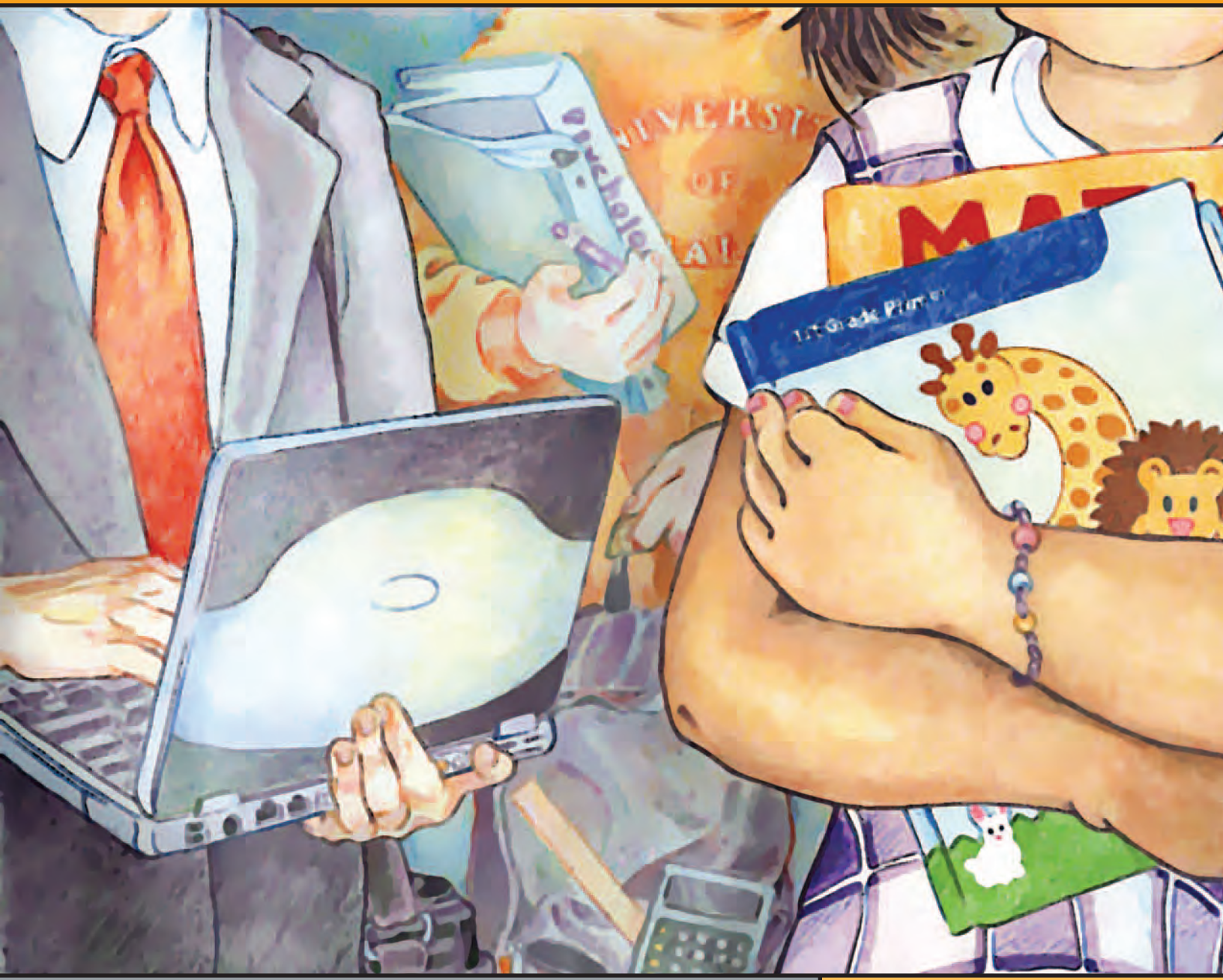
What D'Ya Know?



LIFETIME LEARNING
IN PURSUIT OF THE AMERICAN DREAM

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A LETTER FROM THE ACTING PRESIDENT

The Federal Reserve Bank of Dallas opened for business 90 years ago in rented quarters downtown, a milestone we celebrated in November. Our location has changed three times since then, as we've grown and evolved with the dynamic region we serve. But our fundamental mission—to promote economic prosperity, financial stability and an effective payments system—has not changed. In 2004, we performed essential activities in support of that mission and saw continuation of the evolutionary forces that marked our first 90 years.

The Dallas Fed's evolution will continue in 2005 as it moves forward under new leadership. After nearly 14 years as president and 36 years of service to the Federal Reserve System, Bob McTeer resigned last year to become chancellor of the Texas A&M University System. Richard W. Fisher, vice chairman of Kissinger McLarty Associates, was named the Dallas Fed's 12th president. As the first new president in the 21st century, he'll set the Bank's direction for the coming decades. We're pleased to have Richard join the Bank and look forward to working with him.

ECONOMIC OVERVIEW

The Eleventh District economy continued to expand in 2004, but at a much slower pace than it has enjoyed in the past. After outperforming the nation since the mid-1970s, Texas—by far the District's largest component—has been slow to recover from the most recent recession. Coming out of the downturn in the second half of 2003—more than 18 months after the nation—Texas posted steady job growth of 1.3 percent in 2004, half what it has averaged since 1974.

Several factors account for changes in the Texas economy's performance. The state was hard-hit when the high-tech bubble burst. The sector's slow recovery and the resulting structural change in the economy are among the principal reasons for the state's sluggish growth.

The energy industry did well throughout the District, thanks to soaring oil and natural gas prices, but rising energy prices haven't propelled the Texas economy ahead of the nation's the way they did in the 1970s and '80s. Research conducted here at the Dallas Fed indicates that climbing energy prices still benefit the Texas economy, but only by about a sixth as much as they did in the early 1980s. Since then, the Texas energy industry has shrunk, while the rest of the state's economy has grown.

In the early 1980s, the oil and gas industry accounted for more than 20 percent of Texas output. Today, it accounts for only about 5 percent. At the same time, the energy industry has become less sensitive to price fluctuations. As a result, rising energy prices haven't helped Texas' economic growth the way they once did.

The Texas economy is in transition. However, the good business climate, strong sense of entrepreneurship and optimism, and reliance on free market principles that underpin the state's economy will help it remain dynamic and prosperous.

FINANCIAL SERVICES

An efficient, stable and secure payments system is essential to the U.S. economy. The Federal Reserve and the Dallas Fed continued to have an integral role in the payments system by providing financial institutions with high-quality services and products, evolving with the latest in technology. As consumers and businesses increasingly adopt electronic forms of payment, we have both modified our service offerings and revamped our processing infrastructure for payments.

The Check Clearing for the 21st Century Act, which took effect in October, clears the way for banks to process checks electronically by making substitute checks—created from digital images—the legal equivalent of the original paper checks. Check 21 allows paper checks to be converted to digital images upon initial presentment and exchanged in electronic format through final payment or converted to substitute paper checks, if necessary. The payments system will benefit from the more rapid and less costly electronic collection of checks.

The Fed is supporting Check 21 with new products that facilitate the move to electronic processing. One of our initial services allows financial institutions to present paper checks that the Fed converts to digital images. Another service allows the Fed to receive and process digital images in lieu of paper checks. We will launch additional products and services in 2005.

Major transition in the use of paper checks is prompting changes at the Dallas Fed and across the Federal Reserve System. In 2004, we consolidated check operations at our El Paso and San Antonio branches into the Dallas office as part of the national restructuring of the Fed payments infrastructure. Both consolidations went well, notwithstanding the operational and administrative complexities. Check operations from our Houston Branch and the Oklahoma City Branch of the Kansas City Federal Reserve Bank will move to Dallas in 2005. Meanwhile, the Eleventh District's check-adjustments functions were consolidated at the Houston Branch.

As consumers and businesses continue to write fewer checks and use debit and credit cards and the automated clearinghouse more often, the move from paper will likely accelerate, transforming the nation's payments system.

While the move from checks to electronic payments continued, cash remained generally steady. In 2004, we processed near-record levels of currency and made record improvements in cost efficiency and productivity. We were particularly glad to see the long-awaited Texas quarter hit the streets in June. Demand across the Lone Star State was high, as expected.

BANKING SUPERVISION

Economic growth depends on a sound, competitive banking system. Through its supervisory activities, the Dallas Fed promotes the safe and sound operation of banking institutions based in the Eleventh District. Our supervisory role with District organizations also extends to fostering

compliance with consumer credit laws and encouraging institutions to meet the credit needs of their communities.

In addition to our formal supervisory role, we serve the industry through informal means. Banking supervision staff frequently participate on panels to discuss regulatory changes and other issues. In 2004, we conducted seminars to help bank directors understand their special fiduciary responsibilities, a particularly relevant topic given the focus on corporate governance. We continued to promote electronic filing of required financial reports and distributed tips and clarifications to help filers understand their responsibilities.

The Dallas Fed's consumer affairs staff continued to conduct advisory visits to provide state member banks with guidance on implementing their consumer compliance programs. The staff also serves the public by responding to inquiries about consumer laws and regulations and investigating complaints about specific practices. In 2004, we responded to more than 200 inquiries and complaints.

RESEARCH AND PUBLIC AFFAIRS

In keeping with the tenet that educated citizens are the foundation of a healthy economy, the Bank is dedicated to providing the public with information and insight into economic concepts and ideas. This is accomplished through a full array of public programs and outreach efforts, including conferences, publications and a web site. Our staff is active throughout the District, speaking to groups and providing perspective on issues affecting business and industry.

Sometimes, they go farther afield. Two Dallas Fed economists served on the President's Council of Economic Advisers in 2004. We are also proud of our affiliation with Finn Kydland, a Dallas Fed research associate who in December became a Nobel laureate in economics for his work on business cycles and macroeconomic policy.

Research conferences in 2004 focused on a variety of issues affecting the national and state economies. At one conference, a group of distinguished speakers examined globalization's impact on jobs, the environment, intellectual property rights, child labor and capital flows. Another conference, cosponsored by the National Association for Business Economics, addressed technology's potential impact on economic growth and productivity. We partnered with the University of Texas at Austin, in conjunction with the Delegation of the European Commission, on an international conference that discussed the euro's successes and the obstacles it still faces.

Also on the international front, economists at our San Antonio and El Paso branches convened a panel of experts to discuss the economy along the Texas–Mexico border, where security concerns and global competition are challenging the strong growth the area has enjoyed in recent years. Our Community Affairs office brought together bankers and others to discuss the latest research on immigrants' role in our economy, explore ways to provide them with banking and community development services, and identify business opportunities this growing market presents.

We also reached out to the public through our publications. *Building Wealth*, the Bank's personal finance education guide, was the most downloaded resource from our web site. *E-Perspectives* and *Banking and Community Perspectives* provided readers with information about home-ownership preservation, community development financing, Texas' changing demographics, and ways financial institutions can provide products and services to immigrants and low- to moderate-income populations. One of our most widely read publications

is *Southwest Economy*, which carried articles on the Texas economy, Social Security, immigration, energy prices and service-sector productivity.

Regional and national economic updates were posted on our web site as events unfolded. The Bank's web site attracts readers from around the world; the Spanish-language section has become particularly popular.

Our children are growing up in an increasingly global economy, and the Dallas Fed offers economic education resources for both students and teachers to help young people understand economic issues. Several hundred teachers attended our "Evening at the Fed" program on energy issues, a personal finance education workshop about the cost of credit, and a conference on the past, present and future of the U.S. economy. We saw an increase in the number of students entering our annual economic essay contest and the number of teachers participating in coaching sessions for Fed Challenge, in which high school students simulate the monetary policy decision-making process.

Lifelong Learning

The topic of this year's annual report essay is the importance of lifetime learning in our rapidly changing, knowledge-based economy. As the essay says, learning doesn't stop once we have a diploma in hand. Continually expanding knowledge and updating skills are important to individual workers as well as the economy.

Serving as the Bank's interim president has been a learning experience for me, causing me to study more deeply the Federal Reserve's monetary policy functions. When I joined the Dallas Fed 31 years ago, I never expected to one day participate in Federal Open Market Committee discussions, where monetary policy is made. While we temporarily handed off our vote to my colleague at the Atlanta Fed, as protocol prescribes, I've been proud to deliver the Bank's economic perspective to the FOMC.

The learning never stops for organizations, either—including the Federal Reserve. And as the economy continues to evolve and the needs of our customers change, we'll keep on adjusting, improving and progressing.

In Appreciation

I'd like to acknowledge the tremendous service of our boards of directors and advisory council members last year. All are private citizens who give their time and expertise to help us better understand the dynamics of the economy. Particular appreciation goes to departing board members Ron R. Harris, Marvin L. Ragsdale and R. Tom Roddy at the San Antonio Branch and Richard W. Weekley at the Houston Branch.

I would also like to thank the Bank staff for their accomplishments in 2004. Bank employees do a marvelous job of meeting our mandate, by studying the economy, supervising banks and offering high-quality financial services. Not only do they provide public service to our region and nation, but they also make the Dallas Fed a rewarding place to be. Their spirit of teamwork and dedication to excellence will help ensure the Bank's continued success through the next 90 years.

Helen E. Holcomb

What D'Ya Know?

LIFETIME LEARNING IN PURSUIT OF THE AMERICAN DREAM

Years ago, high school sweethearts Jack and Jill went off to different colleges after being named king and queen of the senior prom. Now they're both 45. He earns $47,000 a year as an assistant shoe store manager; she makes $154,000 as an advertising executive.

Jack got by without studying much in high school, making C's and the occasional D while captain of the football team. He quit college after two years and has hopped from one job to another ever since. Jack's always grumbled about his work. He finds his current job tedious and complains that it doesn't pay as much as the previous one. After work, he's either stretched out on the couch watching TV or hanging out with his buddies at Mike's Sports Bar. He tells friends he's still waiting for his "big break."

Jill got A's and B's in high school by hitting the books and spending a few hours a day in the library. She continued her good study habits in college, where she earned a bachelor's degree in advertising and then an M.B.A. Every place she's worked, Jill's honed her skills, not only to do a better job but also to prepare for the next step up. After working out at the gym several nights a week, she and her husband sometimes join friends for dinner. Other evenings, Jill takes classes, plays piano or catches up on her work.

Most of us know people like Jack and Jill. No matter what their names, these two archetypes provide object lessons in how to achieve the American Dream of opportunity, upward mobility and rising living standards.

The Jacks we know start as apathetic students, then treat their jobs casually. They want money and other rewards but put little effort into improving their skills. When work isn't satisfying, they bellyache about life not being fair.

The Jills do better in the workplace because they study hard in school, build their strengths on the job and take responsibility for personal development. Most important, they never stop learning.

Each of us chooses. We can be like Jack—neglect learning and settle for a

lifetime of complaining that holds us back. Or we can be like Jill—committed to the kind of lifetime learning that feeds success.

Jack and Jill started in the same place, at the same time. Their paths diverged because of different attitudes toward learning. Those attitudes go a long way toward explaining the gap in their paychecks.

You earn what you learn. Our parents, teachers and guidance counselors told us this fact of economic life. They encouraged us to get the most from school and always pursue new skills and knowledge. Many of us followed their advice, and America's free enterprise prosperity rests on one of the world's most educated, most highly skilled workforces.

In the future, learning will be even more important to the nation's economic success. We will live and work in an increasingly knowledge-based, global economy. Competition will intensify and the pace of change will quicken, requiring workers to continually upgrade their skills. Our jobs and living standards will depend on becoming even better at lifetime learning.

The challenge starts with improving our schools, so that they prepare us for the next generation of work. As important as education is, it won't be enough. On average, Americans spend just 4 percent of their lifetime waking hours in the classroom—too little to learn what they'll need for decades in a rapidly changing job market.

So we face a second challenge, one just as important as upgrading formal education. We need to put more effort into learning outside the classroom, so we'll be equipped to seize opportunities in a dynamic world. The economy can't create better jobs if America doesn't produce workers qualified to fill them.

What d'ya know?

We toss out this casual greeting all the time, not really inviting a serious response. When it comes to America's economic future, though, no question carries greater weight. How we answer it holds the key to good jobs and high pay.

What d'ya know?

Not enough.

We can never know enough in the modern workplace. A good education serves as the foundation for productive work. Job experience and training build on it. Lifetime learning offers a well-marked path to success. It's up to us to follow it.

PULLING OURSELVES UP BY OUR OWN BOOKMARKS

Any number of factors can determine a person's fate in the job market. Studies suggest taller men and more attractive women earn higher pay. Some of us are born into the family business. Others are just in the right place at the right time. We can't count on genetics, inheritance or luck, but nothing beats knowledge as a reliable route to greater earnings.

American workers get off to a good start with schooling—the more the better. Among employees aged 25 to 34 in 2003, high school graduates earned an average of $9,726 more a year than the barely educated—those who didn't even finish ninth grade. The income premium increased to $13,977 for some college, $16,673 for an associate's degree and $29,806 for a bachelor's. It reached $38,899 for a master's, $50,064 for a doctorate, and $61,984 for law, dentistry and other professional degrees. (*See Exhibit 1 on page 8.*)

Salaries rise as workers add experience and knowledge. We can get training in the workplace. We can take classes at universities and community colleges. We can read work-related books and search the Internet for industry information. Every day, we can improve by applying ourselves, asking questions and seeking mentors.

It pays off. Today's young Americans are more educated than their predecessors, but we can't overlook the value of experience. With only a short time in the workforce, Americans aged 25 to 34 earned an average of $46,795 in 2003. Those with more work years had time to build job skills. As a result, average pay grew to $63,818 for those 35 to 44. And it kept rising—to $64,739 for ages 45 to 54 and $67,721 for ages 55 to 64. All told, what Americans learned over their working lives added an average of $20,926 per year from the youngest group to the oldest.

Education leverages the value of experience, creating a kind of one–two punch. Among Americans whose formal education ended with high school, incomes increased with time on the job, topping out at $7,237 a year more for workers aged 55 to 64 than those 25 to 34.

The earnings edge for the oldest group of workers increased to $11,342 with some college, $17,447 for college graduates, $19,533 for master's degrees and $42,778 for doctorates. Workers aged 55 to 64 with professional degrees made $70,399 more than their least experienced colleagues.

The benefits of education and experience really show up over the long term. Working 40 years, high school graduates earn an average of $1.5 million. The long-term payoff rises to $2.6 million for finishing college, making a bachelor's degree a four-year investment worth $1.1 million. Gains continue to rise with more education—to $3 million for a master's, $4 million for a doctorate and $5.3 million for a professional degree.

Unemployment data confirm the advantages of education and experience. Jobless rates are lower for workers with more years of schooling, largely because they're more in demand. Among 25- to 34-year-olds, for example, only 3 percent of Americans with bachelor's, master's, doctoral and professional degrees were unemployed

in 2003—about half the rate for the overall economy.

Unemployment rises to nearly 12 percent for high school dropouts. The good news for this group, though, lies in the rate's steady decline as workers gain experience. Among dropouts aged 55 to 64, the unemployment rate retreats toward the national average, suggesting that even workers who start out at a disadvantage can gain the skills, talents and traits to make them valued employees. They earn lower salaries than more-educated workers, of course.

EXHIBIT 1 Our Wealth of Knowledge

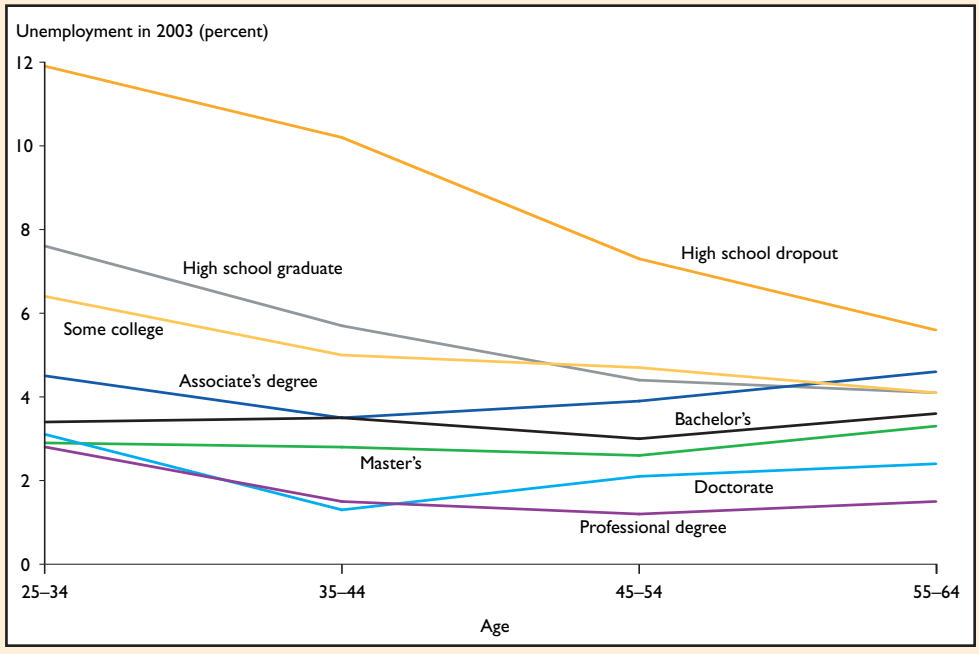
EDUCATION PAYS, AND SO DOES EXPERIENCE

Americans raise their earnings by learning both in school and on the job. Moving down the columns shows the average gains from education. Going across the rows indicates the benefit of added years on the job; the bottom row, how experience pays off for the labor force as a whole. Reading down the second to last column shows that more-educated workers enjoy the largest returns as they gain experience. The last column summarizes the combined effects of education and experience on lifetime earnings.

	Average annual earnings in 2003				Experience premium	Estimated lifetime
Education level	**Ages: 25–34**	**35–44**	**45–54**	**55–64**	**25–34 to 55–64**	**earnings**
Less than 9th grade	$21,839	$23,945	$25,167	$26,685	$4,846	$976,350
High school dropout	25,316	29,177	29,779	30,798	5,482	1,150,698
High school graduate	31,565	36,922	38,235	38,802	7,237	1,455,253
Some college, no degree	35,816	43,469	46,140	47,158	11,342	1,725,822
Associate's degree	38,512	45,594	48,253	47,778	9,266	1,801,373
Bachelor's degree	51,645	67,471	68,509	69,092	17,447	2,567,174
Master's degree	60,738	77,622	77,676	80,271	19,533	2,963,076
Doctorate	71,903	110,564	101,110	114,681	42,778	3,982,577
Professional degree	83,823	139,597	147,777	154,222	70,399	5,254,193
Equally weighted average	$46,795	$63,818	$64,739	$67,721		

SCHOOLING, EXPERIENCE REDUCE UNEMPLOYMENT

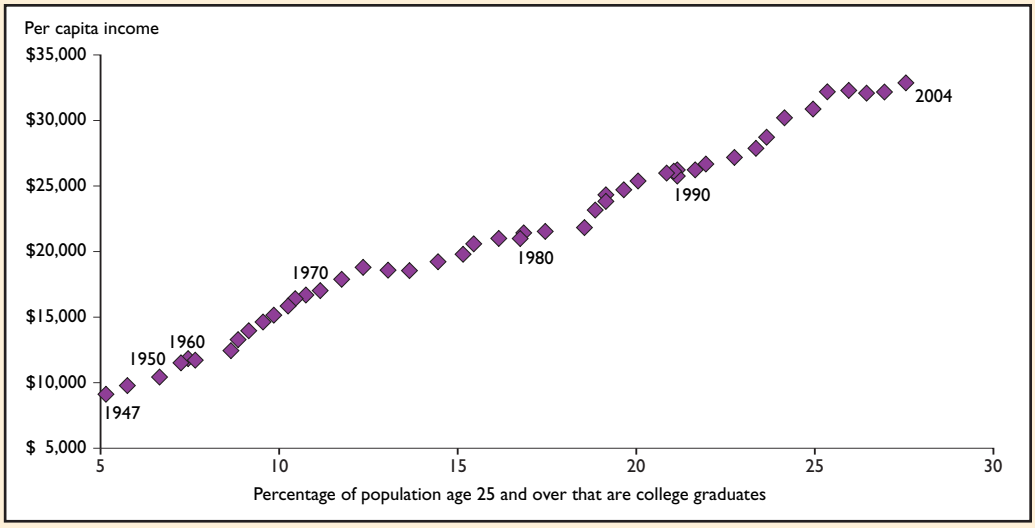
Americans with more education are less likely to be out of work. Unemployment among high school dropouts aged 25–34 is more than three times as high as it is for college graduates. Jobless rates converge for older workers, indicating that experience improves employment prospects for less-educated workers.

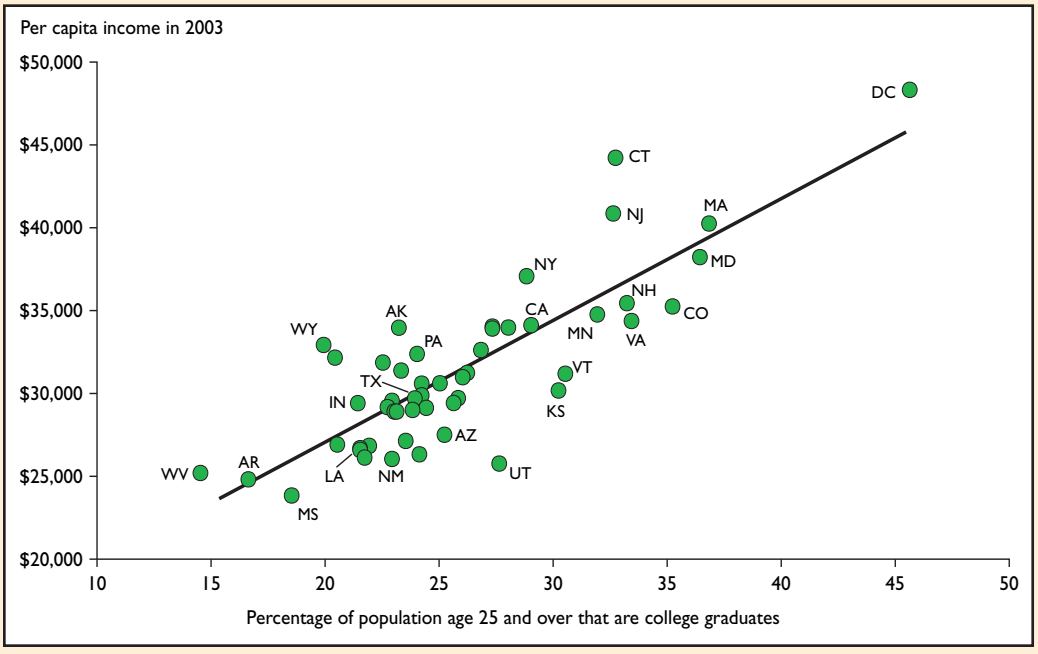


America's track record verifies that capitalism and education make a good team. Per capita income has moved steadily upward since World War II, as more Americans have graduated from high school and pursued higher education. Per capita income across states shows the same strong positive relationship with the population that has bachelor's degrees or better. This holds true around the world, too. The United States and other nations that rank high in years of schooling generate higher GDP per capita than less educated countries. (*See page 12.*)

HELPING ECONOMIES GROW RICHER

Going from individuals to economies, we see per capita income moving upward over time as Americans became better educated, indicated by a higher rate of finishing college (top). States with more college graduates also enjoy higher income (bottom). The solid line summarizes the overall positive relationship between college graduates and states' income.





ON THE DEMAND SIDE: MARKETS MAKE KNOWLEDGE PAY MORE

Why does knowledge pay off so handsomely for Americans?

We're not necessarily any smarter than the rest of the world, but we're fortunate to live in a country with a dynamic economy, one offering vast opportunities and rewards for individual initiative. In turning learning into earning, America's free enterprise system matters as much as education and experience.

Our market economy rewards workers according to the value of what they produce. Formal education gives employees knowledge that makes them more productive, so they receive higher incomes. Learning by doing and workplace training make workers more productive, too, and they see it in their paychecks.

The impetus for productivity comes from the quest for profits. Companies gain by hiring workers with the education and skills to work a better way. Self-interest gives companies the incentive to recruit, train and reward the most productive workers, just as it motivates workers to learn and become more skilled.

Modern market economies create a demand for knowledge, but they don't put the same value on all education. Capitalism's invisible hand nudges workers toward the economy's needs by sending dollars-and-cents signals on how much society values one type of knowledge relative to another.

In 2004, starting salaries for graduates with bachelor's degrees averaged $78,593 in pharmacy, $52,539 in chemical engineering, $49,036 in computer science, $41,058 in accounting and $38,920 in nursing. Other disciplines aren't as lucrative. On their first jobs, graduates in English earned $31,113; in history, $30,344; in psychology, $28,230; and in journalism, $26,758. (*See Exhibit 2.*)

Market-driven earnings disparities also exist in occupations that usually don't require a bachelor's degree. Workers make an average of $95,272 as air traffic controllers, $71,444 as real estate brokers, $59,795 as dental hygienists and $57,077 as elevator repairers. Learning remains the key, of course. Air traffic controllers go through a rigorous training program, often in the military. Real estate brokers and dental hygienists take courses to prepare for licensing exams. Vocational schools and companies teach elevator maintenance.

Highly paid noncollege workers have found ways to acquire knowledge, talents and skills that meet the test of the marketplace. Those who don't invest time and effort in learning earn a lot less—$18,055 as parking lot attendants, $19,373 as sewing machine operators and $20,763 as janitors. All are well below the average U.S. income of $36,999 a year.

Using carrots and sticks, market-based economies put a high rate of return on learning. Nations without a tradition of economic freedom tend to lag in transforming knowledge into income. Nonmarket nations don't tie wages to productivity. They might educate their workers, but pay doesn't induce society to use knowledge effectively.

Still plagued by the legacy of three generations of central planning, Russia manages just a fifth of U.S. per capita GDP, although it averages only two fewer years of schooling. Poland, Romania and Bulgaria also trail in

EXHIBIT 2 More Carrots for Some Shticks

AVERAGE STARTING SALARY FOR BACHELOR'S DEGREE

$95,000

$85,000

Pharmacy

$75,000

$65,000

Petroleum engineering

$55,000

Chemical engineering

Computer science
Actuarial science

$45,000

Mathematics and statistics

Accounting
Economics and finance
Nursing

$35,000

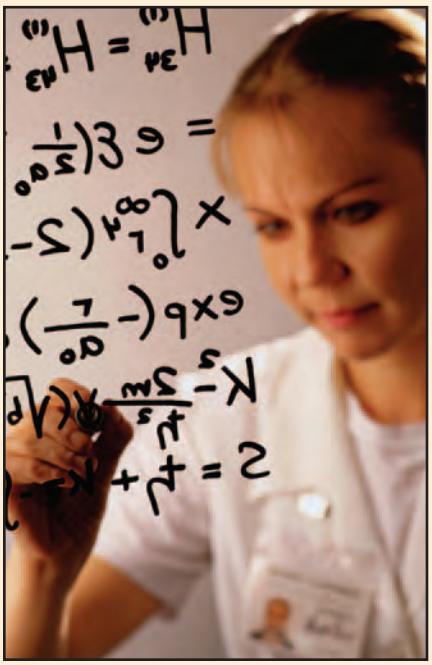
Marketing
Health and related sciences
English
History
Psychology
Journalism

$25,000

$15,000

A free enterprise economy doesn't place equal value on all learning. Among college graduates (left), starting salaries vary widely for different majors—from $26,758 in journalism to $78,593 in pharmacy. Pay differentials encourage students to major in disciplines highly demanded in the economy.

Markets offer the same kinds of incentives for jobs that usually don't require four-year degrees (right). Average incomes range from $95,272 for air traffic controllers down to $34,046 for auto mechanics. Learning still carries weight. The best-paid noncollege workers have acquired specialized skills through the military, vocational schools or on-the-job experience. Workers with the least education earn the lowest pay.



AVERAGE SALARY FOR EXPERIENCED WORKERS

Air traffic controller $95,000

$85,000

$75,000

Real estate broker

$65,000

Fashion designer

Dental hygienist

Elevator repairer $55,000

Construction supervisor

Flight attendant

Electrician $45,000

Brick mason

Crane operator

$35,000

Auto mechanic

Highway maintenance worker

$25,000

Barber

Janitor
Sewing machine operator
Parking lot attendant

$15,000

making education pay off. (*See Exhibit 3.*)

Communist North Korea and Cuba boast relatively high levels of education, but their moribund, state-dominated economies offer few opportunities to put knowledge to use making money. The average North Korean gets more than nine years of schooling—about equal to the average Brit—but the country's per capita GDP is only $1,083. Cuba's eight years of education yield only $1,841 per person. The typical Spaniard is slightly less educated, but the country's per capita GDP is 12 times higher than Cuba's. The difference lies in Spain's move to capitalism a generation ago.

Today, more countries than ever are in the capitalist camp, but America stands out with one of the world's freest labor markets. More than most other nations, we allow companies the freedom to hire and fire. Employers decide how many workers they need, so they're not stuck with unproductive or unnecessary people on the payroll. At the same time, workers are free to leave one job for another in search of higher pay, greater satisfaction or career advancement.

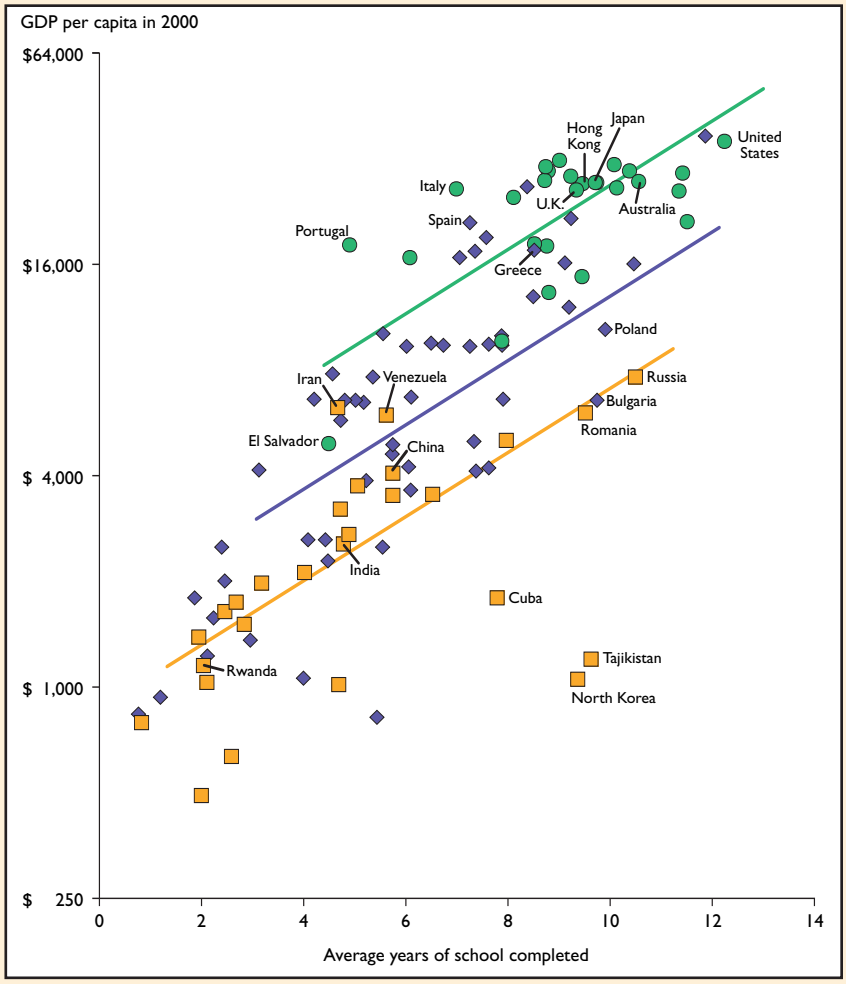
Knowledge can't achieve its full economic potential without labor market freedom. Germany, Italy, France and other countries impose barriers that slow the movement of workers, such as lengthy appeals before layoffs and government-mandated severance packages. These policies, though well-meaning, interfere not only with the quest for productivity but also with incentives to learn.

When companies and workers are free to make job decisions, scarce labor resources are channeled to their best uses, making the economy more productive and allowing learning to yield greater dividends. What we know matters. Just as important, though, is an economic system that puts our knowledge to work.

EXHIBIT 3 Ignorance Is Misery; Knowledge Is Bliss.

Free economies get the most out of education. The top quarter of the 108 nations in the Index of Economic Freedom (in green) cluster toward the top of the chart, indicating they're getting a lot of per capita GDP from years of schooling. The least-free quarter (in orange) tend to get less from their education, which pushes them toward the bottom of the chart. The remaining countries (in purple) make up the middle two quarters of the index.

The solid lines summarize the positive relationship between years of schooling and per capita GDP for the three groups of countries. Nations above the line of their peer group are getting higher returns on schooling. Being below the green line suggests Americans aren't getting as much income as we could from our years in the classroom.



MAKING THE MOST OF INTELLECTUAL CAPITAL

Knowledge didn't fuel America's economy in the past. The Industrial Age thrived on man's mastery over machine. Most work required steady hands to operate factory equipment and minds geared to such repetitive tasks as measuring and counting.

A basic education—the three R's of reading, 'riting and 'rithmetic—sufficed for most jobs. Over the course of workers' careers, jobs changed little, so talents acquired in youth often served until retirement. Lifetime learning didn't matter all that much.

America has left the Industrial Age behind. Factory work is increasingly being performed in other countries; much of what remains in the United States is highly technical, relying more on sharp minds than nimble hands.

Today, services dominate the U.S. workplace, providing 80 percent of the nation's jobs. Some of the work requires only basic skills, but many other jobs require an ability to handle complex tasks in marketing, finance, sales, law, research and business consulting. The skills of the Industrial Age aren't a good fit for these jobs. Only by upgrading their talents will Americans be ready to make the most of what our economy offers in the Information Age and beyond.

The transition entails moving up the hierarchy of human talents.[1] In the early stages of the country's economic development, most work required muscle power to lift, tote, push and pull. As industry replaced agriculture, more workers found their niche with manual dexterity and formulaic intelligence.

Postindustrial nations are shifting workers to more sophisticated jobs that require analytical intelligence, imagination and creativity, and the ability to interact with others. The work relies on brains rather than brawn. While the talents are less bookish than the traditional three R's, education experts insist they can be taught—with the right techniques.

Maintaining a comparative advantage in a modern economy requires that schools do a better job fostering creativity and people skills. Equally important, these skills have to be kept sharp in a world of rapidly changing tastes and technology. We can't just get a good education while young and expect it to suffice for an entire career.

The transformation of the way we work gives intellectual capital precedence over the physical capital that once drove the U.S. economy. Both kinds of capital make us richer, but they differ in important ways.

Physical capital grows when businesses invest in buildings, machinery and other productive assets. These are largely management decisions, and the process usually takes just a few months or years. To expand intellectual capital, we invest in human beings over decades—from learning the ABCs in preschool to mastering the latest computer programs at the office.

Companies make important contributions to creating intellectual capital, but workers must assume a large part of the responsibility. No one can learn for us. We have to supply the effort to develop our skills.

Knowledge is ultimately the property of the employee, rather than the enterprise. Workers take it with them when they switch jobs, a factor that limits companies' ability to capture the benefits of investing in human capital. As a result, workers can't count on employers to provide all the training they'll need. They must be active participants in their own education, engaging in lifetime learning on their own.

The age of intellectual capital carries important lessons for American workers.

First, education and experience pay off more today than they did yesterday. In 1974, high school graduates with about 40 years' experience earned an average of 57 percent more than those with less than a ninth grade education and only a few years on the job. By 2003, the bonus for work experience had widened to 78 percent.

For those with bachelor's degrees, the added value of 40 years' experience rose from 131 percent in 1974 to 216 percent in 2003. After five years or more of college, the premium for 40 years' work rose to 350 percent, up from 185 percent a generation ago.

The pattern holds for all levels of schooling and age groups. By offering increasingly higher financial rewards, markets are prodding Americans to get more education and experience.

Second, the benefits of experience extend deeper into life today. A generation ago, earnings were highest for those aged 35 to 44. Markets, in effect, decreed that older workers weren't as valuable as younger ones. This reflected the prevalence of work

that required physical skills. Job performance deteriorated as workers' bodies fell prey to the effects of aging.

In an economy growing more knowledge-intensive, workers continue to earn more as they grow older. Today, earnings are highest for those aged 55 to 64. Unlike the body, the mind doesn't peak at midlife. It retains the capacity to learn.

Knowledge builds on itself, like compound interest. College-educated workers show the largest gains as they accumulate experience in the labor force. The slowest growth in lifetime earnings occurs among high school dropouts, those least apt to develop a discipline for learning.

Third, intellectual capital depreciates, just like physical capital. Knowledge that once held economic value can lose favor in the marketplace. Calculators and computers, for example, have made quaint art of the ability to use a slide rule to solve math problems. These days, there's little need for the skills of railroad porters and elevator operators.

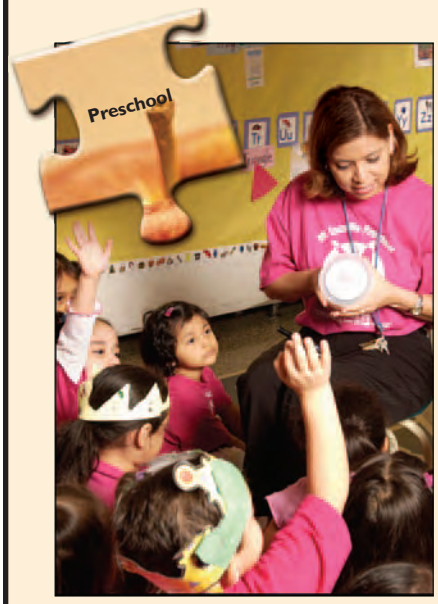
As some skills wither, others blossom. A modern economy needs workers who can design computer games, route bar-coded packages overnight and correct astigmatism with laser surgery. Technology raises the bar on what we need to know. When few employees used a computer at work, only secretaries needed to type. Now, hundreds of occupations involve writing e-mails and entering data. Millions of people do it every day.

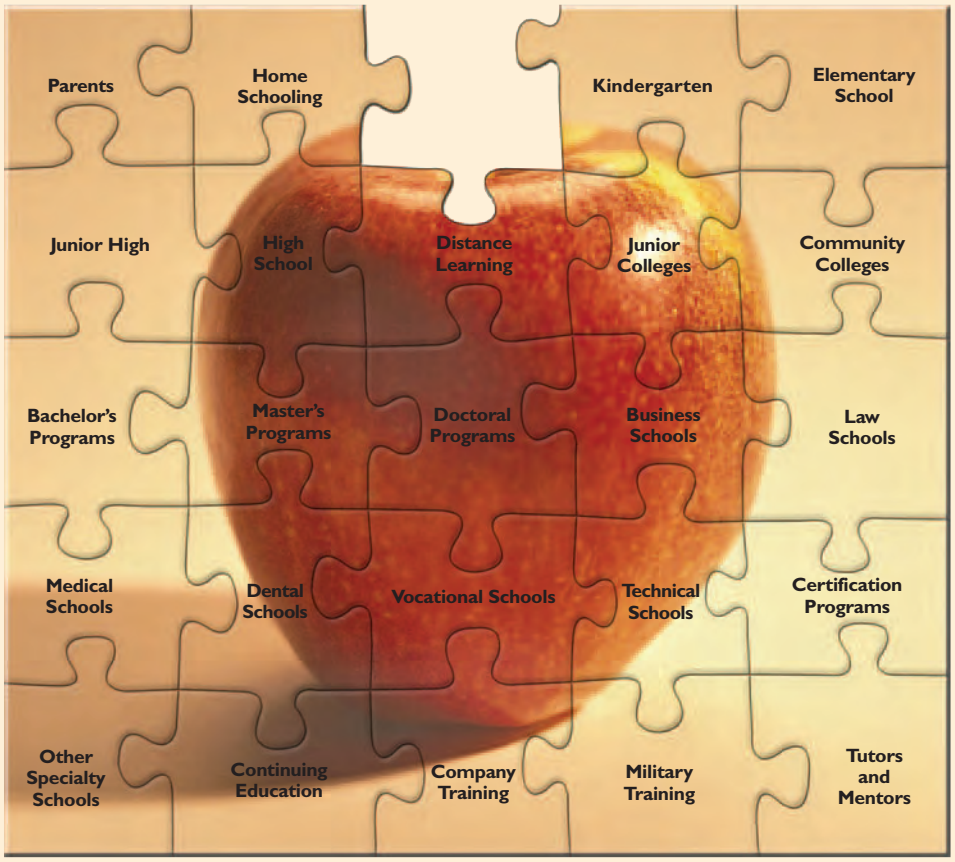
The knowledge needed to excel at today's jobs marches forward, sometimes at a bewildering rate. In a fast-paced economy, being out of the workforce exacts a high toll. Unemployed workers can lose ground without access to on-the-job learning. The more time they spend out of work, the more their wages fall behind. Upon reemployment, workers earn lower wages because they offer less experience and have lost touch with the job market's changing demands. Those on the sidelines for long stretches sometimes never catch up.

Americans will continue to reap the benefits of knowledge only by replenishing their depreciating skills. That's part of the reason lifetime learning carries great weight in today's economy.

Putting Together the Education Puzzle

America offers an abundance of options for lifetime learning—from parents and preschool to adult education and advanced degrees. Each of us must find the pieces that fit the jobs we want.





ON THE SUPPLY SIDE: MAKING AMERICA A SMARTER PLACE

Iconic images of one-room prairie schoolhouses, noisy neighborhood classrooms and ivy-covered colleges belie the fact that the United States emerged as an economic superpower without overwhelming brainpower.

For most of the nation's history, Americans were largely self-educated, if at all. In 1940, only a quarter of the population in their prime working years had graduated from high school and 5 percent held college degrees. As recently as 1965, half of U.S. workers still lacked a high school diploma. (*See Exhibit 4.*)

We're much better educated now. High school and college graduation rates are at all-time highs. Dropout rates have fallen to record lows. Americans have put enormous time, effort and money into education—not surprising, given that learning's rewards are big and consistent.

Over the years, we've built an extensive infrastructure to deliver the knowledge vital to our sophisticated, growing economy. The supply of learning activities arose in response to demand, expressed through both private markets and the political process.

Children begin learning in the home—and from the world around them—the day they are born. America's formal learning assets start with the educational system—the preschool programs, elementary and secondary schools, community colleges, universities and professional schools that cater primarily to younger people. Schools are public, private, state-chartered and home-based. In 2003, enrollment from kindergarten through graduate school reached nearly 70 million—a quarter of the U.S. population.

In terms of time spent in school, the United States ranks as the world's most educated nation, an average of 12.3 years per person. It leads in college graduates, too, at 28 percent of the population age 25 and over.

Knowledge doesn't come cheap. The United States leads the world in education spending, with $11,480 per student on public and private schooling at all levels.

Millions of Americans are also learning through military training and vocational schools that teach everything from computing to the culinary arts. The Internet puts a staggering amount of information at our fingertips, providing opportunities for self-paced instruction. In 2003, 2.6 million U.S. students took college classes online.

People also learn later in life through adult education. Half of workers over age 16 took job-related courses in 2001, testimony to Americans' drive for success. Participation was highest among workers with more years of formal education. They also earn the most, suggesting that higher pay increases the incentive to learn.

Most companies offer some sort of training to build employees' skills in computers, management, communications and other areas. In 2004, per worker corporate spending on in-house education reached $370, compared with $52 two decades earlier. A growing industry provides companies with outside trainers and consultants who bring proven concepts and techniques to workplace education programs.

From kindergarten through adult education, Americans are busy expanding their knowledge. Our efforts have helped forge a high-quality labor force, but a 21st century economy will demand even more.

The challenge starts with our schools. For decades, studies have

shown American students trailing their overseas counterparts academically. The Organization for Economic Cooperation and Development's latest study of 29 countries, released in 2003, ranked American 15-year-olds 24th in math, 24th in problem solving, 19th in science and 15th in reading.

Perhaps more alarming, American students fare worse the more time they spend in school. Fourth-grade students rank close to the top on international tests. By eighth grade, students have slipped into the middle of the pack, but they at least score above the international average in math and science. By the 12th grade, U.S. students' performance has dropped off sharply, falling well below the international average in the two subjects. (*See Exhibit 5 on page 18.*)

These middling results are all the more glaring because the United States spends a lot of money on education. The Czech Republic, with just a third of the financial resources for secondary schools, produces students whose test scores equal Americans'. Australia, Canada, Finland, Japan, South Korea and other countries get more educational quality, as measured by test scores, for less spending per student.

U.S. schools may possess strengths that international tests fail to capture, but the data on the basics suggest a harsh lesson. The United States has *quantity* in education, leading the world in years of schooling. But it trails other countries in *quality*.

Take another look at Exhibit 3, which shows how years of schooling and economic freedom impact per capita GDP (*page 12*). The United States lies below the green line that reflects its peer group of most economically free countries. How can that be? America ranks above average in that group, in both schooling and economic freedom.

The answer lies in the other factors that influence GDP. Nations with abundant natural resources tend to do better than the standard for their group. Oil producers Iran and Venezuela, for example, sit well above the line for the least-free countries. Tourism can provide a similar economic boost, suggesting why Spain, Italy, Greece and Portugal outperform their freedom-index peers.

Now take Japan, a country more efficient than most in converting schooling into income. Japan's a big oil importer and a big tourist exporter. So it doesn't outperform for the same reasons as Venezuela or Spain. Japan's students, however, do well on international tests, indicating a high degree of proficiency in the classroom. Educational quality, as opposed to years in school, appears to be another key factor in generating GDP.

Educational quality could be a factor in why the United States lies below the green line. Data aren't available to compare test scores for all 108 nations in Exhibit 3. High school science and

EXHIBIT 4 **An Educated America: A Relatively Recent Phenomenon**

Economic rewards have led Americans to seek more education. With each decade, a smaller percentage of the population has dropped out before finishing high school, while a greater proportion has gone to college. Today, more than half of Americans have at least some postsecondary education.

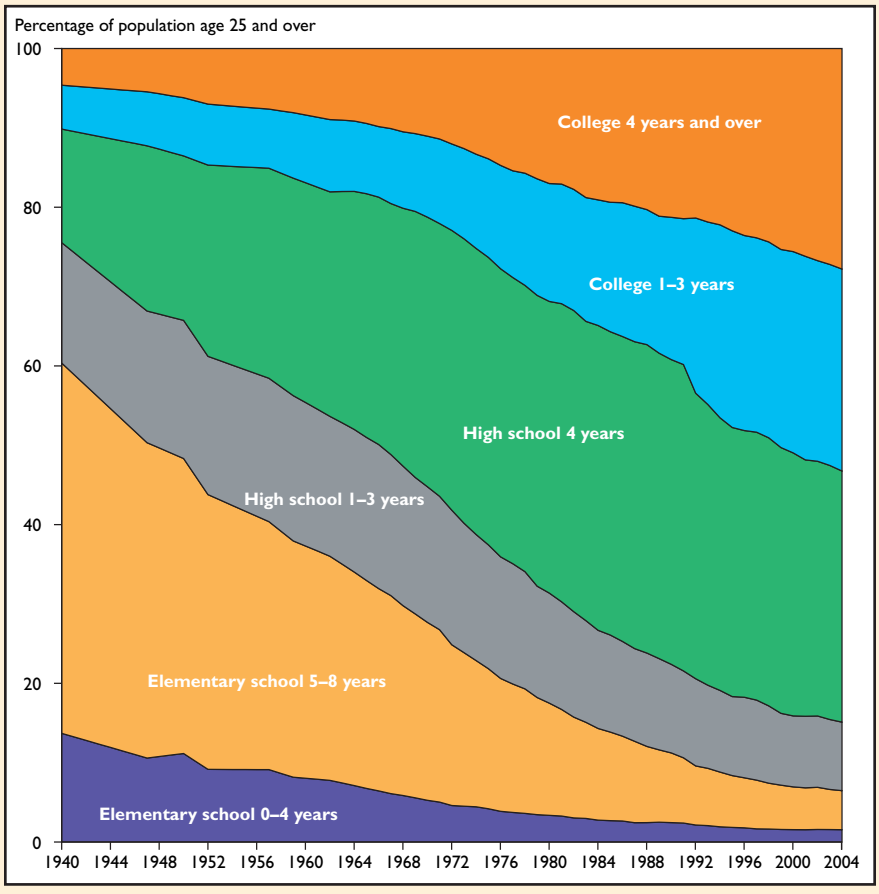
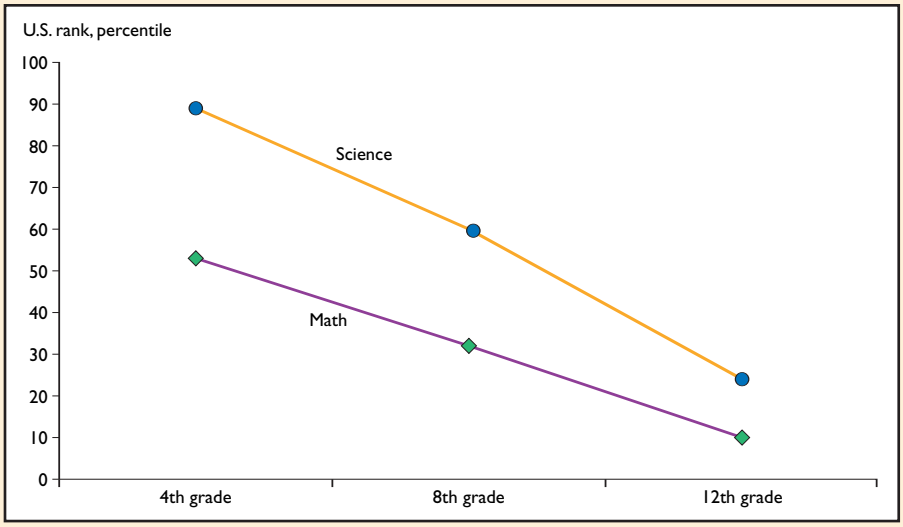
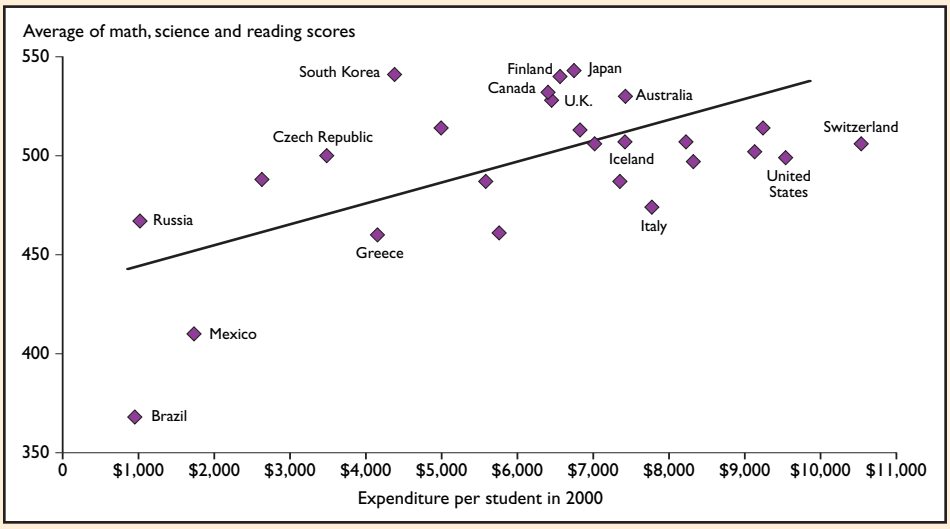


EXHIBIT 5 Education Dollars: Not Enough Bang for the Buck

AMERICAN STUDENTS LOSE GROUND . . .

On international math and science tests, U.S. students' relative performance deteriorates as they move from the fourth to eighth to 12th grade. By the end of high school, they've fallen to near the bottom in educational achievement.



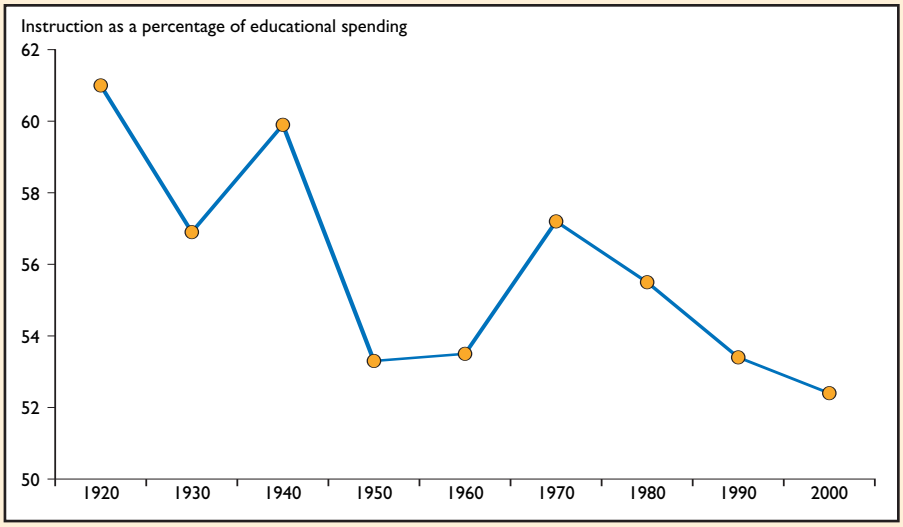


. . . DESPITE HEFTY OUTLAYS FOR SCHOOLING

America ranks near the top in spending per student on secondary education, but its 15-year-olds lag in math, science and reading. The solid line shows the positive relationship between spending and test scores. The United States and the other countries below it are underperforming.

TEACHING GETS LESS OF THE MONEY

Over time, a smaller portion of America's education budget has been going to teaching and a larger share to administration. Recent measures show teaching's slice of the pie shrinking to an all-time low of 52 percent, the result of a steady decline that began in 1970.



math scores only exist for about 20, mostly OECD countries. These data indicate that raising U.S. test scores to the OECD average could increase America's per capita GDP $4,600 to $5,200 a year. Improving educational quality would produce big gains for the United States.

Americans are keenly aware of their schools' shortcomings. Education has been a front-burner issue since at least 1983, when the National Commission on Excellence in Education released the galvanizing *A Nation at Risk: The Imperative for Educational Reform*.

The national debate on education has sparked reforms from Washington all the way down to the local level. Initiatives include computer-equipped classrooms, back-to-basics instruction and rigorous standardized testing.

We've tried more money and more teachers. In elementary and secondary schools, per student spending has risen in real terms from $4,616 in 1980 to $8,416 in 2002. The ratio of pupils to teachers fell from 27 in 1955 to 18.6 in 1980 to 16.1 in 2002. Still, American schools aren't what they should be—except at the college level.

The United States distinguishes itself in higher education. On the London *Times'* 2004 ranking of the world's 200 best institutions of higher learning, the United States took 62 spots, including the top four and seven of the top 10. Runner-up Britain trailed with 30 schools.

At the college level, students are free to deliver a verdict on quality with their feet. America's colleges and universities enrolled 586,000 foreign students in 2003, more than second-place Britain and third-place Germany combined.

The quality of American higher education contrasts sharply with our declining performance in elementary and secondary schools. An important reason is competition. College students are mobile, and for more than a century both public and private institutions have competed for students without regard to where they live.

There's little competition in elementary and secondary education, where public schools dominate. Students aren't free to choose among education producers—unless their families can afford to move to districts with better schools or spend thousands of dollars for private schools. And many parents do make these sacrifices, indicating the high value Americans place on education.

Some economists advocate injecting competition and consumer choice into education, an approach Nobel laureate Milton Friedman champions in *Capitalism and Freedom* (1962) and *Free to Choose* (1980).

Friedman's idea of applying market principles to education has won adherents over the decades, particularly among free enterprise economists. They argue that stripping public schools of their monopoly power would spur quality and encourage innovation, just as it does in the private sector. Society could still support education with public funding, but parents would have an opportunity to shop around for what's best for their children. They'd shun bad schools; they'd favor good ones. Average quality would rise as better schools expanded to meet demand and worse ones improved or withered away.

Pilot programs featuring competition among schools have shown generally positive results in Milwaukee, Cleveland, New York, Dayton and other cities.[2] But the idea remains for the most part untested on a large scale. Many educators are skeptical of the Friedman approach, saying schools aren't the same as cars, TVs and other consumer goods. Government mandates, economic inequality, community instability and other issues complicate the act of "buying" education.

Even supporters concede that market discipline isn't a magic bullet. Competition isn't effective without information. Markets work best when consumers receive timely, accurate data on product, performance and price. Even with good information, schools can't compete in a straitjacket. Society can set broad standards, but schools can best adapt to students' needs when they're as free as possible from ponderous regulations.

Many Americans are working to improve our schools, but formal education by itself won't deliver the workforce we need for a knowledge-based economy. More Americans need to develop a habit of learning every day.

We're not there yet, even though many Americans are actively pursuing knowledge on the job. We could do more at work. Once off, we're enjoying one of the true blessings of American capitalism—more leisure. Those of us who strive to get ahead can use some of that time to better prepare ourselves for an age of global competition and knowledge-based jobs.

Many of us aren't doing that. The typical American aged 25 to 34 spends two hours, 20 minutes a day watching TV but just 17 minutes on educational activities. The learning effort drops off sharply as we grow older.

The United States offers plenty of ways to learn—at work and on our own. But many Americans aren't taking full advantage of them.

PRICE PRITCHETT

Chairman and CEO, Pritchett LP, Dallas

Boyhood chores on a tractor, baked by the West Texas summer sun, convinced Price Pritchett that farming wasn't the life for him. "When I wasn't in school," he says, "I had to work my butt off on the farm." In the classroom, Pritchett developed a love of learning, and it took him all the way to a Ph.D. in psychology from Texas Tech University. After a stint in the Army, Pritchett's doctorate helped him land a job with a management consultant. He had a lot to learn. "My first years on the job were like getting an M.B.A.," he says. In time, Pritchett found his niche, helping executives manage their companies through the wrenching changes wrought by mergers and acquisitions. His boutique firm employs 20 people. His secret to success: "We need to keep stretching ourselves and learning."

ANA 'CHA' GUZMAN

President, Palo Alto College, San Antonio

A 13-year-old girl fled Cuba with her family in 1960—not knowing where she'd end up, not speaking English. She was scared. "My father told me not to worry," Ana Guzman says. " 'Fidel Castro can take our jobs, our houses and our industry,' he said, 'but he can't take my education. We will survive in America.' " After that experience, learning became a big part of Guzman's life. The family settled in Milwaukee, and Guzman graduated from Stout State University in 1968. Married by then, she relocated to Texas. While teaching in a University of Houston program for low-income Hispanics, Guzman met her role models—married women with children who had earned doctorates. She followed in their footsteps, earning her own doctorate in 1979. She became president of 8,000-student Palo Alto, a two-year college, in 2001. "Without that doctorate," she says, "there's no possibility for a leadership position at colleges and universities."

MICHAEL MARIN

Partner, Vinson & Elkins LLP, Austin

It's a long way from Canutillo, Texas, to Harvard Law School. Michael Marin made the journey. He grew up in the working-class community just outside El Paso, the son of a Mexican immigrant mother with a second-grade education and Mexican-American father who finished eighth grade. "My parents wanted better for me," Marin says, "and it was clear that education was the ticket to a better life." The product of public schools, Marin attended the Air Force Academy for three years, then finished his undergraduate studies at the University of Texas at El Paso. After a stint in the Air Force, he headed to Harvard. The Ivy League school opened the door to the prestigious Vinson & Elkins law firm, where he's made partner, and the presidency of the Austin Bar Association. Not bad for a kid from Canutillo.

TIM TINGLE

Storyteller, Canyon Lake, Texas

You learn storytelling on your own. And Tim Tingle did. A Choctaw, he grew up on Texas' Gulf Coast and graduated from the University of Texas in 1974. After driving a milk truck, working for a dance company and managing fast-food restaurants, Tingle founded New Canaan Farms, selling exotic jams, jellies and dips. The company's marketing campaign involved spinning yarns about the farmers who made the products. Tingle loved it. He honed his storytelling skills with Toastmasters events, relating the Trail of Tears tragedy and other aspects of his Choctaw heritage. Tingle had found his calling. He sold the food company and became a storyteller, making his living performing at festivals while selling books and tapes. He earned a master's in Native American studies in 2003. "The key is finding something you love to do," he says. "You can't distinguish between work and play."

JOY WALLACE

President and CEO, J.O.Y. Foods Inc., Dallas

A long and winding road through a succession of corporate jobs led Joy Wallace to a company of her own. After graduating from the University of Chicago, Wallace did financial analysis for Xerox, Rockwell International and Mary Kay Cosmetics. She shifted to strategic planning for Uncle Ben's rice, went into sales and marketing for an El Paso meat company and took on the school lunch market for Pilgrim's Pride. Pizza Hut recruited her to run its nontraditional business, and she developed a ready-to-prepare pizza kit for schools. A 1998 licensing deal for the Pizza Pack gave Wallace her start as an entrepreneur. J.O.Y. Foods has now moved beyond the school market with its own pizza line, called Sprazzo. It's sold to the U.S. military and other food service segments. "Every job I had taught me something I can use in my business," Wallace says.

RON WHITE

Founder, Ron White Training, Dallas

Booted out of college with a dismal grade-point average, Ron White makes his living showing off his mental prowess. He operates Ron White Training, which teaches techniques to improve memory through corporate seminars and the "Memory in a Month" compact-disc course. White's presentation includes amazing mental feats—such as reciting back a long string of random numbers shouted out by his audience. White stumbled into the memory business by getting into telemarketing after flunking out of college. A natural salesman, he did well. One of his clients sold memory aids. He took the course and used what he learned to create his own business. "If you understand capitalism, you don't need a degree to succeed," White says. "If you don't, you won't learn it in college. A lot of it is passion, drive, a work ethic and a good idea."

AMERICA'S FUTURE LIES IN BRAINPOWER

Americans want jobs that pay well, with generous benefits and good working conditions. When workers aren't satisfied, the blame often falls on employers, who get slammed for downsizing, outsourcing and paying low wages.

Good jobs aren't a matter of good intentions. In an era of globalization, geographic and political boundaries are not economic boundaries. Workers compete in a worldwide talent pool, and they will earn according to what they can produce. Economies rich in sophisticated technology and well-trained workers foster high-wage industries. Those lagging in technology and skills are left with lesser jobs.

More than ever, the quality of the labor force determines the quality of jobs. The U.S. economy can only create good jobs if it can supply the qualified workers to fill them.

The payoff for knowledge in the United States has been on the upswing, giving Americans more reason than ever to learn. As individuals, we've got plenty of opportunities to improve ourselves in a nation well endowed with ways to gain knowledge.

The United States already has a highly educated workforce, but we can do better. A wide range of reforms could help U.S. schools close the educational gap with other countries, particularly for secondary school students. They might also help reach at-risk students who for whatever reason don't or can't take advantage of the educational opportunities available.

An education system facing all kinds of stresses can only do so much. The responsibility for becoming smarter workers falls just as much on us as individuals. Our attitudes and actions matter.

Remember Jack and Jill? He's never recognized the value of knowledge, so he's been disappointed in work. She developed a strong commitment to lifetime learning, and our free enterprise economy has rewarded her for it.

Lifetime learning expands opportunities for all Americans. Unlike the physical capital that belongs largely to the rich, intellectual capital is available to everyone with enough ambition to strive for it. Where we start in life doesn't have to determine where we wind up. And coming from nothing doesn't have to mean being stuck there.

The most important tool we have to achieve the American Dream isn't the computer, the Internet or any of the other innovations sure to dazzle us in the future. It is the brain—weighing, on average, just 3 pounds. America will create more good jobs as students and workers build proficiency with this 3-pound tool.[3] Its development through lifetime learning is the key to opportunity, upward mobility and rising living standards.

—W. Michael Cox and Richard Alm

Notes and Credits

Acknowledgments

"What D'Ya Know?" was written by W. Michael Cox and Richard Alm. The essay is based on research conducted by Cox, senior vice president and chief economist, Federal Reserve Bank of Dallas. Alm is an economics writer in the Bank's Research Department. Julia K. Carter, an economic analyst at the Bank, provided important research assistance on the project. Charlene Howell assisted with photo research.

Notes

[1] The hierarchy of human talents is discussed in greater detail in the Dallas Fed's 2003 Annual Report essay, "A Better Way: Productivity and Reorganization in the American Economy," at www.dallasfed.org.

[2] For more on the issue of school choice, see "The Theory and Practice of School Choice," by Paul E. Peterson, in *The Legacy of Milton and Rose Friedman's Free to Choose*, Dallas: Federal Reserve Bank of Dallas, December 2004, pages 37–54.

[3] Price Pritchett, chairman and CEO of Pritchett LP in Dallas, coined the term *3-pound tool* to describe the brain.

Exhibit Notes and Data Sources

All dollar amounts in text and exhibits are in 2004 U.S. dollars; international data are adjusted for purchasing power.

Exhibit 1
Data in the table are for year-round, full-time workers. Lifetime earnings are estimated assuming 40 years of full-time work at average annual earnings prevailing in 2003. Census Bureau, Current Population Survey (CPS), 2004 Annual Social and Economic Supplement, table PINC-04.

"Schooling, Experience Reduce Unemployment"
Bureau of Labor Statistics (BLS), unpublished 2003 data.

"Helping Economies Grow Richer"
Estimating the relationship between state per capita income and the percentage of population age 25 and over that holds a bachelor's degree gives $INCOME = \$11{,}903 + 729.17 \cdot BACHELOR'S$, with the coefficient t values of 6.24 and 10.42, respectively, and $\bar{R}^2 = .68$.

Census Bureau, CPS, historical table A-1 and table 13 (2003). Bureau of Economic Analysis, national income and product accounts and regional economic accounts (2003).

Exhibit 2
Average starting salary for bachelor's degree: National Association of Colleges and Employers, *Salary Survey*, Fall 2004. Average salary for experienced workers: BLS, Occupational Employment Statistics, May 2003.

Exhibit 3
The vertical axis scale is logarithmic to the base 2. Estimating the relationship between per capita GDP, years of schooling and economic freedom (which ranges from 1 to 5, with 1 being freest) gives the result $\log_2 GDP = 13.92 + .30 \cdot SCHOOLING - 1.10 \cdot FREEDOM$, with the t values on *SCHOOLING* and *FREEDOM* being 9.63 and –9.18, respectively, and $\bar{R}^2 = .79$. Each of the solid lines represents the per capita GDP levels predicted within that peer group—from the freest countries (in green) to least free (in orange)—holding the economic freedom index constant at the median within-peer-group values of 2.00, 2.95 and 3.74, respectively.

Robert Barro and Jong-Wha Lee data set (2000), Center for International Development, Harvard University. World Bank, World Development Indicators (2000). *2002 Index of Economic Freedom,* Gerald P. O'Driscoll, Jr., Kim R. Holmes and Mary Anastasia O'Grady, eds., Washington, D.C.: The Heritage Foundation/Wall Street Journal (2000 scores).

Exhibit 4
Census Bureau, CPS, historical table A-1.

Exhibit 5
"American Students Lose Ground…"
Council on Competitiveness, www.compete.org.

"…Despite Hefty Outlays for Schooling"
Estimating the relationship between the average of math, science and reading scores for 15-year-olds and per student expenditures gives $SCORES = 443 + .01 \cdot EXPENDITURES$, with the coefficient t values of 26.04 and 3.36, respectively, and $\bar{R}^2 = .29$.

Organization for Economic Cooperation and Development, *Education at a Glance 2004*.

"Teaching Gets Less of the Money"
U.S. data on educational expenditures are for public schools only. National Center for Education Statistics, *Digest of Education Statistics, 2003*.

Photo Credits

ATI Technical Training Center, Dallas, TX, 214-352-2222, p. 10;
University of Wisconsin, p. 13;
Blonde Productions Group, p. 16.

The picture on page 15 was taken at a Mi Escuelita Preschool in Dallas.

A FOND FAREWELL

Bob McTeer resigned as president and chief executive officer of the Federal Reserve Bank of Dallas on November 4, 2004, to become chancellor of the Texas A&M University System. We'll remember McTeer for using his new paradigm frog and lyrics from Texas picker–poets to explain economic concepts. But his contributions run much deeper. He was among the first to recognize Mexico's importance to the Texas economy, and he created the Center for Latin American Economics here at the Dallas Fed. The Spanish-language section of our web site was started under McTeer's leadership, too.

During his nearly 14 years as president, McTeer branded the Bank as the "Free Enterprise Fed" and focused its resources and energies on promoting free markets. He was an articulate advocate for the benefits of free trade and a strong believer in economic education.

Now that McTeer has returned to academia, his career has come full circle. He joined the Federal Reserve in 1968 as an economist at the Richmond Fed after teaching at the University of Georgia. He rose to head of the Baltimore Branch before coming to the Dallas Fed in 1991. Texas A&M has good times ahead of it with McTeer at the helm. We thank him for his many contributions to the Dallas Fed and the Federal Reserve System and wish him well in his new endeavor.

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Standing (from left):

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Senior Vice President

Millard E. Sweatt
Senior Vice President, General Counsel, Ethics Officer and Secretary

W. Michael Cox
Senior Vice President and Chief Economist

Robert Smith III
Senior Vice President in Charge, Houston Branch

J. Tyrone Gholson
Senior Vice President

Robert D. Hankins
Senior Vice President

Robert W. Gilmer
Vice President in Charge, El Paso Branch

Seated (from left):

Joanna O. Kolson
Senior Vice President

Helen E. Holcomb
Acting President, First Vice President and COO

Harvey Rosenblum
Senior Vice President and Director of Research

Not pictured:

Larry J. Reck and **James L. Stull** retired in 2004.

Bob McTeer and Helen Holcomb

Robert D. McTeer, Jr., retired in 2004 as president and CEO.

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Pat Patterson and Ray Hunt

Dallas Board of Directors

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Ron R. Harris (Chairman)
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Founder and President, SRV Holdings (joined board in December 2004)

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D. Karen Diaz
Acting Branch Manager and Assistant Vice President

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As of December 31, 2004

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Gayle M. Earls
Vice Chairman and CEO
TIB–The Independent BankersBank
Irving, Texas

March 10, 2005

To the Board of Directors of the
Federal Reserve Bank of Dallas:

The management of the Federal Reserve Bank of Dallas (FRBD) is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 2004 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on judgments and estimates of management. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies, and practices documented in the Manual and include all disclosures necessary for such fair presentation.

The management of the FRBD is responsible for maintaining an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements. Such internal controls are designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of reliable Financial Statements. This process of internal controls contains self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in the process of internal controls are reported to management, and appropriate corrective measures are implemented.

Even an effective process of internal controls, no matter how well designed, has inherent limitations, including the possibility of human error, and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements.

The management of the FRBD assessed its process of internal controls over financial reporting including the safeguarding of assets reflected in the Financial Statements, based upon the criteria established in the "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, we believe that the FRBD maintained an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements.

Helen E. Holcomb
Acting President and First Vice President
Federal Reserve Bank of Dallas

Meredith Black
Principal Financial Officer
Federal Reserve Bank of Dallas

To the Board of Directors of the
Federal Reserve Bank of Dallas:

We have examined management's assertion, included in the accompanying Management Assertion, that the Federal Reserve Bank of Dallas ("FRB Dallas") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the financial statements as of December 31, 2004, based on criteria established in *Internal Control–Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRB Dallas' management is responsible for maintaining effective internal control over financial reporting and safeguarding of assets as they relate to the financial statements. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that FRB Dallas maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the financial statements as of December 31, 2004, is fairly stated, in all material respects, based on criteria established in *Internal Control–Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

This report is intended solely for the information and use of management and the Board of Directors and Audit Committee of FRB Dallas, and any organization with legally defined oversight responsibilities and is not intended to be and should not be used by anyone other than these specified parties.

Dallas, Texas
March 16, 2005

REPORT OF INDEPENDENT AUDITORS

To the Board of Governors of the Federal Reserve System
and the Board of Directors of the Federal Reserve Bank of Dallas:

We have audited the accompanying statements of condition of the Federal Reserve Bank of Dallas (the "Bank") as of December 31, 2004 and 2003, and the related statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 3, the 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 of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2004 and 2003, and results of its operations for the years then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

Dallas, Texas
March 16, 2005

Statements of Condition (in millions)

	December 31, 2004	December 31, 2003
ASSETS		
Gold certificates	$ 525	$ 507
Special drawing rights certificates	98	98
Coin	93	141
Items in process of collection	334	383
U.S. government securities, net	33,083	26,475
Investments denominated in foreign currencies	267	442
Accrued interest receivable	232	198
Interdistrict settlement account	1,461	6,997
Bank premises and equipment, net	279	211
Other assets	31	32
Total assets	**$ 36,403**	**$ 35,484**
LIABILITIES AND CAPITAL		
Liabilities		
Federal Reserve notes outstanding, net	$ 33,643	$ 32,657
Securities sold under agreements to repurchase	1,404	1,005
Deposits:		
Depository institutions	684	952
Other deposits	1	2
Deferred credit items	300	487
Interest on Federal Reserve notes due U.S. Treasury	24	84
Accrued benefit costs	56	60
Other liabilities	21	15
Total liabilities	**36,133**	**35,262**
Capital		
Capital paid-in	135	111
Surplus	135	111
Total capital	**270**	**222**
Total liabilities and capital	**$ 36,403**	**$ 35,484**

The accompanying notes are an integral part of these financial statements.

Statements of Income (in millions)

	FOR THE YEARS ENDED December 31, 2004	December 31, 2003
INTEREST INCOME		
Interest on U.S. government securities	$ 968	$ 768
Interest on investments denominated in foreign currencies	3	6
Total interest income	**971**	**774**
INTEREST EXPENSE		
Interest expense on securities sold under agreements to repurchase	13	7
Net interest income	**958**	**767**
OTHER OPERATING INCOME		
Income from services	46	51
Reimbursable services to government agencies	12	11
Foreign currency gains, net	16	60
Other income	2	1
Total other operating income	**76**	**123**
OPERATING EXPENSES		
Salaries and other benefits	93	102
Occupancy expense	15	16
Equipment expense	11	12
Assessments by Board of Governors	46	48
Other expenses	47	39
Total operating expenses	**212**	**217**
Net income prior to distribution	**$ 822**	**$ 673**
DISTRIBUTION OF NET INCOME		
Dividends paid to member banks	$ 8	$ 11
Transferred to (from) surplus	24	(75)
Payments to U.S. Treasury as interest on Federal Reserve notes	790	737
Total distribution	**$ 822**	**$ 673**

The accompanying notes are an integral part of these financial statements.

Statements of Changes in Capital for the Years Ended December 31, 2004, and December 31, 2003 (in millions)

	Capital Paid-In	Surplus	Total Capital
BALANCE AT JANUARY 1, 2003			
(3.7 million shares)	$ 186	$ 186	$ 372
Transferred (from) surplus	—	(75)	(75)
Net change in capital stock redeemed ((1.5) million shares)	(75)	—	(75)
BALANCE AT DECEMBER 31, 2003			
(2.2 million shares)	$ 111	$ 111	$ 222
Transferred to surplus	—	24	24
Net change in capital stock issued (0.5 million shares)	24	—	24
BALANCE AT DECEMBER 31, 2004			
(2.7 million shares)	**$ 135**	**$ 135**	**$ 270**

The accompanying notes are an integral part of these financial statements.

Notes to Financial Statements

1. STRUCTURE

The Federal Reserve Bank of Dallas ("Bank") is 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 System consists of the Board of Governors of the Federal Reserve System ("Board of Governors") and twelve Federal Reserve Banks ("Reserve Banks"). The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branches in El Paso, Houston, and San Antonio serve the Eleventh Federal Reserve District, which includes Texas and portions of Louisiana and New Mexico. Other major elements of the System are the Federal Open Market Committee ("FOMC") and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York ("FRBNY"), and, on a rotating basis, four other Reserve Bank presidents. Banks that are members of the System include all national banks and any state-chartered bank that applies and is approved for membership in the System.

Board of Directors

In accordance with the Federal Reserve Act, supervision and control of the Bank are exercised by a Board of Directors. The Federal Reserve Act specifies the composition of the Board of Directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors, and six directors are elected by member banks. Of the six elected by member banks, three represent the public and three represent member banks. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

2. OPERATIONS AND SERVICES

The System performs a variety of services and operations. Functions include formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearinghouse ("ACH") operations, and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies and state member banks; and administering other regulations of the Board of Governors. The Board of Governors' operating costs are funded through assessments on the Reserve Banks.

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 securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY is also authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange ("F/X") and securities contracts in, nine foreign currencies and to invest such foreign currency holdings, ensuring adequate liquidity is maintained. In addition, FRBNY is authorized to 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 with 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 accounting principles generally accepted in the United States of America ("GAAP"). The primary difference is the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP. In addition, the Bank has elected not to present a Statement of Cash Flows. The Statement of Cash Flows has not been included because the liquidity and cash position of the Bank are not of primary concern to the users of these financial statements. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. A Statement of Cash Flows, therefore, would not provide any additional useful information. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

Each Reserve Bank provides services on behalf of the System for which costs are not shared. Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include: the Bulkdata Transmission Utility; Check Automation Services; Centralized Loans Automated System; National Examination Data System; Desktop Standardization Initiative; Lawson Central Business Administration Function; and Accounts, Risk and Credit System.

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, 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. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

a. Gold Certificates

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged, and the Reserve Banks' gold certificate accounts are lowered. The value of gold for purposes of backing the gold certificates is set by law at $42 2/9 a fine troy ounce. The Board of Governors allocates the gold certificates among Reserve Banks once a year based on average Federal Reserve notes outstanding in each District.

b. Special Drawing Rights Certificates

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2004 or 2003.

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 Bank. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Bank, subject to review by the Board of Governors. There were no outstanding loans to depository institutions at December 31, 2004 and 2003, respectively.

d. U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies

The FOMC has designated the FRBNY to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account ("SOMA"). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. Such authorizations are reviewed and approved annually by the FOMC.

The FRBNY has sole authorization by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements on behalf of the System, in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires the FRBNY to take possession of collateral in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by the FRBNY on a daily basis, with additional collateral obtained as necessary. The securities lent are accounted for in the SOMA.

F/X contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with two authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to foreign currencies 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 FRBNY 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 may result in gains or losses when holdings are sold prior to maturity. Decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government 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. Securities sold under agreements to repurchase are accounted for as secured borrowing transactions with the associated interest expense recognized over the life of the transaction. Such transactions are settled by FRBNY. Interest income is accrued on a straight-line basis. 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. Foreign-currency-denominated assets are revalued daily at current foreign currency 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, net."

Activity related to U.S. government securities bought outright, securities sold under agreements to repurchase, securities loaned, investments denominated in foreign currency, excluding those held under an F/X swap arrangement, and deposit accounts of foreign central banks and governments above core balances are allocated to each Reserve Bank. U. S. government securities purchased under agreements to resell and unrealized gains and losses on the revaluation of foreign currency holdings under F/X swaps and warehousing arrangements are allocated to the FRBNY and not to other Reserve Banks.

In 2003, additional interest income of $61 million, representing one day's interest on the SOMA portfolio, was accrued to reflect a change in interest accrual calculations, of which $2 million was allocated to the Bank. The effect of this change was not material; therefore, it was included in the 2003 interest income.

e. Bank Premises, Equipment, and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are amortized over the remaining useful life of the asset. Maintenance, repairs, and minor replacements are charged to operations in the year incurred. Costs incurred for software, either developed internally or acquired for internal use, during the application development stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which range from two to five years.

f. Interdistrict Settlement Account

At the close of business each day, all Reserve Banks and branches assemble the payments due to or from other Reserve Banks and branches as a result of transactions involving accounts residing in other Districts that occurred during the day's operations. Such transactions may include funds settlement, check clearing and ACH operations, and allocations of shared expenses. The cumulative net amount due to or from other Reserve Banks is reported as the "Interdistrict settlement account."

g. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank.

Assets eligible to be pledged as collateral security include all Federal Reserve Bank assets. 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. The par value of securities pledged for securities sold under agreements to repurchase is similarly deducted.

The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents the Bank's Federal Reserve notes outstanding reduced by its currency holdings of $7,503 million and $7,129 million at December 31, 2004 and 2003, respectively.

h. Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. As a member bank's capital and surplus changes, its holdings of Reserve Bank stock must be adjusted. Member banks are state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of $100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

The Financial Accounting Standards Board (FASB) has deferred the implementation date for SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" for the Bank. When applicable, the Bank will determine the impact and provide the appropriate disclosures.

i. Surplus

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital.

Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury as interest on Federal Reserve notes 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.

In the event of losses or an increase in capital paid-in, payments to the U.S. Treasury are suspended and earnings are retained until the surplus is equal to the capital paid-in. Weekly payments to the U.S. Treasury may vary significantly.

In the event of a decrease in capital paid-in, the excess surplus, after equating capital paid-in and surplus at December 31, is distributed to the U.S. Treasury in the following year. This amount is reported as a component of "Payments to U.S. Treasury as interest on Federal Reserve notes."

j. Income and Costs related to Treasury Services

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services.

k. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank's real property taxes were $3 million for each the years ended December 31, 2004 and 2003, and are reported as a component of "Occupancy expense."

I. Restructuring Charges

In 2003, the System started the restructuring of several operations, primarily check, cash, and Treasury services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in the remaining locations. These restructuring activities continued in 2004.

Footnote 10 describes the restructuring and provides information about the Bank's costs and liabilities associated with employee separations and contract terminations. The costs associated with the write-down of certain Bank assets are discussed in footnote 6. Costs and liabilities associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY.

4. U.S. GOVERNMENT SECURITIES

Securities bought outright are held in the SOMA at the FRBNY. An undivided interest in SOMA activity and the related premiums, discounts, and income, with the exception of securities purchased under agreements to resell, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings that occurs in April of each year. The settlement equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was approximately 4.560 percent and 3.919 percent at December 31, 2004 and 2003, respectively.

The Bank's allocated share of U.S. Government securities, net, held in the SOMA at December 31, was as follows (in millions):

	2004	2003
Par value:		
U.S. government		
Bills	$ 11,990	$ 9,595
Notes	16,452	12,672
Bonds	4,287	3,859
Total par value	32,729	26,126
Unamortized premiums	429	384
Unaccreted discounts	(75)	(35)
Total allocated to Bank	**$33,083**	**$26,475**

The total of the U.S. Government securities, net, held in the SOMA was $725,584 million and $675,569 million at December 31, 2004 and 2003, respectively.

The maturity distribution of U.S. government securities bought outright and securities sold under agreements to repurchase, that were allocated to the Bank at December 31, 2004, was as follows (in millions):

Maturities of Securities Held	U.S. Government Securities (Par value)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	$ 1,397	$ 1,404
16 days to 90 days	8,132	—
91 days to 1 year	7,770	—
Over 1 year to 5 years	9,496	—
Over 5 years to 10 years	2,479	—
Over 10 years	3,455	—
Total	**$ 32,729**	**$ 1,404**

At December 31, 2004 and 2003, U.S. government securities with par values of $6,609 million and $4,426 million, respectively, were loaned from the SOMA, of which $301 million and $173 million, respectively, were allocated to the Bank.

At December 31, 2004 and 2003, securities sold under agreements to repurchase with contract amounts of $30,783 million and $25,652 million, respectively, and par values of $30,808 million and $25,658 million, respectively, were outstanding. The Bank's allocated share at December 31, 2004 and 2003, was $1,404 million and $1,005 million, respectively, of the contract amount and $1,405 million and $1,006 million, respectively, of the par value.

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 purchased under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on F/X swaps and warehousing transactions. This allocation is based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. The Bank's allocated share of investments denominated in foreign currencies was approximately 1.250 percent and 2.223 percent at December 31, 2004 and 2003, respectively.

The Bank's allocated share of investments denominated in foreign currencies, valued at current foreign currency market exchange rates at December 31, was as follows (in millions):

	2004	2003
European Union euro:		
Foreign currency deposits	$ 76	$ 153
Securities purchased under agreements to resell	27	46
Government debt instruments	48	45
Japanese yen:		
Foreign currency deposits	19	33
Government debt instruments	96	163
Accrued interest	1	2
Total	**$267**	**$442**

Total System investments denominated in foreign currencies were $21,368 million and $19,868 million at December 31, 2004 and 2003, respectively.

The maturity distribution of investments denominated in foreign currencies which were allocated to the Bank at December 31, 2004, was as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies	European Euro	Japanese Yen	Total
Within 1 year	$ 112	$ 115	$ 227
Over 1 year to 5 years	38	—	38
Over 5 years to 10 years	2	—	2
Over 10 years	—	—	—
Total	**$ 152**	**$ 115**	**$ 267**

At December 31, 2004 and 2003, there were no material open foreign exchange contracts.

At December 31, 2004 and 2003, the warehousing facility was $5,000 million, with no balance outstanding.

6. BANK PREMISES, EQUIPMENT, AND SOFTWARE

A summary of bank premises and equipment at December 31 is as follows (in millions):

	Maximum Useful Life (in years)	2004	2003
Bank premises and equipment:			
Land	N/A	$ 53	$ 50
Buildings	50	118	117
Building machinery and equipment	20	25	25
Construction in progress	N/A	107	37
Furniture and equipment	10	66	67
Subtotal		$ 369	$ 296
Accumulated depreciation		(90)	(85)
Bank premises and equipment, net		**$279**	**$ 211**
Depreciation expense, for the years ended		**$ 9**	**$ 9**

The Bank has capitalized software assets, net of amortization, of $4 million and $3 million at December 31, 2004 and 2003, respectively. Amortization expense was $3 million and $2 million for the years ended December 31, 2004 and 2003, respectively.

Approximately $103 million of costs associated with the construction of a new building in Houston are included in "Construction in progress."

Assets impaired as a result of the Bank's restructuring plan, as discussed in footnote 10, include building, furniture, and equipment. Asset impairment losses of $1 million and $597 thousand for the years ending December 31, 2004 and 2003, respectively, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2004, the Bank was obligated under noncancelable leases for premises and equipment with terms of less than one year.

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 $2 million for each of the years ended December 31, 2004 and 2003. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 2004, were immaterial.

At December 31, 2004, the Bank had no material commitments or other long-term obligations.

Under the Insurance Agreement of the Federal Reserve Banks dated as of March 2, 1999, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 2004 or 2003.

The Bank is 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 Bank.

8. RETIREMENT AND THRIFT PLANS

Retirement Plans

The Bank currently offers two defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank's employees participate in the Retirement Plan for Employees of the Federal Reserve System ("System Plan") and the Benefit Equalization Retirement Plan ("BEP"). In addition, certain Bank officers participate in the Supplemental Employee Retirement Plan ("SERP").

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. No separate accounting is maintained of assets contributed by the participating employers. The FRBNY acts as a sponsor of the Plan for the System, and the costs associated with the Plan are not redistributed to the Bank. The Bank's projected benefit obligation and net pension costs for the BEP and the SERP at December 31, 2004 and 2003, and for the years then ended, are not material.

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled $3 million and $4 million for the years ended December 31, 2004 and 2003, 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 Bank's 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 Bank funds benefits payable under the medical and life insurance plans as due and, accordingly, has no plan assets. Net postretirement benefit costs are actuarially determined using a January 1 measurement date.

Following is a reconciliation of beginning and ending balances of the benefit obligation (in millions):

	2004	2003
Accumulated postretirement benefit obligation at January 1	$ 56.3	$ 43.0
Service cost-benefits earned during the period	1.3	1.2
Interest cost of accumulated benefit obligation	3.4	3.0
Actuarial loss	2.0	7.3
Curtailment loss	—	3.2
Special termination loss	—	0.4
Contributions by plan participants	0.7	0.5
Benefits paid	(3.0)	(2.3)
Plan amendments	(1.3)	—
Accumulated postretirement benefit obligation at December 31	**$ 59.4**	**$ 56.3**

At December 31, 2004 and 2003, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.75 percent and 6.25 percent, respectively.

Following is a reconciliation of the beginning and ending balance of the plan assets, the unfunded postretirement benefit obligation, and the accrued postretirement benefit costs (in millions):

	2004	2003
Fair value of plan assets at January 1	$ —	$ —
Actual return on plan assets	—	—
Contributions by the employer	2.3	1.8
Contributions by plan participants	0.7	0.5
Benefits paid	(3.0)	(2.3)
Fair value of plan assets at December 31	**$ —**	**$ —**
Unfunded postretirement benefit obligation	$ 59.4	$ 56.3
Unrecognized net curtailment gain	—	—
Unrecognized prior service cost	3.5	11.1
Unrecognized net actuarial loss	(16.2)	(14.8)
Accrued postretirement benefit costs	**$ 46.7**	**$ 52.6**

Accrued postretirement benefit costs are reported as a component of "Accrued benefit costs."

For measurement purposes, the assumed health care cost trend rates at December 31 are as follows:

	2004	2003
Health care cost trend rate assumed for next year	9.00%	10.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	4.75%	5.00%
Year that the rate reaches the ultimate trend rate	2011	2011

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2004 (in millions):

	One Percentage Point Increase	One Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ 0.4	$ (0.3)
Effect on accumulated postretirement benefit obligation	8.5	(7.0)

The following is a summary of the components of net periodic postretirement benefit costs for the years ended December 31 (in millions):

	2004	2003
Service cost-benefits earned during the period	$ 1.3	$ 1.2
Interest cost of accumulated benefit obligation	3.4	3.0
Amortization of prior service cost	(0.9)	(1.2)
Recognized net actuarial loss	0.6	0.3
Total periodic expense	$ 4.4	$ 3.3
Curtailment (gain)/loss	(7.9)	2.0
Special termination loss	—	0.4
Net periodic postretirement benefit costs	**$ (3.5)**	**$ 5.7**

At December 31, 2004 and 2003, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 6.25 percent and 6.75 percent, respectively.

Net periodic postretirement benefit costs are reported as a component of "Salaries and other benefits."

A plan amendment that modified the credited service period eligibility requirements created curtailment gains.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") was enacted in December 2003. The Act established a prescription drug benefit under Medicare ("Medicare Part D") and a federal subsidy to sponsors of retiree health care benefit plans that provide benefits that are at least actuarially equivalent to Medicare Part D. Following the guidance of the Financial Accounting Standards Board, the Bank elected to defer recognition of the financial effects of the Act until further guidance was issued in May 2004.

Benefits provided to certain participants are at least actuarially equivalent to Medicare Part D. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic postretirement benefit costs.

Following is a summary of the effects of the expected subsidy (in millions):

	2004
Decrease in the accumulated postretirement benefit obligation	$ 7.0
Decrease in the net periodic postretirement benefit costs	$ 0.9

Expected benefit payments:

	Without Subsidy	With Subsidy
2005	$ 2.8	$ 2.8
2006	3.0	2.8
2007	3.1	2.9
2008	3.2	2.9
2009	3.4	3.0
2010–2014	18.6	16.6
Total	**$ 34.1**	**$ 31.0**

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2004, measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. For 2004, the Bank changed its practices for estimating postemployment costs and used a 5.25 percent discount rate and the same health care trend rates as were used for projecting postretirement costs. Costs for 2003, however, were estimated 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 Bank at December 31, 2004 and 2003, were $8 million and $7 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2004 and 2003 operating expenses were $3 million and $2 million, respectively.

10. BUSINESS RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of some El Paso and San Antonio operations and staff reductions in various functions of the Bank. In 2004, additional consolidation and restructuring initiatives were announced in the Dallas and Houston operations. These actions resulted in the following business restructuring charges:

Major categories of expense (in millions):

	Total Estimated Costs	Accrued Liability 12/31/03	Total Charges	Total Paid	Accrued Liability 12/31/04
Employee separation	$ 4.9	$ 2.6	$ 1.9	$ (2.1)	$ 2.4
Contract termination	0.1	—	0.1	(0.1)	—
Other	—	—	—	—	—
Total	**$ 5.0**	**$ 2.6**	**$ 2.0**	**$ (2.2)**	**$ 2.4**

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 295, including 233 staff reductions related to restructuring announced in 2003. These costs are reported as a component of "Salaries and other benefits." Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of "Other expenses."

Restructuring costs associated with the write-downs of certain Bank assets, including software, buildings, leasehold improvements, furniture, and equipment are discussed in footnote 6. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in footnote 8. Costs associated with enhanced postretirement benefits are disclosed in footnote 9.

Future costs associated with the restructuring that are not estimable and are not recognized as liabilities will be incurred in 2005.

The Bank anticipates substantially completing its announced plans by July 2005.

Volume of Operations
(UNAUDITED)

	Number of Items Handled (Thousands)		Dollar Amount (Millions)	
	2004	2003	2004	2003
SERVICES TO DEPOSITORY INSTITUTIONS				
CASH SERVICES				
Federal Reserve notes processed	2,696,612	2,652,972	42,370	41,581
Currency received from circulation	2,565,157	2,542,296	42,317	41,374
Coin received from circulation	653,338	809,450	84	105
CHECK PROCESSING				
Commercial–processed	990,886	1,207,923	774,665	829,661
Commercial–fine sorted	23,018	45,221	10,435	87,667
LOANS				
Advances made	62*	38*	114	93
SERVICES TO THE U.S. TREASURY AND GOVERNMENT AGENCIES				
Issues and reinvestments of Treasury securities	42	54	1,801	2,257

*Individual loans, not in thousands.

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2004 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $2.0 million. To ensure auditor independence, the Board of Governors requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2004, the Bank did not engage PwC for any material advisory services.

ABOUT THE DALLAS FED

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

The Federal Reserve Bank of Dallas has served the financial institutions in the Eleventh District since 1914. The district encompasses 350,000 square miles and comprises the state of Texas, northern Louisiana and southern New Mexico. The three branch offices of the Dallas Fed are in El Paso, Houston and San Antonio.

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