. And in light of the persistent strength in domestic demand, the reduced risks of economic weakness abroad, and the recovery in U.S. financial markets, most members believed that for the year ahead the odds around their forecasts were tilted toward further robust growth that would add to pressures on already tight labor markets. The latest statistical and anecdotal information on wages and prices, while somewhat more mixed than earlier, continued on balance to present a picture of benign inflation. However, the firming of oil and other commodity prices, the more frequent anecdotal reports of increases in some costs and prices, and the most recent CPI statistics could be read as suggesting at least that the trend toward lower inflation was coming to an end and perhaps also as harbingers of a less favorable inflation performance going forward, especially if growth in demand did not slow to a more sustainable pace. A key uncertainty in the outlook for inflation related to the prospects for productivity, whose continued acceleration over the past several quarters clearly had helped to contain cost pressures despite widespread indications of persistently tight labor markets. On balance, while an upward trend in underlying inflation had not materialized thus far, the members were concerned that if recent developments continued—especially if demand did not slow to a more sustainable pace—inflation was more likely to rise over time.

The impressive strength in private domestic spending during the first several months of the year featured notable gains in consumer and business expenditures and appreciable growth in outlays for residential construction. Underlying the strength in these key sectors of the economy was the marked improvement in overall financial market conditions since the fall of last year, including the ample availability of financing on relatively favorable terms for many borrowers and the sharp rise in stock market prices. Indicators of possible slowing in these sectors of the economy were limited, especially outside of housing.

Consumer expenditures were expected to be well maintained in conjunction with projections of appreciable further growth in jobs and incomes and a ready availability of financing. A major uncertainty in the outlook for the consumer sector was the largely unpredictable behavior of the stock market. The very large equity price increases in recent years evidently had contributed to high levels of consumer confidence and robust consumer spending, and the further gains in those prices thus far this year would continue to bolster spending for a while. A leveling trend in stock market prices, should one materialize, likely would have a significant restraining effect on consumer confidence and the growth of spending over time. In addition, the substantial accumulation of durable goods by consumers in recent years was seen as a constraining influence on spending for such goods going forward.

Expenditures by business firms for durable equipment were expected to post further sizable gains this year and next, though probably at rates somewhat below those recorded in recent years. Technical advances and ongoing competitive pressures were likely to remain relatively stimulative factors, but a number of developments also were anticipated to exert a tempering influence.

These included the large buildup in equipment over the course of recent years, some moderation in the growth of demand for capital associated with slower expansion of overall spending, and in these circumstances more sluggish growth of business profits. The behavior of stock market prices also would play a role in the cost of business finance and the level of business confidence but one that could not readily be predicted. According to anecdotal reports, commercial and other nonresidential construction activity was at high levels in several regions, though constrained in a number of areas by shortages of skilled labor and some construction materials. Concerns about overbuilding were reported in a few parts of the country. Residential construction activity also was at a high level, and backlogs had developed in some regions because of shortages of labor and some building materials. While these backlogs and continued affordability of home purchases were expected to help sustain residential construction activity near current levels for some period of time, statistical and survey indicators pointed to some loss of momentum in housing sales and new construction, perhaps partly in response to the rise in long-term interest rates.

Foreign trade on net was damping demand pressures on U.S. production capacity, but its negative impact was thought likely to diminish over time. Factors underlying this outlook included indications of stabilizing or improving financial and economic conditions in several East Asian and Latin American countries and expectations of some strengthening in European economies. The resulting impetus to exports was projected to be accompanied by a lower rate of growth in imports as the expansion of the U.S. economy slowed. Anecdotal reports of rising exports, notably to Asian markets, lent some support to this outlook. Members commented, however, that financial and economic prospects remained worrisome in several parts of the world and that the outlook for net exports continued to be subject to downside risks, albeit to a lesser extent than in late 1998 and early 1999.

Members expressed concern about what they now saw as a greater risk of rising inflation even though current indicators continued on the whole to point to quiescent wage and price behavior. The recent performance of the CPI and industrial commodity prices and the more numerous anecdotal reports of price and cost increases were reasons for added caution about the outlook for inflation, though these developments still constituted only very tentative evidence of a possible change in inflation trends. Several members commented in particular that substantial weight should not be attached to the one-month jump in the just-released CPI data. Unexpectedly large gains in productivity had both contributed to demand and helped output to keep pace with the strong growth in demand, but an important portion of that demand also had been met by drawing down the pool of available workers and by rapid increases in imports. Inflation expectations, while perhaps deteriorating a bit recently, were still subdued and undoubtedly continued to help account for restrained pricing behavior and for relatively moderate wage demands despite the tightness in labor markets.

Partly because the economy continued to demonstrate a marked ability to absorb large increases in demand without generating significant cost and price pressures, the members did not see a sizable upturn in underlying inflation as a likely prospect over the next few quarters. The longer-run outlook was more worrisome and would depend importantly on the extent to which the expansion put pressure on labor resources. In particular, if that pressure intensified, at some point further gains in productivity would not be able to offset rising wage increases. Moreover, the effect on prices would tend to be exacerbated by the ebbing or reversal of temporary factors that had served to damp inflation; notable among those factors were the upturn in energy prices and the current or prospective firming of commodity and other import prices as economic activity strengthened abroad. With both the extent of prospective pressures in labor markets and the outlook for productivity subject to considerable uncertainty, a firmer assessment of the future course of inflation needed to await further developments.

Against this background, all the members supported a proposal to maintain an unchanged policy stance and to adopt and announce an asymmetric directive that was tilted toward tightening. Although their concerns about the outlook for inflation had increased significantly since the previous meeting, the members felt that there was still a reasonable chance that the current stance of policy would remain consistent with containing price pressures for some period of time. Signs of an actual change in inflation were still quite tentative and anecdotal, and they did not warrant an adjustment to policy at this meeting. Moreover, as the experience of recent years had amply demonstrated, improvements in productivity growth might permit the economy to continue to accommodate strong demand for some time without generating higher inflation, especially if the growth of demand were to moderate somewhat in the months ahead. In that regard, the prospective strength of demand pressures and related outlook for productivity were subject to a wide range of uncertainty, and there were reasons to believe that economic growth could well slow without any adjustment to policy. The members recognized that the recovery in credit markets, the rise in equity prices, and the turnaround in some foreign economies could imply that the lower federal funds rate established last fall was no longer entirely appropriate. However, they concluded that given the prevailing uncertainties in the economic outlook it was preferable to defer any policy action and to monitor the economy closely for further signs that inflationary pressures were likely to rise.

The members nonetheless agreed that their increased concerns about the outlook for inflation called for the adoption of an asymmetric directive that was tilted toward tightening and, in keeping with the Committee’s recently reaffirmed policy, to announce that change after this meeting. The Committee had said that it would not necessarily publish every change in the symmetry of its directive, but this shift to asymmetry represented a significant change in the Committee’s assessment of the risks of higher inflation, and its announcement would alert the financial markets and the public more generally to this development. That, in turn, should encourage stabilizing reactions in financial markets and perhaps reduce the odds of an outsized response if evolving circumstances in the near term were to require an adjustment to policy that had not previously been anticipated. It was important that the public, including those who participated in financial markets, understood the Committee’s resolve to keep inflation at a low level. A number of members emphasized, however, that the adoption and announcement of an asymmetrical directive should not be viewed as necessarily implying a near-term policy change or indeed any change over time unless circumstances warranted. For now, an asymmetric directive represented the right balance in terms of positioning the Committee for possible tightening at some point.

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 information reviewed at this meeting suggests continued vigorous expansion in economic activity. Nonfarm payroll employment moderated on balance over March and April, and the civilian unemployment rate in April matched its first-quarter average. Total industrial production increased substantially in March and April. Total retail sales edged up in April after recording large gains earlier in the year. Housing starts fell in April. Available indicators suggest that growth of business capital spending has remained relatively rapid. The nominal deficit on U.S. trade in goods and services widened substantially in January and February from its fourth-quarter average. Consumer prices rose substantially in April, boosted by a sharp increase in energy prices; labor costs have remained quiescent thus far this year despite very tight labor markets.
>
> Interest rates on Treasury securities have risen appreciably since the meeting on March 30, 1999, with the largest increases concentrated in intermediate- and long-term maturities; rates on private obligations show mixed changes over the period. Most key measures of share prices in equity markets have registered sizable gains over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar has depreciated somewhat over the period in relation to the currencies of a broad group of important U.S. trading partners.
>
> M2 and M3 recorded sizable increases in April, apparently owing to a tax-related buildup in liquid accounts. For the year through April, M2 is estimated to have increased at a rate somewhat above the Committee's annual range and M3 at a rate slightly above its range. Total domestic nonfinancial debt has continued to expand at a pace somewhat above the middle of its range.
>
> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in February established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.
>
> To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 4¾ percent. In view of the evidence currently available, the Committee believes that prospective developments are more likely to warrant an increase than a decrease in the federal funds rate operating objective during the intermeeting period.

Votes for this action: Messrs. Greenspan, McDonough, Boehne, Ferguson, Gramlich, Kelley, McTeer, Meyer, Moskow, Ms. Rivlin, and Mr. Stern. Votes against this action: None

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, June 29–30, 1999.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary

Meeting Held on June 29–30, 1999

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 29, 1999, at 2:30 p.m. and continued on Wednesday, June 30, 1999, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Ferguson
Mr. Gramlich
Mr. Kelley
Mr. McTeer
Mr. Meyer
Mr. Moskow
Mr. Stern

Messrs. Broaddus, Guynn, Jordan, 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
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Prell, Economist
Mr. Johnson, Economist

Messrs. Alexander, Cecchetti, Hooper, Hunter, Lang, Lindsey, Rolnick, Rosenblum,[7] Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Messrs. Porter[8] and Reinhart, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

Mr. Reifschneider,[8] Section Chief, Division of Research and Statistics, Board of Governors

Mses. Edwards,[9] and Mauskopf,[9] and Messrs. Lebow[8] and Orphanides,[8] Senior Economists, Divisions of Monetary Affairs, International Finance, Research and Statistics, and Monetary Affairs respectively, Board of Governors

Ms. Garrett and Mr. Tetlow,[8] Economists, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Beebe, Eisenbeis, Goodfriend, Hakkio, Rasche, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, Kansas City, St. Louis, and Cleveland respectively

Mr. Fuhrer and Ms. Perelmuter, Vice Presidents, Federal Reserve Banks of Boston and New York respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on May 18, 1999, were approved.

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[7] Attended Tuesday's session only.

[8] Attended portions of the meeting relating to the discussion of the policy implications of uncertainty about key economic variables.

[9] Attended portions of the meeting relating to the Committee's review of the economic outlook and consideration of its monetary and debt ranges for 1999 and 2000.

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, and thus no vote was required 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 May 18, 1999, through June 29, 1999. The Committee ratified these transactions by unanimous vote.

The Committee then turned to a discussion of the economic and financial outlook, the ranges for the growth of money and debt in 1999 and 2000, and the implementation of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting suggested that economic activity continued to expand vigorously, though at a somewhat slower pace than earlier in the year. Consumer outlays and construction spending had decelerated somewhat after having grown very rapidly in the first quarter, but the deceleration had been partly offset by a step-up in business purchases of durable equipment and a smaller decline in net exports. Labor markets remained very tight, and recent wage and price increases had been a little larger on balance; nonetheless, longer-term inflation trends continued generally favorable in an environment of robust improvements in productivity.

Nonfarm payroll employment rose substantially further on balance in April and May, but the increase was a little below the rate for the first quarter. Growth in employment remained robust in the service-producing sector in the April–May period. However, the number of jobs fell in the goods-producing sector: payrolls in manufacturing and mining continued to contract, and construction employment changed little on net after a sizable first-quarter increase. The civilian unemployment rate edged down in May to 4.2 percent, matching its low for the year and for the period since 1970.

Industrial production advanced somewhat further in May despite a sharp weather-related drop in utility services and continued sluggishness in mining activity. Manufacturing output registered another substantial advance, reflecting a surge in the production of motor vehicles and parts and persisting strength in the manufacture of many other durable goods. The output of nondurable goods posted another small increase in May, with the gains being relatively broadly based. Reflecting the stepped-up pace of manufacturing, the rate of utilization of capacity edged higher in May but continued to be below its long-run average level.

Growth of consumer spending appeared to have slowed somewhat from its extraordinary pace of the first quarter; nonetheless, the underlying trend in consumption remained strongly upward, with household income and wealth continuing to expand rapidly and consumer sentiment remaining very high. Total retail sales rose substantially in May following large increases on average earlier in the year. Gains in retail sales were relatively widespread, with outsized advances in the food, general merchandise, and durable goods categories.

Housing demand remained robust in recent months despite the recent rise in mortgage rates. However, builders were faced with shortages of workers and some materials and were hard-pressed to keep pace with the demand for new homes. As a result, both single-family and multifamily housing starts fell somewhat on balance over April and May.

Information on shipments of nondefense capital goods in April and May suggested that business investment in durable equipment picked up substantially in the second quarter from the already brisk pace of the first quarter. Shipments of high-tech equipment, notably computers, were particularly robust over the April–May period. In addition, business demand for motor vehicles continued to be strong, particularly for medium and heavy trucks for which the backlog of unfilled orders was still quite large. By contrast, nonresidential construction activity weakened in April (latest data) after a rise in the first quarter, and available information on contracts for future construction pointed to sluggish building activity for some period ahead.

Business inventory accumulation slowed a bit in April from the relatively subdued first-quarter pace, and total business stocks remained at fairly low levels in relation to sales. In manufacturing, inventories continued to decline in April, and the aggregate inventory–shipment ratio for this sector stayed at the bottom of its range for the past twelve months. Wholesale stocks rose in April at about their average pace for the early months of the year, and the ratio of stocks to sales in this sector stayed in the lower end of its range for the past year. Retail inventory accumulation slowed in April after a relatively large gain in the first quarter, and the aggregate inventory–sales ratio also remained in the lower end of its range for the past twelve months.

The nominal deficit on U.S. trade in goods and services widened somewhat in April from its first-quarter average. The value of exports increased slightly from its first-quarter average, primarily reflecting greater exports of computers and semiconductors, motor vehicles, and industrial supplies. The value of imports rose somewhat more, principally owing to larger imports of oil. The available information suggested that economic activity had picked up somewhat on balance in the major foreign industrial countries. The Japanese economy was reported to have expanded markedly in the first quarter, recording its first quarterly rise in the past year and a half. In Europe, economic growth rebounded in Germany but slowed somewhat in France and the United Kingdom. Signs of an improved economic performance also were evident in Latin America and Southeast Asia.

The consumer price index was unchanged in May following a sizable increase in April that was associated in part with a jump in energy prices. Excluding the effects of movements in food and energy prices, though, consumer inflation was a little higher in the April–May period than in the first quarter; for the twelve months ended in May, core consumer prices rose slightly less than in the previous twelve-month period. Producer prices of finished goods also were affected by the volatility of energy prices in April and May, but core producer prices recorded only a small rise in each month. For the twelve months ended in May, however, core producer inflation was up noticeably compared with the year-earlier period, owing in important part to sharp increases in the prices of tobacco products. With regard to labor costs, average hourly earnings grew a little faster in May than in April, but they rose less in the twelve months ended in May than in the previous twelve-month period.

At its meeting on May 18, 1999, the Committee adopted a directive that called for maintaining conditions in reserve markets that would be consistent with an unchanged federal funds rate of about 4¾ percent, but the directive also contained a bias toward a possible tightening of policy. The members' concerns about inflation had increased appreciably since the meeting in late March; nonetheless, the members felt that the current stance of policy could remain consistent with subdued inflation for some time, especially if productivity gains continued robust and, as projected, the growth of aggregate demand moderated somewhat in the months ahead.

Open market operations were directed throughout the intermeeting period toward maintaining the federal funds rate at around 4¾ percent, and the average rate for the period was very close to the Committee's target. Other interest rates rose somewhat over the period since the May meeting in response to the combined effects of the Committee's announcement of an asymmetric directive, economic data that generally were stronger than expected, and reported comments of Federal Reserve officials. With the market effects of higher interest rates roughly offset by brighter second-quarter earnings prospects, broad indexes of share prices in equity markets changed little on balance over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar edged up over the intermeeting period in relation to the currencies of a broad group of important U.S. trading partners. The dollar appreciated against the euro, partly reflecting the contrast between continuing robust growth in the United States and generally subpar activity in euro-area economies. The dollar also rose against the pound in association with slower growth in the United Kingdom and a reduction in the Bank of England's repo rate. By contrast, the dollar weakened against the yen as yields on Japanese government debt increased sharply relative to rates on U.S. Treasury securities. Among other important trading partners, the dollar fell against the currencies of many emerging Asian economies, whose financial markets had generally improved, but appreciated in terms of the Brazilian *real* in association with periods of particular stress in Brazil's financial markets.

After having recorded sizable increases in April that apparently were associated with tax-related buildups in liquid accounts, the growth of M2 and M3 slowed sharply in May, as tax payments cleared, and appeared to have remained moderate in June. The expansion of these aggregates also seemed to have been damped in recent months by the rise in their opportunity costs associated with earlier increases in interest rates. M2 was estimated to have increased for the year through June at a rate somewhat above the Committee's annual range and M3 at a rate near the upper end of its range. Although growth of total domestic nonfinancial debt had moderated a little recently, it continued to expand at a pace somewhat above the middle of its range.

The staff forecast prepared for this meeting suggested that the expansion would gradually moderate to a rate commensurate with the growth of the economy's estimated potential. The lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place continuing, though diminishing, restraint on the demand for U.S. exports for some period ahead. The increase of private final demand would be restrained by the anticipated waning of positive wealth effects associated with earlier large increases in equity prices; by slower growth of spending on consumer durables, houses, and business equipment in the wake of the prolonged buildup in the stocks of these items; and by the rise that had already occurred in market interest rates, especially for intermediate and longer maturities, in the expectation that higher interest rates would be needed to achieve a better balance between aggregate demand and aggregate supply. Price inflation was projected to rise somewhat over the projection horizon, in large part as a result of some upturn in import prices and a slight firming of gains in nominal labor compensation that would not be fully offset by rising productivity.

In the Committee's discussion of the outlook for economic activity and inflation, members commented that the incoming information continued to suggest a vigorous expansion but also subdued inflation despite very tight labor markets. Growth in aggregate demand was estimated to have slowed somewhat in the second quarter from outsized advances in the two previous quarters, largely as a result of less ebullient though still robust growth in consumer spending. The members questioned, however, whether the limited indications of some moderation in the expansion in recent months were a harbinger of a more sustainable pace of economic activity that would be consistent with the economy's estimated output potential and low inflation. Indeed, in the absence of some policy firming most of the members saw tightening labor markets and an upward drift in measured inflation as a significant risk. They acknowledged that the timing and extent of a potential rise in inflation were subject to considerable uncertainty. In particular, as the experience of recent years had amply demonstrated, strengthening advances in productivity had reduced increases in unit costs to very low or even slightly negative levels despite growing scarcities of labor and some rise in the growth of labor compensation and in profit margins. Rising productivity growth had not been sufficient, however, to keep labor markets from tightening, given the extraordinary strength in final U.S. demands, which if continued would show through into higher inflation. Moreover, it remained unclear how long faster gains in productivity could continue to offset increases in labor costs and avert an intensification of price inflation.

In keeping with the practice at meetings just before the Federal Reserve's semiannual monetary policy report to the Congress and the Chairman's associated testimony, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members had provided individual projections of the growth in nominal and real GDP, the rate of unemployment, and the rate of inflation for the years 1999 and 2000. With regard to the growth of nominal GDP, most of the forecasts were in ranges of 5 to 5½ percent for 1999 as a whole and 4 to 5 percent for 2000. The forecasts of the rate of expansion in real GDP for 1999 had a central tendency of 3½ to 3¾ percent and for 2000 they were centered on a range of 2½ to 3 percent, below the increases experienced over the last three years. The civilian rate of unemployment associated with these forecasts had central tendencies of 4 to 4¼ percent in the fourth quarter of 1999 and 4¼ to 4½ percent in the fourth quarter of 2000. Projections of the rate of inflation, as measured by the consumer price index, pointed to an appreciable increase in 1999, largely reflecting a swing in the price of energy, and little further change in 2000; specifically, the projections converged on CPI inflation rates of 2¼ to 2½ percent in 1999 and 2 to 2½ percent in 2000. The members anticipated that the effects of the century date change on economic activity would, on balance, be limited or negligible over the forecast period, possibly adding somewhat to growth later this year and temporarily reducing growth early next year.

Key factors underlying the members' forecasts of appreciable moderation in the trend of real GDP growth included a waning of the financial stimulus that had boosted domestic demand in recent years and the buildup of stocks of consumer durables, housing, and business equipment after an extended period of rapidly expanding purchases. However, the members acknowledged that the signs of slower growth in household and business spending were still quite limited.

In the household sector, further substantial increases in income and financial wealth and high levels of consumer confidence had fostered continued robust growth in consumer spending in recent months, but apart from exceptional strength in purchases of motor vehicles, growth in real spending for durable consumer goods appeared to have moderated recently from a very rapid pace earlier in the year. How long the favorable factors that continued to stimulate substantial growth in consumer expenditures would persist was uncertain, notably with regard to the outlook for stock market prices and their effects on consumer resources and willingness to spend. The stimulus to household spending from rapidly rising stock market wealth obviously would diminish should prices in the stock market tend to level out as many expected. In that event, growth in consumer spending might be expected to moderate to a pace more in line with the expansion in disposable incomes.

Business investment spending, which featured exceptional growth in expenditures for producers' durable equipment, appeared to have picked up in recent months from an already rapid pace earlier in the year. Nonetheless, business firms were expected to trim the growth in their outlays for equipment as forecasts of moderating expansion in aggregate demand materialized. Such a cutback would be abetted to an extent by the somewhat higher levels of market interest rates that business borrowers now faced. While growth in spending for high-technology equipment and related products probably would remain rapid in light of the accelerated pace of innovations and declining prices for such equipment, a significant deceleration or slowdown in spending for other types of capital equipment seemed likely under projected economic conditions, especially given currently reduced rates of capacity utilization in many manufacturing industries. In the nonresidential construction sector, business expenditures were expected to remain near current levels, reflecting ongoing strength in many parts of the country but also some signs of overbuilding in other areas.

A number of recent indicators suggested that on a seasonally adjusted basis residential building activity had slowed a bit in the second quarter from an elevated level earlier in the year. However, homebuilding apparently had been held back to some extent recently by scarcities of labor and some building supplies, and sizable backlogs evidently had built up. Looking ahead, the members expected residential construction expenditures to hold near current levels in the second half of this year as backlogs were worked lower, but they anticipated some softening subsequently. Factors bearing on this outlook included the large additions to the stock of housing in recent years and to some extent the backup that had occurred in mortgage rates. At some point the higher financing costs would begin to show through to housing demand.

The available information indicated that U.S. exports of goods and services had declined on balance thus far this year, while imports had posted very strong gains in line with continuing strength in U.S. domestic spending. However, improving economies in a number of the nation's important trading partners and the slower expansion forecast for the U.S. economy were expected to have a favorable effect on exports and to moderate increases in imports over the next several quarters. Indeed, recent data suggested that U.S. exports had advanced slightly after having posted sizable declines during the first quarter while imports had continued to grow strongly. On net, the members anticipated that the nation's trade balance would continue to worsen, although more slowly and with a less negative effect on the U.S. economy over the forecast period.

Members commented that inflation, as reflected in a wide range of statistical measures and anecdotal reports, remained remarkably subdued despite the persisting strength of the expansion and very tight labor markets across the nation. It seemed likely that rising productivity, which appeared to have accelerated markedly of late, accounted for much of the surprising combination of rapid growth in economic activity and low inflation. In particular, accelerating labor productivity clearly had curbed the rise in unit labor costs and damped pressures on prices. Very recent data on underlying productivity trends were not yet available, but the fact that profit forecasts had continued to be marked up suggested that it might still be accelerating and holding down costs. Such increases in productivity along with slack in foreign economies contributed to the very strong competition in most markets that was continuing generally to suppress efforts to raise prices. Other factors constraining inflation that were cited by the members included the ample availability of capacity in most industries and the declines that had occurred in non-oil import prices. Despite these favorable developments, most members had become increasingly worried about the risks of an overheating economy and rising inflation over time.

The concerns about the outlook for inflation tended to focus on the risk that, in the absence of an appreciable moderation in overall demands, very tight labor markets would at some point foster significantly faster increases in labor compensation that could no longer be offset by stronger productivity growth. Indeed, at recent rates of increase in output, labor utilization was likely to continue to rise, adding to pressures on costs. The higher labor cost increases would in turn generate more rapid price inflation. Members noted in this regard that the trend in average hourly earnings appeared to have tilted up in recent months. While this relatively recent development was not yet conclusive evidence of accelerating labor costs, especially without further information about productivity, anecdotal reports of faster increases in labor compensation also appeared to have multiplied. In addition, improving economic conditions abroad, among other factors, had induced a firming in oil and other commodity prices, and had supported the foreign exchange value of other currencies relative to the dollar. As a consequence, the declines in commodity and other import prices that had helped to suppress inflation and inflation expectations over the past two years were not likely to be repeated. Members acknowledged that the prospects for rising inflation, including the potential timing of an acceleration, if any, remained uncertain given the questions surrounding both the ongoing strength of aggregate demand and the outlook for productivity, but they viewed the risks of added price pressures as having risen further.

In keeping with the requirements of the Full Employment and Balanced Growth Act of 1978 (the Humphrey–Hawkins Act), the Committee reviewed at this meeting the ranges for growth of the monetary and debt ranges that it had established in February for 1999, and it set tentative ranges for those aggregates for 2000. The current ranges approved in February for the period from the fourth quarter of 1998 to the fourth quarter of 1999, which were unchanged from those for the last several years, included growth of 1 to 5 percent for M2 and 2 to 6 percent for M3. An unchanged range of 3 to 7 percent also was set in February for growth of total domestic nonfinancial debt in 1999.

All the members favored retaining the current ranges for this year and extending them on a provisional basis to 2000. The members recognized that the growth of both M2 and M3, while decelerating markedly from 1998, might still exceed the ranges for the current year and be near the upper ends of the ranges in 2000, assuming economic and financial conditions approximating their current expectations. However, as had been the case for many years, the members remained concerned that forecasts of money growth were still subject to a wide range of error in terms of the anticipated relationships between money growth and aggregate economic performance. Accordingly, they agreed that those ranges should not reflect or be centered on forecasts of money growth under projected economic and financial conditions, but should be regarded as anchors or benchmarks for money growth that would be associated with approximate price stability and sustained economic expansion, assuming behavior of velocity in line with historical experience. A reaffirmation of those ranges for 1999 and their extension to 2000 would therefore underscore the Committee's commitment to achieving and maintaining price stability over time and thereby fostering maximum sustainable economic growth. It was noted during this discussion that the apparent pickup in productivity, if it persisted, suggested that somewhat higher ranges than those adopted in recent years might more accurately reflect money growth under conditions of price stability and historically typical velocity trends. However, the members agreed that the marked degree of uncertainty in the outlook for productivity as well as velocity argued against any increases in the ranges at this point.

The Committee members were unanimously in favor of retaining the current range of 3 to 7 percent for growth of total domestic nonfinancial debt in 1999 and extending that range on a provisional basis to 2000. They took account of a staff projection indicating that growth of the debt aggregate was likely to be around the middle of this range, perhaps somewhat above in 1999 and somewhat below in 2000. Unlike the ranges for the monetary aggregates, selection of the range for debt did not reflect a price stability and sustainable economic growth rationale but was based on forecasts of actual growth in this measure.

At the conclusion of this discussion, the Committee voted to reaffirm the ranges for growth of M2, M3, and total domestic nonfinancial debt that it had established in February for 1999 and to extend these ranges on a tentative basis to 2000. In keeping with its usual procedures under the Humphrey–Hawkins Act, the Committee would review its preliminary ranges for 2000 early next year. Accordingly, the Committee voted to incorporate the following statement regarding the 1999 and 2000 ranges in its domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at this meeting the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 2000, the Committee agreed on a tentative basis to set the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1999 to the fourth quarter of 2000. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

> Votes for this action: Messrs. Greenspan, McDonough, Boehne, Ferguson, Gramlich, McTeer, Meyers, Moskow, Kelly, and Stern. Votes against this action: None. Absent and not voting: Ms. Rivlin

In the Committee's discussion of policy for the intermeeting period ahead, all but one member supported a proposal for a slight tightening of conditions in reserve markets consistent with an increase of ¼ percentage point in the federal funds rate to an average of around 5 percent. In the view of most members, such a policy move represented a desirable and cautious preemptive step in the direction of reducing what they saw as a significant risk of rising inflation. While current indications of accelerating inflation were quite limited, the economy had been expanding rapidly enough to put added pressure on labor markets over time, and many members expressed growing concern that, given the current stance of monetary policy, the persisting strength of domestic demand augmented by increasing demand from abroad would show through at some point to even tighter labor markets and higher inflation, which would impinge over time on the economy's ability to realize its full growth potential. In these circumstances, a small preemptive move at this time would provide a degree of insurance against worsening inflation later. Members commented that the action in question would reverse a portion of the easing actions implemented during the fall of 1998 that had been undertaken in part to protect against the possibility that unsettled global markets would place even greater constraints on foreign and domestic economic activity than were then evident. As financial markets and foreign economies stabilized and recovered, that added protection was no longer required and policy needed to move to a less accommodative stance to promote sustainable growth in spending. One member did not agree that any tightening of policy was necessary to contain inflation, given the persistence of low inflation, accelerating productivity, and what in his view was an already sufficiently restrictive monetary policy stance.

The members were divided over whether to retain the current asymmetrical directive tilted toward restraint or to adopt a symmetrical directive in conjunction with the contemplated tightening action. A majority endorsed a proposal to shift to a symmetrical directive. They agreed that following today's limited policy move the risks would still remain tilted toward rising inflation, and they expected that the announcement of a change in policy shortly after the meeting would include a reference to the Committee's ongoing concerns in that regard. But in light of the marked degree of uncertainty relating to the extent and timing of prospective inflationary pressures, they believed that further firming of policy might not be necessary in the near term and in any case would depend importantly on future developments. Some of these members were concerned that retention of asymmetry might be interpreted as an indication that the Committee was relatively certain that it would need to take further tightening action fairly soon, a view that tended to be reinforced by the behavior of expectations in the period after the announcement of a shift to asymmetry at the May meeting.

Members who preferred to retain an asymmetrical directive agreed that, although there was little likelihood of a further policy change during the intermeeting period, such a directive was the best way to convey their concerns about the risks of rising inflation and the potential need for policy tightening over time. A number of those in favor of asymmetry were concerned that a symmetrical directive would not capture the Committee's thinking with regard to the most likely policy course over an extended period of time and could foster the misleading conclusion that the Committee no longer believed a further adjustment to policy might be warranted at some point later this year. They saw the odds as reasonably high that further tightening would be needed before the end of the year to gain adequate assurance that inflation would be contained. Despite their differing preferences, all the members who supported a policy tightening move also indicated that they could accept a symmetrical directive because the announcement to be released after this meeting along with the Chairman's Humphrey–Hawkins testimony during the latter part of July could serve to correct possible misinterpretations.

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 information reviewed at this meeting suggests continued vigorous expansion in economic activity. Nonfarm payroll employment has increased at a relatively rapid pace in recent months and the civilian unemployment rate, at 4.2 percent in May, matched its low for the year. Manufacturing output rose substantially further in May. Total retail sales increased briskly last month after recording large gains on average earlier in the year. Housing activity has remained robust in recent months. Available indicators suggest that business capital spending, especially for information technology, has accelerated this spring. The nominal deficit on U.S. trade in goods and services widened somewhat in April from its first-quarter average. Consumer price inflation was up somewhat on balance in April and May, boosted by a sharp increase in energy prices; improving productivity has held down increases in unit labor costs despite very tight labor markets.

Interest rates have risen somewhat since the meeting on May 18, 1999. Key measures of share prices in equity markets are unchanged to somewhat lower on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar has changed little over the period in relation to the currencies of a broad group of important U.S. trading partners.

After recording sizable increases in April, apparently owing to a tax-related buildup in liquid accounts, growth of M2 and M3 slowed in May as tax payments cleared and appears to have remained moderate in June. For the year through June, M2 is estimated to have increased at a rate somewhat above the Committee's annual range and M3 at a rate near the upper end of its range. Total domestic nonfinancial debt has continued to expand at a pace somewhat above the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at this meeting the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 2000, the Committee agreed on a tentative basis to set the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1999 to the fourth quarter of 2000. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 5 percent. In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period.

Votes for this action: Messrs. Greenspan, McDonough, Boehne, Ferguson, Gramlich, Meyers, Moskow, Kelley, and Stern. Vote against this action: Mr. McTeer. Absent and not voting: Ms. Rivlin

Mr. McTeer dissented because he believed that tightening was unnecessary to contain inflation. He noted that most measures of current inflation remain low, and he saw few signs of inflation in the pipeline. Conditions that called for a preemptive tightening in 1994—rapidly rising commodity prices and real short-term interest rates near zero—are not present today. While money growth has been rapid by historical standards, market-based indicators of monetary policy suggest sufficient restraint. Except for oil, most sensitive commodity prices have risen only slightly after years of decline, the dollar remains strong, real short-term interest rates are near historical norms, and productivity growth has accelerated in recent quarters. Mr. McTeer does not believe that rapid growth based on new technology, rising productivity, and other supply-side factors is inflationary, especially in the current global environment. He would have preferred to continue to test the growth limits of the new economy.

By notation vote completed on July 14, 1999, available members of the Committee voted unanimously to delegate responsibility to Mr. Gramlich and in his absence to Mr. Ferguson for making decisions on appeals of denials by the secretary of the Committee for access to Committee records. This action was taken in keeping with the provisions of 271.4(d) of the Committee's Rules Regarding Availability of Information.

Votes for this action: Messrs. Greenspan, McDonough, Boehne, Ferguson, Gramlich, Meyers, Moskow, Kelley, and Stern. Votes against this action: None. Not voting: Mr. McTeer and Ms. Rivlin

It was agreed that the next meeting of the Committee would be held on Tuesday, August 24, 1999.

The meeting adjourned at 11:45 a.m.

Donald L. Kohn
Secretary

After the meeting, the following press release was issued:

The Federal Open Market Committee today voted to raise its target for the federal funds rate 25 basis points, to 5 percent. Last fall the Committee reduced interest rates to counter a significant seizing-up of financial markets in the United States. Since then much of the financial strain has eased, foreign economies have firmed, and economic activity in the United States has moved forward at a brisk pace. Accordingly, the full degree of adjustment is judged no longer necessary.

Labor markets have continued to tighten over recent quarters, but strengthening productivity growth has contained inflationary pressures.

Owing to the uncertain resolution of the balance of conflicting forces in the economy going forward, the FOMC has chosen to adopt a directive that includes no predilection about near-term policy action. The Committee, nonetheless, recognizes that in the current dynamic environment it must be especially alert to the emergence, or potential emergence, of inflationary forces that could undermine economic growth.

Meeting Held on August 24, 1999

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 24, 1999, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Ferguson
Mr. Gramlich
Mr. Kelley
Mr. McTeer
Mr. Meyer
Mr. Moskow
Mr. Stern

Messrs. Broaddus, Guynn, Jordan, 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
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Ms. Johnson, Economist

Messrs. Howard, Hunter, Lang, Lindsey, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Whitesell, Assistant Director, Division of Monetary Affairs, Board of Governors

Ms. Edwards,[10] Senior Economist, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Stewart and Ms. Strand, First Vice Presidents, Federal Reserve Banks of New York and Minneapolis respectively

Mr. Beebe, Ms. Browne, Messrs. Eisenbeis, Hakkio, Ms. Krieger, Messrs. Lacker, Rasche, and Steindel, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Boston, Atlanta, Kansas City, New York, Richmond, St. Louis, and New York respectively

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

Mr. Bryan, Assistant Vice President, Federal Reserve Bank of Cleveland

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[10] Attended portion of meeting relating to issues pertaining to year-end operations.

Mr. Viard, Senior Economist, Federal
Reserve Bank of Dallas

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on June 29–30, 1999, were approved.

By unanimous vote, Christine Cumming and David Howard were elected to serve as associate economists until the first meeting of the Committee after December 31, 1999, with the understanding that in the event of the discontinuance of their official connection with a Federal Reserve Bank or with the Board of Governors, they would cease to have any official connection with the Committee.

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, and thus no vote was required 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 June 30, 1999, through August 23, 1999. By unanimous vote, the Committee ratified these transactions.

At this meeting, the Committee considered a number of proposals whose purpose was to enhance the Manager's ability to counter potential liquidity strains in money and financing markets in the period surrounding the century date change and in the process help to ensure the effective implementation of the Committee's monetary policy objectives. The members believed that the prospects for major liquidity problems associated with the century date change were remote, but some strains were already in evidence, and they agreed that it would be prudent to provide the Manager with added leeway and flexibility for a limited period. Because the plans of market participants were likely to be influenced by the Federal Reserve's contemplated action and because detailed preparations with market participants needed to begin promptly, the Committee decided to put the new authorizations in place at this meeting.

The new authority encompassed three policy instruments that, unless renewed, would expire during the early part of 2000 and one permanent change. The temporary authorizations included (1) the expansion of collateral that could be accepted in System open market transactions, (2) authority to use reverse repurchase agreements in addition to the currently available matched sale-purchase transactions to absorb reserves on a temporary basis, and (3) a standby financing facility involving the auction of options on repurchase agreements, reverse repurchase agreements, and matched sale–purchase transactions that could be exercised in the period surrounding the year-end. The permanent change, which also might prove useful during the year-end period, involved the extension of the maximum maturity on regular repurchase and matched sale-purchase transactions from sixty days to ninety days.

The broader range of collateral approved by the Committee for repurchase transactions included mainly pass-through mortgage securities of GNMA, FHLMC, and FNMA, U.S. Treasury STRIPS, and "stripped" securities of other federal government agencies. The expanded pool would facilitate the Manager's task of addressing what potentially could be very large needs to supply reserves in the months ahead, especially in the weeks surrounding the year-end. Such transactions would have to be undertaken at a time of likely heightened demand for U.S. government securities that would diminish the available pool of currently authorized securities for System open market operations. The Federal Reserve Bank of New York would need to establish custody arrangements with commercial banks to manage the clearing of the newly authorized securities on a triparty basis. Some time would be needed to make these arrangements and inform other market participants, and it was anticipated that the new arrangements would not be in place before early October. To implement this decision, the Committee voted unanimously to suspend until April 30, 2000, several provisions of the ‘‘Guidelines for the Conduct of System Operations in Federal Agency Issues,’’ which impose limits on transactions in federal agency transactions. The ‘‘Guidelines’’ as temporarily amended now read as follows:

> 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.

The Committee’s decision to authorize the use of reverse repurchase agreements until April 30 was intended to facilitate temporary reserve draining operations. These agreements are fundamentally equivalent to matched sale-purchase transactions, which the Manager already has the authority to employ. However, the latter are not a common instrument in financial markets. Partly as a consequence, they lack the flexibility for use to drain reserves late during the business day, a flexibility that might be particularly desirable to have in place during the upcoming year-end period. Accordingly, the Committee voted unanimously to add reverse repurchase agreements to its ‘‘Authorization for Domestic Open Market Operations,’’ as shown in new paragraph 1(c) below.

The Committee also approved a temporary financing facility authorizing the Federal Reserve Bank of New York to sell options on repurchase agreements, reverse repurchase agreements, and matched sale-purchase transactions. The members hoped that the availability of such a System facility would reduce concerns about year-end financial conditions and thus help avert the emergence of the illiquid markets that were feared by an apparently growing number of market participants and that would complicate the conduct of open market operations. The sales would be made on a competitive basis to the primary government securities dealers who are regular counterparties in the System’s open market operations. The details of these transactions would be worked out during the weeks ahead.

Members agreed that there was some risk of unintended consequences in implementing these untried transactions. Nonetheless, the costs stemming from a dysfunctional financing market at year-end, in the unlikely event that it materializes, were immeasurably greater. The members did not question the desirability of addressing the latter risks and providing greater assurance that financing markets would retain sufficient depth and liquidity to permit market participants including the Federal Reserve to make necessary portfolio adjustments at year-end. Accordingly, the Committee voted unanimously to authorize the sale of options on temporary transactions for exercise though January 2000. This authority is indicated in the temporary addition of paragraph 4, shown below, to the Authorization for Domestic Open Market Operations.

The decision to extend the maximum maturity on repurchase and sale-purchase transactions was intended to bring the terms of such transactions into conformance with market practice and the pattern of market demand, thereby enhancing the Manager's ability to use these instruments. This maturity extension, which the Committee decided to make permanent, was likely to prove particularly useful in the period of unusually large reserve operations over the months ahead. The new authority is incorporated in paragraphs 1(b), 1(c), and 3 below.

The paragraphs of the Authorization for Domestic Open Market Operations that were amended or added by the Committee, all by unanimous vote, read as follows:

Authorization for Domestic Open Market Operations

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:

(b) To buy U.S. Government securities, 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 90 calendar 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 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 90 calendar 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.

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 90 calendar days 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 order to help ensure the effective conduct of open market operations during the transition period surrounding the century date change, the Committee authorizes the Federal Reserve Bank of New York to sell options on repurchase agreements, reverse repurchase agreements, and matched sale purchase transactions for exercise no later than January 2000.

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 suggested that expansion of economic activity remained solid. The growth of consumer spending and business outlays for durable equipment had moderated somewhat after having increased rapidly earlier in the year. Residential construction activity had weakened a little from the level of last winter but was still elevated. Job growth was quite strong, however, and industrial production appeared to be picking up. Labor markets remained very tight, and recent wage and price increases had been a little larger on balance, though price inflation continued subdued.

Nonfarm payroll employment increased sharply in June and July. Job growth in the service-producing industries soared in both months, and construction employment remained on an upward trend. In manufacturing, the number of jobs turned up in July. The civilian unemployment rate was 4.3 percent in July, matching its average for the first half of the year.

Industrial production recorded a large increase in July after having edged up in June. Part of the July advance reflected a surge in the output of electric utilities associated with the heat wave in the eastern United States and an upturn in mining production after a weak first half of the year. In manufacturing, production advanced briskly over the June–July period. While production of motor vehicles and aircraft fell on balance over the two months, output of high-tech products continued to expand at a rapid pace, and the manufacture of other goods rebounded strongly in July after a small decline in June. Utilization of manufacturing capacity edged up in July but remained below its long-run average rate.

Growth of consumer spending slowed appreciably in the second quarter after having surged earlier in the year; still, the underlying trend in spending remained relatively strong as a result of continuing robust expansion of disposable incomes and household wealth thus far this year and very positive consumer sentiment. Retail sales had increased moderately recently—a small decline in June was more than offset by a July rebound—while consumer outlays for services were buoyant in the second quarter (latest data). Housing activity remained strong in the June–July period; housing starts were only a little below the very high levels of earlier months of the year, and home sales remained at an elevated level in June (latest data).

The limited available information suggested that the pace of expansion in business fixed investment had moderated somewhat after having advanced rapidly in the second quarter. Demand for high-tech equipment remained strong overall, even though growth of outlays for computers appeared to have eased a little recently; spending for motor vehicles and aircraft seemed to be leveling out after a marked decrease in the first half of the year; and expenditures on other types of durable equipment remained sluggish. Nonresidential construction activity slipped in the second quarter after sizable gains last year and the early part of this year.

The book value of business inventories increased moderately in the second quarter, and in many industries the levels of inventory stocks were lean in relation to sales. In manufacturing, inventories continued to edge down in the second quarter, and the aggregate inventory–sales ratio for the sector at the end of the quarter was slightly below the lower end of its range for the preceding twelve months. Wholesale stocks recorded another modest gain in the second quarter, and the stock–shipments ratio for this sector at quarter's end was below the bottom of its narrow range for the past year. Inventory accumulation in the retail sector slowed in the second quarter, but stocks kept pace with sales, and the aggregate stock–sales ratio was in the middle of its range for the past twelve months.

The nominal deficit on U.S. trade in goods and services widened substantially in the second quarter, as the value of imports increased much more than that of exports. The rise in imports was spread widely across the major trade categories; sharply higher prices for imported oil, along with a moderate addition in the quantity imported, accounted for much of the rise, but there also were sizable step-ups in imports of computers, semiconductors, and industrial supplies—notably building materials. The increase in exports was concentrated in agricultural goods, automotive products, industrial supplies, computers, and semiconductors. Recent information suggested that economic recovery in Europe was continuing to gain momentum through the second quarter, while the Japanese economy was showing some signs of having bottomed out over the first half of the year. Economic activity had remained on a strong upward trend in Canada in recent months, and economic growth picked up during the spring in the United Kingdom after having stagnated over the previous two quarters. The recent economic performance of the developing countries had been mixed. Most Asian economies grew robustly in the first half of the year, but economic activity in a number of Latin American economies, with the notable exceptions of Brazil and Mexico, remained weak.

Consumer prices rose moderately in July after having been unchanged in May and June; a rebound in energy prices contributed to the July increase. The strong upturn in energy prices this year accounted for all of the uptick in consumer price inflation in the twelve months ended in July compared with the previous twelve-month period. Excluding food as well as the volatile energy component, core consumer price inflation had remained subdued thus far in 1999 and during the twelve months ended in July. Inflation was modest at the producer level as well, as prices of finished goods other than food and energy edged lower over the June–July period. Core producer prices rose more in the twelve months ended in July than in the year-earlier period, but that pickup resulted in important part from sharp increases in the prices of tobacco products. At earlier stages of processing, producer prices of crude and intermediate materials other than food and energy had firmed noticeably in recent months. While the source of some of those increases had been the pass-through of higher crude oil prices, improved worldwide growth, especially in Asia, also contributed. With labor markets very tight, increases in wages and total compensation had been somewhat larger recently. The employer cost index for hourly compensation of private industry workers jumped in the second quarter after an unusually small gain in the first quarter, and increases in average hourly earnings of production or nonsupervisory workers picked up in June and July. Nonetheless, year-over-year changes in some measures of nominal compensation continued to decline.

At its meeting on June 29–30, 1999, the Committee adopted a directive that called for a slight tightening of conditions in reserve markets consistent with an increase of ¼ percentage point in the federal funds rate to an average of around 5 percent. The members noted at that meeting that there were few current indications of rising inflation; nonetheless, with financial markets and foreign economies recovering since the Committee had eased policy last fall, the persisting strength of demand was enough to put added pressure over time on already very tight labor markets and at some point lead to a pickup in inflation that could threaten the sustainability of the economy's expansion. Because there was substantial uncertainty relating to the extent and timing of prospective inflationary pressures and thus the possibility that further firming of policy might not be needed in the very near term, the directive did not contain any bias relating to the direction of possible adjustments to policy in the intermeeting period.

Open market operations immediately after the meeting were directed toward implementing the desired, slightly greater pressure on reserve positions, and the federal funds rate averaged very close to the Committee's 5 percent target over the intermeeting period. Treasury coupon yields fell early in the intermeeting interval, as market participants apparently adjusted downward their expectations regarding further monetary tightening in response to the generally unexpected move to a neutral directive and, subsequently, the receipt of favorable data on inflation. Yields later retraced their declines, however, in reaction to the semiannual monetary policy report and the Chairman's associated testimony and to the release of data indicating an acceleration of labor costs, growing signs of a firming of activity abroad, and a weaker dollar. On net, most interest rates were about unchanged over the intermeeting interval. Key measures of share prices in equity markets, buoyed early in the period by lower interest rates and better-than-anticipated quarterly earnings reports, largely reversed those gains when rates backed up, and share prices ended the period with mixed results.

In foreign exchange markets, the trade-weighted value of the dollar depreciated slightly over the intermeeting period in relation to the currencies of a broad group of important U.S. trading partners. The dollar declined against the currencies of the major industrial countries in response to indications of improved economic performances in Europe and Japan and to higher long-term interest rates in many of those countries. However, this depreciation was partially offset by a rise in relation to the currencies of other important trading partners, reflecting increased uncertainty in financial markets in many Asian and Latin American countries that was associated in part with concerns about rising U.S. interest rates.

The expansion of broad measures of money had moderated in recent months. The slower growth of nominal GDP and the rise in market interest rates in the spring and summer likely had restrained increases in both M2 and M3. In addition, M3's expansion probably had been held down by a sharp slowing in the growth of bank credit in July. For the year through July, M2 was estimated to have increased at a rate somewhat above the Committee's annual range and M3 at a rate approximating the upper end of its range. Total domestic nonfinancial debt had continued to expand at a pace somewhat above the middle of its range, though borrowing by nonfinancial sectors had slowed in recent months.

The staff forecast prepared for this meeting suggested that the expansion would gradually moderate to a rate commensurate with the growth of the economy's estimated potential. The growth of domestic final demand increasingly would be held back by the anticipated waning of positive wealth effects associated with earlier large gains in equity prices; the slower growth of spending on consumer durables, houses, and business equipment in the wake of the prolonged buildup in the stocks of these items; and the higher intermediate- and longer-term interest rates that had evolved as markets came to expect that a rise in short-term interest rates would be needed to achieve a better balance between aggregate demand and aggregate supply. The lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place continuing, though diminishing, restraint on U.S. exports for some period ahead. Price inflation was projected to rise somewhat over the forecast horizon, in part as a result of higher import prices and some firming of gains in nominal labor compensation in persistently tight labor markets that would not be fully offset by rising productivity.

In the Committee's discussion of current and prospective economic developments, members commented that the expansion of economic activity continued to display substantial underlying strength with few indications of slowing in the growth of consumer and business expenditures. While the information for the second quarter pointed to a marked deceleration from the pace in other recent quarters, the slowdown was induced to an important extent by sharply reduced inventory investment that partly offset robust further growth in consumer and housing expenditures and a surge in spending by business for equipment. The members generally anticipated a rebound in the rate of economic expansion over the balance of the year and in 2000, possibly to a pace averaging around the economy's long-run potential. Growth at this rate would represent a noticeable slowing from the pace that had prevailed in recent years, and its realization depended importantly on the damping effects on domestic demand of the less accommodative financial conditions that had developed in recent months—higher long-term interest rates and a flattening of equity prices. Given the persistent strength of domestic demand and improving economies abroad, many members saw the risks to this outlook as tilted to the upside, especially if short-term interest rates were to remain at their current levels. Against this background, the risks in the outlook for prices also seemed to be tilted toward somewhat higher inflation. Price inflation had been held in check by accelerating productivity and declines in oil and other import prices. Evidence was mixed on whether the acceleration in productivity was persisting, but the earlier favorable developments in import prices were already dissipating, adding to the inflation risk posed by the possibility of further tightening in labor markets should domestic demand fail to moderate.

In their comments about regional economic developments, the members reported generally favorable business conditions and further growth in all regions, with variations ranging from some acceleration in a number of Federal Reserve Districts to modest deceleration in some others. Several indicated that economic activity in some parts of the country was being held down by shortages of labor. Most industries continued to exhibit strength, but weakness was reported in agriculture and related businesses and in manufacturing industries such as textiles.

With regard to the outlook for key sectors of the economy, members referred to the favorable prospects for continued robust growth in employment and incomes that likely would sustain appreciable further expansion in consumer expenditures. However, substantial uncertainty surrounded the outlook for stock market prices whose sharp rise and the associated increase in wealth over the course of recent years had helped to foster a high level of consumer confidence and willingness to spend. The absence of further large gains in stock prices, should recent trends persist, would remove this stimulus and probably induce some moderation in the growth of consumer spending. However, as the experience of recent years had amply demonstrated, stock market trends were very difficult to predict. Concerning the prospects for business capital investment, members saw indications that outlays might rise more moderately after a surge in the second quarter. Weak trends in orders for many types of equipment and softness in nonresidential construction pointed to a considerable deceleration in total business investment. At the same time, however, further advances in technology and declining prices were likely to underpin continued very strong expenditures for computer and communications equipment, thereby sustaining still robust if reduced increases in overall business investment.

Residential construction activity was expected to moderate a bit over coming quarters as the rise that had occurred in mortgage interest rates exerted its lagged effects. The deceleration was likely to be limited in the near term, however, as the backlogs that had built up earlier in the year and associated shortages in inventories of new homes were worked down. Indeed, anecdotal reports indicated currently strong housing markets in several areas of the country. Over time, the outlook for employment and incomes should provide support to the housing market, but likely at a modestly diminished level.

The outlook for inventory investment remained characteristically uncertain, though the members commented that there were reasons to anticipate some pickup in such investment following the shortfall in the second quarter. While the long-run trend undoubtedly remained in the direction of declining inventory–sales ratios, the shortfall of inventory investment during the spring probably had on the whole lowered holdings at least temporarily below intended levels as evidenced in part by anecdotal reports that lean inventories had reduced sales in some areas. Moreover, some buildup relating to century date change concerns seemed likely; in this regard, anecdotal reports suggested that some businesses planned to accumulate inventories in the form of imports because of questions about the availability of such goods around the year-end. Members acknowledged that available survey and anecdotal evidence did not point to any widespread perception of a significant need to build up inventories, and indeed there were indications of overstocking in some industries. Even so, appreciable inventory accumulation was seen as the most likely prospect for the balance of the year. While such a forecast was subject to substantial risks in both directions, it implied, if realized, a significant boost to GDP growth over the second half of the year.

The government sector was now expected to exert somewhat less restraint on overall demand in the economy, as burgeoning budget surpluses seemed to be weakening restraints on federal government outlays and tax cuts were a possibility. In addition, export growth was projected to strengthen in conjunction with an improving economic outlook in a number of important U.S. trading partners, and import growth seemed likely to moderate over the next several quarters, reflecting the projected deceleration in the U.S. economy and the waning effects of the past appreciation of the dollar. A number of members commented, however, that they saw downside risks to the trade outlook despite the improving economic performance in many countries. Adverse developments in those countries remained a worrisome concern in light of unsettled political conditions that made it very difficult for government authorities in many of them to implement the measures that were needed to solve underlying economic problems.

In the course of the Committee's discussion of the outlook for inflation, members commented that there was no persuasive evidence in recent statistical measures that price inflation was currently picking up or that inflation expectations were rising, though the declines in both inflation and expectations experienced over the course of recent years no longer seemed to be occurring. Members nonetheless expressed concern about the risks of some acceleration under foreseeable economic circumstances. They cited a variety of statistical and anecdotal signs that could be viewed as harbingers of rising price inflation. Those included an upturn in commodity prices, notably that of oil whose effects tended over time to spread relatively widely through the economy, and the direct and indirect effects of the dollar's depreciation. Members also reported some indications of reduced discounting by business firms and plans for, or actual implementation of, higher prices that businesses now saw as less likely than earlier to be reversed for competitive reasons. However, these reports were still relatively scattered.

The members' basic concern about the outlook for inflation related to the possibility that continued strength in demand might not be accommodated without placing greater pressures on labor compensation and prices. The greatest risks would come from a further tightening of labor markets, but many members were also concerned about the possibility of accelerating costs at current levels of labor resource utilization. The major uncertainty was the extent to which labor productivity would continue to accelerate and hold down the rise in unit labor costs. Recent data from the product side of the national income and product accounts suggested some slowing in productivity growth and pressure on unit labor costs, but these tendencies were not confirmed by a close reading of income side data. In these circumstances, the outlook for price inflation remained subject to considerable uncertainty.

In the Committee's discussion of policy for the period ahead, the members with one exception favored a proposal for a slight tightening of conditions in reserve markets that would be consistent with an increase in the federal funds rate to an average of about 5¼ percent. In the view of these members, a limited policy move at this time would appropriately supplement the small firming action taken at midyear and at least for now would position monetary policy where it needed to be to foster continued subdued inflation and good economic performance. It would tend to validate the appreciable firming in financial markets that had occurred in recent months, to some extent in anticipation of Committee tightening. That firming was important to hold the expansion of economic activity to a sustainable pace, especially as improving foreign economies boosted the demand for U.S. exports. While key measures of prices did not at this point suggest any upturn in inflation, a failure to act would incur a substantial risk of increasing pressure on already tight labor markets and higher inflation. During the discussion, some members observed that today's action would reduce further the stimulus provided during the autumn of last year to counter the global financial turmoil and related risks to the U.S. economy. While not all vestiges of that turmoil had disappeared, financial conditions had improved markedly, foreign economies had strengthened on balance, and downside risks to economic performance in the United States were generally reduced. One member indicated that in light of the persistence of low inflation, a policy tightening move was not warranted at this time and would in fact incur some risk of unnecessarily curbing the expansion in economic activity.

All the members who supported a tightening action also favored the retention of a symmetric directive. These members agreed that the Committee should keep its options open with regard to the next policy move, whose direction and timing would depend on evolving economic and financial conditions. In this regard, while agreeing that inflation risks had been substantially reduced by the actions taken in June and contemplated at today's meeting, many members continued to see a possible increase in inflation pressures as the main threat to sustained economic expansion. However, they did not anticipate that further tightening would be needed in the near term, allowing the Committee time to gather substantial additional information about the balance of aggregate supply and demand. The members all agreed that a symmetric directive would not preclude a tightening move if warranted by developments over the months ahead.

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 information reviewed at this meeting suggests continued solid expansion of economic activity. Nonfarm payroll employment has increased rapidly in recent months, and the civilian unemployment rate, at 4.3 percent in July, matched its average for the first half of the year. Manufacturing output continued to grow moderately on average in June and July. Total retail sales have grown less rapidly in recent months, while housing activity has remained robust. Available indicators suggest that the expansion in business capital spending has slackened somewhat after a surge this spring. The nominal deficit on U.S. trade in goods and services widened substantially in the second quarter. Consumer price inflation has been boosted in recent months by an appreciable rise in energy prices; against the background of very tight labor markets, increases in wages and total compensation have been somewhat larger.

Most interest rates are little changed on balance since the meeting on June 29–30, 1999. Key measures of share prices in equity markets have posted mixed changes over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar has declined slightly over the period in relation to the currencies of a broad group of important U.S. trading partners.

M2 and M3 have grown at a moderate pace in recent months. For the year through July, M2 is estimated to have increased at a rate somewhat above the Committee's annual range and M3 at a rate approximating the upper end of its range. Total domestic nonfinancial debt has continued to expand at a pace somewhat above the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting in June the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 2000, the Committee agreed on a tentative basis in June to retain the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1999 to the fourth quarter of 2000. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 5¼ percent. In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period.

> Votes for this action: Messrs. Greenspan, McDonough, Boehne, Ferguson, Gramlich, Meyers, Moskow, Kelley, and Stern. Vote against this action: Mr. McTeer.

Mr. McTeer dissented for essentially the same reasons he did at the June 30 meeting: low inflation and, except for energy, minimal inflation in the pipeline. He believes that positive supply-side forces will continue to damp the impact of strong demand on output prices and that productivity gains will continue to damp the effect of higher wages on unit labor costs.

Establishment of Subcommittee

Chairman Greenspan announced the formation of a subcommittee to review the wording of the directive, its meaning, and what the Committee announces shortly after its meetings. He noted that the sentence relating to the symmetry of the directive was subject to differing interpretations, and the Committee's decision to announce immediately significant changes in the symmetry or asymmetry in the directive had made it desirable to clarify its meaning. Members also had expressed some discomfort with the way these announcements had been interpreted. While the Committee did not contemplate retreating from its policy of immediate announcements, it might want to examine whether some adjustment in its procedures would be helpful. The Chairman did not feel that the Committee was prepared to come to a decision on these issues before more experience was gained with the current announcement approach, but he believed it was advisable to form a subcommittee at this time to study the various questions that were involved. He anticipated that the subcommittee would come back to the Committee no later than next spring with recommendations or at least some alternatives for Committee consideration. He asked Mr. Ferguson to serve as its chairman and to select other members after consultation with his colleagues on the Committee.

It was agreed that the next meeting of the Committee would be held on Tuesday, October 5, 1999.

The meeting adjourned at 1:40 p.m.

Donald L. Kohn
Secretary

After the meeting, the following press release was issued:

> The Federal Open Market Committee today voted to raise its target for the federal funds rate by 25 basis points to 5¼ percent. In a related action, the Board of Governors approved a 25 basis point increase in the discount rate to 4¾ percent.
>
> With financial markets functioning more normally, and with persistent strength in domestic demand, foreign economies firming and labor markets remaining very tight, the degree of monetary ease required to address the global financial market turmoil of last fall is no longer consistent with sustained, noninflationary, economic expansion.
>
> Today's increase in the federal funds rate, together with the policy action in June and the firming of conditions more generally in U.S. financial markets over recent months, should markedly diminish the risk of rising

inflation going forward. As a consequence, the directive the Federal Open Market Committee adopted is symmetrical with regard to the outlook for policy over the near term.

In taking the discount rate action, the Federal Reserve Board approved requests submitted by the Boards of Directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Kansas City, and San Francisco. The discount rate is the interest rate that is charged depository institutions when they borrow from their district Federal Reserve Banks.

Meeting Held on October 5, 1999

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, October 5, 1999, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Ferguson
Mr. Gramlich
Mr. Kelley
Mr. McTeer
Mr. Meyer
Mr. Moskow
Mr. Stern

Messrs. Broaddus, Guynn, Jordan, 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
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Prell, Economist
Ms. Johnson, Economist

Ms. Cumming, Messrs. Howard, Lang, Lindsey, Rolnick, Rosenblum, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Messrs. Ettin and Reinhart, Deputy Directors, Divisions of Research and Statistics and International Finance respectively, Board of Governors

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Whitesell, Assistant Director, Division of Monetary Affairs, Board of Governors

Mr. Kumasaka, Assistant Economist, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Ms. Browne, Messrs. Eisenbeis, Goodfriend, Kos, Rasche, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Boston, Atlanta, Richmond, New York, St. Louis, and Cleveland respectively

Messrs. Judd and Sullivan, Vice Presidents, Federal Reserve Banks of San Francisco and Chicago respectively

Mr. Filardo, Assistant Vice President, Federal Reserve Bank of Kansas City

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 24, 1999, 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, and thus no vote was required 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 August 24, 1999, through October 4, 1999. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that the expansion of economic activity was substantial in the quarter just ended. Consumer spending and business investment in durable equipment remained strong, and inventory investment picked up from the sluggish pace of the second quarter, while residential housing activity showed some signs of deceleration. To meet aggregate demand, industrial production increased further and employment gains continued to be relatively robust, keeping labor markets taut. Inflation was moderate, but somewhat above that in 1998, owing to a sharp rebound in energy prices.

Although private nonfarm payroll employment expanded relatively slowly in August, the slowdown had followed a surge in July, and growth for the two months was very close to the brisk pace of the first half of the year. Job gains in the service-producing sector remained strong in the July–August period, while employment in the goods-producing sector continued to decline, though at a slightly slower rate than earlier in the year. The civilian unemployment rate dropped back to 4.2 percent in August, matching its low for the year.

Industrial production was up appreciably further on balance in July and August. Mining activity rose markedly, utility output increased moderately on balance, and manufacturing production recorded a further sizable advance over the two months. Within manufacturing, high-tech goods and motor vehicles were sources of particular strength, while the production of nondurable goods changed little. The rate of utilization of manufacturing capacity climbed over the two months but remained well below its long-term average.

Total retail sales posted strong gains over July and August. Increases in sales were spread across all major categories, with spending for nondurable goods and motor vehicles notably strong. Expenditures on services rose moderately in the two-month period. There were mixed signals with regard to the housing sector. Construction was at a high level, the inventory of unsold homes remained quite low, and starts of multifamily units rose over the July–August period. However, single-family housing starts edged lower on balance over July and August, and sales of existing homes weakened.

The available information suggested that business capital spending continued to climb rapidly. Shipments of nondefense capital goods posted further large gains in July and August, with outlays for high-tech machinery and transportation equipment particularly strong. In addition, new orders for durable equipment turned up sharply in the two months. Nonresidential construction activity changed little on balance in July as continued strength in the office and an increase in the lodging and miscellaneous categories offset reductions in the industrial and non-office commercial categories.

Manufacturing and trade inventories, outside of motor vehicles, picked up sharply in July after posting a small increase in the first half of the year, but inventories remained lean in relation to sales. In manufacturing, stocks rebounded from a substantial June decline; however, the aggregate stock–shipments ratio remained at the bottom of its range for the past twelve months. Wholesalers also increased their inventories in July; while the inventory–shipments ratio for this sector rose, it was in the low end of its range for the past year. In the retail sector, inventories contracted somewhat in July, and the inventory–sales ratio for this sector also was near the bottom of its range over the past year.

The nominal deficit on U.S. trade in goods and services widened in July from its second-quarter average, with the value of imports rising more than the value of exports. The increase in imports was concentrated in aircraft, consumer goods, industrial supplies, and oil. The step-up in exports occurred primarily in industrial machinery and semiconductors. Among the major foreign industrial countries, the limited available information suggested that economic activity was strengthening in Europe and the United Kingdom in the third quarter while economic indicators for Japan were mixed after the strong advance in the first half of the year. Economic growth in Canada seemed to be continuing at a robust pace, and economic recovery in most of the Asian emerging-market economies was proceeding briskly.

Inflation remained relatively moderate, though somewhat above the pace of 1998 because of a sharp rebound in energy prices. Overall consumer prices increased in July and August at about the second-quarter rate. Abstracting from the sharp advances in energy prices and the mild increases in food prices, consumer inflation continued to be relatively subdued over the two months. In the past twelve months, the core CPI rose less than in the previous twelve-month period. At the producer level, prices of finished goods other than food and energy were essentially unchanged over the two months; moreover, the change in core producer prices in the past year was about the same as in the year-earlier period. At earlier stages of processing, however, producer prices of crude and intermediate materials excluding food and energy had firmed noticeably over recent months. Average hourly earnings continued to grow at a moderate pace over July and August, and the rise over the past year was considerably smaller than that for the year-earlier period.

At its meeting on August 24, 1999, the Committee adopted a directive that called for a slight tightening of conditions in reserve markets consistent with an increase of ¼ percentage point in the federal funds rate to an average of around 5¼ percent. The members noted that this move, together with the firming in June, should help to keep inflation subdued and to promote sustainable economic expansion. The Committee also agreed that the directive should be symmetric. A possible rise in inflation remained the main threat to sustained economic expansion, but it was not anticipated that further tightening would be needed in the near term and there would be time to gather substantially more information about the balance of risks relating to trends in aggregate demand and supply.

Open market operations after the meeting were directed toward implementing and maintaining the desired slight tightening of pressure on reserve positions, and the federal funds rate averaged very close to the Committee's 5¼ percent target. Most other short-term market interest rates posted small mixed changes on balance because the policy action was widely anticipated and the FOMC's policy announcement after the August 24 meeting referenced markedly diminished inflation risks. However, longer-term yields rose somewhat over the intermeeting period in response to the receipt of new information indicating both surprisingly strong spending at home and abroad and higher commodity prices. Most measures of share prices in equity markets registered sizable declines over the intermeeting period, apparently reflecting not only higher interest rates but also concerns that U.S. stocks might be overvalued and that foreign equities were becoming relatively more attractive as economic prospects brightened abroad.

In foreign exchange markets, the trade-weighted value of the dollar changed little over the period in relation to the currencies of a broad group of important U.S. trading partners. The dollar depreciated against the currencies of the major foreign industrial countries, especially the Japanese yen, in response to generally stronger-than-expected incoming data on spending and production in those countries. However, the dollar rose against the currencies of the other important trading partners in the broad group, reflecting sizable declines in the currencies of several countries in Latin America and Asia.

Despite a further rise in opportunity costs, M2 and M3 continued to grow at moderate rates in August and evidently in September as well. Expansion of these two monetary aggregates was supported by further rapid expansion in the demand for currency and stronger inflows to retail money market funds at a time of weakness in U.S. bond and equity markets. In addition, growth of M3 was sustained by large flows into institution-only money market funds as the yields on those funds caught up to earlier increases in short-term market rates. For the year through September, M2 was estimated to have increased at a rate somewhat above the Committee's annual range and M3 at a rate just above the upper end of its range. Total domestic nonfinancial debt continued to expand at a pace somewhat above the middle of its range.

The staff forecast prepared for this meeting suggested that the expansion would gradually moderate to a rate around or perhaps a little below the growth of the economy's estimated potential. The growth of domestic final demand increasingly would be held back by the anticipated waning of positive wealth effects associated with earlier large gains in equity prices; the slower growth of spending on consumer durables, houses, and business equipment in the wake of the prolonged buildup in the stocks of these items; and the higher intermediate- and longer-term interest rates that had evolved as markets came to expect that a rise in short-term interest rates would be needed to achieve a better balance between aggregate demand and aggregate supply. The lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place continuing, but substantially diminishing, restraint on U.S. exports for some period ahead. Core price inflation was projected to rise somewhat over the forecast horizon, in part as a result of higher non-oil import prices and some firming of gains in nominal labor compensation in persistently tight labor markets that would not be fully offset by rising productivity growth.

In the Committee's discussion of current and prospective economic conditions, members commented that the incoming information suggested that the expansion had been considerably stronger in recent months than many had anticipated, while most measures of inflation had remained subdued. The economy's substantial momentum seemed likely to persist over the balance of the year, but the members continued to expect some slackening during the year ahead. This outlook was supported by the emergence of somewhat less accommodative conditions in financial markets, including the increases that had occurred in interest rates over the past several months and the steadying of stock market prices over the same period. On the other hand, foreign economies were strengthening more quickly than anticipated and rising exports were likely to offset part of the slowdown in domestic demand.

The implications of continued robust growth for the inflation outlook depended critically on judgments about the supply side of the economy. Productivity and economic potential seemed to have been growing at an increasingly rapid rate in recent years. That acceleration had itself tended to boost consumption and investment demand—in complex interactions of aggregate supply and demand—but it also had held down increases in unit costs and prices. A great deal of uncertainty surrounded the behavior of productivity growth going forward, but some further pickup, and the associated ability of the economy to accommodate more rapid growth without added inflation, was a possibility that could not be overlooked. However, a further pickup in productivity growth was by no means assured, and a number of other favorable developments in supply and prices that had acted to restrain inflation in recent years had already begun to dissipate or reverse. These included the substantial upturn in energy prices, the ebbing of import price declines, and the pickup in health care costs; adverse trends in the latter two factors in particular were likely to be extended. In these circumstances, members generally saw some risk of rising inflation going forward, but they also recognized that similar forecasts in recent years had proved wrong and that considerable uncertainty surrounded expectations of somewhat higher core inflation.

In their review of developments across the nation, members reported continued high levels of activity in all regions and few indications of moderating growth, though agriculture remained relatively depressed in many areas. The anecdotal information from around the nation clearly supported the overall statistical evidence of persisting strength in key components of domestic demand. Consumer spending, notably for light motor vehicles, was continuing to rise at a brisk pace. Some of the strength in consumer durables was related to purchases associated with homebuilding, which, though likely to slacken a little owing to the rise in mortgage interest rates, seemed to be staying at a high level. While consumer spending probably would be sustained by further anticipated growth in employment and incomes, the pause in the stock market, should it persist, and the attendant effects on financial wealth were expected with some lag to damp further gains in consumer expenditures.

Business fixed investment appeared to have accelerated to a surprising extent in the third quarter from an already robust pace earlier in the year. Further noteworthy gains were recorded in business expenditures for computing and communications equipment, evidently reflecting ongoing efforts to take advantage of declining prices and improving technology. Some of the rise in such spending could represent accelerated purchases in advance of the century date change and might well tend to be offset in early 2000. Over time, however, ongoing efforts to enhance productivity for competitive reasons suggested further vigorous growth in spending for such equipment. Forecasts of other business investment expenditures were much less ebullient and on the whole pointed to little change. Building activity currently displayed substantial strength in some major cities, largely involving office and hotel structures, but nonresidential construction activity more generally was relatively sluggish. It seemed likely that commercial building activity would be damped later as new capacity was completed and financing became less attractive in response to the rise that had occurred in market interest rates.

The prospects for business inventories over coming months were difficult to evaluate, with the usual uncertainties accentuated by century date change effects. According to fragmentary information, inventory investment picked up during the summer months from a very low pace in the second quarter. To some extent, the recent strengthening may have reflected precautionary stockbuilding as insurance against potential supply disruptions relating to the century date change. Such stockbuilding might well intensify during the closing months of the year and be reversed early next year, with effects of uncertain magnitude on overall economic activity in that period. Looking beyond such a swing, business inventories, which currently appeared to be near desired levels in most industries, were projected to grow at a moderate pace broadly in line with the expansion in final sales.

The strengthening of many economies around the world was seen as a harbinger of increasing demand for U.S. exports, a view that was reinforced by growing anecdotal indications of improving foreign markets for a wide range of U.S. products. An aspect of that improvement was more attractive investment opportunities abroad and some associated weakening in the foreign exchange value of the dollar that implied upward pressure on the prices of imports and to an uncertain extent on those of competing domestically produced products. Moreover, some members saw the possibility of a steeper drop in the dollar—under pressure from burgeoning foreign dollar portfolios as a consequence of very large U.S. current account deficits—as an added source of risk to the maintenance of sustainable growth and low inflation in the United States.

In the Committee's discussion of the outlook for inflation, a number of members emphasized that the behavior of prices had remained surprisingly benign for an extended period, confounding earlier forecasts of appreciable acceleration stemming from tight labor markets and rising labor costs. That experience argued forcefully in their view for the need to regard forecasts of increasing inflation with considerable caution. Most members nonetheless continued to view some increase in core price inflation as a definite possibility. This view reflected their expectations that the current expansion, even if it did moderate to a pace approximating the economy's trend potential growth, would do so at a level of resource use that, based on the historical record, exceeded the economy's sustainable capacity—perhaps by even more than at present, given the evident strength of aggregate demand. Such an outcome seemed likely to generate further pressures on unit labor costs, which had tended in recent years to be contained by accelerating productivity. There was no evidence that the acceleration was coming to an end, but the members saw a clear risk that upward pressures on labor costs could at some point outpace gains in productivity. Members also mentioned that labor compensation would come under greater pressures as a result of rising healthcare benefit costs and possible increases in the minimum wage.

Other factors cited as pointing to a less benign inflation performance involved the waning or reversal of a number of temporary influences that had exerted a beneficial effect on prices in recent years. In particular, the decline of the dollar from its recent high in July, especially if it were to continue, would mean higher import prices and reduced price competition for a wide range of domestic goods. In this regard, several members observed that they were hearing noticeably fewer comments by business contacts about their inability to raise prices. Members also noted that, in the context of apparently strengthening economic activity worldwide, non-oil commodity prices seemed poised to turn upward, though they had risen only slightly thus far. While oil prices, which had increased sharply this year, had changed relatively little recently and could move down in the future, secondary effects of the earlier increase on costs and prices in other sectors of the economy seemed likely. Nonetheless, considerable uncertainty surrounded expectations of rising inflation. Labor cost increases had not turned up, and core inflation continued to edge lower. Further improvements in productivity growth could keep price pressures in check for some time.

In the Committee's discussion of policy for the intermeeting period ahead, all the members indicated that they favored or could accept an unchanged policy stance. Members commented that they saw little risk of a surge in inflation over coming months, though some pickup from the currently subdued level of core price inflation was a distinct possibility under prospective economic conditions. It was noted that expanding aggregate supply, boosted by accelerating productivity, had remained in reasonable balance with rapidly growing aggregate demand despite an already high level of economic activity; however, substantial uncertainty surrounded the outlook for aggregate supply and aggregate demand going forward, and it was unclear how their interaction would affect the behavior of inflation. In light of the uncertainties surrounding these developments, the members agreed that it would be desirable to await more evidence on the performance of the economy, and in this regard considerable new information on the behavior of the economy and the outlook for inflation would become available during the intermeeting period. The risks of waiting seemed small at this juncture, in part because inflation and inflation expectations were not likely to worsen substantially in the near term, and the Committee had demonstrated its willingness to take needed anticipatory action to curb rising inflationary pressures that could threaten the overall performance of the economy. They also agreed that century date change concerns were not likely to be of a kind or magnitude that would preclude a policy tightening move at the November meeting, should such an action seem warranted at that time.

On the issue of the tilt in the Committee's directive, a majority of the members favored associating an unchanged policy stance with a directive that was biased toward restraint. These members did not anticipate that intermeeting developments would require policy to be tightened during the weeks immediately ahead, but they believed that the Committee probably would need to move to a less accommodative policy stance in the relatively near future, possibly at the November meeting. They also believed that, given the Committee's recently adopted practice of immediately announcing its decisions to change the symmetry of the directive, an asymmetrical directive would help convey the message that policy adjustments might not yet be completed for the balance of this year and that the Committee remained concerned about potential inflationary developments in coming months. Other members, while generally agreeing that the risks pointed on balance to some rise in inflation over time, nonetheless were quite uncertain about the timing of any additional firming in monetary policy and preferred to leave the Committee's possible future course of action more open. Even so, they could accept an asymmetric directive in light of the consensus that had emerged at this meeting in favor of an unchanged policy stance.

With regard to the Committee's announcement of its decision to adopt an asymmetric directive, members observed that the recent practice of making such announcements had led to some misinterpretations of the Committee's intentions and seemed to have added to volatility in financial markets. As a consequence, Committee members briefly considered alternative treatments of symmetry and disclosure for this meeting. Because the Committee had begun a process for examining the wording of its directive and its announcement policy, most of the members concluded that the most satisfactory alternative for now, though it was not fully satisfactory, was to continue with the Committee's recent announcement practice. However, the working group chaired by Governor Ferguson was requested to expedite its report, if possible.

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 information reviewed at this meeting suggests that the expansion of economic activity was substantial in the quarter just ended. Nonfarm payroll employment increased briskly through August, and the civilian unemployment rate dropped back to 4.2 percent, matching its low for the year. Industrial production was up appreciably further in July and August. Total retail sales posted sizable gains over the two months. Housing construction apparently has slowed somewhat but has remained at a high level. Available indicators suggest that the expansion in business capital spending has continued to be rapid. The nominal deficit on U.S. trade in goods and services widened in July from its average in the second quarter. Inflation has continued at a moderate pace, albeit somewhat above that in 1998 owing to a sharp rebound in energy prices.

Most short-term interest rates have posted small mixed changes since the meeting on August 24, 1999, while longer-term yields have risen somewhat. Most measures of share prices in equity markets have registered sizable declines over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar has changed little over the period in relation to the currencies of a broad group of important U.S. trading partners.

M2 and M3 have continued to grow at a moderate pace. For the year through September, M2 is estimated to have increased at a rate somewhat above the Committee's annual range and M3 at a rate just above the upper end of its range. Total domestic nonfinancial debt has continued to expand at a pace somewhat above the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting in June the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 2000, the Committee agreed on a tentative basis in June to retain the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1999 to the fourth quarter of 2000. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5¼ percent. In view of the evidence currently available, the Committee believes that prospective developments are more likely to warrant an increase than a decrease in the federal funds rate operating objective during the intermeeting period.

Votes for this action: Messrs. Greenspan, McDonough, Boehne, Ferguson, Gramlich, McTeer, Meyers, Moskow, Kelley, and Stern. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, November 16, 1999.

The meeting adjourned at 1:25 p.m.

Donald L. Kohn
Secretary

Meeting Held on November 16, 1999

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, November 16, 1999, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Ferguson
Mr. Gramlich
Mr. Kelley
Mr. McTeer
Mr. Meyer
Mr. Moskow
Mr. Stern

Messrs. Broaddus, Guynn, Jordan, 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
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Ms. Johnson, Economist
Mr. Prell, Economist

Ms. Cumming, Messrs. Howard, Hunter, Lang, Lindsey, Rolnick, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Messrs. Ettin and Reinhart, Deputy Directors, Divisions of Research and Statistics and International Finance respectively, Board of Governors

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Whitesell, Assistant Director, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Stewart and Stone, First Vice Presidents, Federal Reserve Banks of New York and Philadelphia respectively

Messrs. Beebe, Eisenbeis, Lacker, Rasche, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, St. Louis, and Cleveland respectively

Messrs. Bentley, Fuhrer, and Kahn, Vice Presidents, Federal Reserve Banks of New York, Boston, and Kansas City respectively

Mr. Wynne, Research Officer, Federal Reserve Bank of Dallas

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on October 5, 1999, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market transactions in foreign currencies for the System's account in the period since the previous meeting, and thus no vote was required 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 October 5, 1999, through November 15, 1999. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of recent and prospective economic and financial developments, and the implementation of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting suggested that economic activity continued to expand briskly. The limited data on aggregate demand that had become available since the summer pointed to some moderation in the growth of consumer spending and of business investment in capital equipment and software. Residential construction appeared to have weakened somewhat. However, industrial production was trending up, job growth was still solid, and the unemployment rate had edged down. Despite tight job markets, labor compensation had been rising more slowly than last year. Inflation remained moderate, though at a pace above that in 1998 because of a sharp rebound in energy prices.

A large increase in nonfarm payroll employment in October followed a small rise in September; the average gain for the two months was appreciable but somewhat below the pace of earlier in the year. Job growth rebounded strongly in most employment categories, but further small losses were posted in manufacturing and retail trade. The robust expansion in the demand for workers in October led to a small decline in the civilian unemployment rate, to 4.1 percent, a new low for the year.

Industrial production recorded a strong gain in October after having fallen slightly in September as a result of the adverse effects of Hurricane Floyd. Manufacturing and utilities output advanced strongly in October, while mining activity edged up. The increases in manufacturing were widespread; however, production of transit equipment, particularly aircraft and parts, and farm equipment continued to decline. The utilization of total industrial capacity rebounded in October from the hurricane-related production losses of the previous month but remained somewhat below its long-run average level.

Growth of consumer spending apparently had moderated somewhat further recently, but surveys indicated that consumer confidence continued to be high and personal income rose briskly in the third quarter. Total nominal retail sales changed little in September and October, with purchases at auto dealerships falling in both months and sales at other stores growing less rapidly on balance. Housing activity weakened somewhat over the summer but was still at a high level. Some of the drop in housing starts in September probably was attributable to unusually heavy rains in parts of the South and Northeast. In addition, sales of both new and existing homes declined appreciably in September.

The expansion of business fixed investment picked up sharply in the third quarter, as a marked acceleration in outlays for durable equipment and computer software more than offset a further weakening of nonresidential construction activity. The strength in spending for durable equipment was concentrated in computer hardware and transportation equipment; the latter included medium and heavy trucks, fleet sales of light vehicles, and commercial aircraft. Outlays for computer software and communications equipment also were up appreciably. Trends in orders suggested that the buoyancy in business spending for capital equipment had continued into the fourth quarter. Weakness in nonresidential building activity in the third quarter was widespread, though office construction remained on a solid upward trend.

Business inventory investment in book value terms picked up somewhat in the third quarter, but with sales increasing rapidly stock–sales ratios generally remained quite low. Manufacturers added slightly to their stocks after two quarters of inventory liquidation. However, the buildup of stocks in the third quarter did not keep pace with the rise in shipments, and the sector's stock–shipments ratio was near the bottom of its range over the preceding twelve months. Wholesalers also added to their inventories in the third quarter, and with stockbuilding keeping pace with sales, the inventory–sales ratio for the sector remained in the lower portion of its range over the past year. In the retail sector, the pace of inventory accumulation slowed noticeably in the third quarter, reflecting a runoff of stocks at auto dealerships. Excluding autos, the rate of retail inventory accumulation changed little from that of the second quarter, and with sales rising rapidly the aggregate inventory–sales ratio fell to its lowest quarterly level since 1980.

The deficit in U.S. trade in goods and services widened on balance over July and August from its average for the second quarter. The value of exports picked up considerably over the two months, with gains widely spread across major trade categories. The value of imports surged, with large increases recorded in all the major trade categories except food. The available information indicated that economic expansion in the foreign industrial countries strengthened further in the third quarter. Economic recovery continued in Japan, though there were signs that consumer demand was lagging somewhat. In the euro area, the United Kingdom, and Canada, economic activity appeared to have accelerated in the third quarter. Among the developing countries, economic activity continued to expand in emerging Asia and parts of Latin America.

Consumer prices increased at a slightly faster rate in September, with a further large rise in energy prices a contributing factor. Core consumer inflation also picked up in September, in part because of a sharp jump in tobacco prices. Nonetheless, core consumer prices rose less over the twelve months ended in September than over the preceding twelve-month period. At the producer level, price inflation for finished goods other than food and energy items slowed appreciably in October from the elevated September rate, which had been boosted by the tobacco price increase. For the year ended in October, core producer prices rose appreciably more than in the preceding year. Measured on a year-over-year basis, labor compensation rose more slowly in the year ending in the third quarter than it had in the preceding year. However, the gain in the third quarter was a little larger than the subdued average pace for the first half of the year; the step-up was entirely attributable to larger increases in benefits. Average hourly earnings edged up in October after a large rise in September. For the twelve months ended in October, average hourly earnings decelerated slightly from the previous twelve months.

At its meeting on October 5, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with an unchanged federal funds rate of around 5¼ percent. The members noted that the behavior of prices had continued to be relatively subdued and that the risk of a substantial worsening in inflation and inflation expectations over coming months seemed to be small. Nonetheless, they saw some pickup in inflation as a distinct possibility under anticipated economic conditions and concluded that the directive should indicate that prospective developments were more likely to warrant an increase than a decrease in the funds rate objective in the near term.

Open market operations throughout the intermeeting period were directed toward maintaining the federal funds rate at around 5¼ percent, and the rate averaged close to the Committee's target. On balance, most market interest rates posted small mixed changes over the intermeeting interval. The Committee's announcement of a bias toward tightening surprised many market participants, and interest rates rose somewhat after the meeting. Yields climbed further in response to incoming data on producer prices and retail sales that boosted market concerns about unsustainable growth, higher inflation, and further monetary tightening. Over the second half of the intermeeting period, however, rates largely retraced their increases in reaction to the release of data indicating low wage and consumer price inflation. Most measures of share prices in equity markets registered sizable gains over the intermeeting period, apparently reflecting stronger-than-expected earnings reports and greater optimism about the prospects for continued robust output growth and low inflation.

In foreign exchange markets, the trade-weighted value of the dollar changed little over the period in relation to the currencies of a broad group of important U.S. trading partners. A small appreciation against the currencies of the major foreign industrial countries offset a comparable depreciation in relation to the currencies of other important trading partners. Among the major currencies, the dollar rose against the euro and the pound sterling despite a tightening of European monetary policy in response to the implications for future inflation of indications of a strong pickup in economic activity. The dollar fell further against the yen, whose strength presumably reflected evidence of continued economic recovery in Japan and the prospect of another substantial fiscal stimulus package. The dollar's drop in terms of the currencies of other important trading partners reflected in part optimism about continued recovery in Asian emerging economies as well as signs of renewed political stability in some Latin American and Asian countries.

M2 continued to grow at a moderate rate in October. The recent performance of this aggregate likely was associated, at least in part, with the rise in market interest rates earlier in the year that boosted the opportunity cost of holding liquid balances. The expansion of M3 picked up over September and October, reflecting a strong acceleration in its non-M2 component that was associated with strong inflows to institutional money market funds and stepped-up issuance of large time deposits to meet credit demands. For the year through October, M2 and M3 were estimated to have increased at rates somewhat above their annual ranges for 1999. Total domestic nonfinancial debt continued to expand at a pace somewhat above the middle of its range.

The staff forecast prepared for this meeting suggested that the expansion would moderate gradually to a rate around, or perhaps a little below, the growth of the economy's estimated potential. The expansion of domestic final demand increasingly would be held back by the anticipated waning of positive wealth effects associated with earlier large gains in equity prices; the slower growth of spending on consumer durables, houses, and business equipment and software in the wake of the prolonged buildup in the stocks of these items; and the higher intermediate- and longer-term interest rates that had evolved as markets came to expect that a rise in short-term interest rates would be needed to achieve sustainable, noninflationary growth. The lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place continuing, though substantially diminishing, restraint on U.S. exports for some period ahead. Core price inflation was projected to rise somewhat over the forecast horizon, partly as a result of the pass-through of higher non-oil import prices and some firming of gains in nominal labor compensation in persistently tight labor markets that would not be fully offset by rising productivity growth.

In the Committee's discussion of current and prospective economic developments, members commented that the statistical and anecdotal information that had become available since the October meeting continued to point to robust growth in overall economic activity, despite some indications of softening in interest-sensitive sectors of the economy. Although productivity developments remained quite favorable, the faster rise in productivity itself apparently had tended to bolster demand more than supply through its effects on equity prices and consumption and on the demand for capital equipment. While real interest rates had increased to some extent to restore balance between supply and demand, they evidently had not risen enough or had not been high for long enough, and growth at an unsustainable pace continued to ratchet up pressures in labor markets. Abstracting from possible temporary fluctuations associated with the upcoming century date change, the members saw few signs of significant slowing in aggregate demand over the next few months. Over a somewhat longer horizon, however, they believed that growth in aggregate demand was likely to moderate to a more sustainable pace that would bring it into closer balance with the expansion in aggregate supply. Key factors cited by the members in support of their expectations of slower growth in overall domestic spending were the lagged and to some extent already evident effects of the rise that had occurred in long-term interest rates, including mortgage rates, and the effects on business and consumer sentiment of a less buoyant stock market, should the latter persist. However, the recent depreciation of the dollar and the ongoing strengthening of many foreign economies would stimulate rising export demand and perhaps substantially reduce the drag exerted on the economy by the foreign trade sector. The members acknowledged that their forecasts were subject to a substantial degree of uncertainty, but the risks on balance were seen as tilted toward growth strong enough to put added pressures on already tight labor markets. Greater pressures on labor resources, should they materialize, would at some point foster larger increases in labor costs, with potentially adverse implications for price inflation over time.

With regard to the prospective performance of key sectors of the economy, forecasts of somewhat slower growth in consumer spending appeared to be supported by recent reports of some moderation in sales of motor vehicles from extraordinarily high levels. Anecdotal reports relating to recent retail sales around the country were mixed, but members indicated that their contacts in the retail industry were uniformly optimistic about the outlook for sales during the holiday season and recent surveys suggested a very high level of consumer confidence. Retail sales might be also augmented during the closing weeks of the year by precautionary purchases related to century date change concerns. Looking ahead, and abstracting from the unwinding in the early part of 2000 of some transitory stockpiling of consumer goods, growth in consumer spending seemed likely to moderate over time. In part, forecasts of a less ebullient consumer sector reflected expectations of reduced demand for household goods associated with a mild downturn in housing activity and the previous slowdown in mortgage refinancings that had lowered household debt-servicing burdens and frequently had made accumulated housing equity available for consumer expenditures. A potentially more important factor in the outlook for consumer spending, however, was the prospect that the wealth effects from sharp earlier increases in the value of stock market holdings would wane in the absence of a new upsurge in stock market prices.

Growth of business spending for equipment and software was expected to moderate in the current quarter, largely in conjunction with what was seen as a temporary slowdown in purchases of computers in the period before the century date change. However, the members saw no significant evidence that the strong uptrend in spending on capital equipment might otherwise be weakening. In contrast to the pattern for business fixed investment, nonfarm inventory investment was projected to rise in the current quarter in connection with a temporary bulge related to the century date change but also to bring lean inventories into better alignment with anticipated sales. Once the perturbations related to the century date change had run their course, inventory growth was expected to return to a more normal pace during 2000.

In the housing market, rising mortgage rates had fostered some declines from recent peaks in starts and sales, and persisting softness in housing activity was anticipated. This expectation tended to be supported by anecdotal reports of moderating homebuilding activity in several parts of the country. Nonetheless, the members cited a number of factors that should tend to sustain overall housing activity at a fairly elevated level. These included continuing though diminishing backlogs of unbuilt homes, rising incomes, and high levels of consumer confidence. In any event, the outlook for housing was subject to considerable uncertainty as reflected in recent surveys that had produced mixed results with regard to the near-term prospects for housing activity.

Members anticipated that the dollar's recent depreciation and the strengthening of foreign economies would foster a significant further pickup in exports. Indeed, available data and anecdotal reports from around the country indicated that foreign demand already had improved markedly for some U.S. products. In these circumstances, domestic demand would need to decelerate considerably for growth to proceed at a sustainable pace.

Concerning the outlook for inflation, members noted that despite the long duration of very tight labor markets across the nation, labor compensation had increased at a slightly lower rate this year while consumer price inflation had remained moderate, albeit above year-earlier levels owing to a sharp rise in energy prices. The deceleration in labor compensation may have been induced in large measure by the low level of consumer price inflation in 1998. In addition, a major factor underlying the persistence of generally subdued price inflation in a period of robust economic expansion was the continued acceleration in productivity, which clearly was holding down increases in unit production costs. The latter contributed to ongoing competitive pressures that severely limited the ability of firms to raise prices, helping to this point to keep inflation at a low level.

The members nonetheless remained concerned about the outlook for inflation. They continued to focus especially on the possibility that the anticipated moderation in the growth of aggregate demand, taking into account the outlook for rising foreign demand for U.S. goods and services, might not be sufficient to avoid added pressures on labor and other resources. To be sure, the economy's potential output appeared to be expanding briskly, with much of the impetus provided by accelerating productivity. Even so, the pool of unemployed workers willing to take a job had continued to be drawn down, and it seemed likely to many members that prospective growth in aggregate demand might generate increasing pressures on the economy's ability to produce goods and services and thus add to inflationary pressures over time. This concern was heightened by the prospect that a number of developments that had tended to contain inflation in the last few years were now reversing. Members mentioned in particular the likelihood that increases in labor compensation might be headed higher in lagged response to the pickup in consumer price inflation this year. Also likely adding to labor cost pressures were relatively large advances in the cost of health care benefits and the possibility of a higher minimum wage. Moreover, the turnaround in energy and import prices could tend to feed through more directly into the prices of U.S.-produced goods by raising costs and reducing competitive pressures to hold down prices. Strengthening demand around the world already seemed to be contributing to higher prices of materials and other nonlabor inputs in the production "pipeline." In general, however, the members anticipated that any pickup in inflation was likely to be gradual, with cost pressures quite possibly continuing to be held largely in check for some time by improving productivity trends. They recognized that forecasts of rising inflation had failed to materialize in recent years, raising questions about their understanding of the empirical specification of the relationships that currently underlie the inflation process. On balance, though, the unsustainable pace of economic expansion along with the reversal of factors that previously had held down overall price increases suggested a significant risk that inflation would strengthen over time given prevailing financial conditions.

Against this background, all the members supported raising the Committee's target for the federal funds rate by 25 basis points at this meeting. Views differed to an extent on the outlook for inflation and policy going forward. However, with tightening resource constraints indicating unsustainable growth, only tentative signs that growth might be slowing, and various factors that had been damping prices now turning around, all the members agreed on the need for a slight tightening at this meeting to raise the odds on containing inflation and forestalling the inflationary imbalances that would undercut the very favorable performance of the economy. This view was reinforced by the prospect that the Committee might not find it desirable to adjust policy at its December meeting when a tightening action could add to the potential financial uncertainties and unsettlement surrounding the century date change. Accordingly, any action might have to wait until the meeting in early February, and the members agreed that the risks of waiting for such an extended period were unacceptably high.

All the members accepted a proposal to adopt a symmetric directive. Such a directive was viewed as consistent with the Committee's current expectation that no further policy move was likely to be considered before the Committee's meeting in February. In the circumstances, a Committee decision to retain the existing asymmetry toward tightening could well send a misleading signal about the probability of near-term action and have an unsettling effect on financial markets at a time when concerns relating to the century date change might be adding to normal year-end pressures. As noted previously, however, views differed to some degree regarding the subsequent outlook for policy. On the basis of currently available information, a number of members indicated that they were quite uncertain about the possible need for further tightening action over coming months to keep inflation within acceptable limits. Continued favorable price and unit cost data, driven in part by improving productivity, suggested that any further action should depend on incoming information about economic activity, pressures on resources, and inflation. Other members, emphasizing the persistently strong growth in economic activity and the unusually high level of labor resource utilization, suggested that additional firming of the stance of policy probably would be necessary to keep inflation in check and hence maintain the favorable backdrop for maximum economic growth. However, in view of the questions surrounding the outlook, the amount of firming already undertaken by the Committee this year including at this meeting and its uncertain effects, and the special situation in financial markets over the year-end, they supported the adoption of a symmetric directive. 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 directive:

> The information reviewed at this meeting suggests continued solid expansion of economic activity. Nonfarm payroll employment increased appreciably on average over September and October, and the civilian unemployment rate dropped to 4.1 percent in October, its low for the year. Industrial production recorded a strong gain in October after having been depressed in September by the effects of Hurricane Floyd. Total retail sales were flat in September and October owing to a drop in sales at auto dealers; sales at other stores were fairly robust. Housing

activity softened somewhat over the summer but has remained at a high level. Trends in orders suggest that business spending on capital equipment has continued to increase. The July–August deficit in U.S. trade in goods and services was higher than its average in the second quarter, as further growth in imports exceeded the rise in exports. Inflation has continued at a moderate pace, though above that in 1998 owing to a sharp rebound in energy prices. Labor compensation rates have been rising more slowly than last year.

Most market interest rates have posted small mixed changes since the meeting on October 5, 1999. However, measures of share prices in equity markets have registered sizable increases over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar has changed little over the period in relation to the currencies of a broad group of important U.S. trading partners. M2 continued to grow at a moderate pace in October while M3 accelerated. For the year through October, M2 and M3 are estimated to have increased at rates somewhat above the Committee's annual ranges for 1999. Total domestic nonfinancial debt has continued to expand at a pace somewhat above the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting in June the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 2000, the Committee agreed on a tentative basis in June to retain the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1999 to the fourth quarter of 2000. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 5½ percent. In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period.

> Votes for this action: Messrs. Greenspan, McDonough, Boehne, Ferguson, Gramlich, Kelley, McTeer, Meyers, Moskow, and Stern. Votes against this action: None.

At this meeting, the working group chaired by Mr. Ferguson provided an interim report on its work to date concerning the wording of the Committee's directives, the Committee's announcements after each meeting, and related issues. The members expressed broad agreement with the direction of the working group's tentative recommendations and provided feedback on specific issues and wording. It was contemplated that the Committee would consider the working group's final report at a meeting in the near future.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 21, 1999. The meeting adjourned at 1:40 p.m.

Donald L. Kohn
Secretary

After the meeting, the following press release was issued:

The Federal Open Market Committee today voted to raise its target for the federal funds rate by 25 basis points to 5½ percent. In a related action, the Board of Governors approved a 25 basis point increase in the discount rate to 5 percent.

Although cost pressures appear generally contained, risks to sustainable growth persist. Despite tentative evidence of a slowing in certain interest-sensitive sectors of the economy and of accelerating productivity, the expansion of activity continues in excess of the economy's growth potential. As a consequence, the pool of available workers willing to take jobs has been drawn down further in recent months, a trend that must eventually be contained if inflationary imbalances are to remain in check and economic expansion continue.

Today's increase in the federal funds rate, together with the policy actions in June and August and the firming of conditions more generally in U.S. financial markets over the course of the year, should markedly diminish the risk of inflation going forward. As a consequence, the directive the Federal Open Market Committee adopted is symmetrical with regard to the outlook for policy over the near term.

In taking the discount rate action, the Federal Reserve Board approved requests submitted by the Boards of Directors of the Federal Reserve Banks of Boston, Cleveland, Richmond, and Kansas City. The discount rate is the rate charged depository institutions when they borrow short-term adjustment credit from their District Federal Reserve Banks.

Meeting Held on December 21, 1999

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 21, 1999, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Boehne
Mr. Ferguson
Mr. Gramlich
Mr. Kelley
Mr. McTeer
Mr. Meyer
Mr. Moskow
Mr. Stern

Messrs. Broaddus, Guynn, Jordan, 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
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Prell, Economist

Ms. Cumming, Messrs. Howard, Hunter, Lang, Rosenblum, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Messrs. Ettin and Reinhart, Deputy Directors, Divisions of Research and Statistics and International Finance respectively, Board of Governors

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Ms. Roseman,[11] Director, Division of Reserve Bank Operations and Payment Systems, Board of Governors

Messrs. Dennis[11] and Whitesell, Assistant Directors, Divisions of Reserve Bank Operations and Payment Systems and Monetary Affairs respectively, Board of Governors

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[11] Attended portion of meeting relating to the Committee's consideration of the Report of Examination of the System Open Market Account.

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. Beebe, Eisenbeis, Goodfriend, Hakkio, Rasche, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, Kansas City, St. Louis, and Cleveland respectively

Ms. Perelmuter, Messrs. Rosengren and Weber, Vice Presidents, Federal Reserve Banks of New York, Boston, and Minneapolis respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 16, 1999, were approved.

The Report of Examination of the System Open Market Account, conducted by the Board's Division of Reserve Bank Operations and Payment Systems as of the close of business on September 10, 1999, was accepted.

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, and thus no vote was required 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 November 16, 1999, through December 20, 1999. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of recent and prospective economic and financial developments, and the implementation of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting suggested continued strong expansion of economic activity. Consumer demand was particularly robust, and business fixed investment remained on a strong upward trend. Housing activity was still at an elevated level despite some recent slippage. As a consequence, manufacturing production had increased briskly in recent months, and nonfarm payrolls continued to rise rapidly. Despite very tight labor markets, labor compensation had been climbing more slowly than last year. Aggregate price increases had been smaller in recent months, reflecting a flattening in energy prices after a rapid run-up.

Nonfarm payroll employment rose substantially further in October and November. Job growth in the services industry remained rapid in the two months, construction hiring continued buoyant against a backdrop of project backlogs and unseasonably warm weather, and the pace of job losses in manufacturing slowed further. The civilian unemployment rate fell to 4.1 percent in October, its low for the year, and remained at that level in November.

Industrial production continued to advance briskly in the October–November period, reflecting sizable gains in manufacturing and mining output. Within manufacturing, the production of consumer goods, construction supplies, and materials was up substantially. The further advance in manufacturing production in the two months boosted the factory operating rate, but capacity utilization in manufacturing in November was still a little below its long-term average.

Total nominal retail sales rose appreciably in the first two months of the fourth quarter. Sales gains were widespread, but purchases of durable goods, especially light vehicles, were particularly strong. Anecdotal reports suggested that growth in consumer outlays was remaining brisk in December.

Housing activity, though somewhat softer in recent months, continued at a high level. Total private housing starts slipped in November after having held steady in October. In addition, sales of new homes in the September–October period (latest data) were a little below the pace recorded in the spring and early summer months, and existing home sales registered a fourth consecutive decline in October.

The available information on orders and shipments suggested some slowing in the very rapid growth of business spending for capital equipment. Shipments of nondefense capital equipment recovered only partially in October from a large September decline. Much of the pickup reflected a surge in shipments of computers and related equipment in October after a plunge in the preceding two months. Trends in orders suggested that business spending on capital equipment, notably for high-tech and transportation equipment, probably had increased further over the balance of the fourth quarter. Outlays and contracts for nonresidential construction slowed further in October. The pace of office construction was close to its third-quarter average; spending for industrial buildings continued to drop, and outlays for commercial structures were unchanged from their low September level.

Business inventory investment slowed in October from the third-quarter pace, primarily reflecting a sizable liquidation of stocks at automotive dealerships. Stockbuilding among manufacturers stepped up slightly in October, but the stock–sales ratio for the sector was near the bottom of its range for the last twelve months. At the wholesale level, inventory accumulation slowed noticeably and the inventory–sales ratio for this sector also was near the bottom of its range for the last twelve months. Total retail stocks changed little on balance in October because of the sharp runoff at automotive dealerships. The inventory–sales ratio for the retail sector as a whole was at the bottom of its range for the last year.

The U.S. deficit on trade in goods and services widened somewhat in October from its average for the third quarter. The value of exports edged up in October from its third-quarter level but the value of imports rose appreciably more, with much of the increase reflecting greater imports of consumer goods and machinery. The available information suggested that economic expansion in the euro area, the United Kingdom, and Canada picked up sharply in the third quarter. In contrast, economic activity declined in Japan during the third quarter after a surge in the first half of the year. Among the developing countries, economic activity continued to expand in emerging Asia and parts of Latin America.

Inflation had remained subdued in recent months. Consumer price inflation edged down in October and November as energy prices steadied after having increased rapidly earlier in the year. Moreover, excluding the volatile food and energy components, consumer prices rose slightly less in the twelve months ended in November than in the previous twelve-month period. At the producer level, prices of finished goods other than food and energy were unchanged in November after a moderate increase in October. For the year ended in November, core producer prices rose somewhat more than in the preceding year. However, producer prices at earlier stages of processing continued to register increases somewhat larger than those for finished goods. With regard to labor costs, the rise in compensation per hour in the nonfarm business sector over the four quarters ending in September was down considerably from the advance in the preceding four-quarter period. In addition, average hourly earnings rose moderately in the October–November period and in the twelve months ended in November.

At its meeting on November 16, the Committee adopted a directive that called for a slight tightening of conditions in reserve markets consistent with an increase of ¼ percentage point in the federal funds rate to an average of around 5½ percent. The members noted that the slight tightening would enhance the chances for containing inflation and forestalling the emergence of inflationary imbalances that could undermine the economy's highly favorable performance. The members also agreed on a symmetric directive. The special situation in financial markets over the year-end, along with uncertainty about the economy's response to the firming already undertaken in 1999, suggested that the Committee would want to assess further developments through early next year before considering additional policy action.

Open market operations during the intermeeting period were directed toward implementing the desired slightly greater pressure on reserve positions, and the federal funds rate averaged close to the Committee's 5½ percent target. However, with the economic expansion still quite strong and in the context of the expression of concern about the inflationary implications of unsustainably fast growth in the Committee's announcement of its decision at the November meeting, incoming economic data were viewed by market participants as increasing, on balance, the chances of further monetary tightening in 2000. As a result, most market interest rates rose somewhat in the period after the November 16 meeting. Despite the appreciable increase in Treasury bond yields, most broad stock market indexes advanced further during the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar changed little over the period in relation to the currencies of a broad group of important U.S. trading partners. The dollar appreciated against the euro and the Canadian dollar, but those movements were largely counterbalanced by declines against the Japanese yen and the currencies of other important trading partners.

M2 continued to grow at a moderate rate in November despite strong currency demand that likely was associated with a combination of robust holiday spending and precautionary stockpiling for the century rollover. Higher opportunity costs and currency demand apparently damped growth in holdings of liquid deposits. By contrast, M3 surged in November, reflecting heavy issuance of large time deposits to fund increases in bank credit and vault cash and large inflows to institution-only money market funds. For the year through November, M2 and M3 were estimated to have increased at rates somewhat above the Committee's annual ranges for 1999. Total domestic nonfinancial debt continued to expand at a pace in the upper portion of its range.

The staff forecast prepared for this meeting suggested that the expansion would gradually moderate from its currently elevated pace to a rate around or perhaps a little below the growth of the economy's estimated potential. The expansion of domestic final demand increasingly would be held back by the anticipated waning of positive wealth effects associated with large earlier gains in equity prices, the slower growth of spending on consumer durables, houses, and business equipment and software in the wake of the prolonged buildup in the stocks of these items, and the higher intermediate- and longer-term interest rates that had evolved as markets came to expect that a rise in short-term interest rates would be needed to achieve sustainable, noninflationary growth. However, continued solid economic expansion abroad was expected to boost the growth of U.S. exports for some period ahead. Core price inflation was projected to rise somewhat over the forecast horizon, partly as a result of higher non-oil import prices and some firming of gains in nominal labor compensation in persistently tight labor markets that would increasingly outpace even continued rapid productivity growth.

In the Committee's discussion of current and prospective economic developments, members commented that the most recent statistical and anecdotal information provided further evidence of persisting strength in the expansion and of relatively subdued wage and price inflation. The economy clearly would carry substantial expansionary momentum into the new year, quite possibly in excess of growth in the economy's long-run potential, and the key issue for the Committee was whether growth in aggregate demand would slow to a more sustainable pace without further tightening in the stance of monetary policy. Members noted in this regard that evidence of a slowdown in the expansion was quite marginal at this point and seemed to be limited largely to some softening in housing activity. Looking beyond the near term, members continued to anticipate some moderation in the growth of domestic demand, though the extent of the moderation remained subject to a wide range of uncertainty related in part to the difficulty of anticipating trends in stock market prices and their effects on business and consumer sentiment and spending. Members also noted that prospective slowing in domestic demand was likely to be offset, at least to some extent, by further growth in exports should foreign economies as a group continue to strengthen as many forecasters anticipated.

Uncertainties about the level and growth of potential output and the dynamics of the inflation process made it difficult to relate with confidence projections of demand and activity to prospects for inflation. Members observed that they saw no indications that the impressive gains in productivity might be moderating, and, indeed, the most recent data suggested some further acceleration. Moreover, persistent disparities between the household and establishment series on employment growth might be reconciled by higher immigration than previously estimated, further boosting potential growth. Nonetheless, the increase in aggregate demand had been exceeding even the now-higher sustainable rate of growth in aggregate supply, as indicated by declines in the pool of available but unemployed workers to a very low level and by the rise in imports. This difference between the growth of demand and potential supply could well persist unless demand moderated. Absent a possible moderation, an upturn in unit labor costs was seen as a likely possibility, with eventual adverse implications for price inflation. Inflation pressures might also be augmented over time by a number of special factors such as the rise in energy prices, the effects on import prices of the dollar's depreciation and strengthening foreign economies, and faster increases in medical costs. While several of these factors implied limited price level adjustments, they could become embedded to a degree in ongoing inflation through their effects on wage increases and inflation expectations. Over the nearer term, however, subdued inflation expectations were likely to damp any incipient uptrend in the rate of price inflation.

In their review of economic conditions across the nation, several members noted that high levels of business activity were severely taxing available labor resources and appeared to be constraining growth in a number of industries and parts of the country. Rising employment and incomes, along with the advance in stock market prices to new highs in recent weeks, were fostering elevated levels of consumer confidence and would be supporting consumer spending going forward. Anecdotal reports pointed to notably brisk retail sales during the current holiday season in many parts of the country. Sales of new automobiles had rebounded recently after moderating somewhat from an exceptionally rapid pace earlier. While recent developments provided little basis for anticipating slower growth in consumer spending, members commented that such spending could be vulnerable to adverse developments in the stock market and the attendant effects on consumer wealth and confidence; and spending for household durables could be damped by the anticipated softness in housing activity.

The capital goods markets also displayed very little evidence of any weakening. They continued to be characterized by disproportionately large investments in high-tech business equipment, although demand for more conventional equipment, apart from farm equipment, also was relatively robust. Assessments of the outlook for overall business capital investment pointed to further rapid growth led by outlays for equipment. Business spending on construction was expected to change little on the whole, with strength in some sectors, such as warehouse facilities, offset by softness in sectors such as industrial structures and office buildings. Some members noted, however, that public works projects would help to support overall construction activity.

Recent data along with anecdotal reports indicated some loss of vigor in the nation's housing markets, though overall activity was still at a high level. The recent pace of homebuilding was somewhat uneven, with relative strength in some areas supported by seasonally favorable weather conditions or large backlogs. Rising mortgage rates were cited as a key factor underlying the limited moderation in residential construction, but other factors included the scarcity of skilled construction workers, with some diverted to nonresidential construction projects, and indications of overbuilding in some areas. Looking ahead, the members anticipated that further growth in incomes and the ready availability financing for most homebuyers would sustain overall housing activity at a relatively high level.

Forecasts indicated that while real net exports would continue to decline over the next several quarters, the rate of decline would moderate substantially. The solid further expansion expected in many foreign economies, the slower growth of domestic demand in the United States, and the effects of the slippage of the foreign exchange value of the dollar on the relative prices of U.S. goods and services were all seen as contributing to this outcome. In the course of their comments, members cited a number of examples of already-improved export markets for a variety of U.S. products. While expanding foreign demand for U.S. goods and services was a welcome development from the perspective of numerous business firms, such demand might add to pressures on U.S. resources with potentially inflationary implications, depending on the extent to which the growth in domestic demand would slow going forward. Several members indicated their concern about the burgeoning current account deficit and the potential that it could lead to a considerable weakening of the dollar at some point, which would tend to add to upward pressure on prices and demand.

In their comments regarding the outlook for inflation, a number of members expressed concern that the anticipated moderation in overall demand might not be large enough or soon enough to forestall added pressures on already-taut labor markets. Although wage growth had remained moderate to date and unit labor costs damped, at some point tightening labor markets would begin to generate wage gains increasingly in excess of productivity gains. Indeed, a few members were concerned that unit labor costs could begin to accelerate even at existing labor utilization levels. In addition, some of the forces that had been restraining inflation—declining oil, import, and commodity prices, and subdued increases in the costs of health care—had already reversed. Even so, resulting acceleration in price inflation might be held down and possibly averted for a time by the economy's buoyant upward trend in productivity, which could support profit margins and help maintain the highly competitive conditions in many markets that made it difficult or impossible for most business firms to raise their prices. In addition, there had been no evidence of any erosion in the widespread expectation that inflation would remain subdued over the long run.

In the Committee's discussion of policy for the period immediately ahead, all the members endorsed a proposal to maintain an unchanged policy stance consistent with a target for the federal funds rate centering on 5½ percent. The members agreed that the Committee's primary near-term objective was to foster steady conditions in financial markets during the period of the century date change and to avoid any action that might erode the markets' confidence that the Federal Reserve was fully prepared to provide whatever liquidity would be needed in this period. The members generally agreed that, if necessary, their concerns about rising inflation could be addressed at the meeting in early February. They saw little risk of a significant acceleration in inflation over the near term, given recent price trends and the absence of indications that inflationary expectations might be deteriorating, and thus little cost in deferring consideration of a policy tightening action. Moreover, the Committee would be in a better position by early February to assess the delayed effects of its earlier tightening actions.

On the issue of the intermeeting tilt in the Committee's directive, most of the members expressed a preference for retaining the symmetry adopted at the November meeting. While a preemptive tightening move might be warranted in the not-too-distant future to help contain inflationary pressures in the economy, these members believed that a symmetrical directive would best convey the message that no tightening action was contemplated for the weeks immediately ahead. Such a directive would therefore be more consistent with their desire to avoid any misinterpretations of their policy intentions that might unsettle financial markets during the sensitive century-date-change period. In this view, longer-run concerns about rising inflation could be addressed in the press statement that would be issued after this meeting. A few members indicated a marginal preference for an asymmetric directive that focused on the possibility of an eventual rise in interest rates. In their view, an asymmetric directive would be more consistent with the consensus among the Committee members regarding the most likely course of monetary policy over the next few meetings and the use of the bias statement that had come to encompass this longer horizon and was understood as such by financial market participants and the public. Moreover, such a directive was widely anticipated in financial markets and hence would incur little risk in their view of a market disturbance in the weeks immediately ahead. However, they could readily accept a symmetrical directive in light of the contemplated press announcement.

At the conclusion of this discussion, the members 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 directive:

The information reviewed at this meeting suggests continued strong expansion of economic activity. Nonfarm payroll employment increased substantially further in October and November, and the civilian unemployment rate stayed at 4.1 percent in November, its low for the year. Manufacturing output recorded sizable gains in October and November. Total retail sales rose appreciably over the two months. Housing activity has softened somewhat over recent months but has remained at a high level. Trends in orders suggest that business spending on capital equipment has increased further. The U.S. nominal trade deficit in goods and services rose in October from its average in the third quarter. Aggregate price increases have been smaller in the past two months, reflecting a flattening in energy prices; labor compensation rates have been rising more slowly than last year.

Most market interest rates are up somewhat since the meeting on November 16, 1999. Measures of share prices in equity markets have risen further over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar has changed little over the period in relation to the currencies of a broad group of important U.S. trading partners.

M2 continued to grow at a moderate pace in November while M3 surged. For the year through November, M2 and M3 are estimated to have increased at rates somewhat above the Committee's annual ranges for 1999. Total domestic nonfinancial debt has expanded at a pace in the upper end of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting in June the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 2000, the Committee agreed on a tentative basis in June to retain the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1999 to the fourth quarter of 2000. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period.

Votes for this action: Messrs. Greenspan, McDonough, Boehne, Ferguson, Gramlich, Kelley, McTeer, Meyer, Moskow, and Stern. Votes against this action: None.

Disclosure Policy

The members of the Committee agreed at this meeting to adopt a number of proposals offered by the Working Group on the Directive and Disclosure Policy chaired by Mr. Ferguson, effective with the first meeting in 2000. One proposal was to issue a press statement after every meeting even when the Committee decided to maintain its existing policy stance and did not change its view of future developments in a major way.

Another proposal was to change the way the Committee characterizes its view of future developments. A few members wanted to retain the current focus on the possible future stance of policy because they thought that the Committee would more readily be able to reach agreement on the likelihood of future actions than on the potential reasons such actions might be considered. The consensus opinion, however, was to replace the Committee’s judgment about the likelihood of an increase or decrease in the intended federal funds rate with a description of the Committee’s perception of the risks in the foreseeable future to the attainment of its long-run goals of price stability and sustainable economic growth. Although the Committee would vote on this assessment of the risks together with its policy stance, the Committee would no longer include its view of future developments in the domestic policy directive to the Federal Reserve Bank of New York, because the new wording did not refer to an operational matter. The Committee’s new directive would contain only a general statement of its policy objectives, its specific operating instructions for the intermeeting period, and in February and July a paragraph on the yearly money and debt ranges. To inform the public about these decisions, the members agreed that an explanatory press release should be issued before the February meeting.

The Committee also accepted a proposal to codify current practice regarding policy moves in the intermeeting period by amending the Authorization for Domestic Open Market Operations in February. The amendment was made necessary by the change in the language of the directive. Intermeeting moves, authorized by the Chairman, would remain possible but, as in recent years, would be made only in exceptional circumstances. One member expressed reservations about the proposed amendment, questioning its need in light of the instruments already in place to deal with liquidity emergencies and its appropriateness because it could potentially allow policy moves to be made, however rarely, without necessarily drawing on the benefits of full Committee participation. The other members, however, noted that the practices in place had worked well over the years, proving themselves a useful adjunct to the regular Committee decision-making process; that the new language would maintain those practices, clarifying that latitude to change policy was to be exercised against the background of the Committee’s previous discussions and only in unusual circumstances; and that, if necessary, adjustments to the Authorization could be made in the future.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, February 1–2, 2000.

The meeting adjourned at 1:30 p.m.

Donald L. Kohn
Secretary

Litigation

During 1999, the Board of Governors was a party in ten lawsuits or appeals filed that year and was a party in fourteen other cases pending from previous years, for a total of twenty-four cases; in 1998, the Board had been a party in a total of thirty-three cases. One of the lawsuits or appeals filed in 1999 raised questions under the Bank Holding Company Act. As of December 31, 1999, twelve cases were pending.

Judicial Review of Board Orders under the Bank Holding Company Act

Irontown Housing Corp. v. Board of Governors, No. 99–9549 (10th Circuit, filed December 27, 1999), is a petition for review of a Board order dated December 13, 1999, approving the merger of First Security Corporation and Zions Bancorporation, both of Salt Lake City, Utah (86 *Federal Reserve Bulletin* 122).

In *Independent Community Bankers of America v. Board of Governors*, No. 98–1482 (D.C. Circuit, filed October 21, 1998), petitioners sought review of a Board order dated September 23, 1998, conditionally approving the application of Travelers Group, Inc., New York, New York, to become a bank holding company by acquiring Citicorp, New York, New York, and its bank and nonbank subsidiaries (84 *Federal Reserve Bulletin* 985). On November 2, 1999, the court affirmed the Board's order (195 F.3d 28).

Attorneys Against American Apartheid v. Board of Governors, No. 98–1483 (D.C. Circuit, filed October 21, 1998), was a petition for review of a Board order dated August 17, 1998, approving the application by NationsBank Corporation, Charlotte, North Carolina, to merge with BankAmerica Corporation, San Francisco, California (84 *Federal Reserve Bulletin* 858). The court dismissed the petition on January 19, 1999.

Litigation under the Financial Institutions Supervisory Act

In *Board of Governors v. Carrasco*, No. 98–3474 (S.D. New York, filed May 15, 1998), the Board sought to freeze the assets of an individual pending the administrative adjudication of an action by the Board requiring restitution by the individual. On May 26, 1998, the district court granted the Board's request for a preliminary injunction. Following entry of the Board's order requiring restitution, 85 *Federal Reserve Bulletin* 142 (1998), the court granted the Board's motion for judgment in the asset freeze action and authorized a judicial sale of the seized property.

In *Board of Governors v. Pharaon*, Nos. 98–6101 and 98–6121 (2nd Circuit, filed May 4 and May 22, 1998), both parties appealed an order of the U.S. District Court for the Southern District of New York (No. 91–6250, March 18, 1998) granting in part and denying in part the Board's motion for partial summary judgment in an action to freeze the assets of an individual pending adjudication of a civil money penalty assessment by the Board. On February 24, 1999, the court of appeals affirmed the district court's grant of a

10 percent surcharge on an unpaid civil money penalty and reversed the district court to the extent it denied the Board prejudgment interest on that penalty. 169 F.3d 110. The case is pending before the district court.

In *Banking Consultants of America v. Board of Governors*, No. 98–5354 (6th Circuit, filed March 10, 1998), plaintiffs appealed an order of the U.S. District Court for the Western District of Tennessee (No. 97–2791, January 23, 1998) dismissing their action to enjoin an investigation by the Board, the Office of the Comptroller of the Currency, and the Department of Labor. The appeal was voluntarily dismissed on November 10, 1999.

Towe v. Board of Governors, No. 97–71143 (9th Circuit, filed September 15, 1997), was a petition for review of a Board order dated August 18, 1997 (83 *Federal Reserve Bulletin* 849), prohibiting Edward Towe and Thomas E. Towe from further participation in the banking industry. On February 23, 1999, the court affirmed the Board's order. 1999 U.S. App. LEXIS 3078.

Other Actions

Wasserman v. Board of Governors, No. 99–6290 (2nd Circuit, filed October 27, 1999), is an appeal by plaintiff of the denial of various post-dismissal motions following the voluntary dismissal of the plaintiff's action in the United States District Court for the Southern District of New York (No. 98–CIV–6017).

Artis v. Greenspan, No. 1:99CV02073 (EGS) (D. District of Columbia, filed August 3, 1999), is an employment discrimination action.

Sheriff Gerry Ali v. U.S. State Department, No. 99–7438 (C.D. California, filed July 21, 1999), is an action relating to impounded bank drafts.

Kerr v. Department of the Treasury, No. 99–16263 (9th Circuit, filed April 28, 1999), is an appeal of the district court's dismissal of an action challenging income taxation and Federal Reserve notes.

Sedgwick v. Board of Governors, No. Civ 99 0701 (D. Arizona, filed April 14, 1999), is an action under the Federal Tort Claims Act alleging violation of bank supervision requirements.

Gadson v. Federal Reserve Bank, No. 99–0866 (N.D. Georgia, filed April 2, 1999), was dismissed as frivolous on May 14, 1999. On December 21, 1999, the Eleventh Circuit Court of Appeals affirmed the dismissal (No. 99–11608).

Folstad v. Board of Governors, No. 1:99 CV 124 (W.D. Michigan, filed February 17, 1999), was an action under the Freedom of Information Act. On November 16, 1999, the district court granted the Board's motion for summary judgment and dismissed the action. 1999 U.S. Dist. LEXIS 17852.

Hummingbird v. Greenspan et al., No. 99–D–319 (D. Colorado, filed February 13, 1999), was a suit involving a federal tax lien. The case was dismissed on March 1, 1999.

Nelson v. Greenspan, No. 1:99CV00215 (EGS) (D. District of Columbia, filed January 28, 1999), is an employment discrimination complaint.

In *Fraternal Order of Police v. Board of Governors*, No. 98–3116 (D. District of Columbia, filed December 22, 1998), plaintiff seeks a declaratory judgment regarding the Board's labor relations policy.

Hunter v. Board of Governors, No. 1:98CV02994 (TFH) (D. District of Columbia, filed December 9, 1998), is an action under the Freedom of Information Act, the Privacy Act, and the First Amendment.

In *Inner City Press/Community on*

the Move v. Board of Governors, No. 98–4608 (2nd Circuit, filed December 3, 1998), plaintiff appealed an order of the U.S. District Court for the Southern District of New York (No. 98–4608, September 30, 1998) granting the Board's motion for summary judgment on plaintiff's Freedom of Information Act complaint. On June 23, 1999, the court of appeals affirmed the district court's dismissal. 1999 U.S. App. LEXIS 3078.

Goldman v. Department of the Treasury, No. 98–9451 (11th Circuit, filed November 10, 1998), was an appeal from an order of the U.S. District Court for the Northern District of Georgia (No. 1–97–CV–3798, November 2, 1998) dismissing an action challenging Federal Reserve notes as lawful money. The district court's judgment was affirmed on August 9, 1999.

Clarkson v. Greenspan, No. 98–5349 (D.C. Circuit, filed July 29, 1998), was an appeal of a district court order granting the Board's motion for summary judgment on plaintiff's Freedom of Information Act complaint. The court of appeals affirmed the district court's order on March 2, 1999.

Fenili v. Davidson, No. C–98–01568CW (N.D. California, filed April 17, 1998), was a case claiming tort and constitutional violations arising out of the return of a check. The case was dismissed on September 29, 1999.

Logan v. Greenspan, No. 98–0049 (D. District of Columbia, filed January 9, 1998), was an employment discrimination action. On September 29, 1999, the case was dismissed without prejudice.

Bettersworth v. Board of Governors, No. 97–CA–624 (W.D. Texas, filed August 21, 1997), is a complaint under the Privacy Act. ■

Federal Reserve System Organization

Board of Governors of the Federal Reserve System

December 31, 1999

Members

	Term expires January 31,
Alan Greenspan, of New York, *Chairman*[1]	2006
Roger W. Ferguson, Jr., of Massachusetts, *Vice Chairman*[1]	2000
Laurence H. Meyer, of Missouri	2002
Edward W. Kelley, Jr., of Texas	2004
Edward M. Gramlich, of Virginia	2008
Vacancy	2010
Vacancy	2012

Officers

Office of Board Members

Lynn S. Fox, *Assistant to the Board*
Donald J. Winn, *Assistant to the Board*
Winthrop P. Hambley, *Deputy Congressional Liaison*
Bob Stahly Moore, *Special Assistant to the Board*
Diane E. Werneke, *Special Assistant to the Board*

Legal Division

J. Virgil Mattingly, Jr., *General Counsel*
Scott G. Alvarez, *Associate General Counsel*
Richard M. Ashton, *Associate General Counsel*
Oliver Ireland, *Associate General Counsel*
Kathleen M. O'Day, *Associate General Counsel*
Katherine H. Wheatley, *Assistant General Counsel*

Office of the Secretary

Jennifer J. Johnson, *Secretary*
Robert deV. Frierson, *Associate Secretary*
Barbara R. Lowrey, *Associate Secretary and Ombudsman*

Division of International Finance

Karen H. Johnson, *Director*
David H. Howard, *Deputy Director*
Vincent R. Reinhart, *Deputy Director*
Dale W. Henderson, *Associate Director*
Thomas A. Connors, *Deputy Associate Director*
Donald B. Adams, *Senior Adviser*
Richard T. Freeman, *Assistant Director*
William L. Helkie, *Assistant Director*
Steven B. Kamin, *Assistant Director*
Ralph W. Tryon, *Assistant Director*

Division of Monetary Affairs

Donald L. Kohn, *Director*
David E. Lindsey, *Deputy Director*
Brian F. Madigan, *Associate Director*
Richard D. Porter, *Deputy Associate Director*
William C. Whitesell, *Assistant Director*
Normand R.V. Bernard, *Special Assistant to the Board*

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[1] The designations as Chairman and Vice Chairman expire on June 20, 2000, and October 5, 2003, respectively, unless the service of these members of the Board shall have terminated sooner.

Board of Governors—Continued

DIVISION OF RESEARCH AND STATISTICS

Michael J. Prell, *Director*
Edward C. Ettin, *Deputy Director*
David J. Stockton, *Deputy Director*
William R. Jones, *Associate Director*
Myron L. Kwast, *Associate Director*
Patrick M. Parkinson, *Associate Director*
Thomas D. Simpson, *Associate Director*
Lawrence Slifman, *Associate Director*
Martha S. Scanlon, *Deputy Associate Director*
Stephen D. Oliner, *Assistant Director*
Stephen A. Rhoades, *Assistant Director*
Janice Shack-Marquez, *Assistant Director*
Charles S. Struckmeyer, *Assistant Director*
Alice Patricia White, *Assistant Director*
Joyce K. Zickler, *Assistant Director*
Glenn B. Canner, *Senior Adviser*
David S. Jones, *Senior Adviser*

DIVISION OF BANKING SUPERVISION AND REGULATION

Richard Spillenkothen, *Director*
Stephen C. Schemering, *Deputy Director*
Herbert A. Biern, *Associate Director*
Roger T. Cole, *Associate Director*
William A. Ryback, *Associate Director*
Gerald A. Edwards, Jr., *Deputy Associate Director*
Stephen M. Hoffman, Jr., *Deputy Associate Director*
James V. Houpt, *Deputy Associate Director*
Jack P. Jennings, *Deputy Associate Director*
Michael G. Martinson, *Deputy Associate Director*
Sidney M. Sussan, *Deputy Associate Director*
Molly S. Wassom, *Deputy Associate Director*
Howard A. Amer, *Assistant Director*
Norah M. Barger, *Assistant Director*
Mary Cross Jacowski, *Assistant Director*
Richard A. Small, *Assistant Director*
William C. Schneider, Jr., *Project Director, National Information Center*

DIVISION OF CONSUMER AND COMMUNITY AFFAIRS

Dolores S. Smith, *Director*
Glenn E. Loney, *Deputy Director*
Sandra F. Braunstein, *Assistant Director*
Maureen P. English, *Assistant Director*
Adrienne D. Hurt, *Assistant Director*
Irene Shawn McNulty, *Assistant Director*

DIVISION OF FEDERAL RESERVE BANK OPERATIONS AND PAYMENT SYSTEMS

Louise L. Roseman, *Director*
Paul W. Bettge, *Assistant Director*
Kenneth D. Buckley, *Assistant Director*
Jack Dennis, Jr., *Assistant Director*
Joseph H. Hayes, Jr., *Assistant Director*
Jeffrey C. Marquardt, *Assistant Director*
Marsha W. Reidhill, *Assistant Director*
Jeff J. Stehm, *Assistant Director*

OFFICE OF STAFF DIRECTOR FOR MANAGEMENT

Stephen R. Malphrus, *Staff Director*

MANAGEMENT DIVISION

Stephen J. Clark, *Associate Director, Finance Function*
Darrell R. Pauley, *Associate Director, Human Resources Function*
Sheila Clark, *Equal Employment Opportunity Programs Director*

Board of Governors—Continued

DIVISION OF INFORMATION TECHNOLOGY
Richard C. Stevens, *Director*
Marianne M. Emerson, *Deputy Director*
Tillena G. Clark, *Assistant Director*
Maureen T. Hannan, *Assistant Director*
Po Kyung Kim, *Assistant Director*
Raymond H. Massey, *Assistant Director*
Edward T. Mulrenin, *Assistant Director*
Day W. Radebaugh, Jr., *Assistant Director*

DIVISION OF SUPPORT SERVICES
Robert E. Frazier, *Director*
George M. Lopez, *Assistant Director*
David L. Williams, *Assistant Director*

OFFICE OF THE INSPECTOR GENERAL
Barry R. Snyder, *Inspector General*
Donald L. Robinson, *Deputy Inspector General*

Federal Open Market Committee

December 31, 1999

Members

ALAN GREENSPAN, *Chairman,* Board of Governors
WILLIAM J. MCDONOUGH, *Vice Chairman,* President, Federal Reserve Bank of New York
EDWARD G. BOEHNE, President, Federal Reserve Bank of Philadelphia
ROGER W. FERGUSON, JR., Board of Governors
EDWARD M. GRAMLICH, Board of Governors
EDWARD W. KELLEY, JR., Board of Governors
ROBERT D. MCTEER, JR., President, Federal Reserve Bank of Dallas
LAURENCE H. MEYER, Board of Governors
MICHAEL H. MOSKOW, President, Federal Reserve Bank of Chicago
GARY H. STERN, President, Federal Reserve Bank of Minneapolis

Alternate Members

J. ALFRED BROADDUS, President, Federal Reserve Bank of Richmond
JACK GUYNN, President, Federal Reserve Bank of Atlanta
JERRY L. JORDAN, President, Federal Reserve Bank of Cleveland
ROBERT T. PARRY, President, Federal Reserve Bank of San Francisco
JAMIE B. STEWART, First Vice President, Federal Reserve Bank of New York

Officers

DONALD L. KOHN, *Secretary and Economist*
NORMAND R.V. BERNARD, *Deputy Secretary*
LYNN S. FOX, *Assistant Secretary*
GARY P. GILLUM, *Assistant Secretary*
J. VIRGIL MATTINGLY, JR., *General Counsel*
THOMAS C. BAXTER, JR., *Deputy General Counsel*
KAREN H. JOHNSON, *Economist*
MICHAEL J. PRELL, *Economist*

Federal Open Market Committee—Continued

CHRISTINE M. CUMMING,
Associate Economist
DAVID H. HOWARD,
Associate Economist
WILLIAM C. HUNTER,
Associate Economist
RICHARD W. LANG,
Associate Economist
DAVID E. LINDSEY,
Associate Economist
ARTHUR J. ROLNICK,
Associate Economist
HARVEY ROSENBLUM,
Associate Economist
LAWRENCE SLIFMAN,
Associate Economist
DAVID J. STOCKTON,
Associate Economist

PETER R. FISHER, *Manager, System Open Market Account*

During 1999 the Federal Open Market Committee held eight regularly scheduled meetings (see Minutes of Federal Open Market Committee Meetings in this REPORT.)

Federal Advisory Council

December 31, 1999

Members

District 1—LAWRENCE K. FISH, *Chairman, President, and Chief Executive Officer,*
Citizens Financial Group, Inc., Providence, Rhode Island
District 2—DOUGLAS A. WARNER III, *Chairman, President, and Chief Executive Officer,*
J.P. Morgan & Co., Incorporated, New York, New York
District 3—RONALD L. HANKEY, *President and Chief Executive Officer,*
Adams County National Bank, Gettysburg, Pennsylvania
District 4—ROBERT W. GILLESPIE, *Chairman and Chief Executive Officer,*
KeyCorp, Cleveland, Ohio
District 5—KENNETH D. LEWIS, *President,* Bank of America, Charlotte, North Carolina
District 6—STEPHEN A. HANSEL, *President and Chief Executive Officer,*
Hibernia National Bank, New Orleans, Louisiana
District 7—NORMAN R. BOBINS, *President and Chief Executive Officer,*
LaSalle National Bank and LaSalle National Corporation, Chicago, Illinois
District 8—KATIE S. WINCHESTER, *President and Chief Executive Officer,*
First Citizens National Bank, Dyersburg, Tennessee
District 9—RICHARD A. ZONA, *Vice Chairman,*
U.S. Bancorp, Minneapolis, Minnesota
District 10—C.Q. CHANDLER, *Chairman and Chief Executive Officer,*
INTRUST Financial Corporation, Wichita, Kansas
District 11—RICHARD W. EVANS, *Chairman and Chief Executive Officer,*
Frost National Bank, San Antonio, Texas
District 12—WALTER A. DODS, JR., *Chairman and Chief Executive Officer,*
BancWest Corporation, Honolulu, Hawaii

Officers

ROBERT W. GILLESPIE, *President*
KENNETH D. LEWIS, *Vice President*
JAMES E. ANNABLE, *Co–Secretary*
WILLIAM J. KORSVIK, *Co–Secretary*

Federal Advisory Council—Continued

Directors

STEPHEN A. HANSEL

RICHARD A. ZONA

The Federal Advisory Council met on February 4–5, May 6–7, September 9–10, and November 4–5, 1999. The Board of Governors met with the council on February 5, May 7, September 10, and November 5, 1999. The 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 on all matters within the jurisdiction of the Board.

Consumer Advisory Council

December 31, 1999

Members

LAUREN ANDERSON, *Executive Director,* Neighborhood Housing Services of New Orleans, Inc., New Orleans, Louisiana

WALTER J. BOYER, *Chairman,* The Diamond Group, Dallas, Texas

WAYNE-KENT A. BRADSHAW, *President and Chief Executive Officer,* Family Savings Bank, FSB, Los Angeles, California

MALCOLM BUSH, *President,* Woodstock Institute, Chicago, Illinois

MARY ELLEN DOMEIER, *President,* State Bank and Trust Company of New Ulm, New Ulm, Minnesota

JEREMY D. EISLER, *Director of Litigation,* South Mississippi Legal Services Corp., Biloxi, Mississippi

ROBERT F. ELLIOTT, *Retired Vice Chairman,* Household International, Prospect Heights, Illinois

JOHN GAMBOA, *Executive Director,* The Greenlining Institute, San Francisco, California

ROSE GARCIA, *Executive Director,* Tierra del Sol Housing Corporation, Las Cruces, New Mexico

VINCENT J. GIBLIN, *Chief Executive Officer,* International Union of Operating Engineers, West Caldwell, New Jersey

KARLA S. IRVINE, *Executive Director,* Housing Opportunities Made Equal of Greater Cincinnati, Inc., Cincinnati, Ohio

WILLIE JONES, *Deputy Director,* The Community Builders, Inc., Boston, Massachusetts

JANET C. KOEHLER, *President,* Koehler Associates, Ponte Vedra Beach, Florida

GWENN S. KYZER, *Vice President,* Experian, Inc., Allen, Texas

JOHN C. LAMB, *Senior Staff Counsel,* Department of Consumer Affairs, Sacramento, California

ANNE S. LI, *Executive Director,* New Jersey Community Loan Fund, Trenton, New Jersey

MARTHA W. MILLER, *President,* Choice Federal Credit Union, Greensboro, North Carolina

DANIEL W. MORTON, *Vice President and Senior Counsel,* The Huntington National Bank, Columbus, Ohio

CAROL J. PARRY, *Retired Executive Vice President,* Chase Manhattan Bank, New York, New York

PHILIP PRICE, JR., *Executive Director,* The Philadelphia Plan, Philadelphia, Pennsylvania

Consumer Advisory Council—Continued

MARTA RAMOS, *Vice President and Community Reinvestment Act Officer,* Banco Popular de Puerto Rico, San Juan, Puerto Rico

DAVID L. RAMP, *Assistant Attorney General,* State of Minnesota, St. Paul, Minnesota

MARILYN ROSS, *Executive Director,* Holy Name Housing Corporation, Omaha, Nebraska

ROBERT G. SCHWEMM, *Ashland Professor of Law,* University of Kentucky, Lexington, Kentucky

DAVID J. SHIRK, *Senior Manager,* Lending Systems Framework, Tarrytown, New York

GAIL M. SMALL, *Executive Director,* Native Action, Lame Deer, Montana

GARY S. WASHINGTON, *Senior Vice President,* ABN AMRO, Chicago, Illinois

ROBERT L. WYNN II, *Financial Education Officer,* Wisconsin Department of Financial Institutions, Madison, Wisconsin

Officers

YVONNE SPARKS STRAUTHER, *Chair*
Vice President, Bank of America
Community Development Banking,
St. Louis, Missouri

DWIGHT GOLANN, *Vice Chair*
Professor of Law,
Suffolk University Law School,
Boston, Massachusetts

The Consumer Advisory Council met with members of the Board of Governors on March 25, June 24, and October 21, 1999. The council is composed of academics, state and local government officials, representatives of the financial industry, and representatives of consumer and community interests. It was established pursuant to the 1976 amendments to the Equal Credit Opportunity Act to advise the Board on consumer financial services.

Thrift Institutions Advisory Council

December 31, 1999

Members

GAROLD R. BASE, *President and Chief Executive Officer*, Community Credit Union, Plano, Texas

JAMES C. BLAINE, *President*, State Employees' Credit Union, Raleigh, North Carolina

DAVID A. BOCHNOWSKI, *Chairman, President, and Chief Executive Officer*, Peoples Bank, SB, Munster, Indiana

LAWRENCE L. BOUDREAUX III, *President and Chief Executive Officer*, Fidelity Homestead Association, New Orleans, Louisiana

RICHARD P. COUGHLIN, *Former President and Chief Executive Officer*, Stoneham Co-operative Bank, Stoneham, Massachusetts

WILLIAM A. FITZGERALD, *Chairman and Chief Executive Officer,* Commercial Federal Bank, Omaha, Nebraska

BABETTE E. HEIMBUCH, *President and Chief Executive Officer*, First Federal Bank of California, FSB, Santa Monica, California

THOMAS S. JOHNSON, *Chairman and Chief Executive Officer*, GreenPoint Bank, Manhattan, New York

WILLIAM A. LONGBRAKE, *Vice Chair and Chief Financial Officer*, Washington Mutual Bank, Seattle, Washington

Thrift Institutions Advisory Council—Continued

KATHLEEN E. MARINANGEL, *Chair, President, and Chief Executive Officer*, McHenry Savings Bank, McHenry, Illinois

F. WELLER MEYER, *President and Chief Executive Officer*, Acacia Federal Savings Bank, Falls Church, Virginia

ANTHONY J. POPP, *President and Chief Executive Officer*, Marietta Savings Bank, Marietta, Ohio

Officers

WILLIAM A. FITZGERALD, *President*

F. WELLER MEYER, *Vice President*

The members of the Thrift Institutions Advisory Council met with the Board of Governors on April 2, July 23, and December 3, 1999. The council, which is composed of representatives from credit unions, savings and loan associations, and savings banks, consults with, and advises, the Board on issues pertaining to the thrift industry and on various other matters within the Board's jurisdiction.

Officers of Federal Reserve Banks and Branches

December 31, 1999

BANK or Branch	Chairman[1] Deputy Chairman	President First Vice President	Vice President in charge of Branch
BOSTON[2]	William C. Brainard	Cathy E. Minehan	
	William O. Taylor	Paul M. Connolly	
NEW YORK[2]	John C. Whitehead	William J. McDonough	
	Peter G. Peterson	Jamie B. Stewart, Jr.	
Buffalo	Bal Dixit		Carl W. Turnipseed[3]
PHILADELPHIA	Joan Carter	Edward G. Boehne	
	Charisse R. Lillie	William H. Stone, Jr.	
CLEVELAND[2]	G. Watts Humphrey, Jr.	Jerry L. Jordan	
	David H. Hoag	Sandra Pianalto	
Cincinnati	George C. Juilfs		Barbara B. Henshaw
Pittsburgh	John T. Ryan III		Robert B. Schaub
RICHMOND[2]	Claudine B. Malone	J. Alfred Broaddus, Jr.	
	Jeremiah J. Sheehan	Walter A. Varvel	
Baltimore	Daniel R. Baker		William J. Tignanelli[3]
Charlotte	Joan H. Zimmerman		Dan M. Bechter[3]

Officers of Federal Reserve Banks and Branches—Continued

BANK or Branch	Chairman[1] Deputy Chairman	President First Vice President	Vice President in charge of Branch
ATLANTA	John F. Wieland Paula Lovell	Jack Guynn Patrick K. Barron	James M. McKee
Birmingham	V. Larkin Martin		Andre T. Anderson
Jacksonville	Marsha G. Rydberg		Robert J. Slack
Miami	Mark T. Sodders		James T. Curry III
Nashville	Whitney Johns Martin		Melvyn K. Purcell[3]
New Orleans	Glenn Pumpelly		Robert J. Musso[3]
CHICAGO[2]	Lester H. McKeever, Jr. Arthur C. Martinez	Michael H. Moskow William C. Conrad	
Detroit	Florine Mark		David R. Allardice[3]
ST. LOUIS	Susan S. Elliott Charles W. Mueller	William Poole W. LeGrande Rives	
Little Rock	Diana T. Hueter		Robert A. Hopkins
Louisville	Roger Reynolds		Thomas A. Boone
Memphis	Mike P. Sturdivant, Jr.		Martha Perine Beard
MINNEAPOLIS	David A. Koch James J. Howard	Gary H. Stern Colleen K. Strand	
Helena	Tom Markle		Samuel H. Gane
KANSAS CITY	Jo Marie Dancik Terrence P. Dunn	Thomas M. Hoenig Richard K. Rasdall	
Denver	Kathryn A. Paul		Carl M. Gambs[3]
Oklahoma City	Larry W. Brummett		Kelly J. Dubbert
Omaha	Gladys Styles Johnston		Steven D. Evans
DALLAS	Roger R. Hemminghaus James A. Martin	Robert D. McTeer, Jr. Helen E. Holcomb	
El Paso	Patricia Z. Holland-Branch		Sammie C. Clay
Houston	Edward O. Gaylord		Robert Smith III[3]
San Antonio	Patty Puig Mueller		James L. Stull[3]
SAN FRANCISCO	Gary G. Michael Nelson C. Rising	Robert T. Parry John F. Moore	
Los Angeles	Lonnie Kane		Mark L. Mullinix[3]
Portland	Nancy Wilgenbusch		Raymond H. Laurence[3]
Salt Lake City	Barbara L. Wilson		Andrea P. Wolcott
Seattle	Richard R. Sonstelie		Gordon R.G. Werkema[4]

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 June 2 and 3, and on December 1 and 2, 1999.

The members of the Executive Committee of the Conference of Chairmen during 1999 were G. Watts Humphrey, Jr., chair; Jo Marie Dancik, vice chair; and Claudine B. Malone, member.

On December 2, 1999, the conference elected its Executive Committee for 2000; it named Jo Marie Dancik as chair, John F. Wieland as vice chair, and Peter G. Peterson 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.

Jerry L. Jordan, President of the Federal Reserve Bank of Cleveland, served as chair of the conference in 1999, and J. Alfred Broaddus, Jr., President of the Federal Reserve Bank of Richmond, served as its vice chair. Stephen J. Ong, of the Federal Reserve Bank of Cleveland, served as its secretary, and Claudia N. MacSwain, of the Federal Reserve Bank of Richmond, served as its assistant secretary.

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.

Colleen K. Strand, First Vice President of the Federal Reserve Bank of Minneapolis, served as chair of the conference in 1999, and Richard K. Rasdall, Jr., First Vice President of the Federal Reserve Bank of Kansas City, served as its vice chair. Niel D. Willardson, of the Federal Reserve Bank of Minneapolis, served as its secretary, and Leesa M. Guyton, of the Federal Reserve Bank of Kansas City, served as its assistant secretary.

On October 5, 1999, the conference elected Richard K. Rasdall, Jr., as its chair for 2000–2001, and Paul M. Connolly, First Vice President of the Federal Reserve Bank of Boston, as its vice chair.

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 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 of Federal Reserve Banks and Branches

DISTRICT 1—BOSTON

Class A

		Term expires Dec. 31
G. Kenneth Perine	President and Chief Executive Officer, National Bank of Middlebury, Middlebury, Vermont	1999
Edwin N. Clift	President and Chief Executive Officer, Merrill Merchants Bank, Bangor, Maine	2000
Terrence Murray	Chairman and Chief Executive Officer, FleetBoston Corporation, Boston, Massachusetts	2001

Class B

Vacancy		1999
Edward Dugger III	President and Chief Executive Officer, UNC Partners, Inc., Boston, Massachusetts	2000
Robert R. Glauber	Adjunct Lecturer, John F. Kennedy School of Government, Harvard University, Cambridge, Massachusetts	2001

Class C

William O. Taylor	Chairman Emeritus, The Boston Globe, Boston, Massachusetts	1999
James J. Norton	President, Graphic Communications International Union, Washington, D.C.	2000
William C. Brainard	Professor of Economics, Yale University, New Haven, Connecticut	2001

DISTRICT 2—NEW YORK

Class A

George W. Hamlin IV	President and Chief Executive Officer, The Canandaigua National Bank and Trust Company, Canandaigua, New York	1999
Walter V. Shipley	Chairman, The Chase Manhattan Corporation, New York, New York	2000
Richard L. Carrion	Chairman, President, and Chief Executive Officer, Banco Popular de Puerto Rico, San Juan, Puerto Rico	2001

DISTRICT 2, New York—Continued

Class B

		Term expires Dec. 31
Ann M. Fudge	Executive Vice President, Kraft Foods, Inc., and President, Coffee & Cereals Division, Tarrytown, New York	1999
Eugene R. McGrath	Chairman, President, and Chief Executive Officer, Consolidated Edison Company of New York, Inc., New York, New York	2000
Ronay Menschel	President, Phipps Houses, New York, New York	2001

Class C

John C. Whitehead	Former Chairman, Goldman, Sachs & Co., Inc., New York, New York	1999
Charles A. Heimbold, Jr.	Chairman and Chief Executive Officer, Bristol-Myers Squibb Co., New York, New York	2000
Peter G. Peterson	Chairman, The Blackstone Group, New York, New York	2001

Buffalo Branch

Appointed by the Federal Reserve Bank

Louise Woerner	Chairman and Chief Executive Officer, HCR, Rochester, New York	1999
Maureen Torrey Marshall	Co-owner, Torrey Farms, Inc., Elba, New York	2000
William E. Swan	President and Chief Executive Officer, Lockport Savings Bank, Lockport, New York	2000
Kathleen R. Whelehan	Executive Vice President, Consumer Finance Division, HSBC, Buffalo, New York	2001

Appointed by the Board of Governors

Patrick P. Lee	Chairman and Chief Executive Officer, International Motion Control, Inc., Buffalo, New York	1999
John E. Friedlander	President and Chief Executive Officer, Kaleida Health, Buffalo, New York	2000
Bal Dixit	President and Chief Executive Officer, Newtex Industries, Inc., Victor, New York	2001

DISTRICT 3—Philadelphia

Class A

David B. Lee	President and Chief Executive Officer, Omega Bank, N.A., State College, Pennsylvania	1999
Harry Elwell III	President and Chief Executive Officer, First National Bank of Absecon, Absecon, New Jersey	2000

DISTRICT 3, *Class A*—Continued

		Term expires Dec. 31
Rufus A. Fulton, Jr.	Chairman, President, and Chief Executive Officer, Fulton Financial Corporation, Lancaster, Pennsylvania	2001

Class B

J. Richard Jones	President and Chief Executive Officer, Insignia/ESG Jackson-Cross Company, Philadelphia, Pennsylvania	1999
Robert D. Burris	President and Chief Executive Officer, Burris Foods, Inc., Milford, Delaware	2000
Howard E. Cosgrove	Chairman and Chief Executive Officer, Conectiv, Wilmington, Delaware	2001

Class C

Joan Carter	President and Chief Operating Officer, UM Holdings Ltd., Haddonfield, New Jersey	1999
Glenn A. Schaeffer	President, Pennsylvania Building and Construction Trades Council, Harrisburg, Pennsylvania	2000
Charisse R. Lillie	Partner Ballard Spahr Andrews & Ingersoll, Philadelphia, Pennsylvania	2001

DISTRICT 4—CLEVELAND

Class A

Tiney M. McComb	Chairman and President, Heartland BancCorp, Gahanna, Ohio	1999
David S. Dahlmann	President and Chief Executive Officer, Southwest Bank, Greensburg, Pennsylvania	2000
John R. Cochran	Chairman and Chief Executive Officer, FirstMerit Corporation, Akron, Ohio	2001

Class B

David L. Nichols	Cincinnati, Ohio	1999
Cheryl L. Krueger-Horn	President and Chief Executive Officer, Cheryl & Co., Westerville, Ohio	2000
Wayne R. Embry	President and Chief Operating Officer, Cleveland Cavaliers, Cleveland, Ohio	2001

DISTRICT 4, Cleveland—Continued

Class C

		Term expires Dec. 31
Robert Y. Farrington	Executive Secretary-Treasurer, Emeritus, Ohio State Building and Construction Trades Council, Columbus, Ohio	1999
G. Watts Humphrey, Jr.	President, GWH Holdings, Incorporated, Pittsburgh, Pennsylvania	2000
David H. Hoag	Former Chairman, The LTV Corporation, Cleveland, Ohio	2001

Cincinnati Branch

Appointed by the Federal Reserve Bank

Judith G. Clabes	President and Chief Executive Officer, Scripps Howard Foundation, Cincinnati, Ohio	1999
Phillip R. Cox	President and Chief Executive Officer, Cox Financial Corporation, Cincinnati, Ohio	1999
Stephen P. Wilson	President and Chief Executive Officer, Lebanon Citizens National Bank, Lebanon, Ohio	2000
Jean R. Hale	President and Chief Executive Officer, Community Trust Bancorp, Inc., Pikeville, Kentucky	2001

Appointed by the Board of Governors

George C. Juilfs	President and Chief Executive Officer, SENCORP, Newport, Kentucky	1999
Wayne Shumate	Chairman and Chief Executive Officer, Kentucky Textiles, Inc., Paris, Kentucky	2000
Thomas Revely III	President and Chief Executive Officer, Cincinnati Bell Supply Co., Cincinnati, Ohio	2001

Pittsburgh Branch

Appointed by the Federal Reserve Bank

Georgia Berner	President, Berner International Corp., New Castle, Pennsylvania	1999
Peter N. Stephans	Chairman and Chief Executive Officer, Trigon Incorporated, McMurray, Pennsylvania	1999
Thomas J. O’Shane	Senior Executive Vice President, Sky Financial Group, New Castle, Pennsylvania	2000
Edward V. Randall, Jr.	Management Consultant, Babst Calland Clements & Zomnir, Pittsburgh, Pennsylvania	2001

DISTRICT 4, Pittsburgh Branch—Continued

Appointed by the Board of Governors

		Term expires Dec. 31
Charles E. Bunch	Senior Vice President, Strategic Planning and Corporate Services, PPG Industries, Inc., Pittsburgh, Pennsylvania	1999
John T. Ryan III	Chairman and Chief Executive Officer, Mine Safety Appliances Company, Pittsburgh, Pennsylvania	2000
Gretchen R. Haggerty	Vice President–Accounting and Finance, U.S. Steel Group, Pittsburgh, Pennsylvania	2001

DISTRICT 5—Richmond

Class A

J. Walter McDowell	Executive Vice President, Wachovia Corporation, Winston-Salem, North Carolina	1999
Elizabeth A. Duke	President and Chief Executive Officer, The Bank of Tidewater, Virginia Beach, Virginia	2000
James M. Culberson, Jr.	Chairman Emeritus, First National Bank & Trust Company, Asheboro, North Carolina	2001

Class B

Wesley S. Williams, Jr.	Partner, Covington & Burling, Washington, D.C.	1999
James E. Haden	President and Chief Executive Officer, Martha Jefferson Hospital, Charlottesville, Virginia	2000
Craig A. Ruppert	President, Ruppert Nurseries, Inc., Laytonsville, Maryland	2001

Class C

Jeremiah J. Sheehan	Chairman and Chief Executive Officer, Reynolds Metals Company, Richmond, Virginia	1999
Claudine B. Malone	President, Financial & Management Consulting, Inc., McLean, Virginia	2000
Irwin Zazulia	President and Chief Executive Officer, Hecht’s, Arlington, Virginia	2001

Baltimore Branch

Appointed by the Federal Reserve Bank

Morton I. Rapoport	President and Chief Executive Officer, University of Maryland Medical System, Baltimore, Maryland	1999
William L. Jews	President and Chief Executive Officer, Blue Cross Blue Shield of Maryland, Owings Mills, Maryland	2000

DISTRICT 5, Baltimore Branch

Appointed by the Federal Reserve Bank—Continued

		Term expires Dec. 31
Virginia W. Smith	President and Chief Executive Officer, Union National Bank, Westminster, Maryland	2000
Jeremiah E. Casey	Director and Former Chairman, Allfirst Financial, Inc., Baltimore, Maryland	2001

Appointed by the Board of Governors

George L. Russell, Jr.	Partner, Piper & Marbury, L.L.P., Baltimore, Maryland	1999
Betty Bednarczyk	International Secretary–Treasurer, Service Employees International Union, AFL-CIO, CLC, Washington, D.C.	2000
Daniel R. Baker	President & Chief Executive Officer, Tate Access Floors, Inc., Jessup, Maryland	2001

Charlotte Branch

Appointed by the Federal Reserve Bank

Lucy J. Reuben	Dean, School of Business, South Carolina State University, Orangeburg, South Carolina	1999
Elleveen T. Poston	President, Quality Transport, Inc., Lake City, South Carolina	2000
Cecil W. Sewell, Jr.	Chairman and Chief Executive Officer, Centura Banks, Inc., Rocky Mount, North Carolina	2000
William H. Nock	President and Chief Executive Officer, Sumter National Bank, Sumter, South Carolina	2001

Appointed by the Board of Governors

Dennis D. Lowery	Chief Executive Officer and Chairman, Continental Chemicals, Charlotte, North Carolina	1999
Joan H. Zimmerman	President, Southern Shows, Inc., Charlotte, North Carolina	2000
James O. Roberson	President, Research Triangle Foundation of North Carolina, Research Triangle Park, North Carolina	2001

DISTRICT 6—Atlanta

Class A

Howard L. McMillan, Jr.	Wealth Management & Investments, Morgan Stanley Dean Witter, Jackson, Mississippi	1999

DISTRICT 6, *Class A*—Continued

		Term expires Dec. 31
D. Paul Jones, Jr.	Chairman and Chief Executive Officer, Compass Bancshares, Inc., Birmingham, Alabama	2000
Waymon L. Hickman	Chairman and Chief Executive Officer, First Farmers and Merchants National Bank, Columbia, Tennessee	2001

Class B

Juanita P. Baranco	Executive Vice President, Baranco Automotive Group, Morrow, Georgia	1999
John Dane III	Chairman, President, and Chief Operating Officer, Friede Goldman Halter, Inc., Gulfport, Mississippi	2000
Suzanne E. Boas	President, Consumer Credit Counseling Service, Inc., Atlanta, Georgia	2001

Class C

John F. Wieland	Chief Executive Officer and Chairman, John Wieland Homes and Neighborhoods, Inc., Atlanta, Georgia	1999
Paula Lovell	President, Lovell Communications, Inc., Nashville, Tennessee	2000
Maria Camila Leiva	Executive Vice President, Miami Free Zone Corporation, Miami, Florida	2001

BIRMINGHAM BRANCH

Appointed by the Federal Reserve Bank

W. Charles Mayer III	President, Alabama Banking Group, AmSouth Bank, Birmingham, Alabama	1999
Roland Pugh	Chairman, Roland Pugh Construction, Inc., Northport, Alabama	2000
Hundley Batts, Sr.	Owner and Managing Agent, Hundley Batts & Associates, Huntsville, Alabama	2000
Robert M. Barrett	President, Union Planters National Bank, Wetumpka, Alabama	2001

Appointed by the Board of Governors

V. Larkin Martin	Managing Partner, Martin Farm, Courtland, Alabama	1999
D. Bruce Carr	Labor-Relations Liaison, Laborers' District Council of Alabama, Gadsden, Alabama	2000
Catherine Sloss Crenshaw	President, Sloss Real Estate Group, Birmingham, Alabama	2001

DISTRICT 6, Atlanta—Continued

Jacksonville Branch

Appointed by the Federal Reserve Bank

		Term expires Dec. 31
William G. Smith, Jr.	President and Chief Executive Officer, Capital City Bank Group, Tallahassee, Florida	1999
Terry R. West	President and Chief Executive Officer, Jax Navy Federal Credit Union, Jacksonville, Florida	2000
Michael W. Poole	Principal, Poole Carbone Capital Partners, Inc., Winter Park, Florida	2000
Harvey R. Heller	President, Heller Bros. Packing Corp., Winter Garden, Florida	2001

Appointed by the Board of Governors

		Term expires Dec. 31
Marsha G. Rydberg	Partner, Foley & Lardner, Tampa, Florida	1999
William E. Flaherty	Chairman, Blue Cross and Blue Shield of Florida, Inc., Jacksonville, Florida	2000
Julie K. Hilton	Vice President and Partner, Paradise Found Resorts & Hotels, Panama City Beach, Florida	2001

Miami Branch

Appointed by the Federal Reserve Bank

		Term expires Dec. 31
D. Keith Cobb	Chairman, Laundromax, Inc., Ft. Lauderdale, Florida	1999
James W. Moore	Managing Partner, Riverside Capital, LLC, Fort Myers, Florida	1999
Carlos A. Migoya	Regional President, Dade and Monroe Counties, First Union National Bank of Florida, Miami, Florida	2000
Vacancy		2001

Appointed by the Board of Governors

		Term expires Dec. 31
Mark T. Sodders	President, Lakeview Farms, Inc., Pahokee, Florida	1999
Kaaren Johnson-Street	President, Kaaren Street Associates, Inc., Miami, Florida	2000
Gregg Borgeson	President and Chief Executive Officer, Hellmann International Forwarders, Inc., Miami, Florida	2001

Term expires Dec. 31

DISTRICT 6, NASHVILLE BRANCH

Appointed by the Federal Reserve Bank

Leonard A. Walker, Jr.	Chairman and Chief Executive Officer, First National Bank and Trust Company, Athens, Tennessee	1999
James E. Dalton, Jr.	President and Chief Executive Officer, Quorum Health Group, Inc., Brentwood, Tennessee	2000
John E. Seward, Jr.	President and Chief Executive Officer, PLC, Inc., Piney Flats, Tennessee	2000
Dale W. Polley	President, First American National Bank, Nashville, Tennessee	2001

Appointed by the Board of Governors

Michael E. Bennett	Past UAW Manufacturing Adviser, Saturn Corporation, Spring Hill, Tennessee	1999
Whitney Johns Martin	Chairman and Chief Executive Officer, Capital Across America, Nashville, Tennessee	2000
Frances F. Marcum	Director, Micro Craft, Inc., Tullahoma, Tennessee	2001

NEW ORLEANS BRANCH

Appointed by the Federal Reserve Bank

Howard C. Gaines	President, Military Division, First USA Partners, Bank One, New Orleans, Louisiana	1999
Teri G. Fontenot	President and Chief Executive Officer, Woman's Health Foundation, Baton Rouge, Louisiana	2000
David Guidry	President and Chief Executive Officer, Guico Machine Works, Inc., Harvey, Louisiana	2000
Howell N. Gage	Chairman, Vicksburg Advisory Group, BankCorp South, Vicksburg, Mississippi	2001

Appointed by the Board of Governors

Glenn Pumpelly	President and Chief Executive Officer, Pumpelly Oil, Inc., Sulphur, Louisiana	1999
Ben Tom Roberts	Senior Executive Vice President, Roberts Brothers, Inc., Mobile, Alabama	2000
Dwight H. Evans	President and Chief Executive Officer, Mississippi Power Company, Gulfport, Mississippi	2001

DISTRICT 7—CHICAGO

Class A

		Term expires Dec. 31
Verne G. Istock	President, Bank One Corporation, Chicago, Illinois	1999
Robert R. Yohanan	Managing Director and Chief Executive Officer, First Bank & Trust of Evanston, Evanston, Illinois	2000
Alan R. Tubbs	President, Maquoketa State Bank and Ohnward Bancshares Inc., Maquoketa, Iowa	2001

Class B

Migdalia Rivera	Former Executive Director, Latino Institute, Chicago, Illinois	1999
Jack B. Evans	President, The Hall-Perrine Foundation, Cedar Rapids, Iowa	2000
James H. Keyes	Chairman and Chief Executive Officer, Johnson Controls, Inc., Milwaukee, Wisconsin	2001

Class C

Robert J. Darnall	President and Chief Executive Officer, Ispat North America, Chicago, Illinois	1999
Lester H. McKeever, Jr.	Managing Partner, Washington, Pittman & McKeever, Chicago, Illinois	2000
Arthur C. Martinez	Chairman and Chief Executive Officer, Sears, Roebuck and Co., Hoffman Estates, Illinois	2001

DETROIT BRANCH

Appointed by the Federal Reserve Bank

Denise Ilitch	President, Olympia Development, Inc., Detroit, Michigan	1999
Irma B. Elder	President, Troy Motors, Inc., Troy, Michigan	1999
David J. Wagner	Chairman, President, and Chief Executive Officer, Old Kent Financial Corporation, Grand Rapids, Michigan	2000
Richard M. Bell	President and Chief Executive Officer, The First National Bank of Three Rivers, Three Rivers, Michigan	2001

Appointed by the Board of Governors

Florine Mark	President and Chief Executive Officer, The WW Group, Inc., Farmington Hills, Michigan	1999
Timothy D. Leuliette	Senior Managing Director and Chief Executive Officer, Heartland Industrial Partners, LP, Bloomfield Hills, Michigan	2000
Stephen R. Polk	Chairman and Chief Executive Officer, R.L. Polk & Co., Southfield, Michigan	2001

DISTRICT 8—St. Louis

Class A

		Term expires Dec. 31
W.D. Glover	Chairman and Chief Executive Officer, First National Bank of Eastern Arkansas, Forrest City, Arkansas	1999
Michael A. Alexander	Chairman and President, First National Bank, Mt. Vernon, Illinois	2000
Thomas H. Jacobsen	Chairman, Firstar Corporation, St. Louis, Missouri	2001

Class B

Joseph E. Gliessner, Jr.	Executive Director, New Directions Housing Corp., Louisville, Kentucky	1999
Robert L. Johnson	Chairman and Chief Executive Officer, Johnson Bryce, Inc., Memphis, Tennessee	2000
Bert Greenwalt	Partner, Greenwalt Company, Hazen, Arkansas	2001

Class C

Veo Peoples, Jr.	Partner, Haverstock, Garrett and Roberts, St. Louis, Missouri	1999
Susan S. Elliott	Chairman and Chief Executive Officer, Systems Service Enterprises, Inc., St. Louis, Missouri	2000
Charles W. Mueller	Chairman, President, and Chief Executive Officer, Ameren Corporation, St. Louis, Missouri	2001

Little Rock Branch

Appointed by the Federal Reserve Bank

Mark Simmons	Chairman, Simmons Foods, Inc., Siloam Springs, Arkansas	1999
Ross M. Whipple	Chairman, Horizon Bank of Columbia County, Magnolia, Arkansas	1999
Lunsford W. Bridges	President and Chief Executive Officer, Metropolitan National Bank, Little Rock, Arkansas	2000
Lawrence A. Davis, Jr.	Chancellor, University of Arkansas at Pine Bluff, Pine Bluff, Arkansas	2001

Appointed by the Board of Governors

Janet M. Jones	President, The Janet Jones Company, Little Rock, Arkansas	1999
Diana T. Hueter	Hueter and Associates, Inc., Little Rock, Arkansas	2000
Vick M. Crawley	Plant Manager, Baxter Healthcare Corporation, Mountain Home, Arkansas	2001

DISTRICT 8, Louisville Branch

Appointed by the Federal Reserve Bank

		Term expires Dec. 31
Larry E. Dunigan	Chairman and Chief Executive Officer, Holiday Management Corp., Evansville, Indiana	1999
Edwin K. Page	Vice President, External Affairs, AP Technoglass Co., Elizabethtown, Kentucky	1999
Frank J. Nichols	Chairman, President, and Chief Executive Officer, Bank of Benton, Benton, Kentucky	2000
Orson Oliver	President, Mid-America Bank of Louisville, Louisville, Kentucky	2001

Appointed by the Board of Governors

J. Stephen Barger	Executive Secretary–Treasurer, Kentucky State District Council of Carpenters, AFL-CIO, Frankfort, Kentucky	1999
Debbie Scoppechio	Chairman and Chief Executive Officer, Creative Alliance, Inc., Louisville, Kentucky	2000
Roger Reynolds	President and Chief Executive Officer, Reynolds Coatings, LLC, Louisville, Kentucky	2001

Memphis Branch

Appointed by the Federal Reserve Bank

Katie S. Winchester	President, Chief Executive Officer, and Director, First Citizens National Bank, Dyersburg, Tennessee	1999
John C. Kelley, Jr.	President, Memphis Banking Group, First Tennessee Bank, Memphis, Tennessee	1999
E.C. Neelly III	Chief Executive Officer, First American National Bank, Iuka, Mississippi	2000
Walter L. Morris, Jr.	President, H & M Lumber Co., Inc., West Helena, Arkansas	2001

Appointed by the Board of Governors

Mike P. Sturdivant, Jr.	Partner, Due West, Glendora, Mississippi	1999
Carol G. Crawley	Senior Vice President, Community Development, Memphis Area Chamber of Commerce, Memphis, Tennessee	2000
Gregory M. Duckett	Senior Vice President and Corporate Counsel, Baptist Memorial Health Care Corporation, Memphis, Tennessee	2001

DISTRICT 9—MINNEAPOLIS

Class A

		Term expires Dec. 31
Lynn M. Hoghaug	President, Ramsey National Bank and Trust Co., Devils Lake, North Dakota	1999
Bruce Parker	President, Norwest Bank Montana, Billings, Montana	2000
W.W. LaJoie	Chief Executive Officer and Chairman, Central Savings Bank, Sault Ste. Marie, Michigan	2001

Class B

		Term expires Dec. 31
Rob L. Wheeler	Vice President, Wheeler Manufacturing Co., Inc., Lemmon, South Dakota	1999
Kathryn L. Ogren	Owner, Bitterroot Motors, Missoula, Montana	2000
Jay F. Hoeschler	President and Owner, Hoeschler Corporation, La Crosse, Wisconsin	2001

Class C

		Term expires Dec. 31
David A. Koch	Chairman, Graco, Inc., Plymouth, Minnesota	1999
Ronald N. Zwieg	President, United Food & Commercial Workers, Local 653, Plymouth, Minnesota	2000
James J. Howard	Chairman, President, and Chief Executive Officer, Northern States Power Company, Minneapolis, Minnesota	2001

HELENA BRANCH

Appointed by the Federal Reserve Bank

		Term expires Dec. 31
Richard E. Hart	President, Mountain West Bank, Great Falls, Montana	1999
Emil W. Erhardt	Chairman and President, Citizens State Bank, Hamilton, Montana	2000
Sandra M. Stash, P.E.	Vice President, Environmental Services, ARCO Environmental Remediation, L.L.C., Anaconda, Montana	2001

Appointed by the Board of Governors

		Term expires Dec. 31
Thomas O. Markle	President and Chief Executive Officer, Markle's Inc., Glasgow, Montana	1999
William P. Underriner	General Manager, Selover Buick Inc., Billings, Montana	2000

Term expires
Dec. 31

DISTRICT 10—Kansas City

Class A

Dennis E. Barrett	Vice Chairman, FirstBank Holding Company of Colorado, Lakewood, Colorado	1999
Bruce A. Schriefer	President, Bankers' Bank of Kansas, Wichita, Kansas	2000
Jeffrey L. Gerhart	President and Chief Executive Officer, First National Bank, Newman Grove, Nebraska	2001

Class B

Charles W. Nichols	Managing Partner, Davison & Sons Cattle Company, Arnett, Oklahoma	1999
Hans Helmerich	President and Chief Executive Officer, Helmerich & Payne, Inc., Tulsa, Oklahoma	2000
Frank A. Potenziani	M & T Trust, Albuquerque, New Mexico	2001

Class C

Colleen D. Hernandez	Executive Director, Kansas City Neighborhood Alliance, Kansas City, Missouri	1999
Terrence P. Dunn	President and Chief Executive Officer, J.E. Dunn Construction Company, Kansas City, Missouri	2000
Jo Marie Dancik	Area Managing Partner, Ernst & Young, LLP, Minneapolis, Minnesota	2001

Denver Branch

Appointed by the Federal Reserve Bank

C.G. Mammel	President and Chief Executive Officer, The Bank of Cherry Creek, N.A., Denver, Colorado	1999
Robert M. Murphy	President, Sandia Properties Ltd., Co., Albuquerque, New Mexico	2000
John W. Hay III	President, Rock Springs National Bank, Rock Springs, Wyoming	2000
Albert C. Yates	President, Colorado State University, Ft. Collins, Colorado	2001

Appointed by the Board of Governors

Teresa N. McBride	Chief Executive Officer, McBride and Associates, Inc., Albuquerque, New Mexico	1999
Kathryn A. Paul	President, Western Operations (Retired), Kaiser Permanente, Denver, Colorado	2000
James A. King	Chief Executive Officer, BT, Incorporated, Riverton, Wyoming	2001

Oklahoma City Branch

Appointed by the Federal Reserve Bank

		Term expires Dec. 31
William H. Braum	President, Braum Ice Cream Co., Oklahoma City, Oklahoma	1999
Michael S. Samis	President and Chief Executive Officer, Macklanburg–Duncan Co., Oklahoma City, Oklahoma	2000
Betty Bryant Shaull	President-Elect and Director, Bank of Cushing and Trust Company, Cushing, Oklahoma	2001
W. Carlisle Mabrey III	President and Chief Executive Officer, Citizens Bank & Trust Co., Okmulgee, Oklahoma	2001

Appointed by the Board of Governors

Larry W. Brummett	Chairman, President, and Chief Executive Officer, ONEOK, Inc., Tulsa, Oklahoma	1999
Patricia B. Fennell	Executive Director, Latino Community Development Agency, Oklahoma City, Oklahoma	2000
David L. Kruse II	Senior Vice President, American Airlines, Inc., Tulsa, Oklahoma	2001

Omaha Branch

Appointed by the Federal Reserve Bank

Bruce R. Lauritzen	Chairman and President, First National Bank of Omaha, Omaha, Nebraska	1999
Frank L. Hayes	President, Hayes & Associates, L.L.C., Omaha, Nebraska	2000
H.H. Kosman	Chairman, President, and Chief Executive Officer, Platte Valley National Bank, Scottsbluff, Nebraska	2000
Bill L. Fairfield	Chairman, Inacom Corp., Omaha, Nebraska	2001

Appointed by the Board of Governors

Bob L. Gottsch	Vice President, Gottsch Feeding Corporation, Hastings, Nebraska	1999
A.F. Raimondo	Chairman and Chief Executive Officer, Behlen Manufacturing Company, Columbus, Nebraska	2000
Gladys Styles Johnston	Chancellor, University of Nebraska at Kearney, Kearney, Nebraska	2001

DISTRICT 11—DALLAS

Class A

		Term expires Dec. 31
Gayle M. Earls	President and Chief Executive Officer, The Independent Bankers Bank, Dallas, Texas	1999
Kirk A. McLaughlin	President and Chief Executive Officer, Security Bank, Ralls, Texas	2000
Dudley K. Montgomery	President and Chief Executive Officer, The Security State Bank of Pecos, Pecos, Texas	2001

Class B

Dan Angel	President, Stephen F. Austin State University, Nacogdoches, Texas	1999
Judy Ley Allen	Partner, Allen Investments, Houston, Texas	2000
Julie S. England	Vice President, Texas Instruments, Dallas, Texas	2001

Class C

James A. Martin	Second General Vice President (Retired), International Association of Bridge, Structural, Ornamental, and Reinforcing Iron Workers, Austin, Texas	1999
H.B. Zachry, Jr.	Chairman and Chief Executive Officer, H.B. Zachry Company, San Antonio, Texas	2000
Roger R. Hemminghaus	Chairman, Ultramar Diamond Shamrock Corp., San Antonio, Texas	2001

EL PASO BRANCH

Appointed by the Federal Reserve Bank

James D. Renfrow	President and Chief Executive Officer, The Carlsbad National Bank, Carlsbad, New Mexico	1999
Melissa W. O'Rourke	President, Charlotte's Inc., El Paso, Texas	1999
Cecil E. Nix	Member, IBEW Local 460, Midland, Texas	2000
Lester L. Parker	El Paso, Texas	2001

Appointed by the Board of Governors

Patricia Z. Holland-Branch	President and Chief Executive Officer, HB/PZH Commercial Environments, Inc., El Paso, Texas	1999
Gail S. Darling	President, Gail Darling, Inc., El Paso, Texas	2000
Beauregard Brite White	Rancher, J.E. White, Jr. & Sons, Marfa, Texas	2001

DISTRICT 11, Houston Branch

Appointed by the Federal Reserve Bank

		Term expires Dec. 31
Judith B. Craven	Physician and Administrator, Houston, Texas	1999
Ray B. Nesbitt	President (Retired), Exxon Chemical Company, Houston, Texas	1999
Alan R. Buckwalter III	Chairman and Chief Executive Officer, Chase Bank of Texas, N.A., Houston, Texas	2000
Richard W. Weekley	Chairman, Weekley Development Company, Houston, Texas	2001

Appointed by the Board of Governors

Peggy Pearce Caskey	President, PPC Holding, L.L.C., Houston, Texas	1999
Malcolm Gillis	President, Rice University, Houston, Texas	2000
Edward O. Gaylord	Chairman, Jacintoport Terminal Company, Houston, Texas	2001

San Antonio Branch

Appointed by the Federal Reserve Bank

Juliet V. Garcia	President, The University of Texas at Brownsville, Brownsville, Texas	1999
Douglas G. MacDonald	President, South Texas National Bank, Laredo, Texas	1999
Arthur R. Emerson	Vice President and General Manager, KVDA-TV 60, San Antonio, Texas	2000
R. Tom Roddy	Chairman, CaminoReal Bank, San Antonio, Texas	2001

Appointed by the Board of Governors

Patty P. Mueller	Vice President, Mueller Energetics Corp., Corpus Christi, Texas	1999
Marvin L. Ragsdale	President, Iron Workers District Council of the State of Texas, Austin, Texas	2000
Ron R. Harris	President and Chief Executive Officer, Pervasive Software, Austin, Texas	2001

DISTRICT 12—SAN FRANCISCO

Class A

		Term expires Dec. 31
E. Lynn Caswell	Chairman and Chief Executive Officer, Pacific Community Banking Group, Laguna Hills, California	1999
John V. Rindlaub	President, Northwest Region, Bank of America, Seattle, Washington	2000
Warren K.K. Luke	Chairman and Chief Executive Officer, Hawaii National Bank, Honolulu, Hawaii	2001

Class B

		Term expires Dec. 31
Robert S. Attiyeh	Senior Vice President and Chief Financial Officer (Retired), Amgen, Inc., Thousand Oaks, California	1999
Krestine Corbin	President and Chief Executive Officer, Sierra Machinery, Inc., Sparks, Nevada	2000
Vacancy		2001

Class C

		Term expires Dec. 31
Gary G. Michael	Chairman and Chief Executive Officer, Albertson's, Inc., Boise, Idaho	1999
Nelson C. Rising	President and Chief Executive Officer, Catellus Development Corporation, San Francisco, California	2000
Sheila D. Harris	Consultant, Harris Consulting, Litchfield Park, Arizona	2001

LOS ANGELES BRANCH

Appointed by the Federal Reserve Bank

		Term expires Dec. 31
John H. Gleason	Executive Vice President, Del Webb Corporation, Phoenix, Arizona	1999
Liam E. McGee	President, Bank of America Southern California, Los Angeles, California	2000
Linda Griego	President and Chief Executive Officer, Los Angeles Community Development Bank, Los Angeles, California	2000
Russell Goldsmith	Chairman and Chief Executive Officer, City National Bank, Beverly Hills, California	2001

Appointed by the Board of Governors

		Term expires Dec. 31
Lori R. Gay	President, Los Angeles Neighborhood Housing Service, Los Angeles, California	1999
Lonnie Kane	President, Karen Kane, Inc., Los Angeles, California	2000
William D. Jones	Chairman, President, and Chief Executive Officer, CityLink Investment Corporation, San Diego, California	2001

DISTRICT 12, PORTLAND BRANCH

Appointed by the Federal Reserve Bank

		Term expires Dec. 31
Phyllis A. Bell	President, Oregon Coast Aquarium, Newport, Oregon	1999
Martin Brantley	President and General Manager, Oregon Television, Inc., KPTV-12, Portland, Oregon	1999
Guy L. Williams	President and Chief Executive Officer, Security Bank, Coos Bay, Oregon	2000
Gary T. Duim	Vice Chairman, U.S. Bancorp, Portland, Oregon	2001

Appointed by the Board of Governors

Nancy Wilgenbusch	President, Marylhurst University, Marylhurst, Oregon	1999
Patrick Borunda	Director, Oweesta Fund, First Nation's Development Institute, Vancouver, Washington	2000
Karla S. Chambers	Vice President, Stahlbush Island Farms, Inc., Corvallis, Oregon	2001

SALT LAKE CITY BRANCH

Appointed by the Federal Reserve Bank

J. Pat McMurray	President, First Security Bank, N.A., Boise, Idaho	1999
Maria Garciaz	Executive Director, Salt Lake Neighborhood Housing Services, Salt Lake City, Utah	1999
R.D. Cash	Chairman, President, and Chief Executive Officer, Questar Corporation, Salt Lake City, Utah	2000
Curtis H. Harris	Chairman, President, and Chief Executive Officer, Barnes Banking Company, Kaysville, Utah	2001

Appointed by the Board of Governors

Nancy S. Mortensen	Vice President–Marketing Services, ZCMI, Salt Lake City, Utah	1999
Barbara L. Wilson	Idaho and Regional Vice President, U.S. West, Boise, Idaho	2000
Jon M. Huntsman, Jr.	Vice Chairman, Huntsman Corporation, Salt Lake City, Utah	2001

DISTRICT 12, SEATTLE BRANCH

Appointed by the Federal Reserve Bank

		Term expires Dec. 31
Tomio Moriguchi	Chairman and Chief Executive Officer, Uwajimaya, Inc., Seattle, Washington	1999
James C. Hawkanson	Managing Director and Chief Executive Officer, The Commerce Bank of Washington, N.A., Seattle, Washington	1999
Betsy Lawer	Vice Chair and Chief Operating Officer, First National Bank of Anchorage, Anchorage, Alaska	2000
Peter H. van Oppen	Chairman and Chief Executive Officer, Advanced Digital Information Corp., Redmond, Washington	2001

Appointed by the Board of Governors

Boyd E. Givan	Senior Vice President and Chief Financial Officer (Retired), The Boeing Company, Seattle, Washington	1999
Richard R. Sonstelie	Chairman, Puget Sound Energy, Inc., Bellevue, Washington	2000
Helen M. Rockey	President and Chief Executive Officer, Just for Feet, Inc., Seattle, Washington	2001

Membership of the Board of Governors, 1913–99

Appointed Members

Name	Federal Reserve District	Date initially took oath of office	Other dates[1]
Charles S. Hamlin	Boston	Aug. 10, 1914	Reappointed in 1916 and 1926. Served until Feb. 3, 1936.[2]
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.[2]
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.[3]
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.[2]
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.[2]
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.[2]
Rudolph M. Evans	Richmond	Mar. 14, 1942	Served until Aug. 13, 1954.[2]
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.

Appointed Members—Continued

Name	Federal Reserve District	Date initially took oath of office	Other dates[1]
C. Canby Balderston	Philadelphia	Aug. 12, 1954	Served through Feb. 28, 1966.
Paul E. Miller	Minneapolis	Aug. 13, 1954	Died Oct. 21, 1954.
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.[2]
J. Dewey Daane	Richmond	Nov. 29, 1963	Served until Mar. 8, 1974.[2]
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.[2]
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	Reappointed in 1990.
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	
Alice M. Rivlin	Philadelphia	June 25, 1996	Resigned July 16, 1999.
Roger W. Ferguson, Jr.	Boston	Nov. 5, 1997	
Edward M. Gramlich	Richmond	Nov. 5, 1997	

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

CHAIRMEN[3]

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[4]
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–[5]

VICE CHAIRMEN[3]

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–

Ex-Officio Members

SECRETARIES OF THE TREASURY

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

COMPTROLLERS OF THE CURRENCY

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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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.

Financial Statements and Statistical Tables

Board of Governors Financial Statements

The financial statements of the Board for 1999 and 1998 were audited by Deloitte & Touche LLP, independent auditors.

Deloitte &
Touche

Independent Auditors' Report

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, 1999 and 1998, and the related statements of revenues and expenses and fund balance, and of 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 generally accepted auditing standards and the standards applicable to financial audits contained in *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 accompanying financial statements present fairly, in all material respects, the financial position of the Board as of December 31, 1999 and 1998, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note 5 to the financial statements, in 1999 the Board changed its method of accounting for the costs of software obtained for internal use.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 18, 2000, on our consideration of the Board's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

February 18, 2000

Deloitte Touche
Tohmatsu

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEETS

	As of December 31,	
	1999	1998
ASSETS		
CURRENT ASSETS		
Cash	$31,072,908	$20,111,430
Accounts receivable	873,148	910,282
Prepaid expenses and other assets	794,000	1,215,277
Total current assets	32,740,056	22,236,989
PROPERTY, BUILDINGS, AND EQUIPMENT, NET (Note 5)	63,928,406	58,438,555
Total assets	$96,668,462	$80,675,544
LIABILITIES AND FUND BALANCE		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	$12,360,089	$ 8,231,187
Accrued payroll and related taxes	7,090,754	7,745,624
Accrued annual leave	8,063,655	7,493,533
Capital lease payable (current portion)	172,058	135,205
Unearned revenues and other liabilities	2,347,303	2,034,129
Total current liabilities	30,033,859	25,639,678
CAPITAL LEASE PAYABLE (non-current portion)	366,464	406,773
ACCUMULATED RETIREMENT BENEFIT OBLIGATION (Note 2)	747,717	773,177
ACCUMULATED POSTRETIREMENT BENEFIT OBLIGATION (Note 3)	3,614,828	20,721,869
ACCUMULATED POSTEMPLOYMENT BENEFIT OBLIGATION (Note 4)	2,581,079	2,183,602
Total liabilities	37,343,947	49,725,099
FUND BALANCE	59,324,515	30,950,445
Total liabilities and fund balance	$96,668,462	$80,675,544

See notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF REVENUES AND EXPENSES AND FUND BALANCE

	For the years ended December 31, 1999	For the years ended December 31, 1998
BOARD OPERATING REVENUES		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures	$213,789,510	$ 178,008,900
Other revenues (Note 6)	8,661,435	8,345,087
Total operating revenues	222,450,945	186,353,987
BOARD OPERATING EXPENSES		
Salaries	115,618,738	110,455,527
Retirement and insurance contributions	16,012,513	18,684,301
Contractual services and professional fees	15,642,464	17,913,599
Depreciation and net losses on disposals	8,124,505	13,013,690
Postage and supplies	6,879,584	6,843,836
Utilities	6,109,935	4,798,940
Travel	5,970,437	5,170,630
Equipment and facilities rental	4,761,618	4,257,297
Software	4,189,644	4,344,064
Repairs and maintenance	3,662,547	3,280,615
Printing and binding	2,387,568	2,138,315
Other expenses (Note 6)	4,717,322	3,931,877
Total operating expenses	194,076,875	194,832,691
BOARD OPERATING REVENUES OVER (UNDER) EXPENSES	28,374,070	(8,478,704)
ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES		
Assessments levied on Federal Reserve Banks for currency costs	484,959,221	408,544,472
Expenses for currency printing, issuance, retirement, and shipping	484,959,221	408,544,472
CURRENCY ASSESSMENTS OVER (UNDER) EXPENSES	0	0
TOTAL REVENUE OVER (UNDER) EXPENSES	28,374,070	(8,478,704)
FUND BALANCE, Beginning of year	30,950,445	39,429,149
TRANSFERS TO THE U.S. TREASURY		
Transfers and accrued transfers from surplus Federal Reserve Bank earnings (Note 1)	0	18,438,855,572
Transfers and accrued transfers to the U.S. Treasury (Note 1)	0	(18,438,855,572)
FUND BALANCE, End of year	$ 59,324,515	$ 30,950,445

See notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF CASH FLOWS

	For the years ended December 31,	
	1999	1998
CASH FLOWS FROM OPERATING ACTIVITIES		
Board operating revenues over (under) expenses	$28,374,070	$ (8,478,704)
Adjustments to reconcile operating revenue over (under) expenses to net cash provided by operating activities:		
Depreciation and net losses on disposals	8,124,505	13,013,690
(Increase) decrease in accounts receivable, prepaid expenses and other assets	458,411	(62,185)
(Increase) decrease in transfers receivable—surplus Federal Reserve Bank earnings	0	652,913,560
Increase (decrease) in accounts payable and accrued liabilities	4,128,902	(1,566,642)
Increase (decrease) in accrued payroll and related taxes	(654,870)	135,843
Increase (decrease) in transfers payable—surplus Federal Reserve Bank earnings	0	(652,913,560)
Increase (decrease) in accrued annual leave	570,122	16,346
Increase (decrease) in capital lease payable	(3,456)	(73,022)
Increase (decrease) in unearned revenues and other liabilities	313,174	17,939
Increase (decrease) in accumulated retirement benefit obligation	(25,460)	32,680
Increase (decrease) in accumulated postretirement benefit obligation	(17,107,041)	528,835
Increase (decrease) in accumulated postemployment benefit obligation	397,477	413,956
Net cash provided by operating activities	24,575,834	3,978,736
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from disposals	88,292	16,400
Capital expenditures	(13,702,648)	(7,248,540)
Net cash used in investing activities	(13,614,356)	(7,232,140)
NET INCREASE (DECREASE) IN CASH	10,961,478	(3,253,404)
CASH BALANCE, Beginning of year	20,111,430	23,364,834
CASH BALANCE, End of year	$31,072,908	$ 20,111,430
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Capital lease obligations incurred	$ 123,020	$ 0

See notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOTES TO FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 1999 AND 1998

(1) SIGNIFICANT ACCOUNTING POLICIES

Organization—The Federal Reserve System was founded by Congress in 1913 and consists of the Board of Governors (Board) and twelve regional Reserve Banks. The Board 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 accompany financial statements include only the operations and activities for the Board and are prepared in accordance with generally accepted accounting principles.

Board Operating Revenues and Expenses—Assessments made on the Federal Reserve Banks for Board operating expenses and capital expenditures are calculated based on expected cash needs. These assessments, other operating revenues, and operating expenses are recorded on the accrual basis of accounting.

Issuance and Redemption of Federal Reserve Notes—The Board incurs expenses and assesses the Federal Reserve Banks for the costs of printing, issuing, shipping, and retiring 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, Buildings 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 4 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.

Federal Reserve Bank Surplus Earnings—The Omnibus Budget Reconciliation Act of 1993 required that surplus Federal Reserve Bank earnings be transferred from the Banks to the Board and then to the U.S. Treasury for the period October 1, 1996, to September 30, 1998. Prior to October 1, 1996, and after September 30, 1998, the Federal Reserve Banks made their transfers directly to the Treasury. The Board accounted for these transfers when earned and due, which may have resulted in transfers receivable and payable as of the balance sheet date.

Estimates—The preparation of financial statements in conformity with generally accepted accounting principles 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 1998 amounts have been reclassified to conform with the 1999 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 multiemployer 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 1999 and 1998, and the Board was not assessed a contribution for these years. Excess Plan assets will continue to fund future years' contributions. The Board is not accountable for the assets of this plan.

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 benefits plans are administered by the Office of Personnel Management. The Board's contributions to these plans totaled $244,000 and $233,000 in 1999 and 1998, 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 $4,966,000 and $4,794,000 in 1999 and 1998, 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 because of 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 1999 and 1998 is summarized in the following table:

	1999	1998
Change in benefit obligation		
Benefit obligation at beginning of year	$897,822	$527,980
Service cost	12,206	65,357
Interest cost	37,840	21,296
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss	(234,999)	319,002
Benefits paid	(81,605)	(35,813)
Benefit obligation at end of year	$631,264	$897,822

	1999	1998
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	81,605	35,813
Plan participants' contributions	0	0
Benefits paid	(81,605)	(35,813)
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
Funded status	$ (631,264)	$ (897,822)
Unrecognized net actuarial (gain)/loss	(320,381)	(109,357)
Unrecognized prior service cost	(851,331)	(923,851)
Unrecognized net transistion obligation	1,055,259	1,157,853
Prepaid/(accrued) postretirement benefit cost	$ (747,717)	$ (773,177)
Amounts recognized in the Statement of Financial Position consist of:		
Prepaid benefit cost	$ 0	$ 0
Accrued benefit liability	(747,717)	(844,000)
Intangible asset	0	70,823
Accumulated other comprehensive income	0	0
Net amount recognized	$ (747,717)	$ (773,177)
Weighted-average assumptions as of December 31		
Discount rate	7.50%	6.25%
Expected asset return	N/A	N/A
Salary scale	5.00%	4.25%
Corridor	10.00%	10.00%
Components of net periodic expense for year		
Service cost	$ 12,206	$ 65,357
Interest cost	37,840	21,296
Expected return on plan assets	0	0
Amortization of prior service cost	(72,520)	(72,520)
Recognized net actuarial gain	(23,975)	(48,234)
Amortization of net liability	102,594	102,594
Net periodic benefit expense	$ 56,145	$ 68,493

(3) Postretirement Benefits

The Board provides certain defined benefit health benefits (through 1998) and life insurance programs for its active employees and retirees. Activity for 1999 and 1998 is summarized in the following table:

	1999	1998
Change in benefit obligation		
Benefit obligation at beginning of year	$22,946,312	$22,973,898
Service cost	162,487	133,733
Interest cost	265,565	1,397,922
Plan participants' contributions	0	195,272
Plan amendments	(1,384,322)	0
Actuarial (gain)/loss	(1,703,601)	(549,800)
Benefits paid	(16,190,030)	(1,204,713)
Benefit obligation at end of year	$ 4,096,411	$22,946,312
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	16,190,030	1,009,441
Plan participants' contributions	0	195,272
Benefits paid	(16,190,030)	(1,204,713)
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
Funded status	$(4,096,411)	$(22,946,312)
Unrecognized net actuarial (gain)/loss	481,583	2,224,443
Unrecognized prior service cost	0	0
Unrecognized net transition obligation	0	0
Prepaid/(accrued) postretirement benefit cost	$(3,614,828)	$(20,721,869)
Components of net periodic expense for year		
Service cost	$ 162,487	$ 133,733
Interest cost	265,565	1,397,922
Amortization of prior service cost	0	0
Amortization of (gains)/losses	39,259	6,621
Total net periodic expense	467,311	1,538,276
Other credit	(1,384,322)	0
Total expense	$ (917,011)	$ 1,538,276

	1999	1998
Effect of a one-percentage point increase in health care cost trend rate on:		
Year-end benefit obligation	N/A	$2,382,383
Total of service and interest cost components	N/A	97,751
Effect of a one-percentage point decrease in health care cost trend rate on:		
Year-end benefit obligation	N/A	$(1,885,077)
Total of service and interest cost components	N/A	(156,553)

The liability and costs for the postretirement benefit plan were determined using discount rates of 7.50 percent as of December 31, 1999, and 6.25 percent as of December 31, 1998. Unrecognized losses of $481,583 and $2,224,443 as of December 31, 1999 and 1998, 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 6 percent.

The above accumulated postretirement benefit obligation is related to the Board sponsored health benefits (through 1998) and life insurance programs. During 1997, a special retirement program was offered to employees who were eligible to retire by May 31, 1998. This resulted in a curtailment loss of $1,174,489 for 1997, comprised of $1,044,096 for 62 employees covered by the Board sponsored health benefits plan, and $130,393 for 78 employees covered by the Board sponsored life insurance plan. The Board has no liability for future payments to employees who continue coverage under the federally sponsored programs upon retiring. Contributions for active employees participating in federally sponsored programs totaled $4,482,000 and $3,839,000 in 1999 and 1998, respectively.

The medical component of the benefit obligation at end of year 1998 was $18,538,000. Pursuant to the Federal Employees Health Care Act of 1998, on January 11, 1999, the Board paid the Office of Personnel Management $16,100,000 to compensate the Employee Health Benefits Fund for the costs of providing future health care benefits. Coverage for Board employees and retirees enrolled in the Federal Reserve System Health Plan terminated involuntarily on December 31, 1998. Therefore, data for the effect of a one-percentage point increase or decrease in health care cost trend rate is not applicable to 1999.

(4) POSTEMPLOYMENT BENEFIT PLAN

The Board provides certain postemployment 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. The postemployment benefit expense was $628,000 and $614,000 for 1999 and 1998, respectively.

(5) PROPERTY, BUILDINGS AND EQUIPMENT

The following is a summary of the components of the Board's property, buildings, and equipment, at cost, net of accumulated depreciation.

	As of December 31,	
	1999	1998
Land and improvements	$ 1,301,314	$ 1,301,314
Buildings	43,661,936	41,147,334
Furniture and equipment	49,187,837	42,723,644
Software	5,047,293	3,409,767
Construction in process	4,699,571	2,014,706
	103,897,951	90,596,765
Less accumulated depreciation	(39,969,545)	(32,158,210)
Property, buildings, and equipment, net	$ 63,928,406	$ 58,438,555

Furniture and equipment and accumulated depreciation include $738,000 and $225,000, and $615,000 and $102,500 as of December 31, 1999 and 1998, respectively, for capitalized leases.

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.

During 1998 the Board increased the threshold for capitalization of furniture and equipment from $1,000 to $5,000 per item. The Board expensed the undepreciated value of previously capitalized furniture and equipment not meeting the new capitalization threshold. The Board also simplified the method of capitalizing major building modifications, eliminating the previously used depreciation recovery method of reporting. For 1998, these changes increased depreciation expense $4,033,000, decreased cost by $44,112,000, and decreased accumulated depreciation by $40,079,000.

Effective January 1, 1999, in accordance with AICPA Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, the Board began to capitalize the costs of computer software developed or obtained for internal use. Prior to 1999, the Board capitalized purchased software only. For 1999, these changes increased software assets and decreased expenses by $1,691,000. For 1999, these changes did not affect accumulated depreciation.

(6) OTHER REVENUES AND OTHER EXPENSES

The following are summaries of the components of Other Revenues and Other Expenses.

	As of December 31, 1999	1998
Other revenues		
Data processing revenue	$4,073,910	$4,332,513
National Information Center	1,937,206	2,052,273
Subscription revenue	1,240,032	1,248,121
Reimbursable services to other agencies	609,442	147,491
Miscellaneous	800,845	564,689
Total Other Revenues	$8,661,435	$8,345,087
Other expenses		
Tuition, registration, and membership fees	$1,352,849	$1,428,717
Cafeteria operations, net	857,435	756,548
Subsidies and contributions	856,893	666,843
Miscellaneous	1,650,145	1,079,769
Total Other Expenses	$4,717,322	$3,931,877

(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, 1999, are as follows:

2000	$ 4,851,000
2001	4,846,000
2002	4,820,000
2003	4,578,000
2004	4,932,000
After 2004	6,247,000
	$30,274,000

Rental expenses under the operating leases were $4,334,000 and $3,873,000 in 1999 and 1998, 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’’). During 1999 and 1998, the Board paid $327,000 and $249,000, respectively, in assessments for operating expenses of the Council. These amounts are included in other expenses for 1999 and 1998. During 1998, the Board paid $159,000 for office space sub-leased from the Council, and the Board did not sub-lease office space from the Council in 1999. ■

Deloitte & Touche

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND COMPLIANCE BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

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 year ended December 31, 1999, and have issued our report thereon dated February 18, 2000. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Board's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition 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 the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance

As part of obtaining reasonable assurance about whether the Board's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. The results of our tests 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 Members and management of the Board and the Inspector General of the Board of Governors of the Federal Reserve System, and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche LLP

February 18, 2000

Deloitte Touche Tohmatsu

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, 1999 and 1998.

PRICEWATERHOUSECOOPERS

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, 1999 and 1998, and the related combined statements of income and changes in capital for the years then ended. 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. Those standards require that we plan and perform the audits 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 accounting principles generally accepted in the United States.

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, 1999 and 1998, and combined results of their operations for the years then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

Washington, D.C.
March 15, 2000

THE FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CONDITION
December 31, 1999 and 1998

(in millions)

ASSETS	1999	1998
Gold certificates	$ 11,048	$ 11,046
Special drawing rights certificates	6,200	9,200
Coin	207	358
Items in process of collection	6,524	6,933
Loans to depository institutions	233	17
Securities purchased under agreements to resell (tri-party)	140,640	. . .
U.S. government and federal agency securities, net	483,902	488,911
Investments denominated in foreign currencies	16,140	19,768
Accrued interest receivable	5,314	4,680
Bank premises and equipment, net	1,861	1,787
Other assets	2,391	1,942
Total assets	$674,460	$544,642
LIABILITIES AND CAPITAL		
LIABILITIES		
Federal Reserve notes outstanding, net	$600,662	$491,657
Deposits		
Depository institutions	24,027	26,306
U.S. Treasury, general account	28,402	6,086
Other deposits	274	413
Deferred credit items	6,117	5,924
Surplus transfer due U.S. Treasury	1,066	1,373
Accrued benefit cost	816	780
Other liabilities	234	199
Total liabilities	661,598	532,738
CAPITAL		
Capital paid-in	6,431	5,952
Surplus	6,431	5,952
Total capital	12,862	11,904
Total liabilities and capital	$674,460	$544,642

The accompanying notes are an integral part of these financial statements.

THE FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF INCOME
for the years ended December 31, 1999 and 1998

(in millions)

	1999	1998
Interest income		
Interest on U.S. government and federal agency securities	$28,216	$26,842
Interest on foreign currencies	225	435
Interest on loans to depository institutions	11	9
Total interest income	28,452	27,286
Other operating income (loss)		
Income from services	836	816
Reimbursable services to government agencies	295	299
Foreign currency (losses) gains, net	(504)	1,870
Government securities (losses) gains, net	(22)	44
Other income	83	72
Total other operating income	688	3,101
Operating expenses		
Salaries and other benefits	1,446	1,358
Occupancy expense	189	181
Equipment expense	242	244
Cost of unreimbursed Treasury services	8	8
Assessments by Board of Governors	699	587
Other expenses	294	374
Total operating expenses	2,878	2,752
Net income prior to distribution	$26,262	$27,635
Distribution of net income		
Dividends paid to member banks	$ 374	$ 343
Transferred to surplus	479	732
Payments to U.S. Treasury as interest on Federal Reserve notes	25,409	8,774
Payments to U.S. Treasury as required by statute	. . .	17,786
Total distribution	$26,262	$27,635

The accompanying notes are an integral part of these financial statements.

THE FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CHANGES IN CAPITAL
for the years ended December 31, 1999 and 1998

(in millions)

	Capital paid-in	Surplus	Total capital
Balance at January 1, 1998 (109 million shares)	$5,433	$5,220	$10,653
Net income transferred to surplus	. . .	732	732
Net change in capital stock issued (10 million shares)	519	. . .	519
Balance at December 31, 1998 (119 million shares)	$5,952	$5,952	$11,904
Net income transferred to surplus	. . .	479	479
Net change in capital stock issued (9 million shares)	479	. . .	479
Balance at December 31, 1999 (128 million shares)	$6,431	$6,431	$12,862

The accompanying notes are an integral part of these financial statements.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS

(1) ORGANIZATION AND BASIS OF PRESENTATION

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.

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, adjusted to eliminate interdistrict accounts and transactions.

Structure

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. 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.

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 operations, and check processing; distribution of coin and currency; 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, and the lending of U.S. government securities. Additionally, the FRBNY is authorized by the FOMC to hold balances of and to execute spot and forward foreign exchange and securities contracts in fourteen 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*.

The 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 (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 required by GAAP. In addition, the Board of Governors and the Reserve Banks have elected not to include a Statement of Cash Flows or a Statement of Comprehensive Income. 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 financial statements. The Statement of Comprehensive Income, which comprises net income plus or minus certain adjustments, such as the fair value adjustments for securities, has not been included because as stated above the securities are reported at amortized cost and there are no other adjustments in the determination of Comprehensive Income applicable to the Reserve Banks. 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 or a Statement of Comprehensive Income 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 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 and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. 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 2⁄9 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 U.S. 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 any loans were deemed to be uncollectible, an appropriate reserve would be established. Interest is recorded on the accrual basis and is charged at the applicable discount rate established at least every fourteen days by the boards of directors of the Reserve Banks, subject to review by the Board of

Governors. However, Reserve Banks retain the option to impose a surcharge above the basic rate in certain circumstances.

The Board of Governors established a Special Liquidity Facility (SLF) to make discount window credit readily available to depository institutions in sound financial condition around the century date change (October 1, 1999, to April 7, 2000) in order to meet unusual liquidity demands and to allow institutions to confidently commit to supplying loans to other institutions and businesses during this period. Under the SLF, collateral requirements are unchanged from normal discount window activity and loans are made at a rate of 150 basis points above the FOMC's target federal funds rate.

(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 other needs specified by the FOMC in carrying out the System's central bank responsibilities.

Purchases of securities under agreements to resell and matched sale–purchase transactions are accounted for as separate sale and purchase transactions. Purchases under agreements to resell are transactions in which the FRBNY purchases a security and sells it back at the rate specified at the commencement of the transaction. Matched sale–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.

In addition to the aforementioned purchases of securities under agreements to resell and matched sale–purchase transactions, the FRBNY also through FOMC's temporary authorization engages in tri-party repurchase and reverse repurchase agreements (''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 repurchase and reverse repurchase transactions are accounted for as financing transactions with the associated interest income and interest expense recorded over the period of the agreement. Tri-party operations commenced in October 1999 and have been approved by the FOMC through April 2000.

Another tool employed by the FRBNY to address potential reserve shortages was the ability to sell options on overnight repurchase agreements. The FRBNY has the temporary authority to sell European options to primary dealers that give the dealers the right to enter into repurchase agreements with the FRBNY on the exercise date. The options were auctioned in three week long ''strips'' with each strip consisting of the right to exercise overnight repurchase agreements for up to five consecutive business days. In general, the options could only be exercised at strike price of 150 to 250 basis points above the most recently announced FOMC Federal funds target rate.

Effective April 26, 1999 the FRBNY was given the 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, 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. The FOMC policy requires FRBNY to take possession of collateral in amounts 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. Prior to April 26, 1999, all Reserve Banks were authorized to engage in such lending activity.

Foreign exchange 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, maintains renewable, short-term F/X swap arrangements with 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 that 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. However, decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, 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 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 and federal agency securities are reported as ‘‘Government securities gains, net.’’ Foreign currency denominated assets are revalued monthly 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 counter party, and warehousing arrangements are revalued monthly, with the unrealized gain or loss reported as a component of ‘‘Other assets’’ or ‘‘Other liabilities,’’ as appropriate.

(E) *Bank Premises and Equipment*

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.

(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 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 agency securities, loans allowed under section 13, and investments denominated in foreign currencies are pledged as collateral for net Federal Reserve notes outstanding. 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. Tri-party agreements, which received temporary authorization through April 2000, however, are valued at the contract amount. 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 U.S. government.

The ‘‘Federal Reserve notes outstanding, net’’ account represents Federal Reserve notes reduced by cash held in the vaults of the Reserve Banks of $221,297 million and $120,030 million at December 31, 1999 and 1998, respectively.

At December 31, 1999 and 1998, all gold certificates, all special drawing rights certificates, and domestic securities with par values of $583,414 million and $471,411 million, respectively, were pledged as collateral. At December 31, 1999 and 1998, 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% 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% 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. 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. Payments made after September 30, 1998, represent payment of interest on Federal Reserve notes outstanding.

The Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66, Section 3002) codified the existing Board surplus policies as statutory surplus transfers, rather than as payments of interest on Federal Reserve notes, for federal government fiscal years 1998 and 1997 (which ended on September 30, 1998 and 1997, respectively). In addition, the legislation directed the Reserve Banks to transfer to the U.S. Treasury additional surplus funds of $107 million and $106 million during fiscal years 1998 and 1997 respectively. Reserve Banks were not permitted to replenish surplus for these amounts during this time. Payments to the U.S. Treasury made after September 30, 1998, represent payment of interest on Federal Reserve notes outstanding.

The Consolidated Appropriations Act of 1999 (Public Law 106-113, Section 302) directed the Reserve Banks to transfer to the U.S. Treasury additional surplus funds of $3,752 million during the Federal Government's 2000 fiscal year. The Reserve Banks will make this payment prior to September 30, 2000.

In the event of losses, payments to the U.S. Treasury are suspended until such losses are recovered through subsequent earnings. Weekly payments to the U.S. Treasury vary significantly.

(I) *Income and Cost 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. The costs of providing fiscal agency and depository services to the Treasury Department that have been billed but will not be paid are reported as the "Cost of unreimbursed Treasury services."

(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 and held under agreements to resell are held in the SOMA at the FRBNY.

Total securities held in the SOMA at December 31, 1999 and 1998, that were bought outright were as follows (in millions):

	1999	1998
Par value		
Federal agency	$ 181	$ 337
U.S. government		
Bills	176,518	194,772
Notes	218,467	187,895
Bonds	82,978	69,474
Total par value	478,144	452,478
Unamortized premiums	9,098	7,387
Unaccreted discounts	(3,340)	(3,198)
Total	$483,902	$456,667

The maturities of U.S. government and federal agency securities bought outright, which were held in the SOMA at December 31, 1999, were as follows (in millions):

Maturities of securities held	U.S. government securities	Federal agency obligations	Total
	Par value		
Within 15 days	$ 4,632	$. . .	$ 4,632
16 days to 90 days	91,919	31	91,950
91 days to 1 year	139,866	20	139,886
Over 1 year to 5 years	124,169	10	124,179
Over 5 years to 10 years	51,107	120	51,227
Over 10 years	66,270	. . .	66,270
Total	$477,963	$181	$478,144

Total securities held under agreements to resell at December 31 1999 were $140,640 million that consisted entirely of agreements through third party custodial arrangements and are reported as "Securities purchased under agreements to resell (tri-party)." Securities held under agreements to resell at December 31, 1998 totaled $32,244 million and are included in "U.S. government and federal agency securities, net." In August 1999, the FOMC extended the maximum pemissible maturity for securities purchased under agreements to resell from 60 days to 90 days.

Notes to the Combined Financial Statements of the Federal Reserve Banks—Continued

At December 31, 1999 and 1998, matched sale–purchase transactions involving U.S. government securities with par values of $39,182 million and $20,297 million, respectively, were outstanding. Matched sale–purchase transactions are generally overnight arrangements.

At December 31, 1999 and 1998, U.S. government securities with par values of $2,061 million and $325 million, respectively, were loaned.

Option contracts that were held on overnight repurchase agreements at December 31, 1999 were as follows (in millions):

	12/30/1999–01/05/2000	01/06/1999–01/12/2000
Outstanding options	$222,950	$144,000

(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):

	1999	1998
German marks		
Foreign currency deposits	$ . . .	$10,451
Government debt instruments including agreements to resell	. . .	2,373
European Union euros		
Foreign currency deposits	4,333	. . .
Government debt instruments including agreements to resell	2,538	. . .
Japanese yen		
Foreign currency deposits	323	666
Government debt instruments including agreements to resell	8,898	6,196
Accrued interest	48	97
Total	$16,140	$19,783

In addition to the balances reported above, $15 million in unearned interest collected on certain foreign currency holdings were also reported as "Investments denominated in foreign currencies" at December 31, 1998.

The maturities of investments denominated in foreign currencies at December 31, 1999, were as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies	
Within 1 year	$15,071
Over 1 year to 5 years	496
Over 5 years to 10 years	573
Total	$16,140

At December 31, 1999 and 1998, there were no open foreign exchange contracts or outstanding F/X swaps.

At December 31, 1999 and 1998 the warehousing facility was $5,000 million, with nothing outstanding.

(6) Bank Premises and Equipment

A summary of bank premises and equipment at December 31 is as follows (in millions):

	1999	1998
Bank premises and equipment		
Land	$ 191	$ 191
Buildings	1,222	1,177
Building machinery and equipment	287	271
Construction in progress	98	41
Furniture and equipment	1,238	1,244
	3,036	2,924
Accumulated depreciation	(1,175)	(1,137)
Bank premises and equipment, net	$1,861	$1,787

Depreciation expense was $183 million and $184 million for the years ended December 31, 1999 and 1998, respectively.

Bank premises and equipment at December 31 include the following amounts for leases that have been capitalized (in millions):

	1999	1998
Bank premises and equipment	$33	$89
Accumulated depreciation	(19)	(78)
Capitalized leases, net	$14	$11

Certain of the Reserve Banks lease unused space to outside tenants. Those leases have terms ranging from 1 to 16 years. Rental income from such leases totaled $17 million for each of the years ended December 31, 1999 and 1998. Future minimum lease payments under agreements in existence at December 31, 1999, were (in millions):

2000	$15
2001	14
2002	13
2003	9
2004	8
Thereafter	21
Total	$80

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

(7) COMMITMENTS AND CONTINGENCIES

At December 31, 1999, the Reserve Banks were obligated under noncancelable leases for premises and equipment with terms ranging from 1 year to approximately 24 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 $66 million and $64 million for the years ended December 31, 1999 and 1998, 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 1 year or more, at December 31, 1999, were (in millions):

	Operating
2000	$ 13
2001	11
2002	7
2003	6
2004	6
Thereafter	$114
Total	$157

At December 31, 1999, the Reserve Banks had contractual commitments through the year 2007 totaling $391 million for the maintenance of currency and check processing machines, none of which has been recognized. One Reserve Bank contracts for maintenance for these machines on behalf of the System and allocates the costs, annually, to each other Reserve Bank.

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' employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan) and the Benefit Equalization Retirement Plans offered by each individual Reserve Bank (BEPs).

The System Plan is a multi-employer plan with contributions fully funded by participating employers. No separate accounting is maintained of assets contributed by the participating employers. FRBNY acts as the sponsor of this plan. The prepaid pension cost includes amounts related to the participation of employees of the 12 Reserve Banks, the Board of Governors, and the Plan Administrative Office in the plan.

Following is a reconciliation of the beginning and ending balances of the System Plan benefit obligations (in millions):

	1999	1998
Estimated actuarial present value of projected benefit obligation at January 1	$2,774	$2,476
Service cost—benefits earned during the period	89	79
Interest cost of projected benefit obligation	169	169
Actuarial (gain) loss	(330)	140
Contributions by plan participants	3	4
Benefits paid	(129)	(125)
Plan amendments	. . .	31
Estimated actuarial present value of projected benefit obligation at December 31	$2,576	$2,774

Following is a reconciliation showing the beginning and ending balance of the System Plan assets, the funded status, and the prepaid pension benefit cost (in millions):

	1999	1998
Estimated fair value of plan assets at January 1	$5,798	$5,031
Actual return on plan assets	484	888
Contributions by employer	. . .	. . .
Contributions by plan participants	3	4
Benefits paid	(129)	(125)
Estimated fair value of plan assets at December 31	$6,156	$5,798
Funded status	$3,580	$3,024
Unrecognized initial net transition (obligation)	(91)	(136)
Unrecognized prior service cost	136	152
Unrecognized net actuarial (gain)	(1,767)	(1,549)
Prepaid pension benefit cost	1,858	1,491

Prepaid pension benefit cost is 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:

	1999	1998
Discount rate	7.50%	6.25%
Expected long-term rate of return on plan assets	9.00%	9.00%
Rate of compensation increase	5.00%	4.25%

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

The components of net periodic pension benefit credit for the System Plan as of December 31 are shown below (in millions):

	1999	1998
Service cost—benefits earned during the period	$ 89	$ 79
Interest cost on projected benefit obligation	169	169
Amortization of initial net transition obligation	(45)	(45)
Amortization of prior service cost	16	15
Recognized net (gain)	(76)	(59)
Expected return on plan assets	(520)	(448)
Net periodic pension benefit (credit)	$(367)	$(289)

Net periodic pension benefit (credit) is reported as a component of ''Other expense.''

The Reserve Banks' projected benefit obligation and net pension costs for the BEP at December 31, 1999 and 1998, 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 $45 million and $43 million for the years ended December 31, 1999 and 1998, 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 cost is actuarially determined, using a January 1 measurement date.

Following is a reconciliation of beginning and ending balances of the benefit obligation (in millions):

	1999	1998
Accumulated postretirement benefit obligation at January 1	$645	$588
Service cost—benefits earned during the period	18	15
Interest cost of accumulated benefit obligation	39	39
Actuarial loss (gain)	(73)	41
Contributions by plan participants	3	3
Benefits paid	(25)	(24)
Plan amendments	(7)	(17)
Accumulated postretirement benefit obligation at December 31	$600	$645

Following is a reconciliation of the beginning and ending balance of the plan assets, the unfunded postretirement benefit obligation, and the accrued postretirement benefit cost (in millions):

	1999	1998
Fair value of plan assets at January 1	$ . . .	$ . . .
Actual return on plan assets	. . .	. . .
Contributions by the employer	22	21
Contributions by plan participants	3	3
Benefits paid	(25)	(24)
Fair value of plan assets at December 31	$ . . .	$ . . .
Unfunded postretirement benefit obligation	$600	$645
Unrecognized prior service cost	99	100
Unrecognized net actuarial gain/(loss)	(23)	(50)
Accrued postretirement benefit cost	$722	$695

Accrued postretirement benefit cost is reported as a component of "Accrued benefit cost."

The weighted-average assumption used in developing the postretirement benefit obligation as of December 31, 1999 and 1998, was 7.50% and 6.25%, respectively.

For measurement purposes, an 8.75% annual rate of increase in the cost of covered health care benefits was assumed for 2000. Ultimately, the health care cost trend rate is expected to decrease gradually to 5.50% by 2006, and remain at that level thereafter.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A 1 percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 1999 (in millions):

	1 Percentage Point Increase	1 Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit cost	$ 12	$ (9)
Effect on accumulated postretirement benefit obligation	94	(77)

The following is a summary of the components of net periodic postretirement benefit cost for the years ended December 31 (in millions):

	1999	1998
Service cost—benefits earned during the period	$18	$15
Interest cost of accumulated benefit obligation	39	39
Amortization of prior service cost	(9)	(8)
Recognized net actuarial loss	. . .	. . .
Net periodic postretirement benefit cost	$48	$46

Net periodic postretirement benefit cost is 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, 1999 and 1998, were $93 million and $84 million, respectively. This cost is included as a component of ‘‘Accrued benefit cost.’’ Net periodic postemployment benefit costs included in 1999 and 1998 operating expenses were $20 million and $19 million, respectively.

Statistical Tables

1. Statement of Condition of the Federal Reserve Banks, by Bank, December 31, 1999 and 1998

Millions of dollars

Item	Total		Boston	
	1999	1998	1999	1998
ASSETS				
Gold certificate account	11,048	11,046	533	582
Special drawing rights certificate account	6,200	9,200	307	530
Coin	207	358	4	23
Loans				
To depository institutions	233	17	91	0
Other	0	0	0	0
Securities purchased under agreements to resell (tri-party)	140,640	. . .	0	. . .
Federal agency obligations				
Bought outright	181	338	9	18
Held under repurchase agreements	0	10,702	0	0
U.S. Treasury securities				
Bought outright[1]	477,963	452,141	24,717	24,625
Held under repurchase agreements	0	19,674	0	0
Total loans and securities	619,017	482,872	24,817	24,643
Items in process of collection	7,278	7,582	383	539
Bank premises	1,365	1,301	93	94
Other assets				
Denominated in foreign currencies[2]	16,140	19,769	725	958
All other[3]	17,300	16,628	778	683
Interdistrict settlement account	0	0	9,921	1,172
Total assets	**678,556**	**548,756**	**37,562**	**29,225**
LIABILITIES				
Federal Reserve notes	600,662	491,657	34,764	26,417
Deposits				
Depository institutions	24,027	26,306	1,545	1,568
U.S. Treasury, general account	28,402	6,086	0	0
Foreign, official accounts	71	167	1	7
Other[4]	1,270	1,619	34	68
Total deposits	53,770	34,179	1,580	1,643
Deferred credit items	6,871	6,574	400	392
Other liabilities and accrued dividends[5]	4,390	4,442	240	238
Total liabilities	**665,694**	**536,852**	**36,985**	**28,690**
CAPITAL ACCOUNTS				
Capital paid in	6,431	5,952	289	267
Surplus	6,431	5,952	289	267
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	**678,556**	**548,756**	**37,562**	**29,225**
FEDERAL RESERVE NOTE STATEMENT				
Federal Reserve notes outstanding (issued to Bank)	821,959	611,688	42,799	30,296
Less: Held by Bank	221,297	120,030	8,034	3,879
Federal Reserve notes, net	**600,662**	**491,657**	**34,764**	**26,417**
Collateral for Federal Reserve notes				
Gold certificate account	11,048	11,046	. . .	. . .
Special drawing rights certificate account	6,200	9,200	. . .	. . .
Other eligible assets	0	0	. . .	. . .
U.S. Treasury and federal agency securities	583,414	471,412	. . .	. . .
Total collateral	**600,662**	**491,657**	. . .	. . .

For notes see end of table.

1.—Continued

New York		Philadelphia		Cleveland		Richmond	
1999	1998	1999	1998	1999	1998	1999	1998
4,435	4,206	319	323	566	643	834	807
2,431	3,202	187	282	299	574	516	792
9	15	8	23	11	16	38	53
0	0	1	0	0	0	12	0
0	0	0	0	0	0	0	0
140,640	. . .	0	. . .	0	. . .	0	. . .
72	125	5	10	10	22	14	27
0	10,702	0	0	0	0	0	0
190,346	167,582	14,316	13,145	27,667	29,386	35,957	35,617
0	19,674	0	0	0	0	0	0
331,059	198,083	14,322	13,155	27,677	29,408	35,983	35,644
941	745	282	266	401	527	493	624
164	158	50	50	158	158	125	125
3,277	4,002	479	1,034	1,081	1,271	3,356	3,066
8,056	8,465	522	475	900	815	1,218	1,083
–69,615	–5,656	8,761	2,181	3,273	–4,170	646	4,985
280,757	**213,219**	**24,930**	**17,790**	**34,366**	**29,242**	**43,209**	**47,179**
236,509	194,182	23,437	16,456	31,757	26,164	36,876	41,577
10,035	7,533	592	433	1,118	1,574	1,957	1,898
28,402	6,086	0	0	0	0	0	0
47	53	1	8	2	9	6	22
564	484	15	147	26	89	74	188
39,048	14,156	608	588	1,145	1,672	2,037	2,109
973	809	326	242	315	334	566	676
1,575	1,654	159	151	259	275	347	342
278,106	**210,802**	**24,531**	**17,437**	**33,477**	**28,445**	**39,826**	**44,704**
1,325	1,208	199	177	444	399	1,691	1,238
1,325	1,208	199	177	444	399	1,691	1,238
0	0	0	0	0	0	0	0
280,757	**213,219**	**24,930**	**17,790**	**34,366**	**29,242**	**43,209**	**47,179**
326,492	239,794	30,931	18,434	38,915	29,535	54,760	50,920
89,983	45,611	7,493	1,978	7,158	3,370	17,884	9,343
236,509	**194,182**	**23,437**	**16,456**	**31,757**	**26,164**	**36,876**	**41,577**
. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .

1. Statement of Condition of the Federal Reserve Banks, by Bank, December 31, 1999 and 1998—Continued

Millions of dollars

Item	Atlanta		Chicago	
	1999	1998	1999	1998
ASSETS				
Gold certificate account	724	717	993	998
Special drawing rights certificate account	450	602	549	900
Coin	20	44	32	35
Loans				
To depository institutions	14	4	34	3
Other	0	0	0	0
Securities purchased under agreements to resell (tri-party)	0	. . .	0	. . .
Federal agency obligations				
Bought outright	11	21	17	32
Held under repurchase agreements	0	0	0	0
U.S. Treasury securities				
Bought outright[1]	29,093	27,504	44,890	43,406
Held under repurchase agreements	0	0	0	0
Total loans and securities	29,118	27,529	44,942	43,442
Items in process of collection	603	1,050	753	794
Bank premises	146	82	107	107
Other assets				
Denominated in foreign currencies[2]	1,134	1,295	1,581	1,911
All other[3]	945	807	1,379	1,185
Interdistrict Settlement Account	13,643	4,780	23,292	1,838
Total assets	**46,784**	**36,906**	**73,628**	**51,210**
LIABILITIES				
Federal Reserve notes	43,852	33,103	68,385	44,608
Deposits				
Depository institutions	899	1,769	2,970	4,282
U.S. Treasury, general account	0	0	0	0
Foreign, official accounts	2	9	3	14
Other[4]	36	81	56	121
Total deposits	937	1,860	3,029	4,416
Deferred credit items	772	821	637	609
Other liabilities and accrued dividends[5]	302	285	420	410
Total liabilities	**45,863**	**36,069**	**72,471**	**50,044**
CAPITAL ACCOUNTS				
Capital paid in	460	418	578	583
Surplus	460	418	578	583
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	**46,784**	**36,906**	**73,628**	**51,210**
FEDERAL RESERVE NOTE STATEMENT				
Federal Reserve notes outstanding (issued to Bank)	62,089	44,429	79,306	54,114
Less: Held by Federal Reserve Bank	18,237	11,326	10,920	9,506
Federal Reserve notes, net	**43,852**	**33,103**	**68,385**	**44,608**

NOTE. Differences may exist between amounts reported in these statistical tables and amounts reported in the audited Federal Reserve Bank financial statements because of intercompany eliminations, reclassifications, and rounding required for presentation of the audited data on the basis of generally accepted accounting principles (GAAP).

Components may not sum to totals because of rounding.

. . . Not applicable.

[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.

1.—Continued

St. Louis		Minneapolis		Kansas City		Dallas		San Francisco	
1999	1998	1999	1998	1999	1998	1999	1998	1999	1998
337	358	140	128	313	289	575	530	1,279	1,465
175	340	78	123	175	247	341	367	692	1,241
10	19	13	16	17	24	16	40	30	52
37	7	10	0	11	2	10	0	12	1
0	0	0	0	0	0	0	0	0	0
0	. . .	0	. . .	0	. . .	0	. . .	0	. . .
6	12	2	4	5	9	9	15	19	42
0	0	0	0	0	0	0	0	0	0
15,722	15,889	5,716	4,967	14,333	12,543	23,816	20,558	51,389	56,919
0	0	0	0	0	0	0	0	0	0
15,765	15,908	5,729	4,971	14,350	12,554	23,835	20,574	51,421	56,962
471	516	599	510	474	496	296	392	1,581	1,123
32	31	128	130	51	54	146	149	165	162
327	462	549	710	381	456	616	1,029	2,635	3,574
498	444	209	169	457	362	743	583	1,594	1,558
5,176	–1,841	–3,050	1,381	3,969	1,324	–9,087	1,679	13,071	–7,673
22,792	**16,235**	**4,395**	**8,139**	**20,186**	**15,806**	**17,481**	**25,343**	**72,468**	**58,463**
21,575	14,701	2,766	6,136	18,829	14,256	15,269	23,072	66,641	50,984
440	692	482	1,039	480	652	1,246	1,166	2,263	3,700
0	0	0	0	0	0	0	0	0	0
1	3	1	5	1	3	1	7	5	26
20	32	5	33	18	50	49	105	374	222
461	727	488	1,077	499	706	1,297	1,278	2,641	3,948
272	398	584	442	340	414	269	334	1,419	1,102
168	168	87	79	160	149	226	205	446	486
22,476	**15,994**	**3,925**	**7,734**	**19,828**	**15,525**	**17,060**	**24,889**	**71,147**	**56,520**
158	121	235	202	179	140	211	227	660	972
158	121	235	202	179	140	211	227	660	972
0	0	0	0	0	0	0	0	0	0
22,792	**16,235**	**4,395**	**8,139**	**20,186**	**15,806**	**17,481**	**25,343**	**72,468**	**58,463**
26,444	17,290	11,348	7,690	24,597	17,214	36,681	33,678	87,597	68,294
4,869	2,589	8,581	1,554	5,769	2,958	21,412	10,606	20,956	17,310
21,575	**14,701**	**2,766**	**6,136**	**18,829**	**14,256**	**15,269**	**23,072**	**66,641**	**50,984**

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2. Valued monthly at market exchange rates.

3. The Federal Reserve System total includes depository institution overdrafts of $22 million for 1999 and $11 million for 1998.

4. Includes international organization deposits of $139 million for 1999 and $104 million for 1998. 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.

2. Federal Reserve Open Market Transactions, 1999

Millions of dollars

Type of security and transaction	Jan.	Feb.	Mar.	Apr.
U.S. TREASURY SECURITIES				
Outright transactions (excluding matched transactions)				
Treasury bills				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Exchanges	35,069	36,862	35,065	48,142
New bills	35,069	36,862	35,065	48,142
Redemptions	0	0	0	0
Others within 1 year				
Gross purchases	0	2,103	1,060	1,677
Gross sales	0	0	0	0
Maturity shift	2,865	5,578	3,015	3,768
Exchanges	–400	–7,458	–5,956	–3,370
Redemptions	492	0	0	726
0 to 5 years				
Gross purchases	0	2,752	2,428	3,362
Gross sales	0	0	0	0
Maturity shift	–2,865	–4,928	–3,015	–3,768
Exchanges	0	4,778	5,956	3,020
5 to 10 years				
Gross purchases	0	335	346	945
Gross sales	0	0	0	0
Maturity shift	0	–650	0	0
Exchanges	400	1,340	0	0
More than 10 years				
Gross purchases	615	0	2,404	262
Gross sales	0	0	0	0
Maturity shift	0	0	0	0
Exchanges	0	1,340	0	350
All maturities				
Gross purchases	615	5,190	6,238	6,246
Gross sales	0	0	0	0
Redemptions	492	0	0	726
Matched transactions				
Gross purchases	357,544	317,833	393,267	365,078
Gross sales	355,369	316,424	394,865	362,716
Repurchase agreements				
Gross purchases	21,968	26,098	62,878	45,067
Gross sales	37,157	27,025	53,706	48,867
Net change in U.S. Treasury securities	–12,891	5,672	13,812	4,082
FEDERAL AGENCY OBLIGATIONS				
Outright transactions				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Redemptions	2	0	25	0
Repurchase agreements				
Gross purchases	23,577	37,416	35,731	20,623
Gross sales	31,744	36,067	34,009	22,937
Net change in agency obligations	–8,169	1,349	1,697	–2,314
Total net change in System Open Market Account	**–21,060**	**7,021**	**15,509**	**1,768**

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.

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
37,107	35,045	42,037	37,052	42,643	35,844	36,882	42,468	464,218
37,107	35,045	42,037	37,052	42,643	35,844	36,882	42,468	464,218
0	0	0	0	0	0	0	0	0
1,421	880	951	429	960	0	964	1,450	11,895
0	0	0	0	0	0	0	0	0
3,768	2,740	3,279	7,669	3,468	3,831	6,675	3,936	50,590
–4,607	–5,540	–368	–10,798	–2,125	–368	–10,150	–2,175	–53,315
0	0	41	0	0	170	0	0	1,429
4,442	948	0	1,272	0	0	1,014	3,514	19,731
0	0	0	0	0	0	0	0	0
–3,768	–2,740	–3,279	–4,751	–3,468	–3,831	–3,685	–3,936	–44,032
2,562	5,540	0	8,433	2,125	0	8,015	2,175	42,604
1,584	65	0	447	0	0	0	581	4,303
0	0	0	0	0	0	0	0	0
0	0	0	–2,918	0	0	–2,273	0	–5,841
2,045	0	373	1,290	0	0	2,135	0	7,583
2,890	0	0	1,075	0	0	925	1,257	9,428
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	–717	0	–717
0	0	0	1,075	0	374	0	0	3,139
10,337	1,893	951	3,223	960	0	2,903	6,802	45,357
0	0	0	0	0	0	0	0	0
0	0	41	0	0	170	0	0	1,429
356,960	379,534	347,067	374,032	346,904	329,213	317,537	488,845	4,373,815
358,362	379,126	346,747	373,159	349,041	327,361	318,294	510,605	4,392,070
27,605	17,710	27,707	23,097	29,369	30,600	48,145	73,995	434,239
30,531	14,614	33,612	23,717	24,337	24,437	35,895	42,090	395,988
6,008	5,397	–4,675	3,476	3,855	7,846	14,396	16,946	63,924
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
0	52	10	11	0	50	7	0	157
38,167	32,786	46,941	61,968	53,224	47,197	33,205	81,583	512,418
36,962	32,104	48,840	56,053	47,963	52,863	18,575	22,288	440,406
1,205	630	–1,909	5,904	5,261	–5,716	14,623	59,295	71,856
7,213	**6,028**	**–6,584**	**9,380**	**9,116**	**2,130**	**29,019**	**76,241**	**135,780**

3. Federal Reserve Bank Holdings of U.S. Treasury and Federal Agency Securities, December 31, 1997–99

Millions of dollars

Description	December 31			Change	
	1999	1998	1997	1998 to 1999	1997 to 1998
U.S. TREASURY SECURITIES					
Held outright[1]	**517,145**	**473,068**	**447,762**	**44,077**	**25,306**
By remaining maturity					
Bills					
1–90 days	124,294	106,996	112,892	17,298	–5,896
91 days to 1 year	91,405	108,703	101,257	–17,298	7,446
Notes and bonds					
1 year or less	59,899	49,149	49,370	10,750	–221
More than 1 year through 5 years	124,169	107,730	95,028	16,439	12,702
More than 5 years through 10 years	51,107	44,822	40,907	6,285	3,915
More than 10 years	66,270	55,668	48,308	10,602	7,360
By type					
Bills	215,699	215,699	214,149	0	1,550
Notes	218,467	187,895	174,206	30,572	13,689
Bonds	82,978	69,474	59,407	13,504	10,067
Repurchase agreements	**57,925**	**19,674**	**21,188**	**38,251**	**–1,514**
MSPs, foreign accounts	**39,182**	**20,927**	**17,027**	**18,255**	**3,900**
MSPs, in the market	**0**	**0**	**0**	**0**	**0**
FEDERAL AGENCY SECURITIES					
Held outright[1]	**181**	**338**	**685**	**–157**	**–347**
By remaining maturity					
1 year or less	51	102	252	–51	–150
More than 1 year through 5 years	10	61	153	–51	–92
More than 5 years through 10 years	120	175	255	–55	–80
More than 10 years	0	0	25	0	–25
By issuer					
Federal Farm Credit Banks	0	10	10	–10	0
Federal Home Loan Banks	6	38	57	–32	–19
Federal Land Banks	0	0	0	0	0
Federal National Mortgage Association	175	290	618	–115	–328
Repurchase agreements	**82,715**	**10,702**	**2,652**	**72,013**	**8,050**

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).

4. Number and Annual Salaries of Officers and Employees of the Federal Reserve Banks, December 31, 1999

Federal Reserve Bank (including Branches)	President	Other officers		Employees			Total	
	Salary (dollars)	Number	Salaries (dollars)	Number		Salaries (dollars)	Number	Salaries (dollars)
				Full-time	Part-time			
Boston	211,700	61	7,268,971	1,083	153	53,157,926	1,298	60,638,597
New York	270,100	257	37,747,467	3,280	77	172,176,688	3,615	210,194,255
Philadelphia	236,000	55	6,589,300	1,169	39	48,117,573	1,264	54,942,873
Cleveland	212,700	49	5,445,100	1,271	45	48,343,035	1,366	54,000,835
Richmond	212,700	85	9,115,800	1,958	162	76,911,285	2,206	86,239,785
Atlanta	227,750	92	10,218,800	2,472	56	92,431,469	2,621	102,878,019
Chicago	238,000	84	9,847,650	1,996	66	90,283,184	2,147	100,368,834
St. Louis	200,300	70	7,044,134	1,147	83	43,248,765	1,301	50,493,199
Minneapolis	223,200	47	5,336,700	1,065	112	45,138,755	1,225	50,698,655
Kansas City	211,200	59	6,278,800	1,466	66	56,683,548	1,592	63,173,548
Dallas	211,000	62	5,653,052	1,416	87	47,458,436	1,566	53,322,488
San Francisco	291,300	92	11,796,830	2,271	94	111,920,269	2,458	124,008,399
Federal Reserve Information Technology	0	25	3,059,930	593	11	36,623,080	629	39,683,010
Total	**2,745,950**	**1,038**	**125,402,534**	**21,187**	**1,051**	**922,494,013**	**23,288**	**1,050,642,497**

5. Income and Expenses of the Federal Reserve Banks, by Bank, 1999

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
CURRENT INCOME					
Loans	11,117	962	921	104	114
U.S. Treasury and federal agency securities	28,216,124	1,436,150	11,537,044	813,464	1,637,471
Foreign currencies	224,804	10,221	45,641	7,457	14,958
Priced services	835,895	44,326	91,661	40,904	54,289
Other	58,896	1,460	35,035	994	1,866
Total	**29,346,836**	**1,493,119**	**11,710,303**	**862,923**	**1,708,698**
CURRENT EXPENSES					
Salaries and other personnel expenses	1,140,657	63,601	233,164	57,027	58,560
Retirement and other benefits	305,175	18,012	67,968	14,098	15,489
Net periodic pension costs[1]	−366,765	0	−366,870	10	−1
Fees	43,902	2,357	7,804	842	2,289
Travel	50,813	2,402	7,693	2,249	3,093
Software expenses	71,252	3,806	7,481	2,144	5,217
Postage and other shipping costs	83,819	1,735	6,212	1,869	2,406
Communications	11,431	380	2,761	365	683
Materials and supplies	55,261	2,577	9,980	3,577	3,152
Building expenses					
Taxes on real estate	31,071	4,469	4,041	1,522	2,632
Property depreciation	66,215	4,379	12,986	2,808	5,927
Utilities	27,700	2,333	5,720	2,122	2,068
Rent	35,128	711	14,152	276	281
Other	29,284	754	6,961	1,550	1,978
Equipment					
Purchases	10,137	599	1,608	743	352
Rentals	31,393	218	2,043	314	171
Depreciation	116,649	6,250	19,245	5,598	5,630
Repairs and maintenance	83,778	4,824	10,581	4,232	5,167
Earnings-credit costs	320,605	17,157	55,848	10,605	30,942
Other	67,734	4,526	12,740	1,948	4,417
Shared costs, net[2]	0	5,592	23,196	12,003	13,995
Recoveries	−65,613	−10,756	−8,699	−2,643	−2,768
Expenses capitalized[3]	−2,015	−250	0	−198	−117
Total	**2,147,611**	**135,677**	**136,616**	**123,061**	**161,562**
Reimbursements	−295,449	−16,495	−55,999	−24,611	−28,080
Net expenses	1,852,162	119,182	80,618	98,450	133,482

For notes see end of table.

5.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
556	772	2,124	1,886	1,490	1,284	35	868
2,085,871	1,666,120	2,586,694	917,220	320,192	804,292	1,331,753	3,079,855
44,893	15,629	21,973	4,665	7,709	5,286	9,067	37,305
65,624	153,058	97,391	41,989	44,797	59,957	56,028	85,871
3,242	3,984	3,552	1,008	659	741	1,136	5,219
2,200,185	**1,839,563**	**2,711,733**	**966,768**	**374,848**	**871,560**	**1,398,019**	**3,209,117**
133,931	112,018	108,375	52,629	51,726	68,288	68,047	133,291
36,098	30,282	29,927	15,810	13,606	15,439	17,327	31,120
19	20	21	20	0	20	–2	–2
14,515	4,387	3,526	2,242	1,456	890	855	2,740
6,286	4,816	5,231	2,417	3,034	3,325	3,285	6,982
31,052	4,839	3,994	2,279	1,689	1,632	2,322	4,797
3,890	43,051	5,276	2,845	3,104	4,276	2,668	6,486
988	970	1,511	573	478	900	919	902
6,340	6,299	5,426	3,381	1,920	3,323	3,742	5,542
2,032	1,606	3,773	343	5,303	600	1,876	2,874
5,670	4,123	5,712	3,124	4,005	4,120	5,565	7,795
2,337	1,551	2,459	1,460	1,567	1,313	1,763	3,008
10,360	6,197	1,473	721	61	244	378	274
2,752	1,989	5,191	1,220	1,228	989	2,259	2,413
1,711	1,081	617	313	403	566	649	1,495
26,021	625	769	323	214	126	106	464
29,329	11,386	8,991	4,322	4,336	5,343	5,464	10,754
16,346	10,717	8,804	3,093	3,090	3,035	4,327	9,562
44,777	17,234	46,171	15,649	7,373	13,447	21,921	39,481
8,661	7,077	7,000	2,838	2,763	4,371	4,901	6,491
–147,498	5,872	21,451	14,552	8,978	18,064	14,084	9,710
–19,202	–3,169	–5,881	–1,803	–758	–1,000	–4,946	–3,988
–117	–625	–325	–83	0	–208	–49	–43
216,296	**272,345**	**269,493**	**128,269**	**115,580**	**149,103**	**157,461**	**282,148**
–31,174	–15,347	–21,867	–18,939	–20,555	–21,576	–10,968	–29,840
185,122	256,999	247,626	109,330	95,025	127,527	146,493	252,308

5. Income and Expenses of the Federal Reserve Banks, by Bank, 1999—Continued

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
PROFIT AND LOSS					
Current net income	27,494,674	1,373,937	11,629,685	764,473	1,575,216
Additions to and deductions from (–) current net income[4]					
Other additions	168	0	18	2	1
Total additions	168	0	18	2	1
Losses on sales of U.S. Treasury and federal agency securities	–21,564	–1,110	–8,640	–648	–1,235
Losses on foreign exchange transactions	–504,465	–22,664	–102,424	–14,959	–33,778
Other deductions	–48	–1	–6	–2	–2
Total deductions	–526,076	–23,775	–111,071	–15,609	–35,015
Net addition to or deduction from (–) current net income	–525,909	–23,775	–111,052	–15,607	–35,014
Cost of unreimbursed Treasury services	7,649	232	557	3,650	608
Assessments by Board					
Board expenditures[5]	213,790	9,626	43,670	6,388	14,282
Cost of currency	484,959	26,057	191,537	16,232	25,808
Net income before payment to U.S. Treasury	26,262,368	1,314,248	11,282,869	722,596	1,499,504
Dividends paid	373,579	16,974	78,159	11,483	24,890
Payments to U.S. Treasury (interest on Federal Reserve notes)	25,409,736	1,276,090	11,087,629	688,190	1,428,727
Transferred to surplus	479,053	21,184	117,081	22,923	45,887
Surplus, January 1	5,952,024	267,411	1,208,394	176,503	398,543
Surplus, December 31	6,431,077	288,595	1,325,475	199,425	444,429

NOTE. Also see note to table 1.

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 $366,994 thousand. The Retirement Benefits Equalization Plan is recorded by each Federal Reserve Bank.

2. Includes distribution of costs for projects performed by one Reserve Bank for the benefit of one or more other Reserve Banks.

3. Includes expenses for labor and materials temporarily capitalized and charged to activities when the products are consumed.

4. 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.

5. For details, see the chapter "Board of Governors Financial Statements."

5.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
2,015,063	1,582,564	2,464,107	857,438	279,823	744,033	1,251,525	2,956,810
69	18	5	0	0	0	15	37
69	18	5	0	0	0	15	37
–1,615	–1,313	–2,021	–705	–260	–651	–1,083	–2,283
–104,887	–35,450	–49,412	–10,229	–17,150	–11,902	–19,262	–82,348
–10	–3	–8	–2	–2	–4	–6	0
–106,512	–36,766	–51,442	–10,936	–17,412	–12,556	–20,351	–84,631
–106,443	–36,747	–51,437	–10,936	–17,412	–12,556	–20,336	–84,594
350	280	593	123	258	427	263	306
44,415	14,964	20,840	4,479	7,292	5,174	7,956	34,704
41,011	32,652	44,000	14,501	6,052	14,062	22,758	50,289
1,822,844	1,497,920	2,347,236	827,399	248,808	711,814	1,200,212	2,786,917
85,629	25,823	35,775	8,692	12,806	9,827	13,009	50,512
1,283,329	1,429,976	2,316,040	781,446	203,418	663,528	1,203,828	3,047,536
453,887	42,122	–4,578	37,261	32,584	38,459	–16,624	–311,131
1,237,545	418,268	583,009	120,692	202,353	140,425	227,270	971,612
1,691,431	460,390	578,431	157,954	234,937	178,884	210,646	660,481

6. Income and Expenses of the Federal Reserve Banks, 1914–99

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (–)[1]	Assessments by Board of Governors	
				Board expenditures	Costs of currency
All Banks					
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[2]	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, 1914–99—Continued

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (–)[1]	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
Total, 1914–99	**501,822,364**	**36,209,032**	**4,846,682**	**2,880,460**	**5,647,091**
Aggregate for each Bank, 1914–99					
Boston	27,098,102	2,451,609	159,416	110,190	327,542
New York	165,137,721	5,843,173[4]	1,506,510	737,121	1,838,198
Philadelphia	18,789,099	1,999,002	125,768	131,917	219,058
Cleveland	32,313,902	2,292,337	221,671	198,873	349,259
Richmond	39,975,264	3,152,765	354,007	225,573	488,382
Atlanta	24,133,136	3,492,233	388,007	235,960	325,334
Chicago	64,255,429	4,673,235	566,581	362,681	675,717
St. Louis	17,413,129	1,863,842	85,701	77,962	211,406
Minneapolis	8,941,714	1,705,734	142,188	84,082	94,216
Kansas City	19,277,304	2,323,259	139,176	109,520	217,218
Dallas	24,988,909	2,344,656	441,460	183,240	271,408
San Francisco	59,498,657	4,067,186	716,198	423,341	629,352
Total	**501,822,364**	**36,209,032**	**4,846,682**	**2,880,460**	**5,647,091**

NOTE. Also see note at the end of table 1.

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 to 1932; transfers made under section 13b of the Federal Reserve Act from 1935 to 1947; and transfers made under section 7 of the Federal Reserve Act for 1996 and 1997.

[3] The $6,772,749 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) and $107,000 thousand (1997) 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 $6,431,077 thousand on December 31, 1999.

[4] This amount is reduced $1,773,208 thousand, which is related to the System Retirement Plan. See note 1, table 5.

6.—Continued

Dividends paid	Payments to U.S. Treasury		Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Statutory transfers[2]	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
4,665,159	**44,113,958**	**406,380,601**	**−4**	**6,772,749**[3]
189,267	2,579,504	21,292,012	135	307,258
1,206,982	17,307,161	138,296,614	−433	1,415,416
224,873	1,312,118	14,802,417	291	225,191
334,645	2,827,043	26,062,046	−10	471,380
391,942	3,083,928	31,274,256	−72	1,712,496
364,317	2,713,230	16,904,129	5	485,935
575,069	4,593,811	53,322,604	12	618,880
127,527	1,833,837	13,215,931	−27	168,351
134,564	416,227	6,405,077	65	243,937
173,416	1,249,703	15,152,229	−9	191,144
279,700	1,510,802	20,613,022	55	227,484
662,857	4,686,594	49,040,263	−17	705,278
4,665,159	**44,113,958**	**406,380,601**	**−4**	**6,772,749**[3]

7. Acquisition Costs and Net Book Value of Premises of the Federal Reserve Banks and Branches, December 31, 1999

Thousands of dollars

Federal Reserve Bank or Branch	Acquisition costs				Net book value	Other real estate[3]
	Land	Buildings (including vaults)[1]	Building machinery and equipment	Total[2]		
BOSTON	22,074	95,845	14,401	132,320	92,989	. . .
NEW YORK	20,330	161,882	46,894	229,107	159,202	. . .
Buffalo	888	4,761	3,144	8,793	5,202	. . .
PHILADELPHIA	2,380	63,104	9,004	74,488	50,279	. . .
CLEVELAND	3,073	119,607	24,452	147,132	128,810	. . .
Cincinnati	2,247	17,345	8,499	28,091	13,082	. . .
Pittsburgh	1,658	12,533	8,062	22,253	16,158	. . .
RICHMOND	6,375	64,721	25,294	96,390	71,879	. . .
Baltimore	6,478	27,101	4,929	38,509	25,740	. . .
Charlotte	3,130	27,541	4,750	35,421	27,289	. . .
ATLANTA[4]	17,689	77,436	0	95,125	95,120	5,939
Birmingham[4]	4,852	0	0	4,852	4,852	. . .
Jacksonville	1,730	17,226	2,945	21,901	16,387	48
Miami	3,839	14,188	3,790	21,817	14,812	. . .
Nashville	629	3,171	2,724	6,523	3,426	. . .
New Orleans	3,497	7,958	4,076	15,532	10,908	. . .
CHICAGO	5,044	123,078	14,878	143,001	99,004	. . .
Detroit	798	6,363	3,722	10,883	8,082	. . .
ST. LOUIS	700	21,599	6,415	28,714	17,181	. . .
Little Rock	1,148	4,632	1,272	7,053	5,428	. . .
Louisville	700	4,281	1,502	6,483	4,494	. . .
Memphis	1,136	4,571	2,792	8,499	5,069	. . .
MINNEAPOLIS	11,193	99,947	13,301	124,441	117,922	. . .
Helena	1,978	9,419	788	12,185	10,218	. . .
KANSAS CITY	2,048	18,826	8,379	29,253	15,922	. . .
Denver	3,188	7,436	3,700	14,325	8,833	. . .
Oklahoma City	646	11,243	3,493	15,382	11,151	. . .
Omaha	6,535	11,058	1,401	18,993	14,905	. . .
DALLAS	29,049	104,271	19,700	153,020	130,881	. . .
El Paso	262	2,911	1,018	4,191	2,842	. . .
Houston	2,205	4,840	2,045	9,090	6,321	679
San Antonio	482	5,506	2,707	8,696	6,012	. . .
SAN FRANCISCO	15,600	77,529	18,727	111,855	77,772	. . .
Los Angeles	3,892	53,609	9,875	67,377	49,303	952
Portland	2,884	11,421	2,598	16,903	14,331	. . .
Salt Lake City	495	9,439	2,587	12,520	9,944	. . .
Seattle	325	13,450	3,542	17,316	13,672	. . .
Total	**191,177**	**1,319,848**	**287,409**	**1,798,434**	**1,365,423**	**7,618**

NOTE. Also see note to table 1.

Components may not sum to totals because of rounding.

. . . Not applicable.

[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.

[4] The Atlanta and Birmingham offices sold their buildings and building machinery and equipment in 1997 and 1998 respectively. These offices are leasing back their buildings pending completion of their new facilities.

8. Operations in Principal Departments of the Federal Reserve Banks, 1996–99

Operation	1999	1998	1997	1996
Millions of pieces (except as noted)				
Loans (thousands)[1]	. . .	4	7	6
Currency processed	29,031	26,341	24,510	23,436
Currency destroyed	7,303	7,251	7,769	8,686
Coin received[2]	6,719	8,454	9,603	8,654
Checks handled				
U.S. government checks	288	321	378	436
Postal money orders	226	213	204	206
All other	17,075	16,573	15,949	15,487
Government securities transfers	13	14	13	13
Transfer of funds	103	98	90	83
Automated clearinghouse transactions				
Commercial	3,344	2,966	2,603	2,372
Government	809	753	677	625
Food stamps redeemed	1,158	1,843	2,854	3,637
Millions of dollars				
Loans[1]	. . .	20,431	39,863	25,350
Currency processed	444,234	409,166	399,080	375,399
Currency destroyed	85,259	94,858	123,359	148,394
Coin received[2]	778	1,001	1,212	1,175
Checks handled				
U.S. government checks	306,077	343,670	401,989	462,647
Postal money orders	29,118	28,469	26,464	25,831
All other	13,788,037	13,076,097	12,169,087	11,584,276
Government securities transfers	179,486,282	197,781,609	174,949,330	160,637,460
Transfer of funds	343,381,658	328,748,912	288,419,808	249,140,021
Automated clearinghouse transactions				
Commercial	10,862,424	10,338,376	9,128,779	8,287,711
Government	2,233,279	1,988,335	1,581,552	1,250,472
Food stamps redeemed	6,221	9,278	15,054	18,669

1. Collection of data discontinued effective 1999.

2. For 1999, 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, 1999

Reserve Bank	Adjustment credit[1]	Seasonal credit[2]	Extended credit[3]		Special Liquidity Facility credit[4]
			First thirty days of borrowing	After thirty days of borrowing	
All Federal Reserve Banks	5.00	5.70	5.00	6.20	7.00

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. See section 201.3(a) of Regulation A.

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. See section 201.3(b) 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. See section 201.3(c) of Regulation A.

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.

4. Special Liquidity Facility credit became available on October 1, 1999, to help depository institutions in sound financial condition meet unusual needs for funds in the period around the century date change. The interest rate on loans from the special facility is the Federal Open Market Committee's intended federal funds rate plus 150 basis points.

10. Reserve Requirements of Depository Institutions, December 31, 1999

Type of deposit	Requirements	
	Percentage of deposits	Effective date
Net transaction accounts[1]		
$0 million–$44.3 million[2]	3	12-30-99
More than $44.3 million[3]	10	12-30-99
Nonpersonal time deposits[4]	0	12-27-90
Eurocurrency liabilities[5]	0	12-27-90

NOTE. Required reserves must be held in the form of deposits with Federal Reserve Banks or vault cash. Nonmember 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] 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 30, 1999, for depository institutions that report weekly, and with the reserve maintenance period beginning January 20, 2000, for institutions that report quarterly, the amount was decreased from $46.5 million to $44.3 million.

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 30, 1999, for depository institutions that report weekly, and with the reserve maintenance period beginning January 20, 2000, for institutions that report quarterly, the exemption was raised from $4.9 million to $5.0 million.

[3] 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.

[4] For institutions that report weekly, the reserve requirement on nonpersonal time deposits with an original maturity of less than 1½ years was reduced from 3 percent to 1½ 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 1½ years was reduced from 3 percent to zero on January 17, 1991.

The reserve requirement on nonpersonal time deposits with an original maturity of 1½ years or more has been zero since October 6, 1983.

[5] The reserve requirement on Euroccurency 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 1½ years (see note 4).

11. Initial Margin Requirements under Regulations T, U, and X

Percent of market value

Effective date	Margin stocks	Convertible bonds	Short sales, T only[1]
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, 1999 and 1998

Millions of dollars, except as noted

Item	Total	Member banks			Nonmember banks
		Total	National	State	
	1999				
ASSETS					
Loans and investments	3,963,401	3,134,072	2,373,265	760,807	829,328
Loans, gross	2,972,232	2,376,913	1,827,078	549,835	595,319
Net	2,969,585	2,375,445	1,825,931	549,514	594,141
Investments	991,169	757,159	546,187	210,972	234,010
U.S. Treasury and federal agency securities	307,786	205,988	140,704	65,284	101,798
Other	683,383	551,171	405,482	145,688	132,212
Cash assets, total	236,968	196,509	149,177	47,331	40,459
LIABILITIES					
Deposits, total	3,060,565	2,353,313	1,755,358	597,956	707,251
Interbank	54,663	47,321	36,797	10,524	7,342
Other transaction	650,167	496,439	371,086	125,353	153,728
Other nontransaction	2,355,734	1,809,553	1,347,475	462,079	546,181
Equity capital	457,393	367,684	271,058	96,626	89,709
Number of banks	8,654	3,409	2,409	1,000	5,245
	1998[r]				
ASSETS					
Loans and investments	3,644,645	2,870,285	2,193,860	676,425	774,360
Loans, gross	2,763,384	2,199,633	1,720,549	479,083	563,752
Net	2,760,379	2,197,968	1,719,181	478,787	562,411
Investments	881,261	670,653	473,311	197,342	210,608
U.S. Treasury and federal agency securities	301,052	198,655	127,701	70,954	102,397
Other	580,208	471,998	345,609	126,388	108,211
Cash assets, total	243,481	203,091	155,526	47,564	40,390
LIABILITIES					
Deposits, total	2,933,832	2,263,347	1,708,186	555,161	670,485
Interbank	56,032	48,506	38,083	10,423	7,526
Other transaction	696,993	538,011	408,923	129,088	158,982
Other nontransaction	2,180,808	1,676,831	1,261,180	415,651	503,977
Equity capital	437,465	349,619	258,305	91,313	87,847
Number of banks	8,962	3,534	2,547	987	5,428

NOTE. Components may not sum to totals because of rounding.

r. Data have been revised.

13. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items—Year-End 1918–99, and Month-End 1999

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding								Gold stock[6]	Special drawing rights certificate account	Treasury currency outstanding[7]
	U.S. Treasury and federal agency securities			Loans	Float[3]	All other[4]	Other Federal Reserve assets[5]	Total			
	Total	Bought outright[1]	Held under repurchase agreement[2]								
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											
Currency in circulation	Treasury cash holdings[8]	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve accounts[5]	Required clearing balances	Other Federal Reserve liabilities and capital[5]	Member bank reserves[9]			
		Treasury	Foreign	Other				With Federal Reserve Banks	Currency and coin[10]	Required[11]	Excess[11]
4,951	288	51	96	25	118	0	0	1,636	0	1,585	51
5,091	385	51	73	28	208	0	0	1,890	0	1,822	68
5,325	218	57	5	18	298	0	0	1,781	0	0	0
4,403	214	96	12	15	285	0	0	1,753	0	1,654	99
4,530	225	11	3	26	276	0	0	1,934	0	0	0
4,757	213	38	4	19	275	0	0	1,898	0	1,884	14
4,760	211	51	19	20	258	0	0	2,220	0	2,161	59
4,817	203	16	8	21	272	0	0	2,212	0	2,256	–44
4,808	201	17	46	19	293	0	0	2,194	0	2.250	–56
4,716	208	18	5	21	301	0	0	2,487	0	2,424	63
4,686	202	23	6	21	348	0	0	2,389	0	2,430	–41
4,578	216	29	6	24	393	0	0	2,355	0	2,428	–73
4,603	211	19	6	22	375	0	0	2,471	0	2,375	96
5,360	222	54	79	31	354	0	0	1,961	0	1,994	–33
5,388	272	8	19	24	355	0	0	2,509	0	1,933	576
5,519	284	3	4	128	360	0	0	2,729	0	1,870	859
5,536	3,029	121	20	169	241	0	0	4,096	0	2,282	1,814
5,882	2,566	544	29	226	253	0	0	5,587	0	2,743	2,844
6,543	2,376	244	99	160	261	0	0	6,606	0	4,622	1,984
6,550	3,619	142	172	235	263	0	0	7,027	0	5,815	1,212
6,856	2,706	923	199	242	260	0	0	8,724	0	5,519	3,205
7,598	2,409	634	397	256	251	0	0	11,653	0	6,444	5,209
8,732	2,213	368	1,133	599	284	0	0	4,026	0	7,411	6,615
11,160	2,215	867	774	586	291	0	0	12,450	0	9,365	3,085
15,410	2,193	799	793	485	256	0	0	13,117	0	11,129	1,988
20,499	2,303	579	1,360	356	339	0	0	12,886	0	11,650	1,236
25,307	2,375	440	1,204	394	402	0	0	14,373	0	12,748	1,625
28,515	2,287	977	862	446	495	0	0	15,915	0	14,457	1,458
28,952	2,272	393	508	314	607	0	0	16,139	0	15,577	562
28,868	1,336	870	392	569	563	0	0	17,899	0	16,400	1,499
28,224	1,325	1,123	642	547	590	0	0	20,479	0	19,277	1,202
27,600	1,312	821	767	750	106	0	0	16,568	0	15,550	1,018
27,741	1,293	668	895	565	714	0	0	17,681	0	16,509	1,172
29,206	1,270	247	526	363	746	0	0	20,056	0	19,667	389
30,433	1,270	389	550	455	777	0	0	19,950	0	20,520	–570
30,781	761	346	423	493	839	0	0	20,160	0	19,397	763
30,509	796	563	490	441	907	0	0	18,876	0	18,618	258
31,158	767	394	402	554	925	0	0	19,005	0	18,903	102
31,790	775	441	322	426	901	0	0	19,059	0	19,089	–30
31,834	761	481	356	246	998	0	0	19,034	0	19,091	–57
32,193	683	358	272	391	1,122	0	0	18,504	0	18,574	–70
32,591	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 1918–99 and Month-End 1999—Continued

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding								Gold stock[6]	Special drawing rights certificate account	Treasury currency outstanding[7]
	U.S. Treasury and federal agency securities			Loans	Float[3]	All other[4]	Other Federal Reserve assets[5]	Total			
	Total	Bought outright[1]	Held under repurchase agreement[2]								
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[5]	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	63,659	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	20,404
1991	288,429	272,531	15,898	218	1,026	0	34,524	324,197	11,059	10,018	21,017
1992	308,517	300,423	8,094	675	3,350	0	30,278	342,820	11,056	8,018	21,452
1993	349,866	336,654	13,212	94	963	0	33,394	384,317	11,053	8,018	22,101
1994	378,746	368,156	10,590	223	740	0	33,441	413,150	11,051	8,018	23,001
1995	394,693	380,831	13,862	135	231	0	33,483	428,543	11,050	10,168	24,011
1996	414,715	393,132	21,583	85	5,297	0	32,222	452,319	11,048	9,718	24,981
1997	455,260	431,420	23,840	2,035	561	0	32,044	489,901	11,047	9,200	25,606
1998	482,854	452,478	30,376	17	1,009	0	37,692	521,573	11,046	9,200	26,270[r]
1999	618,784	478,144	140,640	233	407	0	34,799	654,223	11,048	6,200	28,013

13.—Continued

Factors absorbing reserve funds											
Currency in circulation	Treasury cash holdings[8]	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve accounts[5]	Required clearing balances	Other Federal Reserve liabilities and capital[5]	Member bank reserves[9]			
		Treasury	Foreign	Other				With Federal Reserve Banks	Currency and coin[10]	Required[11]	Excess[11,12]
32,869	377	485	217	533	941	0	0	17,081	2,544	18,988	637
33,918	422	465	279	320	1,044	0	0	17,387	2,544	18,988	96
35,338	380	597	247	393	1,007	0	0	17,454	3,262	20,071	645
37,692	361	880	171	291	1,065	0	0	17,049	4,099	20,677	471
39,619	612	820	229	321	1,036	0	0	18,086	4,151	21,663	574
42,056	760	668	150	355	211	0	0	18,447	4,163	22,848	–238
44,663	1,176	416	174	588	–147	0	0	19,779	4,310	24,321	–232
47,226	1,344	1,123	135	563	–773	0	0	21,092	4,631	25,905	–182
50,961	695	703	216	747	–1,353	0	0	21,818	4,921	27,439	–700
53,950	596	1,312	134	807	0	0	1,919	22,085	5,187	28,173	–901
57,903	431	1,156	148	1,233	0	0	1,986	24,150	5,423	30,033	–460
61,068	460	2,020	294	999	0	0	2,131	27,788	5,743	32,496	1,035
66,516	345	1,855	325	840	0	0	2,143	25,647	6,216	32,044	98[12]
72,497	317	2,542	251	1,419[13]	0	0	2,669	27,060	6,781	35,268	–1,360
79,743	185	2,113	418	1,275[13]	0	0	2,935	25,843	7,370	37,011	–3,798
86,547	483	7,285	353	1,090	0	0	2,968	26,052	8,036	35,197	–1,103[14]
93,717	460	10,393	352	1,357	0	0	3,063	25,158	8,628	35,461	–1,535
103,811	392	7,114	379	1,187	0	0	3,292	26,870	9,421	37,615	–1,265
114,645	240	4,196	368	1,256	0	0	4,275	31,152	10,538	42,694	–893
125,600	494	4,075	429	1,412	0	0	4,957	29,792	11,429	44,217	–2,835
136,829	441	3,062	411	617	0	0	4,671	27,456	13,654	40,558	675
144,774	443	4,301	505	781	0	117	5,261	25,111	15,576	42,145	–1,442
154,908	429	5,033	328	1,033	0	436	4,990	26,053	16,666	41,391	1,328
171,935	479	3,661	191	851	0	1,013	5,392	20,413	17,821	39,179	–945
183,796	513	5,316	253	867	0	1,126	5,952	20,693	n.a.	n.a.	n.a.
197,488	550	9,351	480	1,041	0	1,490	5,940	27,141			
211,995	447	7,588	287	917	0	1,812	6,088	46,295			
230,205	454	5,313	244	1,027	0	1,687	7,129	40,097			
247,649	395	8,656	347	548	0	1,605	7,683	37,742			
260,456	450	6,217	589	1,298	0	1,618	8,486	36,713			
286,965	561	8,960	369	242	0	1,962	8,147	36,696			
307,759	636	17,697	968	1,706	0	3,949	8,113	25,464			
334,706	508	7,492	206	372	0	5,898	7,984	26,181			
365,277	377	14,809	386	397	0	6,332	9,292	28,619			
403,851	335	7,161	250	876	0	4,197	11,959	26,592			
424,253	270	5,979	386	932	0	5,167	12,342	24,444			
450,663	249	7,742	167	892	0	6,601	13,829	17,923			
482,390	225	5,444	457	900	0	6,666[r]	15,500	24,172[r]			
517,484[r]	85	6,086	167	1,605	0	6,784[r]	16,354	19,522[r]			
628,359	109	28,402	71	1,261	0	7,483	17,256	16,544			

13. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items—Year-End 1918–99, and Month-End 1999—Continued

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding								Gold stock[6]	Special drawing rights certificate account	Treasury currency outstanding[7]
	U.S. Treasury and federal agency securities			Loans	Float[3]	All other[4]	Other Federal Reserve assets[5]	Total			
	Total	Bought outright[1]	Held under repurchase agreement[2]								
1999											
Jan. . . .	461,795	454,775	7,020	60	376	0	36,700	498,930	11,048	9,200	26,397
Feb. . . .	468,814	461,372	7,442	16	184	0	34,317	503,331	11,047	9,200	26,508
Mar. . . .	484,333	465,997	18,336	246	–19	0	32,600	517,159	11,049	8,200	26,638
Apr. . . .	486,106	473,884	12,222	68	–106	0	33,680	519,747	11,050	8,200	26,757
May . . .	493,342	482,841	10,501	121	416	0	32,339	526,218	11,048	8,200	26,874
June . . .	499,404	485,125	14,279	220	413	0	33,018	533,056	11,046	8,200	27,004
July . . .	492,827	486,352	6,475	348	–44	0	34,547	527,678	11,048	8,200	27,151
Aug. . . .	502,206	490,436	11,770	338	317	0	32,622	535,483	11,045	8,200	27,298
Sept. . . .	511,338	489,275	22,063	480	231	0	34,305	546,353	11,047	7,200	27,457
Oct. . . .	513,486	490,926	22,560	173	–182	0	35,273	548,750	11,049	7,200	27,636
Nov. . . .	542,532	493,092	49,440	78	693	0	32,942	576,244	11,049	7,200	27,831
Dec. . . .	618,784	478,144	140,640	233	407	0	34,799	654,223	11,048	6,200	28,013

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] Beginning in 1969, 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.

[2] Beginning December 1, 1966, includes federal agency obligations held under repurchase agreements and beginning September 29, 1971, includes federal agency issues bought outright.

[3] Beginning in 1960, 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, 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 dividends, 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] Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

[9] Beginning in November 1979, includes reserves of member banks, Edge Act corporations, and U.S. agencies and branches of foreign banks. Beginning on November 13, 1980, includes reserves of all depository institutions.

Beginning in 1984, data on ‘‘Currency and coin’’ and ‘‘Required’’ and ‘‘Excess’’ reserves changed from daily to biweekly basis.

13.—Continued

Factors absorbing reserve funds											
Currency in circulation	Treasury cash holdings[8]	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve accounts[9]	Required clearing balances	Other Federal Reserve liabilities and capital[5]	Member bank reserves[9]			
		Treasury	Foreign	Other				With Federal Reserve Banks	Currency and coin[10]	Required[11]	Excess[11,12]
505,528	98	7,623	234	246	0	6,510	16,269	9,067	n.a.	n.a.	n.a.
511,709	120	4,538	200	225	0	6,576	16,460	10,259			
517,790	135	5,374	166	235	0	6,443	16,805	16,098			
519,751	167	10,040	260	263	0	6,458	17,214	11,603			
528,042	145	5,056	157	223	0	6,576	17,575	14,564			
532,026	90	6,720	410	241	0	6,630	17,662	15,526			
533,517	57	4,984	257	229	0	6,770	18,389	9,872			
538,466	84	5,559	166	225	0	6,725	18,728	12,075			
544,101	93	6,641	243	191	0	6,815	19,105	14,869			
555,720	94	4,527	189	202	0	6,796	18,401	8,706			
583,103	85	5,025	501	221	0	6,924	18,618	7,847			
628,359	109	28,402	71	1,261	0	7,483	17,256	16,544			

10. Between December 1, 1959, and November 23, 1960, part was allowed as reserves; thereafter all was allowed.

11. Estimated through 1958. Before 1929, data were available only on call dates (in 1920 and 1922 the call date was December 29). Beginning on September 12, 1968, the amount is based on close-of-business figures for the reserve period two weeks before the report date.

12. Beginning with week ending November 15, 1972, 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.

13. 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.

14. 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 in the United States, December 31, 1998 and 1999

Type of office	Total	Commercial banks[1]					State-chartered savings banks
		Total	Member			Nonmember	
			Total	National	State		
	All banking offices						
BANKS							
Number, Dec. 31, 1998	**9,189**	**8,729**	**3,401**	**2,408**	**993**	**5,328**	**460**
Changes during 1999							
New banks	259	237	86	53	33	151	22
Banks converted into branches	–411	–394	–193	–129	–64	–201	–17
Ceased banking operation[2]	–50	–45	–16	–13	–3	–29	–5
Other[3]	0	2	43	–7	50	–41	–2
Net change	–202	–200	–80	–96	16	–120	–2
Number, Dec. 31, 1999	**8,987**	**8,529**	**3,321**	**2,312**	**1,009**	**5,208**	**458**
BRANCHES AND ADDITIONAL OFFICES							
Number, Dec. 31, 1998	**65,916**	**62,648**	**45,995**	**35,337**	**10,658**	**16,653**	**3,268**
Changes during 1999							
New branches	2,197	2,040	1,309	901	408	731	157
Branches converted from banks	411	397	223	150	73	174	14
Discontinued[2]	–1,210	–1,158	–934	–768	–166	–224	–52
Other[3]	0	129	433	193	240	–304	–129
Net change	1,398	1,408	1,031	476	555	377	–10
Number, Dec. 31, 1999	**67,314**	**64,056**	**47,026**	**35,813**	**11,213**	**17,030**	**3,258**
	Banks affiliated with bank holding companies						
BANKS							
Number, Dec. 31, 1998	**6,988**	**6,850**	**2,817**	**1,984**	**833**	**4,033**	**138**
Changes during 1999							
BHC-affiliated new banks	281	264	110	66	44	154	17
Banks converted into branches	–365	–352	–173	–117	–56	–179	–13
Ceased banking operation[2]	–46	–42	–15	–12	–3	–27	–4
Other[3]	0	2	33	–7	40	–31	–2
Net change	–130	–128	–45	–70	25	–83	–2
Number, Dec. 31, 1999	**6,858**	**6,722**	**2,772**	**1,914**	**858**	**3,950**	**136**

[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.

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1999

A. Mergers Approved Involving Wholly Owned Subsidiaries of Different Holding Companies

The following transactions involve banks that are subsidiaries of different bank holding companies. In each case the SUMMARY REPORT BY THE ATTORNEY GENERAL indicated that the transaction would not have a significant adverse effect on competition. Also, in each case the Federal Reserve determined that the banking factors and considerations relating to the convenience and needs of the community to be served were consistent with approval.

Institution[1]	Assets (millions of dollars)	Date Summary Report issued	Date of approval	Board of Governors comment
People First Bank, Hennessey, Oklahoma	394	12-15-98	1-4-99	The parties operate in the same market
to merge with				
First State Bank, Hobart, Oklahoma	37			
Centura Banks, Inc., Rocky Mount, North Carolina	7,000	12-30-98	1-8-99	The parties operate in the same market
to acquire assets and liabilities of				
First Coastal Bank, Virginia Beach, Virginia (20 branches)	582			
First State Bank, Brunsville, Iowa	14	1-14-99	1-8-99	The parties operate in the same market
to merge with				
Farmers State Bank, Merrill, Iowa	25			
Anadarko Bank and Trust Company, Anadarko, Oklahoma	39	1-14-99	1-12-99	The parties operate in the same market
to acquire assets and liabilities of				
BancFirst, Oklahoma City, Oklahoma (1 branch)	17			
Mobile County Bank, Grand Bay, Alabama	23	1-14-99	1-22-99	The parties operate in the same market
to acquire assets and liabilities of				
Union Planters Bank, N.A., Memphis, Tennessee (1 branch)	9			
F&M Bank–Northern Virginia, Fairfax, Virginia	658	1-28-99	2-17-99	The parties operate in the same market
to merge with				
Security Bank Corporation, Manassas, Virginia	60			
Manufacturers and Traders Trust Company, Buffalo, New York	19,000	2-11-99	2-22-99	The parties operate in the same market
to acquire assets and liabilities of				
First National Bank of Rochester, Rochester, New York (4 branches)	568			

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1999—Continued

A. Mergers Approved Involving Wholly Owned Subsidiaries of Different Holding Companies—Continued

Institution[1]	Assets (millions of dollars)	Date Summary Report issued	Date of approval	Board of Governors comment
Compass Bank (Arizona Bank), Tucson, Arizona	803	12-15-98	3-3-99	The parties do not operate in the same market
to acquire assets and liabilities of				
Norwest Bank Arizona, N.A., Phoenix, Arizona (14 branches)	597			
Compass Bank, Birmingham, Alabama	17,700	3-15-99	3-3-99	The parties do not operate in the same market
to merge with				
Compass Bank–Colorado, Englewood, Colorado	291			
Bank of Oakfield, Oakfield, Wisconsin	28	3-15-99	3-4-99	The parties operate in the same market
to merge with				
M&I Central State Bank, Ripton, Wisconsin (1 branch)	8			
Premier Bank, Lenexa, Kansas	117	4-6-99	3-30-99	The parties do not operate in the same market
to merge with				
Bank of Craig, Craig, Missouri	8			
Northwestern Bank, Chippewa Falls, Wisconsin	177	3-30-99	3-30-99	The parties operate in the same market
to merge with				
M&I Community State Bank, Eau Claire, Wisconsin (1 branch)	11,400			
WestStar Bank, Vail, Colorado	294	4-20-99	4-12-99	The parties operate in the same market
to acquire assets and liabilities of				
World Savings Bank and World Savings and Loan, Oakland, California	43			
First Interstate Bank, Billings, Montana	1,608	4-6-99	4-15-99	The parties operate in the same market
to acquire assets and liabilities of				
First National Bank of Montana, Libby, Montana (2 branches)	2			
Union Colony Bank, Greeley, Colorado	249	4-20-99	4-23-99	The parties operate in the same market
to acquire assets and liabilities of				
World Savings and Loan Association, Brighton, Colorado (1 branch)	47			

15.—Continued

A.—Continued

Institution[1]	Assets (millions of dollars)	Date Summary Report issued	Date of approval	Board of Governors comment
Central Savings Bank, Sault Saint Marie, Michigan	120	5-3-99	5-7-99	The parties operate in the same market
to acquire assets and liabilities of				
North Country Bank & Trust, Mainstique, Michigan (2 branches)	12			
Summit Bank, Bethlehem, Pennsylvania	2,900	5-24-99	5-17-99	The parties operate in the same market
to merge with				
Prime Bank, Philadelphia, Pennsylvania	1,000			
Eaton Bank, Eaton, Colorado	248	5-24-99	5-19-99	The parties operate in the same market
to acquire assets and liabilities of				
World Savings Bank and World Savings and Loan Association, Oakland, California	47			
FCNB Bank, Frederick, Maryland	1,300	6-4-99	5-19-99	The parties operate in the same market
to merge with				
First Bank of Frederick, Frederick, Maryland	122			
Republic Security Bank, West Palm Beach, Florida	3,000	6-4-99	5-26-99	The parties operate in the same market
to merge with				
First National Bank of Central Florida, Longwood, Florida	137			
Old Kent Bank, Grand Rapids, Michigan	16,000	6-4-99	5-27-99	The parties do not operate in the same market
to merge with				
Community First Bank, Lansing, Michigan	900			
Chemical Bank Bay Area, Bay City, Michigan	214	6-22-99	6-9-99	The parties operate in the same market
to acquire assets and liabilities of				
National City Bank Michigan/Illinois, Bannockburn, Illinois (2 branches)	32			
Laurel Bank, Johnstown, Pennsylvania	1,900	6-22-99	6-10-99	The parties operate in the same market
to merge with				
First Philson Bank, N.A., Berlin, Pennsylvania	212			

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1999—Continued

A. Mergers Approved Involving Wholly Owned Subsidiaries of Different Holding Companies—Continued

Institution[1]	Assets (millions of dollars)	Date Summary Report issued	Date of approval	Board of Governors comment
Citizens Banking Company, Salineville, Ohio	1,800	6-4-99	6-17-99	The parties operate in the same market
to acquire assets and liabilities of First Western Bank, N.A., New Castle, Pennsylvania (43 branches)	2,000			
Mid American National Bank and Trust Company, Toledo, Ohio	2,000	6-4-99	6-17-99	The parties operate in the same market
to acquire assets and liabilities of First Federal Bank, F.S.B., Bowling Green, Ohio (4 branches)	168			
First American Bank & Trust Company, Purcell, Oklahoma	98	6-4-99	6-18-99	The parties do not operate in the same market
to acquire assets and liabilities of Dewey County State Bank, Taloga, Oklahoma (1 branch)	16			
F&M Bank–Winchester, Winchester, Virginia	802	6-30-99	6-28-99	The parties operate in the same market
to acquire assets and liabilities of Wachovia Bank, N.A., Winston–Salem, North Carolina (2 branches)	26			
Bank of Utah, Ogden, Utah	330	7-15-99	7-16-99	The parties do not operate in the same market
to acquire assets and liabilities of First Commerce Bank, Logan, Utah (19 branches)	30			
Old Kent Bank, Grand Rapids, Michigan	16,600	7-29-99	7-28-99	The parties do not operate in the same market
to merge with Pinnacle Bank, Cicero, Illinois	870			
Clear Lake Bank and Trust Company, Clear Lake, Iowa	141	7-29-99	7-30-99	The parties operate in the same market
to acquire assets and liabilities of Liberty Bank, F.S.B. (Liberty), Arnolds Park, Iowa (1 branch)	22			
Glacier Bank, Kalispell, Montana	370	8-12-99	8-6-99	The parties do not operate in the same market
to acquire assets and liabilities of Washington Mutual Bank, FSB, Salt Lake City, Utah (2 branches)	82			

15.—Continued

A.—Continued

Institution[1]	Assets (millions of dollars)	Date Summary Report issued	Date of approval	Board of Governors comment
Orrstown Bank, Orrstown, Pennsylvania	239	9-2-99	8-9-99	The parties do not operate in the same market
to acquire assets and liabilities of Sovereign Bank, Wyomissing, Pennsylvania (1 branch)	5			
Pullman Bank and Trust Company, Chicago Illinois	494	9-2-99	8-13-99	The parties operate in the same market
to merge with Chicago City Bank and Trust Company, Chicago Illinois	169			
Manufacturers & Traders Trust Company, Buffalo, New York	20,000	7-15-99	8-16-99	The parties operate in the same market
to acquire assets and liabilities of Chase Manhattan Bank, New York, New York (33 branches)	291,000			
Bank Iowa, Red Oak, Iowa	20	7-29-99	8-18-99	The parties operate in the same market
to acquire assets and liabilities of US Bank, N.A., Minneapolis, Minnesota (1 branch)	20			
Citizens Bank, Flint, Michigan	4,000	9-2-99	8-19-99	The parties operate in the same market
to acquire assets and liabilities of Bank One Michigan, Detroit, Michigan (15 branches)	23,000			
Sky Bank, Salineville, Ohio	1,800	9-2-99	8-19-99	The parties operate in the same market
to merge with Mahoning National Bank of Youngstown, Youngstown, Ohio	808			
Banco Popular North America, New York, New York	4,000	7-29-99	8-20-99	The parties do not operate in the same market
to merge with Banco Popular, N.A. (Texas), Houston, Texas	125			
Texas State Bank, McAllen, Texas	2,000	7-29-99	8-23-99	The parties do not operate in the same market
to merge with Harlingen National Bank, Harlingen, Texas	212			

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1999—Continued

A. Mergers Approved Involving Wholly Owned Subsidiaries of Different Holding Companies—Continued

Institution[1]	Assets (millions of dollars)	Date Summary Report issued	Date of approval	Board of Governors comment
Compass Bank, Birmingham, Alabama	16,400	9-2-99	8-26-99	The parties operate in the same market
to merge with				
Hartland Bank, National Association, Austin, Texas	294			
Cumberland Bank, Carthage, Tennessee	158	9-23-99	9-3-99	The parties do not operate in the same market
to acquire assets and liabilities of				
American City Bank, Tullahoma, Tennessee (2 branches)	104			
United Bank of Philadelphia, Philadelphia, Pennsylvania	114	7-29-99	9-7-99	The parties operate in the same market
to acquire assets and liabilities of				
First Union National Bank, Charlotte, North Carolina (4 branches)	230,000			
Citizens Bank & Trust Company, Okmulgee, Oklahoma	83	9-2-99	9-14-99	The parties operate in the same market
to acquire assets and liabilities of				
Bank of Oklahoma, N.A., Tulsa, Oklahoma (3 branches)	2			
Fifth Third Bank of Indiana, Indianapolis, Indiana	1,380	9-2-99	9-14-99	The parties operate in the same market
to merge with				
Civitas Bank, St. Joseph, Michigan	7,700			
Fifth Third Bank of Kentucky, Louisville, Kentucky	1,960	9-2-99	9-14-99	The parties operate in the same market
to acquire assets and liabilities of				
Civitas Bank, Louisville, Kentucky (4 branches)	.1			
Ohio Bank, Findlay, Ohio	1,200	9-23-99	9-15-99	The parties do not operate in the same market
to acquire assets and liabilities of				
National City Bank, Kenton, Ohio (1 branch)	31			
Sky Bank, Salineville, Ohio	1,800	9-23-99	9-15-99	The parties do not operate in the same market
to acquire assets and liabilities of				
National City Bank, Wellsville, Ohio (1 branch)	7			

15.—Continued

A.—Continued

Institution[1]	Assets (millions of dollars)	Date Summary Report issued	Date of approval	Board of Governors comment
Southern Financial Bank, Warrenton, Virginia	272	9-2-99	9-15-99	The parties operate in the same market
to merge with				
Horizon Bank of Virginia, Merrifield, Virginia	135			
Fifth Third Bank–Indiana, Indianapolis, Indiana	1,384	9-23-99	9-20-99	The parties operate in the same market
to merge with				
Peoples Bank & Trust Company, Indianapolis, Indiana	672			
First Bank of Philadelphia, Philadelphia, Pennsylvania	71	7-29-99	9-21-99	The parties operate in the same market
to merge with				
Pennsylvania Savings Bank, Philadelphia, Pennsylvania	182			
Pinnacle Bank, Papillion, Nebraska	259	9-2-99	9-24-99	The parties do not operate in the same market
to merge with				
Waverly Bank, Waverly, Missouri	22			
Union Colony Bank, Greeley, Colorado	279	10-13-99	10-18-99	The parties do not operate in the same market
to merge with				
First National Bank of Johnstown, Johnstown, Colorado	34			
Compass Bank, Birmingham, Alabama	18,000	10-27-99	11-5-99	The parties do not operate in the same market
to acquire assets and liabilities of				
Western Bank, Albuquerque, New Mexico (10 branches)	274			
UnionBank, West, Macomb, Illinois	141	10-27-99	11-5-99	The parties do not operate in the same market
to acquire assets and liabilities of				
Associated Bank, Illinois N.A., Rockford, Illinois (1 branch)	2,700			
Peapack Gladstone Financial Corporation, Gladstone, New Jersey	409	10-27-99	11-12-99	The parties operate in the same market
to merge with				
Chatham Savings, F.S.B., Chatham, New Jersey	81			

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1999—Continued

A. Mergers Approved Involving Wholly Owned Subsidiaries of Different Holding Companies—Continued

Institution[1]	Assets (millions of dollars)	Date Summary Report issued	Date of approval	Board of Governors comment
Valencia Bank & Trust, Santa Clarita, California	185	10-13-99	11-16-99	The parties operate in the same market
to acquire assets and liabilities of First Valley National Bank, Lancaster, California (2 branches)	38			
Provident Bank, Cincinnati, Ohio	8,000	11-10-99	11-17-99	The parties operate in the same market
to acquire assets and liabilities of Centennial Bank, Cincinnati, Ohio (8 branches)	803			
Midwest Bank of Western Illinois, Monmouth, Illinois	143	10-10-99	12-3-99	The parties do not operate in the same market
to acquire assets and liabilities of Associated Bank Illinois, N.A., Rockford, Illinois (1 branch)	17			
Republic National Bank of New York, New York, New York	49,000	9-2-99	12-6-99	The parties operate in the same market
to merge with HSBC Bank USA, Buffalo, New York	34,000			
First Security Bank of Nevada, Las Vegas, Nevada	1,500	12-10-99	12-16-99	The parties operate in the same market
to acquire assets and liabilities of Nevada State Bank, Las Vegas, Nevada (42 branches)	1,200			
Grant County Bank, Medford, Oklahoma	51	12-22-99	12-22-99	The parties operate in the same market
to acquire assets and liabilities of First Capital Bank, Guthrie, Oklahoma (1 branch)	389			
Bank of Colorado, Fort Lupton, Colorado	445	12-22-99	12-31-99	The parties do not operate in the same market
to acquire assets and liabilities of Burns National Bank, Durango, Colorado (1 branch)	145			
Effingham State Bank, Effingham, Illinois	193	12-22-99	12-31-99	The parties do not operate in the same market
to acquire assets and liabilities of Associated Bank Illinois, National Association, Rockford, Illinois (1 branch)	25			

Footnotes appear at the end of table 15, C.

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1999—Continued

B. Mergers Approved Involving Wholly Owned Subsidiaries of the Same Bank Holding Company

The following transactions involve banks that are subsidiaries of the same bank holding company. In each case, the SUMMARY REPORT BY THE ATTORNEY GENERAL indicated that the transaction would not have a significantly adverse effect on competition because the proposed merger is essentially a corporate reorganization. The Board of Governors, the Federal Reserve Bank, or the Secretary of the Board of Governors, whichever approved the application, determined that the competitive effects of the proposed transaction, the financial and managerial resources and prospects of the banks concerned, as well as the convenience and needs of the community to be served were consistent with approval.

Institution[1]	Assets (millions of dollars)	Date of approval
Union Bank & Trust Company, Bowling Green, Virginia	420	1-28-99
Merger		
King George State Bank, King George, Virginia	73	
Baylake Bank, Sturgeon Bay, Wisconsin	486	2-5-99
Merger		
Baylake Bank, N.A., Poy Sippi, Wisconsin	98	
First Virginia Bank–Southwest, Roanoke, Virginia	821	2-11-99
Merger		
First Virginia Bank–Clinch Valley, Tazewell, Virginia	266	
First Virginia Bank–Piedmont, Lynchburg, Virginia	222	
First Virginia Bank–Franklin County, Rocky Mount, Virginia	139	
First Liberty Bank & Trust, Jermyn, Pennsylvania	352	2-12-99
Merger		
NBO National Bank–Olyphant, Olyphant, Pennsylvania	164	
NBO National Bank–Scranton, Scranton, Pennsylvania	69	
NBO National Bank–Pittston, Pittston, Pennsylvania	32	
First Community Bank, Glasgow, Montana	112	3-4-99
Merger		
First Community Bank of Froid, Froid, Montana	12	
Pinnacle Bank–Torrington, Torrington, Wyoming	87	3-18-99
Merger		
Pinnacle Bank of Cheyenne, Cheyenne, Wyoming	19	
Citizens Bank and Trust Company, Van Buren, Arkansas	187	3-19-99
Merger		
River Bank & Trust Company, Lavaca, Arkansas	81	
Adams Bank, Ogallala, Nebraska	230	3-24-99
Merger		
Bank of Indianola, Indianola, Nebraska	22	

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1999—Continued

B. Mergers Approved Involving Wholly Owned Subsidiaries of the Same Bank Holding Company—Continued

Institution[1]	Assets (millions of dollars)	Date of approval
Pinnacle Bank, Papillion, Nebraska	242	3-25-99
Merger		
Gretna State Bank, Gretna, Nebraska	25	
Farmers Bank of Maryland, Annapolis, Maryland	887	4-6-99
Merger		
First Virginia Bank–Maryland, Upper Marlboro, Maryland	290	
Fifth Third Bank, Florida, Naples, Florida	240	4-27-99
Merger		
South Florida Bank, Fort Myers, Florida	90	
BANKFIRST, Sioux Falls, South Dakota	221	5-12-99
Merger		
Minnesota BANKFIRST, Minneapolis, Minnesota	135	
First Security Bank of Nevada, Las Vegas, Nevada	1,100	5-14-99
Merger		
Nevada Banking Company, Stateline, Nevada	128	
Comstock Bank, Reno, Nevada	223	
Community First Bank & Trust, Celina, Ohio	645	5-21-99
Merger		
Union Trust Bank, Union City, Indiana	45	
Pullman Bank and Trust Company, Chicago, Illinois	914	5-21-99
Merger		
Regency Savings Bank–Chicago Branch, Chicago, Illinois	44	
Regency Savings Bank–Dolton Branch, Dolton, Illinois	146	
Regency Savings Bank–Sauk Village Branch, Sauk Village, Illinois	21	
Regency Savings Bank–Lansing Branch, Lansing, Illinois	61	
Regency Savings Bank–Chicago Branch, Chicago, Illinois	78	
F&M Bank–Iowa Central, Marshalltown, Iowa	350	6-14-99
Merger		
F&M–Iowa South Central, Grinnell, Iowa	121	
F&M–Iowa Story County, Story County, Iowa	91	
First Virginia Bank of Tidewater, Norfolk, Virginia	534	6-16-99
Merger		
First Virginia Bank–Commonwealth, Newport News, Virginia	253	
Iowa State Bank, Calmar, Iowa	22	6-16-99
Merger		
Ossian State Bank, Ossian, Iowa	23	

15.—Continued

B.—Continued

Institution[1]	Assets (millions of dollars)	Date of approval
Fifth Third Bank of Central Kentucky, Inc., Cynthiana, Kentucky	61	6-17-99
Merger		
Fifth Third Bank of Central Kentucky, Inc., Louisville, Kentucky	1,870	
Civitas Bank, St. Joseph, Michigan	7,200	7-14-99
Merger		
First Indiana Bank, F.S.B., Indianapolis, Indiana (5 branches)	132	
WestStar Bank, Vail Colorado	290	7-15-99
Merger		
Bank of Telluride, Telluride, Colorado	86	
Western Colorado Bank, Montrose, Colorado	58	
County Bank, Merced, California	441	7-16-99
Merger		
Town and Country Finance and Thrift, Turlock, California	47	
First American Bank, Carpentersville, Illinois	1,142	7-27-99
Merger		
First American Bank, Joliet, Illinois	126	
First American Bank, Kankakee, Illinois	133	
Compass Bank, Birmingham, Alabama	16,400	7-28-99
Merger		
Arizona Bank, Tucson, Arizona	833	
First Interstate Bank, Billings, Montana	1,561	7-29-99
Merger		
Security State Bank and Trust Company, Polson, Montana	62	
Fort Madison Bank & Trust Co., Fort Madison, Iowa	113	8-5-99
Merger		
Bank of Dallas City, Dallas City, Illinois	14	
Effingham State Bank, Effingham, Illinois	162	8-6-99
Merger		
State Bank of Farina, Farina, Illinois	29	
Fifth Third Bank of Lexington, Inc., Lexington, Kentucky	203	8-19-99
Merger		
Fifth Third Bank, Kentucky, Inc., Louisville, Kentucky	1,973	
Fifth Third Kentucky, Inc., Louisville, Kentucky	1,973	8-19-99
Merger		
Fifth Third Bank of Lexington, Inc., Lexington, Kentucky	201	

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1999—Continued

B. Mergers Approved Involving Wholly Owned Subsidiaries of the Same Bank Holding Company—Continued

Institution[1]	Assets (millions of dollars)	Date of approval
Pinnacle Bank, Papillion, Nebraska	259	10-14-99
Merger		
Pinnacle Bank, Palmer, Nebraska	18	
Pinnacle Bank, N.A., Central City, Nebraska	33	
Provident Bank, Cincinnati, Ohio	8,071	10-25-99
Merger		
Oak Hill Savings and Loan Company, Cincinnati, Ohio	277	
The Bank of Orange, County, Fountain Valley, California	95	10-27-99
Merger		
Security First Bank, Fullerton, California	51	
CalWest Bank, Downey, California	62	10-27-99
Merger		
National Business Bank, Torrance, California	13	
AmSouth Bank, Birmingham, Alabama	20,500	11-2-99
Merger		
First American National Bank, Nashville, Tennessee	21,300	
SunTrust Bank, Atlanta, Atlanta, Georgia	20,100	11-18-99
Merger		
SunTrust Bank, Alabama, N.A., Florence, Alabama	374	
SunTrust Bank, Central Florida, N.A., Orlando, Florida	8,619	
SunTrust Bank, East Central Florida, Daytona Beach, Florida	1,268	
SunTrust Bank, Gulf Coast, Sarasota, Florida	2,249	
SunTrust Bank, Miami, N.A., Miami, Florida	5,405	
SunTrust Bank, Mid-Florida, Lakeland, Florida	1,050	
SunTrust Bank, Nature Coast, Brooksville, Florida	1,775	
SunTrust Bank, North Central Florida, Ocala, Florida	1,034	
SunTrust Bank, North Florida, N.A., Jacksonville, Florida	1,137	
SunTrust Bank, South Florida, N.A., Fort Lauderdale, Florida	4,725	
SunTrust Bank, Southwest Florida, Fort Myers, Florida	1,614	
SunTrust Bank, Northwest Florida, Tallahassee, Florida	1,199	
SunTrust Bank, Tampa, Florida	2,835	
SunTrust Bank, Northeast Georgia, N.A., Athens, Georgia	694	
SunTrust Bank, Southeast Georgia, N.A., Brunswick, Georgia	573	
SunTrust Bank, West Georgia, N.A., Columbus, Georgia	551	
SunTrust Bank, Augusta, N.A., Evans, Georgia	586	
SunTrust Bank, South Georgia, N.A., Leesburg, Georgia	721	
SunTrust Bank, Middle Georgia, N.A., Macon, Georgia	675	
SunTrust Bank, Northwest Georgia, N.A., Rome, Georgia	365	
SunTrust Bank, Savannah, N.A., Savannah, Georgia	710	
SunTrust Bank, Chattanooga, N.A., Chattanooga, Tennessee	1,570	
SunTrust Bank, East Tennessee, N.A., Knoxville, Tennessee	2,210	
SunTrust Bank, Nashville, N.A., Nashville, Tennessee	4,947	
SunTrust Bank, South Central Tennessee, N.A., Pulaski, Tennessee	337	
Crestar Bank, Richmond, Virginia	25,659	

15.—Continued

B.—Continued

Institution[1]	Assets (millions of dollars)	Date of approval
SunTrust Bank, Atlanta, Atlanta, Georgia	20,701	11-24-99
Merger		
STI Capital Management, N.A., Orlando, Florida	9	
F&M Bank Northeast, Pulaski, Wisconsin	355	12-2-99
Merger		
F&M Bank–Algoma, Algoma, Wisconsin	94	
F&M Bank–Appleton, Appleton, Wisconsin	76	
F&M Bank–Brodhead, Brodhead, Wisconsin	37	
F&M Bank–Central, Stevens Point, Wisconsin	138	
F&M Bank–Darlington, Darlington, Wisconsin	112	
F&M Bank–Elkhorn, Elkhorn, Wisconsin	96	
F&M Bank–East Troy, East Troy, Wisconsin	57	
F&M Bank–Grant County, Fennimore, Wisconsin	134	
F&M Bank–Hilbert, Hilbert, Wisconsin	34	
F&M Bank–Jefferson, Jefferson, Wisconsin	97	
F&M Bank–Kiel, Kiel, Wisconsin	45	
F&M Bank–Kaukauna, Kaukauna, Wisconsin	149	
F&M Bank–Lakeland, Woodruff, Wisconsin	197	
F&M Bank–Landmark, Hudson, Wisconsin	47	
F&M Bank–New London, New London, Wisconsin	38	
F&M Bank–Prairie du Chien, Prairie du Chien, Wisconsin	98	
F&M Bank–Superior, Superior, Wisconsin	35	
F&M Bank–Waushara County, Waucoma, Wisconsin	107	
F&M Bank–Winnegago County, Omro, Wisconsin	102	
Wesbanco Bank Wheeling, Wheeling, West Virginia	1,111	12-7-99
Merger		
Wesbanco Bank Charleston, Charleston, West Virginia	144	
Wesbanco Bank Fairmont, Fairmont, West Virginia	575	
Wesbanco Bank Parkersburg, Parkersburg, West Virginia	426	
Columbia Bank, Tampa, Florida	78	12-8-99
Merger		
Southern Exchange Bank, Tampa, Florida	220	
Gold Bank, Leawood, Kansas	329	12-22-99
Merger		
Citizens State Bank & Trust Company, Seneca, Kansas	67	
Peoples National Bank, Clay Center, Kansas	133	
Farmers National Bank, Oberlin, Kansas	52	
First National Bank in Alma, Alma, Kansas	31	
Farmers State Bank, Sebetha, Kansas	58	
Peoples State Bank, Colby, Kansas	26	
The First State Bank & Trust Company, Pittsburg, Kansas	115	

Footnotes appear at the end of table 15, C.

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1999—Continued

C. Mergers Approved Involving a Non-Operating Institution with an Existing Bank

The following transactions have no significant effect on competition; they merely facilitate the acquisition of the voting shares of a bank (or banks) by a holding company. In such cases, the SUMMARY REPORT BY THE ATTORNEY GENERAL indicates that the transaction will merely combine an existing bank with a non-operating institution; in consequence, and without regard to the acquisition of the surviving bank by the holding company, the merger would have no effect on competition. The Board of Governors, the Federal Reserve Bank, or the Secretary of the Board, whichever approved the application, determined that the proposal would, in itself, have no adverse competitive effects and that the financial factors and considerations relating to the convenience and needs of the community were consistent with approval.

Institution[1]	Assets (millions of dollars)[2]	Date of approval
First American Bank and Trust Company, Purcell, Oklahoma	96	1-21-99
Merger		
First American Bank (Interim Branch), Maysville, Oklahoma		
Frontier Bank of Laramie County, Cheyenne, Wyoming	21	3-18-99
Merger		
Pinnacle Bank of Cheyenne (Interim Branch), Cheyenne, Wyoming		
Minster Bank, Minster, Ohio	181	5-6-99
Merger		
MSB Interim Bank, Minster, Ohio		
Lemay Bank and Trust Company, St. Louis, Missouri	561	5-25-99
Merger		
LBT Interim Bank, St. Louis, Missouri		
Community First Bank, Lansing, Michigan	900	5-27-99
Merger		
CFSB Acquisition Corp., Lansing, Michigan		
State Bank of Remington, Inc., Remington, Virginia	70	7-7-99
Merger		
JRB Acquisition Bank, Inc., Suffolk, Virginia		
Main Street Bank, Reading, Pennsylvania	1,291	8-2-99
Merger		
Main Street Bank New Jersey (in formation), Lambertville, New Jersey		
Harlingen National Bank, Harlingen, Texas	212	8-23-99
Merger		
Texas Regional Acquisition Corp., Delaware		
The Vintage Bank, Napa, California	191	10-4-99
Merger		
The Vintage Merger Co., Napa, California		

15.—Continued

C.—Continued

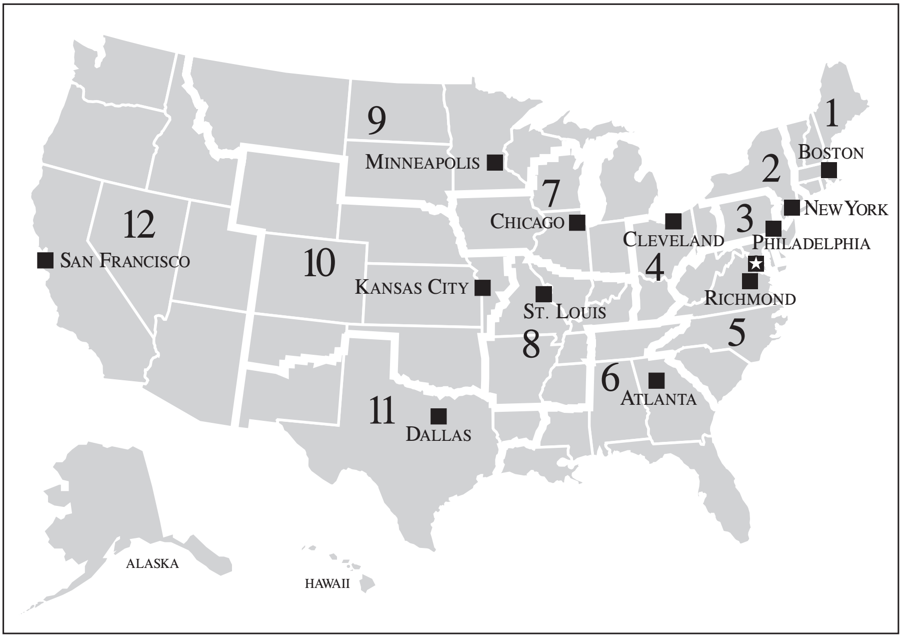
Institution[1]	Assets (millions of dollars)	Date of approval
First National Bank of Johnstown, Johnstown, Colorado	34	10-18-99
Merger		
FN Acquisition Corp., Johnstown, Colorado		
Potomac Valley Bank, Petersburg, West Virginia	92	11-26-99
Merger		
Potomac Interim Bank, Inc., Petersburg, West Virginia		
First State Bank, Oklahoma City, Oklahoma	112	11-30-99
Merger		
First State Bank, Oklahoma City, Oklahoma		

1. Each proposed transaction was to be effected under the charter of the first named bank. The entries are in chronological order of approval. Some transactions include the acquisition of certain assets and liabilities of the affiliated bank.

2. Where no assets are listed, the bank is newly organized and not in operation.

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

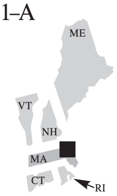
Note

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.

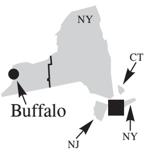
The System serves commonwealths and territories as follows: The New York Bank serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands; the San Francisco Bank serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands. The maps show the boundaries within the System as of year-end 1999.

1–A



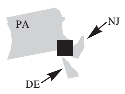
BOSTON

2–B



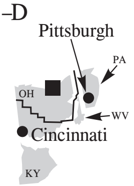
NEW YORK

3–C



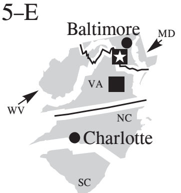
PHILADELPHIA

4–D



CLEVELAND

5–E

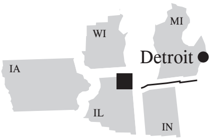


RICHMOND

6–F

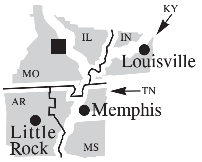
ATLANTA

7–G



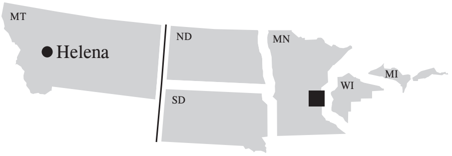
CHICAGO

8–H



ST. LOUIS

9–I



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