

# Opportunity Knocks

*Selling Our Services to the World*



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# A Letter from the President

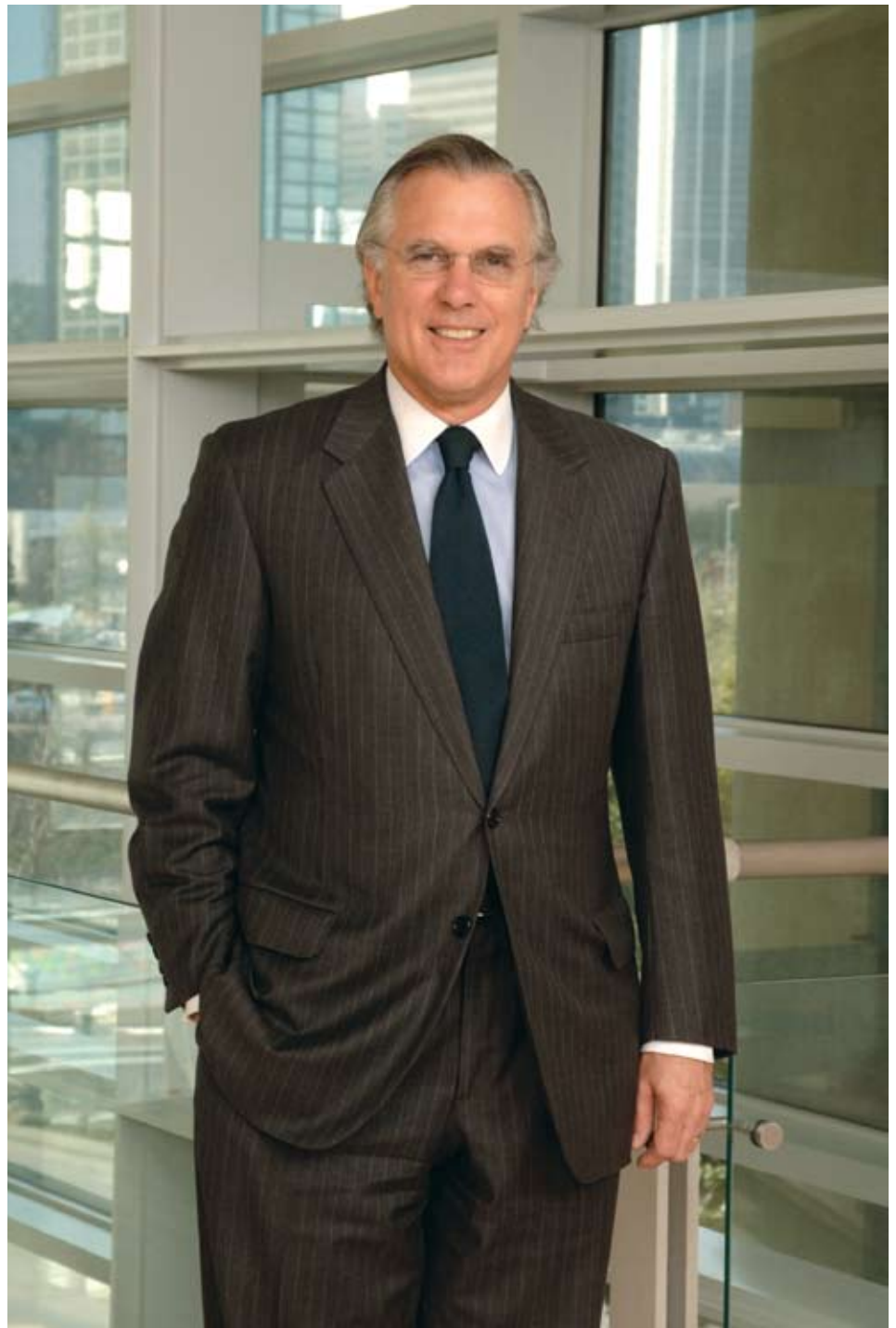
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All of us can see the footprints of globalization in everyday life. They appear in what we buy, in our jobs, in our evolving culture and in our investment portfolios. While the word *globalization* has been defined in many ways, I believe it remains misunderstood by both the public and policymakers.

I took the reins of the Dallas Fed three years ago with a strong suspicion the economic models used for monetary policy were systematically overlooking globalization as a critical factor in the economy. Essentially, these models treat the economy as if borders are closed and what happens beyond them matters little. In reality, borders become more open every day, and what happens around the world matters more than ever.

No businessmen or women I know would think of sourcing their inputs or selling their products or services solely within a domestic framework. And all U.S.-based businesses look at capital markets from a global perspective today. Yet the imaginations of policymakers often seem confined by our territorial borders.

At the Dallas Fed, we are rethinking this closed-economy view. It was with great pride



**The Globalization and Monetary Policy Institute's goal entails developing the tools monetary policymakers need to accomplish their objectives in the 21st century.**

last fall that we launched the Globalization and Monetary Policy Institute to examine the policy implications arising from freer flows of goods, services, capital and labor across national borders.

The Dallas Fed already boasts a top-notch team of economists dedicated to researching and monitoring our dynamic economy, and they will continue to do so. With this new, in-house institute, we are ratcheting up our commitment to producing groundbreaking research on key issues of globalization and monetary policy. We will endeavor to develop better models of trade, capital flows and migration; explore how global demand affects commodity prices; examine the repercussions of the large labor and consumer pools in China and India; estimate the impact of trade on pricing decisions; and execute other ambitious economic research.

Many of the world's most influential monetary policy scholars and practitioners have agreed to be our guides and companions on this fascinating intellectual journey. Chairing our advisory board is John B. Taylor, an eminent Stanford professor and senior fellow at the Hoover Institution and developer of the widely heralded Taylor rule for monetary policymaking.

Also on the board's roster are Charles R. Bean, executive director and chief economist at the Bank of England; Martin Feldstein, Harvard economics professor and president of the National Bureau of Economic Re-

search; R. Glenn Hubbard, dean of Columbia University's Graduate School of Business and former chairman of the Council of Economic Advisers; Otmar Issing, president of Germany's Center for Financial Studies and former member of the European Central Bank executive board; Finn Kydland, professor at the University of California, Santa Barbara, Dallas Fed consultant and winner of the 2004 Nobel Memorial Prize in economics; Guillermo Ortiz, governor of Banco de México; Kenneth S. Rogoff, Harvard professor, Brookings Institution fellow and former research director of the International Monetary Fund; and William White, head of the Monetary and Economic Department at the Bank for International Settlements.

Mark A. Wynne, the institute's director, has assembled a staff of five full-time economists and recruited three highly regarded economists to serve as senior fellows: the University of British Columbia's Michael B. Devereux, the University of Virginia's Francis E. Warnock and Dallas Fed chief economist W. Michael Cox.

The Globalization and Monetary Policy Institute's goal entails developing the tools monetary policymakers need to accomplish their objectives in the 21st century, when it is critical to understand what is happening around the world, not just at home. The institute has a challenging mission, but one that our advisors, staff and fellows believe must be accomplished if monetary policy is to be effective in the future.



John B. Taylor

## The Globalization and Monetary Policy Institute



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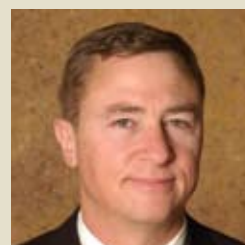
Mark A. Wynne



Michael B. Devereux



Francis E. Warnock



W. Michael Cox

**U.S. companies are ready to meet the world's growing demand for services—but we will face competition. Staying ahead in services trade requires well-educated workers and adroit managers; developing more of them will be key to selling our services to the world.**

### Success Abroad

The Dallas Fed's commitment to research on globalization extends to our annual report essays. For 2005, we examined how globalization disciplines public policy and for 2006, how it impacts productivity and costs. In this year's essay—“Opportunity Knocks: Selling Our Services to the World”—Mike Cox and senior economics writer Richard Alm counter the hand-wringing over globalization by looking at a U.S. success story: dominance in the service sector.

We export more services than any other nation—by a long shot. Better still, most of what we sell abroad are highly valued services—industrial engineering, entertainment, health care, and the work of architects, lawyers and other professionals. Our growing services trade supports many well-paying jobs.

We developed our expertise in these services to meet the needs of our own economy, but the prospects for exporting them have never been brighter. Internet Age technologies are shrinking the constraints of time and space, opening global markets to more services. Just as important, global demand will rise rapidly as consumers in China, India and other fast-growing nations shift their spending from goods to services.

One of the essay's valuable insights comes from explaining what economists call “income elasticity of demand,” a powerful concept that can help us better understand globalization. High elasticities suggest rising incomes will lead to rapid growth in global consumption of many of the services we

produce so well.

Scattered throughout the essay are stories that spotlight Texas companies taking advantage of the growing global market for services. Dallas-based Laguarda.Low Architects designed a world-class project on the shores of Tokyo Bay. The seismic crews of Houston's Geokinetics Inc. are doing their part in the oil and gas industry's worldwide search for new reserves. San Antonio's Methodist Healthcare System treats 1,500 foreign patients a year.

Global business is complex, and the Dallas office of FTI Consulting helps companies cope with it. Irving-based Fluor Corp., an engineering and construction firm, is just one of many Texas multinationals doing business on a global scale. But even a small El Paso web designer has found a niche for selling services abroad. Many other Texas companies have done likewise, and I am sure we will see others follow them into the global marketplace.

U.S. companies are ready to meet the world's growing demand for services—but we will face competition. Staying ahead in services trade requires well-educated workers and adroit managers; developing more of them will be key to selling our services to the world. Every chance I get, I stress the importance of education to good jobs and rising incomes in this country—a point this essay underscores.

### Closer to Home

While I am on the subject of providing good service, I am tremendously proud of

the Dallas Fed's continued success in operational areas. In 2007, the Federal Reserve System decided that its 22 check-processing sites around the country would be consolidated into just four centers. The Dallas Fed will be responsible for processing checks deposited in the entire western United States, allowing us to play a vital role in the smooth functioning of our nation's payments system. I am confident in the ability of our check-processing staff and management to meet the challenges of this consolidation while continuing the same outstanding service to financial institutions.

2007 marked the first full year our cash operations handled the increased volume from the consolidation of an out-of-state cash-processing center and dramatic growth in international deposits. As a result, the Dallas Fed paid and received a record \$121 billion in currency.

In response to pressures in the short-term funding markets, the Federal Reserve established a term auction facility (TAF) to help promote efficient dissemination of liquidity. As administrative and development site for the automated system the Reserve Banks use for discount window operations, our Dallas team was called on to quickly develop the software capabilities to support the TAF.

The Federal Reserve and the U.S. Treasury's Financial Management Service launched the *Go Direct*® program in 2005, aimed at increasing electronic payments and decreasing paper checks for people who

receive federal benefits. The Dallas Fed assists this program by hosting a *Go Direct* call center and website that handle direct deposit enrollments. Monthly participation expanded throughout the year, and in August, our call center processed its 1 millionth enrollment.

Our public outreach and education programs continued to make their mark on the Eleventh District. Our staff organized community forums in Austin, San Antonio, Laredo, Corpus Christi, Abilene, Las Cruces, McAllen and Amarillo. They also planned conferences and roundtables on homeownership preservation and health care. In 2007, our highly successful Building Wealth program, which teaches sound financial management principles, was launched in CD-ROM format. More than 70,000 *Building Wealth* workbooks, available in English and Spanish, and 50,000 CDs were distributed in 48 states and six countries.

It is an honor to work for and alongside the dedicated women and men of the Federal Reserve Bank of Dallas and its branches in Houston, San Antonio and El Paso. They, and their counterparts at the 11 other Federal Reserve Banks and at the Board of Governors in Washington, are the backbone of the Federal Reserve System. I am grateful for their support and brilliant work.



Richard W. Fisher

**The Dallas Fed will be responsible for processing checks deposited in the entire western United States, allowing us to play a vital role in the smooth functioning of our nation's payments system.**

# Opportunity Knocks

## *Selling Our Services to the World*

**Over the past century, the U.S. has developed a deep, diverse pool of skilled, productive and well-paid service providers.**



*T*oday's rapid globalization worries many Americans—and it's not hard to figure out why. We're bombarded by news of trade deficits, soaring oil prices, outsourced jobs, shrinking factory employment, a weakening dollar and hazardous imports—made all the more troubling by the rise of such new competitors as China and India.

Globalization may require us to revise our operating manuals, but we do ourselves a disservice when we accentuate the negative. An increasingly integrated world economy promotes efficient production, lowers costs, speeds growth and fosters better economic

policies. It gives U.S. consumers more access to foreign products and U.S. producers more access to foreign consumers. Therein lies one of the dangers in the downbeat view: It ignores the

opportunity globalization offers America to sell our services to the world.

Over the past century, the U.S. has developed a deep, diverse pool of skilled, productive and well-paid service providers. They're part of

a sprawling service sector—fully four-fifths of our economy—that incorporates skills and talents honed in the highly competitive U.S. market. We're world-class providers of financial, legal, medical, construction and industrial engineering services. We excel in supplying entertainment, education and information management. We lead in telecommunications, management and consulting, travel services and tourism.

Thanks to fundamental shifts in the global marketplace, America's services expertise can now exert itself worldwide. The Internet, satellites and fiber-optic transmission lines have bound economies together by making it cheaper and easier to collect, process and distribute information, a key component in supplying sophisticated services. Many services, once limited to domestic markets, now trade internationally.

These new technologies have arrived at a time of explosive growth in global demand. In the past two decades, China, India and other big, fast-growing countries have thrown open their economies, giving the rest of the world billions of potential new customers. As these emerging nations grow richer in coming decades, they'll spend more of their incomes on the kinds of services U.S.



companies can deliver.

We hear a lot about American businesses and workers facing growing competition from low-cost rivals around the world—call center operators in the Philippines, computer programmers in China, accountants in India, back-office workers in Brazil. We hear little about U.S. service companies that create jobs and grow profits by expanding their businesses overseas.

Yet examples are everywhere. Foreign audiences accounted for almost 60 percent of Hollywood's box-office revenues from movies released in 2007. McDonald's and KFC serve fast food at more stores abroad than here at home. A quarter of the lawyers at the 15 largest U.S.-based firms work in foreign outposts. U.S. architects design office towers, airports and stadiums in China, Dubai, Canada and other foreign locales. American forensic experts investigate accidents and crimes around the globe. Our programmers create video games, our professors teach classes, our financial advisors manage money—for both foreign and domestic customers.

Services are often dismissed as the province of dead-end jobs and low wages. Nothing could be more wrong. Many of our

service workers are well-educated, commanding high pay because of their ability to add value to what they produce. Our economy's transition to services has brought higher incomes and better jobs, making this sector our best hope for prospering in the era of globalization.

Opportunity knocks. The U.S. has been sharpening its service skills for decades. We have what it takes to be a world-beater in the services that provide well-paying jobs. Opening the door to the expansion in services trade will lead to faster economic growth and rising incomes. Turning away from globalization's call risks squandering a golden opportunity.

### **Services Ascendant**

A century and a half ago, German economist Ernst Engel documented the differences in how poor and rich families spend their money. Those with low incomes tend to allocate relatively more to basic needs—food, clothing and shelter. Higher-income consumers spend more on entertainment, travel, personal care and other wants.

The shift from needs to wants shapes patterns of consumer demand at all income levels. At a per capita income of \$3,700, for



**Economists analyze spending patterns with a concept called income elasticity of demand—the growth in demand relative to the growth in income.**

example, India's consumers allocate an average 46 percent of their budgets to food and 3 percent to recreation. At a per capita income of \$45,000, Americans spend 12 percent on food but 8 percent on recreation.

Engel's observations are fundamental and still hold today. Demand grows slower than income for needs and faster than income for wants. Economists analyze spending patterns with a concept called *income elasticity of demand*—the growth in demand relative to the growth in income.

Elasticities below 0 indicate *inferior* goods and services. Spending on them declines as income rises. Intercity bus service is one example, but inferior goods and services are rare. *Necessities* have elasticities of 0 to 1 because consumption increases more

slowly than income. Demand grows faster than income for *superior* goods, which have elasticities above 1.

Using economists James Seale, Anita Regmi and Jason Bernstein's work on world consumption patterns, we calculated 2006 elasticities for nine categories of goods and services in 116 countries. Demand patterns change markedly from low-income countries to higher income ones (*Exhibit 1, pages 10 and 11*).

Start with the most basic item—food, a necessity for most countries but an inferior good for a few. For each 10 percent increase in income, spending on food for home consumption rises 6.1 percent in China and 7.1 percent in India. In the U.S., spending drops 1.1 percent, partly because Americans eat



### ★ Texas Services Exporter

#### **Laguarda.Low Architects Urban Designers**

Since its founding in 2000, Dallas-based Laguarda.Low has completed more than 20 projects in eight countries, ranging from Brazil to Poland to China. The firm, currently working on assignments in 17 countries, has offices in Beijing, Tokyo and Kiev.

Laguarda.Low beat out eight other international architectural firms for the Toyosu retail and lifestyle center in Tokyo, which opened in October 2006. The 915,000-square-foot project includes department stores, restaurants and entertainment venues.

The Toyosu design blends modern, functional shopping areas with flourishes that capture the historic character of the IHI dockyards that once stood on the site. A double-layer mesh facade mimics shipbuilding techniques. Prowlike forms frame a large public plaza that abuts the waterfront and offers stunning views of Tokyo Bay.

The company won an American Institute of Architects award for the Toyosu project's residential towers.

out more as their earnings rise.

Clothing and footwear are necessities, but poor and rich countries have roughly the same elasticities. The measures decline only slightly—from 0.93 in Madagascar, where per capita income averages less than \$1,000 a year, to 0.90 in far wealthier nations, such as Japan and Canada.

As incomes move up from low levels, spending on housing and utilities rises sharply at first, then more slowly as consumers shift to other goods and services. Elasticities fall from a high of 1.34 at the lowest income levels to 1.15 for nations like Norway, where per capita income averages \$40,000 a year. A nearly identical pattern is found for other household operations, a category that includes expenditures on furnishings and

maintenance.

The richer families become, the larger the portion of their budget spent on medicine and health care, with some of the money paying for elective procedures. For every 10 percent increase in income, medical spending goes up 13.4 percent in Brazil, 13.1 in Russia and 12.3 in Australia. In the poorest nations, the increase is 24 percent.

Elasticities show demand rising faster than income in the communications and transportation category. Communications mainly consists of telephone service, both wired and cellular. Transportation covers cars and other goods, but it also includes many services, such as auto repairs, airline flights and public transport.

The data for the 116 countries don't



### **Geokinetics Inc.** **Geophysical Services**

Houston-based Geokinetics uses seismic technology to help clients in the oil and gas industry find new reserves. The company maintains offices in 18 countries, including Canada, Colombia, Brazil, Egypt and Australia.

Geokinetics used both proprietary and state-of-the-art technology to conduct three-dimensional surveys of more than 4,000 square miles around the world in 2007. The data produced computer-generated cross-sections, maps and 3D images of the subsurface.

Geokinetics specializes in surveying in difficult environments—high mountains, dense jungles, deserts, swamps, and the transition zone between land and sea.

For the Florena Pauto project in Colombia's Llanos Foothills, crews covered a vast region of high mountains, steep slopes, limited roads and environmentally sensitive areas.

After 10 months in Florena Pauto, Geokinetics provided its client with about 200 square miles of data to assist with decisions about drilling.

### ★ **Texas Services Exporter**



## Exhibit 1

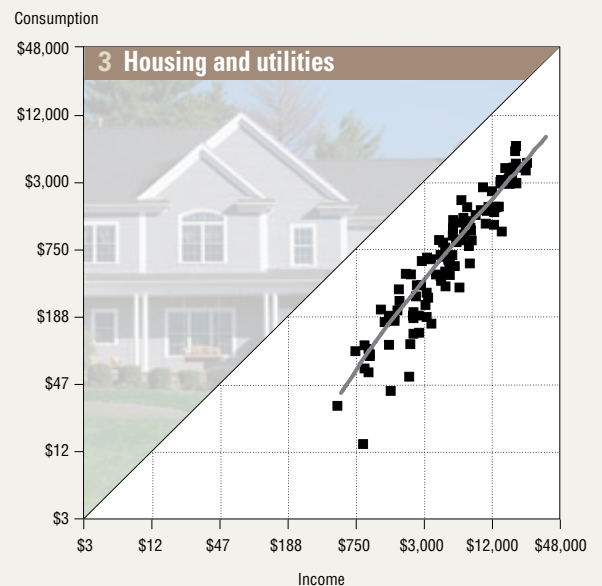
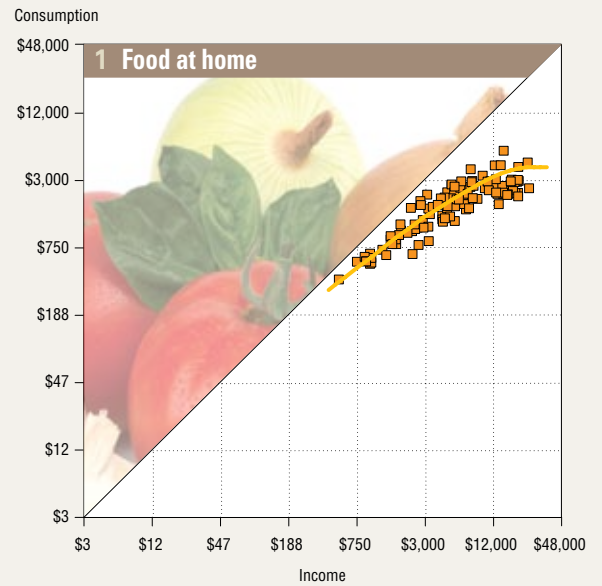
### Demand Moving Up to Services

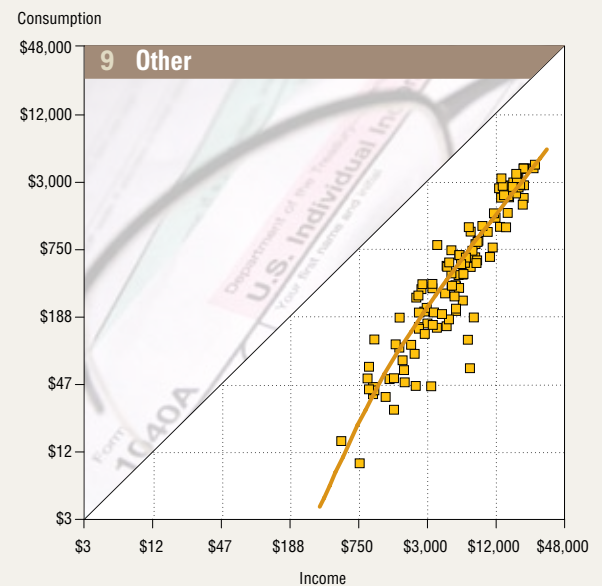
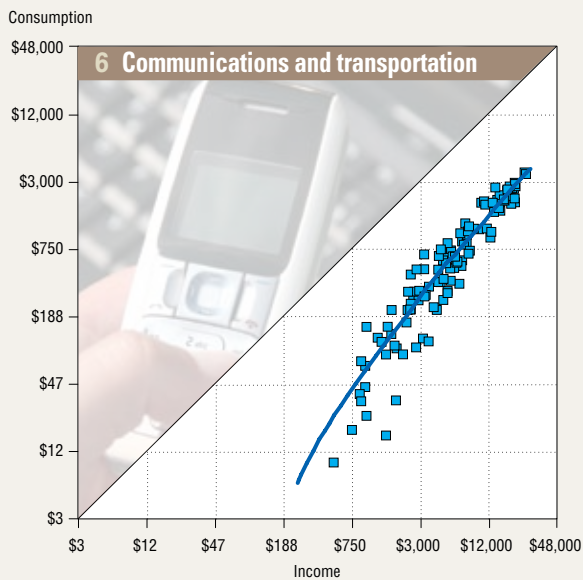
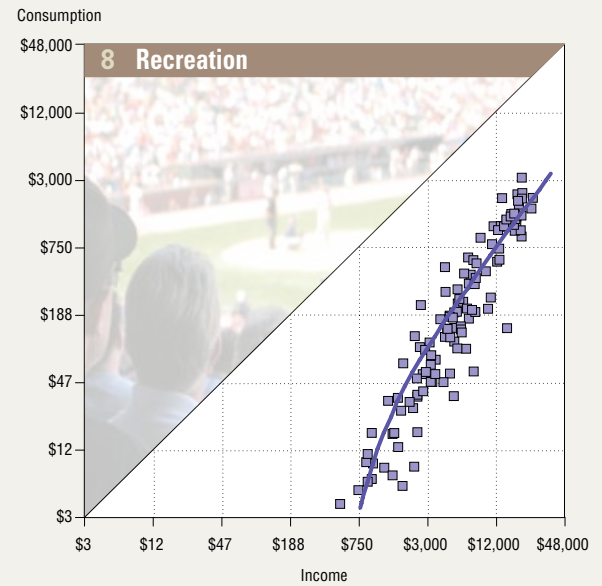
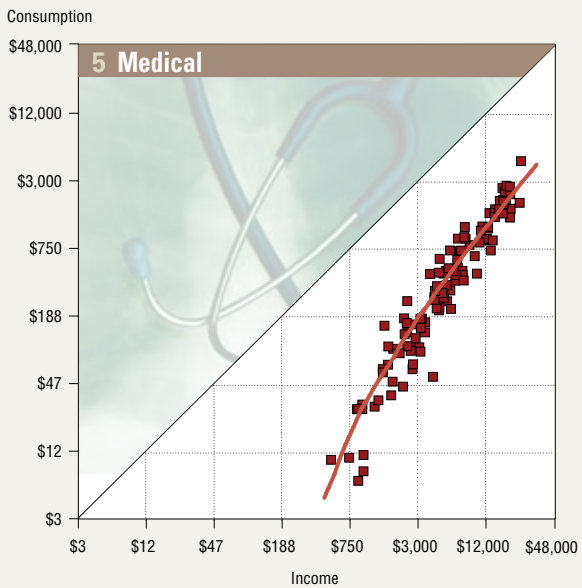
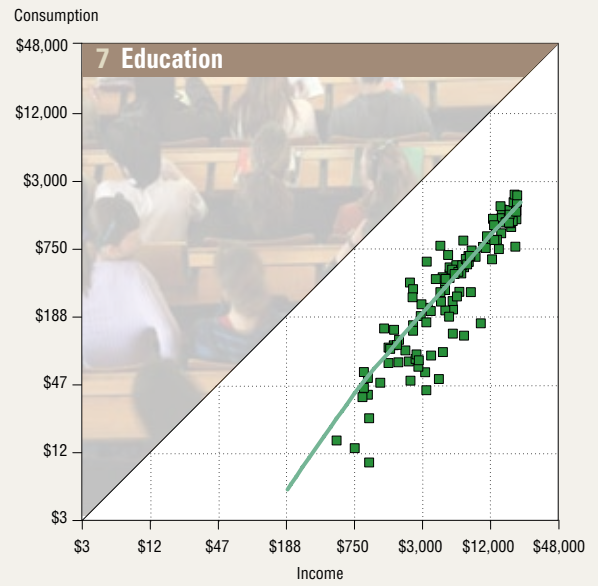
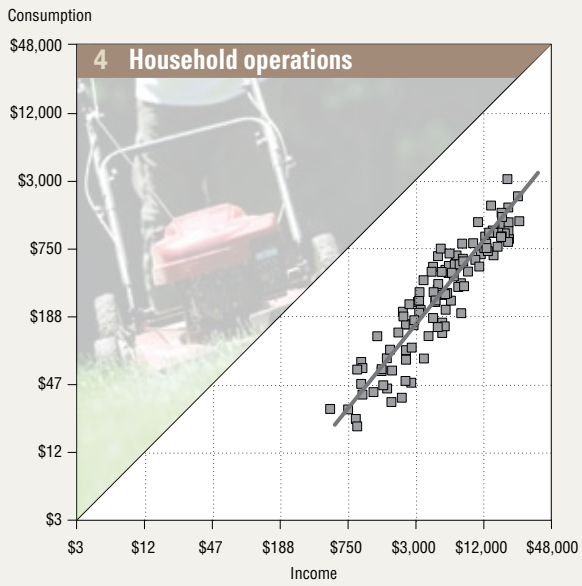
Spending data from countries at all levels of development show how rising per capita income shapes demand in nine broad consumption categories. Households shift away from goods and toward services as incomes increase.

The center line's 45-degree slope connotes demand growing at the same pace as income. A trend line's relationship to this diagonal indicates whether a category's budget share tends to shrink, stay the same or grow as we move from poor to richer countries.

As a country's per capita income rises, spending on food tends to fall away from the diagonal, suggesting that relative demand is weakening (*panel 1*). Expenditures for clothing and footwear also lag income, although at a much slower rate (*panel 2*). Housing and household operations register modest gains in budget shares, with consumer demand growing slightly faster than income (*panels 3–4*).

Services-heavy consumption categories tend to rise faster relative to the diagonal, indicating a strengthening of demand as countries grow richer. This pattern holds for medical services, communications and transportation, education and recreation (*panels 5–8*). Consumption also rises with income for a category made up of other products, including many services (*panel 9*).





**Services exhibit a high degree of income elasticity. Countries with rising per capita incomes will likely follow the path trod by U.S. consumers and allot a growing portion of their spending to services.**

allow us to separate communications and transportation. Looking at spending patterns for U.S. consumers only, however, we find relatively high elasticities for cell phone service and air travel. This suggests the category's overall elasticity is probably being pulled up by the services it embodies.

Recreation spending exhibits the highest elasticity at all income levels, indicating households worldwide are especially eager to consume more of it. The types of recreation, of course, vary along the income scale—from buying playing cards and dominoes in poor countries, to attending soccer games in developing nations, to enjoying Broadway plays in the U.S.

In many poor households, children drop out of school to work. As families

earn more money, they can afford to allow their children more years in the classroom. Education is a superior good, with income elasticities that range from 1.07 to 1.09, not as high as the medical, recreation and communications categories. Education is a priority because it holds the key to higher incomes, but its measured elasticity may be held down because spending decisions are often made by governments, not households.

Consumption rises faster than income for the catchall category “other.” Made up largely of services not captured elsewhere, it includes lawyers drafting wills, CPAs filing tax returns and geeks fixing computers. The category also covers many of the personal services consumers regularly use—from haircuts to dry cleaning.



### ★ Texas Services Exporter

#### **Methodist Healthcare System Medical Care**

San Antonio's largest provider of medical services, Methodist Healthcare extends its reach across borders by caring for patients from Mexico, Spain, Russia, Brazil, India and three dozen other countries.

With 22 San Antonio-area facilities, Methodist Healthcare offers a full range of medical specialties—obstetrics, cardiology, oncology, transplants. The system treated more than 1,500 international patients in 2007.

The international services department's multilingual staff helps foreigners with doctors' appointments, medical records and air ambulances. Concierge services lighten families' burdens by tending to their needs—from travel and accommodations to sightseeing and recreation.

In the past few years, doctors performed a bone marrow transplant on a 5-year-old girl from Pakistan and implanted a \$90,000 automatic internal defibrillator in a patient from Peru. Under the disease management program, a Mexican business executive flew in for check-ups every three months.

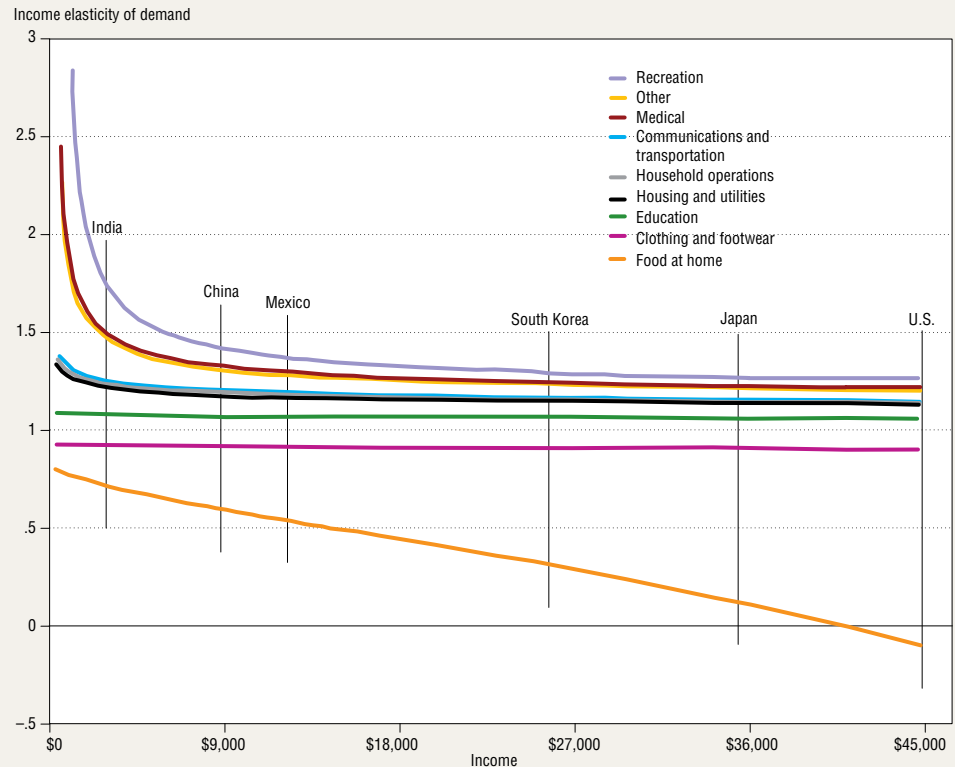
## Exhibit 2

### How We Consume— From Poor to Rich

Food and clothing have the lowest income elasticities of demand. The elasticity for food starts well below 1 and declines as we move from the poorest to the richest nations. Spending won't keep pace with global income growth.

Elasticities for recreation, medical care and other categories are high initially, fall as income increases and settle in at levels well above 1. Their shares of the global consumer budget will grow as income rises.

Six countries show the elasticities typically associated with various income levels.



Overall, services exhibit a high degree of income elasticity. Countries with rising per capita incomes will likely follow the path trod by U.S. consumers and allot a growing portion of their spending to services. Wealthier households will want more food, energy and factory goods, but global demand will gradually skew toward maids, hairdressers, entertainers, insurance agents, financial advisors, doctors and other service providers.

Increased consumption of services is a hallmark of societies growing richer (*Exhibit 2*). Their changing spending patterns mean producers of inferior goods will be left behind. Producers of superior goods and services are

better positioned to take advantage of growing global demand, especially if what they sell can be traded in markets where consumers have more to spend.

Per capita incomes have been rising in many countries—Spain and Poland in Europe, Brazil and Chile in South America, Thailand and Vietnam in East Asia. Their demand for services will continue to increase, but China and India may be the biggest potential consumers.

Although still poor by U.S. standards, these two nations have moved up rapidly in recent years. Combined, they have 2.4 billion people—eight times the U.S. population—



and they, too, will want even more services. The emerging giants we sometimes fear may offer our greatest opportunity.

With its large population and fast growth, China will contribute more to the rise in global demand than any other country in 2008. The nation's spending increases alone should reach \$151 billion for communications and transportation, \$116 billion for medical services, \$87 billion for education and \$79 billion for recreation (*Exhibit 3*).

India won't match the incremental demand from China and the U.S., but it should add \$37 billion for communications and transportation, \$25 billion for medical services, \$24 billion for education and \$16 billion for

recreation.

Spending increases will become even larger as China and India continue to grow. A big chunk of this demand will no doubt be filled by domestic service providers, but consumers and businesses in China, India and elsewhere will also shop the world market. This will mean potential new business for companies that deliver quality and value in services exports—business for the U.S. and, yes, for other countries as well.










In 2006, our largest markets for services exports were countries with long-standing economic ties to the U.S.—the United Kingdom, Japan, Canada, Mexico and Germany. American companies have had decades to build up busi-

### Exhibit 3

#### Big Countries, Big Demands

For China and India, fast growth and large populations will combine with high elasticities to drive strong demand for services in 2008.

The huge, rich U.S. economy won't grow as fast, but it's still among the top three contributors to global demand.

	China Pop. 1.314 billion \$8,662 per capita GDP 10.8% annual GDP growth			India Pop. 1.113 billion \$3,724 per capita GDP 8.6% annual GDP growth			U.S. Pop. 0.3 billion \$44,617 per capita GDP 1.9% annual GDP growth		
 <b>Food at home</b>	34%	.61	\$263	46%	.70	\$124	12%	-.11	-\$14
 <b>Clothing &amp; footwear</b>	7%	.91	\$76	7%	.92	\$24	6%	.90	\$14
 <b>Housing &amp; utilities</b>	14%	1.19	\$203	12%	1.23	\$50	18%	1.15	\$51
 <b>Household operations</b>	6%	1.19	\$88	5%	1.23	\$22	8%	1.14	\$22
 <b>Medical</b>	7%	1.34	\$116	5%	1.47	\$25	11%	1.22	\$32
 <b>Education</b>	7%	1.07	\$87	6%	1.08	\$24	8%	1.07	\$20
 <b>Communications &amp; transportation</b>	10%	1.21	\$151	9%	1.25	\$37	14%	1.15	\$38
 <b>Recreation</b>	5%	1.43	\$79	3%	1.69	\$16	8%	1.25	\$23
 <b>Other</b>	10%	1.32	\$161	7%	1.45	\$36	15%	1.21	\$44
	Budget shares	Demand elasticities	*Increase in demand	Budget shares	Demand elasticities	*Increase in demand	Budget shares	Demand elasticities	*Increase in demand

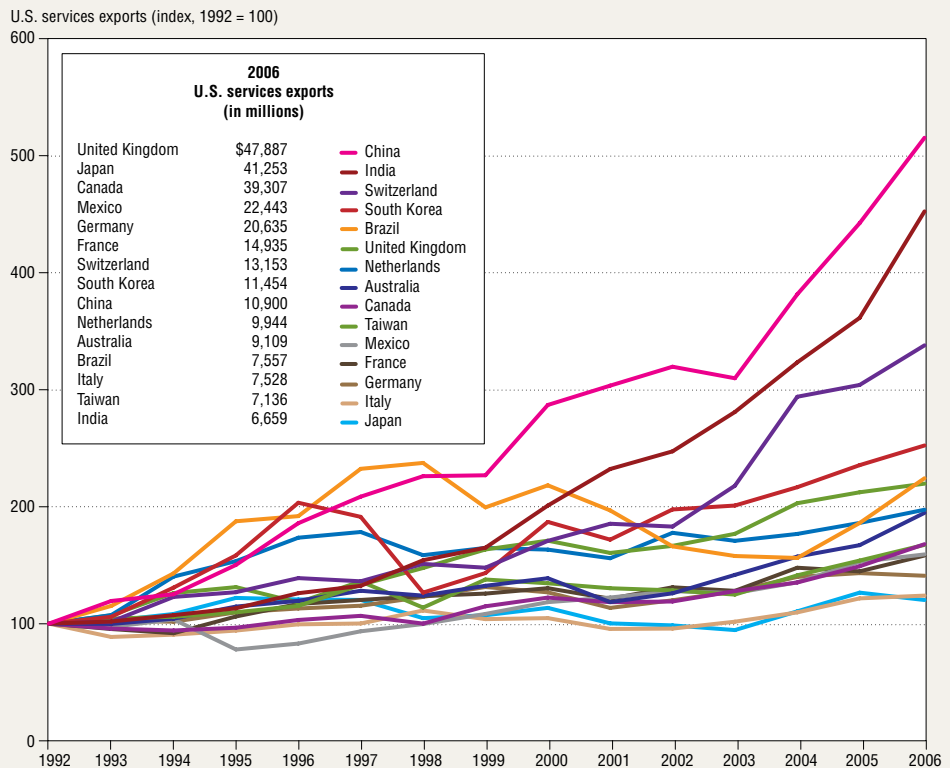
\*In billions



## Exhibit 4

### Serving It Up to China, India

Most U.S. services exports still go to traditional markets in Europe, North America and Japan, but sales to China and India have taken off since 1992. Both countries are now among the top 15 destinations for U.S. services.



ness in these markets, and our services exports to them are still growing (*Exhibit 4*).

China and India, largely closed to outsiders before market-friendly reforms in the 1980s and '90s, have been the fastest growing markets for U.S. services exports in the past 15 years. Sales to China are up 500 percent and to India, 450 percent.

By 2006, China was already among the top 10 U.S. export markets in eight service categories—freight; port services; management, consulting and public relations; legal services; construction, engineering, architectural and mining services; equipment installation and maintenance; operational leasing; and other business and professional services.

India joined China in the top 10 in construction, engineering, architectural and

mining services, and other business and professional services, plus it ranked high in travel and passenger transport. India was first and China second in using U.S. educational services.

### Our Services Edge

The price of services relative to goods has more than doubled since returning veterans set off on a spending spree after World War II. We've been willing to pay more for services because our incomes have risen, services elasticities are high and the quality of services has improved relative to goods.

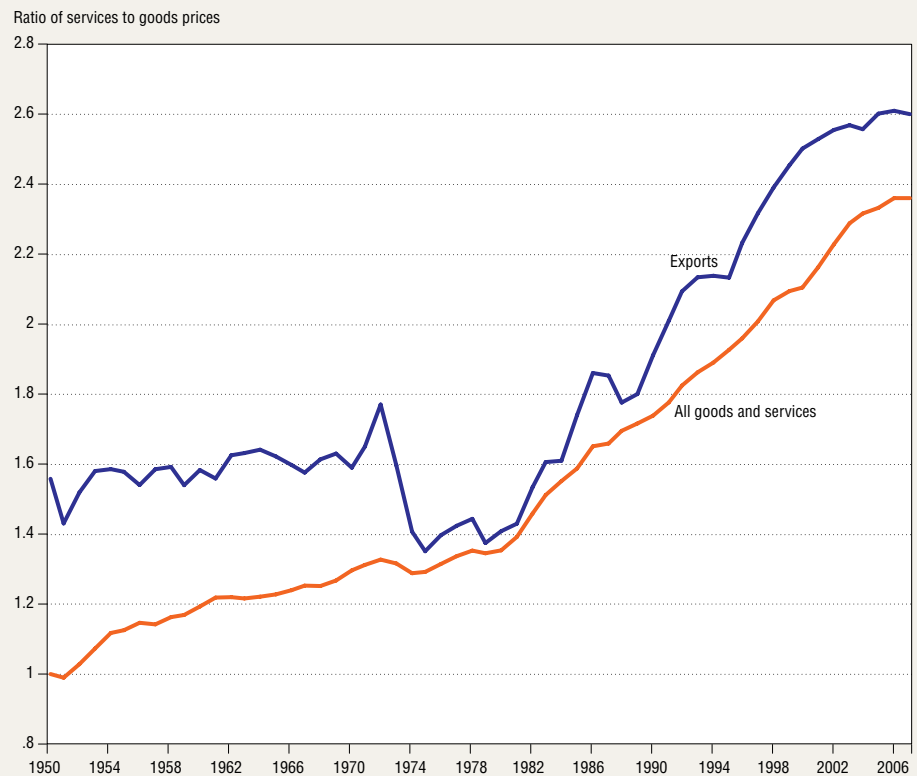
It wasn't until the early 1980s, however, that prices for services *exports* started gaining on goods (*Exhibit 5*). Since then, the ratio of services to goods prices for U.S. exports

**China and India have been the fastest growing markets for U.S. services exports in the past 15 years.**

## Exhibit 5

### Paying More for Services—First at Home, Then Abroad

The prices of services relative to goods began rising over a half century ago in the overall U.S. economy. This wasn't seen with exports until new communications technologies made it easier to sell services in the global marketplace.



has risen rapidly, suggesting that we're selling the world more valuable services. Rising incomes in other countries and treaties that removed trade barriers also contributed to higher relative prices for services exports.

The timing, however, suggests the key factor at work was technology. Services' relative prices took off just as the revolution in information processing and communications hit its stride. The invention of the microprocessor led to computers, cell phones, the Internet and e-mail, expanding the capacity to move vast amounts of data virtually anywhere. Service producers could connect to distant customers in ways never before possible.

Services differ from goods in fundamental ways. Most goods can be mass-produced,

crated, warehoused and shipped; production and consumption may be widely separated in time and space. They're easily traded, even over long distances. Most services, on the other hand, are created for specific customers, delivered directly to them and consumed when produced. They were difficult to trade until technology reduced the barriers imposed by distance.

Goods still account for the bulk of U.S. exports, but services have gained ground, rising from 19.6 percent of total exports in 1980 to 29.8 percent in 2007 (*Exhibit 6, page 18*). The nation's foreign sales of services totaled \$488.5 billion in 2007, far more than any other country. We topped the next two largest service-exporting nations combined—Britain at \$275.5 billion and Germany at

\$210 billion, countries that benefit from easy access to the markets of their European Union partners.

Breaking it down by industry, we find U.S. services exports exceeded imports in 15 of the 20 categories tracked by the Commerce Department—often by a large margin (*Exhibit 7, page 19*). Our biggest edge was in industrial engineering, where exports were almost 24 times imports. This reflects global demand for U.S. technicians, who go overseas to install computerized control systems, design industrial robots and streamline supply chains.

In 2006, U.S. movie studios produced such box-office hits as *Pirates of the Caribbean: Dead Man's Chest*, helping our foreign distribution of films and TV shows exceed

imports by a factor of 13.

Media reports have focused on Americans traveling abroad in search of affordable health care, but foreigners spent 10 times more on U.S. medical services than we spent overseas in 2006. The United States leads the world in medical research, helping doctors and hospitals offer patients advanced care they may be unable to find in their home countries.

Foreigners are employing U.S. firms for infrastructure and exploration projects. In construction, engineering, architectural and mining services, our exports were nearly 10 times our imports. The next largest U.S. export-to-import ratios were in database and other information services and installation, repair and maintenance of equipment.



### FTI Consulting Business Advice

Working for companies and shareholders to preserve enterprise value, FTI Consulting helps clients navigate the treacherous waters of global financial, legal and regulatory issues. It has 2,400 employees in 52 offices around the world.

Enhancing the expertise of FTI advisors is proprietary technology for information management and electronic investigation that allows users to review, manage and transmit documents in more than 200 languages.

In the past year, Dallas-based consultants worked on investigations that took them to Venezuela, India, Indonesia, Russia, Dubai, Scotland, Angola, Ireland and Slovakia.

The Dallas office led the financial restructuring of a telecommunications manufacturer. FTI set up new finance and accounting systems and arranged debt financing in six countries.

"You don't have to be the corporate headquarters to take advantage of opportunities in global markets," says Terry Orr, a senior managing director in Dallas.

### ★ Texas Services Exporter

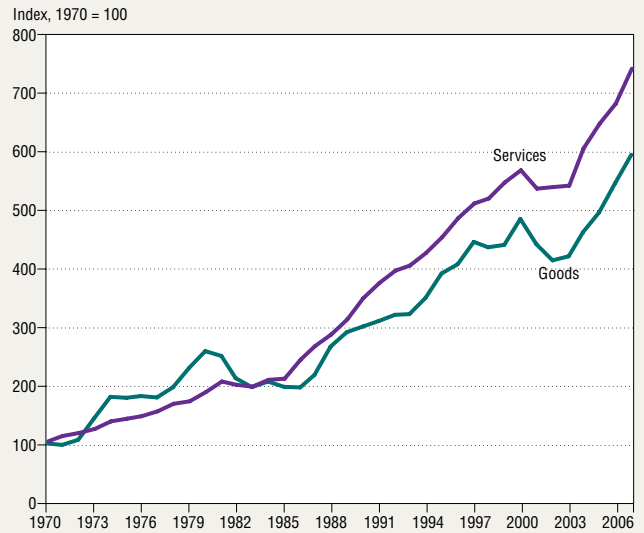


## Exhibit 6

### U.S. Services Exports Surging

U.S. exports of both goods and services have risen sharply since 1970. Until the early 1980s, goods were leading the way. Since then, however, foreign sales of U.S. services have risen faster.

Until the early 1980s, technology placed limits on the ability to deliver many services to foreign markets. The pace of services exports began picking up when a new generation of technologies facilitated the exchange of information and data.

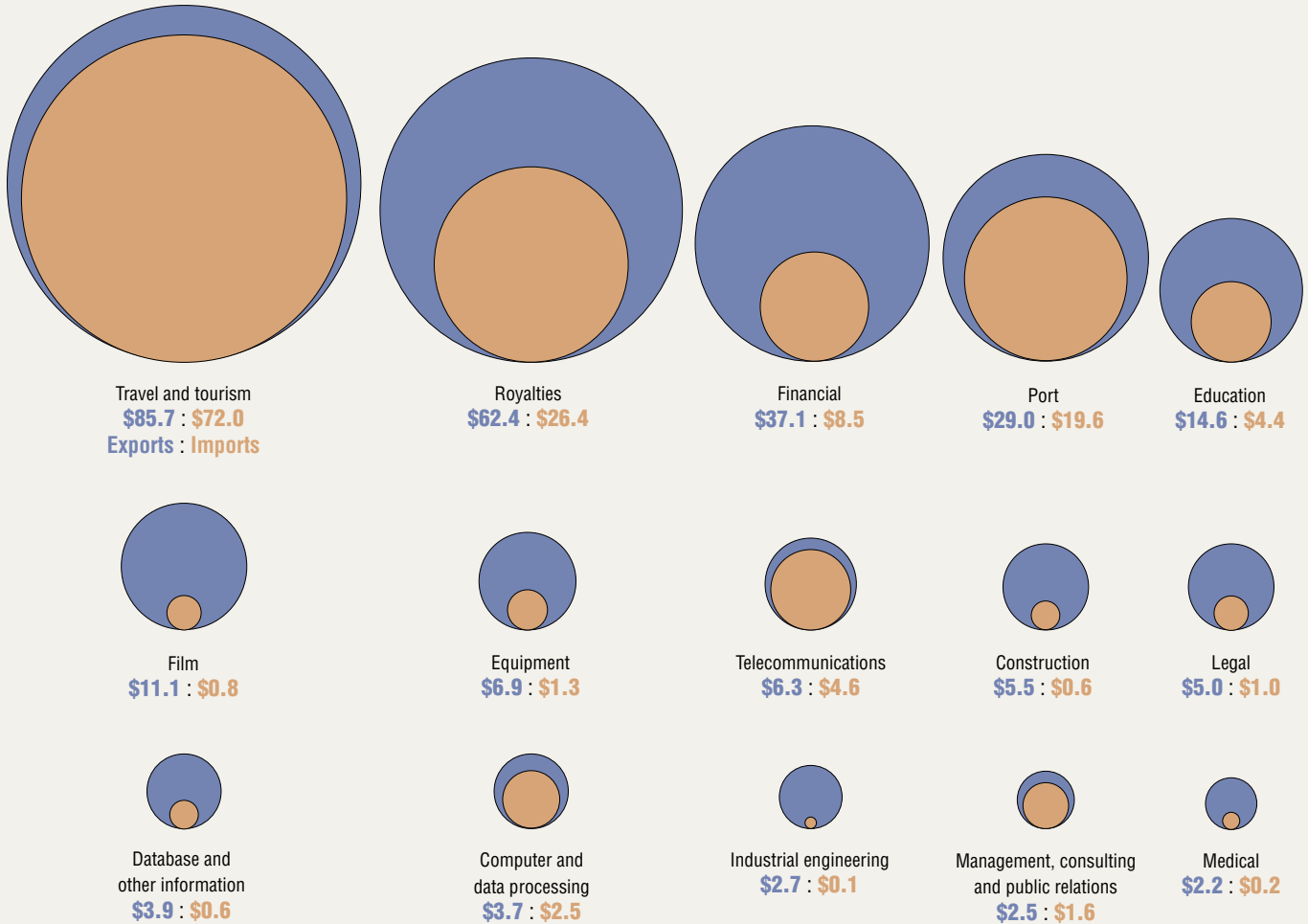


## Exhibit 7 U.S. Edge in Services

Circles proportional to the dollar value of trade illustrate how U.S. exports exceed imports by a wide margin in all but a handful of industries. America enjoys its most significant competitive advantages in industrial engineering, film distribution and medical services. The blue circles denote exports and the tan imports. The numbers below each pair are for 2006.

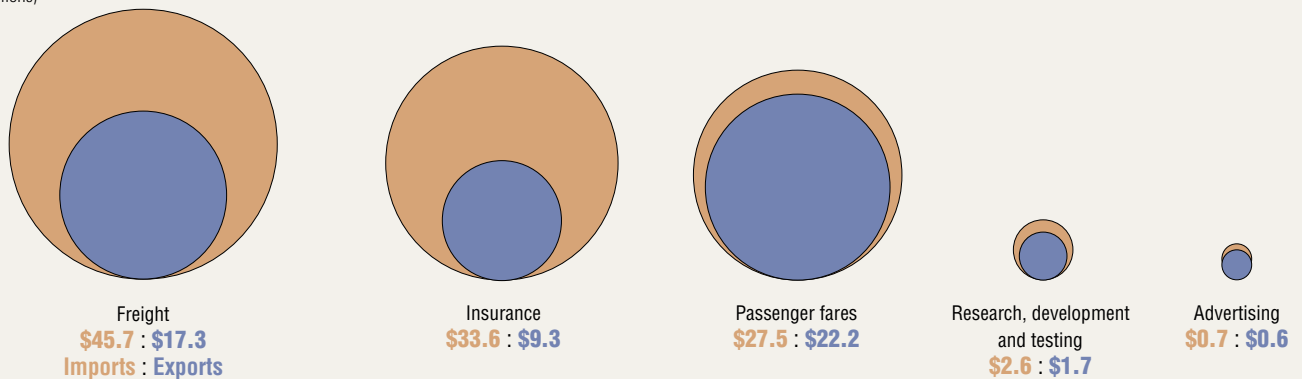
### Services Exports Exceed Imports

(in billions)



### Services Imports Exceed Exports

(in billions)



U.S. experts are being hired to make foreign companies more efficient.

Our law firms have polished their skills in a highly sophisticated legal system. This wealth of talent helped give the U.S. a 5 to 1 edge in legal services. Our industrial might began making us rich more than a century ago, providing an impetus for developing the financial expertise needed to manage the money. This legacy explains why our financial services exports were four times imports in 2006. Many American colleges and universities rank among the best in the world. The educational services we sell foreigners are three times greater than what we buy abroad.

U.S. companies have developed a deep reservoir of profitable copyrights and pat-

ents. Taking this intellectual property to the global marketplace earns them royalties and licensing fees. What we receive from foreigners exceeds what we pay to other countries by better than 2 to 1.

The U.S. ran a slight services surplus in travel and tourism, the largest service category in international trade. Our exports also exceeded imports in port services, telecommunications, computer and data processing, and management, consulting and public relations.

We ran significant trade deficits in just two categories of services—freight and insurance. We had smaller deficits in three other areas—passenger fares, advertising, and research, development and testing.

Broad trade patterns show the U.S.



### ★ Texas Services Exporter

#### **Fluor Corp. Engineering and Construction**

Irving-based Fluor operates across six continents, handling large-scale projects in such countries as Russia, Saudi Arabia, South Africa, China, Mongolia and Australia. The company's services include engineering, procurement, construction and maintenance.

Fluor often works in remote and inhospitable settings. From 2004 to 2007, its Houston office was part of a global design, logistics and construction team for an onshore oil-processing facility on Russia's Sakhalin Island, where winters bring minus-40-degree temperatures and blizzard whiteout conditions.

Some of the world's most advanced satellite-based communications linked offices in Houston, Moscow, India and South Korea to subcontractors on Sakhalin Island. On a fast-track schedule, Fluor's engineers divided the project into 36 prefabricated units, each weighing up to 1,700 metric tons. The mammoth modules could only be sent by sea.

Fluor successfully completed its work on the Sakhalin project ahead of schedule, earning the company additional business in the region.

is globally competitive in a wide range of industries that employ skilled services professionals capable of complex and sophisticated work. The services we trade involve embedded knowledge. We're more likely to sell foreigners cancer treatments than cold remedies, merger and acquisition advice than patent searches, computer system design than basic programming.

### Exporting Knowledge

Some of Americans' anxiety over globalization arises from a gut-level question: How will we maintain our high standard of living in this new economic environment? Services exports are a big part of the answer.

China, India and other low-wage nations compete at the low end of services

trade with call centers, back-office operations and the like. U.S. service exporters do business at the other end of the skills spectrum. We provide high-value-added services—those worth more to customers because they embody the skills and talents of highly educated professionals. Workers who add the most value earn the highest incomes.

The United States has been expanding its value-added production for generations—within jobs, firms and industries, and across the economy as a whole.

Farms have shifted from labor- to capital-intensive production. Factories have moved from making textiles and toys to producing aircraft, pharmaceuticals and microchips. The services hierarchy isn't any different. It started with seamstresses,

**Broad trade patterns show the U.S. is globally competitive in a wide range of industries that employ skilled services professionals capable of complex and sophisticated work.**

### Stanton Street Web Developers

Even small businesses are cashing in on services exports.

El Paso's Stanton Street assembled a bilingual, bicultural and binational team to develop Internet solutions for companies. In addition to U.S. customers, the company found business across the border in Mexico.

Novamex, a food and beverage producer, hired Stanton Street to create a website featuring its products, including Jarritos soft drinks, Ibarra chocolates, Mineragua mineral water and Cholula hot sauce.

Website visitors enter a Mexican mercado without ever stepping across the border. Novamex uses Spanish and English to communicate directly with retailers serving its target market of first- and second-generation Mexican-Americans living in the U.S.

"We see growth opportunities for Stanton Street based on the fact that U.S. companies are doing more business in Mexico and Mexican companies are doing more business in the U.S.," says President Brian Wancho.

### ★ Texas Services Exporter



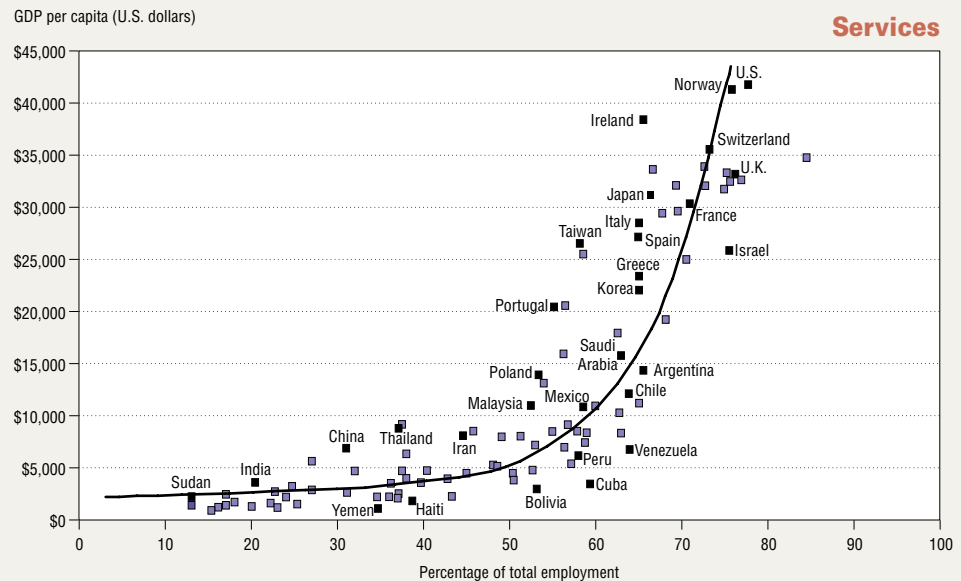
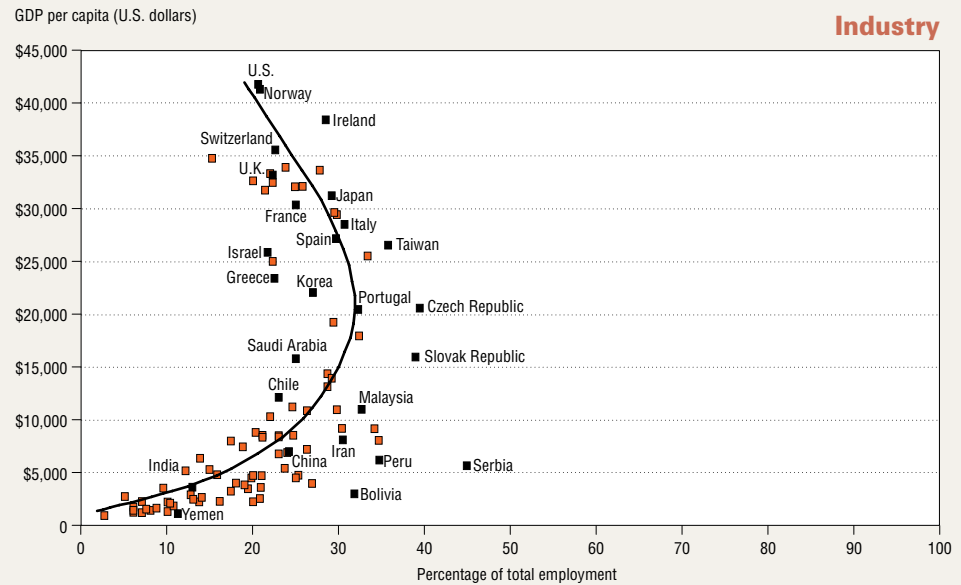
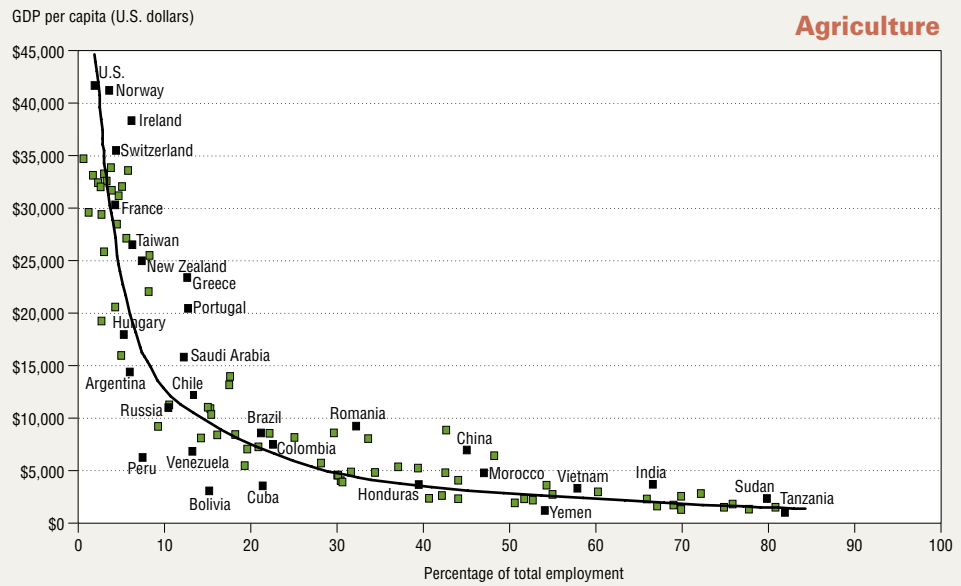
## Exhibit 8

### The Road from Serfdom

Looking at a broad cross-section of economies makes the link between services and higher incomes unmistakable. Countries with small agricultural sectors tend to be rich, while those allocating a large share of labor to farming have relatively low per capita incomes (*top*).

Reducing labor in agriculture and gearing up industry allows nations to increase their incomes. However, industrialization's gains no longer occur after about a third of labor resources have shifted into goods production (*middle*).

The richest countries have moved beyond industry, and most of their workers are employed in services. The 10 countries with the highest incomes all have at least two-thirds of their labor in this sector. The 10 poorest countries still have less than a quarter of their labor in services industries (*bottom*).





launderers, clerks, telephone operators and low-end personal services and steadily climbed upward to jobs as medical specialists, forensic accountants, industrial psychologists and environmental architects.

At the macroeconomic level, agriculture gave way to the growth of industry; in time, industry has given way to the expansion of services. This pattern has been repeated in most other nations as income growth shifts consumer demand and the relative quality of services improves.

Nations with 30 percent or more of their labor in agriculture usually have incomes below \$6,000 a year (*Exhibit 8, top*). As this sector shrinks, income rises, slowly at first but then at a faster pace. Countries with less than 5 percent of their labor in farming tend to have per capita incomes above \$30,000 a year. U.S. farms and ranches employ just 1.5 percent of the nation's workers.

The adoption of more-productive farming techniques frees up rural labor, which migrates to the cities to work in manufacturing and construction. Workers fresh from the farm tend to be low skilled and less educated, but machinery and on-the-job training quickly raise their productivity. Per capita incomes rise. Step by step, industrial economies make progress—up to a point (*Exhibit 8, middle*).

Growth tends to reach a natural limit as industry approaches 30 percent of employment. Above that, the share of jobs in industry falls as incomes rise. In the United States, manufacturing, mining and construction jobs topped out at a third of employment in the early 1950s and have ebbed ever since, falling below 20 percent.

Labor resources no longer needed by industry find their way into services. Per capita incomes rise quickly once services constitute more than 50 percent of jobs, indicating that economies have shifted to a new model for success, one centered on educating their workers for high-end services jobs (*Exhibit 8, bottom*). The U.S. service sector has expanded rapidly in recent decades and now employs roughly 80 percent of workers.

High incomes and large service sectors go hand in hand, belying the old criticism of services as a sector of low-wage, dead-end jobs. The record shows that services are the path to prosperity, not poverty. America's service-dominated economy trails only tiny Luxembourg's in per capita income. Right behind us are Norway, Ireland, Switzerland and other nations far along in the transition to services.

These economies couldn't thrive unless services jobs paid well. U.S. wages have been rising faster in services industries than in manufacturing. Since 1990, the gains have been particularly strong in finance, insurance and real estate; education and health; information; and professional and business services (*Exhibit 9, top*). Among major job categories, only transportation and warehousing have failed to outpace manufacturing.

In 2007, average hourly manufacturing earnings, excluding overtime, stood at \$16.40, but a typical worker earned \$27.93 in utilities, \$23.92 in information, \$20.14 in professional and business services, and \$19.66 in finance, insurance and real estate. Retail trade and leisure and hospitality, however, didn't pay as much as manufacturing in 2007.

High pay in services is due to human

**Services are the path to prosperity, not poverty. Education, acquired skills, life experience and innate talents make U.S. workers among the most productive in the world.**



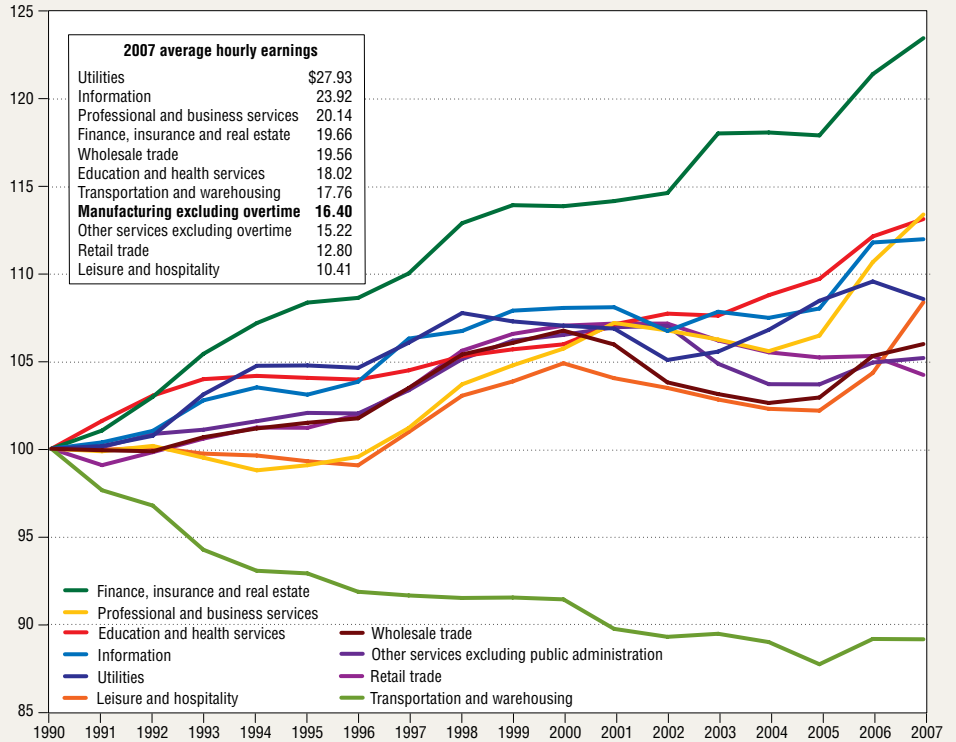
## Exhibit 9

### Services Shine in Pay . . .

Good services jobs are what make developed economies wealthier. In the U.S., services occupations that require sophisticated knowledge pay better than manufacturing jobs, while those that don't rely on specialized knowledge have lower wages (*inset*).

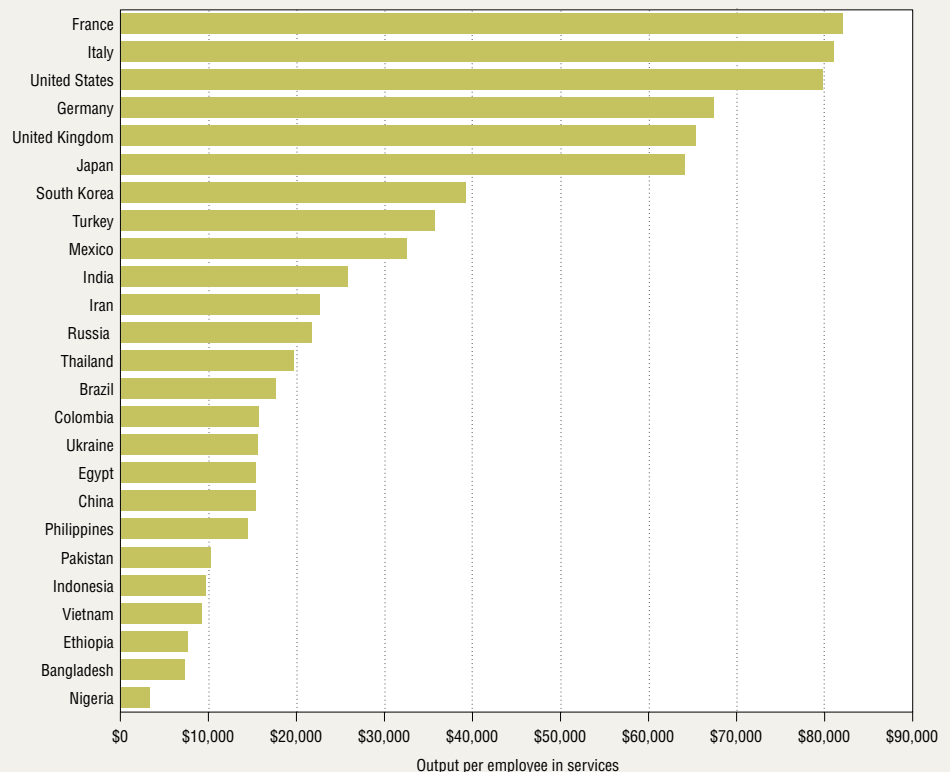
Relative to manufacturing, pay for most high-end services occupations has been rising. The ratio has declined in only one sector—low-skilled transportation and warehousing.

Ratio of services to manufacturing pay (index, 1990 = 100)



### . . . and Productivity

Productivity is key to higher pay in services. The United States is one of three countries well ahead of the rest of the world in output of services per employee. France and Italy have large tourism industries that boost their measured services productivity. The U.S. has a larger business and professional services category.



capital—workers' know-how. Their education, acquired skills and innate talents allow U.S. service workers to generate average annual output of nearly \$80,000, a figure that makes them among the most productive in the world (*Exhibit 9, bottom*).

Workers' wages derive from their productivity, and their productivity derives from the availability of the capital needed to do their jobs. In goods production, firms provide nearly all the capital that makes workers more productive—machinery, equipment and training.

The intellectual capital that dominates services, however, derives largely from investments by the workers themselves, who make decisions on schooling. Knowledge acquired on the job embeds itself in workers, and they take it with them when they change employers. In short, service workers take in and out the door the knowledge-intensive capital that makes them valuable.

Human capital explains the vast differences in service-sector pay. Service workers with the most education and training command the highest hourly pay—\$88.53 for surgeons, \$67.76 for dentists, \$54.65 for lawyers and \$48.77 for financial managers. Jobs requiring little human capital pay relatively low wages—\$7.67 for fast-food cooks, \$8.99 for maids, \$10.62 for taxi drivers and chauffeurs, and \$11.51 for retail clerks (*Exhibit 10*).

Pay scales aren't as diverse in goods-producing industries, primarily because the educational requirements don't vary as much and firms can easily supply physical capital. Pay ranges from \$48.86 for petroleum engineers, who are usually college educated, to \$9.78 for sewing machine operators, a job requiring little specialized training.

Services' human capital starts with formal education, especially at colleges and professional schools. More than half those



## Exhibit 10

### Education Key to Better Pay

Pay varies widely in services. Occupations that require a lot of education tend to pay the highest wages, while low-skilled ones lag far behind. The same is true for the goods sector, but the range of wages is wider in services because of greater differences in educational requirements.

### Service Sector Jobs

2006 average hourly wage

Surgeons	\$88.53
Dentists	67.76
Lawyers	54.65
Financial managers	48.77
Computer software engineers	39.42
Computer programmers	33.42
Accountants and auditors	29.17
Interior designers	23.08
Truck drivers	17.46
Telephone operators	15.73
Retail salespeople	11.51
Taxi drivers and chauffeurs	10.62
Maids, house cleaners	8.99
Fast-food cooks	7.67

### Goods Sector Jobs

2006 average hourly wage

Petroleum engineers	\$48.86
Industrial production managers	40.37
Mechanical engineers	34.89
Elevator installers	29.78
Building inspectors	23.37
Carpenters	19.20
Roofers	16.99
Filling machine operators	12.02
Sewing machine operators	9.78

in management, business and financial occupations have earned bachelor's degrees or higher. Two-thirds of workers holding professional jobs are college graduates. By contrast, only 10 percent of sales workers finished college.

Human capital doesn't just come from book learning; it's not just analytical brain-power. Today, human capital increasingly reflects people skills and emotional intelligence, developed mainly through face-to-face contact. Here's where America's melting pot serves us well. We are a richly diverse nation—multiracial, multicultural and multi-ethnic, a composite of virtually every society on the globe.

We also have more experience than the rest of the world in delivering services. Most of our workers are already in the sector, where they've been dealing directly with other people, not with machinery or the land. The combination of diversity and experience puts us ahead of most other countries in the ability to deliver services to a global marketplace.

In the 1930s, economists Eli Heckscher and Bertil Ohlin refined David Ricardo's theory of comparative advantage and showed that nations tend to export goods and services that intensely use their abundant factors of

production. Countries well endowed with land and other natural resources sell food, minerals, lumber and the like. Countries with ample plants and equipment export steel, machinery and other manufactured goods.

The U.S. has the world's most abundant stock of knowledge. It is, of course, one reason our country has emerged as a large exporter of sophisticated manufactured goods. But knowledge is inherent in our high-value-added services, many of which can now be more easily exported, thanks to today's technology.

### **America's Opportunity**

We live in a world of constant change, where the new and better continually roil the status quo. Firms fail, workers lose their jobs and old ways get left behind by the creation of new products, new industries and new jobs. It's the price of progress. Enduring the economy's constant churning is the only way nations climb the ladder leading to higher-value-added production and rising incomes.

Poor countries stand on the lower rungs. They can move upward by adding physical capital and reallocating resources from agriculture to industry. Rich countries have already climbed to the higher rungs by



shifting their economies toward services. Their best bet for rising even further lies in sharpening their ability to deliver higher-value-added services. The way to do that is through investing in human capital—more and better education, of course, but also learning through work and life experiences.

Domestic demand will continue to fuel America's services industries, but we have an epochal opportunity in the global marketplace. The ability to deliver more services to distant customers comes as global demand surges. If American service providers don't take advantage of the opportunity, others will.

Globalization's critics would have us fear our times. They're looking for ways to slow the integration of the world economy—or stifle it altogether. While it might be wise to mitigate globalization's unwanted side effects, a protectionist backlash risks squandering the benefits and opportunities globalization offers.

Trade surpluses in an array of service industries prove America can compete in a global marketplace. We need to become smarter and even better educated. We need to embrace globalization and recognize the bright prospects for selling our services to the world. It's time to seize the opportunity.

—W. Michael Cox and Richard Alm

## Acknowledgments

"Opportunity Knocks" was written by W. Michael Cox and Richard Alm. The essay is based on research conducted by Cox, senior vice president and chief economist, Federal Reserve Bank of Dallas. Alm is senior economics writer in the Bank's Research Department. Julia K. Carter, a senior economic analyst at the Bank, provided important research assistance on the project.

The authors wish to thank Professor James L. Seale of the University of Florida for providing data and for numerous discussions.

### Exhibit Notes and Data Sources

All consumption and income per capita are adjusted for purchasing power parity.

#### EXHIBITS 1, 2 and 3

James Seale Jr., Anita Regmi and Jason Bernstein (2003), "International Evidence on Food Consumption Patterns," Technical Bulletin no. 1904, U.S. Department of Agriculture, October.

The Conference Board and Groningen Growth and Development Centre, Total Economy Database, January 2007.

World Bank, World Development Indicators database.

Bureau of Economic Analysis (BEA), national economic accounts, for GDP chain price index.

International Monetary Fund (IMF), World Economic Outlook, October 2007.

Central Intelligence Agency (CIA), *The World Factbook 2007*.

Exhibit 1: Luxembourg is excluded because its per capita GDP of \$53,074 is too high to be plotted on the scale. Food includes food at home, beverages and tobacco. Housing includes rent and utilities. Household operations includes furniture and maintenance. Medical includes foreign patients treated at U.S. hospitals. Education includes foreign students in the U.S.

Exhibit 2: The chart excludes Madagascar, Malawi, Tanzania, Zambia and Zimbabwe, whose recreation elasticities are too high to be plotted on the scale used. Luxembourg is not shown because its income is too high to be plotted.

Exhibit 3: Authors' calculations.

#### EXHIBIT 4

BEA, international economic accounts, for international services, and national economic accounts, for GDP chain price index.

#### EXHIBIT 5

BEA, national economic accounts, for GDP chain price indexes.

#### EXHIBIT 6

BEA, national economic accounts, for exports and GDP chain price index.

#### EXHIBIT 7

BEA, international economic accounts, for international services.

#### EXHIBIT 8

World Bank, World Development Indicators database.

CIA, *The World Factbook 2007*.

#### EXHIBIT 9

Bureau of Labor Statistics (BLS), Current Employment Statistics, 1990–2007; Occupational Employment Statistics, May 2006.

World Bank, World Development Indicators database.

CIA, *The World Factbook 2007*.

#### EXHIBIT 10

BLS, Occupational Employment Statistics, May 2006. The jobs are classified in the service or goods sector based on the industry, not the work the job entails.

**NOTE:** The photo on page 12 is representational only; it does not depict an actual event at Methodist Healthcare System.



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*Chairman and CEO  
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## MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

March 20, 2008

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, Statements of Income and Comprehensive Income, and Statement of Changes in Capital as of December 31, 2007 (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 Federal Reserve Banks* ("Manual"), and as such, include amounts, some of which are based on management judgments and estimates. 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 establishing and maintaining effective internal control over financial reporting as it relates to the Financial Statements. Such internal control is designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of the Financial Statements in accordance with the Manual. Internal control contains self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in internal control are reported to management and appropriate corrective measures are implemented.

Even effective internal control, 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. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The management of the FRBD assessed its internal control over financial reporting 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. Based on this assessment, we believe that the FRBD maintained effective internal control over financial reporting as it relates to the Financial Statements.

Federal Reserve Bank of Dallas



President



First Vice President



Principal Financial Officer

## 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, 2006, and the related statements of income and changes in capital for the year 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 audit.

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

As described 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*, which is 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, 2006, and the results of its operations for the year then ended, on the basis of accounting described in Note 3.

*PricewaterhouseCoopers LLP*

March 12, 2007

## REPORT OF INDEPENDENT AUDITORS (continued)

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 statement of condition of the Federal Reserve Bank of Dallas ("FRB Dallas") as of December 31, 2007, and the related statements of income and comprehensive income and changes in capital for the year then ended, which have been prepared in conformity with accounting principles established by the Board of Governors of the Federal Reserve System. We also have audited the internal control over financial reporting of FRB Dallas as of December 31, 2007, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRB Dallas's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management Assertion*. Our responsibility is to express an opinion on these financial statements and an opinion on FRB Dallas's internal control over financial reporting based on our audit. The financial statements of FRB Dallas for the year ended December 31, 2006, were audited by other auditors whose report, dated March 12, 2007, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

FRB Dallas's internal control over financial reporting is a process designed by, or under the supervision of, FRB Dallas's principal executive and principal financial officers, or persons performing similar functions, and effected by FRB Dallas's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System. FRB Dallas's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of FRB Dallas; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System, and that receipts and expenditures of FRB Dallas are being made only in accordance with authorizations of management and directors of FRB Dallas; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of FRB Dallas's

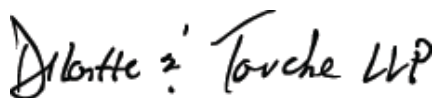
## REPORT OF INDEPENDENT AUDITORS (continued)

assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As described in Note 3 to the financial statements, FRB Dallas has prepared these financial statements in conformity with accounting principles established by the Board of Governors of the Federal Reserve System, as set forth in the *Financial Accounting Manual for Federal Reserve Banks*, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The effects on such financial statements of the differences between the accounting principles established by the Board of Governors of the Federal Reserve System and accounting principles generally accepted in the United States of America are also described in Note 3.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of FRB Dallas as of December 31, 2007, and the results of its operations for the year then ended, on the basis of accounting described in Note 3. Also, in our opinion, FRB Dallas maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.



March 20, 2008

## Statements of Condition (in millions)

	December 31, 2007	December 31, 2006
<b>ASSETS</b>		
Gold certificates	\$ 613	\$ 575
Special drawing rights certificates	98	98
Coin	130	81
Items in process of collection	126	348
Loans to depository institutions	1,400	—
Securities purchased under agreements to resell	2,043	—
U.S. government securities, net	32,760	35,168
Investments denominated in foreign currencies	653	236
Accrued interest receivable	281	302
Interdistrict settlement account	—	3,537
Bank premises and equipment, net	287	294
Other assets	28	25
	<u>\$ 38,419</u>	<u>\$ 40,664</u>
<b>LIABILITIES AND CAPITAL</b>		
<b>Liabilities</b>		
Federal Reserve notes outstanding, net	\$ 32,411	\$ 37,759
Securities sold under agreements to repurchase	1,933	1,329
Deposits:		
Depository institutions	635	704
Other deposits	1	1
Deferred credit items	129	306
Interest on Federal Reserve notes due U.S. Treasury	59	37
Interdistrict settlement account	2,425	—
Accrued benefit costs	86	91
Other liabilities	14	13
	<u>37,693</u>	<u>40,240</u>
<b>Capital</b>		
Capital paid-in	363	212
Surplus (including accumulated other comprehensive loss of \$15 million and \$28 million at December 31, 2007 and 2006, respectively)	363	212
	<u>726</u>	<u>424</u>
<b>Total capital</b>	<u>726</u>	<u>424</u>
<b>Total liabilities and capital</b>	<u>\$ 38,419</u>	<u>\$ 40,664</u>

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

## Statements of Income and Comprehensive Income (in millions)

### INTEREST INCOME

Interest on U.S. government securities	
Interest on securities purchased under agreements to resell	
Interest on investments denominated in foreign currencies	
Interest on loans to depository institutions	

#### Total interest income

### INTEREST EXPENSE

Interest expense on securities sold under agreements to repurchase	
--	--

#### Net interest income

### OTHER OPERATING INCOME

Compensation received for services provided	
Reimbursable services to government agencies	
Foreign currency gains, net	
Other income	

#### Total other operating income

### OPERATING EXPENSES

Salaries and other benefits	
Occupancy expense	
Equipment expense	
Assessments by the Board of Governors	
Other expenses	

#### Total operating expenses

### Net income prior to distribution

Change in funded status of benefit plans	
--	--

### Comprehensive income prior to distribution

### DISTRIBUTION OF COMPREHENSIVE INCOME

Dividends paid to member banks	
Transferred to surplus and change in accumulated other comprehensive loss	
Payments to U.S. Treasury as interest on Federal Reserve notes	

#### Total distribution

### FOR THE YEARS ENDED

December 31, 2007

December 31, 2006

\$ 1,711	\$ 1,621
63	—
8	4
2	—
<u>1,784</u>	<u>1,625</u>

75	61
<u>1,709</u>	<u>1,564</u>

47	60
15	14
27	14
5	3
<u>94</u>	<u>91</u>

117	112
22	20
12	12
35	29
51	59
<u>237</u>	<u>232</u>

<u>1,566</u>	<u>1,423</u>
--------------	--------------

13	—
<u>1,579</u>	<u>1,423</u>

<u>\$ 1,579</u>	<u>\$ 1,423</u>
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\$ 17	\$ 12
151	87
1,411	1,324
<u>\$ 1,579</u>	<u>\$ 1,423</u>

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



**Statements of Changes in Capital  
for the Years Ended December 31, 2007,  
and December 31, 2006  
(in millions)**

	Capital Paid-In	Surplus			Total Capital
		Net Income Retained	Accumulated Other Comprehensive Loss	Total Surplus	
<b>BALANCE AT JANUARY 1, 2006</b> <b>(3.1 million shares)</b>	\$ 153	\$ 153	\$ —	\$ 153	\$ 306
Net change in capital stock issued (1.1 million shares)	59	—	—	—	59
Transferred to surplus	—	87	—	87	87
Adjustment to initially apply SFAS No. 158	—	—	(28)	(28)	(28)
<b>BALANCE AT DECEMBER 31, 2006</b> <b>(4.2 million shares)</b>	\$ 212	\$ 240	\$ (28)	\$ 212	\$ 424
Net change in capital stock issued (3.1 million shares)	151	—	—	—	151
Transferred to surplus and change in accumulated other comprehensive loss	—	138	13	151	151
<b>BALANCE AT DECEMBER 31, 2007</b> <b>(7.3 million shares)</b>	<b>\$ 363</b>	<b>\$ 378</b>	<b>\$ (15)</b>	<b>\$ 363</b>	<b>\$ 726</b>

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 is exercised by a board of directors. The Federal Reserve Act specifies the composition of the board of directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors of the Federal Reserve System (“Board of Governors”) to represent the public, 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 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 Reserve Banks perform a variety of services and operations. Functions include participation in formulating and conducting monetary policy; participation in the payments system, including large-dollar transfers of funds, automated clearinghouse (“ACH”) operations, and check collection; distribution of coin and currency; performance of fiscal agency functions for the U.S. Treasury, certain federal agencies, and other entities; serving as the federal government’s bank; provision of short-term loans to depository institutions; service to the consumer and the community by providing educational materials and information regarding consumer laws; and supervision of bank holding companies, state member banks, and U.S. offices of foreign banking organizations. Certain services are provided to foreign and international monetary authorities, primarily by the FRBNY.

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. The FRBNY is authorized and directed by the FOMC to conduct operations in domestic markets, including the 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. The FRBNY executes these open market transactions at the direction of the FOMC and holds the resulting securities and agreements in the portfolio known as the System Open Market Account (“SOMA”).

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System’s central bank responsibilities. The FRBNY is authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange (“FX”) and securities contracts for, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements (“FX swaps”) with four 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, the FRBNY may enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their 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 the 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 operations and product or function 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, the 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; National Examination Data System; Desktop Standardization Initiative; Payment Application Modernization; Lawson Central Business Administration Function; Accounts, Risk and Credit System; and *Go Direct*<sup>®</sup>.

### 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 accounting standard-setting bodies. The Board of Governors has developed specialized accounting principles and practices that it considers to be appropriate for the nature and function of a central bank, which differ significantly from those of 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 of the 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 generally accepted accounting principles 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 securities holdings at amortized cost, rather than using the fair value presentation required by GAAP. 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. Amortized cost more appropriately reflects the Bank's securities holdings given the System's 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 securities 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 decisions related to policy or open market activities.

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 Reserve Banks' unique powers and responsibilities. A Statement of Cash Flows, therefore, would not provide additional meaningful information. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income and Comprehensive 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, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reporting period. Actual results

could differ from those estimates. Unique accounts and significant accounting policies are explained below.

**a. Gold 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. The 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 reduced. 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.

SDR certificates 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. SDR certificates 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. When SDR certificates are issued to the Reserve Banks, 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 each Reserve Bank’s Federal Reserve notes outstanding at the end of the preceding year. There were no SDR transactions in 2007 or 2006.

**b. Loans to Depository Institutions**

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. The Bank offers three discount window programs to depository institutions: primary credit, secondary credit, and seasonal credit, each with its own interest rate. 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 and determination by the Board of Governors.

In addition, depository institutions that are eligible to borrow under the Reserve Bank’s primary credit program are also eligible to participate in the temporary term auction facility (“TAF”) program. Under the TAF program, the Reserve Banks conduct auctions for a fixed amount of funds, with the interest rate determined by the auction process, subject to a minimum bid rate. All advances under the TAF must be fully collateralized.

Outstanding 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.

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

Interest income on U.S. government securities and investments denominated in foreign currencies comprising the SOMA 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, net” in the Statements of Income and Comprehensive Income.

Activity related to U.S. government securities, including the 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 the interdistrict settlement account that occurs in April of each year. The settlement also equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding in each District. Activity related to investments denominated in foreign currencies 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. Securities Purchased Under Agreements to Resell, Securities Sold Under Agreements to Repurchase, and Securities Lending**

The FRBNY may engage in tri-party purchases of securities under agreements to resell ("tri-party agreements"). Tri-party agreements are conducted with two commercial custodial banks that manage the clearing and settlement of collateral. Collateral is held in excess of the contract amount. Acceptable collateral under tri-party agreements primarily includes U.S. government securities, pass-through mortgage securities of the Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Association, STRIP securities of the U.S. government, and "stripped" securities of other government agencies. The tri-party agreements are accounted for as financing transactions, with the associated interest income accrued over the life of the agreement.

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 reported in the Statements of Condition at their contractual amounts, and the related accrued interest payable is reported as a component of "Other liabilities."

U.S. government securities held in the SOMA are lent to U.S. government securities dealers 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 a fee for borrowing securities, and the fees are reported as a component of "Other income."

Activity related to securities sold under agreements to repurchase and securities lending is allocated to each of the Reserve Banks on a percentage basis derived from an annual settlement of the interdistrict settlement account. On February 15, 2007, the FRBNY began allocating to the other Reserve Banks the activity related to securities purchased under agreements to resell.

**e. FX Swap Arrangements and Warehousing Agreements**

FX swap arrangements are contractual agreements between two parties, the FRBNY and an authorized foreign central bank, whereby the parties agree to exchange their currencies up to a prearranged 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 support its international operations and give the authorized foreign central bank temporary access to dollars. Drawings under the FX swap arrangements can be initiated by either party and must be agreed to by the other party. The FX swap arrangements are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. Foreign currencies received pursuant to these agreements are reported as a component of "Investments denominated in foreign currencies" in the Statements of Condition.

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.

FX swap arrangements 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 recorded by FRBNY and not allocated 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 the estimated useful lives of the assets, which range from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are depreciated over the remaining useful life of the asset or, if appropriate, over the unique useful life of the alteration, renovation, or improvement. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred.

Costs incurred for software during the application development stage, either developed internally or acquired for internal use, 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. Maintenance costs related to software are charged to expense in the year incurred.

Capitalized assets including software, buildings, leasehold improvements, furniture, and equipment are impaired when events or changes in circumstances indicate that the carrying amount of assets or asset groups is not recoverable and significantly exceeds their fair value.

**g. Interdistrict Settlement Account**

At the close of business each day, each Reserve Bank assembles the payments due to or from other Reserve Banks. These payments result from transactions between Reserve Banks and transactions that involve depository institution accounts held by other Reserve Banks, such as Fedwire funds and securities transfers, and check and ACH transactions. 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 and their designees) to the Reserve Banks upon deposit with such agents of specified 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 at least equal to the sum of the notes applied for by such Reserve Bank.

Assets eligible to be pledged as collateral security include all of the Bank’s assets. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, for which the 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 issued to 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, Federal Reserve notes are obligations of the United States government. At December 31, 2007, all Federal Reserve notes issued to the Reserve Banks were fully collateralized.

“Federal Reserve notes outstanding, net” in the Statements of Condition represents the Bank’s Federal Reserve notes outstanding, reduced by the Bank’s currency holdings of \$24,860 million and \$19,391 million at December 31, 2007 and 2006, respectively.

**i. Items in Process of Collection and Deferred Credit Items**

Items in process of collection in the Statements of Condition primarily represents amounts attributable to checks that have been deposited for collection and that, as of the balance sheet date, have not yet been presented to the paying bank. 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 vary significantly.

**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. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

By law, each Reserve 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. To reflect the Federal Reserve

Act requirement that annual dividends are deducted from net earnings, dividends are presented as a distribution of comprehensive income in the Statements of Income and Comprehensive Income.

**k. Surplus**

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31 of each year. 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.

Accumulated other comprehensive income is reported as a component of surplus in the Statements of Condition and the Statements of Changes in Capital. The balance of accumulated other comprehensive income is comprised of expenses, gains, and losses related to defined benefit pension plans and other postretirement benefit plans that, under accounting standards, are included in other comprehensive income but excluded from net income. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 9 and 10.

The Bank initially applied the provisions of SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, at December 31, 2006. This accounting standard requires recognition of the overfunded or underfunded status of a defined benefit postretirement plan in the Statements of Condition, and recognition of changes in the funded status in the years in which the changes occur through comprehensive income. The transition rules for implementing the standard required applying the provisions as of the end of the year of initial implementation, and the effect as of December 31, 2006, is recorded as "Adjustment to initially apply SFAS No. 158" in the Statements of Changes in Capital.

**l. Interest on Federal Reserve Notes**

The Board of Governors requires the Reserve Banks to transfer excess earnings to the U.S. Treasury as interest on Federal Reserve notes, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. This amount is reported as "Payments to U.S. Treasury as interest on Federal Reserve notes" in the Statements of Income and Comprehensive Income and is reported as a liability, or as an asset if overpaid during the year, in the Statements of Condition. Weekly payments to the U.S. Treasury may vary significantly.

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.

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.

**m. 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. During the years ended December 31, 2006 and 2007, the Bank was reimbursed for all services provided to the Department of the Treasury.

**n. Compensation Received for Services Provided**

The Federal Reserve Bank of Atlanta ("FRBA") has overall responsibility for managing the Reserve Banks' provision of check and ACH services to depository institutions, and, as a result, recognizes total System revenue for these services on its Statements of Income and Comprehensive Income. Similarly, the FRBNY manages the Reserve Banks' provision of Fedwire funds and securities transfer services and recognizes total System revenue for these services on its Statements of Income and Comprehensive Income. The FRBA and FRBNY compensate the other Reserve Banks for the costs incurred to provide these services. The Bank reports this compensation as "Compensation received for services provided" in the Statements of Income and Comprehensive Income.

**o. 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 as of December 31 of the prior year. The Board of Governors also assesses each Reserve Bank for the expenses incurred for the U.S. Treasury to prepare 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 prior year.

**p. 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, 2007 and 2006, respectively, and are reported as a component of "Occupancy expense."

**q. Restructuring Charges**

The Reserve Banks recognize restructuring charges for exit or disposal costs incurred as part of the closure of business activities in a particular location, the relocation of business activities from one location to another, or a fundamental reorganization that affects the nature of operations. Restructuring charges may include costs associated with employee separations, contract terminations, and asset impairments. Expenses are recognized in the period in which the Bank commits to a formalized restructuring plan or executes the specific actions contemplated in the plan and all criteria for financial statement recognition have been met.

Note 11 describes the Bank's restructuring initiatives and provides information about the costs and liabilities associated with employee separations and contract terminations. The costs associated with the impairment of certain of the Bank's assets are discussed in Note 6. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all of the Reserve Banks are recorded on the books of the FRBNY.

**r. Recently Issued Accounting Standards**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ("SFAS No. 157"). SFAS No. 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and expands on required disclosures about fair value measurement. SFAS No. 157 is generally effective for the Bank on January 1, 2008, though the effective date of some provisions is January 1, 2009. The provisions of SFAS No. 157 will be applied prospectively and are not expected to have a material effect on the Bank's financial statements.

**4. U.S. GOVERNMENT SECURITIES, SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL, 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 4.394 percent and 4.488 percent at December 31, 2007 and 2006, respectively.

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

	2007	2006
Par value:		
U.S. government		
Bills	\$ 10,010	\$ 12,432
Notes	17,653	18,058
Bonds	4,877	4,467
Total par value	32,540	34,957
Unamortized premiums	351	391
Unaccreted discounts	(131)	(180)
<b>Total allocated to the Bank</b>	<b>\$ 32,760</b>	<b>\$ 35,168</b>

At December 31, 2007 and 2006, the fair value of the U.S. government securities allocated to the Bank, excluding accrued interest, was \$34,145 million and \$35,719 million, respectively, as determined by reference to quoted prices for identical securities.

The total of the U.S. government securities, net, held in the SOMA was \$745,629 million and \$783,619 million at December 31, 2007 and 2006, respectively. At December 31, 2007 and 2006, the fair value of the U.S. government securities held in the SOMA, excluding accrued interest, was \$777,141 million and \$795,900 million, respectively, as determined by reference to quoted prices for identical securities.



Although the fair value of security holdings can be substantially greater or less than the recorded value at any point in time, these unrealized gains or losses have no effect on the ability of the Reserve Banks, as central bank, to meet their financial obligations and responsibilities, and should not be misunderstood as representing a risk to the Reserve Banks, their shareholders, or the public. The fair value is presented solely for informational purposes.

Financial information related to securities purchased under agreements to resell and securities sold under agreements to repurchase for the year ended December 31, 2007, was as follows (in millions):

	Securities Purchased Under Agreements to Resell	Securities Sold Under Agreements to Repurchase
Allocated to the Bank:		
Contract amount outstanding, end of year	\$ 2,043	\$ 1,933
Weighted average amount outstanding, during year	1,541	1,531
Maximum month-end balance outstanding, during year	2,263	1,933
Securities pledged, end of year		1,935
System total:		
Contract amount outstanding, end of year	\$ 46,500	\$ 43,985
Weighted average amount outstanding, during year	35,073	34,846
Maximum month-end balance outstanding, during year	51,500	43,985
Securities pledged, end of year		44,048

At December 31, 2006, the total contract amount of securities sold under agreements to repurchase was \$29,615 million, of which \$1,329 million was allocated to the Bank. The total par value of SOMA securities that were pledged for securities sold under agreements to repurchase at December 31, 2006, was \$29,676 million, of which \$1,332 million was allocated to the Bank.

The contract amounts for securities purchased under agreements to resell and securities sold under agreements to repurchase approximate fair value.

The maturity distribution of U.S. government securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2007, was as follows (in millions):

	U.S. Government Securities (Par value)	Securities Purchased Under Agreements to Resell (Contract amount)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	\$ 1,199	\$ 2,043	\$ 1,933
16 days to 90 days	6,579	—	—
91 days to 1 year	6,690	—	—
Over 1 year to 5 years	10,569	—	—
Over 5 years to 10 years	3,601	—	—
Over 10 years	3,902	—	—
<b>Total allocated to the Bank</b>	<b>\$ 32,540</b>	<b>\$ 2,043</b>	<b>\$ 1,933</b>

At December 31, 2007 and 2006, U.S. government securities with par values of \$16,649 million and \$6,855 million, respectively, were loaned from the SOMA, of which \$732 million and \$308 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 with 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 issuing foreign governments.

The Bank's allocated share of investments denominated in foreign currencies was approximately 1.382 percent and 1.154 percent at December 31, 2007 and 2006, respectively.

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

	2007	2006
European Euro:		
Foreign currency deposits	\$ 380	\$ 72
Securities purchased under agreements to resell	35	25
Government debt instruments	64	47
Japanese Yen:		
Foreign currency deposits	39	30
Government debt instruments	79	62
Swiss Franc:		
Foreign currency deposits	56	—
<b>Total allocated to the Bank</b>	<b>\$ 653</b>	<b>\$ 236</b>

At December 31, 2007, the total amount of foreign currency deposits held under foreign exchange contracts was \$24,381 million, of which \$337 million was allocated to the Bank. At December 31, 2006, there were no open foreign exchange contracts.

At December 31, 2007 and 2006, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was \$653 million and \$236 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government securities discussed in Note 4, unrealized gains or losses have no effect on the ability of a Reserve Bank, as central bank, to meet its financial obligations and responsibilities.

Total System investments denominated in foreign currencies were \$47,295 million and \$20,482 million at December 31, 2007 and 2006, respectively. At December 31, 2007 and 2006, the fair value of the total System investments denominated in foreign currencies, including accrued interest, was \$47,274 million and \$20,434 million, respectively.

The maturity distribution of investments denominated in foreign currencies that were allocated to the Bank at December 31, 2007, was as follows (in millions):

	European Euro	Japanese Yen	Swiss Franc	Total
Within 15 days	\$ 69	\$ 41	\$ —	\$ 110
16 days to 90 days	319	6	56	381
91 days to 1 year	38	28	—	66
Over 1 year to 5 years	53	43	—	96
Over 5 years to 10 years	—	—	—	—
Over 10 years	—	—	—	—
<b>Total allocated to the Bank</b>	<b>\$ 479</b>	<b>\$ 118</b>	<b>\$ 56</b>	<b>\$ 653</b>

At December 31, 2007 and 2006, the authorized warehousing facility was \$5,000 million, with no balance outstanding.

## 6. BANK PREMISES, EQUIPMENT, AND SOFTWARE

Bank premises and equipment at December 31 are as follows (in millions):

	2007	2006
Bank premises and equipment:		
Land	\$ 61	\$ 60
Buildings	227	222
Building machinery and equipment	37	36
Construction in progress	—	2
Furniture and equipment	74	75
Subtotal	399	395
Accumulated depreciation	(112)	(101)
<b>Bank premises and equipment, net</b>	<b>\$ 287</b>	<b>\$ 294</b>
<b>Depreciation expense, for the year ended December 31</b>	<b>\$ 14</b>	<b>\$ 13</b>

The Bank leases space to outside tenants with remaining lease terms ranging from one to nine years. Rental income from such leases was \$1 million and \$174 thousand for the years ended December 31, 2007 and 2006, respectively, and is reported as a component of “Other income.” Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2007, are as follows (in thousands):

2008	\$ 1,594
2009	1,594
2010	1,597
2011	1,600
2012	1,456
Thereafter	4,462
<b>Total</b>	<b>\$ 12,303</b>

The Bank has capitalized software assets, net of amortization, of \$4 million and \$6 million at December 31, 2007 and 2006, respectively. Amortization expense was \$2 million for each of the years ended December 31, 2007 and 2006. Capitalized software assets are reported as a component of “Other assets” and the related amortization is reported as a component of “Other expenses.”

## 7. COMMITMENTS AND CONTINGENCIES

At December 31, 2007, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from one to approximately three years. These leases provide for increased rental payments based upon increases in real estate taxes and operating costs.

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 \$287 thousand and \$212 thousand for the years ended December 31, 2007 and 2006, 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, 2007, were not material.

At December 31, 2007, there were no material unrecorded unconditional purchase commitments or long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve

Banks. Losses are borne in the ratio of a Reserve Bank's capital paid-in 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 the agreement at December 31, 2007 or 2006.

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 Reserve Bank officers participate in the Supplemental Employee Retirement Plan ("SERP").

The System Plan provides retirement benefits to employees of the Federal Reserve Banks, the Board of Governors, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. The FRBNY, on behalf of the System, recognizes the net assets and costs associated with the System Plan in its financial statements. Costs associated with the System Plan are not redistributed to other participating employers.

The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2007 and 2006, and for the years then ended, were 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 \$4 million for each of the years ended December 31, 2007 and 2006, respectively, and are reported as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income. The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2007 and 2006, 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 the beginning and ending balances of the benefit obligation (in millions):

	2007	2006
Accumulated postretirement benefit obligation at January 1	\$ 82.9	\$ 67.5
Service cost-benefits earned during the period	3.3	2.1
Interest cost on accumulated benefit obligation	5.0	4.0
Net actuarial loss (gain)	(10.6)	12.1
Contributions by plan participants	1.2	1.0
Benefits paid	(4.2)	(4.0)
Medicare Part D subsidies	0.2	0.2
<b>Accumulated postretirement benefit obligation at December 31</b>	<b>\$ 77.8</b>	<b>\$ 82.9</b>

At December 31, 2007 and 2006, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 6.25 percent and 5.75 percent, respectively.

Discount rates reflect yields available on high-quality corporate bonds that would generate the cash flows 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):

	2007	2006
<b>Fair value of plan assets at January 1</b>	\$ —	\$ —
Contributions by the employer	2.8	2.8
Contributions by plan participants	1.2	1.0
Benefits paid, net of Medicare Part D subsidies	(4.0)	(3.8)
<b>Fair value of plan assets at December 31</b>	<b>\$ —</b>	<b>\$ —</b>
<b>Unfunded obligation and accrued postretirement benefit cost</b>	<b>\$ 77.8</b>	<b>\$ 82.9</b>
Amounts included in accumulated other comprehensive loss are shown below:		
Prior service cost	\$ 2.3	\$ 2.7
Net actuarial loss	(17.0)	(31.0)
<b>Total accumulated other comprehensive loss</b>	<b>\$(14.7)</b>	<b>\$(28.3)</b>

Accrued postretirement benefit costs are reported as a component of "Accrued benefit costs" in the Statements of Condition.

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

	2007	2006
Health care cost trend rate assumed for next year	8.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2013	2012

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, 2007 (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	\$ 1.4	\$ (1.2)
Effect on accumulated postretirement benefit obligation	10.4	(8.6)

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

	2007	2006
Service cost-benefits earned during the period	\$ 3.3	\$ 2.1
Interest cost on accumulated benefit obligation	5.0	4.0
Amortization of prior service cost	(0.4)	(0.4)
Amortization of net actuarial loss	3.4	1.8
<b>Net periodic postretirement benefit expense</b>	<b>\$ 11.3</b>	<b>\$ 7.5</b>

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense (credit) in 2008 are shown below:

Prior service cost	\$ (0.4)
Net actuarial loss	1.3
<b>Total</b>	<b>\$ 0.9</b>

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2007 and 2006, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.75 percent and 5.50 percent, respectively.

Net periodic postretirement benefit expense is reported as a component of “Salaries and other benefits” in the Statements of Income and Comprehensive Income.

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 under 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 gain in the accumulated postretirement benefit obligation and net periodic postretirement benefit expense.

There were no receipts of federal Medicare Part D subsidies in the year ended December 31, 2006. Receipts in the year ending December 31, 2007, related to benefits paid in the years ended December 31, 2006 and 2007, were \$0.2 million, respectively. Expected receipts in 2008, related to benefits paid in the year ended December 31, 2007, are \$0.1 million.

Following is a summary of expected postretirement benefit payments (in millions):

	Without Subsidy	With Subsidy
2008	\$ 4.0	\$ 3.7
2009	4.4	4.1
2010	4.9	4.5
2011	5.3	4.9
2012	5.7	5.2
2013–2017	33.9	30.5
<b>Total</b>	<b>\$ 58.2</b>	<b>\$ 52.9</b>

#### Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 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 were \$7 million for each of the years ended December 31, 2007 and 2006. This cost is included as a component of “Accrued benefit costs” in the Statements of Condition. Net periodic postemployment benefit expense included in operating expenses were \$1 million for each of the years ended December 31, 2007 and 2006, and are recorded as a component of “Salaries and other benefits” in the Statements of Income and Comprehensive Income.

**10. ACCUMULATED OTHER COMPREHENSIVE INCOME AND OTHER COMPREHENSIVE INCOME**

Following is a reconciliation of beginning and ending balances of accumulated other comprehensive loss (in millions):

	Amount Related to Postretirement Benefits Other Than Pensions
<b>Balance at January 1, 2006</b>	\$ —
Adjustment to initially apply SFAS Statement No. 158	(28)
<b>Balance at December 31, 2006</b>	<b>\$ (28)</b>
Change in funded status of benefit plans:	
Net actuarial gain arising during the year	11
Amortization of prior service cost	(1)
Amortization of net actuarial loss	3
Change in funded status of benefit plans—other comprehensive income	13
<b>Balance at December 31, 2007</b>	<b>\$ (15)</b>

Additional detail regarding the classification of accumulated other comprehensive loss is included in Note 9.

**11. BUSINESS RESTRUCTURING CHARGES****2006 Restructuring Plans**

In 2006, the Bank announced plans for restructuring to streamline its Houston operations and reduce costs. There were no costs in 2007 incurred by the Bank for restructuring plans.

Following is a summary of financial information related to the restructuring plans (in millions):

	2006 Restructuring Plans
Information related to restructuring plans as of December 31, 2007:	
Total expected costs related to restructuring activity	\$ 1.0
Expected completion date	2008
Reconciliation of liability balances:	
<b>Balance at January 1, 2006</b>	<b>\$ —</b>
Total charges	1.0
<b>Balance at December 31, 2006</b>	<b>\$ 1.0</b>
Adjustments	(0.3)
Payments	(0.5)
<b>Balance at December 31, 2007</b>	<b>\$ 0.2</b>

Employee separation costs are primarily severance costs for identified staff reductions of approximately 17 associated with the announced restructuring plans in 2006. Separation costs that are provided under terms of ongoing benefit arrangements are recorded based on the accumulated benefit earned by the employee. Separation costs that are provided under the terms of one-time benefit arrangements are generally measured based on the expected benefit as of the termination date and recorded ratably over the period to termination. Restructuring costs related to employee separations

for the year ended December 31, 2006, are reported as a component of “Salaries and other benefits” in the Statements of Income and Comprehensive Income.

Adjustments to the accrued liability are primarily due to changes in the estimated restructuring costs and are shown as a component of the appropriate expense category in the Statements of Income and Comprehensive Income.

Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8.

## **12. SUBSEQUENT EVENTS**

In March 2008, the Board of Governors announced several initiatives to address liquidity pressures in funding markets and promote financial stability, including increasing the term auction facility (see Note 3b) to \$100 billion and initiating a series of term repurchase transactions (see Notes 3d and 4) that may cumulate to \$100 billion. In addition, the Reserve Banks’ securities lending program (see Notes 3d and 4) was expanded to lend up to \$200 billion of Treasury securities to primary dealers for a term of 28 days, secured by federal agency debt, federal agency residential mortgage-backed securities, agency collateralized mortgage obligations, non-agency AAA/Aaa-rated private-label residential mortgage-backed securities, and AAA/Aaa-rated commercial mortgage-backed securities. The FOMC also authorized increases in its existing temporary reciprocal currency arrangements (see Notes 3e and 5) with specific foreign central banks. These initiatives will affect 2008 activity related to loans to depository institutions, securities purchased under agreements to resell, U.S. government securities, net, and investments denominated in foreign currencies, as well as income and expenses. The effects of the initiatives do not require adjustment to the amounts recorded as of December 31, 2007.

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The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2007 was Deloitte & Touche LLP (D&T). Fees for these services totaled \$4.7 million. To ensure auditor independence, the Board of Governors requires that D&T be independent in all matters relating to the audit. Specifically, D&T 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 2007, the Bank did not engage D&T for any material advisory services.

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## Volume of Operations

(UNAUDITED)

	Number of Items Handled (Thousands)		Dollar Amount (Millions)	
	2007	2006	2007	2006
<b>SERVICES TO DEPOSITORY INSTITUTIONS</b>				
<b>CASH SERVICES</b>				
Federal Reserve notes processed	3,041,050	2,970,987	55,830	53,050
Currency received from circulation	3,199,798	3,074,837	55,936	53,304
Coin received from circulation	723,432	738,927	105	81
<b>CHECK PROCESSING</b>				
Commercial—processed	738,826	942,688	902,479	1,052,639
Commercial—fine sorted	4,556	9,563	4,802	8,206
Check 21 forward substitute check— processed	203,037	108,614	360,212	268,258
<b>LOANS</b>				
Advances made	80*	79*	1,654	259

\*Individual loans, not in thousands.



## About the Dallas Fed

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

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

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