

RACING TO THE TOP

How Global Competition Disciplines Public Policy



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Old Words, Renewed Meaning

In a February 2006 speech at an Institute of Economic Affairs' conference in London, Dallas Fed President Richard W. Fisher paid homage to economist Joseph Schumpeter and his concept of creative destruction. The following is adapted from that speech.

I like Schumpeter because his writings focus the mind on the process of change and adaptation. They are particularly relevant today. Listen carefully to these quotes from two of his seminal works.

In his book *Capitalism, Socialism, and Democracy*, Schumpeter wrote: “The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory . . . illustrate the same process of industrial mutation . . . that incessantly revolutionizes the economic structure *from within*, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is . . . what every capitalist concern has got to live in.”

And from volume 1 of Schumpeter's *Business Cycles*: “A railroad through new country, *i.e.*, country not yet served by railroads, as soon as it gets into working order upsets all conditions of location, all cost calculations, all production functions within its radius of influence; and hardly any ‘ways of doing things’ which have been optimal before remain so afterward.”

String the key phrases of these citations together and you get the bottom-line plot of capitalism's process of creative destruction: *The opening up of new markets, foreign or domestic, revolutionizes the economic structure, destroying the old one, creating a new one. [It] upsets all conditions of location, all cost calculations, all production functions, and hardly any ways of doing things which have been optimal before remain so afterward.*

Here is where China and India and all the bristling new economic entrants come in. They are today's equivalent of Schumpeter's railroads. They and the phenomenon of globalization are agents of creative destruction writ large. From now on, hardly any way of doing things which used to be optimal will ever be so again.

A LETTER FROM THE PRESIDENT

Shortly after becoming president of the Dallas Fed, I stumbled upon an observation from the great British prime minister William Gladstone, and it has become a favorite of mine: *Not even love has made so many fools of men as pondering over the nature of money.*

Gladstone's witticism is a humbling reminder for me and my colleagues in the Federal Reserve System. Our job is to contemplate the nature of money: how to protect its value; how to use monetary policy to promote growth with low inflation; how to manage the payments system to keep our financial infrastructure humming at peak efficiency.

My first year as president of the Federal Reserve Bank of Dallas has been filled with all those contemplations—and many more. I have been truly inspired by the intelligence, integrity, competence and work ethic I have found at the Federal Reserve, not only in Dallas but in Washington and at the other regional Banks around the country. I owe a particular debt to my colleagues at the Dallas Fed. I cannot think of a more interesting job than serving as the leader of this exemplary group of women and men.

The Forces of Change

The global economy is in the midst of a tectonic transformation. Powerful new players—among them China's 1.3 billion people and India's 1.1 billion—have entered the marketplace in full force. At the same time, technology continues to make enormous advances that spawn new forms of competition and transform how businesses operate worldwide.

Trade and technology accelerate what economist Joseph Schumpeter



called “creative destruction,” a somewhat self-contradictory shorthand for how capitalist systems constantly replace existing ways of doing business with new ones. (For more on Schumpeter, see the excerpts across from this page.) Yesterday's business practices are rapidly replaced by tomorrow's ways of doing business in an economic revolution that reaches into nearly every corner of the world.

We are not sheltered from the forces of change at the Dallas Fed. New technologies are creating challenges and opportunities in the way we process payments, run cash operations, serve as the Treasury's fiscal agent, supervise and

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Our mission is to have the Dallas Fed be the look-to Bank in the Federal Reserve System. We are striving to become the System's standard for excellence and innovation.

regulate banks and provide them with liquidity, and keep the public informed.

One of the essays in this annual report, "Critical Mission," summarizes the Dallas Fed's business side and reports some numbers that illustrate the depth and breadth of our operations. Last year, for example, we processed almost 1 billion checks, worth about \$900 billion. We paid out and received a record 5.4 billion in circulating notes worth almost \$92 billion.

This is important work. Money flows are an economy's lifeblood, and the Federal Reserve's great responsibility lies in maintaining the cardiovascular system of American capitalism. The Fed's operations—from payments processing to bank regulation to the New York Desk's trading activities—keep open the arteries, veins and even the capillaries of capitalism.

The sacred duty of the Federal Reserve System is to conduct monetary policy that sustains non-inflationary economic growth. To fulfill our role of helping set monetary policy for the United States, the Dallas Fed must conduct groundbreaking research to better understand how our economy behaves in an intensely interconnected, increasingly globalized world. The new reality creates a need to rework key assumptions about the gearing of the U.S. economy and how it affects the Federal Reserve's ability to do its job.

Immediately upon becoming Bank president last year, I challenged our research team to develop new principles and analytical tools for a globalized world—new ideas that could serve as guides for the Federal Open Market Committee and stimulate the thinking of monetary economists worldwide. "Racing to the Top," the cover essay of this annual report, pre-

sents a view of globalization's impact on the economy and its effect on a wide range of public policies.

The essay notes a striking correlation between increasing globalization and better economic policies. A good example is price stability. In a world where capital moves at light speed, nations that allow inflation to erode the value of their money face stiff penalties in the form of capital flight. Sound money has become imperative, and inflation has been receding in all parts of the world over the past two decades.

The Dallas Fed's work on globalization is only beginning. Over the next few years, we will devote much attention to the benefits and challenges of a world where national borders are becoming less significant as economic barriers. We will keep you informed of our findings.

Our mission is to have the Dallas Fed be the look-to Bank in the Federal Reserve System. As we hone our operations and expand our research frontiers, we are striving to become the System's standard for excellence and innovation.

My first day at the Dallas Fed, I called a meeting of the entire staff and quoted a passage from Carlos Ruiz Zafón's brilliant novel, *The Shadow of the Wind*: "What destiny does not do is home visits. You have to go for it."

The men and women of the Dallas Federal Reserve are not sitting back, waiting for change to affect us. We have a responsibility to anticipate and effect the change our hypercompetitive world requires. We are wasting no time in going for it.



Richard W. Fisher

RACING TO THE TOP

How Global Competition Disciplines Public Policy



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All over the world, consumers are getting more of what they buy from other countries. Since 1987, exports have jumped from 16 percent to 27 percent of the global economy.

More investors are prowling the world for higher returns. Since 1990, foreign direct investment has nearly tripled and cross-border portfolio investment has risen fivefold as a percentage of world output.

More people than ever are venturing abroad. The number of international tourists per 100 people has doubled over the past two decades.

The far corners of the globe are now plugged in. International telephone calls, mobile phone subscribers and Internet users have skyrocketed in the past decade.

These are but a few of the telling signs of a more interdependent and interconnected world, all reflecting the economic reality of our times—globalization. Political and geographic borders are less of an economic barrier as goods, services, people and ideas move more freely across international boundaries. (*See Exhibit 1.*)

The United States and other countries have benefited significantly from globalization. It has meant increased competition—which is good. Competition sharpens the wits and improves muscle tone. Facing foreign competition head-on keeps countries at the forefront of the global economy by encouraging businesses to do what they should do: create jobs and profits in a virtuous cycle that goes on indefinitely.

Consumers gain from lower prices and greater variety. A trip to any supermarket or discount store gives testament to the benefits of globalization: bananas from Ecuador, fresh-cut flowers from Colombia, low-priced dolls and games from China, coffee from Vietnam, software from Estonia, big-screen TVs from Taiwan.

Like technology, globalization unleashes the forces of creative destruction, a process described by economist Joseph Schumpeter more than 50 years ago. Some industries advance. Others recede. Jobs are gained and lost, businesses boom and bust, but economies emerge from the crucible more efficient, more productive and more wealthy.

The economic shifts make globalization a hot-button issue. In many parts of the world, protesters blame it for job losses as well as cultural and environmental degradation. Critics clamor for protection from globalization, pleading with their governments for new restrictions on global trade and investment.

Advocates of freer markets and further globalization emphasize the gains generated by an increasingly integrated world economy. They argue that open borders not only intensify competition but also encourage specialization.

Competition and specialization fuel economic progress. The most globalized nations lead their less open rivals in such measures as living standards, growth and job creation,

while the poorest usually have the fewest ties to the world economy.

This is where most commentaries on globalization end—tallying the efficiencies gained in the private sector.

What about the public sector? There, too, globalization pays dividends through the competition it generates. An examination of key policies in 60 nations shows a strong correlation between globalization and policies that shape nations' economic performance.

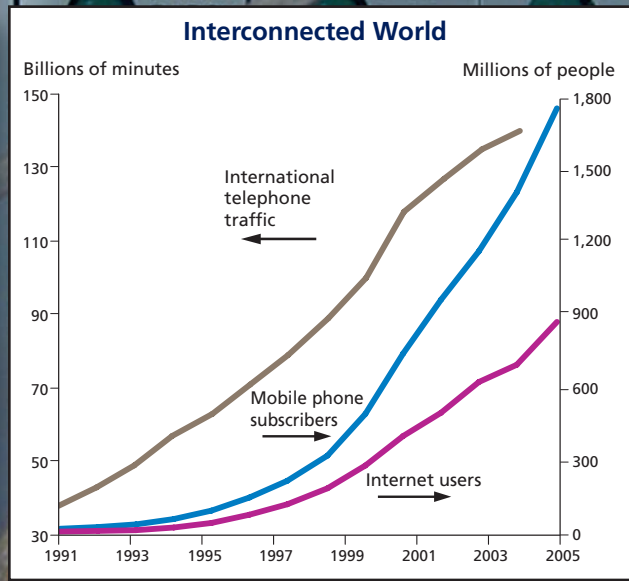
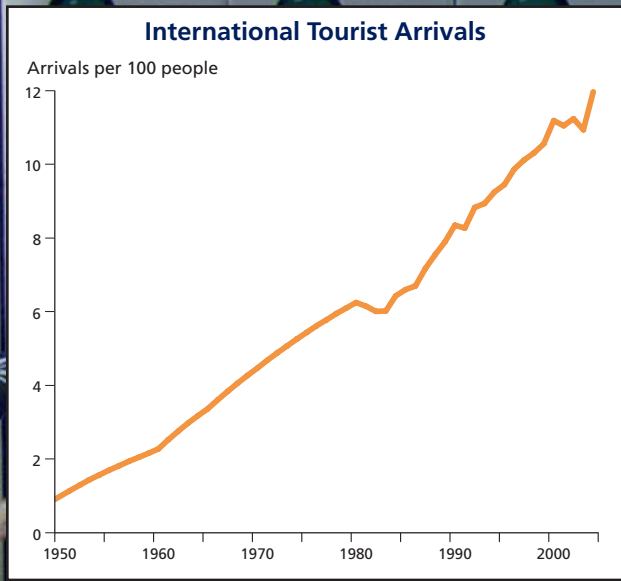
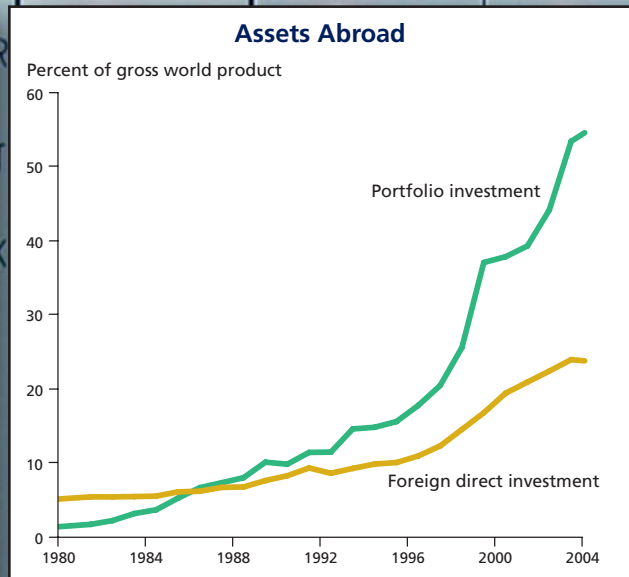
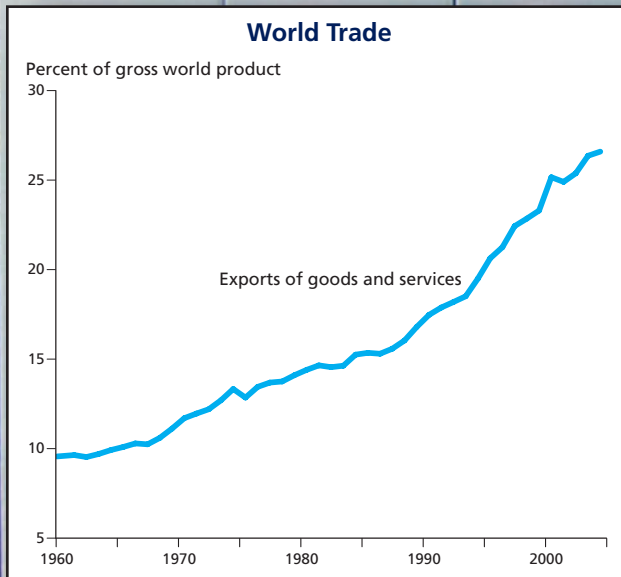
Lowering barriers loosens the hold nations have on the capital, labor, businesses and know-how that create wealth. Increasingly mobile factors of production shun bureaucratic restrictions that lock them into outmoded methods. They avoid intrusive governments that hamstring their ability to adapt to a rapidly changing economy. They look for maximum returns on capital and the lowest tax burden on the sweat of the brow.

The more freely these factors of production can move across borders, the greater governments' incentive to pursue policies that will attract and retain valuable resources. In a globalizing world, countries win by instituting better policies and lose by overburdening their economies with taxes, regulations, trade barriers and policy instability.

The notion that competition between governments and factor mobility lead to better policies shouldn't surprise many Americans. This is our history. Tax and regulatory

EXHIBIT 1 Going Global—Goods to Gigabytes

Globalization has been advancing as countries open markets and adopt new technologies. Trade is up. Both portfolio investment and foreign direct investment have surged. More tourists are crossing borders. International telephone lines, cell phones and Internet connections make access to information easier and cheaper.



policies have always differed across the 50 states, spurring capital, labor and businesses to migrate in search of the best place to settle.

In the 1950s, American economist Charles Tiebout saw competing jurisdictions as a corollary to markets. If companies and workers could vote with their feet, it would pressure governments to provide services more efficiently and effec-

tively. Just as Adam Smith's invisible hand directs the private sector to meet consumers' desires at lower prices, competition leads the public sector to policies that reflect people's needs and wants. Contemporary economists Geoffrey Brennan, James Buchanan, Dwight Lee and Richard McKenzie have also analyzed how factor mobility shapes public policy.

Globalization's critics charge that a more open world economy sets off a race to the bottom by encouraging nations to jettison protections for consumers, workers and the environment. Proponents contend that globalization prompts a race to the top by pushing countries toward policies that promote faster growth, lower inflation, higher incomes and greater economic freedom.



Reducing Inflation's Bite

As globalization has knit the world closer together in recent decades, inflation has fallen sharply in many countries.

The seven largest developed nations recorded average annual inflation of 10.2 percent from 1973 to 1983. Since 1995, their average rate has declined to just 1.8 percent a year. (See *Exhibit 2 on page 8*.)

Nearly all theorists recognize that inflation is largely a monetary phenomenon, but globalization changes the economic environment in which central banks operate. In a world where nations compete for investment dollars, the prospect of rapidly rising prices will spark capital flight to countries with more stable money. Central banks can't afford to allow inflation to exceed the global norm.

Cheap imports, moreover, have meant bargains for consumers. Forced to match foreign competition, domestic producers lowered costs by improving management, adopting new technologies and buying cheaper inputs overseas. Specialization added efficiencies by allowing labor, capital and other productive factors to flow toward centers of comparative advantage, where they could produce the most output at the lowest relative cost.

By exerting monetary discipline and spurring productivity growth, globalization has led to more stable prices. The U.S. has found itself with tamer inflation and faster growth than would have been possible without globalization.

A.T. Kearney Inc. and *Foreign Policy* magazine have developed a globalization index that ranks 62 nations on such factors as openness

to trade and investment, Internet access, cross-border communication and travel, and involvement in international organizations. Singapore, Ireland and Switzerland stand out as the world's most globalized nations. The United States ranks a very respectable fourth—off the charts in technology but lagging the leaders in trade, foreign direct investment and treaty commitments.

France, Germany and Japan post middling scores, largely because of lingering protectionism. Russia, China, Brazil and India are among the least globalized economies, indicating they still have a long way to go before full integration into the world economy.

Nations in the top quarter of the A.T. Kearney rankings did better than those toward the bottom in maintaining sound money, as measured by the Fraser Institute's Economic Freedom of the World index. The United States sits atop the Fraser standings, giving new meaning to the old saw about being sound as a dollar. Other sound money stars include Singapore, Sweden, Denmark and Finland—all highly globalized.

Throughout the A.T. Kearney rankings, price stability goes hand in hand with globalization. Nations in the bottom quarter had average inflation of 10 percent from 2001 to 2003. Rates tend to fall as nations globalize, reaching an average 2.3 percent for the top quarter.

Although the evils of inflation can't be denied, some governments are still tempted to pump up the money supply as a short-term palliative for sluggish growth, unemployment or ballooning fiscal deficits. When inflation gets out of hand, it erodes the value of money, destroys

savings and corrupts the incentives that direct the efficient allocation of resources.

Sound money, on the other hand, is an asset to an economy. It provides companies and individuals with a stable unit of value, so decisions about spending, saving and investing can be made on a reliable economic basis.

Globalization makes low inflation imperative, but nations have pursued monetary discipline in a variety of ways. The European Union institutionalized German-style monetary policy when it created a continental central bank in 1998 and gave it the sole mandate to maintain low inflation.

Mexico, once prone to severe bouts of inflation, achieved its smallest price increases on record in 2005—just 3.3 percent. The process of restoring stable prices began with a 1995 constitutional amendment guaranteeing the central bank's independence from political interference.

Ecuador and El Salvador adopted the U.S. dollar as their currency, effectively putting monetary policy beyond the reach of national leaders. The governor of New Zealand's central bank can be fired for exceeding its inflation target.

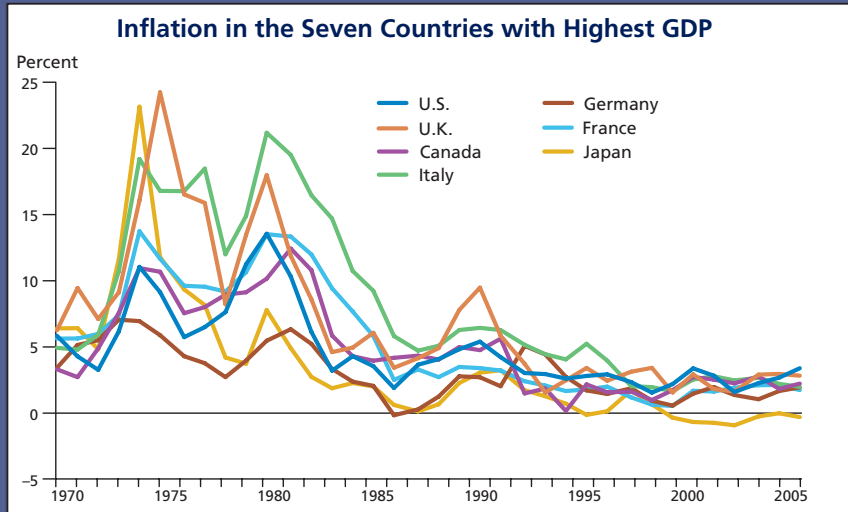
In the United States, the path to today's low inflation started in the early 1980s, when the Federal Reserve instituted tough policies to drive down double-digit price increases. The payoff has been average inflation of 3 percent a year for two decades.

Sound money does a world of good, but a nation's business climate also depends on other policies. Does globalization have an impact beyond keeping inflation in check?

EXHIBIT 2 The Path to Price Stability

Inflation is falling . . .

Over the past quarter century, inflation has declined sharply in most parts of the world, including the United States and other major developed countries.

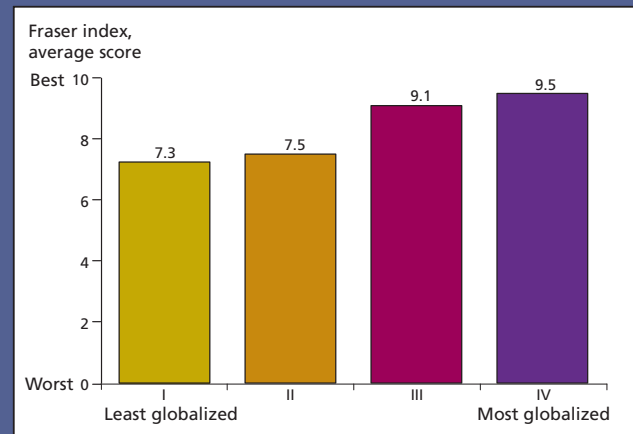
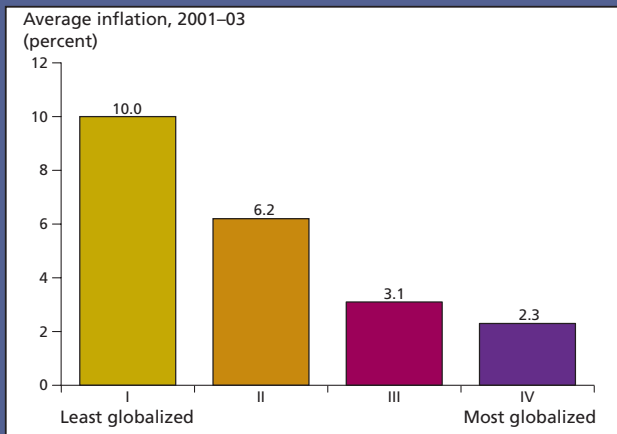


. . . with globalization playing a role . . .

Countries most open to international business tend to have far lower inflation rates than those that are closed (for rankings, see the box at the bottom). The pattern suggests globalization has contributed to price stability.

. . . in encouraging sound money.

The Fraser Institute's scores for sound money confirm the relationship between globalization and policies that keep inflation at bay.



For the past five years, A.T. Kearney Inc. and *Foreign Policy* magazine have ranked nations on globalization. The box below shows the pecking order for 2005, divided into quartiles, ranked from least (60) to most (1) globalized.

LEAST GLOBALIZED							
I		II		III		IV	
60	Iran	45	Argentina	30	Poland	15	Czech Republic
59	India	44	Thailand	29	South Korea	14	Norway
58	Indonesia	43	Saudi Arabia	28	Greece	13	Australia
57	Egypt	42	Nigeria	27	Japan	12	United Kingdom
56	Bangladesh	41	Sri Lanka	26	Italy	11	New Zealand
55	Brazil	40	Mexico	25	Spain	10	Finland
54	Turkey	39	Senegal	24	Slovak Republic	9	Austria
53	Venezuela	38	Morocco	23	Panama	8	Sweden
52	China	37	Ukraine	22	Hungary	7	Denmark
51	Peru	36	Tunisia	21	Portugal	6	Canada
50	Russia	35	Taiwan	20	Germany	5	Netherlands
49	Colombia	34	Romania	19	Slovenia	4	United States
48	Pakistan	33	Chile	18	Malaysia	3	Switzerland
47	Kenya	32	Uganda	17	France	2	Ireland
46	South Africa	31	Philippines	16	Israel	1	Singapore

MOST GLOBALIZED

Open for Business

Imagine a capitalist manifesto. It would prescribe free trade, open competition, individual choice, strong property rights and all the other ingredients vital to a healthy market economy.

These attributes can be measured. The Fraser Institute, World Bank, Heritage Foundation, Institute for Strategy and Competitiveness, Transparency International and other think tanks compile consistent, fact-based ratings on the climate for capitalism around the world. Taken together, they provide a broad range of yardsticks for gauging the relative quality of economic policies.

Comparing these measures against A.T. Kearney's globalization rankings reveals a marked correlation between more open borders and policies that bolster economic performance.

The two forces are complementary—so strict causality is elusive. Globalization clearly gives governments incentives to enact policies to attract and retain mobile factors. At the same time, countries with solid policies will be more successful in the global economy, encouraging further opening and deeper cross-border connections. The chicken-and-egg debate shouldn't detract from the fundamental truth that globalization and good policies go together.

Let's run through a dozen policy measures to see how they correlate with globalization. (*See Exhibit 3 on page 10.*)

Trade policies make a good starting point. Since 1990, nations have peeled away restrictions on goods and services, signing nearly 180 regional trade pacts, including the North American Free Trade Agreement in

1992. The creation of the 149-nation World Trade Organization (WTO) in 1995 delivered a jolt of liberalization in such areas as global financial services, telecommunications and other high-value-added sectors. The WTO also established a forum for further market opening, and its members are now aiming for breakthroughs on such tough issues as farm-trade restrictions and subsidies.

The flurry of trade deals has opened markets. Since 1980, negotiations have slashed the average tariff from 27.6 percent to 11.3 percent for developing nations and from 9.8 percent to 4 percent for industrial countries.

Trade policies are integral to globalization, so it's no surprise that nations scoring high on Fraser's measure of freedom to trade cluster toward the top of the A.T. Kearney index.

Investment policies that free capital to seek its best uses give countries more resources to expand production. Many of the treaties that sweep away restraints on trade also knock down international barriers to investment. Since signing NAFTA, for example, Mexico has welcomed foreign capital, reducing red tape and opening sectors once reserved for nationals. Mexico's payoff has been \$145 billion in direct investment from abroad over the past decade.

Countries well connected to the world economy post the highest scores on Fraser's measure of capital market openness. Despite the benefits of open capital markets, less globalized nations persist in hindering money flows because they either want to keep capital at home or limit foreign involvement in their economies.

Regulatory policies may be largely domestic, but they play a

significant role in international competitiveness. More-globalized economies rank higher on Fraser's measure of the lack of regulatory burden and the World Bank's barometer of regulatory quality.

In more open economies, governments are less likely to impose price controls and other burdens on business. Effective regulation isn't just about what government ought not do. It also covers policies important to the smooth functioning of market economies, such as adequate supervision of banks.

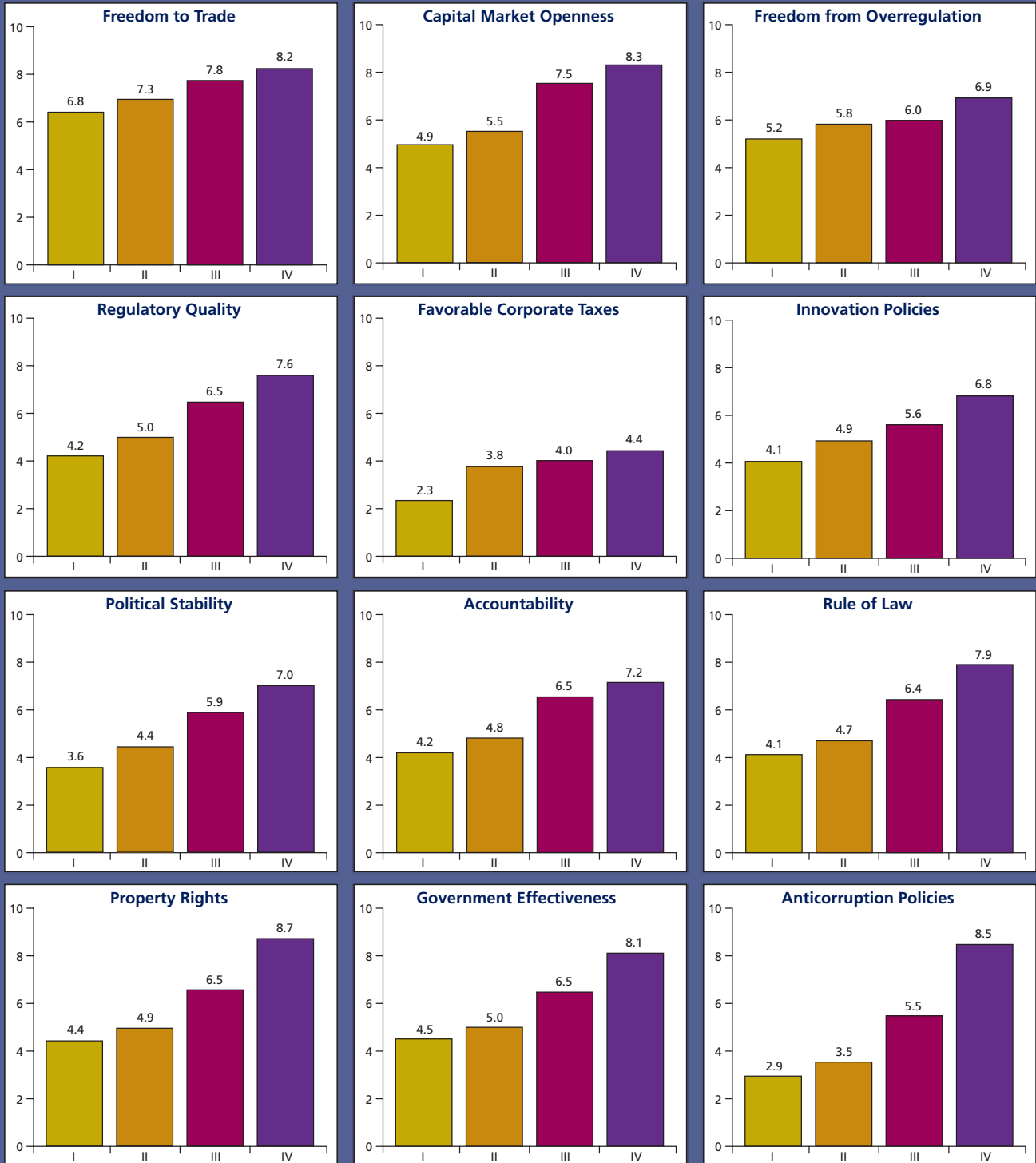
Favorable tax policies are an important asset in an era when multinational operations and mobile capital enable companies to invest and produce anywhere in the world. In the past two decades, nations responded to globalization by reducing tax burdens—as shown by the Heritage Foundation's measure of favorable corporate taxation.

High taxes discourage work and investment, and dozens of countries lowered top income tax rates for individuals between 1980 and 2000, some significantly. Including national and provincial taxes, South Korea lopped off 45 percentage points; Portugal, 44; and Britain, 43. More than a dozen developed countries have lowered top corporate rates by at least 10 percentage points from 1986 to 2000, led by Ireland's 26 points and Sweden's 24. Among the 30 members of the Organization for Economic Cooperation and Development, the average top corporate tax rate at the national level fell from 33 percent in 1998 to 27.7 percent in 2004.

Lower levies helped Ireland halt its brain drain, attract foreign businesses and launch an economic

EXHIBIT 3 Raising the Bar

As countries open themselves to international competition, they tend to pursue policies that promote success in the world marketplace. From freer trade to low levels of corruption, the more-globalized countries fare better on various research groups' measures of sound policies. Countries become more globalized moving from quartile I to quartile IV. Policies improve from 0 to 10.



INDICATOR	MEASURE	INDICATOR	MEASURE
Freedom to trade (Fraser Institute)	Barriers to goods and services	Political stability (World Bank)	Likelihood of unfavorable events
Capital market openness (Fraser)	Restrictions on capital flows	Accountability (World Bank)	Responsiveness to citizens
Freedom from overregulation (Fraser)	Extent of government intrusion on business	Rule of law (World Bank)	Strength of legal system
Regulatory quality (World Bank)	Effectiveness of civil service	Property rights (Fraser)	Protection from arbitrary losses
Favorable corporate taxes (Heritage Foundation)	Burden on company profits	Government effectiveness (World Bank)	Competent administration
Innovation policies (Harvard University)	Support for technology	Anticorruption policies (Transparency International)	Honesty in the public sector

revival. Free of communism, new EU members Latvia, Lithuania, Estonia and Slovakia bucked the continent's progressive tradition by instituting flat taxes.

Innovation policies help foster new business formation and expand opportunities for established companies. Harvard's Institute for Strategy and Competitiveness ranks nations on their commitment to technology, shown by such measures as protection for intellectual property, size of R&D tax credits, and attractiveness to scientists and engineers.

Open economies exhibit a greater willingness to nurture new technologies. Many of the Harvard study's most innovation-friendly nations are among A.T. Kearney's most globalized.

Political stability matters to economies because confusion, uncertainty and violence wreak havoc on markets. Businesses and individuals will be wary of entering into contracts and other long-term arrangements unless they're fairly certain society's basic structure will endure. When administering public policies, stable regimes are more effective and consistent.

The World Bank finds the most stability among long-standing democracies of Western Europe, North America and Australia. Many of these nations score well on the A.T. Kearney globalization rankings.

Accountability emerges as a key aspect of political stability. The potential for chaos recedes in societies with civil liberties, political and human rights, and opportunities for citizens to select and influence their governments.

The World Bank's readings on accountability, like those on stability, favor democratic nations with a strong tradition of individual rights. These countries tend to have free enterprise economies that are engaged in the world economy.

Rule of law narrows the focus to the justice system. Society's norms receive greater respect in countries with lower crime, effective courts and dependable enforcement of contracts. An abiding respect for the rule of law enhances the predictability businesses require for forward-looking decisions based on the sanctity of contracts.

Countries seeking to establish themselves as good places to do business will maintain fair and functional legal systems. The most open economies already do, while the least globalized struggle to deliver adequate law enforcement.

Property rights are a specific aspect of the rule of law. When caprice or government actions call into question the ownership or value of property, economic activity becomes risky and may grind to a halt. Strong protection of property rights makes market economies function more smoothly by enabling buyers and sellers to conduct transactions with a higher degree of trust.

The most globalized nations guarantee property rights; the least globalized offer less protection. The ranking relies on Fraser's measure of the effectiveness of nations' legal systems and their protections for property rights. Countries earn high scores if their citizens have legal recourse to prevent theft, fraud and government actions that jeopardize their homes and businesses.

Government effectiveness recognizes that good policies don't inspire respect and confidence without competent administration and consistency over time.

The World Bank focuses on the quality of government services, the capabilities of civil servants, the political independence of public agencies and the credibility of the government's commitment to good policies. Highly globalized countries realize they can't succeed without good government at home.

Anticorruption policies take aim at illicit dealings that undermine economies by raising costs, creating uncertainty and thwarting competition. Russia's transition from communism to capitalism, for example, has degenerated into a kleptocracy that can't keep insiders from enriching themselves by rigging the system.

The most globalized countries are less likely to tolerate corruption. They rank significantly higher on Transparency International's index for absence of corruption and the World Bank's measure of the ability to control corruption.

Globalization's influence does not end with the policies and attributes studied by the think tanks. Honing labor's skills, for instance, creates an edge in our high-tech age, and businesses are likely to flow toward nations that better educate workers. The forces of an increasingly global economy are also likely to play a role in immigration, education and energy policies. Indeed, as nations grow even more interconnected, globalization may impact realms of public policy that today seem far removed from the world economy.

Labor Pains

The demands of the international marketplace are a force for better policies when factors are highly mobile. Globalization has been less decisive in changing policies affecting resources less free to migrate.

Factors of production differ in their ability to move across borders. Information and money zip from one part of the world to another in the blink of an eye. At the other end of the spectrum, land can't be moved at all. Labor seeks its international advantage slowly, restricted by immigration laws and our affinity for homeland, culture and family.

Most likely owing to workers' limited international mobility, the

World Bank's measure of labor flexibility doesn't improve as countries become more globalized—until we get to the top quarter. The most internationalized nations do give companies greater freedom to determine employment conditions, an indication of a link between labor policies and globalization. (See Exhibit 4.)

For now, these countries are the exception. Even in our globalizing era, many nations maintain laws that hinder the hiring and firing of workers. Job protection may sound appealing at first, but such policies impede workers' ability to compete. When companies face onerous labor regulations, they can't adjust quickly to new opportunities in the marketplace. They're often wary of hir-

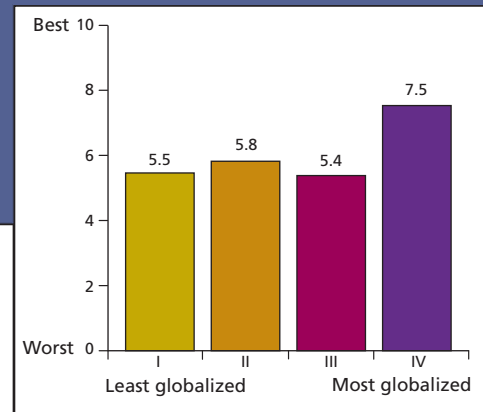
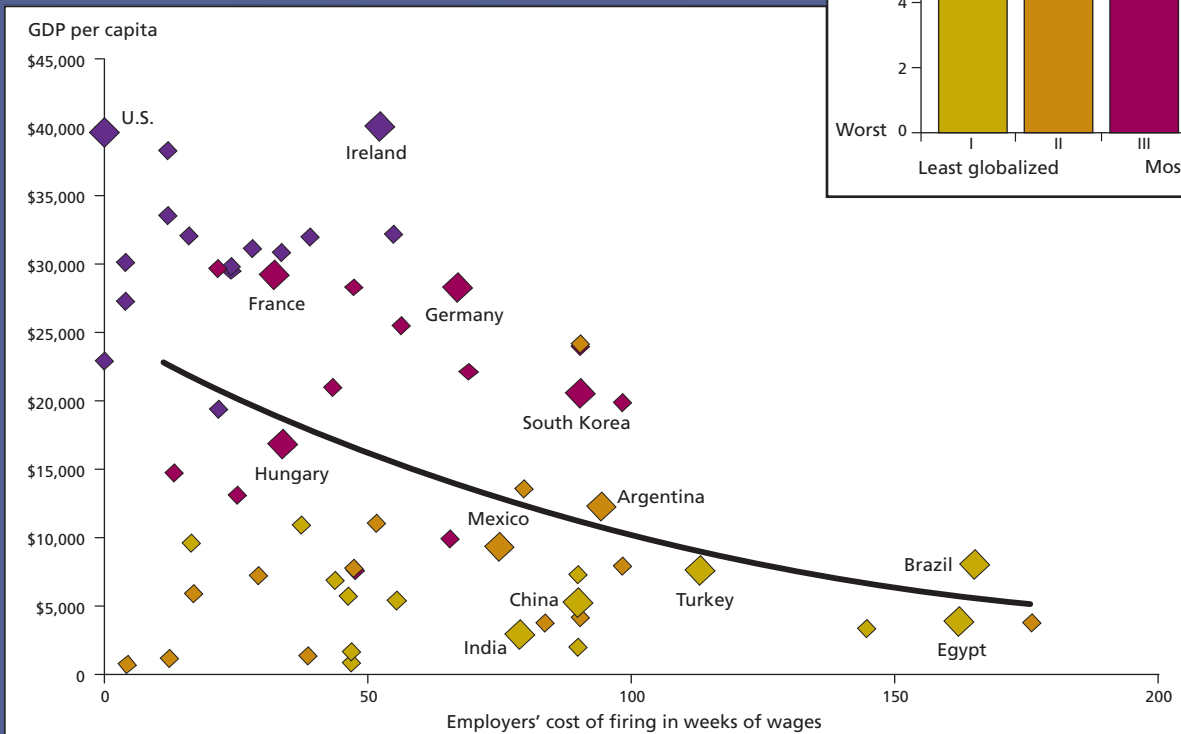
ing new workers, who will be difficult to shed if optimistic sales expectations turn sour.

Japan's insistence on preserving its tradition of lifetime employment has been a big reason its once high-flying economy languished for more than a decade after 1990. Germany's labor policies have retarded growth in what once was a locomotive for the global economy.

Countries with the most regulated labor markets tend to have lower per capita income. The World Bank reports that many nations impose huge burdens on employers that lay off workers—the equivalent of 165 weeks of pay in Brazil, 112 in Turkey, 90 in China, 79 in India. All are relatively poor countries.

EXHIBIT 4 Labor Market Flexibility

Highly globalized nations tend to allow greater freedom in hiring and firing workers (right). Increased labor mobility helps make these economies more productive and dynamic, leading to higher per capita incomes (below).



By contrast, countries that impose fewer burdens on employers are usually richer. The United States, for example, mandates no severance at all, allowing companies to determine their own policies.

Times may be changing. France's new labor laws, enacted last year, make it easier for small companies to hire and fire employees. One provision allows firms to lay off workers without cause during the first two years of employment. A third of Japan's labor force now consists of temporary and contract workers, up from 20 percent a decade ago. They don't hold lifetime employment rights. Germany, Italy and other nations have begun to debate labor reform, a sign that at least some of their leaders recognize being a global competitor requires the capacity to adapt quickly.

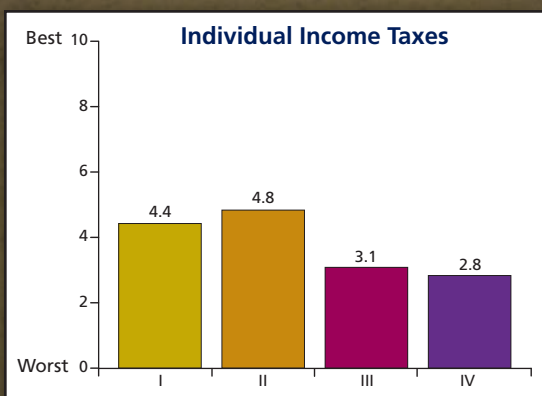
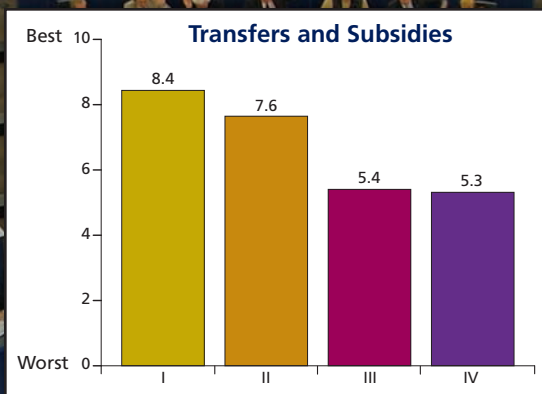
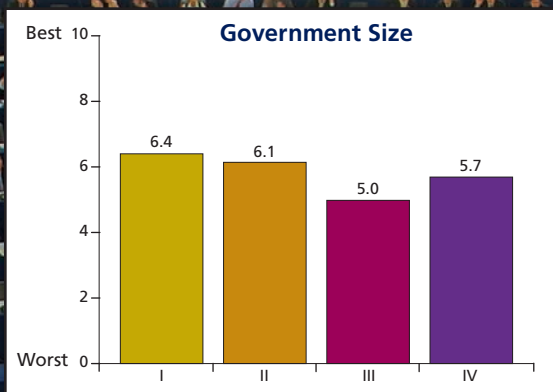
These changes are encouraging, but old-style labor policies have powerful constituencies. As a result, reform has been grudging and incremental, rather than sweeping. The less globalized countries still have a long way to go before they achieve the labor market flexibility seen in the United States and others toward the top of the A.T. Kearney index.

The persistence of labor market restrictions shows the journey from globalization to better public policies isn't complete. Countries will drag their feet. Many will resist calls to dismantle job protections and other popular regulations, even if leaders recognize what must be done. The direction of the march, however, can't be mistaken. The world is moving toward more market-driven economic policies, thanks in part to the demands of globalization.



EXHIBIT 5 Fiscal Policy and Globalization

Bigger government bogs down economies, but interconnected ones aren't reducing the size of their public sectors (*top*). They tend to maintain costly transfers and subsidies (*middle*). And despite pressure to cut rates, they have maintained a high tax burden to support generous social programs (*bottom*). Countries become more globalized moving from quartile I to quartile IV.



Fiscally Unfit

Market economies rely on the private sector for food, clothing, shelter, entertainment and much more. Government meets needs that markets can't supply efficiently—roads, police protection, a legal system, to suggest just a few.

Public sector wish lists grow longer as societies grow richer. If governments become too big, economies suffer as resources siphoned from the private sector become subject to political decisionmaking.

Although bigger government can sap economic vitality, the public sector is expanding in many countries, the most globalized as well as the least. Fraser's scores on government size show that the most open countries aren't doing much better than the least internationalized ones. When it comes to government transfers and subsidies, the most globalized actually score worse. (*See Exhibit 5.*) The data suggest globalization hasn't disciplined fiscal policy to the same degree it has monetary policy.

Tax cutting may have lowered top rates, but even highly globalized countries are still exacting a heavy toll to support social spending. In France, for example, income taxes are 9 percent of labor costs, but levies on workers and employers for social programs total another 39 percent. Germany maintains costly programs that give the unemployed as much as 63 percent of their working income—paid for by taxpayers, of course.

Countries have found they can't tax mobile factors heavily. So workers and their employers, less able than money to move across borders,

get stuck with the tab for an expanding public sector.

Fiscal policy shouldn't be exempt from globalization—at least in theory. Companies and workers ought to realize that ever-growing spending, when not covered by existing or new revenue streams, will someday lead to budget cuts or higher taxes. Knowing this, they should seek the safety of economies with sounder fiscal policies.

Why aren't mobile factors on the run from bigger government? Many businesses and workers, of course, have language, cultural and other bonds to their home countries. Many governments operate on debt, so the lag between receiving benefits and paying for them may also be key. Companies, investors and even workers may be willing to stay put for short-term advantages of government spending, including lucrative subsidies and contracts aimed at attracting business. Otherwise-mobile factors can pocket the money now, knowing they are free to relocate when

the bills come due and leave the debt to future generations.

Openness itself may also take some of the pain out of running deficits—at least in the short run. Borrowing abroad reduces deficit spending's tendency to crowd out private investment and raise interest rates. Political pressure to cut spending is less likely to build without the spur of higher borrowing costs.

Australia, Canada, Britain and several of the smaller EU countries, all highly globalized, have cut deficit spending since the early 1990s. Germany and France, less open to globalization, haven't maintained the EU standard of deficits below 3 percent of GDP. After a few years of budget surpluses, the United States now faces substantial federal deficits and huge, unfunded long-term obligations for retirees and health care. The red ink for 2006 has been estimated at 3.2 percent of GDP.

Persistent deficit spending can create problems for monetary policy. When fiscal authorities run large deficits, they leave central banks

with a troublesome choice: monetize the red ink and cause inflation, or take a stand for price stability with higher interest rates that dampen economic activity.

To guard against easy money, the United States and other nations grant their central banks a high degree of independence from political influence. When monetary authorities are insulated, they've usually proven capable of resisting pressure to pump up the money supply to finance deficits.

Such independence can't be taken for granted. Overflowing red ink can divide monetary and fiscal authorities on the importance of price stability. Weakening the consensus on fighting inflation only increases the temptation for political meddling in monetary policy.

Central bank independence carries even more weight in a globalized world, with its increasingly mobile capital. The more politics encroaches on monetary policy, the greater the risk of fiscal folly, serious inflation and capital flight.



Toward a Global Economy

Globalization isn't new. The ancient Silk Road, a 4,000-mile overland route stretching from the Mediterranean to Imperial China, was an early conduit of international commerce. In the rapidly industrializing 19th century, steamships, railroads, telegraphs and other advances in communications and commerce ignited a vigorous round of worldwide economic integration.

These earlier periods of globalization couldn't be sustained. Desert sands swallowed the Silk Road in the 15th century. The great 19th century globalization slammed into reverse as trade and foreign investment collapsed in the face of two world wars and the widespread protectionism of the 1930s. Economic

activity's retreat behind borders left the world a far poorer place.

The present episode has its roots in the years after World War II, when the U.S. and other nations, mindful of the hardships wrought by the prior globalization's collapse, opened their economies. Since then, globalization has gained momentum as countries have prospered by freeing their economies from restraints that hinder greater integration with the rest of the world. (See Exhibit 6.)

Economies can grow without good policies—for a time. Consider China. Although freer than it was, its economy maintains vestiges of its state-dominated past. Scores on many policy measures are still low. On labor flexibility, for example, China ranks with Peru and Venezuela, far below the United States.

Despite these handicaps, China has been able to grow rapidly, largely because abundant, cheap labor fuels exports and foreign investment. The country, though, remains relatively poor, and its hidebound policies—if left unchanged—will ultimately hinder economic development.

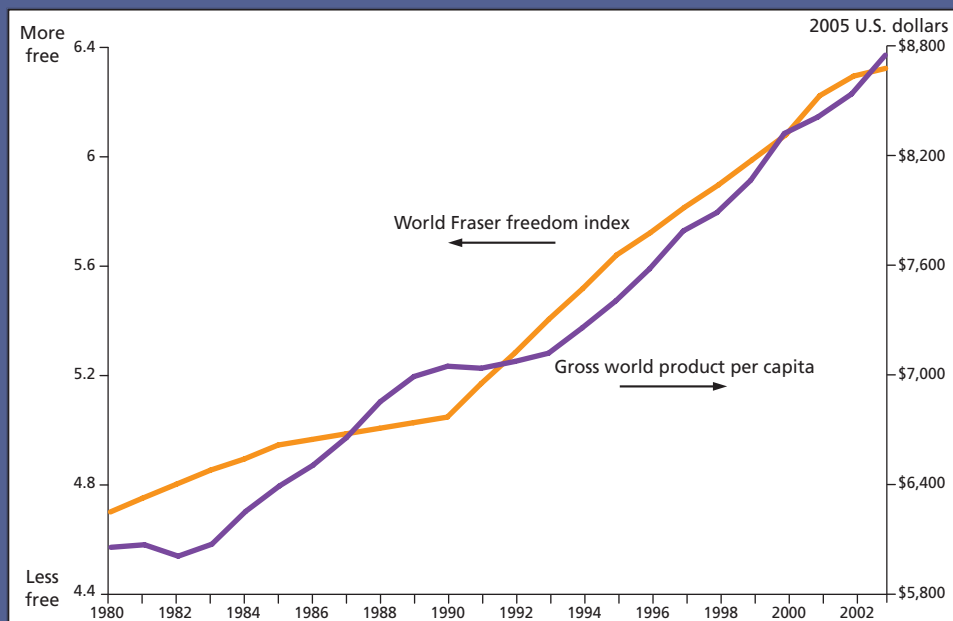
Countries that resist globalization's imperative for adaptability and retain rigid economic structures are likely to lose ground. Germany, France and Italy, for example, have seen per capita GDP slip to where it was in the 1970s relative to the U.S. level.

History teaches this lesson: Globalization is natural, but it's not inevitable.

Economies grow closer because of powerful forces celebrated since the time of Adam Smith—self-inter-

EXHIBIT 6 Richer and Freer

The past quarter century has brought a surge of economic freedom as nations in all parts of the world have jettisoned many restrictions on the private sector. Adopting free market policies has led to improved living standards, as measured by per capita income.



est and economic freedom. Left to their own devices, companies and individuals will usually do business with whoever offers the best deal, regardless of nationality.

Through literally billions of diverse transactions, economies will interconnect and intertwine to the extent governments refrain from erecting barriers to commerce or adopting policies that cripple cross-border business.

If nations can avoid past mistakes, our times are primed for further globalization. The Internet and other technologies have made telecommunications, travel and transport cheaper and faster. They allow companies and individuals to take greater advantage of the trend toward more open, market-oriented policies that favor globalization.

Some will still resist, fearing the inevitable disruption that follows opening to the world. When critics call for isolation and protectionism, we should remember this: The two most recent periods of globalization—the one that began in the 19th century and our own—have been marked by rapid economic growth, great strides in technology and vastly improved living standards. It was the widespread rejection of economic openness between the two globalizations that brought the miseries of world war and the Great Depression.

For America, globalization holds promise and responsibility. Our \$13 trillion economy, the world's largest by far, scores well year after year in competitiveness studies. Unlike Japan and Germany, we haven't handicapped our system with excess labor

regulations that rob the private sector of its flexibility and adaptability.

We are technologically adept. We employ a skilled workforce, augmented by the best and brightest from around the world. We have a wealth of managerial talent—millions of able, committed professionals who on a daily basis face the challenges of an interconnected world economy.

The United States stands to prosper in a more globalized world. The world's largest economy can lead by example to help foster a consensus on open markets. If we surrender to calls for policies that thwart globalization, other nations may do the same, creating a race to the bottom. If our country shows the way toward globalization, others will follow in a race to the top. ■



Acknowledgments

"Racing to the Top" was written by W. Michael Cox, senior vice president and chief economist, and Richard Alm, economics writer, Federal Reserve Bank of Dallas. The essay was inspired by President and CEO Richard W. Fisher, who writes and speaks frequently on globalization and its role in shaping monetary policy. Julia K. Carter, senior economic analyst, provided research assistance. Charlene Howell assisted with photo research.

The authors wish to thank A.T. Kearney Inc. for permission to use the A.T. Kearney/Foreign Policy Globalization Index, Paul Laudicina of A.T. Kearney for his insights into the index, and James Gwartney and Robert Lawson, coauthors of *Economic Freedom of the World: 2005 Annual Report*, for helpful comments on the essay.

Exhibit Notes and Data Sources

EXHIBIT 1

Exports of goods and services and gross national income: World Bank, World Development Indicators (WDI) database.

Foreign direct investment, outward stock: United Nations Conference on Trade and Development (UNCTAD), Foreign Direct Investment database.

Portfolio investment assets (stock measure): International Monetary Fund, International Financial Statistics database.

International tourist arrivals: World Tourism Organization; midyear world population, U.S. Census Bureau.

Internet users, mobile phone subscribers, international telephone traffic: International Telecommunication Union.

EXHIBIT 2

Inflation, top seven countries by GDP, extracted using Haver Analytics database: Bureau of Labor Statistics (U.S.); Ministry of Internal Affairs and Communications (Japan); Statistisches Bundesamt (Germany); Institut National de la Statistique et des Etudes Economiques (France); Office for National Statistics (U.K.); Istituto Nazionale di Statistica (Italy); and Statistics Canada.

Percentage change in consumer prices: International Monetary Fund, International Financial Statistics database.

Sound money scores: *Economic Freedom of the World: 2005 Annual Report* (EFW), James Gwartney and Robert Lawson, Fraser Institute, September 2005, www.freetheworld.com. The sound money index (category 3) is based on rate of money supply growth, inflation variability, recent inflation and freedom to own foreign currency.

A.T. Kearney/Foreign Policy Globalization Index 2005, www.atkearney.com and www.ForeignPolicy.com. Index is based on trade and foreign direct investment flows, international travel, international telephone traffic, cross-border remittances and personal transfers, number of Internet users and secure

servers, international organization memberships, contributions to U.N. peacekeeping missions, multi-lateral treaties, and international governmental transfers and receipts. The Dallas Fed eliminated Croatia and Botswana from the 62-country data set because other indexes used for comparisons in this report do not always include these countries.

EXHIBIT 3

Freedom to trade: EFW, category 4, parts A–D. Index is based on taxes on international trade, regulatory trade barriers, size of the trade sector relative to its expected size, and the difference between official and black-market exchange rates.

Capital market openness: EFW, category 4, part E. Index is based on access to foreign capital and restrictions on global capital transactions.

Freedom from overregulation: EFW, category 5. Index is based on regulation of credit markets, labor markets and regulatory obstacles for business.

Regulatory quality: World Bank Institute, 2005 governance indicators (WBI), www.worldbank.org/wbi/governance/govdata. Index is based on such measures of government intervention policy as price controls, selective business protections, barriers to starting a business, and excessive regulation in such areas as administration and business development.

Favorable corporate taxes: Heritage Foundation/Wall Street Journal, www.heritage.org/research/features/index/downloads.cfm. Index is based on top marginal corporate tax rates, a component of the 2006 fiscal burden of government index.

Innovation policies: "National Innovative Capacity," Michael E. Porter and Scott Stern, www.isc.hbs.edu/Innov_9211.pdf. Index is based on effectiveness of intellectual property protection, a country's ability to retain its scientists and engineers, and the size and availability of research and development tax credits for the private sector.

Political stability: WBI. Index is based on stability of government's power, vulnerability to revolutions, internal and external conflicts and wars, political assassinations, extremism and terrorism.

Accountability: WBI, voice and accountability subcategory. Index is based on civil liberties, political and human rights, government checks and balances, and accountability of public officials.

Rule of law: WBI. Index is based on incidence of crime, police quality, judicial effectiveness and predictability, and contract enforceability.

Property rights: EFW, category 2. Index is based on judicial independence, impartial courts, intellectual property protection, military interference in the rule of law and political process, and legal system integrity.

Government effectiveness: WBI. Index is based on credibility and effectiveness of government actions, consistency and stability of policy, competence of civil servants and their independence from political pressure, and quality of public service provision.

Anticorruption policies: Corruption Perceptions Index, 2005, Transparency International, www.transparency.org/surveys/index.html#cpi. Index is based on frequency and size of bribes, misuse of public office for personal or political gain, implementation of anticorruption initiatives (audits and disclosures), protections for whistleblowers and media coverage of corruption.

EXHIBIT 4

Weeks of wages and labor market flexibility: 2006 Doing Business database, World Bank Group. The Dallas Fed calculated the flexibility index using the hiring and firing workers subcategories, which measure cost of hiring and firing workers, rigidity of working hours, Social Security payments by the employer and retirement benefits.

GDP per capita: WDI database; International Institute for Management Development, *World Competitiveness Yearbook*, 2005. GDP is adjusted for purchasing power parity.

EXHIBIT 5

Government size: EFW, category 1. Index is based on general government consumption spending as a percentage of total consumption, government domestic redistributive transfers and subsidies as a share of GDP, government enterprises and investment as a share of total investment, and top marginal income and payroll tax rate.

Transfers and subsidies: EFW, category 1, part B. Index is based on government domestic redistributive transfers and subsidies as a share of GDP.

Individual income taxes: Heritage Foundation/Wall Street Journal. Index is based on top marginal income tax rates, a component of the fiscal burden of government index.

EXHIBIT 6

World freedom index: The Dallas Fed calculated the index using the EFW chain link index. The index measures size of government, legal structure and property rights, access to sound money, freedom to trade internationally, and regulation of credit, labor and business. We estimated missing values and weighted all values for 123 countries by the corresponding population data. We summed each year's values and interpolated five-year intervals.

Gross world product per capita (i.e., gross national income for the world), adjusted for purchasing power parity: WDI database.

Photo Credits

www.belindalawley.com, p. 6.

AP Images, p. 13.

Photo European Parliament—Architecte: Association des architectes du CIC: Vanden Bossche sprl, C.R.V. s.a., CDG sprl, Studiegroep D. Bontinck, p. 14.

Yale University/The Office of International Students and Scholars, p. 17.

"Our mission, as set forth by the Congress, is a critical one: to preserve price stability, to foster maximum sustainable growth in output and employment, and to promote a stable and efficient financial system that serves all Americans well and fairly."

— Federal Reserve Chairman Ben S. Bernanke

Critical Mission

The Business Side of Central Banking

As Hurricane Rita threatened the Texas Gulf Coast in the storm-prone fall of 2005, 3 million residents hurriedly gathered their most precious possessions and crowded onto traffic-jammed highways heading inland.

They carried food, water, clothing and—another essential—money. Chances are these funds were pulled from ATMs before leaving home or along the way. Without this ready access to cash, many evacuees would have been greatly hampered in their move out of harm's way.

Making sure that currency is available when it's needed is one of many ways the Federal Reserve System touches the lives of Americans every day—often without their even realizing it.

Did the resident leaving Houston know the money withdrawn from the ATM was put in circulation by a Federal Reserve Bank? Does the bank customer realize the Fed's supervision of financial institutions helps ensure the safety and accessibility of her money? Is the shopper paying for groceries with a check aware the Federal Reserve has an integral role in processing the check and moving funds from his bank to the store?

The Fed carries out its overall mission in three major ways: maintaining an efficient payments system,

supervising the banking system for safety and soundness, and making monetary policy that promotes price stability and maximum employment. Through these functions, the Federal Reserve—the nation's central bank—helps ensure that we have a healthy economy and financial system.

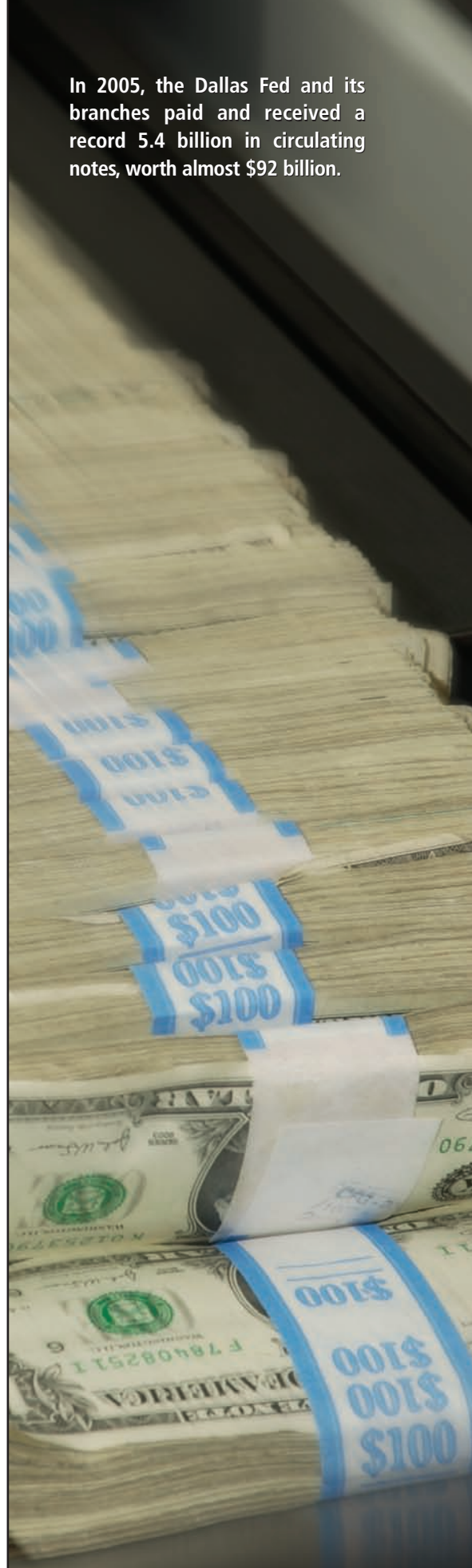
Moving Currency Through the Economy

The Federal Reserve's cash operations help ensure that a steady supply of high-quality currency is in circulation to meet the needs of consumers and businesses.

Reserve Banks and their branches, which supply money to financial institutions, hold currency reserves in their vaults. Institutions that have more cash than needed to meet their liquidity requirements can ship the excess to the Federal Reserve. In 2005, the Dallas Fed and its branches paid and received a record 5.4 billion in circulating notes, worth almost \$92 billion. Cash volume is expected to continue growing in 2006 as the Dallas Fed begins serving the Kansas City Fed's Oklahoma City Branch territory.

Upon receipt of currency from depository institutions, the Dallas Fed employs sophisticated sorting machines to weed out notes too worn for further circulation and

In 2005, the Dallas Fed and its branches paid and received a record 5.4 billion in circulating notes, worth almost \$92 billion.





In 2005, the Dallas Fed processed almost 1 billion checks, worth about \$900 billion.

detect counterfeit bills. Worn bills are replaced with new currency, and suspected counterfeits are turned over to the Secret Service.

Hurricanes Katrina and Rita presented a unique test for the Federal Reserve, but the System rose to the challenge. The Dallas Fed, along with other Reserve Banks, provided support to the Atlanta Fed, which serves southern Louisiana and Mississippi, by filling over 500 orders for currency from financial institutions in Atlanta's Sixth District. The Dallas and Houston cash operations expanded their hours to fill currency orders seven days a week for six weeks, until the immediate crisis had passed.

In late September—when financial institutions in many parts of Texas and Louisiana anticipated peak demand for cash—Dallas, Houston and San Antonio currency orders were up 136 percent from the same period in 2004.

Maintaining a Dynamic Payments System

Millions of checks flow through the nation's economy daily. The Federal Reserve serves an important role in helping ensure these checks are processed quickly and efficiently so the public has confidence in the payments system. In 2005, the Dallas Fed processed almost 1 billion checks, worth about \$900 billion.

In recent years, consumers and businesses have stepped up their use of debit cards, electronic bill paying and credit cards, resulting in a decline in paper check volume. The Federal Reserve responded with a program to improve the efficiency of check operations by standardizing the automated processes of all

major check applications and reducing the number of processing sites.

During 2005, check processing operations at the Houston Branch were moved to Dallas, where San Antonio and El Paso processing had previously been consolidated. In December, the Dallas office also assumed check processing responsibilities from the Oklahoma City Branch. As a result of these consolidations, Dallas now handles checks for five Federal Reserve offices—on average processing 4.5 million items per day—making it one of the System's largest check processors.

Following Hurricane Katrina, some Louisiana financial institutions redirected their checks to the Dallas Fed until services provided by the New Orleans Branch could be restored. During Hurricane Rita, the Fed acted as a kind of shock absorber for affected Southeast Texas financial institutions by deferring check charges until they could resume operations at contingency sites.

Hurricane Rita also required the use of alternate delivery arrangements for both deposit and presentment of checks. The measures taken by the Fed helped provide essential liquidity to financial institutions and the public in the midst of uncertain conditions caused by the storm.

An innovation that is improving the daily delivery of checks is the Check Clearing for the 21st Century Act. Check 21 allows banks and other financial institutions to send electronic images of paper checks received for payment rather than physically transporting the original documents for processing and payment. These electronic images can then be used to create paper repro-

ductions, known as substitute checks, which have the same legal status as the original. The payments system functions more efficiently as checks clear more rapidly and at lower cost.

Check 21 was fully implemented at the Dallas Fed in 2005. The Fed's image deposit products were complemented by private industry's introduction of new image delivery service options. The Dallas Fed currently processes about \$500 million in checks every day through the exchange of Check 21 digital images.

Advancing Electronic Payments Technologies

Consumers, businesses and government agencies are increasingly using electronic forms of payment for mortgages, utility bills, payrolls, Social Security payments and taxes. The Automated Clearinghouse (ACH)—a system the Fed and private sector developed jointly in the early 1970s—processes these recurring payments electronically.

The Fed recently added an international ACH component. A joint venture between the central bank of Mexico and the Federal Reserve aims to increase the efficiency of sending remittances from the United States to Mexico and reduce costs for both sender and recipient. In addition, Canada, Mexico and several European countries participate in FedACH International Services, which encourages the use of ACH for other international transactions.

Institutions holding accounts with Reserve Banks use the Fedwire® Funds Service to initiate large, single electronic transactions. Each day, the Federal Reserve System transfers billions of dollars



electronically between financial institutions worldwide.

Serving the U.S. Treasury

The Federal Reserve serves as the fiscal agent for the Treasury. In this role, the Reserve Banks offer the Treasury and other agencies a variety of payments-related services.

The Dallas Fed serves the U.S. government through the Bank's Treasury Services operation.

The Bank assists the Treasury's Financial Management Service by supporting the *Go Direct*SM and Electronic Transfer Account (ETA)SM programs. *Go Direct* is Treasury's campaign to encourage recipients of Social Security and Supplemental

Security Income payments to convert to direct deposit. In 2005, the Dallas Fed began providing *Go Direct* services on a national level after a highly successful pilot project managed by the Bank. The Dallas Fed supports the program with a call center and web site that accept direct deposit enrollments from federal benefit recipients.

While *Go Direct* targets those who already have a bank account, the ETA program is an effort to convert the unbanked to direct deposit. The Treasury developed the ETA as a low-cost bank account for federal benefit recipients or their representatives. Dallas provides a call center and web site that help federal benefit

recipients locate financial institutions that offer the ETA.

Direct deposit is safer and cheaper than mail, with an estimated cost savings of about 77 cents a check. Multiplied by more than 150 million payments sent annually, direct deposit represents significant savings. Moreover, recipients can access their funds more quickly because they do not have to wait for a check to be delivered by mail.

During the hurricane evacuations, for example, those with direct deposit didn't need to worry about receiving their Social Security checks or other government payments because the funds went directly into their bank accounts.

Guarding the Safety and Soundness of the Banking System

A sound banking system is vital to a vibrant economy, and the Federal Reserve is charged with supervising and regulating state member banks, bank holding companies and foreign banking organizations operating in the United States. A strong financial system allows money to flow by linking borrowers and savers, thereby facilitating access to and efficient use of funds.

At the Dallas Fed, banking supervision and regulation entail several functions and include examiners and economists. Although the Fed's banking regulations are written by the Federal Reserve Board in Washington, their enforcement is the regional Reserve Banks' responsibility.

Bank examiners scrutinize an institution's financial condition, risk-management processes, and compliance with laws and regulations, including those designed to

protect consumers and promote an accessible banking system.

Traditional on-site examinations continue to be the cornerstone of the supervisory process. But, aided by technology, newer approaches to supervision, most notably off-site monitoring and surveillance techniques, play an increasingly prominent role. Economists in the Dallas office, working with Federal Reserve Board staff, have developed a sophisticated early-warning model used throughout the System. It serves as the Fed's primary resource for off-site statistical modeling of safety and soundness.

Providing Liquidity to the Banking System

To further maintain stability of the banking system, the Fed operates the discount window to offer financial institutions a source of short-term liquidity. This function is carried out at all Reserve Banks.

The discount window plays an important role in the smooth functioning of the payments system, contingency planning and dealing with seasonal swings in an institution's loans and deposits.

Banks in sound financial condition can obtain primary credit from their regional Reserve Banks, usually on an overnight basis. Banks that do not qualify for primary credit may get secondary credit at rates above that available for primary credit. Market-based credit is available to assist smaller institutions that need funds due to seasonal fluctuations.

Setting Sound Monetary Policy

The Federal Reserve sets the nation's monetary policy by targeting

the federal funds rate and influencing the supply of money and credit. The goal is price stability, paving the way for sustainable growth in employment and overall economic activity.

All the Reserve Bank presidents and Federal Reserve governors participate in establishing monetary policy through the Federal Open Market Committee. Each Reserve Bank has research economists with different areas of specialization who study specific forces affecting the economy in order to advise their president on monetary policy.

The Dallas Fed has long had a special emphasis on energy, the U.S.–Mexico border economy and immigration, reflecting their importance to the regional economy.

That perspective was expanded last year to encompass the increasingly important role a more globalized, interconnected world plays in making monetary policy decisions. This involves understanding how factors such as freer trade and more mobile international capital flows, deregulation and rapid technological change affect the economy.

The Fed's structure ensures input from each region into monetary policymaking. Each Reserve Bank produces a Beige Book—an anecdotal report of current economic conditions—in advance of FOMC meetings. The Beige Book describes overall economic conditions and trends in each district and helps the Reserve Bank presidents formulate their views.

Economists and technical staff at the Dallas Fed have developed several useful tools for analyzing regional and national economic trends. These include an index of leading economic indicators for

Texas, the Texas Industrial Production Index and a survey of regional manufacturing activity. In 2005, the Dallas Fed also developed the Trimmed-Mean PCE inflation measure, which tracks inflation trends in the U.S. economy.

Providing Public Programs

The Dallas Fed is committed to expanding public knowledge of the Federal Reserve and everyday economics.

The Bank provides information to high school and college students and educators, business and civic organizations, public officials and young professionals across the Eleventh District. This is accomplished through public speaking engagements, on-site visits, Bank tours, print and electronic materials, and economic education conferences.

In 2005, the Bank offered educational programs on such topics as the global economy, personal finance education and energy. Specific events included a series of regional “Evening at the Fed” dinners and discussions for high school teachers on the economic and fiscal effects of immigration; a lecture by Finn E. Kydland, winner of the 2004 Nobel Memorial Prize in Economic Sciences; a conference on the maquiladora industry exploring the future of the electronic and automotive sectors; and a “Lunch & Learn” event for young professionals on the economics of education and the importance of lifelong learning.

An increasingly effective outreach tool is the Bank’s web site—dallasfed.org—which attracted a large influx of new and returning visitors last year. This growth was

fueled in part by a more than 1,000 percent increase in visits to Bank officials’ speeches, signaling a growing interest in globalization’s role in shaping monetary policy. Home page hits soared, as did users’ accessing of timely regional and national economic data; publications such as *Building Wealth*, the Bank’s popular workbook on budgeting, saving and investing; a Spanish-language section, *Entrada*; and an array of other features and information.

Through its Community Affairs program, the Bank encourages community and economic development by providing information to financial institutions; local business, civic and government officials; and community development organizations.

For example, to coincide with the United Nations’ designation of 2005 as the International Year of



Microcredit, the Dallas Fed brought together financial institutions, academics, philanthropists, public officials and local economic developers. The meeting highlighted the role microenterprise plays as a bridge to the mainstream for low-wealth individuals and as a potential economic benefit for local communities.

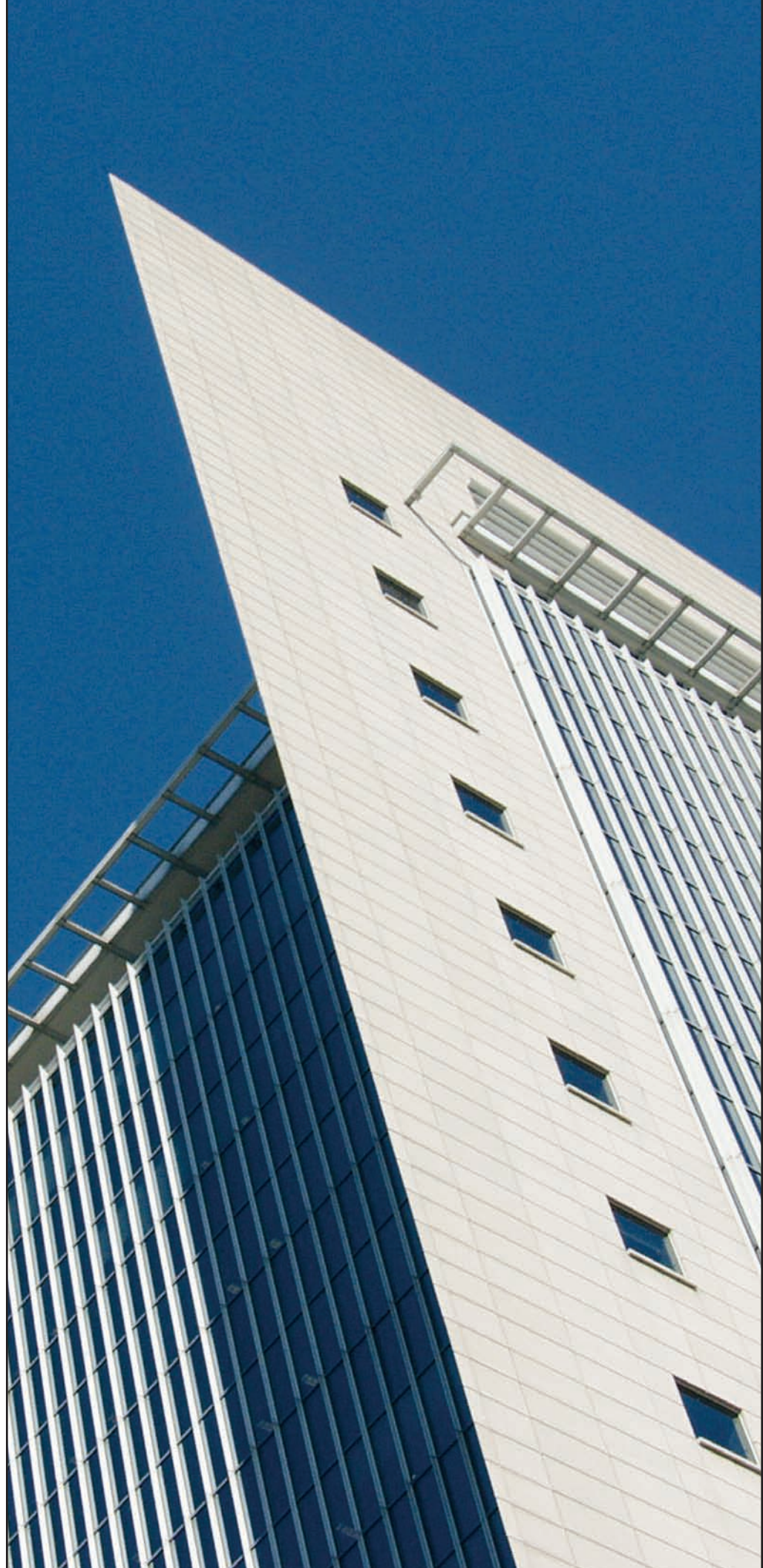
To encourage community reinvestment, the Dallas Fed's Community Affairs office provides financial institutions with information on the Community Reinvestment Act (CRA) and models of successful community development lending partnerships and strategies. Congress passed the CRA in 1977 to encourage commercial banks to meet the credit needs of their communities and stimulate investment in low- and moderate-income neighborhoods.

By fostering economic education, financial literacy and economic development, the Dallas Fed contributes to the economic growth goals of the Federal Reserve.

Conclusion

The Dallas Fed, along with the other 11 Reserve Banks, is an integral part of setting monetary policy and of vital importance to the safe and sound operation of the nation's banking and payments systems.

Through its cash and check operations, bank supervision, economic research and public programs, the Dallas Fed offers its region unique perspective, services and support, as well as insight into the rapidly changing global economy that affects every individual, not just in the Eleventh District but around the world. ■



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As of December 31, 2005

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Auctioneers Inc.
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Vice Chairman and CEO
TIB—The Independent
BankersBank
Irving, Texas

MANAGEMENT'S ASSERTION

March 6, 2006

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, 2005 (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.

Federal Reserve Bank of Dallas



President



First Vice President



Principal Financial Officer

REPORT OF INDEPENDENT ACCOUNTANTS

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 of December 31, 2005, 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. 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 of December 31, 2005, 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.



March 8, 2006
Dallas, Texas

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, 2005 and 2004, 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, these 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, 2005 and 2004, and results of its operations for the years then ended, on the basis of accounting described in Note 3.



March 8, 2006
Dallas, Texas

Statements of Condition (in millions)

	December 31, 2005	December 31, 2004
ASSETS		
Gold certificates	\$ 549	\$ 525
Special drawing rights certificates	98	98
Coin	67	93
Items in process of collection	535	334
Loans to depository institutions	3	—
U.S. government securities, net	36,949	33,083
Investments denominated in foreign currencies	217	267
Accrued interest receivable	287	232
Interdistrict settlement account	—	1,461
Bank premises and equipment, net	297	279
Other assets	29	31
	<u>39,031</u>	<u>36,403</u>
Total assets	\$ 39,031	\$ 36,403
LIABILITIES AND CAPITAL		
Liabilities		
Federal Reserve notes outstanding, net	\$ 33,311	\$ 33,643
Securities sold under agreements to repurchase	1,502	1,404
Deposits:		
Depository institutions	811	684
Other deposits	1	1
Deferred credit items	303	300
Interest on Federal Reserve notes due U.S. Treasury	31	24
Interdistrict settlement account	2,693	—
Accrued benefit costs	58	56
Other liabilities	15	21
	<u>38,725</u>	<u>36,133</u>
Total liabilities	38,725	36,133
Capital		
Capital paid-in	153	135
Surplus	153	135
	<u>306</u>	<u>270</u>
Total capital	306	270
Total liabilities and capital	\$ 39,031	\$ 36,403

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

Statements of Income (in millions)

	FOR THE YEARS ENDED	
	December 31, 2005	December 31, 2004
INTEREST INCOME		
Interest on U.S. government securities	\$ 1,360	\$ 968
Interest on investments denominated in foreign currencies	<u>3</u>	<u>3</u>
Total interest income	1,363	971
INTEREST EXPENSE		
Interest expense on securities sold under agreements to repurchase	<u>39</u>	<u>13</u>
Net interest income	1,324	958
OTHER OPERATING INCOME		
Income from services	—	46
Compensation received for check services provided	49	—
Reimbursable services to government agencies	11	12
Foreign currency gains (losses), net	(32)	16
Other income	<u>4</u>	<u>2</u>
Total other operating income	32	76
OPERATING EXPENSES		
Salaries and other benefits	101	93
Occupancy expense	20	15
Equipment expense	11	11
Assessments by the Board of Governors	33	46
Other expenses	<u>51</u>	<u>47</u>
Total operating expenses	216	212
Net income prior to distribution	\$ 1,140	\$ 822
DISTRIBUTION OF NET INCOME		
Dividends paid to member banks	\$ 9	\$ 8
Transferred to surplus	18	24
Payments to U.S. Treasury as interest on Federal Reserve notes	<u>1,113</u>	<u>790</u>
Total distribution	\$ 1,140	\$ 822

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

**Statements of Changes in Capital
for the Years Ended December 31, 2005,
and December 31, 2004 (in millions)**

	Capital Paid-In	Surplus	Total Capital
BALANCE AT JANUARY 1, 2004			
(2.2 million shares)	\$ 111	\$ 111	\$ 222
Transferred to surplus	—	24	24
Net change in capital stock issued (0.5 million shares)	24	—	24
	<u>24</u>	<u>—</u>	<u>24</u>
BALANCE AT DECEMBER 31, 2004			
(2.7 million shares)	\$ 135	\$ 135	\$ 270
Transferred to surplus	—	18	18
Net change in capital stock issued (0.4 million shares)	18	—	18
	<u>18</u>	<u>—</u>	<u>18</u>
BALANCE AT DECEMBER 31, 2005			
(3.1 million shares)	<u><u>\$ 153</u></u>	<u><u>\$ 153</u></u>	<u><u>\$ 306</u></u>

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”) and one of the twelve Reserve Banks (“Reserve Banks”) created by Congress under the Federal Reserve Act of 1913 (“Federal Reserve Act”), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. 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.

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. Banks that are members of the System include all national banks and any state-chartered banks that apply and are approved for membership in the System. 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.

The System also consists, in part, of the Board of Governors of the Federal Reserve System (“Board of Governors”) and the Federal Open Market Committee (“FOMC”). The Board of Governors, an independent federal agency, is charged by the Federal Reserve Act with a number of specific duties, including general supervision over the Reserve Banks. 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.

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 system including large-dollar transfers of funds, automated clearinghouse (“ACH”) operations, and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government’s bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies, state member banks, and U.S. offices of foreign banking organizations; and administering other regulations of the Board of Governors. The System also provides certain services to foreign central banks, governments, and international official institutions.

The FOMC, in the conduct of monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and annually issues authorizations and directives to the FRBNY for its execution of transactions. FRBNY is authorized to conduct operations in domestic markets, including direct purchase and sale of U.S. government 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. FRBNY executes these open market transactions and holds the resulting securities, with the exception of securities purchased under agreements to resell, 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 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. The FRBNY is authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange ("F/X") and securities contracts for 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 two central banks, and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks. In connection with its foreign currency activities, FRBNY 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.

Although Reserve Banks are separate legal entities, in the interests of greater efficiency and effectiveness, they collaborate in the delivery of certain operations and services. The collaboration takes the form of centralized competency centers, operations sites, and product or service offices that have responsibility for the delivery of certain services on behalf of the Reserve Banks. Various operational and management models are used and are supported by service agreements between the Reserve Bank providing the service and the other eleven Reserve Banks. In some cases, costs incurred by a Reserve Bank for services provided to other Reserve Banks are not shared; in other cases, Reserve Banks are billed for services provided to them by another Reserve Bank.

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; Accounts, Risk and Credit System; and *Go Direct*SM.

Beginning in 2005, the Reserve Banks adopted a new management model for providing check services to depository institutions. Under this new model, the Federal Reserve Bank of Atlanta ("FRBA") has the overall responsibility for managing the Reserve Banks' provision of check services and recognizes total System check revenue on its Statements of Income. FRBA compensates the other eleven Banks for the costs incurred to provide check services. This compensation is reported as "Compensation received for check services provided" in the Statements of Income. If the management model had been in place in 2004, the Bank would have reported \$52 million as compensation received for check services provided and \$46 million in check revenue would have been reported by FRB Atlanta rather than the Bank.

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 various accounting standard-setting bodies. 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, and the financial statements have been prepared in accordance with the Financial Accounting Manual.

Differences exist between the accounting principles and practices in the Financial Accounting Manual and those generally accepted in the United States ("GAAP") primarily due to the unique nature of the Bank's powers and responsibilities as part of the nation's central bank. The primary difference is the presentation of all security holdings at amor-

tized cost, rather than using the fair value presentation requirements in accordance with GAAP. Amortized cost more appropriately reflects the Bank's security holdings given its unique responsibility to conduct monetary policy. While the application of current market prices to the securities holdings 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 Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio may involve transactions that result in gains or losses when holdings are sold prior to maturity. Decisions regarding security and foreign currency 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 securities and currencies are incidental to the open market operations and do not motivate its activities or policy decisions.

In addition, the Bank has elected not to present a Statement of Cash Flows because the liquidity and cash position of the Bank are not a primary concern given the Bank's unique powers and responsibilities. A Statement of Cash Flows, therefore, would not provide any additional meaningful information. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

The preparation of the financial statements in conformity with the Financial Accounting Manual requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, 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 and Special Drawing Rights Certificates

The Secretary of the U.S. Treasury is authorized to issue gold and special drawing rights ("SDR") certificates to the Reserve Banks.

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 the average Federal Reserve notes outstanding in each Reserve Bank.

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 2005 or 2004.

b. Loans to Depository Institutions

All depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations 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, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Bank, subject to review by the Board of Governors.

c. U.S. Government Securities and Investments Denominated in Foreign Currencies

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. Interest income is accrued on a straight-line basis. 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 (losses), net."

Activity related to U.S. government securities, including the related premiums, discounts, and realized and unrealized gains and losses, 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 in each District. Activity related to investments in foreign-currency-denominated assets is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31.

d. U.S. Government Securities Sold Under Agreements to Repurchase and Securities Lending

Securities sold under agreements to repurchase are accounted for as financing transactions and the associated interest expense is recognized over the life of the transaction. These transactions are carried in the Statements of Condition at their contractual amounts and the related accrued interest is reported as a component of "Other liabilities."

U.S. government securities held in the SOMA are lent to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements in order to facilitate the effective functioning of the domestic securities market. Securities-lending transactions are fully collateralized by other U.S. government securities, and the collateral taken is in excess of the market value of the securities loaned. The FRBNY charges the dealer or bank a fee for borrowing securities, and the fees are reported as a component of "Other Income" in the Statements of Income.

Activity related to U.S. government securities sold under agreements to repurchase and securities lending is allocated to each Reserve Bank on a percentage basis derived from the annual settlement of interdistrict clearings. Securities purchased under agreements to resell are allocated to FRBNY and not to the other Banks.

e. Foreign Currency Swaps and Warehousing

F/X swap arrangements are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. 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 the foreign currencies it may need to intervene to support the dollar and give the counterparty temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either FRBNY or the counterparty (the drawer) and must be agreed to by the drawee. The F/X

swaps are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. 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 U.S. Treasury, U.S. dollars for foreign currencies held by the U.S. 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 U.S. Treasury and ESF for financing purchases of foreign currencies and related international operations.

Foreign currency swaps and warehousing agreements are revalued daily at current market exchange rates. Activity related to these agreements, with the exception of the unrealized gains and losses resulting from the daily revaluation, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. Unrealized gains and losses resulting from the daily revaluation are allocated to FRBNY and not to the other Reserve Banks.

f. 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 operating expense in the year incurred. Capitalized assets including software, building, leasehold improvements, furniture, and equipment are impaired when it is determined that the net realizable value is significantly less than book value and is not recoverable.

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.

g. Interdistrict Settlement Account

At the close of business each day, each Reserve Bank assembles the payments due to or from other Reserve Banks as a result of the day's transactions that involve depository institution accounts held by other Districts. Such transactions may include funds settlement, check clearing, and ACH operations. The cumulative net amount due to or from the other Reserve Banks is reflected in the "Interdistrict settlement account" in the Statements of Condition.

h. 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 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 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 the currency issued to the Bank but not in circulation, of \$17,163 million and \$7,503 million at December 31, 2005 and 2004, respectively.

i. Items in Process of Collection and Deferred Credit Items

The balance in the “Items in process of collection” line in the Statements of Condition primarily represents amounts attributable to checks that have been deposited for collection by the payee depository institution and, as of the balance sheet date, have not yet been collected from the payor depository institution. Deferred credit items are the counterpart liability to items in process of collection, and the amounts in this account arise from deferring credit for deposited items until the amounts are collected. The balances in both accounts can fluctuate and vary significantly from day to day.

j. 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. These shares are nonvoting with a par value of \$100 and may not be transferred or hypothecated. As a member bank’s capital and surplus changes, its holdings of Reserve Bank stock must be adjusted. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. By law, each Bank is required to pay each member bank 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.

k. 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 at a Reserve Bank, 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.”

l. Income and Costs Related to U.S. 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.

m. Assessments by the Board of Governors

The Board of Governors assesses the Reserve Banks to fund its operations based on each Reserve Bank’s capital and surplus balances. The Board of Governors also assesses each Reserve Bank for the expenses incurred for the U.S. Treasury to issue and retire Federal Reserve notes based on each Reserve Bank’s share of the number of notes comprising the System’s net liability for Federal Reserve notes on December 31 of the previous year.

n. 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 \$4 million and \$3 million for the years ended December 31, 2005 and 2004, respectively, and are reported as a component of "Occupancy expense."

o. Restructuring Charges

In 2003, the System began the restructuring of several operations, primarily check, cash, and U.S. 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 and 2005.

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 in connection with the restructuring activities for all Reserve Banks are recorded on the books of the FRBNY, and those associated with enhanced postretirement benefits are discussed in footnote 9.

4. U.S. GOVERNMENT SECURITIES, SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE, AND SECURITIES LENDING

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank's allocated share of SOMA balances was approximately 4.925 percent and 4.560 percent at December 31, 2005 and 2004, respectively.

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

	2005	2004
Par value:		
U.S. government		
Bills	\$ 13,361	\$ 11,990
Notes	18,721	16,452
Bonds	4,572	4,287
Total par value	36,654	32,729
Unamortized premiums	434	429
Unaccreted discounts	(139)	(75)
Total allocated to Bank	\$36,949	\$33,083

The total of the U.S. government securities, net held in the SOMA was \$750,202 million and \$725,584 million at December 31, 2005 and 2004, respectively.

At December 31, 2005 and 2004, the total contract amount of securities sold under agreements to repurchase was \$30,505 million and \$30,783 million, respectively, of which \$1,502 million and \$1,404 million were allocated to the Bank. The total par value of the SOMA securities pledged for securities sold under agreements to repurchase at December 31, 2005 and 2004, was \$30,559 million and \$30,808 million, respectively, of which \$1,505 million and \$1,405 million was allocated to the Bank.

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, 2005, 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	\$ 2,020	\$ 1,502
16 days to 90 days	8,484	—
91 days to 1 year	9,175	—
Over 1 year to 5 years	10,380	—
Over 5 years to 10 years	2,792	—
Over 10 years	3,803	—
Total	\$ 36,654	\$ 1,502

At December 31, 2005 and 2004, U.S. government securities with par values of \$3,776 million and \$6,609 million, respectively, were loaned from the SOMA, of which \$186 million and \$301 million, respectively, were allocated to the Bank.

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.

The Bank's allocated share of investments denominated in foreign currencies was approximately 1.146 percent and 1.250 percent at December 31, 2005 and 2004, respectively.

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

	2005	2004
European Union Euro:		
Foreign currency deposits	\$ 62	\$ 76
Securities purchased under agreements to resell	22	27
Government debt instruments	41	49
Japanese Yen:		
Foreign currency deposits	30	19
Government debt instruments	62	96
Total	\$217	\$267

Total System investments denominated in foreign currencies were \$18,928 million and \$21,368 million at December 31, 2005 and 2004, respectively.

The maturity distribution of investments denominated in foreign currencies which were allocated to the Bank at December 31, 2005, was as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies	European	Japanese	Total
	Euro	Yen	
Within 15 days	\$ 39	\$ 30	\$ 69
16 days to 90 days	29	8	37
91 days to 1 year	24	11	35
Over 1 year to 5 years	33	43	76
Over 5 years to 10 years	—	—	—
Over 10 years	—	—	—
Total	\$ 125	\$ 92	\$ 217

At December 31, 2005 and 2004, there were no material open foreign exchange contracts.

At December 31, 2005 and 2004, 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):

	Useful Life Range (in years)	2005	2004
Bank premises and equipment:			
Land	N/A	\$ 56	\$ 53
Buildings	2 to 50	220	118
Building machinery and equipment	1 to 20	36	25
Construction in progress	N/A	2	107
Furniture and equipment	1 to 20	75	66
Subtotal		\$ 389	\$ 369
Accumulated depreciation		(92)	(90)
Bank premises and equipment, net		\$297	\$279
Depreciation expense, for the years ended		\$ 11	\$ 9

The Bank leases space to outside tenants with lease terms ranging from one to 10 years. Rental income from such leases was \$101 thousand for the year ended December 31, 2005. The Bank had no rental income from leases for the year ended December 31, 2004. Future minimum lease payments under noncancelable agreements in existence at December 31, 2005, were (in thousands):

2006	\$ 185
2007	183
2008	182
2009	182
2010	186
Thereafter	842
	\$ 1,760

The Bank has capitalized software assets, net of amortization, of \$5 million and \$4 million at December 31, 2005 and 2004, respectively. Amortization expense was \$2 million and \$3 million for the years ended December 31, 2005 and 2004, respectively. Capitalized software assets are reported as a component of "Other assets," and related amortization is reported as a component of "Other expenses."

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 for the period ending December 31, 2004, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses." The Bank had no impairment losses in 2005.

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2005, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from one to approximately five years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was \$1 million and \$2 million for the years ended December 31, 2005 and 2004, respectively. 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, 2005, were immaterial.

At December 31, 2005, there were no other material commitments and long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks, each Reserve Bank has agreed to bear, on a per incident basis, a pro rata share of losses in excess of 1 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, 2005 or 2004.

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 three 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"). Employees at certain compensation levels participate in the Benefit Equalization Retirement Plan ("BEP"), and 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 System. No separate accounting is maintained of assets contributed by the participating employers. The FRBNY acts as a sponsor of the System Plan, and the costs associated with the Plan are not redistributed to other participating employers. The Bank's benefit obligation and net pension costs for the BEP and the SERP at December 31, 2005 and 2004, 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 for each of the years ended December 31, 2005 and 2004, and are reported as a component of "Salaries and other benefits." The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2005 and 2004, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

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.

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

	2005	2004
Accumulated postretirement benefit obligation at January 1	\$ 59.4	\$ 56.3
Service cost-benefits earned during the period	1.6	1.3
Interest cost of accumulated benefit obligation	3.5	3.4
Actuarial loss	5.7	2.0
Curtailment (gain) loss	—	—
Special termination (gain) loss	—	—
Contributions by plan participants	0.9	0.7
Benefits paid	(3.6)	(3.0)
Plan amendments	—	(1.3)
Accumulated postretirement benefit obligation at December 31	\$ 67.5	\$ 59.4

At December 31, 2005 and 2004, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.50 percent and 5.75 percent, respectively.

Discount rates reflect yields available on high-quality corporate bonds that would generate the cash flow necessary to pay the plan's benefits when due.

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):

	2005	2004
Fair value of plan assets at January 1	\$ —	\$ —
Actual return on plan assets	—	—
Contributions by the employer	2.7	2.3
Contributions by plan participants	0.9	0.7
Benefits paid	(3.6)	(3.0)
Fair value of plan assets at December 31	\$ —	\$ —
Unfunded postretirement benefit obligation	\$ 67.5	\$ 59.4
Unrecognized net curtailment gain	—	—
Unrecognized prior service cost	3.2	3.5
Unrecognized net actuarial loss	(20.7)	(16.2)
Accrued postretirement benefit costs	\$ 50.0	\$ 46.7

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:

	2005	2004
Health care cost trend rate assumed for next year	9.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	4.75%
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, 2005 (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	\$ 0.9	\$ (0.7)
Effect on accumulated postretirement benefit obligation	8.8	(7.3)

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

	2005	2004
Service cost-benefits earned during the period	\$ 1.6	\$ 1.3
Interest cost of accumulated benefit obligation	3.5	3.4
Amortization of prior service cost	(0.4)	(0.9)
Recognized net actuarial loss	1.2	0.6
Total periodic expense	\$ 5.9	\$ 4.4
Curtailment gain	—	(7.9)
Special termination loss	—	—
Net periodic postretirement benefit costs (credit)	\$ 5.9	\$ (3.5)

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2005 and 2004, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.75 percent and 6.25 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 in 2004.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 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. The benefits provided by the Bank’s plan to certain participants are at least actuarially equivalent to the Medicare Part D prescription drug benefit. 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 expected benefit payments (in millions):

Expected benefit payments:	Without Subsidy	With Subsidy
2006	\$ 3.5	\$ 3.2
2007	3.8	3.5
2008	3.9	3.6
2009	4.1	3.7
2010	4.3	3.9
2011–2015	23.6	21.0
Total	\$ 43.2	\$ 38.9

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2005, measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank at December 31, 2005 and 2004, were \$7 million and \$8 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2005 and 2004 operating expenses were \$1 million and \$3 million, respectively, and are recorded as a component of "Salaries and other benefits."

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 (in millions):

	Total Estimated Costs	Accrued Liability 12/31/04	Total Charges	Total Paid	Accrued Liability 12/31/05
Employee separation	\$ 4.9	\$ 2.4	\$ (0.9)	\$ (1.5)	\$ —
Contract termination	0.1	—	—	—	—
Total	\$ 5.0	\$ 2.4	\$ (0.9)	\$ (1.5)	\$ —

There were no charges in 2005. Negative total charges represent adjustments to the accrued liability balance for revisions to previous estimates.

Employee separation costs are primarily severance costs related to staff reductions of approximately 295, including 62 staff reductions related to restructuring announced in 2004. 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.

Volume of Operations
(UNAUDITED)

	Number of Items Handled		Dollar Amount	
	(Thousands)		(Millions)	
	2005	2004	2005	2004
SERVICES TO DEPOSITORY INSTITUTIONS				
CASH SERVICES				
Federal Reserve notes processed	2,730,220	2,696,612	44,499	42,370
Currency received from circulation	2,691,171	2,565,157	45,490	42,317
Coin received from circulation	430,458	653,338	46	84
CHECK PROCESSING				
Commercial—processed	882,076	990,886	880,988	774,665
Commercial—fine sorted	11,991	23,018	6,299	10,435
U.S. government checks	0	0	0	0
LOANS				
Advances made	67*	62*	147	114
SERVICES TO THE U.S. TREASURY AND GOVERNMENT AGENCIES				
Issues and reinvestments of Treasury securities	10	42	356	1,801

*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 2005 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$4.6 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 2005, 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 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 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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