
90th Annual Report
2003

Board of Governors of the Federal Reserve System

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Report
2003*



Board of Governors of the Federal Reserve System

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Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., April 2004

THE SPEAKER OF
THE HOUSE OF REPRESENTATIVES

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

This report covers operations of the Board during calendar year 2003.

Sincerely,

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

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*Monetary Policy and
Economic Developments*

Monetary Policy and the Economic Outlook

The economic expansion in the United States gathered strength during 2003 while price inflation remained quite low. At the beginning of the year, uncertainties about the economic outlook and about the prospects of war in Iraq apparently weighed on spending decisions and extended the period of subpar economic performance that had begun more than two years earlier. However, with the support of stimulative monetary and fiscal policies, the nation's economy weathered that period of heightened uncertainty to post a marked acceleration in economic activity over the second half of 2003. Still, slack in resource utilization remained substantial, unit labor costs continued to decline as productivity surged, and core inflation moved lower. The performance of the economy last year further bolstered the case that the faster rate of increase in productivity, which began to emerge in the late 1990s, would persist. The combination of that favorable productivity trend and stimulative macroeconomic policies is likely to sustain robust economic expansion and low inflation in 2004.

At the time of our last *Monetary Policy Report to the Congress*, in July, near-term prospects for U.S. economic activity remained unclear. Although the Federal Open Market Committee (FOMC) believed that policy stimulus and rapid gains in productivity would

eventually lead to a pickup in the pace of the expansion, the timing and extent of the improvement were uncertain. During the spring, the rally that occurred in equity markets when the war-related uncertainties lifted suggested that market participants viewed the economic outlook as generally positive. By then, the restraints imparted by the earlier sharp decline in equity prices, the retrenchment in capital spending, and lapses in corporate governance were receding. As the price of crude oil dropped back and consumer confidence rebounded last spring, household spending seemed to be rising once again at a moderate rate. Businesses, however, remained cautious; although the deterioration in the labor market showed signs of abating, private payroll employment was still declining, and capital spending continued to be weak. In addition, economic activity abroad gave few signs of bouncing back, even though long-term interest rates in major foreign economies had declined sharply. At its June meeting, the FOMC provided additional policy accommodation, given that, as yet, it had seen no clear evidence of an acceleration of U.S. economic activity and faced the possibility that inflation might fall further from an already low level.

During the next several months, evidence was accumulating that the economy was strengthening. The improvement was initially most apparent in financial markets, where prospects for stronger economic activity and corporate earnings gave a further lift to equity prices. Interest rates rose as well, but financial conditions appeared to remain, on net, stimulative to spending, and

NOTE. The discussion here and in the next section ("Economic and Financial Developments in 2003 and Early 2004") consists of the text, tables, and selected charts from the Monetary Policy Report submitted to the Congress on February 11, 2004, pursuant to section 2B of the Federal Reserve Act.

additional impetus from the midyear changes in federal taxes was in train. Over the remainder of the year, in the absence of new shocks to economic activity and with gathering confidence in the durability of the economic expansion, the stimulus from monetary and fiscal policies showed through more readily in an improvement in domestic demand. Consumer spending and residential construction, which had provided solid support for the expansion over the preceding two years, rose more rapidly, and business investment revived. Spurred by the global recovery in the high-tech sector and by a pickup in economic activity abroad, U.S. exports also posted solid increases in the second half of the year. Businesses began to add to their payrolls, but only at a modest pace that implied additional sizable gains in productivity.

The fundamental factors underlying the strengthening of economic activity during the second half of 2003 should continue to promote brisk expansion in 2004. Monetary policy remains accommodative. Financial conditions for businesses are quite favorable: Profits have been rising rapidly, and corporate borrowing costs are at low levels. In the household sector, last year's rise in the value of equities and real estate exceeded the further accumulation of debt by enough to raise the ratio of household net worth to disposable income after three consecutive years of decline. In addition, federal spending and tax policies are slated to remain stimulative during the current fiscal year, while the restraint from the state and local sector should diminish. Lastly, the lower foreign exchange value of the dollar and a sustained economic expansion among our trading partners are likely to boost the demand for U.S. production. Considerable uncertainty, of course, still attends the economic out-

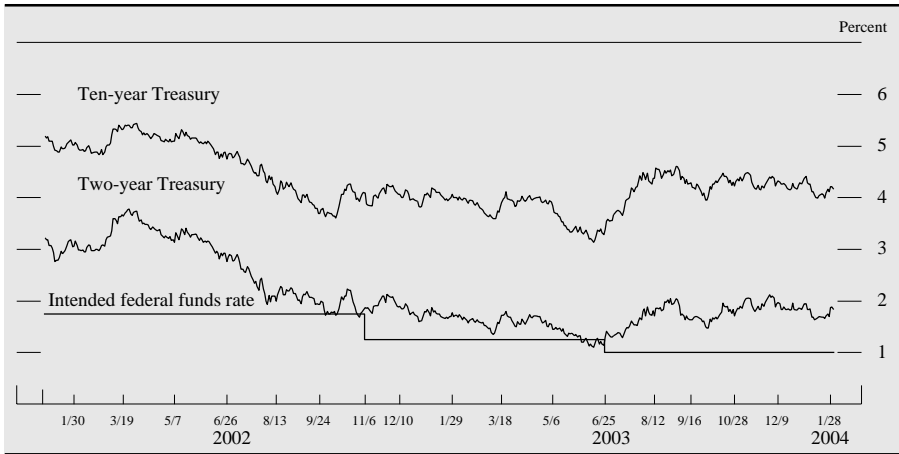
look despite these generally favorable fundamentals. In particular, questions remain as to how willing businesses will be to spend and hire and how durable will be the pickup in economic growth among our trading partners. At its meeting on January 27–28, 2004, the Committee perceived that upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal.

Prospects for sustained high rates of increase in productivity are quite favorable. Businesses are likely to retain their focus on controlling costs and boosting efficiency by making organizational improvements and exploiting investments in new equipment. With the ongoing gains in productivity, the existing margins of slack in resource utilization should recede gradually, and any upward pressure on prices should remain well contained. The FOMC indicated at its January meeting that, with inflation low and resource use still slack, it can be patient in removing its policy accommodation.

Monetary Policy, Financial Markets, and the Economy over 2003 and Early 2004

During the opening months of 2003, the softness in economic conditions was exacerbated by the substantial uncertainty surrounding the onset of war in Iraq. Private nonfarm businesses began again to cut payrolls substantially, consumer spending slowed, and business investment was muted. Although the jump in energy prices pushed up overall inflation, slack in resource utilization and the rapid rise in labor productivity pushed core inflation down. In financial markets, the heightened sense of caution among investors generated safe-haven demands for Treasury and other fixed-

Selected Interest Rates



NOTE. The data are daily and extend through February 4, 2004. The dates on the horizontal axis are those of scheduled FOMC meetings.

income securities, and equity prices declined.

At its meeting on March 18, the FOMC maintained its 1¼ percent target for the federal funds rate to provide support for a stronger economic expansion that appeared likely to materialize. The Committee noted that the prevailing high degree of geopolitical uncertainty complicated any assessment of prospects for the economy, and members refrained from making a determination about the balance of risks with regard to its goals of maximum employment and stable prices. At the same time, the Committee agreed to step up its surveillance of the economy, which took the form of a series of conference calls in late March and early April to consult about developments. When military action in Iraq became a certainty, financial markets began to rally, with risk spreads on corporate debt securities narrowing and broad equity indexes registering notable gains. Economic news, however, remained mixed.

Indicators of the economy at the time of the May 6 FOMC meeting continued

to suggest only tepid growth. Uncertainty in financial markets had declined, and rising consumer confidence and a wave of mortgage refinancing appeared to be supporting consumer spending. However, persistent excess capacity evident in labor and product markets pointed to possible further disinflation. The lifting of some of the uncertainty clouding the economic outlook allowed the Committee to make the determination that the risks to economic growth were balanced but that the probability of an unwelcome substantial fall in inflation exceeded that of a pickup in inflation. The FOMC judged that, taken together, the balance of risks was weighted toward weakness. The Committee left the federal funds rate target at 1¼ percent, but the Committee's announcement prompted a rally in the Treasury market, and coupon yields fell substantially as market participants marked down their expectations for the path of the federal funds rate.

By the time of the June 24–25 FOMC meeting, risk spreads had narrowed further and equity prices had extended their

rise, but the prospects for sustained economic expansion still seemed tentative. Although Committee members referred to signs of improvement in some sectors of the economy, they saw no concrete evidence of an appreciable overall strengthening in the economic expansion and viewed the excess capacity in the economy as likely to keep inflation in check. The Committee lowered the target for the federal funds rate $\frac{1}{4}$ percentage point, to 1 percent, to add further support to the economic expansion and as a form of insurance against a further substantial drop in inflation, however unlikely. The members saw no serious obstacles to further conventional policy ease down to the zero lower bound on nominal interest rates should that prove to be necessary. The Committee also discussed alternative means of providing monetary stimulus should the target federal funds rate be reduced to a point at which they would have little or no latitude for additional easing through this traditional channel.

Longer-term interest rates backed up following the meeting, as investors had apparently placed substantial odds on a policy move larger than 25 basis points and may have been disappointed that the announcement failed to mention any potential “unconventional” monetary policy options. Ten-year Treasury yields rose sharply during the following weeks in reaction to interpretations of the Chairman’s congressional testimony, the release of Committee members’ economic projections, and positive incoming news about the economy and corporate profits. A substantial unwinding of hedging positions related to mortgage investments may well have amplified the upswing in market yields. Over the intermeeting period, labor markets continued to be soft, but industrial production, personal consumption expenditures, and business outlays all

strengthened, and the housing market remained robust. By the time of the August 12 FOMC meeting, members generally perceived a firming in the economy, most encouragingly in business investment spending, and believed that, even after the rise in longer-term rates, financial conditions were still supportive of vigorous economic growth. Given the continued slack in resource use across the economy, however, members saw little risk of inducing higher inflation by leaving the federal funds rate at its accommodative level. On the basis of the economic outlook, and to reassure market participants that policy would not reverse course soon, Committee members decided to include in the announcement a reference to their judgment that under the anticipated circumstances, policy accommodation could be maintained for a “considerable period.”

Through the September 16 and October 28 FOMC meetings, the brightening prospects for future growth put upward pressure on equity prices and longer-term interest rates. The Committee’s retention of the phrase “considerable period” in the announcements following each of these meetings apparently provided an anchor for near-term interest rates. The Committee’s discussion at these two meetings focused on the increased evidence of a broadly based acceleration in economic activity and on the continued weakness in labor markets. Rising industrial production, increased personal consumption and business investment spending, higher profits, receptive financial markets, and a lower foreign exchange value of the dollar all suggested that sustained and robust economic growth was in train. The Committee’s decision to leave the stance of monetary policy unchanged over this period reflected, in part, a continuing confidence that gains in productivity would support economic growth

and suppress inflationary pressures. In fact, the Committee generally viewed its goal of price stability as essentially having been achieved.

By the time of the December 9 FOMC meeting, the economic expansion appeared likely to continue at a rate sufficient to begin to reduce slack in labor and product markets. Equity markets continued to rally, and risk spreads, particularly on the debt of speculative-grade firms, narrowed further. The labor market was finally showing some signs of improvement, and spending by households remained strong even as the impetus from earlier mortgage refinancings and tax cuts began to wane. The acceleration in capital spending and evidence that some firms were beginning to accumulate inventories seemed to signal that business confidence was on the mend. However, twelve-month core consumer price inflation was noticeably lower than in the previous year. Even though the unemployment rate was expected to move down gradually, continued slack in labor and product markets over the near term was viewed as sufficient to keep any nascent inflation subdued. Uncertainty about the pace at which slack would be worked down, however, made longer-run prospects for inflationary pressures difficult to gauge. Given the better outlook for sustained economic growth, the possibility of pernicious deflation associated with a pronounced softening in real activity was seen as even more remote than it had been earlier in the year. The Committee indicated that keeping policy accommodative for a considerable period was contingent on its expectation that inflation would remain low and that resource use would remain slack.

At its meeting on January 27–28, 2004, the Committee viewed a self-sustaining economic expansion as even more likely. Members drew particular

reassurance from reports of plans for stronger capital spending and the widespread distribution of increased activity across regions. Accommodative financial market conditions, including higher equity prices, narrower risk spreads on bonds, and eased standards on business loans, also seemed supportive of economic expansion. However, some risks remained in light of continued lackluster hiring evidenced by the surprisingly weak December payroll employment report. With the likelihood for rapid productivity growth seemingly more assured, Committee members generally agreed that inflation pressures showed no sign of increasing and that a bit more disinflation was possible. Under these circumstances, the Committee concluded that current conditions allowed monetary policy to remain patient. As to the degree of policy accommodation, the Committee left its target for the federal funds rate unchanged. The Committee's characterization that policy could be patient instead of its use of the phrase "considerable period" in its announcement prompted a rise in Treasury yields across the yield curve and a fall in equity prices.

Economic Projections for 2004

Federal Reserve policymakers expect that the economic expansion will continue at a brisk pace in 2004. The central tendency of the forecasts of the change in real gross domestic product made by the members of the Board of Governors and the Federal Reserve Bank presidents is 4½ percent to 5 percent, measured from the final quarter of 2003 to the final quarter of 2004. The full range of these forecasts is somewhat wider—from 4 percent to 5½ percent. The FOMC participants anticipate that the projected increase in real economic activity will be associated with a further

Economic Projections for 2004

Percent

Indicator	MEMO: 2003 actual	Federal Reserve Governors and Reserve Bank presidents	
		Range	Central tendency
<i>Change, fourth quarter to fourth quarter¹</i>			
Nominal GDP	5.9	5½–6½	5½–6¼
Real GDP	4.3	4–5½	4½–5
PCE chain-type price index	1.4	1–1½	1–1¼
<i>Average level, fourth quarter</i>			
Civilian unemployment rate	5.9	5¼–5½	5¼–5½

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

gradual decline in the unemployment rate. They expect that the unemployment rate, which has averaged 5¾ percent in recent months, will be between 5¼ percent and 5½ percent in the fourth quarter of the year. With rapid increases in productivity likely to be sustained and inflation expectations stable, Federal Reserve policymakers anticipate

that inflation will remain quite low this year. The central tendency of their forecasts for the change in the chain-type price index for personal consumption expenditures (PCE) is 1 percent to 1¼ percent; this measure of inflation was 1.4 percent over the four quarters of 2003. ■

Economic and Financial Developments in 2003 and Early 2004

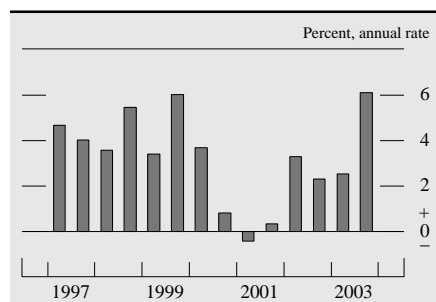
The pace of economic expansion strengthened considerably in the second half of 2003 after almost two years of uneven and, on balance, sluggish growth. In early 2003, accommodative monetary policy and stimulative fiscal policies were in place, but economic activity still seemed to be weighed down by a number of factors that had restrained the recovery earlier: Geopolitical tensions were again heightened, this time by the impending war in Iraq, businesses remained unusually cautious about the strength of the expansion, and economic activity abroad was still weak. In June the continued lackluster economic growth and a further downshift in inflation from an already low level prompted a further reduction in the federal funds rate. In addition, the tax cuts that became effective at midyear provided a significant boost to disposable income. In the succeeding months, the macroeconomic stimulus began to show through clearly in sales and production, and some of the business caution

seemed to recede. Real GDP increased at an annual rate of 6 percent, on average, in the third and fourth quarters of last year. In contrast, between late 2001 and mid-2003, real GDP had risen at an annual rate of only 2½ percent.

During the period of recession and subpar economic expansion, considerable slack developed in labor and product markets. The firming of economic activity in the second half of last year produced modest increases in rates of resource utilization. Sustained efforts by businesses to control costs led to further rapid gains in productivity. As a result, unit labor costs declined, and core rates of inflation continued to slow in 2003; excluding food and energy, the PCE chain-type price index increased just 0.9 percent last year. Measures of overall inflation, which were boosted by movements in food and energy prices, were higher than those for core inflation.

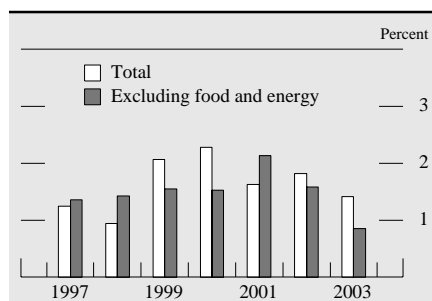
Domestic financial market conditions appeared to become increasingly sup-

Change in Real GDP



NOTE. Here and in subsequent charts, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period.

Change in PCE Chain-Type Price Index



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

portive of economic growth last year. The economic expansion lowered investors' perception of, and perhaps aversion to, risk, and continued disinflation was interpreted as a sign that monetary policy would remain on hold, even as the economy picked up steam. Although yields on Treasury coupon securities rose modestly on balance over the year, risk spreads on corporate debt narrowed to the point that yields on corporate issues declined. The low-interest-rate environment spurred considerable corporate bond issuance and generated a massive wave of mortgage refinancing activity by households. Equity markets began to rally when the uncertainty over the timing of military intervention in Iraq was resolved. The climb in stock prices continued for the rest of the year, driven by improving corporate earnings reports and growing optimism about the prospects for the economy. At the same time, with economic conditions abroad improving and with concerns about the financing burden of the U.S. current account deficit gaining increased attention in financial markets, the dollar fell appreciably on a trade-weighted basis.

The Household Sector

Consumer Spending

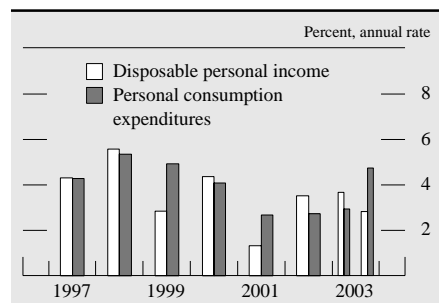
Early in 2003, consumer spending was still rising at about the same moderate pace as in 2001 and 2002. In the late spring and in the summer, however, households stepped up their spending sharply. As a result, in the second half of last year, real personal consumption expenditures rose at an annual rate of 4¾ percent after having increased at a rate of just under 3 percent in the first half. Although wage and salary earnings rose slowly during most of the year, the midyear reductions in tax rates and the advance of rebates to households

eligible for child tax credits provided a substantial boost to after-tax income. In 2003, real disposable personal income increased 3¼ percent, after having risen 3½ percent in 2002. Low interest rates provided additional impetus to household spending by reducing borrowing costs for new purchases of houses and durable goods; they also indirectly stimulated spending by facilitating an enormous amount of mortgage refinancing.

The personal saving rate has fluctuated within a fairly narrow range around 2 percent over the past three years. Although households continued to see the value of their homes appreciate over this period, they also were adjusting to the substantial drop in equity wealth that occurred after the peak in the stock market in 2000. By itself, a fall in the ratio of household wealth to income of the magnitude that households experienced between 2000 and 2002 might have triggered a noticeable increase in the personal saving rate. However, in this case, the tendency for households to save more as their wealth declines appears to have been tempered in part by their willingness to take advantage of the attractive pricing and financing environment for consumer goods.

Real consumer expenditures for durable goods surged more than 11 percent in 2003. Sales of new motor vehicles

Change in Real Income and Consumption



remained brisk as many consumers responded to the low financing rates and various incentive deals that manufacturers offered throughout the year. Falling prices also made electronic equipment attractive to consumers, and spending on home furnishings likely received a boost from the strength of home sales. Altogether, real outlays for furniture and household equipment jumped 13½ percent in 2003.

In contrast, real consumer expenditures on nondurable goods and on services continued to rise at a moderate pace, on balance, last year. Outlays for food and apparel increased a bit faster than in 2002, and the steady uptrend in spending for medical services was well maintained. However, consumers responded to the higher cost of energy by cutting back their real spending on gasoline, fuel oil, and natural gas and electricity services.

Consumer confidence was shaken temporarily early in 2003 by concerns about the consequences of a war in Iraq, but it snapped back in the spring. Toward year-end, sentiment appeared to brighten more as households saw their current financial conditions improve and gained confidence that business conditions would be better during the year ahead. Those positive views became more widely held in January, and the index of consumer sentiment prepared by the Michigan Survey Research Center (SRC) reached its highest level in three years.

Residential Investment

Housing activity was robust for a second consecutive year in 2003. After having risen 7 percent in 2002, real expenditures on residential construction jumped more than 10 percent in 2003. These gains were fueled importantly by the lowest levels of mortgage interest

rates in more than forty years, which, according to the Michigan SRC's survey of consumer sentiment, buoyed consumer attitudes toward homebuying throughout the year. The average rate on thirty-year fixed-rate mortgages dropped sharply during the first half of 2003 and reached a low of 5¼ percent in June. Although the thirty-year rate subsequently firmed somewhat, it remained below 6 percent, on average, in the second half of last year.

Construction of new single-family homes accelerated during 2003, and for the year as a whole, starts averaged 1.5 million units, an increase of 10 percent compared with the level in 2002. Sales of both new and existing single-family homes also picked up sharply further last year. The brisk demand for homes was accompanied by rapid increases in the average price paid for them. The average price paid for new homes rose 10 percent over the four quarters of 2003, and the average price of existing homes was up 7¾ percent over the same period. However, house price inflation was lower after adjusting for shifts in the composition of transactions toward more expensive homes. The constant-quality price index for new homes, which eliminates the influence of changes in their amenities and their geographic distribution, increased 4¾ percent over the four quarters of 2003—down from an increase of 6 percent during 2002. The year-over-year increase in Freddie Mac's index of the prices paid in repeat sales of existing homes stood at 5½ percent as of the third quarter of 2003, compared with a rise of 7¼ percent as of the third quarter of 2002.

Starts in the multifamily sector totaled 350,000 units in 2003, a pace little changed from that of the past several years. Vacancy rates for these units rose and rents fell during the year, but falling

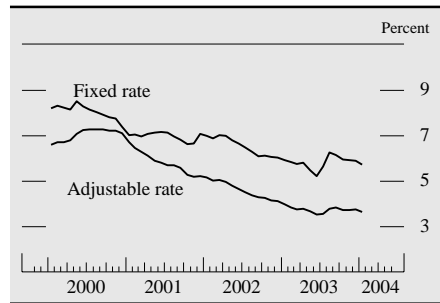
mortgage rates apparently helped to maintain building activity.

Household Finance

Household debt increased 10¾ percent last year, in large part because of the surge in mortgage borrowing induced by record-low mortgage interest rates. Refinancing activity was torrid in the first half of the year, as mortgage rates declined. Some of the equity that households extracted from their homes during refinancings was apparently used to fund home improvements and to pay down higher-interest consumer debt. When mortgage rates rebounded in the second half of the year, mortgage borrowing slowed from the extremely rapid clip of the first half, but it remained brisk through year-end. Consumer credit increased at a pace of 5¼ percent in 2003, a little faster than a year earlier, as revolving credit picked up somewhat from the slow rise recorded in 2002. Despite the pickup in household borrowing, low interest rates kept the household debt-service and financial-obligation ratios—which gauge pre-committed expenditures relative to disposable income—at roughly the levels posted in 2002. Most measures of delinquencies on consumer loans and home mortgages changed little on net last year, and household bankruptcies held roughly steady near their elevated level in 2002.

Even with the rapid expansion in debt, net worth of the household sector increased as the value of household assets rose noticeably. Stock prices were boosted by the rise in corporate earnings and the ebbing of uncertainty about future economic growth. Households directed substantial flows into stock mutual funds in the third and fourth quarters despite highly publicized scandals in the mutual fund industry.

Mortgage Rates



NOTE. The data, which are monthly and extend through January 2004, are contract rates on thirty-year mortgages.

SOURCE. Federal Home Loan Mortgage Corporation.

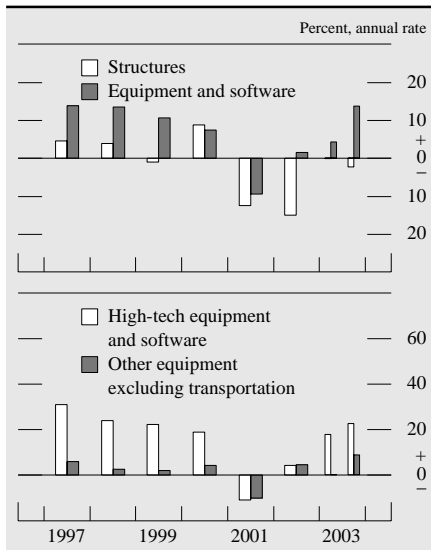
Although the companies directly implicated in wrongdoing experienced heavy outflows from their funds, most of these withdrawals apparently were transferred to other mutual funds with little effect on the industry as a whole. A considerable rise in real estate wealth further augmented household assets. Although prices of existing homes climbed more slowly than they had in the previous year, the rate of increase remained sizable. Overall, the advance in the value of household assets outstripped the accumulation of household debt by enough to boost the ratio of net worth to disposable income over the year.

The Business Sector

Fixed Investment

Business spending on equipment and software was still sluggish at the beginning of 2003. However, it accelerated noticeably over the course of the year as profits and cash flow rebounded and as businesses gained confidence in the strength of the economic expansion and in the prospective payoffs from new investment. At the same time, business financing conditions were very favor-

Change in Real Business Fixed Investment



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

able: Interest rates remained low, equity values rallied, and the enhanced partial-expensing tax provision gave a special incentive for the purchase of new equipment and software. After having changed little in the first quarter of the year, real outlays for equipment and software increased at an annual rate of 11¾ percent over the remaining three quarters of the year.

Outlays for high-technology items—computers and peripherals, software, and communications equipment—which had risen a moderate 4½ percent in 2002, posted a significantly more robust increase of more than 20 percent in 2003. That gain contributed importantly to the pickup in overall business outlays for equipment and software and pushed the level of real high-tech outlays above the previous peak at the end of 2000. The increase in spending last year on computing equipment marked the sharpest gain since 1998, and investment in

communications equipment, which had continued to contract in 2002 after having plummeted a year earlier, turned up markedly.

In contrast, the recovery in spending on non-high-tech equipment was, on balance, more muted, in part because outlays for transportation equipment continued to fall. The prolonged slump in business purchases of new aircraft continued in 2003 as domestic air carriers grappled with overcapacity and high fixed costs. By the fourth quarter, real outlays for aircraft had dropped to their lowest level in ten years. In the market for heavy (class 8) trucks, sales were quite slow in early 2003 when businesses were concerned about the performance of models with engines that met new emission standards. But as potential buyers overcame those concerns, sales recovered. By the fourth quarter of 2003, sales of medium and heavy trucks had moved noticeably above the slow pace of 2001 and 2002. Apart from outlays for transportation equipment, investment in other types of non-high-tech equipment was, on balance, little changed during the first half of the year. Demand was strong for medical equipment, instruments, and mining and oil-field machinery, but sales of industrial equipment and farm and construction machinery were sluggish. In the second half of the year, however, the firming in business spending for non-high-tech items became more broadly based.

The steep downturn in nonresidential construction that began in 2001 moderated noticeably in 2003, although market conditions generally remained weak. After having contracted at an average annual rate of 13½ percent during 2001 and 2002, real expenditures for nonresidential construction slipped just 1¼ percent, on balance, during 2003. Spending on office buildings and manufacturing structures, which had dropped sharply

over the preceding two years, fell again in 2003. The high office vacancy rates in many areas and low rates of factory utilization implied little need for new construction in these sectors even as economic activity firmed. Investment in communications infrastructure, where a glut of long-haul fiber-optic cable had developed earlier, also continued to shrink. In contrast, outlays for retail facilities, such as department stores and shopping malls, turned up last year, and the retrenchment in construction of new hotels and motels ended. In addition, investment in drilling and mining structures, which is strongly influenced by the price levels for crude oil and natural gas, increased noticeably in 2003.

Inventory Investment

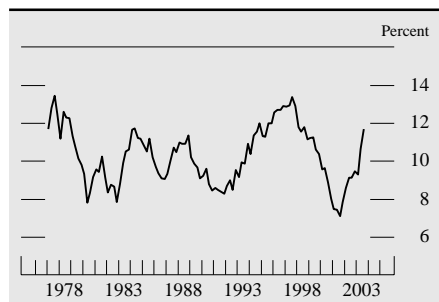
During 2002, businesses appeared to have addressed most of the inventory imbalances that had developed a year earlier. But the moderate pace of final demand during the first half of 2003 apparently restrained firms from embarking on a new round of inventory accumulation. Even though final sales picked up in the second half of the year, the restraint seemed to recede only gradually. Over the first three quarters of 2003, nonfarm businesses trimmed their inventories at an average annual rate of \$2¾ billion in constant-dollar terms, and the preliminary estimate for the final quarter of the year indicated only modest restocking. As a result, most firms appear to have ended the year with their inventories quite lean relative to sales, even after taking into account the downward trend in inventory–sales ratios that has accompanied the ongoing shift to improved inventory management. Motor vehicle dealers were an exception; their days' supply of new vehicles moved higher on average for a second year in a row.

Corporate Profits and Business Finance

Higher profits allowed many firms to finance capital spending with internal funds, and business debt rose only slightly faster than the depressed rate in 2002. Moreover, a paucity of cash-financed merger and acquisition activity further limited the need to issue debt. Gross equity issuance was extremely weak in the first half of the year but perked up in the latter half in response to the rally in equity prices. Nevertheless, for the year as a whole, firms extinguished more equity than they issued.

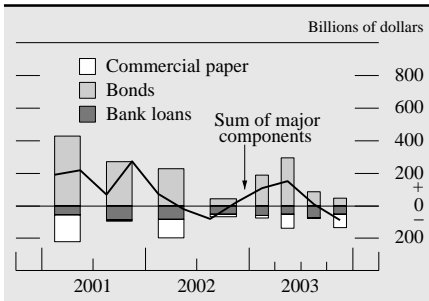
The pace of gross corporate bond issuance was moderate at the start of the year but shot up in late spring as firms took advantage of low bond yields to pay down short-term debt, to refund existing long-term debt, and to raise cash in anticipation of future spending. Bond issuance by investment-grade firms slowed after midyear as firms accumulated a substantial cushion of liquid assets and as interest rates on higher-quality debt backed up. However, issuance by speculative-grade firms continued apace, with the yields on their debt continuing to decline dra-

Before-Tax Profits of Nonfinancial Corporations as a Percent of Sector GDP



NOTE. The data are quarterly and extend through 2003:Q3. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.

Major Components of Net Business Financing



NOTE. Seasonally adjusted annual rate for non-financial corporate business. The data for the sum of major components are quarterly. The data for 2003:Q4 are estimated.

matically presumably because of investors' increased optimism about the economic outlook and greater willingness to take on risk. The sum of bank loans and commercial paper outstanding, which represent the major components of short-term business debt, contracted throughout the year. In large part, this decline reflected ongoing substitution toward bond financing, but it also was driven by the softness of fixed investment early in the year and the liquidation of inventories over much of the year.

Respondents to the Senior Loan Officer Opinion Survey on Bank Lending Practices noted that terms and standards on business loans were tightened during the first half of the year but that both had been eased considerably by year-end. They also reported that demand for business loans was quite weak for much of the year. However, despite the fact that outstanding levels of business loans continued to decline, survey responses in the last quarter of the year indicated that demand for loans had begun to stabilize. Many banks cited customers' increased investment and inventory spending as factors helping to generate

the increase in loan demand toward the end of the year. The apparent divergence between survey responses and data on actual loan volumes may suggest that demand for lines of credit has increased but that these lines have not yet been drawn. In other short-term financing developments, nonfinancial firms that issued commercial paper in 2003 found a very receptive market, in large part because of the scarcity of outstanding issues. Many of the riskiest borrowers had exited the market in 2002, and remaining issuers improved their attractiveness to investors by continuing to restructure their balance sheets.

Gross equity issuance rose over the course of 2003 as the economic outlook strengthened and stock prices moved higher. The market for initial public offerings continued to languish in the first half of the year but showed signs of life by the end of the summer. The volume of seasoned offerings also picked up in the second half of the year. On the other side of the ledger, merger and acquisition activity again extinguished shares in 2003, although only at a subdued pace. In addition, firms continued to retire a considerable volume of equity through share repurchases. For the year as a whole, net equity issuance was negative.

Corporate credit quality improved, on balance, over the year. Notably, the default rate on corporate bonds declined sharply, delinquency rates on commercial and industrial (C&I) loans at commercial banks turned down, and the pace of bond-rating downgrades slowed considerably. Low interest rates and the resulting restructuring of debt obligations toward longer terms also importantly contributed to improved business credit quality. Bank loan officers noted that the aggressive tightening of lending standards in earlier years was an important factor accounting for the lower

delinquency and charge-off rates in recent quarters.

Commercial mortgage debt increased noticeably during most of 2003 despite persistently high vacancy rates, falling rents, and sluggish growth in construction expenditures. Low interest rates on this type of collateralized debt may have induced some corporate borrowers to tap the market to pay down more-costly unsecured debt. Delinquency rates on commercial mortgages generally remained low throughout 2003, and risk spreads were relatively narrow. Loan performance has held up well because of low carrying costs for property owners and because the outstanding loans generally had been structured to include a sizable equity contribution, which makes default less attractive to borrowers.

The Government Sector

Federal Government

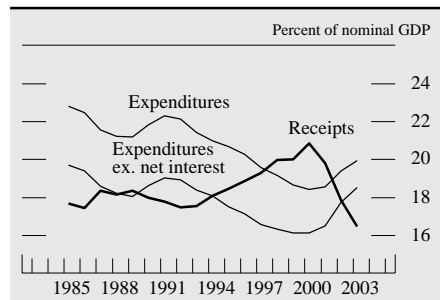
The federal budget deficit continued to widen in fiscal year 2003 as a result of the slow increase in nominal incomes, outlays associated with the war in Iraq, and legislative actions that reduced taxes and boosted spending. The deficit in the unified budget totaled \$375 billion, up substantially from the deficit of \$158 billion recorded in fiscal 2002. The Congressional Budget Office is projecting that the unified federal deficit will increase further in fiscal 2004, to more than \$475 billion.

Federal receipts have fallen in each of the past three years; the drop of nearly 4 percent in fiscal 2003 brought the ratio of receipts to GDP to 16½ percent, 2 percentage points below the average for the past thirty years. About half of the decrease in receipts last year was a consequence of legislation that shifted due dates for corporate payments

between fiscal years. In addition, personal income tax collections dropped sharply because of the slow rise in nominal wages and salaries, diminished capital gains realizations in 2002, and the tax cuts enacted under the Jobs and Growth Tax Relief Reconciliation Act of 2003. The act advanced refund checks to households eligible for the 2003 increment to the child tax credit and resulted in lower withholding schedules for individual taxpayers. The act also expanded the partial-expensing incentive for businesses, but because corporate profits accelerated sharply last year, corporate tax receipts rose appreciably after adjusting for the shifts in the timing of payments.

At the same time, federal outlays other than for interest expense rose rapidly for the second consecutive year in fiscal 2003; these outlays increased about 9 percent after having risen 11 percent in fiscal 2002. Spurred by operations in Iraq, defense spending soared again, and outlays for homeland security rose further. Spending for income support, such as unemployment insurance, food stamps, and child credits under the earned income tax credit program, also posted a sizable increase. The ongoing rise in the cost and utilization of medical services continued

Federal Receipts and Expenditures



NOTE. The budget data are from the unified budget and are for fiscal years (October through September); GDP is for the year ending in Q3.

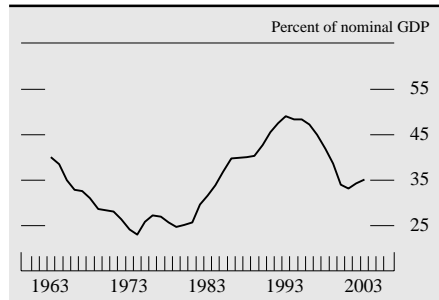
to push up spending for Medicare and Medicaid. Overall, real federal consumption and investment (the measure of federal spending that is included in real GDP) increased 6 percent over the four quarters of 2003, after having risen 10 percent a year earlier.

The federal government had contributed increasingly to national saving in the late 1990s and 2000 as budget deficits gave way to accumulating surpluses. However, with the swing back to large deficits in recent years, the federal government has again become a drain on national saving. Using the accounting practices followed in the national income and product accounts (NIPA), gross federal saving as a percent of GDP dropped sharply in late 2001 and has trended down since then; the drop contributed to a decline in overall gross national saving as a percent of GDP from 18 percent in calendar year 2000 to 13 percent, on average, in the first three quarters of 2003. Federal saving net of estimated depreciation fell from its recent peak of 2½ percent of GDP in 2000 to negative 4 percent of GDP, on average, in the first three quarters of 2003. As a result, despite a noticeable pickup in saving from domestic nonfederal sources, overall net national saving, which is an important determinant of private capital formation, fell to less than 1½ percent of GDP, on average, in the first three quarters of 2003, compared with a recent high of 6½ percent of GDP in 1998.

Federal Borrowing

The Treasury ramped up borrowing in 2003 in response to the sharply widening federal budget deficit, and federal debt held by the public as a percent of nominal GDP increased for a second year in a row after having trended down over the previous decade. As had been

Federal Government Debt Held by the Public



NOTE. Through 2002, the data for debt are year-end figures, and the corresponding value for GDP is for Q4 at an annual rate; the final observation is for 2003:Q3. Excludes securities held as investments of federal government accounts.

the case in 2002, the Treasury was forced to resort temporarily to accounting devices in the spring of 2003 when the statutory debt ceiling became a constraint, but debt markets were not disrupted noticeably. In May, the Congress raised the debt ceiling from \$6.4 trillion to \$7.4 trillion. With large deficits expected to persist, the Treasury made a number of adjustments to its regular borrowing program, including reintroducing the three-year note, increasing to monthly the frequency of five-year note auctions, reopening the ten-year note in the month following each new quarterly offering, and adding another auction of ten-year inflation-indexed debt. As a result of these changes, the average maturity of outstanding Treasury debt, which had reached its lowest level in decades, began to rise in the latter half of 2003.

State and Local Governments

State and local governments faced another difficult year in 2003. Tax receipts on income and sales continued to be restrained by the subdued performance of the economy. Despite further

efforts to rein in spending, the sector's aggregate net saving, as measured in the NIPA, reached a low of negative \$40 billion (at an annual rate), or negative 0.4 percent of GDP, in the first quarter of the year. Most of these jurisdictions are subject to balanced-budget requirements and other rules that require them to respond to fiscal imbalances. Thus, in addition to reducing operating expenses, governments drew on reserves, issued bonds, sold assets, and made various one-time adjustments in the timing of payments to balance their books. In recent years, many have also increased taxes and fees, thereby reversing the trend toward lower taxes that prevailed during the late 1990s.

Recent indications are that the fiscal stress in this sector is beginning to ease. The improvement reflects a noticeable upturn in tax collections in recent quarters while restraint on operating expenditures largely remains in place. On a NIPA basis, real spending on compensation and on goods and services purchased by state and local governments was little changed in the second half of 2003, as it was over the preceding year. However, investment in infrastructure, most of which is funded in the capital markets, accelerated in the second half of 2003. As of the third quarter of 2003, state and local net saving had moved back into positive territory.

State and Local Government Borrowing

Gross issuance of debt by state and local governments was quite robust last year. Weak tax receipts from a sluggish economy, significant demands for infrastructure spending, and low interest rates all contributed to the heavy pace of borrowing. Borrowing was strongest in the second quarter of the year, as governments took advantage of the extraordinarily

low longer-term rates to fund capital expenditures and to advance refund existing higher-cost debt. Because of the financial stresses facing these governments, the credit ratings of several states, most notably California, were lowered last year. Although bond downgrades outnumbered upgrades for the sector as a whole, the imbalance between the two was smaller than it was in 2002.

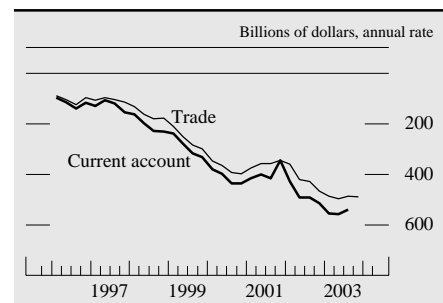
The External Sector

Over the first three quarters of 2003, the U.S. current account deficit widened relative to the comparable period in 2002, a move largely reflecting developments in the deficit on trade in goods and services. Net investment income rose over the same period, as receipts from abroad increased and payments to foreign investors in the United States declined.

International Trade

The trade deficit widened considerably in the first half of 2003 but narrowed slightly in the third quarter, as the value of exports rebounded in response to strengthening foreign economic activity and the depreciation of the dollar.

U.S. Trade and Current Account Balances



NOTE. The data are quarterly and extend through 2003:Q3.

Available trade data through November suggest that the trade deficit narrowed further in the fourth quarter, as an additional strong increase in exports outweighed an increase in imports.

Real exports of goods and services increased about 6 percent in 2003. Exports of services rose about 5 percent. They were held down early in the year by a drop in receipts from foreign travelers, owing to the effects of the SARS (severe acute respiratory syndrome) epidemic and the war in Iraq; services exports rebounded strongly later in the year as those concerns receded. Exports of goods rose about 6¾ percent over the course of the year—considerably faster than in 2002. Exports increased in all major end-use categories of trade, with particularly strong gains in capital goods and consumer goods. Reflecting the global recovery in the high-tech sector, exports of computers and semiconductors picked up markedly in 2003, particularly in the second half. By geographic area, exports of goods increased to Western Europe, Canada, and, particularly, to developing countries in East Asia—a region where economic activity expanded at a rapid pace last year. Prices of exported goods rose in 2003, with prices of agricultural exports recording particularly large increases. In response to poor crops and strong demand, prices for cotton and soybeans increased sharply. For beef, disruptions in supply led to notably higher prices through much of 2003. Beef prices, however, fell back in late December after a case of mad cow disease was discovered in the state of Washington and most countries imposed bans on beef imports from the United States.

Real imports of goods and services rose about 3½ percent in 2003. Imports of services fell in the first half of the year but bounced back in the second half, as concerns about the SARS

epidemic and the war in Iraq came and went; for the year as a whole, real imports of services were about unchanged from the previous year. Real imports of goods expanded about 4 percent in response to the strengthening of U.S. demand, but the pattern was choppy, with large gains in the second and fourth quarters partially offset by declines in the first and third. Despite a surge in the second quarter, the volume of oil imports increased modestly, on balance, over the course of the year. Real non-oil imports were up about 4½ percent, with the largest increases in capital goods and consumer goods. Imports of computers posted solid gains, whereas imports of semiconductors were flat.

Despite a substantial decline in the value of the dollar, the prices of imported non-oil goods rose only moderately in 2003. By category, the prices of consumer goods were unchanged last year, and prices of capital goods excluding aircraft, computers, and semiconductors increased only a little more than 1 percent. Price increases were larger for industrial supplies. The price of imported natural gas spiked in March and rose again late in the year; these fluctuations were large enough to show through to the overall price index for imported goods. At year-end, prices of industrial metals rose sharply, with the spot price of copper reaching the highest level in six and one-half years. The strength in metals and other commodity prices has been attributed, at least in part, to depreciation of the dollar and strong global demand, particularly from China.

In 2003, the spot price of West Texas intermediate (WTI) crude oil averaged more than \$31 per barrel—the highest annual average since the early 1980s. The spot price of oil began to rise at the end of 2002 when ethnic unrest in Nige-

ria and a nationwide strike in Venezuela sharply limited oil supplies from those two countries. In the first quarter of 2003, geopolitical uncertainty in the period leading up to the war in Iraq also added upward pressure on oil prices. On March 12, the spot price of WTI closed at \$37.83 per barrel, the highest level since the Gulf War in 1990. When the main Iraqi oil fields had been secured and it became apparent that the risks to oil supplies had subsided, the spot price of WTI fell sharply to a low of \$25.23 per barrel on April 29. However, oil prices began rising again when, because of difficult security conditions, the recovery of oil exports from Iraq was slower than expected. Prices also were boosted in September by the surprise reduction in OPEC's production target. In the fourth quarter of 2003 and early 2004, strengthening economic activity, falling oil inventories, and the continued depreciation of the dollar contributed to a further run-up in oil prices.

The Financial Account

The financing counterpart to the current account deficit experienced a sizable shift in 2003, as net private inflows fell while foreign official inflows increased. Private foreign purchases of U.S. securities were at an annual rate of about \$350 billion through November, about \$50 billion lower than in the previous year. Private foreign purchases of U.S. equities continued to recede, and, although the level of bond purchases was little changed in the aggregate, foreign purchases shifted somewhat away from agency bonds and toward corporate bonds. Over the same period, purchases by private U.S. investors of foreign securities increased nearly \$80 billion. Accordingly, net inflows through private securities transactions decreased markedly. In contrast, foreign

official purchases of U.S. assets surged to record levels in 2003, with the accumulation of dollar reserves particularly high in China and Japan.

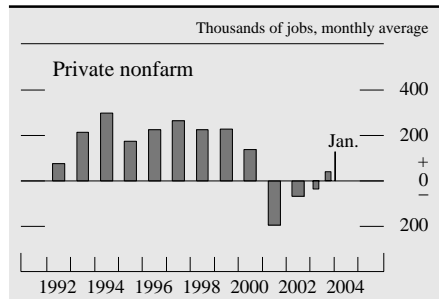
Compared with the pace in 2002, foreign direct investment in the United States increased, as merger activity picked up and corporate profits improved. U.S. direct investment abroad held relatively steady at a high level that was largely the result of continued retained earnings. On net, foreign direct investment outflows fell about \$50 billion through the first three quarters of 2003.

The Labor Market

Employment and Unemployment

With economic activity still sluggish during the first half of 2003, the labor market continued to weaken. Over the first eight months of the year, private nonfarm payroll employment fell, on average, more than 35,000 per month, extending the prolonged period of cut-backs that began in early 2001. The civilian unemployment rate, which had hovered around 5¾ percent for much of 2002, moved up to 6¼ percent by June. However, by late in the summer, the labor market began to recover slowly. Declines in private payrolls gave way to

Net Change in Payroll Employment



moderate increases in employment; over the five months ending in January, private nonfarm establishments added, on average, about 85,000 jobs per month. By January, the unemployment rate moved back down to 5.6 percent.

During the late summer and early fall, prospects for business sales and production brightened, and firms began to lay off fewer workers. Initial claims for unemployment insurance dropped back, and the monthly Current Population Survey (CPS) of households reported a decline in the number of workers who had lost their last job. However, for many unemployed workers, jobs continued to be difficult to find, and the number of unemployed who had been out of work for twenty-seven weeks or more remained persistently high. The labor force participation rate, which tends to be sensitive to workers' perceptions of the strength of labor demand, drifted lower. Although the CPS indicated a somewhat greater improvement in employment than the payroll report—even after adjusting for conceptual differences between the two measures—the increase in household employment lagged the rise in the working-age population, and the ratio of employment to population fell further during 2003.

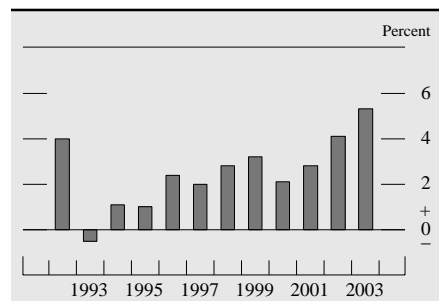
The modest upturn in private payroll employment that began in September was marked by a step-up in hiring at businesses supplying professional, business, and education services, and medical services continued to add jobs. Employment in both the construction industry and the real estate industry rose further, although the number of jobs in related financial services dropped back a bit as mortgage refinancing activity slackened. At the same time, although manufacturers were still laying off workers, the monthly declines in factory employment became smaller and less widespread than earlier. Employment

stabilized in many industries that produce durable goods, such as metals, furniture, and wood products, as well as in a number of related industries that store and transport goods. In several other areas, employment remained weak. Manufacturers of nondurables, such as chemicals, paper, apparel, and textiles, continued to cut jobs. Employment in retail trade remained, on net, little changed.

Productivity and Labor Costs

Business efforts to increase efficiency and control costs led to another impressive gain in labor productivity last year. Output per hour in the nonfarm business sector surged 5¼ percent in 2003 after having risen a robust 4 percent in 2002 and 2¾ percent in 2001. What is particularly remarkable about this period is that productivity did not decelerate significantly when output declined in 2001, and it posted persistently strong gains while the recovery in aggregate demand was sluggish. Typically, the outsized increases in productivity that have occurred during cyclical recoveries have followed a period of declines or very weak increases in productivity during the recession and have been associated with rebounds in economic activity that

Change in Output per Hour



NOTE. Nonfarm business sector.

were stronger than has been the case, until recently, in this expansion.

On balance, since the business cycle peak in early 2001, output per hour has risen at an average annual rate of 4 percent—noticeably above the average increase of 2½ percent that prevailed between 1996 and 2000. In the earlier period, an expansion of the capital stock was an important element in boosting the efficiency of workers and their firms; that impetus to productivity has weakened in the recent period as a result of the steep cutbacks in business investment in 2001 and 2002. Instead, the recent gains appear to be grounded in organizational changes and innovations in the use of existing resources—which are referred to as multifactor productivity. The persistence of a rapid rise in multifactor productivity in recent years, along with signs of a pickup in capital spending, suggests that part of the step-up in the rate of increase of labor productivity may be sustained for some time.

In 2003, the employment cost index (ECI) for private nonfarm businesses, which is based on a survey conducted quarterly by the Bureau of Labor Statistics, rose 4 percent—about ¾ percentage point more than the increase in 2002. Compensation per hour in the nonfarm business sector, which is based on data constructed for the NIPA, is estimated to have increased 3¼ percent in 2003, up from 1½ percent in 2002. In recent years, the NIPA-derived series has shown much wider fluctuations in hourly compensation than the ECI, in part because it includes the value of stock option exercises, which are excluded from the ECI. The value of options exercised shot up in 2000 and then dropped over the next two years.

Most of the acceleration in hourly compensation in 2003 was the result of larger increases in the costs of employee

benefits. The ECI for wages and salaries rose 3 percent—up slightly from the pace in 2002 but still well below the rates of increase in the preceding six years. Wage gains last year likely were restrained by persistent slack in the demand for labor as well as by the pressure on employers to control overall labor costs in the face of the rapidly rising cost of benefits. Employer costs for benefits, which had risen 4¾ percent in 2002, climbed another 6½ percent in 2003. The cost of health insurance as measured by the ECI has been moving up at close to a double-digit rate for three consecutive years. In addition, in late 2002 and early 2003, employers needed to substantially boost their contributions to defined-benefit retirement plans to cover the declines in the market value of plan assets.

Prices

Headline consumer price inflation in 2003 was maintained by an acceleration in food prices and another sizable increase in energy prices, but core rates of inflation fell for a second year. Although the strong upturn in economic activity in the second half of last year began to reduce unemployment and to boost industrial utilization rates, considerable slack in labor and product markets continued to restrain inflation throughout the year. A further moderation in the costs of production also helped to check inflation: As a result of another rapid rise in productivity, businesses saw their unit labor costs decline in 2003 for a second consecutive year. In contrast, prices for imported goods excluding petroleum, computers, and semiconductors increased at about the same rate as prices more generally; between 1996 and 2002, these import prices fell relative to overall prices for personal consumption expenditures

(PCE). The chain-type price index for PCE excluding food and energy rose just under 1 percent in 2003, about $\frac{3}{4}$ percentage point less than in 2002. A broader measure of inflation, the chain-type price index for GDP, increased $1\frac{1}{2}$ percent in 2003, the same slow pace as in 2002. Both measures of inflation were roughly a percentage point lower than in 2001.

Consumer energy prices fluctuated widely over the four quarters of 2003, and the PCE index for energy was up $7\frac{1}{4}$ percent over the period. In the first quarter of the year, the combination of a further rise in the cost of crude oil, increased wholesale margins for gasoline, and unusually tight supplies of natural gas pushed up consumer energy prices sharply. Although the prices of petroleum-based products turned down when the price of crude oil fell back in March, a number of supply disruptions in late summer resulted in another temporary run-up in the retail price of gasoline. In the spring, the price of natural gas began to ease as supplies improved, but it remained high relative to the level in recent years. Electricity prices also moved up during 2003, in part because of the higher input costs of natural gas. In January 2004, a cold wave in the Northeast, together with the rise in the price of crude oil since early December, once again led to spikes in the prices of gasoline and natural gas.

The PCE price index for food and beverages increased $2\frac{3}{4}$ percent in 2003 after having risen just $1\frac{1}{4}$ percent a year earlier. Much of the acceleration can be traced to strong demand for farm products, but prices paid by consumers for food away from home—which depend much more heavily on the cost of labor than on prices of food products—were up 3 percent in 2003, also somewhat more than overall consumer price inflation. Poor harvests abroad, especially in

Europe, contributed importantly to the heightened demand for U.S. farm products. Thus, despite a bumper crop of corn and some other grains in the United States, world stocks were tight and prices remained high. In addition, the U.S. soybean crop was crimped by late-season heat and dryness, which further tightened world supplies. Concerns about the cases of mad cow disease that were identified in herds in Japan and Canada supported strong domestic and export demand for U.S. beef for most of last year while supplies edged down. But, at year-end, when a case of mad cow disease was discovered in a domestic herd, export demand for U.S. beef plunged and drove the price of live cattle down sharply. A portion of the drop in cattle prices likely will show through to consumer prices for beef early this year.

The decline in core inflation in 2003 was broadly based. Prices of core consumer goods fell somewhat faster than a year earlier; the declines were led by larger cuts in prices of apparel, motor vehicles, electronic equipment, and a variety of other durable goods. At the same time, prices of non-energy services rose less rapidly. The deceleration in core consumer prices measured by the CPI is somewhat greater than that measured by the PCE index. In each index, the costs of housing services to tenants and owners rose less in 2003 than in 2002, but because these costs receive a larger weight in the CPI, their slowing contributed a greater amount to the CPI's deceleration. In addition, the different measurement of the prices of medical services in the two series contributed to the smaller deceleration in non-energy services in the PCE. The medical services component of the CPI, which measures out-of-pocket expenses paid by consumers, increased 4 percent in 2003, down from $5\frac{1}{2}$ percent a year

Alternative Measures of Price Change

Percent

Price measure	2001	2002	2003
<i>Chain-type</i>			
Gross domestic product	2.4	1.4	1.5
Gross domestic purchases	1.6	1.7	1.6
Personal consumption expenditures	1.6	1.8	1.4
Excluding food and energy ...	2.1	1.6	.9
Chained CPI	1.5	1.8	1.4
Excluding food and energy ...	2.1	1.6	.6
<i>Fixed-weight</i>			
Consumer price index	1.8	2.2	1.9
Excluding food and energy ...	2.7	2.1	1.2

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

earlier. Alternatively, the PCE for medical services is a broader measure that uses producer price indexes (PPI) to capture the costs of services provided by hospitals and doctors; it continued to increase more slowly than the CPI for medical services last year, 3¼ percent, but it was up slightly from its increase of 2½ percent in 2002.

Survey measures of expected inflation were little changed, on balance, in 2003. According to the Federal Reserve Bank of Philadelphia's survey of professional forecasters, expectations for CPI inflation ten years ahead remained at 2½ percent last year. As measured by the Michigan Survey Research Center survey of households, median five- to ten-year inflation expectations, which averaged 3 percent in 2001, were steady at 2¾ percent in 2003 for a second consecutive year. Inflation compensation as measured by the spread between the yield on nominal Treasury securities and their indexed counterparts varied over a wide range in 2003, settling at just under 2½ percent at year-end. Shorter-term inflation expectations also posted some wide swings during 2003; year-ahead expectations in the Michigan SRC survey spiked early in the year

with the sharp increase in energy prices and dipped briefly to an unusually low level at midyear as actual inflation eased in response to lower energy prices. However, year-ahead inflation expectations settled back to just over 2½ percent at the end of the year, about the same as at the end of 2002.

The PPI for crude materials excluding food and energy products, which had dropped 10 percent in 2001, rose 11¾ percent in 2002 and another 17½ percent in 2003. The upswing was driven by the pickup in demand associated with the acceleration in both domestic and worldwide industrial activity and by the pass-through of higher energy costs. Such wide cyclical swings in commodity prices have only a small effect on movements in the prices of intermediate and finished goods. At later stages of production and distribution, commodity costs represent only a small share of overall costs, and some portion of the change in commodity prices tends to be absorbed in firms' profit margins. Thus, the recent pickup in prices at the intermediate stage of processing has been more muted; after having fallen almost 1½ percent in 2001, the PPI for core intermediate materials rose 1¼ percent in 2002 and 2 percent in 2003.

U.S. Financial Markets

On balance, financial market conditions became increasingly supportive of growth over 2003 as investors became more assured that the economy was on solid footing. Equity prices marched up after the first quarter of the year in response to the initiation and swift conclusion of major combat operations in Iraq, positive earnings reports, and—in the second half of the year—a stronger pace of economic growth. Risk spreads on corporate debt declined, with the

spreads on the debt of both investment-grade firms and speculative-grade firms ending 2003 at their lowest levels since 1998. Thus, although Treasury coupon yields ended the year 30–40 basis points higher, yields on many corporate bonds ended the year lower. Commercial banks appeared somewhat slower than bond investors to lend at more favorable terms; nevertheless, by late in the year, banks had eased both standards and terms on C&I loans.

Demand for short-term debt, however, remained very weak, and business loans and outstanding commercial paper continued to run off. In response to a widening budget deficit and a rapid expansion of federal debt, the Treasury increased the frequency of its debt auctions. Declines in mortgage interest rates over the first half of the year led to an extraordinary increase in mortgage debt, as originations for home purchase and for refinancings both climbed to record levels.

Interest Rates

Interest rates fell for most of the first half of 2003, primarily in response to continuing weak economic data and an associated marking down of expectations for the federal funds rate. Global uncertainty ran high, particularly surrounding the timing of military intervention in Iraq, which elevated safe-haven demands and depressed yields on Treasury securities. Moreover, the weak March employment report and other disappointing news about economic activity seemed to cause a substantial shift in views about monetary policy. Data from the federal funds futures market suggested a significant probability of a further easing of policy and did not imply any tightening before early 2004. Even as geopolitical tensions eased, weaker-than-expected economic data contin-

Interest Rates on Selected Treasury Securities



NOTE. The data are daily and extend through February 4, 2004.

ued to hold down Treasury yields. The FOMC's statement following its May meeting that an "unwelcome fall in inflation" remained a risk reinforced the notion that monetary policy would stay accommodative, and, indeed, judging from market quotes on federal funds futures, market participants anticipated further easing. Mortgage rates followed Treasury yields lower, precipitating a huge surge of mortgage refinancing. To offset the decline in the duration of their portfolios stemming from the jump in prepayments, mortgage investors reportedly bought large quantities of longer-dated Treasuries, amplifying the fall in yields. Interest rates on corporate bonds also declined in the first half of the year, prompting many firms to issue long-term debt to pay down other, more expensive forms of debt and build up cash assets. Growing confidence that the frequency and severity of corporate accounting scandals were waning likely contributed to the narrowing in risk spreads. By the end of spring, default rates on corporate bonds had begun to decline, and corporate credit quality appeared to stabilize.

By the time of the June FOMC meeting, federal funds futures data implied that market participants had generally

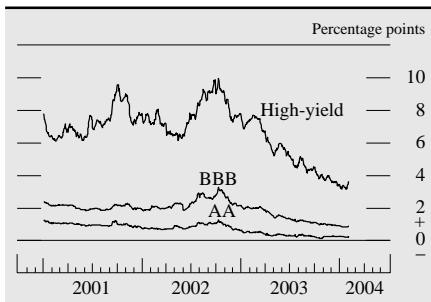
come to expect an aggressive reduction in the target federal funds rate, so the Committee's decision to lower the target rate by only 25 basis points came as a surprise to some. In addition, some investors were reportedly disappointed that the statement following this meeting included no mention of "unconventional" monetary policy actions that would be aimed at lowering longer-term yields more directly than through changes in the federal funds rate target alone. As a result, market interest rates backed up, with the move probably amplified by the unwinding of mortgage-related hedging activity. The Chairman's monetary policy testimony in July, and the FOMC's statements at subsequent meetings that noted that policy could remain accommodative for "a considerable period," apparently provided an anchor for the front end of the yield curve. At the same time, increasingly positive economic reports bolstered confidence in the markets, and longer-dated Treasury securities ended the year about 40 basis points above their year-earlier levels. But, with the expansion evidently gaining traction and investors becoming more willing to take on risk, corporate risk spreads, particu-

larly those on speculative-grade issues, continued to fall over the second half of the year. Treasury yields fell early in 2004, largely in response to the weaker-than-expected December labor market report. After the release of the Committee's statement following its January meeting, Treasury yields backed up a bit as futures market prices implied an expectation of an earlier onset of tightening than had been previously anticipated.

Equity Markets

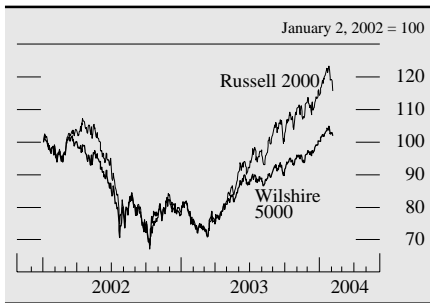
Broad equity price indexes ended the year 25 percent to 30 percent higher. Early in the year, stock prices were buffeted by mixed news about the pace of economic expansion and by heightened geopolitical tensions. Rising oil prices boosted the shares of energy companies very early in the year while, by and large, stocks in other sectors were stumbling. By spring, however, positive news on corporate earnings—often exceeding expectations—and easing of geopolitical tensions associated with the initiation of military action in Iraq boosted equity prices significantly. Subsequently, the swift end to major combat operations in Iraq caused implied volatility on the S&P 500 index to fall substantially. Over the rest of the year, increasingly positive earnings results contributed to a sustained rally in stock prices, and implied volatility in equity markets fell further. Corporate scandals—albeit on a smaller scale than in previous years—continued to emerge in 2003, but these revelations appeared to leave little lasting imprint on broad measures of stock prices. For the year as a whole, the Russell 2000 index of small-cap stocks and the technology-laden Nasdaq composite index, which rose 45 percent and 50 percent, respectively, noticeably outpaced broader

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



NOTE: The data are daily and extend through February 4, 2004. The spreads compare the yields on the Merrill Lynch AA, BBB, and 175 high-yield indexes with the yield on the ten-year off-the-run Treasury note.

Major Stock Price Indexes



NOTE. The data are daily and extend through February 4, 2004.

indexes. To date in 2004, equity markets have continued to rally.

With the sustained rise in stock prices, the ratio of expected year-ahead earnings to stock prices for firms in the S&P 500 edged down over 2003. The gap between this ratio and the real ten-year Treasury yield—a crude measure of the equity risk premium—narrowed a bit over the course of the year, though it remains in the upper part of the range observed over the past two decades.

Debt and Financial Intermediation

Aggregate debt of the domestic non-financial sectors is estimated to have increased about $8\frac{1}{4}$ percent in 2003, just over a percentage point faster than in 2002. Federal debt accelerated sharply, rising 11 percent, owing to the larger budget deficit. Household debt rose almost as rapidly, and the increase in state and local government debt also was substantial. In contrast, business borrowing remained subdued last year.

In the business sector, investment spending, particularly in the beginning of the year, was mainly financed with internal funds, limiting, though not eliminating, businesses' need to increase debt. With long-term rates falling through midyear and credit spreads—

especially for riskier borrowers—narrowing, corporate treasurers shifted their debt issuance toward bond financing and away from shorter-term debt. Household borrowing also shifted in response to lower longer-term rates. Mortgage rates followed Treasury rates lower in the spring, and mortgage originations for both home purchases and refinancings surged. Refinancing activity appears to have held down growth of consumer credit as households extracted equity from their homes and used the proceeds, in part, to pay down higher-cost consumer debt. Nevertheless, consumer credit posted a moderate advance in 2003, buoyed by heavy spending on autos and other durables. A substantial widening of the federal deficit forced the Treasury to increase its borrowing significantly. To facilitate the pickup in borrowing, the Treasury altered its auction cycle to increase the frequency of certain issues and reintroduced the three-year note.

Depository credit rose 6 percent in 2003 and was driven by mortgage lending and the acquisition of mortgage-backed securities by both banks and thrift institutions. Consumer lending also was substantial, as lower interest rates and auto incentives spurred spending on durable goods. In contrast, business loans fell $7\frac{1}{4}$ percent over 2003, a drop similar to the runoff in 2002. Survey evidence suggests that the decline in business lending at banks was primarily the result of decreased demand for these loans, with respondent banks often citing weak investment and inventory spending. Moreover, the contraction was concentrated at large banks, whose customers tend to be larger corporations that have access to bond markets, and the proceeds of bond issuance were apparently used, in part, to pay down bank loans. The January 2004 Senior Loan Officer Opinion Survey reported a

pickup in business loan demand arising mainly from increased spending on plant and equipment and on inventories. Supply conditions apparently played a secondary role in the weakness in business loans in 2003. Banks tightened standards and terms on business loans somewhat in the first half of the year, but by year-end they had begun to ease terms and standards considerably, in part because of reduced concern about the economic outlook.

The M2 Monetary Aggregate

M2 increased 5¼ percent in 2003, a pace somewhat slower than in 2002 and a bit below the rate of expansion of nominal income. The deceleration in M2 largely reflected a considerable contraction in the final quarter of the year after three quarters of rapid growth. The robust growth in money around mid-year was concentrated in liquid deposits and likely resulted in large part from the wave of mortgage refinancings, which tend to boost M2 as the proceeds are temporarily placed in non-interest-bearing accounts pending disbursement to the holders of mortgage-backed securities. Moreover, around the middle of the year, the equity that was extracted from home values during refinancings probably provided an additional boost to deposits for a time, as households temporarily parked these funds in M2 accounts before paying down other debt or spending them. In the fourth quarter, M2 contracted at an annual rate of 2 percent, the largest quarterly decline since consistent data collection began in 1959. As mortgage rates backed up and the pace of refinancing slowed, the funds that had been swelling deposits flowed out, depressing M2. The sustained rally in equity markets after the first quarter of the year may also have slowed M2 growth, as expectations of continued

higher returns led households to shift funds from M2 assets to equities, a view reinforced by the strong flows into equity mutual funds.

International Developments

Economic growth abroad rebounded in the second half of last year as factors that weighed on the global economy in the first half—including the SARS epidemic and uncertainty surrounding the war in Iraq—dissipated. Foreign growth also was boosted by the strong rebound in the U.S. economy, the revival of the global high-tech sector, and, in many countries, ample policy stimulus.

Strong second-half growth in China stimulated activity in other emerging Asian economies and Japan by raising the demand for their exports. Growth in Japan also was spurred by a recovery in private spending there on capital goods. Economic activity in Europe picked up in the second half, as export growth resumed. Economic growth in Latin America has been less robust; the Mexican economic upturn has lagged that of the United States, and Brazil's economy has only recently begun to recover from the effects of its 2002 financial crisis.

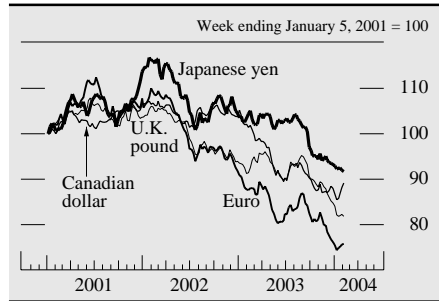
Monetary authorities abroad generally eased their policies during the first half of 2003 as economic activity stagnated. In the second half, market participants began to build in expectations of eventual monetary tightening abroad, and official interest rates were raised by year-end in the United Kingdom and Australia. Canadian monetary policy followed a different pattern; the Bank of Canada raised official interest rates in the spring as inflation moved well above its 1 percent to 3 percent target range but cut rates later in the year and again early this year as slack emerged and inflation moderated. Similarly, lower inflation in Mexico and Brazil allowed

authorities to ease monetary policy during 2003. The Bank of Japan maintained official interest rates near zero and continued to increase the monetary base.

In foreign financial markets, equity prices fell, on average, until mid-March but since then have risen in reaction to indications of stronger-than-expected global economic activity. Emerging-market equity indexes outpaced those in the industrial countries in 2003, with markets in Latin America posting particularly strong gains. Around midyear, long-term interest rates declined to multiyear lows in many countries as economic growth slowed and inflationary pressures diminished, but those rates moved higher in the second half as growth prospects improved. Bond spreads came down substantially during the year, both for industrial-country corporate debt and for emerging-market sovereign debt; spreads of the J.P. Morgan Emerging Market Bond Index (EMBI+) over U.S. Treasury securities fell to their lowest levels since before the Russian crisis of 1998. Gross capital flows to emerging markets, however, remained well below their 1997 peak.

The foreign exchange value of the dollar continued to decline last year as concerns over the financing of the large and growing U.S. current account deficit took on greater prominence. The dollar declined 18 percent against the Canadian dollar, 17 percent against the euro, and 10 percent against the British pound and the Japanese yen. In contrast, the value of the dollar was little changed, on net, against the currencies of our other important trading partners, in part because officials of China and of some other emerging Asian economies managed their exchange rates so as to maintain stability in terms of the dollar. Among Latin American currencies, the dollar declined against the Brazilian and Argentine currencies but appreciated

U.S. Dollar Exchange Rate against Selected Major Currencies



NOTE. The data are weekly and are in foreign currency units per dollar. Last observations are the average of trading days through February 4, 2004.

against the Mexican peso. On balance, the dollar depreciated 9 percent during 2003 on a trade-weighted basis against the currencies of a broad group of U.S. trading partners.

Industrial Economies

The euro-area economy contracted in the first half of 2003, weighed down in part by geopolitical uncertainty and higher oil prices. In the second half, economic activity in the euro area began to grow as the global pickup in activity spurred a recovery of euro-area exports despite the continued appreciation of the euro. The monetary policy of the European Central Bank (ECB) was supportive of growth, with the policy interest rate lowered to 2 percent by midyear. Consumer price inflation slowed to around 2 percent, the upper limit of the ECB's definition of price stability. Despite increased economic slack, inflation moved down only a little, partly because the summer drought boosted food prices. For the second straight year, the governments of Germany and France each recorded budget deficits in excess of the 3 percent deficit-to-GDP limit specified by the Stability

and Growth Pact. However, in light of economic conditions, European Union finance ministers chose not to impose sanctions.

After a sluggish first quarter, the U.K. economy expanded at a solid pace for the remainder of 2003, supported by robust consumption spending and considerable government expenditure. The Bank of England cut rates in the first half of the year but reversed some of that easing later in the year and early this year as the economy picked up and housing prices continued to rise at a rapid, albeit slower, pace. In June, the British government announced its assessment that conditions still were not right for the United Kingdom to adopt the euro. In December, the British government changed the inflation measure to be targeted by the Bank of England from the retail prices index excluding mortgage interest (RPIX) to the consumer prices index. U.K. inflation currently is well below the objective of 2 percent on the new target index.

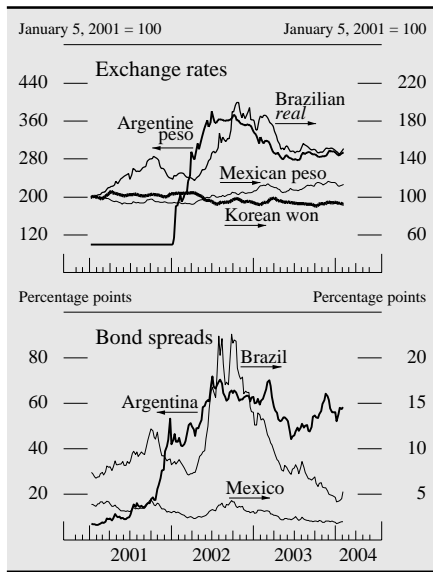
The Canadian economy contracted in the second quarter owing to the impact of the SARS outbreak in Toronto on travel and tourism, but it rebounded in the latter half of the year. Canadian economic growth continued to be led by strong domestic demand; consumption remained robust and investment spending accelerated, offsetting the negative effect of Canadian dollar appreciation on both exports and import-competing industries. Canadian consumer price inflation swung widely last year, rising to 4½ percent on a twelve-month basis in February before falling to 1½ percent in November and ending the year at 2 percent. The swing partly reflected movements in energy prices, but changes in auto insurance premiums and cigarette taxes also played an important role.

Japanese real GDP recorded significant growth in 2003 for the second straight year. Private investment spending made the largest contribution to the expansion. Consumer spending remained sluggish as labor market conditions continued to be soft. However, nominal wages stabilized following a sharp drop in 2002, and leading indicators of employment moved higher. Despite an appreciation of the yen late in the year, Japanese exports posted a strong increase in 2003 primarily because of gains in exports to China and other emerging Asian economies. With consumer prices continuing to decline, the Bank of Japan (BOJ) maintained its policy interest rate near zero and eased monetary policy several times during 2003 by increasing the target range for the outstanding balance of reserve accounts held by private financial institutions at the BOJ. The BOJ also took other initiatives last year to support the Japanese economy, including launching a program to purchase securities backed by the assets of small- and medium-sized enterprises. Japanese banks continued to be weighed down by large amounts of bad debt, but some progress was made in resolving problems of insufficient bank capital and in reducing bad-debt levels from their previous-year highs.

Emerging-Market Economies

Growth in the Asian developing economies rebounded sharply in the second half of 2003 after having contracted in the first half. The outbreak of SARS in China and its spread to other Asian economies was the primary factor depressing growth in the first half, and the subsequent recovery of retail sales and tourism after the epidemic was contained was an important factor in the

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



NOTE. The exchange rate data are weekly averages indexed to the week ending January 5, 2001. Last observations are the average of trading days through February 4, 2004. Exchange rates (top panel) are in foreign currency units per dollar. Bond spreads (bottom panel) are the spreads of the J.P. Morgan Emerging Market Bond Index (EMBI+) over U.S. Treasury securities.

sharp rebound. The pattern of Asian growth also reflected the sharp recovery of the global high-tech sector in the second half after a prolonged period of weakness. Exports continued to be the main engine of growth for the region. However, domestic demand contributed importantly to growth in China, where state-sector investment increased at a rapid clip and a boom in construction activity continued. Supply problems caused food prices and overall consumer prices in China to rise on a twelve-month basis last year, following a period of price deflation during the previous year. In addition, concerns emerged that some sectors of the Chinese economy, particularly the property

markets in Beijing and Shanghai, may be overheating.

Korean economic growth turned negative in the first half, as the high level of household debt, labor unrest, and concerns over North Korea's nuclear development depressed private-sector spending. A sharp rise in exports spurred a revival of growth in the second half even as domestic demand remained subdued.

The Mexican economy remained sluggish through much of the year but recently has shown some signs of improvement. After lagging the rise in U.S. production, Mexican industrial production posted strong gains in October and November, although it remains well below the peak it reached in 2000. Exports rose late last year to almost the peak they had reached in 2000. Consumer price inflation came down over the course of 2003 to 4 percent, the upper bound of the 2 percent to 4 percent target range. The Bank of Mexico has left policy unchanged since tightening five times between September 2002 and March 2003, but market interest rates have fallen owing to weakness in economic activity.

The Brazilian economy contracted in the first half of 2003 partly as a result of the 2002 financial crisis and the consequent monetary policy tightening. It then expanded moderately in the second half, boosted by strong export growth and a recovery in investment spending. Brazilian financial indicators improved significantly in 2003, in part because the Brazilian government began to run a substantial primary budget surplus and to reform the public-sector pension system. The Brazilian stock market soared nearly 100 percent last year, and Brazil's EMBI+ bond spread narrowed by nearly two-thirds. As the Brazilian currency stabilized and began to appreciate, Brazil's inflation outlook improved,

allowing the central bank to reverse fully its earlier rate hikes and to reduce the overnight interest rate to a multi-year low, although real interest rates remained high.

The Argentine economy rebounded in 2003 from the sharp contraction that occurred in the wake of its financial crisis in 2001–02. Still, economic activity remains far below pre-crisis levels,

and many of Argentina's structural problems have not been addressed. With the government still in default to its bondholders, the country's sovereign debt continued to carry a very low credit rating, and its EMBI+ spread remained extremely high. Even so, the Argentine peso appreciated on balance in 2003, and the Merval stock index nearly doubled over the course of the year. ■

Monetary Policy Report of July 2003

Monetary Policy and the Economic Outlook

The subpar performance of the U.S. economy extended into the first half of 2003. Although accommodative macroeconomic policies and continued robust productivity growth helped to sustain aggregate demand, businesses remained cautious about spending and hiring. All told, real gross domestic product continued to rise in the first half of the year but less quickly than the economy's productive capacity was increasing, and margins of slack in labor and product markets thereby widened further. As a result, underlying inflation remained low—and, indeed, seems to have moved down another notch. In financial markets, longer-term interest rates fell, on net, over the first half of the year as the decline in inflation and the subdued performance of the economy led market participants to conclude that short-term interest rates would be lower than previously anticipated. These lower interest rates helped to sustain a rally in equity prices that had begun in mid-March.

During the first quarter of the year, the economy's prospects were clouded by the uncertainties surrounding the onset, duration, and potential consequences of war in Iraq. War-related concerns provided a sizable boost to crude oil prices; as a result, households faced higher bills for gasoline and heating oil, and many firms were burdened with

rising energy costs. These concerns also caused consumer confidence to sag and added to a general disinclination of firms to spend, hire, and accumulate inventories. Caution was apparent in financial markets as well, and investors bid down the prices of equities in favor of less-risky securities.

The swift prosecution of the war in Iraq resolved some of these exceptional uncertainties but by no means all of them. Nonetheless, oil prices receded, and the improvement in the economic climate was sufficient to cause stock prices to rally, risk spreads on corporate securities to narrow, and consumer confidence to rebound. At the same time, the incoming economic data—much of which reflected decisions made before the war—remained mixed, and inflation trended lower. At the conclusion of its May meeting, the Federal Open Market Committee (FOMC) indicated that, whereas the risks to the outlook for economic growth were balanced, the risk of an unwelcome substantial fall in inflation from its already low level, though minor, exceeded that of a pickup in inflation. In the weeks that followed, market participants pushed down the expected future path of the federal funds rate, which contributed to the fall in longer-term interest rates and a further rise in equity prices.

At the time of the June FOMC meeting, the available evidence did not yet compellingly demonstrate that a material step-up in economic growth was under way, though some indicators did point to a firming in spending and a stabilization in the labor and product markets. The Committee concluded that a slightly more expansive monetary pol-

NOTE. The discussion in this section consists of the text and tables from the Monetary Policy Report submitted to the Congress on July 15, 2003; the charts from this report (as well as earlier reports) are available on the Board's web site, at www.federalreserve.gov/boarddocs/hh.

icy would be warranted to add further support to the economic expansion. The Committee's assessment and ranking of the risks to the outlook for economic growth and inflation were the same as in May.

The Federal Reserve expects economic activity to strengthen later this year and in 2004, in part because of the accommodative stance of monetary policy and the broad-based improvement in financial conditions. In addition, fiscal policy is likely to be stimulative as the provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003 go into effect and as defense spending continues to ramp up. Severe budgetary pressures are causing state and local governments to cut spending and to increase taxes and fees, but these actions should offset only a portion of the impetus from the federal sector. Moreover, the continued favorable performance of productivity growth should lift household and business incomes and thereby encourage capital spending. Given the ongoing gains in productivity and the existing margin of resource slack, aggregate demand could grow at a solid pace for some time before generating upward pressure on inflation.

Monetary Policy, Financial Markets, and the Economy over the First Half of 2003

During the weeks before the January meeting of the FOMC, geopolitical developments and the uneven tone of economic data releases created substantial uncertainty. Businesses had continued to reduce their payrolls and postpone capital expenditures. However, the absence of fresh revelations of lapses in corporate governance or accounting problems and some increased appetite for risk on the part of investors helped push down yields on corporate debt,

which encouraged firms to issue bonds to reduce their financing costs and restructure their balance sheets. Meanwhile, moderate gains in household income and historically low mortgage rates underpinned still-considerable demand for housing. Retail sales, particularly those of motor vehicles, also were strong at the end of 2002 despite some drop-off in consumer confidence. Core inflation seemed to be on a declining trend, although the foreign exchange value of the dollar had depreciated, and top-line inflation was being boosted by a sizable run-up in energy prices. The substantial slack in resource utilization, as well as the solid gains in labor productivity, led members to the view that consumer price inflation—by then already very low—was unlikely to increase meaningfully. Against that backdrop, the Committee members continued to believe that economic fundamentals were in place to support a pickup in the growth of economic activity during the year ahead. Accordingly, the FOMC decided at the January meeting to leave interest rates unchanged and assessed the risks as balanced with respect to its dual goals of sustainable economic growth and price stability.

In subsequent weeks, economic performance proved disappointing. The increasing likelihood of war in Iraq was accompanied by a steep rise in crude oil prices and considerable volatility in financial markets. For much of that period, investors sought the relative safety of fixed-income instruments; that preference induced declines in yields on Treasury securities and high-quality corporate bonds and a drop in stock prices. Consumer outlays also softened after January, although low mortgage rates and rising incomes were still providing support for household spending. Businesses continued to trim workforces and cut capital spending.

When the Committee met on March 18, full-scale military conflict in Iraq seemed imminent. In an environment of considerable uncertainty, the FOMC had to weigh whether economic sluggishness was largely related to worries about the war, and hence would lift once the outcome was decided, or was indicative of deep-seated restraints on economic activity. The Committee, which reasoned that it could not make such a distinction in the presence of so much uncertainty, left the funds rate unchanged and declined to characterize the balance of risks with respect to its dual goals. However, the Committee noted that, given the circumstances, heightened surveillance would be particularly informative, and it held a series of conference calls during late March and April to discuss the latest economic developments.

Some of the uncertainty was resolved by the quick end to major military action in Iraq. Equity prices and consumer confidence rose while oil prices and risk spreads on corporate debt fell. Fiscal policy seemed set to become even more stimulative given the prospect of increased spending on defense and homeland security as well as the likely enactment of additional tax cuts. Part of the federal stimulus, however, was thought likely to be offset by the efforts of state and local governments to close their budget gaps.

Economic reports were generally disappointing. Industrial production declined in March, and capacity utilization fell to a twenty-year low. The employment reports for March and April indicated that private nonfarm payrolls had continued to fall. Although order backlogs for nondefense capital goods had risen recently, businesses generally remained reluctant to invest in new capacity.

In light of the financial and policy stimulus already in place, the FOMC left the federal funds rate unchanged at its May meeting. To provide more specific guidance about its views, the FOMC included in its announcement separate assessments of the risks to the outlook for economic growth and inflation as well as the overall balance between the two. The Committee viewed the upside and downside risks to economic growth as balanced, but it perceived a higher probability of an unwelcome substantial fall in inflation than of a pickup in inflation from its current low level. The Committee considered that the overall balance of risks to its dual objectives was weighted toward weakness. That said, members concluded that there was only a remote possibility that resource utilization would remain so low that the disinflation process would cumulate to produce a declining overall price level for an extended period.

Financial market participants reacted strongly to this characterization of risks, believing that the Committee's focus on leaning against appreciable disinflation implied that monetary policy would be more accommodative and remain so for longer than previously thought. Investors pushed down the expected path of the federal funds rate in the weeks following the meeting. Intermediate- and long-term interest rates fell significantly and spurred another round of long-term bond issuance. The resulting decline in real interest rates helped sustain the rally in equity prices.

Between the May and June meetings, a few tentative signs suggested that the pace of economic activity might be firming. Industrial production and retail sales edged up in May, available data indicated that employment had stopped declining, residential investment remained strong, and survey mea-

sures of consumer sentiment and business conditions were well above the levels of earlier in the year. Financial conditions had improved markedly, but businesses reportedly remained somewhat averse to new investment projects, in part because of significant unused capacity. They also seemed reluctant to expand their workforces until they viewed a sustained pickup in aggregate demand as more certain.

With inflation already low and inflation expectations subdued, the Committee judged that it would be prudent to add further support for economic expansion, and it lowered the target for the federal funds rate 25 basis points, to 1 percent. The FOMC continued to view the risks to economic growth as balanced and again noted that the minor probability of substantial further disinflation exceeded the probability of a pickup in inflation from its current low level. But because of the considerable amount of economic slack prevailing and the economy's ability to expand without putting upward pressure on prices, the Committee indicated that the small chance of an unwelcome substantial decline in the inflation rate was likely to remain its predominant concern for the foreseeable future.

Economic Projections for 2003 and 2004

The members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, expect economic activity to accelerate in the second half of this year and to gather additional momentum in 2004. The central tendency of the FOMC participants' forecasts for the increase in real GDP over the four quarters of 2003 spans a narrow range of 2½ percent to 2¾ per-

Economic Projections for 2003 and 2004

Percent

Indicator	Federal Reserve Governors and Reserve Bank presidents	
	Range	Central tendency
2003		
<i>Change, fourth quarter to fourth quarter¹</i>		
Nominal GDP	3½–4¾	3¾–4½
Real GDP	2¼–3	2½–2¾
PCE chain-type price index	1–1¾	1¼–1½
<i>Average level, fourth quarter</i>		
Civilian unemployment rate	6–6¼	6–6¼
2004		
<i>Change, fourth quarter to fourth quarter¹</i>		
Nominal GDP	4¾–6½	5¼–6¼
Real GDP	3½–5¼	3¾–4¾
PCE chain-type price index	¾–2	1–1½
<i>Average level, fourth quarter</i>		
Civilian unemployment rate	5½–6¼	5½–6

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

cent, which, given the modest increase in real GDP in the first quarter, implies a noticeable pickup in growth as the year progresses. The central tendency for projections of real GDP growth in 2004 spans a range of 3¾ percent to 4¾ percent. The civilian unemployment rate is expected to be between 6 percent and 6¼ percent in the fourth quarter of 2003 and to decline to between 5½ percent and 6 percent by the fourth quarter of 2004.

Inflation is anticipated to be quite low over the next year and a half. The chain-type price index for personal consumption expenditures (PCE) rose 1¾ percent over the four quarters of 2002, and

most FOMC participants expect inflation to run somewhat lower this year and then to hold fairly steady in 2004. The central tendency of projections for PCE inflation is 1¼ percent to 1½ percent in 2003 and 1 percent to 1½ percent in 2004.

Economic and Financial Developments in 2003

Economic activity in the United States remained sluggish in the first half of 2003. Businesses continued to be reluctant to undertake new projects given the unusual degree of uncertainty in the economic environment, and the softness in activity abroad crimped the demand for U.S. exports. However, consumer spending grew moderately, housing activity retained considerable vigor, and defense spending picked up. Real GDP rose at an annual rate of just 1½ percent in the first quarter and appears to have posted another modest gain in the second quarter. With output growth remaining tepid and labor productivity rising at a fairly robust pace, firms continued to trim payrolls in the first half of 2003, though job losses in the private sector were a little smaller than they had been, on average, in 2002.

For much of the first half of the year, headline inflation news was shaped by movements in energy prices, which soared during the winter, retreated during the spring, and more recently firmed. Core inflation—which excludes the direct effects of food and energy prices—was held to a low level by slack in resource utilization and continued sizable advances in labor productivity.

As a result of slow economic growth and the prospect that inflation would remain very subdued, the federal funds rate was maintained at the accommodative level of 1¼ percent for much of the first half of the year. Intermediate- and

longer-term yields declined, in some cases to their lowest levels on record. Equity prices, which through mid-March had fallen in response to weaker-than-expected economic news and rising geopolitical tensions, began a broad rally as it became clear that the war in Iraq would begin imminently. The apparent increase in investors' appetite for risk also helped push down risk spreads on corporate bonds and triggered inflows to equity and high-yield bond mutual funds. Since the beginning of the year, the foreign exchange value of the dollar has depreciated nearly 5 percent against the broad group of currencies of our major trading partners.

Households and businesses have taken advantage of the decline in intermediate-term and long-term interest rates from their already low levels, mostly by refinancing debt at ever more favorable rates. Partly as a result, household credit quality was little changed over the first half of the year, and household debt continued to expand at a rapid pace as mortgage interest rates fell to their lowest levels in more than three decades. Business balance sheets strengthened noticeably, and many measures of corporate credit performance showed some improvement. Still, net borrowing by businesses continued to be damped by the softness in investment spending.

The Household Sector

Consumer Spending

Consumer spending continued to increase in the first half of 2003, though not as quickly as in the past few years. In total, real personal consumption expenditures (PCE) rose at an annual rate of 2 percent in the first quarter and likely posted another moderate advance in the second quarter. Purchases of new

light motor vehicles were sustained by the automakers' use of increasingly aggressive price and financing incentives. Spending on goods other than motor vehicles rose briskly in the first quarter, though that was largely because of the high level of spending around the turn of the year; the data through May suggest a further increase for this category in the second quarter. In contrast, outlays on services rose only slowly over the first five months of the year as weakness lingered in a number of categories, including air travel and recreation.

The rise in real consumption expenditures so far in 2003 has about matched the growth in real disposable personal income (DPI), which has been restrained by the poor job market and by the surge in consumer energy prices early in the year. Real DPI rose about $2\frac{1}{4}$ percent at an annual rate between the fourth quarter of 2002 and May after having increased at a considerably faster pace in 2002; the larger increase in real DPI in 2002 in part reflected the effects of the tax cuts enacted in 2001.

Among other key influences on consumption, household wealth grew about in line with nominal DPI in the fourth quarter of 2002 and the first quarter of 2003 after having fallen sharply over the preceding two years. While the rebound in the stock market in the second quarter should help the wealth-to-income ratio recoup some of the ground it lost earlier, households likely have not yet completed the adjustment of their spending to the earlier drop in wealth. Meanwhile, the high level of mortgage refinancing in recent quarters has bolstered consumer spending by allowing homeowners to reduce their monthly payments, pay down more costly consumer debt, and in many cases cash out some of the equity that has accumulated during the upswing in house prices over the

past few years. Reflecting these influences, the personal saving rate averaged $3\frac{1}{2}$ percent over the first five months of the year—about the same as the annual average for 2002 but more than 1 percentage point above that for 2001.

Consumer confidence, which has exhibited some sharp swings in recent years, remained volatile in the first half of 2003. After having declined markedly over the second half of 2002, survey readings from both the Michigan Survey Research Center and the Conference Board took another tumble early this year on concerns about the potential consequences of a war in Iraq. With the combat in Iraq largely over and the stock market recovering, confidence rose appreciably, on net, in the spring.

Residential Investment

Housing activity remained robust in the first half of this year, as very low mortgage interest rates apparently offset much of the downward pressure from the soft labor market. In the single-family sector, starts averaged an annual rate of 1.39 million units over the first five months of the year—2 percent greater than the rapid pace for 2002 as a whole. In addition, sales of new and existing homes moved to exceptionally high levels. According to the Michigan survey, consumers' assessments of homebuying conditions currently are very favorable, mainly because of the low mortgage rates.

The available indicators provide differing signals on the magnitude of recent increases in home prices, but, in general, they point to smaller gains than those recorded a year or two ago. Notably, over the year ending in the first quarter, the constant-quality price index for new homes rose just $2\frac{1}{2}$ percent, one of the lowest readings of the past few years. Meanwhile, the four-quarter increase in

the repeat-sales price index for existing homes, which topped out at 8½ percent in 2001, was 6½ percent in the first quarter. Still, the share of income required to finance the purchase of a new home, adjusted for variations over time in structural characteristics, has continued to move down as mortgage rates have dropped, and it is now very low by historical standards.

Activity in the multifamily sector appears to have slipped somewhat this year, perhaps in part because the strong demand for single-family homes may be cutting into the demand for apartments. Multifamily starts totaled 325,000 units at an annual rate over the first five months of the year, a pace 6 percent below that for 2002 as a whole. In addition, vacancy rates for multifamily rental properties rose further in the first quarter, and apartment rents continued to fall.

Household Finance

Household real estate debt grew rapidly in the first half of the year with the support of the brisk pace of home sales, rising home prices, and falling mortgage interest rates. Indeed, according to Freddie Mac, the average rate on thirty-year conventional home mortgages fell sharply until June, though it has edged back up in recent weeks and now stands at about 5½ percent. Applications for mortgages to purchase homes rose well above the already elevated level of last year. Sales of existing homes, in particular, add significantly to the level of mortgage debt because the purchaser's mortgage is typically much larger than the seller's had been. The pace of mortgage refinancing—which adds to borrowing because households often increase the size of their mortgages when they refinance—set consecutive quarterly records in the first and second

quarters of 2003 in response to the declines in mortgage rates. According to Freddie Mac, more than 40 percent of the refinancings in the first quarter were “cash-out” refinancings, and the amount of equity extracted likely set a record in the first half of this year. The combination of rising home prices and low interest rates also energized home equity lending during the first half of 2003.

A major use of the proceeds from both cash-out refinancing and home equity loans reportedly has been to pay down credit card and other higher-cost consumer debt. Indeed, in line with those reports, consumer debt advanced at a relatively subdued 4½ percent annual rate in the first quarter. The growth of revolving debt was about 5 percent at an annual rate, and nonrevolving debt expanded at a 3½ percent annual rate. The growth of consumer debt picked up in the spring; the acceleration in part reflected somewhat higher motor vehicle sales that boosted the nonrevolving component, which in turn offset a deceleration in revolving credit. Meanwhile, the average interest rates charged on credit cards and on new car loans at auto finance companies this year have remained near the low end of their recent ranges.

In total, household debt grew at a 10 percent annual rate in the first quarter, a pace about unchanged from last year's. Despite the marked rise of this debt over the past several quarters, the aggregate debt-service burden of households ticked down in both the fourth quarter of 2002 and the first quarter of this year—periods during which borrowing rates fell and the average maturity of household debt rose. Although households continued to borrow at a rapid pace in the second quarter, the declines in mortgage interest rates and an elevated level of refinancing imply

that the debt-service burden was likely little changed.

The credit quality of household debt remained fairly stable in the first quarter. The delinquency rates both on residential mortgages and on credit card loans edged down in the first quarter, though persistently high delinquencies among subprime borrowers remain a problem area. Delinquency rates on auto loans at captive finance companies have edged up in recent months from their very low levels of the past few years. However, lenders probably anticipated some increase as the plethora of new vehicle loans issued in late 2001 and early 2002 seasoned. The fact that a large number of households declared bankruptcy in the first half of the year suggests that some households continue to experience considerable distress.

In a continuation of the trend during the second half of 2002, households invested heavily in bond mutual funds—and relatively safe bond funds at that—during the first quarter of 2003 and disinvested from equity funds. However, starting in March, households showed a growing willingness to purchase shares of riskier funds. As corporate credit quality improved and risk-free interest rates fell to record lows, a significantly larger portion of the investment in bond mutual funds flowed into corporate bond funds—including high-yield funds—at the expense of government bond funds. Inflows to equity mutual funds reportedly resumed in mid-March and continued through June.

The Business Sector

Fixed Investment

Investment in equipment and software (E&S) continues to languish. Firms reportedly remain reluctant to undertake new projects because of the uncer-

tainty about the economic outlook and heightened risk aversion in the wake of last year's corporate governance and accounting problems. Excess capacity—in addition to being a factor weighing on nonresidential construction—also is limiting demand for some types of equipment, most notably in the telecommunications area. But other key determinants of equipment spending are reasonably favorable. The aggressive actions taken by firms over the past few years to boost productivity and trim costs have provided a lift to corporate profits and cash flow. In addition, low interest rates and a rising stock market are helping hold down firms' cost of capital, as is the partial-expensing investment tax incentive. In addition, technological advances continue to depress the relative price of computers at a time when stretched-out replacement cycles have apparently widened the gap between the latest technology and that embodied in many of the machines currently in use.

Real spending on E&S fell at an annual rate of nearly 5 percent in the first quarter. The outlays were restrained by a sharp decline in spending on transportation equipment, especially motor vehicles; excluding that category, spending posted a small gain. Real outlays on high-tech equipment and software rose at an annual rate of about 11 percent in the first quarter, a bit faster than they had in 2002. Real purchases of computers and peripheral equipment remained on the moderate uptrend that has been evident since such spending bottomed out in 2001, and outlays on communications equipment picked up after an extended period of weakness. Meanwhile, investment outside the transportation and high-tech areas dropped back a bit.

Real E&S spending appears to have turned up in the second quarter, in part

because of a step-up in the pace of real computer investment. However, incoming data suggest that outlays on communications equipment did not repeat their first-quarter spurt. The data on shipments of capital goods point to moderate increases in spending outside of high-tech and transportation in the second quarter; moreover, backlogs of unfilled orders for equipment in this broad category have risen some this year after having declined over the preceding two years.

Nonresidential construction remained weak in the first half of 2003. Although real construction outlays were off only a little in the first quarter, they had fallen nearly 16 percent in 2002, and partial data for the second quarter point to continued softness. The downturn in spending has been especially pronounced in the office sector, where vacancy rates have surged and rents have plunged. Spending on industrial facilities also has fallen dramatically over the past couple of years; it has continued to contract in recent quarters and is unlikely to improve much in the absence of a significant rise in factory operating rates. Construction expenditures on other commercial buildings (such as those for retail, wholesale, and warehouse space), which had declined less than did outlays for other major categories of nonresidential construction over the past couple of years, moved up in the first quarter of 2003, but they too have shown some renewed softness lately. One bright spot is the drilling and mining sector, in which outlays have risen sharply this year in response to higher natural gas prices.

Inventory Investment

Most businesses have continued to keep a tight rein on inventories after the massive liquidation in 2001. Real inventory

investment in the first quarter was a meager \$5 billion at an annual rate and occurred entirely in the motor vehicle industry, where sagging sales and ambitious production early in the year created a noticeable bulge in dealer stocks, especially of light trucks. In the second quarter, the automakers reduced assemblies and expanded incentives to bolster sales, but these steps were sufficient only to reduce stocks a little, and inventories remained high relative to sales through June. Apart from the motor vehicle industry, firms reduced stocks, on net, over the first five months of 2003, and, with only a few exceptions, inventories appear reasonably well aligned with sales.

Corporate Profits and Business Finance

Before-tax profits of nonfarm, nonfinancial corporations grew at a 6½ percent annual rate in the first quarter of 2003, and they constituted 8½ percent of the sector's first-quarter GDP, the highest proportion since the third quarter of 2000. Focusing on the companies that make up the S&P 500, earnings per share for the first quarter were up about 7 percent at a quarterly rate from the fourth quarter of 2002 and were 11 percent higher than four quarters earlier. Although oil companies accounted for the majority of the four-quarter increase, earnings from the financial, utility, and consumer durable sectors were also strong and exceeded the market's conservative expectations by larger-than-usual margins. The recent depreciation of the dollar substantially boosted revenues of U.S. multinational corporations, but the hedging of currency risk likely limited the extent to which sales gains showed through to profits.

Net equity retirements in the first quarter of 2003 were probably a shade

larger than in the fourth quarter of 2002, as the decline in gross new issuance more than offset lower gross retirements. Equity retirements from cash-financed mergers were a bit below their pace in the past two years, and share repurchases appear to be running somewhat slower as well. Volatile and declining equity prices in the first quarter brought initial public offerings (IPOs) to a standstill during the first four months of this year. One small IPO was undertaken in May, and another one came to market in June. With regard to seasoned equity offerings, a war-related lull in March and April held the average monthly pace of issuance this year well below last year's level. Most of these offerings have been from energy firms and utilities that have used the proceeds primarily to reduce leverage and increase liquidity.

The net debt growth of nonfinancial corporate business was just 3 percent at an annual rate in the first quarter, as rising profits and lower outlays for fixed and working capital held down corporations' need for external funds. Nonetheless, low interest rates continued to attract firms to the bond market during the first half of 2003, and issuance ran well ahead of its rate of the second half of 2002. Moreover, a large fraction of the issues were from below-investment-grade firms, which likely were responding to the even sharper fall in their borrowing rates than investment-grade firms enjoyed. A substantial portion of the proceeds of recent bond issues have been slated to pay down commercial paper and commercial and industrial (C&I) loans, and each of those components contracted markedly during the first half of the year. Another factor contributing to the weakening in demand for C&I loans this year was the absence of merger and acquisition activity, according to the Federal Reserve's

Senior Loan Officer Opinion Survey on Bank Lending Practices.

The runoff in C&I loans appears related more to a decrease in demand than to a tightening of supply conditions, and bank credit appears to remain available for qualified business borrowers. The net fraction of banks in the Senior Loan Officer Opinion Survey that reported having tightened lending standards and terms on C&I loans during the first part of the year decreased markedly, and the Survey of Small Business by the National Federation of Independent Business showed that the net percentage of small businesses believing credit had become more difficult to obtain hovered near the middle of its recent range. Moreover, in the April Senior Loan Officer Opinion Survey, a number of banks reported that they had eased lending terms in response to increased competition for C&I loans from nonbank lenders. Indeed, data from Loan Pricing Corporation indicate that nonbank financial institutions purchased a record amount of new syndicated loans during the first quarter of this year; the buyers were reportedly attracted in part by improving liquidity in the secondary loan market.

The decline in both short- and long-term interest rates, combined with slow increases in total business debt, contributed to a further reduction in the net interest burden of nonfinancial corporations during the first quarter. Moreover, by issuing bonds and paying down short-term debt, businesses have substantially lengthened the overall maturity of their debt, thus reducing their near-term repayment obligations. These developments, together with higher profitability, have helped most measures of corporate credit performance to improve this year. The number of ratings downgrades continued to exceed upgrades but by a notably smaller mar-

gin than last year. The six-month trailing bond default rate declined considerably in the first half of the year. The four-quarter moving average of recovery rates on defaulted bonds improved a bit in the first quarter, although it remained at the low end of its range of the past several years. The delinquency rate on C&I loans at commercial banks also moved down some in the first quarter, albeit to a level well above that of the late 1990s.

Commercial Real Estate

The growth of debt backed by commercial real estate remained robust this year despite some deterioration in that sector's underlying fundamentals. In the first quarter of 2003, the expansion of debt was driven by lending at commercial banks and was spread about equally across broadly defined types of commercial real estate loans. Although the issuance of commercial-mortgage-backed securities (CMBS) slowed somewhat in the first quarter from the rapid pace of the second half of last year, issuance appears to have rebounded strongly in the second quarter.

Despite continued increases in vacancy rates and declines in the rents charged for various types of commercial properties, the credit quality of commercial mortgages has yet to show appreciable signs of deterioration. At commercial banks, delinquency rates on commercial mortgages edged up only slightly in the first quarter of 2003 from their historically low levels of recent years. Delinquency rates on CMBS, which were stable in 2002 at about the midpoint of their recent range, have also risen just a bit this year. Respondents to the April 2003 Senior Loan Officer Opinion Survey attributed the resiliency of the credit quality of commercial real estate loans in part to borrowers' ability

to refinance at lower interest rates; they also mentioned that the many borrowers with substantial equity positions in the mortgaged properties have an extra incentive to remain current. Banks also pointed to their having tightened lending standards and terms, including maximum loan-to-value ratios, well in advance of the current downturn.

In line with the assessment that, to date, credit quality in the sector remains good, spreads on CMBS over Treasuries have remained in the lower half of the ranges observed over the past few years. Market reports indicate that CMBS issuers generally have had access to terrorism insurance for the underlying properties, and the cost of that insurance has come down significantly. In addition, newly formed pools that include high-profile properties reportedly have been diversified to further protect investors from losses due to acts of terrorism.

The Government Sector

Federal Government

The federal budget deficit has widened significantly as a consequence of the persistent softness in receipts and legislative actions affecting both spending and taxes. Over the first eight months of the current fiscal year—October to May—the deficit in the unified budget was \$292 billion, nearly \$150 billion larger than that recorded during the comparable period last year. Moreover, recent policy actions are projected to boost the deficit significantly over the remainder of the fiscal year. In particular, receipts will be reduced appreciably by several provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003, including advance refund checks for the 2003 increment to the child tax credit, downward adjustments to withholding schedules for individual

taxpayers, and the sweetening of the partial-expensing investment incentive for businesses. In addition, outlays will be boosted by the supplemental appropriations for defense and foreign aid and by additional grants to the states. If the latest projection from the Congressional Budget Office is realized, the unified deficit will increase from \$158 billion in fiscal 2002 to more than \$400 billion in fiscal 2003.

The deterioration in the unified budget has been mirrored in a sharp downswing in federal saving—essentially, the unified surplus or deficit adjusted to conform to the accounting practices followed in the national income and product accounts (NIPA). Indeed, net federal saving, which accounts for the depreciation of government capital, fell from a high of a positive 2 percent of GDP in 2000 to a negative 2½ percent of GDP in the first quarter of 2003. With little change, on balance, in nonfederal domestic saving over this period, the downswing in federal saving showed through into net national saving, which was equal to less than 1 percent of GDP in the first quarter, compared with the recent high of 6½ percent of GDP in 1998. If not reversed over the longer haul, such low levels of national saving could eventually impinge on the formation of private capital that contributed to the improved productivity performance of the past half-decade.

Federal receipts in the first eight months of the current fiscal year were nearly 3 percent lower than during the comparable period of fiscal 2002 after adjusting for some shifts in the timing of payments during the fall of 2001. Individual receipts were especially weak: Although withheld taxes, which tend to move in line with wages and salaries, held up fairly well (after adjusting for changes in tax law) during this period, nonwithheld payments, which are more

sensitive to capital income, dropped sharply. This spring's net final payments, which are largely payments on the previous year's liabilities, were exceptionally soft for a second year in a row; in combination with the information on withheld and estimated payments, they imply that individual liabilities continued to shrink as a percentage of the NIPA tax base in 2002. The substantial drop in the ratio of liabilities to NIPA income over the past couple of years reflects in part a reversal of the capital gains bonanza of the late 1990s and the tax reductions enacted in 2001. (Capital gains are not included in the NIPA income measure, which, by design, includes only income from current production.) In addition, the change in the distribution of income in the late 1990s, which concentrated more income in the upper tax brackets, may have been reversed some during the past couple of years.

Federal spending during the first eight months of fiscal year 2003 was 6½ percent higher than during the same period last year; excluding the drop in net interest outlays, spending was more than 7½ percent higher. Spurred by the war in Iraq, defense spending has moved up another 15 percent thus far this year; outlays for homeland security have risen briskly as well. Expenditures for income security programs, which include the temporary extended unemployment compensation program, also have risen at a fairly rapid rate. Though growth in spending on Medicare and Medicaid, taken together, has slowed a bit this year, the rising cost and utilization of medical care continue to put upward pressure on these programs.

Expenditures for consumption and gross investment, the part of federal spending that is included in GDP, rose just slightly in real terms in the first quarter as a sizable increase in non-

defense purchases was nearly offset by a surprising decline in defense spending. The dip in defense spending followed several quarters of large increases; with the supplemental appropriation in place, defense spending in the second quarter appears to have resumed its rapid growth.

Federal debt held by the public advanced at a 2¼ percent annual rate in the first quarter and remained at just below 35 percent of nominal GDP. During the first half of the year, the Treasury announced several changes in its debt management, including the reintroduction of three-year notes and regular reopenings of certain five-year and ten-year notes, to position itself better to address the widening federal deficit. These steps have the consequences of lengthening the average maturity of its outstanding debt and trimming the size of some of its auctions. The Treasury also noted that it would be increasing the frequency and size of its auctions of inflation-indexed securities.

Beginning in February 2003, the Treasury needed to take steps to avoid exceeding the level of the statutory debt ceiling and employed several accounting devices to which market participants have become accustomed. It also temporarily suspended the issuance of the type of Treasury debt instrument in which the proceeds of advance refundings by state and local governments are allowed to be invested. No adverse reaction in financial markets was apparent during this period, however, and a bill increasing the debt ceiling \$984 billion, to \$7.384 trillion, was enacted on May 23.

State and Local Governments

On the whole, the budget situation at state and local governments remains grim. Like the federal government, states and localities were running siz-

able budgetary surpluses in the late 1990s and now face large deficits. After having enacted a series of tax reductions in the second half of the 1990s, they subsequently saw their receipts eroded by weak incomes and the falling stock market. At the same time, these entities boosted their outlays considerably, in large part because of rising health care costs and increased demands for security-related spending. The fiscal difficulties have been especially acute at the state level. And although local governments generally have fared somewhat better, many are now facing reductions in assistance from cash-strapped states. According to the NIPA, the state and local sector's aggregate current deficit rose to about \$50 billion in 2002—or ½ percent of GDP, the largest annual deficit relative to GDP on record—and that gap exceeded \$65 billion at an annual rate in the first quarter of 2003.

Almost all states and most localities are subject to balanced budget and other statutory rules that force them to address fiscal imbalances. These rules typically apply to operating budgets, and governments have taken a variety of actions to meet their budgetary requirements for fiscal 2003 and to pass acceptable budgets for fiscal 2004, which started on July 1 in most states and many localities. Strategies have included drawing upon accumulated reserves, issuing bonds, and, in some cases, using one-time measures such as moving payments into the next fiscal year and selling assets. Increases in taxes and fees also have become more widespread. Still, spending restraint has remained an important component of the adjustment. Governments—especially at the state level—have held the line on hiring and have limited their outlays for a variety of other goods and services. In the NIPA, real expenditures for consumption and gross investment in the state

and local sector rose only $\frac{1}{2}$ percent over the year ending in the first quarter, compared with increases averaging more than $3\frac{1}{2}$ percent per year over the preceding five years. Available data point to continued softness in such spending in the second quarter.

The pace of gross issuance of municipal bonds remained robust in the first half of the year; it was fueled in part by the needs of state and local governments to finance capital spending, which is not subject to balanced budget requirements. Long-term debt issuance was heavily used for new education and transportation projects. Declining yields on municipal debt and high short-term borrowing demands also provided important impetus to debt issuance. Despite continued fiscal pressures on many state and local governments, the credit quality of municipal bonds has shown some signs of stabilizing. Although the spread of BBB-rated over AAA-rated municipal bond yields has widened somewhat, the number of municipal bond upgrades by S&P has slightly exceeded the number of downgrades so far this year. The yields on municipal bonds declined more slowly than the yields on Treasury securities of comparable maturity over much of the first half of the year; these moves lowered the yield differential from the tax-advantaged status of municipal securities.

The External Sector

Trade and the Current Account

In the first quarter of 2003, the U.S. current account deficit amounted to \$544 billion at an annual rate, or about 5 percent of GDP, a somewhat higher percentage than in any quarter of last year. The deficit on trade in goods and services widened \$22 billion in the first quarter, to \$486 billion, as the value of

imports rose more than that of exports. U.S. net investment income registered a \$16 billion surplus in the first quarter, little changed from the previous quarter but significantly larger than the outcome for last year as a whole. The increase over last year is attributable primarily to lower net interest and dividend payments. Net unilateral transfers and other income were a negative \$74 billion, down from a negative \$67 billion in the fourth quarter.

Real exports of goods and services fell $1\frac{1}{4}$ percent at an annual rate in the first quarter; this decline, like that in the previous quarter, reflected in part slow economic growth of our major trading partners. Within this total, exports of goods increased nearly 2 percent after declining sharply in the fourth quarter of last year. Moderate increases in most trade categories were partly offset by a decrease in exports of capital goods (particularly aircraft and computers). Meanwhile, real exports of services declined about 8 percent in the first quarter, mainly because of a drop in receipts from foreign travelers. Prices of exported goods and services, which rose nearly 4 percent at an annual rate in the first quarter, were boosted by rising prices of services and industrial supplies (mainly goods with a high energy component). Prices of exported capital goods, automotive products, and consumer goods showed little change in the first quarter.

U.S. real imports of goods and services declined $6\frac{1}{4}$ percent at an annual rate in the first quarter following four quarters of increases. Imports of oil, other industrial supplies, aircraft, and services (primarily U.S. travel abroad) all dropped sharply. Imports of automotive products decreased for the second consecutive quarter, but imports of machinery and consumer goods rose. The price of imported goods jumped

12 percent at an annual rate in the first quarter, mainly resulting from spikes in the prices of natural gas and oil. The price of imported goods excluding fuels rose about 2 percent in the first quarter, the fourth consecutive quarter of small increases, in part because of the depreciation of the dollar since early 2002. Slight declines in prices of imported capital goods, automotive products, and consumer goods were offset by small increases in other categories.

The spot price of West Texas intermediate crude oil rose to a twelve-year high of nearly \$38 per barrel in mid-March as the United States moved closer to war in Iraq and as a nationwide strike slowed Venezuelan oil production to a trickle. With the commencement of military action in Iraq and the relatively rapid conclusion of the war, prices fell to less than \$26 per barrel by late April. Downward pressure on prices was also exerted by increased production from some OPEC countries, particularly Saudi Arabia, Kuwait, and Venezuela, where oil production recovered substantially relative to the first quarter. In early June, oil prices moved back above \$30 per barrel after it became apparent that Iraqi exports of oil would return more slowly than market participants had previously expected.

The Financial Account

The U.S. current account deficit continued to be financed in large part by private flows into U.S. bonds and by foreign official inflows. Private foreign purchases of U.S. securities, which slowed in the latter part of 2002, stepped down a bit more in the first quarter of 2003, owing in part to weaker demand for U.S. equities. In contrast, inflows into the United States from official sources, which surged in 2002, picked up further in the first half of 2003 partly

in response to downward pressures on the foreign exchange value of the dollar. U.S. residents, who had sold foreign securities on net last year, recorded sizable net purchases in the first quarter of this year: Relatively large purchases of foreign equities outweighed further sales of bonds.

Direct investment into the United States, after being restrained in 2002 by a slowdown of global mergers and acquisitions, picked up in the first quarter of 2003, as merger activity resumed. U.S. direct investment abroad was steady in 2002 and the first quarter of 2003.

The Labor Market

Employment and Unemployment

The demand for labor has weakened further this year, though the pace of job losses appears to have slowed somewhat. After having fallen an average of 55,000 per month in 2002, private payroll employment declined 35,000 per month, on average, in the first quarter of 2003 and 21,000 per month in the second quarter. The civilian unemployment rate, which had been fluctuating around 5¾ percent since late 2001, was little changed in the first quarter but moved up in the spring. In June, it stood at 6.4 percent.

The manufacturing sector has continued to shed jobs this year. On average, factory payrolls fell 55,000 per month over the first half of 2003—essentially as fast as over 2002 as a whole. Employment declines were widespread, but the metals, machinery, and computers and electronics industries continued to be especially hard hit. The weakness in manufacturing also cut into employment at help-supply firms and at wholesale trade establishments, although help-

supply jobs increased noticeably in May and June.

Apart from manufacturing and related industries, private employment increased slightly, on net, in the first half after having been about unchanged in 2002. Employment in the financial activities sector rose briskly, in part because of the boom in mortgage refinancings. Construction employment, which had been essentially unchanged, on net, since 1999, remained soft in the first quarter but posted a sizable gain in the second quarter. Employment in the information sector, which includes telecommunications, publishing, and Internet-related services, continued to decrease, though a shade less rapidly than over the preceding two years. Demand for workers in retail trade, leisure and hospitality, and transportation and utilities remained lackluster.

The unemployment rate was little changed in the first quarter, but it subsequently turned up. In June, it stood at 6.4 percent, $\frac{1}{2}$ percentage point higher than the average in the fourth quarter of 2002 and about $2\frac{1}{2}$ percentage points above the lows reached in 2000. The rise in the unemployment rate over the spring was chiefly driven by the ongoing softness in labor demand. Most recently, it also coincided with an uptick in labor force participation. That uptick notwithstanding, the participation rate has trended down over the past couple of years, a slide mainly reflecting declines for adult men and younger persons.

Productivity and Labor Costs

Labor productivity has continued to post solid gains in recent quarters as businesses have remained reluctant to expand their payrolls and instead have focused on cutting costs in an environment of sluggish—and uncertain—

demand. According to the currently published data, output per hour worked in the nonfarm business sector rose at an annual rate of 2 percent in the first quarter and $2\frac{1}{2}$ percent over the four quarters ending in the first quarter. Though the recent gains are down from the very rapid increases in late 2001 and 2002, they are similar to those achieved in the second half of the 1990s. However, whereas the earlier productivity gains were driven importantly by an expansion of the capital stock, the recent gains appear to have come mainly from efficiency-enhancing changes in organizational structures and better use of the capital already in place.

The employment cost index (ECI) for private nonfarm businesses increased about $3\frac{3}{4}$ percent over the twelve months ending in March—only a shade less than over the preceding year but more than $\frac{1}{2}$ percentage point below the increases of a few years earlier. The deceleration in hourly compensation over the past few years has been concentrated in wages, for which gains slowed from about 4 percent per year in 2000 and 2001 to 3 percent over the year ending this March. The slowing in wage growth primarily reflects the effects of the soft labor market and lower rates of price inflation; in addition, employers may be exerting more restraint on wages to offset some of the upward pressure on total compensation from rising benefit costs. The increase in benefits was especially sharp in the first quarter of 2003; in that period, employers stepped up their contributions to defined-benefit retirement plans in response to declines in the market value of plan assets, and health insurance costs continued to increase rapidly. In total, benefit costs rose 6 percent over the year ending in March.

The growth in compensation per hour in the nonfarm business sector—an

alternative measure of hourly compensation based on the NIPA—has swung widely in recent years. Fluctuations in the value of stock option exercises, which are excluded from the ECI, likely have contributed importantly to these swings. In any event, the increase in this measure over the year ending in the first quarter was $3\frac{1}{4}$ percent and roughly in line with the rise indicated by the ECI.

Prices

Headline inflation numbers have been heavily influenced by movements in energy prices, but underlying inflation has remained subdued and according to some measures has even moved somewhat lower. Reflecting the surge in energy prices, the chain-type price index for personal consumption expenditures (PCE) increased at an annual rate of $2\frac{3}{4}$ percent in the first quarter, about 1 percentage point faster than the increase over 2002 as a whole; this index moved down in April and May as energy prices retreated. PCE prices excluding food and energy—the so-called core PCE price index—were nearly unchanged during the spring, and the twelve-month change in this series stood at $1\frac{1}{4}$ percent in May, compared with a reading of $1\frac{3}{4}$ percent over the preceding twelve months.

In the main, the quiescence of underlying inflation reflects continued slack in labor and product markets and the robust productivity gains of recent years. In addition, inflation expectations have remained in check—and, indeed, may have subsided a bit further. For example, according to the Michigan Survey Research Center, the median expectation for inflation over the coming year was running about 2 percent in May and June, compared with $2\frac{1}{2}$ percent to 3 percent over much of the preceding few years. Readings on this mea-

sure had been considerably higher earlier in the year, when energy prices were rising, and it is difficult to know whether the decline of late was driven chiefly by the retreat in energy prices during the spring. Non-oil import prices posted a sizable increase in the first quarter after having been little changed in 2002, but the first-quarter rise was due largely to a spike in the price of imported natural gas, which should not have much effect on core consumer price inflation. Given the decline in the dollar from its peak in early 2002, non-oil import prices will probably trend up modestly in coming quarters.

PCE energy prices rose sharply in the first quarter but turned down in the spring, a pattern largely mirroring the swings in crude oil prices. Gasoline prices, which had already been elevated in late 2002 by weather-related supply disruptions, increased further early this year as crude oil costs rose and wholesale margins remained large; by June 1, gasoline prices had reversed that increase, and they have changed little, on net, since that time. Natural gas prices also soared in early 2003 as tight inventories were depleted further by unusually cold weather; since the unwinding of February's dramatic spike, prices have held in a narrow range. Inventories of natural gas have increased significantly of late, but they are still low enough to raise concerns about the possibility of future price spikes in the event of a heat wave later this summer or an unusually cold winter. Reflecting the higher natural gas input costs, PCE electricity prices rose substantially over the first five months of 2003 after having fallen some in 2002.

Increases in core consumer prices of both goods and services have slowed over the past year, with the deceleration most pronounced for goods. Prices for core PCE goods fell $2\frac{1}{4}$ percent over

the year ending in May after having decreased 1 percent over the preceding twelve months. Meanwhile, the rise in prices for non-energy services totaled 2¾ percent over the year ending in May, a little less than over the preceding period. Among the major types of services, the price of owner-occupied housing was up only 2½ percent after having risen 4¼ percent over the preceding period. But prices for some other types of services accelerated. Most notably, the prices of financial services provided by banks without explicit charge turned up after having decreased over the preceding two years; because these prices cannot be derived from market transactions and thus must be imputed, they are difficult to measure and tend to be volatile from year to year.

Increases in the core consumer price index (CPI) also have been very small recently, and the twelve-month change in this measure slowed from 2½ percent in May 2002 to 1½ percent in May 2003—a somewhat greater deceleration than in core PCE prices. The greater deceleration in the CPI is primarily accounted for by its narrower scope and different weighting structure than the PCE measure. In particular, it excludes the imputed prices of financial services rendered without explicit charge as well as several other categories for which market prices are not available; these non-market-based prices have accelerated notably recently. In fact, when the nonmarket categories are stripped from the core PCE index, the remaining components show a deceleration close to that in the core CPI. Another consideration is that housing costs have a much larger weight in the CPI than in the PCE index, partly because of the CPI's narrower coverage. Thus, the smaller price increases for housing services of late have a bigger damping effect on core CPI inflation, just as the hefty increases

Alternative Measures of Price Change

Percent

Price measure	2001 to 2002	2002 to 2003
<i>Chain-type</i>		
Gross domestic product	1.4	1.6
Gross domestic purchases .....	.8	2.3
Personal consumption expenditures .....	.9	2.2
Excluding food and energy ...	1.5	1.5
Chained CPI .....	.9	2.5
Excluding food and energy ...	1.9	1.4
<i>Fixed-weight</i>		
Consumer price index	1.3	2.9
Excluding food and energy ...	2.5	1.8

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

in this category in 2001 and 2002 tended to lift the CPI relative to the PCE index.

Broader price measures likewise point to low inflation over the year ending in the first quarter. In particular, the chain-type price index for GDP rose only 1½ percent over that period, about the same as during the comparable period four quarters earlier. Meanwhile, the price index for gross domestic purchases—which is defined as the prices paid for consumption, investment, and government purchases—increased 2¼ percent, up from ¾ percent during the preceding period. The upswing mainly reflects the effect of higher energy prices and roughly matches the acceleration in total PCE prices; the price indexes for construction and government purchases also recorded somewhat larger increases than they had over the preceding period.

U.S. Financial Markets

On balance, major stock indexes have climbed noticeably this year, government and corporate interest rates have declined, and risk spreads, which had

dropped significantly late last year, have fallen further.

Before the War in Iraq

The year began on an optimistic note in financial markets, in part owing to the release of a surprisingly strong report from the Institute for Supply Management and the announcement of a larger-than-expected package of proposed tax cuts, which included elimination of the personal federal income tax on many corporate dividend payments. In addition, yields and risk spreads on corporate bonds had dropped significantly in the fourth quarter of 2002, partly in reaction to the absence of new revelations of accounting irregularities and to the improved outlook for corporate credit quality. Money market futures rates apparently embedded an expectation that the FOMC would begin increasing the federal funds rate as early as mid-summer 2003.

That short burst of optimism was quickly damped by subsequent economic reports that were decidedly less rosy, a jump in oil prices in response to the looming prospect of war in Iraq, and increased tensions with North Korea. Measures of uncertainty, such as implied volatility, moved up in several markets. Major equity indexes slid and by mid-March were off about 4 percent to 9 percent from the beginning of the year. Investors also came to believe that the onset of FOMC tightening would occur later than they had earlier believed, a shift in perception that was reflected in lower yields on Treasury bonds. Yields on investment-grade corporate bonds fell about in line with those on Treasuries, and investors appeared to be substituting high-quality bonds for equities as part of a broader flight to fixed-income securities over this period. By contrast, yields on below-investment-

grade bonds rose a bit, on balance, between mid-January and mid-March, a move that left their risk spreads higher as well.

After the War in Iraq

Once it became clear that military action in Iraq was imminent, a robust rally erupted in both the equity and bond markets, as some of the uncertainties apparently dissipated and investors began to show a greater appetite for riskier assets. Equity indexes jumped about 8 percent in the two weeks bracketing the President's ultimatum to Saddam Hussein, and prices climbed an additional 3 percent through the end of April, partly on the release of generally better-than-expected earnings reports for the first quarter. Gains in share prices were fairly widespread and included technology, defense, petroleum, and especially financial companies.

The easing of tensions also put upward pressure on Treasury yields, but additional disappointing economic data offset the diminished safe-haven demands and left those rates down, on balance, during the period covering the war in Iraq and its immediate aftermath. Yields on corporate bonds also declined, in part because of strengthened corporate balance sheets, the reduction in uncertainty, and perhaps because investors began to search for higher returns. Moreover, according to one widely used measure, spreads on speculative-grade bonds tumbled about 150 basis points, to about 520 basis points, from mid-March until mid-May, and then fluctuated somewhat before ending June near that level. The rally in below-investment-grade bonds was particularly evident in sectors that had previously experienced some of the greatest widening of spreads—telecom, energy trading, and utilities; the interest in these

sectors further indicated investors' increased appetite for risk.

A stubbornly sluggish economy and rapid growth of productivity muted both inflation and inflation expectations, inducing the FOMC to begin pointing to a further substantial decline in inflation as a concern at its May meeting. Market participants took this to imply that short-term rates would be held along a lower path for longer than they had previously expected. This shift in expectations triggered a further decline in intermediate- and long-term yields. With long-term inflation expectations apparently only little changed, the decline in yields translated into a sizable decline in real interest rates.

That drop in real interest rates was among several factors providing a boost to equity prices in May and June. Implied volatility of the S&P 100 index, which had been elevated earlier in the year, fell substantially with the conclusion of major hostilities in Iraq; it is now near the bottom of its range of the past several years. Moreover, downward revisions to analysts' earnings expectations for the year ahead have been the smallest since early 2000. The tax package passed in late May, which included a cut in taxes on capital gains and dividends, may have provided some additional impetus to equity prices.

The FOMC decided on June 25 to reduce the target federal funds rate 25 basis points, to 1 percent, but some observers had been anticipating a cut of 50 basis points. In addition, markets appeared to read the Committee's assessment of economic prospects as more upbeat than expected. Partly as a result, yields on longer-dated Treasury securities reversed a portion of their previous decline in the weeks following the meeting. Yields on high-quality corporate bonds rose about in line with Treasuries

over the same period, but yields on speculative-grade bonds edged up only slightly, and risk spreads narrowed further. Forward-looking economic indicators were generally positive, and stock price indexes—the Nasdaq, in particular—continued to trend higher.

On net, the constant-maturity yield on the two-year Treasury note has fallen 24 basis points this year, to 1.37 percent as of July 9, while the yield on the ten-year Treasury bond has fallen 10 basis points, to 3.73 percent. Over the same period, the Wilshire 5000 is up 15½ percent, and the Nasdaq has surged more than 30 percent. As a result of the decline in real interest rates, the spread between the twelve-month forward earnings-price ratio for the S&P 500 and the real ten-year yield remains wide despite the run-up in stock prices.

Shorter-Term Debt Markets

The average interest rate on commercial and industrial loan originations—a substantial majority of which have adjustable interest rates—has fallen to its lowest level since the start of the Federal Reserve's Survey of Terms of Business Lending in 1977. The survey also indicates that risk spreads on these loans receded a bit over the first half of 2003 after having trended up for most of the past several years. Prices in the secondary loan market have risen this year, reportedly in part because some of the large inflows to high-yield mutual funds were used to purchase distressed loans and because of the expectation that many outstanding loans would continue to be prepaid with the proceeds of bond refinancing.

Interest rates on commercial paper also dropped to very low levels in the first half of 2003. Risk spreads in this

market were relatively stable and near the bottom of the range observed over the past several years, in part because of businesses' efforts to strengthen their balance sheets and improve their liquidity.

Debt and Financial Intermediation

The debt of all domestic nonfinancial sectors—government, businesses, and households—grew at a 6½ percent annual rate in the first quarter, down from 8 percent in the fourth quarter of 2002 but still well in excess of the growth of nominal GDP. The proportion of the new credit supplied by depository institutions rose significantly in the second half of last year and remained at about 25 percent in the first half of this year. In large part, the jump reflects the sector's support of the booming mortgage market—through both direct lending and the acquisition of mortgage-backed securities—which has more than offset weak business lending. At commercial banks, revenues from mortgage-related activities reportedly helped sustain profits in the first quarter at the elevated levels of the past several years despite some erosion in net interest margins.

The delinquency rate on all loans and leases at banks edged down further during the first quarter, to its lowest level in two years. Increases in the delinquency rates on commercial real estate loans and non-credit-card consumer loans were offset by declines in those on residential real estate loans, credit card loans, and business loans. For business and credit card loans, however, the delinquency rates at banks remain elevated, and the recent improvement likely reflects, in part, the effect of the tightening of lending standards and terms that has been reported for

some time now in the Senior Loan Officer Opinion Survey. On a seasonally adjusted basis, the ratio of loan-loss provisions to assets declined in the final quarter of last year, and it was about unchanged from that still-elevated level in the first quarter of 2003. In addition to the buffer against future losses provided by their high profitability and substantial provisions, virtually all banks—98 percent by assets—remain well capitalized.

Among nondepository financial institutions, issuers of asset-backed securities provided about 13 percent of the total credit extended to domestic nonfinancial sectors in the first quarter. The share of net lending supplied by mutual funds increased notably to almost 10 percent in the first quarter, and with the continuation of strong flows to bond mutual funds, they likely were large suppliers in the second quarter as well. Meanwhile, available data suggest that insurance companies likely accounted for about 7 percent of total credit extended during the first half of the year, a proportion near the top of the range seen since the mid-1990s.

Government-sponsored enterprises (GSEs) provided 11 percent of the net lending (net acquisition of credit market instruments) in the first quarter, an amount roughly in line with their level in the second half of 2002. The duration gaps in the portfolios of the housing GSEs were maintained near their targets. In early June, Freddie Mac replaced its top three executives amid questions about its accounting practices. The spreads on longer-term Freddie Mac debt widened a bit, and its stock price declined sharply; the prices of Fannie Mae securities also declined but to a lesser extent. On net, there appears to be little, if any, spillover into broader financial markets.

Monetary Aggregates

Through the first half of 2003, the growth rate of M2 was buoyed by several factors and remained elevated. The rising level of mortgage refinancing causes money growth to accelerate because the associated prepayments on mortgage-backed securities that are temporarily held in escrow accounts increase liquid deposits. Demand for M2 was also supported by the decline in short-term market interest rates, which further reduced the opportunity cost of holding money. Precautionary demand for safe and liquid M2 assets also likely buttressed the growth of M2 in the run-up to the war in Iraq.

In contrast, mutual fund flows related to the bond market rally and the post-war pickup in the stock market may have siphoned funds from M2. Retail money market mutual funds and small time deposits both experienced net outflows during the first half of the year. While some of that money continued to feed the extraordinary growth of liquid deposits, it is likely that a portion was redirected to long-term mutual funds.

After having weakened significantly in 2002, growth of M3 slowed further in the first half of 2003. Much of this year's slowdown can be attributed to rapid runoffs of institutional money market mutual funds. The runoffs were, in turn, partially the result of an unwinding of the strength late last year and the fact that interest rates paid by those funds declined faster than the interest rates paid by the underlying assets this year. The drop in institutional money funds has been offset by growth in eurodollar deposits and repurchase agreements.

International Developments

Economic activity abroad was sluggish in the first quarter of 2003, with real

output in the euro area and Japan little changed from the previous quarter. Geopolitical uncertainties, higher oil prices, slow growth in the United States, persistent weakness in global high-tech sectors, and continued negative wealth effects from past declines in equity prices all weighed on foreign growth. Foreign economic expansion appeared to remain weak in the second quarter despite the reduction in uncertainty associated with Iraq. Indicators suggest that manufacturing activity abroad has not picked up; instead, industrial production declined in April and May, on average, relative to the first quarter in Japan, Germany, and France. Concerns over the spread of the SARS virus appear to have hurt growth in the second quarter in several Asian developing economies and in Canada.

Central banks in several major foreign industrial countries moved to ease monetary policy during the first half of this year. The European Central Bank and the central banks of the United Kingdom, Sweden, Switzerland, Norway, and New Zealand all cut official interest rates. The pace of monetary easing in Europe picked up toward mid-year, when inflation pressures dissipated amid growing slack, currency appreciation vis-à-vis the dollar, and the decline in oil prices after the conflict in Iraq. In contrast, the Bank of Canada raised interest rates twice in the spring, in a continued effort to contain inflation. The Bank of Canada left rates unchanged in June, however, in response to a sharp appreciation of the Canadian dollar and a drop in Canadian inflation in April, some slackening of demand in labor markets in May, and concerns about the pace of activity in the United States. The Bank of Japan (BOJ) maintained short-term interest rates at near-zero levels, further expanded its target for current account balances held by financial

institutions at the BOJ, and took some additional measures to add stimulus to the economy.

In the first quarter, foreign financial markets were influenced by heightened anxieties ahead of the war in Iraq, but those concerns appeared to diminish as the war proceeded. Foreign equity prices declined in the first quarter, but they have since recovered. Broad stock indexes for the major industrial countries are up on balance since the beginning of the year but, with the exception of Japan, they have gained less than in the United States. Long-term interest rates in most foreign industrial countries fell during the first half of the year because prospects for inflation diminished, growth sputtered, and market participants began to expect that policy interest rates would remain low for an extended period. Asset prices in emerging markets, particularly in Latin America, picked up during the first half of this year; equity prices rose significantly, and risk spreads on emerging-market bonds narrowed. Bonds issued by a number of emerging-market economies included collective action clauses (CACs) that are designed to facilitate a debt restructuring in the event of default; this development had little noticeable effect on spreads.

The dollar's foreign exchange value continued to decrease in the first half of 2003. Since the end of 2002, the dollar has depreciated on a trade-weighted basis nearly 5 percent against the currencies of a broad group of U.S. trading partners. The dollar has declined 13 percent against the Canadian dollar and more than 7 percent on net against the euro but has fallen less than 1 percent versus the Japanese yen. During the first quarter, the dollar appeared to react to concerns about the war in Iraq, falling when news indicated a heightened risk of hostilities and strengthening as con-

cerns appeared to abate. After the resolution in April of major hostilities, the dollar fell further, and market commentary focused more on the financing needs posed by the large and growing U.S. current account deficit.

Industrial Economies

The euro-area economy stagnated in the first quarter of 2003. Consumer spending continued to expand at a modest rate and inventory investment grew, but business fixed investment fell sharply and exports declined. The German economy contracted in the first quarter and continued to underperform the euro-area average, in part owing to a fiscal tightening undertaken to bring the budget deficit into line with limits set out in the euro area's Stability and Growth Pact. The rise in the exchange value of the euro over the past year has begun to hurt euro-area manufacturers; exports have leveled off while imports have continued to rise. Recent indicators have shown little rebound in the pace of euro-area activity following the conclusion of the Iraq war, and business and consumer sentiment have remained sour. Core inflation has slowed from its 2002 peak, and headline inflation, which was temporarily boosted by oil prices, recently has fallen to the 2 percent upper limit of the ECB's definition of price stability.

Economic growth in the United Kingdom slowed to a crawl in the first quarter, but recent indicators—such as consumer confidence and industrial production—suggest that the pace has been somewhat stronger during the past few months. Growth of consumption has slowed but continues to be held up by a strong labor market and by past gains in housing prices, although lately these prices have decelerated.

The Japanese economy barely grew in the first quarter after expanding

almost 2½ percent in 2002. Business investment continued to grow in the first quarter, and private consumption increased despite stagnating incomes; however, residential and public investment both fell sharply, and exports declined because of the weak global economy. The severity of consumer price deflation lessened somewhat, partly because of the spike in energy prices. Japanese banks continued to be weighed down by bad loans.

Canada's economy maintained a moderate pace of expansion in the first quarter, but recent indicators suggest that growth of real GDP slowed in the second quarter. First-quarter growth was supported by continued strength in domestic demand, as Canada's strong labor and housing markets kept propelling the economy. However, exports declined in the first quarter, largely because of a drop in exports of industrial supplies and forestry products to the United States. More recently, employment declined slightly in April and May, and the unemployment rate moved up. The outbreak of the SARS virus in Toronto hurt Canadian travel and tourism, and weak U.S. demand slowed the Canadian manufacturing sector. In June, employment rebounded, but the gain was almost all in part-time work, and manufacturing employment continued to fall.

Emerging-Market Economies

Economic growth in the Asian developing countries slowed in the first quarter, brought down by weakness in business investment and consumer spending. In South Korea, growth of real GDP turned negative in the first quarter after a rapid expansion in 2002. Tensions with North Korea contributed to a decline in consumer and business sentiment, but these indicators have stabilized in the past

couple of months. The Hong Kong economy also contracted, following strong growth in the second half of last year. The SARS outbreak held down both personal consumption and tourism in the first quarter, and even more negative effects are likely to be seen in the second-quarter data. Although the Chinese economy has also been adversely affected by SARS, it has been sustained by strong export growth and investment. Chinese inflation has moved back into positive territory on a twelve-month basis, largely owing to higher prices for energy and food.

The Mexican economy contracted in the first quarter, and exports and business confidence have declined in recent months. Consumer price inflation has come down recently, a decline helped in part by the net appreciation of the Mexican peso since early March. Measures of inflation expectations suggest that market participants expect the central bank to come close to achieving its inflation target this year.

Brazilian economic growth stagnated in the first quarter largely as a result of the tightening of macroeconomic policies in response to the financial crisis that erupted in mid-2002. The growth slowdown largely reflected a continued weakening in domestic demand, but exports also deteriorated. Monthly inflation has come down since early this year, and Brazil's central bank recently lowered slightly its benchmark interest rate. The Lula administration's efforts to implement social security and tax reforms have bolstered investor confidence. Financial conditions in Brazil have improved markedly: Equity prices have risen more than 20 percent so far this year, the *real* has gained more than 20 percent against the U.S. dollar, and credit spreads on Brazilian government debt have narrowed more than 600 basis points.

The Argentine economy has started to turn around from the sharp contraction that occurred in the wake of the devaluation and default in late 2001, but the level of economic activity remains far below pre-crisis levels, and many of Argentina's structural problems have

not been addressed. The Argentine peso appreciated more than 20 percent against the dollar during the first half of the year. In July, Argentina implemented controls on short-term capital inflows in an effort to stabilize the appreciating currency. ■

Federal Reserve Operations

Consumer and Community Affairs

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

- writing and interpreting regulations to implement federal laws that protect and inform consumers
- supervising banks to ensure their compliance with the regulations
- investigating complaints from the public about bank compliance with regulations
- promoting community development in historically underserved markets

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

Supervision for Compliance with Consumer Protection and Community Reinvestment Laws

Activities Related to the Community Reinvestment Act

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

- examines state member banks to assess their compliance with the CRA

- analyzes applications for mergers and acquisitions by state member banks and bank holding companies in relation to CRA performance
- disseminates information on community development techniques to bankers and the public through Community Affairs Offices at the Reserve Banks

Examinations for Compliance with the CRA

The Federal Reserve assesses and rates the CRA performance of state member banks in the course of examinations carried out at a frequency set by statute.¹ During the 2003 reporting period, the Federal Reserve conducted 313 CRA examinations. Of the banks examined, 42 were rated "outstanding" in meeting community credit needs, 270 were rated "satisfactory," none were rated "needs to improve," and 1 was rated as being in "substantial noncompliance."²

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

Under the Bank Holding Company Act and the Bank Merger Act, the Board

1. By statute, banks with assets of less than \$250 million that were rated "satisfactory" for CRA performance in their most recent examination are examined not more than once every forty-eight months, and those that were rated "outstanding" are examined not more than once every sixty months. Banks with assets of \$250 million or more that were rated "satisfactory" or "outstanding" in their most recent examination are examined not more than once every twenty-four months.

2. The 2003 reporting period was July 1, 2002, through June 30, 2003.

considers applications for which CRA protests are raised or significant issues exist regarding CRA or consumer compliance. Other cases are decided by the Reserve Banks under delegated authority.

During 2003, the Board of Governors considered applications for several significant banking mergers:

- An application by Royal Bank of Canada (Toronto, Canada) and RBC Banks, Inc. (Rocky Mount, North Carolina), to acquire Admiralty Bancorp, Inc. (Palm Beach Gardens, Florida), was approved in January.
- An application by M&T Bank Corporation (Buffalo, New York) to acquire Allfirst Financial, Inc. (Baltimore, Maryland), was approved in March.
- An application by SouthTrust Corporation (Birmingham, Alabama) to acquire Founders Bancshares, Inc. (Dallas, Texas), was approved in March.
- Two applications by The Royal Bank of Scotland Group, plc (Edinburgh, Scotland), and Citizens Financial Group, Inc. (Providence, Rhode Island), to acquire Port Financial Corp. (Brighton, Massachusetts) and Thistle Group Holdings, Co. (Philadelphia, Pennsylvania), were approved in June and December respectively.
- An application by Cathay Bancorp, Inc., to acquire GBC Bancorp (both in Los Angeles, California) was approved in September.
- Applications by Wells Fargo & Company (San Francisco, California) to acquire Pacific Northwest Bancorp (Seattle, Washington) and Two Rivers

Corporation (Grand Junction, Colorado) were approved in October.

Comments from the public were received on each of these applications. Most of the commenters expressed concerns that lending to lower-income communities and populations was insufficient and that the institutions had failed to address the convenience and needs of affected communities. Commenters also raised issues relating to potentially abusive lending practices involving subprime and payday lenders; the potentially adverse effects of branch closings; failure of minority-owned and -operated institutions to adequately serve other minority populations; and alleged fraud.

In addition to considering these applications for significant banking mergers, the Board acted on twelve other bank and bank holding company applications that involved protests by members of the public concerning the performance of insured depository institutions under the CRA. The Board also reviewed two applications that involved institutions having CRA ratings lower than satisfactory and another thirty applications involving other issues related to the CRA, fair lending, or compliance with consumer credit protection laws.³

Other Consumer Compliance Activities

The Division of Consumer and Community Affairs supports and oversees the supervisory efforts of the Federal Reserve Banks to ensure that consumer protection laws and regulations are fully and fairly enforced. Division staff provide guidance and expertise to the

3. In addition, two applications involving adverse CRA ratings and three involving other CRA or compliance issues were withdrawn in 2003.

Reserve Banks on consumer protection regulations, examination and enforcement techniques, examiner training, and emerging issues. They develop and update examination policies, procedures, and guidelines and review Reserve Bank supervisory reports and work products. They also participate in interagency activities that promote uniformity in examination principles and standards.

Examinations are the Federal Reserve's primary means of enforcing bank compliance with consumer protection laws. During the 2003 reporting period, the Reserve Banks conducted 402 consumer compliance examinations—368 of state member banks and 34 of foreign banking organizations.⁴

The Board periodically issues guidance for Reserve Bank examiners on consumer protection laws and regulations. In addition to updating examination procedures for a number of regulations in concert with the other federal financial institution regulatory agencies, the Board in 2003 revised the Federal Reserve's procedures for reviewing compliance with the Children's Online Privacy Protection Act. Further, the Board updated its risk-focused supervision program to facilitate the sharing of information about risks in the consumer compliance area with examiners in other specialty areas (for example, safety and soundness, trust, and information technology). The Board also issued exam-

iner guidance for reviewing mortgage-servicing disclosures and a checklist to assist examiners in reviewing financial institutions' web sites for compliance with consumer protection laws.

Fair Lending

The Board has a responsibility to ensure that the banks under its jurisdiction comply with the federal fair lending laws—the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. The ECOA prohibits creditors from discriminating against an applicant, in any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex, marital status, or age. In addition, creditors may not discriminate against an applicant because the applicant receives income from a public assistance program or has exercised, in good faith, any right under the Consumer Credit Protection Act. Congress assigned responsibility for administrative enforcement of the ECOA to the Board for banks under its jurisdiction, to other regulators for creditors that they regulate, and to the Federal Trade Commission for all other creditors.

The Fair Housing Act covers credit for the purchase, construction, improvement, maintenance, or repair of a dwelling. It makes it unlawful for a creditor to deny any form of financial assistance, or to discriminate in fixing the amount, interest rate, or any other terms or conditions of any financial assistance, on the basis of race, color, religion, national origin, handicap, familial status, or sex.

The ECOA also obligates the Board and other agencies with enforcement responsibilities under the act to refer any pattern or practice of ECOA violations to the Department of Justice. When a violation of the ECOA also violates the Fair Housing Act, the matter may be referred to the Department of Urban

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

Development. To promote consistency in the way fair lending issues are analyzed throughout the System, Division of Consumer and Community Affairs staff coordinate the investigation of potential fair lending violations with Reserve Bank staff and develop recommendations for the division director regarding whether referral is necessary or appropriate.

During 2003, division staff received and reviewed seven reports from Reserve Banks regarding possibly referable violations. Four of the reports involved possible discrimination in underwriting standards on the basis of age or gender; the other three involved apparent discriminatory loan-pricing practices. In three of the underwriting standards cases, the staff concluded that referral was not warranted; the other four cases remained under consideration at year-end.

Since 1994, the Federal Reserve has used a two-stage statistical regression program to help assess fair lending compliance by high-volume mortgage lenders. The program uses reported HMDA data for a stage one analysis to identify banks having significant disparities between minority and non-minority applicants' loan denial rates; it then targets these banks for a stage two analysis that considers extensive additional information taken from a sample of a bank's loan files. The program produces statistically reliable results even in cases in which the number of denied applicants in a protected class is relatively small.

Flood Insurance

The National Flood Insurance Act imposes certain requirements for loans secured by buildings or mobile homes located in, or to be located in, areas determined to have special flood haz-

ards. Under the Federal Reserve's Regulation H, which implements the act, state member banks in general are prohibited from making, extending, increasing, or renewing any such loan unless the building or mobile home and any personal property securing the loan are covered by flood insurance for the term of the loan. The act requires the Federal Reserve to impose civil money penalties when it finds a pattern or practice of violations. The money is turned over to the Federal Emergency Management Agency for deposit into the National Flood Mitigation Fund.

During 2003, the Board imposed civil money penalties on eleven state member banks for violations of the flood insurance rules. The penalties, which were assessed via consent orders, ranged from \$1,750 to \$34,100.

Coordination with Other Federal Banking Agencies

The member agencies of the Federal Financial Institutions Examination Council (FFIEC) develop uniform examination principles, standards, procedures, and report formats.⁵ In 2003, the FFIEC issued revised examination procedures for determining compliance with Regulation Z (Truth in Lending); Regulation M (Consumer Leasing); the Real Estate Settlement Procedures Act; the homeownership counseling provisions of the Housing and Urban Development Act; and Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). Additionally, the FFIEC issued an updated edition of its

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

booklet “A Guide to HMDA Reporting: Getting It Right!” which is designed to assist financial institutions in accurately reporting HMDA data.

The FFIEC member agencies maintain a database of local community contacts that can help the agencies’ examination staffs develop community profiles, identify opportunities for financial institutions to meet local credit needs, and help provide a context for evaluating institutions’ CRA performance. The FFIEC significantly upgraded the community contacts database in 2003 to facilitate the sharing of information among the agencies and to streamline the process by which the data are accessed and maintained.

Ten federal agencies—the FFIEC member agencies, the Federal Trade Commission, the Department of Housing and Urban Development, the Department of Justice, the Federal Housing Finance Board, and the Office of Federal Housing Enterprise Oversight—collaborated in 2003 to develop a consumer education brochure titled “Putting Your Home on the Loan Line Is Risky Business.” The brochure cautions consumers to carefully consider the terms of equity-based loans before using their home equity to address financial problems.

During the year the Board, the OCC, and the FDIC also updated the host-state loan-to-deposit ratios used to determine compliance with section 109 of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994.

Training for Bank Examiners

Ensuring that financial institutions comply with laws that protect consumers and encourage community reinvestment is an important part of the bank examination and supervisory process. As the

number and complexity of consumer financial transactions grow, training for examiners of the state member banks under the Federal Reserve’s supervisory responsibility becomes even more important. The consumer affairs curriculum comprises courses on various consumer protection laws, regulations, and examination concepts. In 2003, these courses were offered in ten sessions to more than 200 Federal Reserve consumer compliance examiners.

Board and Reserve Bank staff regularly review the core curriculum for examiner training, updating subject matter and adding new elements as appropriate. During 2003, the staff revised two core courses to incorporate changes in policy and laws. The courses reviewed were

- *Introduction to Consumer Compliance Examinations.* Emphasizes examination procedures and the practical application of banking regulations, and focuses on the consumer laws that govern financial institutions’ non-real-estate lending and operational procedures. Geared toward assistant examiners with three to six months of examination experience.
- *Consumer Compliance Examinations II.* Equips assistant examiners with the skills needed to determine compliance with the basic elements of consumer laws governing real estate transactions; also covers System policies on all major aspects of the consumer compliance risk-focused examination process. For assistant examiners with six to twelve months of examination experience.

Also in 2003, a new course that will be added to the core curriculum, CA Risk-Focused Examination Techniques, was pilot-tested. The course is designed

to enhance examiners' analytical, decisionmaking, and leadership skills.

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

The training staff also look for opportunities to deliver courses via alternative channels such as the Internet or other distance-learning technologies. For example, a live videoconference curriculum, which included a session discussing recent revisions to the HMDA data reporting requirements, was implemented during the year. In addition, the staff assisted in developing online materials for the consumer affairs portion of the Banking and Supervision Elements course, a foundation course for assistant examiners from all examination specialty areas.

Reporting on Home Mortgage Disclosure Act Data

The Home Mortgage Disclosure Act (HMDA) requires that mortgage lenders collect and make public certain data about their home purchase, home improvement, and refinancing loan transactions. A depository institution generally is covered by the act if (1) it is located in a metropolitan area, (2) it met the asset threshold at the end of the preceding calendar year (for 2001, assets of more than \$31 million; for 2002 and 2003, more than \$32 million), and (3) it originated at least one home purchase loan (or refinancing) in the preceding calendar year. A for-profit mortgage company is covered if (1) it has offices in a metropolitan area, (2) it had assets of more than \$10 million

(when combined with the assets of any parent company) at the end of the preceding calendar year or it originated 100 or more home purchase loans or refinancings in the preceding calendar year, and (3) its home purchase loan originations and refinancings accounted for 10 percent or more of its total loans by dollar volume in the preceding calendar year.

In 2003, a total of 6,767 depository institutions and affiliated mortgage companies and 1,004 independent mortgage companies reported HMDA data for calendar year 2002. Lenders submitted information about the disposition of loan applications, the geographic location of the properties related to loans and loan applications, and, in most cases, the race or national origin, income, and sex of applicants and borrowers. The FFIEC processed the data and produced disclosure statements on behalf of the FFIEC member agencies and the Department of Housing and Urban Development (HUD).

The FFIEC prepared individual disclosure statements for each lender that reported data—one statement for each metropolitan area in which the lender had offices and reported loan activity for 2002. In 2003, the FFIEC prepared more than 57,000 disclosure statements.⁶ In July, each institution made its disclosure statement public, and reports containing aggregate data for all mortgage and home improvement loans in each of the 337 metropolitan areas in the United States were made available at central depositories.⁷ These data are used by

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

7. Central depository sites include libraries, universities, and city planning offices. A list of

FFIEC agencies, the reporting institutions, HUD, the Department of Justice (DOJ), and members of the public. They also assist HUD, the DOJ, and state and local agencies in responding to allegations of lending discrimination and in targeting lenders for further inquiry.

The HMDA data reported for 2002 covered 31 million loans and loan applications, about 13 percent more than in 2001. The greater volume was due primarily to an increase of about 22 percent in refinancing activity. The number of covered home purchase loans extended in 2002, compared with 2001, increased 11 percent for Hispanics, 18 percent for Asians, 2 percent for blacks, 23 percent for Native Americans, and 3 percent for whites. Over the period 1993 through 2002, the number of loans extended for home purchase increased 186 percent for Hispanics, 126 percent for Asians, 80 percent for blacks, 57 percent for Native Americans, and 30 percent for whites.

For each income category, the number of home purchase loans reported was higher in 2002 than in 2001; the increase was 4.5 percent for lower-income applicants, 3.2 percent for middle-income applicants, and 4.1 percent for upper-income applicants. From 1993 through 2002, the number of home purchase loans to lower-, middle-, and upper-income applicants increased 91 percent, 54 percent, and 66 percent respectively.

In 2002, 27 percent of Hispanic applicants and 28 percent of black applicants for home purchase loans reported under HMDA sought government-backed mortgages; the comparable figures were 14 percent for white applicants, 19 percent for Native American applicants, and 6 percent for Asian appli-

cants. Twenty-five percent of lower-income applicants for home purchase loans, compared with 7 percent of upper-income applicants, applied for government-backed mortgages.

Overall, the denial rate for conventional home purchase loans (that is, loans that are not government-backed) was 14 percent in 2002. The rate rose steadily from 1993 through 1998 but has fallen since then. In 2002, denial rates for conventional home purchase loans reported under HMDA were 26 percent for black applicants, 23 percent for Native American applicants, 18 percent for Hispanic applicants, 12 percent for white applicants, and 10 percent for Asian applicants. Each of these rates was lower than the comparable rate for 2001.

Agency Reports on Compliance with Consumer Protection Laws

The Board reports annually on compliance with consumer protection laws by entities supervised by federal agencies. This section summarizes data collected from the twelve Federal Reserve Banks, the FFIEC member agencies, and other federal enforcement agencies.⁸

Regulation B (Equal Credit Opportunity)

The FFIEC agencies reported that 84 percent of the institutions examined during the 2003 reporting period were in compliance with Regulation B, compared with 83 percent for the 2002 reporting period. The most frequent violations involved failure to take one or more of the following actions:

8. Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2003 reporting period was July 1, 2002, through June 30, 2003.

sites can be found at www.ffiec.gov/hmdacf/centdep/default2.cfm.

- collect information for monitoring purposes about the race or national origin and sex of applicants seeking credit primarily for the purchase or refinancing of a principal residence
- note on the application form when an applicant chooses not to provide monitoring information regarding race or national origin and sex
- provide a written notice of credit denial or other adverse action containing a statement of the action taken, the name and address of the creditor, a notice of rights, and the name and address of the federal agency that enforces compliance
- notify the credit applicant of the action taken within the time frames specified in the regulation
- provide a statement of reasons for credit denial or other adverse action that is specific and indicates the principal reasons for the adverse action

Three formal enforcement actions containing provisions relating to Regulation B were issued during the 2003 reporting period—two by the OCC and one by the OTS. During 2003, the Federal Trade Commission continued litigation against a mortgage lender for alleged violations of the ECOA and Regulation B as well as enforcement efforts against other organizations.

The other agencies that enforce the ECOA—the Farm Credit Administration (FCA), the Department of Transportation, the Securities and Exchange Commission, the Small Business Administration, and the Grain Inspection, Packers and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise.

The FCA's examination and enforcement activities revealed that most Regulation B violations involved creditors' failure to provide timely or complete notifications of denial or failure to identify the FCA as the federal agency that administers compliance. These agencies did not initiate any formal enforcement actions relating to Regulation B during 2003, although the FCA indicated that its supervisory process requires corrective actions for violations noted.

Regulation E (Electronic Fund Transfers)

The FFIEC agencies reported that approximately 94 percent of the institutions examined during the 2003 reporting period were in compliance with Regulation E, compared with 92 percent for the 2002 reporting period. The most frequent violations involved failure to comply with one or more of the following requirements:

- determine whether an error occurred, and transmit the results of the investigation to the consumer within ten business days
- provide initial disclosures at the time a consumer contracts for an electronic fund transfer service that contain required information, including limitations on the types of transfers permitted and error resolution procedures
- credit the customer's account in the amount of the alleged error within ten business days of receiving the error notice, if more time is needed to conduct the investigation
- when a determination is made that no error has occurred, provide a written explanation and note the consumer's

right to request documentation supporting the institution's findings

In 2003, the Federal Trade Commission filed and settled one case in federal district court involving violations of the Electronic Fund Transfer Act (EFTA). The defendants had conditioned the extension of credit to consumers on agreement to compulsory electronic funds transfers from consumer accounts, in violation of the EFTA. The settlement requires the defendant to cancel and cease collections on approximately \$24 million in final court judgments against consumers, bars misrepresentations about the terms of any contract, and requires the defendants to give consumers the option to switch their method of payment.

Regulation M (Consumer Leasing)

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2003 reporting period were in compliance with Regulation M, which is comparable to the level of compliance for the 2002 reporting period. The few violations noted involved failure to adhere to specific disclosure requirements. The agencies did not issue any formal enforcement actions relating to Regulation M during the period.

Regulation P (Privacy of Consumer Financial Information)

The FFIEC agencies reported that 97 percent of the institutions examined during the 2003 reporting period were in compliance with Regulation P. The most frequent violations involved failure to comply with one or more of the following requirements:

- provide a clear and conspicuous initial privacy notice to customers that accurately reflects the institution's privacy policies and practices, not later than when the customer relationship is established
- disclose the institution's information-sharing practices in initial, annual, and revised privacy notices
- provide a clear and conspicuous annual privacy notice to customers

The OCC issued one formal enforcement action containing provisions relating to the privacy regulations during the 2003 reporting period.

Regulation Z (Truth in Lending)

The FFIEC agencies reported that 78 percent of the institutions examined during the 2003 reporting period were in compliance with Regulation Z, compared with 77 percent for the 2002 reporting period. The most frequent violations involved failure to take one or more of the following actions:

- accurately disclose the finance charge, using that term, and provide a brief definition of "finance charge"
- accurately disclose the amount financed, appropriately subtracting any prepaid finance charges
- ensure that disclosures reflect that the creditor has or will acquire a security interest in the property identified
- on certain residential mortgage transactions, provide a good faith estimate of the required disclosures before consummation, or not later than three business days after receipt of the loan application

Four formal enforcement actions containing provisions relating to Regulation Z were issued during the 2003 reporting period—three by the OCC and one by the OTS. In addition, 147 institutions supervised by the Federal Reserve, the FDIC, or the OTS were required, under the Interagency Enforcement Policy on Regulation Z, to refund a total of approximately \$1.3 million to consumers. The FTC continued its enforcement activities to halt certain illegal practices of subprime lenders. The agency entered into two settlements, issued one new complaint (currently in litigation), and pursued two ongoing lawsuits for alleged violations of the Truth in Lending Act and the Federal Trade Commission Act.

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

The three banking regulators with responsibility for enforcing Regulation AA's Credit Practices Rule—the Federal Reserve, the OCC, and the FDIC—along with the NCUA reported that 99 percent of institutions examined during the 2003 reporting period were in compliance, the same proportion as for the 2002 reporting period. The few violations involved one or both of the following actions:

- failing to provide a clear and conspicuous disclosure regarding a cosigner's liability for a debt
- entering into a consumer credit contract containing a nonpossessory security interest in household goods

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

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

The FFIEC agencies reported that 90 percent of institutions examined during the 2003 reporting period were in compliance with Regulation CC, the same proportion as for the 2002 reporting period. Among the institutions not in full compliance, the most frequently cited violations involved the failure to take one or more of the following actions:

- make available on the next business day the lesser of \$100 or the aggregate amount of checks deposited that are not subject to next-day availability
- follow special procedures when invoking the exception for large-dollar deposits
- make funds from certain checks, both local and nonlocal, available for withdrawal within the times prescribed by the regulation
- when placing an exception hold on an account other than a new account, provide the customer with a notice containing certain information within prescribed time periods

The OTS issued one formal enforcement action containing provisions relating to Regulation CC during the 2003 reporting period.

*Regulation DD
(Truth in Savings)*

The FFIEC agencies reported that 89 percent of institutions examined during the 2003 reporting period were in compliance with Regulation DD, compared with 87 percent for the 2002

reporting period. Among the institutions not in full compliance, the most frequently cited violations involved

- failing to provide account disclosures containing certain required information
- using the phrase “annual percentage yield” in an advertisement without disclosing additional terms and conditions of customer accounts
- providing advertisements that were inaccurate or misleading (or both).

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

Implementation of Statutes Designed to Inform and Protect Consumers

Changes to Regulation B

In February 2003, following a comprehensive review of the regulation and staff commentary, the Board published a final rule amending Regulation B, which implements the Equal Credit Opportunity Act (ECOA). Two significant revisions were made, one relating to the general prohibition against a creditor’s noting an applicant’s personal characteristics and the other to prescreened credit solicitations. The final rule took effect in April 2003, and compliance becomes mandatory on April 15, 2004.

Data Collection in Connection with Nonmortgage Credit

Because the ECOA makes it unlawful for creditors to consider any prohibited basis of discrimination in extending credit, Regulation B has generally prohibited creditors from inquiring about,

or noting, an applicant’s sex, race, color, religion, and national origin. The premise for this prohibition is that if creditors are not allowed to inquire about or note applicants’ personal characteristics, they are less likely to consider that information unlawfully in credit transactions.

The Board’s proposal to remove this prohibition in connection with non-mortgage credit elicited strong comments from those favoring removal and those opposed. In the final rule, the Board generally retained the prohibition restricting creditor access to information about applicants’ personal characteristics. It did, however, create an exception that allows a creditor to collect information on applicant characteristics for the limited purpose of conducting a self-test.

A self-test is a program, practice, or study designed and used by a creditor specifically to determine its compliance with the ECOA. Under the ECOA, because the results of the self-test are privileged, they may not be obtained in an examination or investigation of the creditor, or in any proceeding or lawsuit alleging a violation of the ECOA or Regulation B. Certain other information—such as whether a creditor conducted a self-test and the methodology or the scope of the test—is not privileged. The purpose of the self-test privilege, which was added to the ECOA by Congress in 1996, was to encourage institutions to undertake candid and complete self-tests for possible fair lending violations and to act decisively to correct any discovered problems. The privilege applies only if the creditor takes appropriate corrective action when the creditor determines that it is more likely than not that a violation occurred.

Under the exception adopted by the Board, creditors will be able to develop compliance programs that use appli-

cant data in a controlled and targeted manner. The constraints imposed by the self-test provision help ensure that personal information such as race and ethnicity is not used to discriminate on a prohibited basis, but that it is collected and used to monitor compliance with the ECOA and to serve as a basis for appropriate corrective action.

Prescreened Credit Solicitations

There has long been a concern that prescreened solicitations could provide the means for creditors to circumvent or evade the ECOA and defeat its purposes by excluding prospective applicants on a prohibited basis. The issue arises in part because the ECOA generally protects credit applicants—persons who have, at a minimum, requested credit—from discrimination. In the case of prescreened solicitations, the creditor identifies prospective customers and solicits an application from those who meet its criteria.

With advances in technology that facilitate the building of databases, the use of prescreened solicitations has become more common and more sophisticated. Prescreened solicitations can be used to target those consumers who are most likely to use a particular credit product or those segments of the population most likely to respond to the offer of credit. Conversely, prescreened solicitations can be used to exclude some consumers from receiving offers of credit.

Under the final rule, creditors are required to retain information about the criteria used to select potential customers, the text of any solicitation mailing, and any complaints received about the solicitation. This requirement will allow the Board and other enforcement agencies to monitor creditors' solicitation

practices systematically on the basis of information that creditors currently maintain. For example, under the Fair Credit Reporting Act, creditors that use information in consumer reports to select recipients for offers of credit are required to retain records pertaining to the selection criteria for three years after the date the offer is made to the consumer.

Other Regulatory Actions

The Board also took the following regulatory actions during 2003:

- In March the Board revised the official staff commentary to Regulation Z (Truth in Lending) to give guidance on certain fees associated with credit cards; the replacement of an existing credit card with one or more cards; the disclosure of private mortgage insurance premiums; and the selection of the appropriate Treasury yield for determining whether a mortgage loan is covered by the Home Ownership and Equity Protection Act of 1994.
- In August the Board raised from \$488 to \$499 the total dollar amount of points and fees that triggers additional requirements for certain mortgage loans under the Home Ownership and Equity Protection Act, effective in January 2004, to reflect changes in the consumer price index, as prescribed by the statute.
- In December the Board raised to \$33 million the threshold for depository institutions required to collect data in 2004 under the Home Mortgage Disclosure Act, to reflect changes in the consumer price index, as prescribed by the statute.

Economic Effects of the Electronic Fund Transfer Act

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

According to data from the most recent Survey of Consumer Finances (conducted in 2001), approximately 88 percent of U.S. families in that year had or used one or more EFT services—for example, an ATM card, a debit card, direct deposit, or direct payment—up from approximately 85 percent in 1998. Automated teller machines (ATMs) remained the most widely used EFT service; approximately 70 percent of U.S. families had an ATM card. In 2003, the number of ATM transactions per month averaged approximately 902 million, and the number of installed ATMs rose nearly 5.4 percent from 2002, to 371,000.

Direct deposit is also widely used. About 67 percent of U.S. families have funds deposited directly into their checking or savings account. Use of the service is particularly common in the public sector; during fiscal year 2003, approximately 74 percent of all government payments were made using EFT, including 80 percent of social security payments, 98 percent of federal salary and retirement payments, and 41 percent of federal income tax refunds.

About 47 percent of U.S. families use debit cards, which consumers can use at merchant terminals to pay for purchases. Approximately 15.6 billion debit card transactions took place in 2002, an increase of approximately 25 percent from the previous year's volume. Direct payment is a less widely used EFT payment mechanism; about 40 percent of U.S. families have payments automatically deducted from their accounts.

The incremental costs associated with the EFTA are difficult to quantify because no one knows how industry practices would have evolved in the absence of statutory requirements. The benefits of the EFTA are also difficult to measure, as they cannot be isolated from consumer protections that would have been provided in the absence of regulation. The available evidence suggests no serious consumer problems with the EFTA (see "Agency Reports on Compliance with Consumer Protection Laws" earlier in this chapter).

Consumer Complaints

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

The Board provides guidance to the Reserve Banks on complaint program policies and procedures through advisory letters and periodic updates to the Consumer Complaint Manual. In 2003, the Board issued guidance on releasing information in response to Privacy Act and Freedom of Information Act requests. The Board also revised its policy and special procedures for Reserve Bank investigations of complaints alleging credit discrimination and streamlined the review process.

Complaints and inquiries received by the Federal Reserve System are entered into its online database, Complaint Analysis Evaluation System and Reports (CAESAR). The CAESAR Users Advisory Group released a new version of the CAESAR data entry system in 2003. Enhancements included features that allow Board and Reserve Bank staff to identify emerging consumer concerns; to document dollar amounts

Consumer Complaints against State Member Banks, by Subject of Complaint, 2003

Subject of complaint	Total		Not investigated	
	Number	Percent	Unable to obtain sufficient information from consumer	Explanation of law provided to consumer
Loans				
Discrimination alleged				
Real estate loans	16	1	0	0
Credit cards	11	1	0	1
Other loans	11	1	1	1
Other type of complaint				
Real estate loans	521	19	9	44
Credit cards	971	36	1	66
Other loans	207	8	3	19
Deposits	637	24	14	102
Electronic fund transfers	38	1	1	1
Trust services	24	1	0	5
Other	208	8	7	35
Total	2,644	100	36	274

returned to consumers as a result of complaint investigations; and to more quickly update and retrieve data in the CAESAR database. The advisory group also completed an analysis of the Federal Reserve System’s code structure and its statistical reports for consumer complaints. As a result of that analysis, new codes and enhanced reports were implemented.

The advisory group is currently developing requirements for a web-based CAESAR database application that will streamline the complaint process to better serve the System’s business needs and to facilitate the sharing of complaint information with consumer compliance supervisory staff. The web-based system will enable the Federal Reserve to eliminate duplicative automation tools at the Reserve Banks and disseminate information to and from other System applications—

improvements that will help consumer complaints and consumer compliance staff carry out their supervisory and risk-management responsibilities.

In September the Board held a conference for Reserve Bank officers and managers in charge of the complaint program. The conference covered policy and program changes recently implemented by the Board; issues related to investigation of complaints alleging credit discrimination; Reserve Bank complaint programs in general; and the Board’s proposal to create a national complaint web site. It also included presentations on complaint trends and demonstrations by Board and Reserve Bank staff of automation tools currently used in an integrated compliance risk environment as well as a demonstration by the Office of the Comptroller of the Currency of its automated complaints and inquiry database.

Consumer Complaints—Continued

Bank legally correct		Investigated					Pending, December 31
No reim- bursement or other accommo- dation	Goodwill reimburse- ment or other accommo- dation	Customer error	Bank error	Factual or contractual dispute— resolvable only by the courts	Possible bank violation— bank took corrective action	Matter in litigation	
6	0	0	3	0	1	0	6
2	2	0	1	0	0	0	5
2	2	0	0	0	0	0	5
213	107	0	87	14	11	7	29
275	431	5	90	7	2	5	89
75	46	1	29	7	4	8	15
241	131	0	70	25	4	9	41
11	9	0	6	1	7	0	2
12	0	0	1	0	0	3	3
51	19	1	16	8	2	4	65
888	747	7	303	62	31	36	260

Complaints against
State Member Banks

In 2003 the Federal Reserve received almost 5,500 complaints from consumers by mail, by telephone, and electronically via the Internet. About 48 percent of the complaints (2,644) were against state member banks (see tables); the remainder were referred to other agencies. Of the complaints against state member banks, 66 percent involved loan functions: 3 percent alleged discrimination on a basis prohibited by law (race, color, religion, national origin, sex, marital status, age, the fact that the applicant's income comes from a public assistance program, or the fact that the applicant has exercised a right under the Consumer Credit Protection Act), and 63 percent concerned other credit-related practices, such as the interest rate charged on credit card accounts

or credit denial on a basis not prohibited by law (for example, credit history or length of residence). Twenty-four percent of the complaints involved disputes about interest on deposits and general deposit account practices, and the remaining 10 percent concerned disputes about electronic fund transfers, trust services, or other practices. Information on the outcome of investigations of these complaints is provided in the table.

During 2003, the Federal Reserve System completed investigations of 286 complaints against state member banks that were pending at year-end 2002, finding ten violations. In most cases, the bank had handled the customer's account correctly but nevertheless chose to reimburse or otherwise accommodate the customer.

The Federal Reserve also handled almost 1,700 inquiries about consumer

Consumer Complaints against State
Member Banks, by Classification, 2003

Classification	Number
Regulation B (Equal Credit Opportunity) ...	38
Regulation C (Home Mortgage Disclosure Act)	0
Regulation E (Electronic Fund Transfers) ...	38
Regulation H (Bank Sales of Insurance)	0
Regulation M (Consumer Leasing)	0
Regulation P (Privacy of Consumer Financial Information)	13
Regulation Q (Payment of Interest)	0
Regulation Z (Truth in Lending)	318
Regulation BB (Community Reinvestment) .	1
Regulation CC (Expedited Funds Availability)	19
Regulation DD (Truth in Savings)	35
Fair Credit Reporting Act	150
Fair Debt Collection Practices Act	9
Fair Housing Act	1
Flood insurance rules	27
Regulations T, U, and X	0
Real Estate Settlement Procedures Act	19
Unregulated practices	1,976
Total	2,644

credit and banking policies and practices during 2003. In responding to these inquiries, the Board and Reserve Banks gave specific explanations of laws, regulations, and banking practices and provided relevant print materials on consumer issues.

Unregulated Practices

As required by section 18(f) of the Federal Trade Commission Act, the Board monitors complaints about banking practices that are not subject to existing regulations, focusing on those that concern practices that are possibly unfair or deceptive. In 2003 the Board received almost 2,000 complaints against state member banks that involved unregulated practices. The categories that received the most complaints involved checking accounts, credit card accounts, and real estate loans. Consumers complained about insufficient-funds charges and procedures (136 complaints) and

disputed amounts withdrawn (115); they complained about fees associated with credit card accounts (114), interest rates and terms (109), and escrow account problems (96). The remainder of the complaints concerned a wide range of unregulated practices in other areas, including credit card fraud, the amount charged for late payments, and credit denials attributed to credit history.

Complaint Referrals to HUD

In accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies, in 2003 the Federal Reserve referred eleven complaints to HUD that alleged state member bank violations of the Fair Housing Act. In six of the eleven cases the Federal Reserve's investigations revealed no evidence of illegal discrimination. In one case, the bank had made an error in handling the customer's construction-permanent loan payments, which it had subsequently corrected. The remaining four cases were pending at year-end.

Advice from the Consumer Advisory Council

The Board's Consumer Advisory Council—whose members represent consumer and community organizations, the financial services industry, academic institutions, and state agencies—advises the Board of Governors on matters concerning laws and regulations that the Board administers and on other issues related to consumer financial services. Council meetings are open to the public. (For a list of members of the Council, see the section "Federal Reserve System Organization.")

In 2003, the Council met in March, June, and October. In March, Council members discussed bounced-check pro-

tection services and how those services should be treated under Regulation Z (Truth in Lending). The discussion focused on whether the fees that banks charge to cover overdrafts on customers' accounts are finance charges. Council members who believed that the fees are finance charges argued that Regulation Z applies to bounced-check protection and that, consequently, fee disclosures are required. The disclosures, they said, would make consumers aware of the high cost of these services. Other members asserted that because financial institutions make no promise to pay overdrafts and have no written agreement with the customer to pay overdrafts, overdraft fees are not finance charges and hence are not covered by Regulation Z.

Other discussion of Regulation Z in March focused on credit card disclosures and on the type of cost information that is most useful to consumers. Members discussed, but did not reach consensus on, whether disclosing the dollar amount of fees on periodic statements or disclosing the annual percentage rate, which reflects both the interest and other fees charged, is the better way to inform consumers about the cost of credit.

Predatory lending was a topic at the March and June meetings. The March discussion focused on the effectiveness of state and local laws in reducing predatory lending practices. While many Council members favored reliance on state and local laws, others noted those laws' lack of uniformity and believed that federal regulators are in the best position to establish and enforce effective laws to combat abusive practices. In June, Council members discussed efforts to counter the tactics of abusive lenders and to provide assistance to consumers who experience the consequences of predatory lending. Several

members emphasized the significant role the Federal Reserve and other federal agencies can play in preventing predatory practices.

In June, Council members also discussed the 1996 amendments to the Fair Credit Reporting Act, which preempted the states from enacting laws or regulations pertaining to the availability of information for underwriting purposes, procedures for dispute resolution, and the marketing of credit information. Some members asserted that because the credit reporting system is a national system, uniform national standards are necessary to maintain its viability. Other members believed that states have an important role in protecting the public and are in the best position to respond to local concerns about credit information. Despite differing views, members agreed on the critical importance of accurate reporting, given the devastating effect that errors in credit information can have, particularly on the lives of low-income individuals.

Also in June, Council members discussed the lengthy and complex privacy notices that financial institutions use to comply with the privacy portions of the Gramm–Leach–Bliley Act. After reviewing a proposed “short-form” notice, members strongly supported the concept of short-form privacy notices but urged the federal financial institution regulators to obtain customer comment on the notices before moving forward.

At the October meeting, members discussed the effect on nonprofit organizations of a decline in operating income and funding sources. Council members cited possible reasons for the diminished capacity of nonprofit organizations to serve the needs of their communities and suggested ways in which nonprofits could mitigate the effects of cutbacks by major funding sources.

The Council also discussed payroll cards and convenience checks issued in connection with credit card accounts. Members considered whether the Truth in Lending Act's consumer protections for credit cards should extend to convenience checks and whether Regulation Z disclosures are adequate. With respect to payroll cards, which employers use to make salary and other compensation payments to employees, the discussion focused on whether requirements of the Electronic Fund Transfer Act and Regulation E should or should not apply.

Promotion of Community Economic Development in Historically Underserved Markets

During 2003, the community affairs function within the Federal Reserve System engaged in a variety of initiatives to promote community economic development that benefit low- and moderate-income communities and populations. Activities included conducting research, preparing publications, sponsoring conferences and seminars, and providing advisory services, all of which facilitate the delivery of pertinent information to both general and targeted audiences.

As a decentralized function, the community affairs programs at the Board and each of the twelve Reserve Banks design activities that are responsive to the communities in the regions they serve. Reserve Bank Community Affairs Offices focus on providing information and promoting awareness of investment opportunities to financial institutions, government agencies, and organizations that serve low- and moderate-income communities and populations, while the Board's Community Affairs Office engages in activities that have national implications for public policy. Spe-

cific topics addressed by the System's community affairs programs in 2003 included personal financial education, evaluating the effectiveness of various community economic development strategies, identifying sources of funding and investment for community development, the challenges to creating sustainable community economic development organizations, and creating policies that support the development of minority-owned small businesses.

While the Federal Reserve has sponsored activities related to financial literacy for many years, the System increased its visibility in this area in 2003 by sponsoring a national awareness campaign on personal financial education. Various programs were undertaken by the Board and the Reserve Banks to support national, regional, and local financial education efforts. (See related box "Spotlight on Financial Education.")

To promote effective community economic development strategies, the community affairs function undertook several significant initiatives. The System's third biennial community affairs research conference in April focused on evaluating the efficacy of various community development efforts. Titled *Seeds of Growth—Sustainable Community Development: What Works, What Doesn't, and Why*, the conference attracted nearly 350 attendees and provided a forum for discussion of the strengths and weaknesses of programs, projects, partnerships, and policies related to development in lower-income neighborhoods. The conference papers and other community development research studies are posted on the System's research repository web site, the Community and Economic Development Research Information Center (CEDRIC) (www.chicagofed.org/cedric/cedric_index.cfm).

The Board's Community Affairs Office, in partnership with the Chicago, Kansas City, Philadelphia, and St. Louis Reserve Banks, undertook an initiative designed to foster learning and highlight models of community economic development. The web-based database *Lessons Learned: Community and Economic Development Case Studies* (www.chicagofed.org/cedric/lesle_index.cfm) provides detailed case studies that identify a community development issue, present one community's solution, describe the results, and offer "lessons learned" to community developers addressing similar concerns in their communities. Residing on the CEDRIC web site, the database is an efficient means for exchanging information among community development professionals, giving them the benefit of the experiences of their counterparts throughout the country.

Another web-based resource, the Fiscal Impact Tool, was launched in 2003 to support community and economic development activity in mid-size communities. This analytic tool enables community economic developers to conduct a cost-benefit analysis of a proposed development project by estimating its effect on local sales and property tax revenues and on costs to local government. The tool, which is available through the Board's web site (www.federalreserve.gov/forms/fiscalimpactrequest.cfm), can aid decisionmakers in determining the economic value of a proposed activity for their community.

The community affairs area has been a source of information on creative financing of community economic development for many years, and in 2003, efforts in this area expanded. The Community Affairs Offices at both the San Francisco Reserve Bank and the Board developed new resources relat-

ing to community development investments. San Francisco's Center for Community Development Investments, drawing on the expertise of an advisory board of community economic development professionals, offers an in-depth discussion of various investment vehicles used to finance community development. As a centralized resource for information, contacts, and training opportunities, the center seeks to expand access to information on the funding tools that can support economic growth in low- and moderate-income communities (www.sf.frb.org/cdinvestments/index.html).

Similarly, the Board's community affairs program developed a web site that gives guidance on the types of investments certain banking institutions may engage in to support community economic development and public welfare benefits (www.federalreserve.gov/communityaffairs/cdi/default.htm). In addition, several Reserve Banks partnered with a nonprofit organization, Wall Street Without Walls, to help increase awareness of the capital markets' role in funding community economic development. In 2003, the Boston, Richmond, and Atlanta Reserve Banks cosponsored seminars that gave an overview of the benefits of and challenges associated with accessing the capital markets to fund development in lower-income neighborhoods and populations.

Given the important role of public policy in effecting change in underserved communities, the community affairs function engaged in activities to examine challenges relating to the community development field. The Board's Community Affairs Office addressed the sustainability of community economic development organizations in a policy forum cohosted with the Aspen Institute, a national research

Spotlight on Financial Education

No matter who you are, making informed decisions about what to do with your money will help build a more stable financial future for you and your family.

Alan Greenspan, *Chairman*, Board of Governors
May 2003

The growing complexity of the financial services marketplace—in terms of both the products offered and the number and variety of providers—has in recent years focused the attention of government agencies and consumer and community groups on the importance of financial education. In addition, ongoing interest in protecting consumers from abusive and deceptive lending practices has underscored the role of education as a line of defense against entanglement in unsuitable financial arrangements that can have detrimental, even devastating, effects.

Consistent with its interest in economic growth, consumer protection, and community development, the Federal Reserve System has long been an active supporter of educational programs that provide practical information on how the economy and the banking industry function. More recently, this interest has extended to personal financial education as a way of helping consumers develop the skills that can lead to financial success for themselves and their families. To underscore this message, the Community Affairs and Public Information Offices of the Federal Reserve System in 2003 collaborated to raise awareness of the importance of personal financial management and to highlight some of the resources available to consumers.

The collaboration resulted in the nationwide campaign “There’s a Lot to Learn about Money.” This multifaceted campaign was launched in May 2003 with a public service announcement featuring Chairman Greenspan, who has spoken often of the importance of education in developing sound financial decisionmaking skills. Electronic and print media and

video were used to broaden consumers’ access to information on personal financial education and to help establish the Federal Reserve System as a central source of information. A toll-free number was established to respond to inquiries generated by the announcement, and a brochure describing strategies for taking charge of one’s finances was sent to interested callers. For consumers who like to obtain their information electronically, a robust central Federal Reserve web site was launched, linking to specially prepared educational tools and resource information on the web sites of the twelve Reserve Banks (www.federalreserveeducation.org/fined/index.cfm).

The campaign attracted the attention of other central banks that are also seeking ways to help consumers better manage their finances. During the year, Board staff met with officials of the central banks of Canada, England, Finland, and Malaysia to discuss the Federal Reserve’s various roles in supporting personal financial education.

The System undertook numerous projects during the year to reinforce the campaign’s objectives. For example, the Board and several Reserve Banks partnered with a national nonprofit financial education organization, Operation HOPE, to emphasize the importance of understanding and managing finances to students in inner-city public schools. In one partnership activity, Chairman Greenspan and the president of the Richmond Reserve Bank recounted for middle school students in Washington, D.C., the ways in which financial education, as well as their interest in finances, has affected their lives. Simi-

larly, the presidents of the Boston, Cleveland, Chicago, St. Louis, Kansas City, and Dallas Banks spoke with students in those cities.

The Community Affairs Offices at several Reserve Banks used their research capacity, publications, and work with local organizations to raise awareness of regional efforts that support financial education. The Cleveland Reserve Bank surveyed organizations offering personal financial education programs in the Fourth District to increase understanding of the breadth of providers of such programs. The survey led to the convening of regional roundtables at which financial educators in Cleveland, Pittsburgh, and Cincinnati discussed opportunities for partnerships to leverage resources and increase efficiency in delivering financial education. The Atlanta and Kansas City Banks sponsored initiatives to help establish regional networks. The Boston Bank collaborated with a group serving a low-income Hispanic community in Springfield, Massachusetts, to develop a curriculum that meets the information needs of residents of the neighborhood. The New York, Philadelphia, Atlanta, St. Louis, Minneapolis, Dallas, and San Francisco Banks hosted train-the-trainer sessions—some focused on youth, Hispanic, faith-based, and Native American populations—to help increase the effectiveness of organizations that provide financial education in their communities.

Research having indicated that the workplace is an effective venue for financial education, the Community Affairs Offices at the Board and the Boston, Atlanta, St. Louis, and Dallas Banks in 2003 conducted seminars for employees on personal financial management strategies and consumer protection issues. The Board hosted sessions on budgeting and saving, reading and correcting credit reports, using the Board's benefit programs to meet savings goals, and understanding the implications of identity theft.

In addition to providing practical information, the Federal Reserve System is contributing to policy development, public information, and research on financial education. Staff have conducted research on savings patterns among low-income households and on households without checking accounts and have shared the results with researchers and practitioners in those areas.

As an extension of long-standing efforts to support community economic development in Native American communities, the Community Affairs Offices at the Board and the Minneapolis, Kansas City, and San Francisco Reserve Banks in May 2003 cosponsored a policy forum on financial education for residents of Indian Country. Together with a coalition of tribal leaders, bankers, and Native American nonprofit development and policy organizations, the Federal Reserve is working to facilitate partnerships that can provide financial education and improve access to financial services on reservations. Task forces have been established to work on specific initiatives, including developing a national training strategy, designing research to evaluate the effectiveness of programs, and formulating a national outreach initiative to promote financial literacy in Indian Country.

To contribute to the limited body of research, the Board is collaborating with the Department of Defense on a longitudinal study of the efficacy of the personal financial education the department provides to military personnel. The study will assess financial behaviors and changes in financial status over time to determine whether and how financial education contributes to positive outcomes.

In recognition of the role that financial education plays in the successful functioning of households and of the broader economy, the Federal Reserve will continue to seek opportunities to highlight its interest and to pursue initiatives that will contribute to better informed and more knowledgeable consumers of financial services.

and leadership development organization. Featuring preliminary findings of research on these topics conducted by the institute, the event explored some of the challenges that confront the community economic development field relating to organizational infrastructure and capitalization. Forum participants—leaders of prominent national community development organizations—described, from their particular perspectives, the fundamental issues that define the mission and future of their organizations. The Cleveland Reserve Bank sponsored a conference on the evolution of community economic development as policy has shifted from program-driven to market-based strategies for addressing redevelopment challenges in lower-income neighborhoods.

The Board's community affairs program also participated in an interagency policy initiative involving minority small business development in 2003. As part of the initiative, the agencies issued a joint policy paper that examines ways in which their policies and regulations can be more effective in supporting access to capital and technical assistance by minority business owners.

Outreach Activities

The Board engages in outreach activities throughout the year to provide information to the public about the Board's responsibilities, to facilitate understanding of changes in banking regulations and their impact on banks and consumers, to promote community development and consumer education, and to foster discussion of public policy issues. Board staff periodically meet with financial institutions, community groups, and other members of the public in formal and informal settings. The Board sponsors and participates in meetings, conferences, and seminars for the general public and for targeted audiences. This year, the Board participated in the Congressional Black Caucus Foundation's 2003 annual legislative conference, which provides a national forum for examining strategies and viable solutions to public policy issues facing African Americans. Board staff distributed consumer education materials provided by the Federal Reserve System and used the opportunity to inform conference attendees about the Federal Reserve and its multifaceted responsibilities. ■

Banking Supervision and Regulation

Insured commercial banks in 2003 experienced record earnings and built stronger balance sheets while adapting to significant changes in the business climate. Net income reached \$100 billion, up 14 percent from the preceding year. Historically low interest rates, along with the resilience of the U.S. household sector, continued to support strong mortgage origination revenues and healthy growth of mortgage-related assets early in the year. Lower interest rates created the opportunity for banks to sell their higher-yielding investment securities at a premium, realizing gains that further supported earnings in the first half of the year. Although the steeper yield curve began to dampen mortgage origination activity in the latter half of the year, continuing recovery in the U.S. economy sparked equity markets and bolstered fees related to financial market activities. Moreover, asset quality improved steadily during the year, allowing banks to set aside less of their income for future credit losses.

Net interest margins—the pretax rate of profitability on earning assets—contracted significantly during the year, for several reasons. New mortgage-related assets carried historically low yields, the same reason refinancing was attractive to mortgage borrowers. Normal repricing of interest-sensitive assets, coupled with rate-motivated acceleration of prepayments, reduced asset yields. By liquidating higher-yielding investment securities in order to record gains in current income, banks effectively traded future margin income for current-period revenues. Finally, premium pricing on money market and savings deposit accounts, although contrib-

uting to deposit growth, also limited the benefit of lower rates for overall funding costs.

Commercial lending and market-sensitive revenues were weak throughout the year, reflecting cautious improvement in economic activity and equity markets. The latter showed some recovery late in the year. Growth in commercial real estate loans remained rapid in 2003, exceeding 9 percent for the seventh consecutive year and reaching 11.1 percent of the industry's assets.

Non-interest expense grew only moderately. At the same time, banks were able to realize benefits from cost-cutting measures. Salary and benefits expense per employee grew 6.4 percent for the year.

Core deposits, especially money market and savings accounts, experienced remarkable growth. These deposits offer banks greater funding stability and attractive interest rate risk characteristics in addition to growth in deposit fees. As a strategic objective, banks actively competed to attract these deposits, offering attractive rates and investing in branches and other delivery systems. Depositors for their part appeared content to hold assets in the form of these highly liquid insured deposits while interest rates remained low and, during the first half of the year, while equity prices remained weak. Money market and savings balances funded 30.6 percent of bank assets at year-end, up from 28.9 percent a year earlier. This funding provided support to the acquisition of residential mortgage and home equity loans and, in the first half of the year, mortgage-backed securities.

A steeper yield curve in midyear eroded a significant portion of unrealized gains on banks' investment securities and also slowed the pace of mortgage refinancing. Responding to these market changes, banks strategically reduced their holdings of long-term securities during the latter half of the year, although not by enough to offset the acquisitions earlier in the year. The effect was most pronounced in mortgage pass-through securities, which declined about 6.5 percent during the second half of 2003. Banks also issued new long-term fixed-rate debt, prepaid higher-cost pre-existing term debt, and acquired interest rate derivatives to hedge against possible future increases in market interest rates.

Capitalization remained a key source of strength for the industry. Banks added \$42.5 billion in equity (net) during the year. Aggregate regulatory capital ratios remained well above minimums, while nearly 99 percent of insured commercial banks were well capitalized at year-end 2003. Dividend payout increased only slightly for the year—77.4 percent of earnings, versus 76.4 percent in 2002—despite the introduction of more-favorable federal tax treatment of dividend income.

Nonperforming assets and net charge-offs declined steadily through the year, each having earlier reached a peak level in September 2002. Although this decline was influenced by positive macroeconomic developments, it was also supported by secondary markets for troubled loans that remained deep and liquid through the year. At the same time, banks strengthened their credit risk management and measurement capabilities and were able to call on a wider range of credit risk mitigation instruments and techniques to manage the extent of their risk-taking. Problem

loans remained somewhat elevated at year-end 2003, with nonperforming assets representing 0.94 percent of loans and related assets. Nonetheless, the peak levels reached in this credit cycle did not approach the extremes of the early 1990s.

The number of insured commercial banks fell by 121 institutions, to 7,761, principally because of acquisitions and consolidation of related bank charters by multibank organizations. Two banks, with combined assets of \$1.4 billion, failed in 2003.

Significant acquisitions of banking institutions and major business lines were an important development in 2003. Bank of America and FleetBoston announced their proposed merger late in 2003, and J.P. Morgan Chase and Bank One announced their proposed merger just after year-end. Each of these institutions would have assets in the vicinity of \$1 trillion. Assuming that these transactions are consummated, the three largest bank holding companies in the United States would together account for \$3.2 trillion in assets, or 37 percent of the assets of all reporting bank holding companies.

Scope of Responsibilities for Supervision and Regulation

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

Bank Secrecy Act and consumer protection and civil rights laws.¹

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

The Federal Reserve exercises important regulatory influence over entry into the U.S. banking system and the structure of the system through its administration of the Bank Holding Company Act, the Bank Merger Act (with regard to state member banks), the Change in Bank Control Act (with regard to bank holding companies and state member banks), and the International Banking Act. The Federal Reserve is also responsible for imposing margin requirements on securities transactions. In carrying out these responsibilities, the Federal Reserve coordinates its supervisory activities with other federal banking agencies, state agencies, functional regulators, and the bank regulatory agencies of other nations.

Supervision for Safety and Soundness

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

1. The Board's Division of Consumer and Community Affairs is responsible for coordinating the Federal Reserve's supervisory activities with regard to the compliance of banking organizations with consumer protection and civil rights laws. To carry out this responsibility, the Federal Reserve trains a number of its bank examiners in the evaluation of institutions with regard to such compli-

Examinations and Inspections

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

State Member Banks

At the end of 2003, 935 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented approximately 12 percent of all insured U.S.

ance. The chapter of this volume covering consumer and community affairs describes these regulatory responsibilities. Compliance with other banking statutes and regulations, which is treated in this chapter, is the responsibility of the Board's Division of Banking Supervision and Regulation and the Federal Reserve Banks, whose examiners also check for safety and soundness.

State Member Banks and Holding Companies, 1999–2003

Entity/Item	2003	2002	2001	2000	1999
<i>State member banks</i>					
Total number	935	949	970	991	1,010
Total assets (billions of dollars)	1,912	1,863	1,823	1,645	1,423
Number of examinations	822	814	816	899	858
By Federal Reserve System	581	550	561	610	551
By state banking agency	241	264	255	289	307
<i>Top-tier bank holding companies</i>					
Large (assets of more than \$1 billion)					
Total number	365	329	312	309	283
Total assets (billions of dollars)	8,295	7,483	6,905	6,213	5,625
Number of inspections	454	439	413	352	332
By Federal Reserve System ¹	446	431	409	346	329
On site	399	385	372	309	298
Off site	47	46	37	37	31
By state banking agency	8	8	4	6	3
Small (assets of \$1 billion or less)					
Total number	4,787	4,806	4,816	4,800	4,831
Total assets (billions of dollars)	847	821	768	716	679
Number of inspections	3,453	3,726	3,486	3,347	3,064
By Federal Reserve System	3,324	3,625	3,396	3,264	2,973
On site ²	183	264	730	835	684
Off site	3,141	3,361	2,666	2,429	2,289
By state banking agency	129	101	90	83	91
<i>Financial holding companies</i>					
Domestic	612	602	567	462	...
Foreign	32	30	23	21	...

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

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

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

... Not applicable.

commercial banks and held approximately 26 percent of all insured commercial bank assets in the United States. The guidelines for Federal Reserve examinations of state member banks are fully consistent with section 10 of the Federal Deposit Insurance Act, as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and by the Riegle Community Development and Regulatory Improvement Act of 1994. A full-scope, on-site examination of these banks is required at least once a year; exceptions are certain well-capitalized, well-managed institutions having assets of less than \$250 million, which may be examined once every eighteen months.

Bank Holding Companies

At year-end 2003, a total of 6,038 U.S. bank holding companies were in operation, of which 5,152 were top-tier bank holding companies. These organizations controlled 6,298 insured commercial banks and held approximately 96 percent of all insured commercial bank assets in the United States.

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

prepared by the federal and state banking authorities that have primary responsibility for the supervision of those banks, thereby minimizing duplication of effort and reducing the burden on banking organizations.

Small, noncomplex bank holding companies—those that have consolidated assets of \$1 billion or less—are subject to a special supervisory program that was implemented in 1997 and modified in 2002.² The program permits a more flexible approach to supervision of such companies. If all of a company's subsidiary depository institutions have composite and management ratings of "satisfactory" or better, and if no material outstanding issues at the holding company or consolidated level are otherwise indicated, only a composite rating and a management rating based on the ratings of the lead subsidiary depository institution are assigned to the company. In 2003, the Federal Reserve conducted 3,324 reviews of such bank holding companies. If a company's subsidiary depository institutions have ratings lower than "satisfactory" or have other significant supervisory issues, a more thorough off-site review of the organization is conducted using surveillance results and other information. If the information obtained off-site from these sources is not sufficient to determine the overall financial condition of the holding company and to assign the composite and management ratings, the holding company is subject to increased supervisory review that may include an on-site review and off-site monitoring.

2. Refer to SR Letter 02-01 for a discussion of the factors considered in determining whether a bank holding company is complex or noncomplex (www.federalreserve.gov/boarddocs/SRLETTERS/2002/sr0201.htm).

Financial Holding Companies

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

As of year-end 2003, 612 domestic bank holding companies and 32 foreign banking organizations had financial holding company status. Of the domestic financial holding companies, 45 had consolidated assets of \$15 billion or more; 98, between \$1 billion and \$15 billion; 93, between \$500 million and \$1 billion; and 376, less than \$500 million.

Specialized Examinations

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

Information Technology Activities

In recognition of the importance of information technology to safe and

sound operations in the financial industry, the Federal Reserve reviews the information technology activities of supervised financial institutions as well as certain independent data centers that provide information technology services to these institutions. Several years ago, the information technology reviews of banking institutions were integrated into the overall supervisory process, and thus all safety and soundness examinations are now expected to include a review of information technology risks and activities. During 2003 the Federal Reserve was the lead agency in two examinations of large, multiregional data processing servicers examined in cooperation with the other federal banking agencies.

Fiduciary Activities

The Federal Reserve has supervisory responsibility for institutions that together hold more than \$14 trillion of assets in various fiduciary capacities. During on-site examinations of fiduciary activities, the institution's compliance with laws, regulations, and general fiduciary principles and potential conflicts of interest are reviewed; its management and operations, including its asset- and account-management, risk-management, and audit and control procedures, are also evaluated. In 2003 Federal Reserve examiners conducted 164 on-site fiduciary examinations.

Transfer Agents and Securities Clearing Agencies

As directed by the Securities Exchange Act of 1934, the Federal Reserve conducts specialized examinations of those state member banks and bank holding companies that are registered with the Board as transfer agents. Among other things, transfer agents countersign and

monitor the issuance of securities, register the transfer of securities, and exchange or convert securities. On-site examinations focus on the effectiveness of the institution's operations and its compliance with relevant securities regulations. During 2003 the Federal Reserve conducted on-site examinations at 27 of the 92 state member banks and bank holding companies that were registered as transfer agents. Also during the year the Federal Reserve examined 1 state member limited-purpose trust company acting as a national securities depository.

Government and Municipal Securities Dealers and Brokers

The Federal Reserve is responsible for examining state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with Department of the Treasury regulations governing dealing and brokering in government securities. Thirty-three state member banks and 9 state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 2003 the Federal Reserve conducted 10 examinations of broker-dealer activities in government securities at these institutions. These examinations are generally conducted concurrently with the Federal Reserve's examination of the state member bank or branch.

The Federal Reserve is also responsible for ensuring compliance with the Securities Act Amendments of 1975 by state member banks and bank holding companies that act as municipal securities dealers, which are examined pursuant to the Municipal Securities Rule-making Board's rule G-16 at least once each two calendar years. Of the 24 entities that dealt in municipal securities

during 2003, 8 were examined during the year.

Securities Credit Lenders

Under the Securities Exchange Act of 1934, the Federal Reserve Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. In addition to examining banks under its jurisdiction for compliance with the Board's margin regulations as part of its general examination program, the Federal Reserve maintains a registry of persons other than banks, brokers, and dealers who extend credit subject to those regulations. The Federal Reserve may conduct specialized examinations of these lenders if they are not already subject to supervision by the Farm Credit Administration, the National Credit Union Administration, or the Office of Thrift Supervision.

At the end of 2003, 700 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 215 of these lenders, and the remaining 485 were subject to limited Federal Reserve supervision. On the basis of regulatory requirements and annual reports, the Federal Reserve exempted 269 lenders from its on-site inspection program. The securities credit activities of the remaining 216 lenders were subject to either biennial or triennial inspection. Eighty-nine inspections were conducted during the year, compared with 127 in 2002.

Enforcement Actions and Civil Money Penalties

In 2003 the Federal Reserve completed 44 enforcement cases involving 62 separate actions. The actions included cease-and-desist orders, written agreements,

removal and prohibition orders, and civil money penalties.

In 2003 the Board of Governors assessed \$103.1 million in civil money penalties. All civil money penalties assessed by the Board are remitted, as directed by statute, either to the U.S. Department of the Treasury or to the Federal Emergency Management Agency.

All final enforcement orders issued by the Board and all written agreements executed by the Reserve Banks are available to the public and are posted on the Board's web site (www.federalreserve.gov/boarddocs/enforcement). In addition to formal enforcement actions, the Reserve Banks in 2003 completed 141 informal enforcement actions, such as board of directors resolutions and memoranda of understanding. These informal actions are not available to the public.

Risk-Focused Supervision

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

Regional Banking Organizations

The risk-focused supervision program for regional banking organizations applies to institutions having a management structure organized by function or business line, a broad array of products, and operations that span multiple supervisory jurisdictions. For smaller regional banking organizations, the supervisory

program may be implemented with a point-in-time inspection. For larger institutions, it may take the form of a series of targeted reviews. For the largest, most complex institutions, the process is continuous, as described in the next section. To minimize burden on the institution, work is performed off site to the greatest extent possible. Additionally, to minimize the number of requests for information from the institution, examiners make use of public and regulatory financial reports, market data, information from automated surveillance screening systems (see section “Surveillance and Off-Site Monitoring”), and internal management reports.

Large, Complex Banking Organizations

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

agency information-sharing through an automated system.

In support of the supervision of domestic banking organizations and foreign banking organizations (FBOs) with a U.S. banking presence, there is an automated application—the Banking Organization National Desktop (BOND)—which was developed to facilitate real-time, secure electronic information-sharing and collaboration among federal and certain state banking regulators. During 2003, BOND was comprehensively updated to provide information on regional and community banking organizations; to allow for seamless integration with other Federal Reserve national information systems, such as the National Examination Database (NED), Central Document and Text Repository (CDTR), Performance Report Information and Surveillance Monitoring (PRISM), and the National Information Center (NIC); and to enable the addition of supervisory documents to the CDTR and FBO rating data to NED. Other revisions facilitate analysis across business activities and help document the sharing of confidential supervisory information on FBOs and domestic banking organizations having a global presence with foreign regulators.

In April 2003, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC) published “Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System.” An interagency working group had been formed in 2002 to assess whether, in light of the post-September 11 risk environment, additional guidance on business resumption was needed. The agencies held a series of meetings with financial institutions and core clearing and settlement organizations to discuss lessons learned and

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

the need to improve the resilience of the financial system after a wide-scale disruption. In September 2002, the working group published for comment a draft interagency white paper on strengthening resilience. The final paper incorporated comments received on that draft and additional discussions with industry representatives. In 2003, the Federal Reserve began to develop a process for assessing the implementation by financial institutions of the sound practices presented in the paper.

Community Banks

The risk-focused supervision program for community banks emphasizes the review of activities having the highest level of risk to an institution and provides a tiered approach to the examination of these activities. Examination procedures are tailored to the characteristics of the bank, keeping in mind its size, complexity, and risk profile. The examination procedures entail both off-site and on-site work, including planning, completion of a pre-examination visit, preparation of a detailed scope-of-examination memorandum, thorough documentation of the work done, and preparation of an examination report tailored to the scope and findings of the examination. The framework for risk-focused supervision of community banks was developed jointly with the Federal Deposit Insurance Corporation (FDIC) and has been adopted by the Conference of State Bank Supervisors.

Surveillance and Off-Site Monitoring

The Federal Reserve uses automated screening systems to monitor the financial condition and performance of state member banks and bank holding companies between on-site examinations. The

screening systems analyze supervisory data and regulatory financial reports to identify companies that appear to be weak or deteriorating. This analysis helps to direct examination resources to institutions that exhibit higher risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities. The Federal Reserve also monitors various market indices, including equity prices, debt spreads and ratings, and measures of expected default frequency to gauge market perceptions of the risks in banking organizations.

In addition to using automated screening systems, the Federal Reserve prepares quarterly Bank Holding Company Performance Reports (BHCPRs) for use in monitoring and inspecting supervised banking organizations. The reports contain, for individual bank holding companies, financial statistics and comparisons with peer companies. They are compiled from data provided by large bank holding companies in quarterly regulatory reports (FR Y-9C and FR Y-9LP). BHCPRs are made available to the public on the Board's National Information Center web site (www.ffiec.gov/nic/).

During 2003, a web version of the Performance Report Information and Surveillance Monitoring application was implemented. PRISM is a querying tool for Federal Reserve analysts that accesses and displays financial, surveillance, and examination data. In the analytical module, users can customize the presentation of financial data for banks, bank holding companies, and other financial institutions that are drawn from data in several types of reports—Call Report, Uniform Bank Performance Report, FR Y-9, and Bank Holding Company Performance Report, among others. In the surveillance module, users

can generate reports summarizing the results of System surveillance screens for banks and bank holding companies. Users can also use PRISM to generate customized surveillance screens, and all PRISM reports can be transferred to Excel spreadsheets.

The Federal Reserve works through the Federal Financial Institutions Examination Council (FFIEC) Task Force on Surveillance Systems to coordinate surveillance activities with the other federal banking agencies.

International Activities

The Federal Reserve supervises the foreign branches of and overseas investments by member banks, Edge Act and agreement corporations, and bank holding companies and the investments by bank holding companies in export trading companies. It also supervises the activities that foreign banking organizations conduct through entities in the United States, including branches, agencies, representative offices, and subsidiaries.

Foreign Operations of U.S. Banking Organizations

The Federal Reserve examines the international operations of state member banks, Edge Act corporations, and bank holding companies principally at the U.S. head offices of these organizations, where the ultimate responsibility for their foreign offices lies. The examinations abroad are conducted with the cooperation of the supervisory authorities of the countries in which they take place; when appropriate, the examinations are coordinated with the Office of the Comptroller of the Currency. Examiners also make visits to the overseas offices of U.S. banks to obtain financial and operating information

and, in some instances, to evaluate their efforts to implement corrective measures or to test their adherence to safe and sound banking practices.

At the end of 2003, 56 member banks were operating 818 branches in foreign countries and overseas areas of the United States; 32 national banks were operating 622 of these branches, and 24 state member banks were operating the remaining 196. In addition, 17 nonmember banks were operating 19 branches in foreign countries and overseas areas of the United States.

Edge Act and Agreement Corporations

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

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

Edge Act and agreement corporations numbered 78 and were operating 11 branches at year-end 2003. These corporations are examined annually.

U.S. Activities of Foreign Banks

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

As of year-end 2003, 190 foreign banks from 54 countries were operating 240 state-licensed branches and agencies (of which 8 were insured by the Federal Deposit Insurance Corporation) as well as 51 branches licensed by the Office of the Comptroller of the Currency (of which 6 had FDIC insurance). These foreign banks also directly owned 16 Edge Act and agreement corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 85 U.S. commercial banks.

Altogether, the U.S. offices of these foreign banks at the end of 2003 controlled approximately 18 percent of U.S. commercial banking assets. These foreign banks also operated 73 representative offices; an additional 60 foreign banks operated in the United States solely through a representative office.

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

The Federal Reserve conducts a joint program for supervising the U.S. operations of foreign banking organizations

in cooperation with the other federal banking agencies and state banking agencies. The program has two main parts. One part addresses the examination process for those foreign banking organizations that have multiple U.S. operations and is intended to ensure coordination among the various U.S. supervisory agencies. The other part is a review of the financial and operational profile of each organization to assess its general ability to support its U.S. operations and to determine what risks, if any, the organization poses through its U.S. operations. Together, these two processes provide critical information to U.S. supervisors in a logical, uniform, and timely manner. The Federal Reserve conducted or participated with state and federal regulatory authorities in 269 examinations during 2003.

Technical Assistance

In 2003 the Federal Reserve System continued to provide technical assistance on bank supervisory matters to foreign central banks and supervisory authorities. Technical assistance involves visits by System staff members to foreign authorities as well as consultations with foreign supervisors who visit the Board or the Reserve Banks. Technical assistance in 2003 was concentrated in Latin America, Asia, and former Soviet bloc countries.

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

vision, and the Financial Stability Institute.

Supervisory Policy

The Federal Reserve's supervisory policy function is responsible for developing guidance for examiners and financial institutions as well as regulations for financial institutions under the supervision of the Federal Reserve. Staff members participate in international supervisory forums and provide support for the work of the Federal Financial Institutions Examination Council.

Capital Adequacy Standards

During 2003 the Federal Reserve, together with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, issued an interim rule amending the agencies' regulatory capital guidelines, an advance notice of proposed rulemaking on regulatory capital standards for internationally active banking organizations, and guidance on credit card lending; revised the appraisal guidelines; and issued an advisory on mortgage banking activities. The Federal Reserve also clarified the reporting and capital treatment of trust preferred stocks.

Asset-Backed Commercial Paper Programs and Early Amortization Provisions

In October the Federal Reserve and the other federal banking agencies adopted an interim rule with a request for comments that amended the agencies' risk-based capital standards by providing an interim capital treatment for assets in asset-backed commercial paper (ABCP) programs that are consolidated onto the balance sheets of sponsoring banking

organizations as a result of Financial Accounting Standards Board Financial Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). The comment period ended on November 17, 2003. The interim capital treatment allows sponsoring banking organizations to remove the consolidated ABCP program assets from their risk-weighted asset bases for purposes of calculating their risk-based capital ratios. Sponsoring banking organizations must continue to hold risk-based capital against all other risk exposures arising in connection with ABCP programs, including direct credit substitutes, recourse obligations, residual interests, long-term liquidity facilities, and loans, in accordance with existing risk-based capital standards. In addition, any minority interests in ABCP programs that are consolidated as a result of FIN 46 are to be excluded from sponsoring banking organizations' minority interest component of tier 1 capital and, hence, from total risk-based capital.

The interim capital treatment is in effect only for the regulatory reporting periods ending September 30 and December 31, 2003, and March 31, 2004. In addition, the interim capital treatment does not alter the accounting rules for balance sheet consolidation, nor does it affect the denominator of the tier 1 leverage capital ratio calculation, which continues to be based primarily on on-balance-sheet assets as reported under generally accepted accounting principles (GAAP). Thus, as a result of FIN 46, banking organizations must include all assets of consolidated ABCP programs in on-balance-sheet assets for purposes of calculating the tier 1 leverage capital ratio. The interim risk-based capital treatment will expire on April 1, 2004.

Concurrent with the issuance of the interim rule, the agencies also published

a notice of proposed rulemaking that would amend their risk-based capital standards by removing the April 1, 2004, sunset provision in order to permit sponsoring banking organizations to continue to exclude from their risk-weighted asset base those assets in ABCP programs that are consolidated onto sponsoring banking organizations' balance sheets as a result of FIN 46. The comment period ended on November 17, 2003. The removal of the sunset provision is contingent upon the agencies' implementing proposed risk-based capital requirements for liquidity facilities having an original maturity of one year or less that organizations provide to ABCP programs, regardless of whether the organization sponsors the program or must consolidate the program under GAAP. This treatment recognizes that such facilities expose banking organizations to credit risk and is consistent with the industry's practice of internally allocating economic capital against this risk associated with such facilities. A separate capital charge on liquidity facilities provided to an ABCP program would not be required of banking organizations that are required to (or of other banks that choose to) consolidate the program for purposes of risk-based capital. In addition, the agencies proposed a risk-based capital charge for certain types of securitizations of revolving retail credit facilities (for example, credit card receivables) that incorporate early-amortization provisions.

Proposed Advance Rulemaking of the Risk-Based Capital Standards for Certain Internationally Active Banking Organizations

In August the Federal Reserve, along with the OCC, FDIC, and OTS, issued for public comment an advance notice of proposed rulemaking (ANPR) setting

forth the agencies' current views on a proposed framework for implementing revisions to the Basel Capital Accord in the United States. In particular, the ANPR described significant elements of the advanced internal ratings-based approach for credit risk and the advanced measurement approaches for operational risk (together, the advanced approaches). The ANPR specified criteria for determining which banking organizations would be required to use the advanced approaches and the criteria, supervisory standards, and disclosure requirements the banking organizations would be required to meet. Other organizations meeting the criteria would be permitted to use the advanced approaches. Under the advanced approaches, banking organizations would use internal estimates of certain risk components as key inputs in determining their regulatory capital requirements. The ANPR included a number of questions intended to highlight for the industry certain areas for which comment was particularly requested.

Concurrent with the issuance of the ANPR, the federal banking agencies issued for public comment draft supervisory guidance on internal ratings-based systems for corporate credits and advanced measurement approaches for operational risk. The guidance described supervisory expectations for institutions that are considering developing advanced measurement systems. The guidance on corporate credit set forth essential components and characteristics of an internal ratings-based system, including expectations vis-à-vis assignment of internal ratings, quantification, data maintenance, and control and oversight mechanisms. The draft supervisory guidance on operational risk measurement approaches outlined critical expectations vis-à-vis corporate governance,

the elements of operational risk management, and the primary components of an advanced measurement approach.

The comment period for the ANPR and the draft supervisory guidance ended on November 3, 2003. The Federal Reserve received more than 100 comments on the two issuances. Work is continuing on both the framework and the guidance.

Guidance on the Reporting and Capital Treatment of Trust Preferred Stocks

In July the Board issued SR Letter 03-13, which instructed bank holding companies to continue to follow the existing guidelines for the reporting and capital treatment of trust preferred stocks when preparing bank holding company regulatory reports even though these treatments may not concur with the most current treatment of trust preferred stocks set forth in FIN 46. Under existing procedures, bank holding companies report trust preferred stocks as minority interest in the equity accounts of a consolidated subsidiary and include trust preferred stocks in tier 1 capital. The interpretation of FIN 46 would have resulted in bank holding companies' reflecting subordinated debt issued to the trusts on their consolidated balance sheets under generally accepted accounting principles instead of the preferred stocks issued by the trusts to third-party investors.

Credit Card Lending

In January the Federal Reserve, along with the OCC, the FDIC, and the OTS, jointly issued Account Management and Loss Allowance Guidance. The guidance describes the agencies' expectations regarding prudent risk-management practices for credit card

activities, particularly with respect to credit-line management, over-limit accounts, and workouts. It also addresses income recognition and loss-allowance practices in connection with credit card lending.

Regulation W

In SR Letter 03-2, which was issued in January, the Federal Reserve summarized the significant issues resolved with the adoption of Regulation W. Regulation W, which implements sections 23A and 23B of the Federal Reserve Act, includes seventy years' worth of interpretative guidance furnished by the Federal Reserve concerning statutory requirements. The nine significant issues resolved by the issuance of Regulation W are (1) the conditions for derivatives transactions, (2) the conditions for intraday credit transactions, (3) the definition of financial subsidiaries as affiliates of banks, (4) the exemption for general-purpose credit card transactions, (5) the application of sections 23A and 23B to certain activities of U.S. branches and agencies of foreign banks, (6) the conditions for the exemption of a bank's purchase of loans from its affiliates, (7) the exemption of certain bank loans to a third party secured by securities issued by a mutual fund affiliate of the bank, (8) an exemption that would permit a banking organization to engage more expeditiously in certain internal reorganization transactions, and (9) new valuation rules.

Appraisal Guidelines

In October the Federal Reserve and the other federal banking agencies issued a joint statement on the independence of the collateral valuation process (SR Letter 03-18). The purpose of the statement is to serve as a reminder to

regulated institutions that there needs to be an effective, independent real estate appraisal and evaluation program for all their lending functions, including all real-estate-related financial transactions originated or purchased by a regulated institution for its own portfolio or as assets held for sale. The statement should be read in conjunction with each agency's appraisal and with real-estate-lending regulations and the 1994 Interagency Appraisal and Evaluation Guidelines.

Mortgage Banking Activities

The Federal Reserve, along with the OCC, the FDIC, and the OTS, issued an interagency advisory on mortgage banking activities in February. The purpose of the guidance (SR Letter 03-4) was to address the weaknesses in risk management, valuation, and modeling of hedging practices related to mortgage-servicing assets (MSAs) noted in recent examinations. These weaknesses include the use of unsupported or inappropriate valuation assumptions; inadequate stratification, amortization, and impairment practices; and weak oversight and controls. Additional examiner scrutiny is warranted when such weaknesses are encountered. Banking organizations were reminded of the expectation that they fully comply with generally accepted accounting principles and with accounting guidance regarding servicing assets that was issued previously. The banking agencies expect institutions to perform mortgage-banking operations in a safe and sound manner. Management should ensure that detailed policies and procedures are in place to monitor and control mortgage-banking activities, including loan production, pipeline and warehouse administration, secondary market transactions, servicing operations, and management of MSAs.

Business Continuity

In April the Federal Reserve, along with the Office of the Comptroller of the Currency and the Securities and Exchange Commission, published an interagency paper titled "Sound Practices to Strengthen the Resilience of the U.S. Financial System." The paper identifies four sound practices for organizations that provide core clearing and settlement services and firms that play significant roles in critical financial markets. The sound practices focus on the back-up capacity necessary for recovery and resumption of clearing and settlement of material open transactions and are designed to minimize the immediate systemic effects of a wide-scale disruption of critical financial markets. They build on long-standing principles of business continuity planning and reflect actions identified by industry members in meetings and in comments on a draft of the paper that was published during 2002.

The sound practices include the identification of all clearing and settlement activities that support critical financial markets and the determination of appropriate recovery and resumption objectives (that is, within the business day on which the disruption occurs). They provide that covered organizations should maintain sufficient geographically dispersed resources to meet recovery and resumption objectives. They also provide that recovery and resumption arrangements should be in routine use or subject to sufficient testing to ensure that they are effective.

Core clearing organizations are expected to implement the sound practices by the end of 2004, and firms that play significant roles in critical markets are expected to implement the sound practices during 2006, although the implementation period may have to be

extended in some cases. Implementation plans should incorporate interim milestones against which progress can be measured. Financial firms not deemed to be a core clearing and settlement organization or a firm that plays a significant role in critical markets are encouraged to review and consider implementing the sound practices.

Anti-Tying Restrictions

In August the Federal Reserve requested public comment on an interpretation of the anti-tying restrictions in section 106 of the Bank Holding Company Act Amendments of 1970 and related supervisory guidance. Section 106 generally prohibits a bank from conditioning the availability or price of one product on the customer's obtaining another product from the bank or an affiliate. The Board's proposed interpretation of section 106 provides banking organizations and their customers a comprehensive guide to the special anti-tying restrictions applicable to banks under section 106. The related supervisory guidance describes the types of policies and procedures that should help banks ensure and monitor their compliance with section 106.

Discount Window Guidance

In July the Federal Reserve and the other federal banking, thrift, and credit union regulatory agencies issued guidance on the appropriate use of the Federal Reserve's primary credit discount window program in depository institutions' liquidity risk management and contingency planning. The guidance provided background on the Federal Reserve's discount window programs and reiterated well-established supervisory policies on sound contingency planning in relation to liquidity. It also

discussed sound practices in using primary credit program borrowings in liquidity contingency planning.

Commodities Derivatives Authority

In June the Federal Reserve approved a modification to Regulation Y that allows bank holding companies engaged in permissible derivatives activities to transfer title to commodities underlying derivatives contracts on an instantaneous, pass-through basis. Prior to this modification, a bank holding company could take and make delivery only on physically settled derivatives involving commodities that a state member bank is permitted to own, such as investment-grade corporate debt securities, U.S. government and municipal securities, foreign exchange, and certain precious metals. For all other types of physically settled derivatives, the bank holding company was required to make reasonable efforts to avoid delivery, and the contract was required to have assignment, termination, or offset provisions.

International Guidance on Supervisory Policies

As a member of the Basel Committee on Banking Supervision, the Federal Reserve in 2003 participated in efforts to revise the international capital regime and to develop international supervisory guidance. The Federal Reserve's goals in these activities are to advance sound supervisory policies for internationally active banking institutions and to improve the stability of the international banking system. The efforts are described in the following sections.

Capital Adequacy

The Federal Reserve continued to participate in a number of technical work-

ing groups of the Basel Committee in efforts to develop a new capital accord. In April the Basel Committee published a revised consultative paper based on further deliberations of the committee and on comments received by the committee on its January 2001 consultative paper and on technical papers subsequently issued by the working groups. The Basel Committee received more than 200 comments on the consultative paper.

Also during 2003, the Federal Reserve and other U.S. bank regulatory agencies participated in the third international Quantitative Impact Study conducted by the Basel Committee to evaluate the possible effects of the proposed revised capital standards. The study, which involved 22 large U.S. banking organizations and more than 350 banks worldwide, has helped guide the committee in developing capital requirements for banks' individual portfolios and sub-portfolios. During the second half of the year the technical working groups analyzed the comments and data gathered through the study and developed additional modifications to the capital proposals. U.S. authorities plan to conduct a fourth study during 2004 before issuing new capital regulations for public comment.

In addition, the Basel Committee decided to base the revised framework on unexpected losses rather than combined unexpected and expected losses, which had served as the basis for earlier proposals. The committee solicited additional public comment through December 31, 2003, on this fundamental change to the proposed capital framework.

Risk Management

The Federal Reserve contributed to several supervisory policy papers,

reports, and recommendations issued by the Basel Committee during 2003. These documents were generally aimed at improving the supervision of banking organizations' risk-management practices.

- "Principles and Management and Supervision of Interest Rate Risk," (issued in September) revised an earlier version of the paper on the basis of comments received from institutions, industry associations, supervisory authorities, and others.
- "Management and Supervision of Cross-Border Electronic Banking Activities" (issued in July) and "Risk Management for Electronic Banking" (issued in July) were prepared for the purposes of identifying banks' risk-management responsibilities with respect to cross-border banking and focusing attention on the need for effective home country supervision of, and continued international cooperation regarding, electronic banking.
- "Management and Supervision of Operational Risk" (issued in February) outlines a set of principles that provide a framework for the effective management and supervision of operational risk, for use by banks and supervisory authorities when evaluating operational-risk-management policies and practices.

International Accounting and Disclosure

The Federal Reserve participates in the Basel Committee's Task Force on Accounting Issues and its Transparency Group and represents the Basel Committee at international meetings on the issues addressed by these groups. In

particular, a Federal Reserve official in 2003 represented the Basel Committee at meetings of a committee of the International Accounting Standards Board (IASB) that works to improve guidance on accounting for financial instruments. In addition, a representative of the Federal Reserve is a member of the IASB's Standards Advisory Council.

During 2003, the Federal Reserve and the Basel Committee provided comments on the IASB's amendments to statements 32 and 39. The amendments addressed key issues related to financial instruments, including loan-loss allowances, fair-value accounting, and hedge accounting. The Federal Reserve and the Basel Committee also worked with the International Federation of Accountants to promote stronger international audit standards and greater participation by public interest groups in the audit-standard-setting process. The Transparency Group is developing guidance on improving disclosure, for the purpose of enhancing market discipline. The group's current focus is on developing and finalizing "Pillar 3" proposals that would improve disclosures in support of the revised international capital accord.

Joint Forum

In its work with the Basel Committee (BCBS), the Federal Reserve also continued its participation in the Joint Forum—a group made up of representatives of the committee, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS). The Joint Forum works to increase mutual understanding of issues related to the supervision of firms operating in each of the financial sectors. The Joint Forum issued three papers during 2003: "Initiatives by the BCBS, IAIS, and

IOSCO to Combat Money Laundering and the Financing of Terrorism" (June), "Trends in Risk Integration and Aggregation" (August), and "Operational Risk Transfer across Financial Sectors" (August).

Securities Underwriting Authority

In February the Federal Reserve issued an interpretation concerning securities underwriting by banking organizations that are subject to the Bank Holding Company Act. The interpretation clarifies that a banking organization that wishes to engage in underwriting securities that are to be distributed in the United States must either be a financial holding company or have authority to engage in underwriting activity under section 4(c)(8) of the Bank Holding Company Act.

Sarbanes–Oxley Act

The Federal Reserve is actively involved in evaluating the effect of the Sarbanes–Oxley Act on financial institutions. In May, in conjunction with the OCC and the OTS, the Federal Reserve issued SR Letter 03–8, Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations. The interagency statement responded to questions that the agencies had received as to whether the agencies expected small, non-public banking organizations to comply with the Sarbanes–Oxley Act and the recent corporate governance proposals of the New York Stock Exchange and Nasdaq.

In issuing this interagency statement, the banking agencies reiterated their long-standing endorsement, through regulation and guidance, of sound corporate governance and auditing policies and practices for all banking organi-

zations under their supervision. They stated that their regulatory approach, as well as the approach adopted by Congress in the Sarbanes–Oxley Act, has sought to balance the goal of strong corporate governance with the recognition that smaller, non-public banking organizations typically have fewer resources and less-complex operations than public organizations.

The Federal Reserve also provided comments to the Securities and Exchange Commission and the Public Company Accounting Oversight Board on their efforts to promote enhanced standards for management and external auditors to follow when considering internal control matters. In addition, the Federal Reserve is working with the FDIC and other banking agencies to consider what changes should be made to the regulations implementing the Federal Deposit Insurance Corporation Improvement Act to promote strong internal controls and consistency with Sarbanes–Oxley requirements.

Efforts to Enhance Transparency

The Federal Reserve has long supported sound accounting policies and meaningful public disclosure by banking and financial organizations to improve market discipline and foster stable financial markets. Effective market discipline can serve as an important complement to bank supervision and regulation. The more informative the data released by financial institutions, the better the evaluation of counterparty risks by market participants can be and the better their adjustments to the availability and pricing of funds will be. Thus, transparency can promote efficiency in financial markets and sound practices by banks. The Federal Reserve also seeks to strengthen audit and control standards

for banks; the quality of management information and financial reporting is dramatically affected by internal control systems and internal and external audit programs.

As part of ongoing efforts to address bank supervisory issues and enhance supervision through guidance that encourages sound practices, the Federal Reserve, together with the other banking agencies, in March amended the guidance on internal audit and outsourcing. SR Letter 03–5 conformed supervisory guidance to the independence rules for external auditors promulgated under the Sarbanes–Oxley Act. In addition, the policy strengthened and refined guidance intended to enhance corporate governance at regulated institutions.

The Federal Reserve worked closely with the other banking agencies in reviewing the American Institute of Certified Public Accountants' exposure draft of a proposed statement of position, "Allowance for Credit Losses," which was issued for public comment in June. A joint comment letter was submitted in October.

In August the Federal Reserve, along with the other federal bank and thrift regulatory agencies, issued final rules governing their authority to take disciplinary actions against independent public accountants and accounting firms that perform the audit and attestation services required by section 36 of the Federal Deposit Insurance Act. The final rules, which took effect on October 1, 2003, establish procedures under which the agencies can, for good cause, remove, suspend, or bar an accountant or firm from performing audit and attestation services for insured depository institutions with assets of \$500 million or more. The rules permit immediate suspensions in limited circumstances.

Bank Holding Company Regulatory Financial Reports

The Federal Reserve requires that U.S. bank holding companies submit periodic regulatory financial reports. These reports provide information essential to the supervision of the organizations and the formulation of regulations and supervisory policies. The Federal Reserve also uses the information in responding to requests from Congress and the public for information on bank holding companies and their nonbank subsidiaries.

The FR Y-9 series of reports provides standardized financial statements for the consolidated bank holding company. The reports are used to detect emerging financial problems, review performance and conduct pre-inspection analysis, monitor and evaluate risk profiles and capital adequacy, evaluate proposals for bank holding company mergers and acquisitions, and analyze the holding company's overall financial condition. The nonbank subsidiary series of reports, FR Y-11 and FR 2314, aid the Federal Reserve in determining the condition of bank holding companies that are engaged in nonbanking activities and in monitoring the volume, nature, and condition of their nonbanking subsidiaries. The FR Y-8 report collects information on transactions between an insured depository institution and its affiliate that are subject to section 23A of the Federal Reserve Act. It enhances the Federal Reserve's ability to monitor bank exposures to affiliates and to ensure compliance with section 23A of the Federal Reserve Act.

In March 2003, several revisions to the FR Y-9C report were implemented to make it consistent with revisions to the bank Call Report and to conform to changes in generally accepted accounting principles. Also, the relevance of the

FR Y-9 series of reports was improved by revising existing items and adding new items related to companies acquired by bank holding companies that are involved in significant acquisitions. In addition, mandatory electronic submission of several reports—FR Y-9C, FR Y-9LP, FR Y-9SP, and FR Y-9ES—was implemented, resulting in more-efficient data collection and dissemination.

In June the FR Y-8 was revised to collect additional information to be used in monitoring compliance with section 23A and to assist in monitoring derivatives transactions and establishing policy for regulating such transactions. The report was also revised to reflect interpretations and definitions in Regulation W, the rule that comprehensively implements sections 23A and 23B of the Federal Reserve Act.

Federal Financial Institutions Examination Council

The Federal Reserve continued its participation on the Federal Financial Institutions Examination Council over 2003. The FFIEC serves as a coordinating body for the federal banking agencies and the National Credit Union Administration. State supervisory authorities also participate in some FFIEC initiatives. During 2003, the FFIEC focused on coordinating the agencies' efforts to identify and eliminate outdated, unnecessary, or unduly burdensome regulations. This initiative is pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. The FFIEC also initiated a project to modernize and streamline the way in which the banking agencies collect, process, and distribute quarterly bank financial reports. In addition, the FFIEC continued its efforts related to examiner training and education, consumer compli-

ance issues, bank surveillance processes, and information sharing. A few initiatives are highlighted below.

Bank Call Reports

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

The Call Report modernization project is intended to improve the timeliness and quality of supervisory data and to enhance market discipline through more timely access by the public. Proposed enhancements to the data collection and disclosure process include requiring electronic submission of Call Reports to a central data repository, accelerating the filing deadline for reports, and requiring data validation checks to be performed by respondents as a condition of the accepted filing of the reports. The central repository is expected to be ready for testing in late 2004.

Call Report changes implemented in 2003 include the reporting of insurance-related income, credit enhancements for securitizations, accrued fees and finance charges on credit cards, and the fair value of derivatives at small banks having derivatives contracts. Also, a proposal was issued in November to revise

the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002) to include additional information on derivatives contracts.

Information Technology

In 2003 the FFIEC completed the first year of a two-year pilot test of its revised framework for the interagency examination program for information technology service providers. Examinations of providers of information technology and processing services to financial institutions are conducted by the Federal Reserve or other financial institution supervisory agencies under the Bank Service Company Act. The revised framework promotes a risk-based rationale for conducting such examinations by identifying and analyzing material supervisory risks to financial institutions that use the services of these companies. It includes risk-focused criteria for determining the examination schedule and the scope of the examinations.

During the year, the FFIEC also issued revisions to the FFIEC information systems examination manual, last updated in 1996. Booklets on six topics (which will replace the current chapters in the manual) were issued: information security; business continuity planning; information technology audit; e-banking; FedLine; and supervision of technology service providers. Also in 2003, the Federal Reserve and the other agencies began developing the final six booklets planned to update the manual: retail payments; outsourcing; operations; wholesale payments; management; and development and acquisition. Agency examiners field-tested all but the wholesale payments booklet in 2003, and all six remaining booklets are scheduled for publication in 2004.

Supervisory Information Technology

Under the direction of the division's chief technology officer, the supervisory information technology (SIT) function within the Board's Division of Banking Supervision and Regulation facilitates the management of information technology within the Federal Reserve's supervision function. Its goals are to ensure that

- IT initiatives support a broad range of supervisory activities without duplication or overlap
- the underlying IT architecture fully supports those initiatives
- adequate resources are devoted to interagency working groups on supervisory initiatives (for example, Call Report modernization for the FFIEC central data repository)
- the supervision function's use of technology leverages the resources and expertise available more broadly within the Federal Reserve System
- practices that maximize supervision's business value, cost effectiveness, and quality are identified, analyzed, and approved for implementation

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

SIT Project Management

In 2003, the SIT project management staff, in partnership with other Federal

Reserve System staff, made significant progress in identifying opportunities for enhancing business value through the use of information technology. The supervision function completed implementation of a Systemwide technology platform for scheduling examination resources. Staff members continue to provide substantial assistance and resources to support modernization of the Shared National Credit program. The modernization is an interagency effort aimed at reducing examination costs and improving the timeliness and reliability of data associated with the review of large, syndicated credit facilities of commercial banks. In conjunction with efforts of Board and Reserve Bank internal IT providers, the staff has also supported supervision and regulation projects to assess opportunities in the areas of electronic applications, administrative systems, and learning management systems to improve the delivery of information technology services for supervision.

National Information Center

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

In 2003, a secure, web-enabled version of the NED application was put into operation. The application was updated to reflect changes in OCC and FDIC examination processes and changes in the commercial bank Call Report and the bank holding company FR Y-9 reports. The secure web ver-

sion of NED is expected to be made available to state banking departments in early 2004. Also in 2003, the CDTR was modified to include examination reports from other agencies and expanded to include reports of regional and community examinations filed by the Reserve Banks. Significant resources continue to be devoted in support of Call Report modernization for the FFIEC central data repository initiative, with expected implementation in the fourth quarter of 2004.

Staff Development

The Federal Reserve System’s staff development program trains staff mem-

bers at the Board of Governors, the Reserve Banks, and state banking departments who have supervisory and regulatory responsibilities and students from foreign supervisory authorities. Training is offered at the basic, intermediate, and advanced levels in several disciplines within bank supervision: safety and soundness, information technology, international banking, and consumer affairs. Classes are conducted in Washington, D.C., as well as at Reserve Banks and other locations.

The Federal Reserve System also participates in training offered by the FFIEC and by certain other regulatory agencies. The System’s involvement includes developing and implementing

Training Programs for Banking Supervision and Regulation, 2003

Program	Number of sessions conducted	
	Total	Regional
<i>Schools or seminars conducted by the Federal Reserve</i>		
Core schools		
Banking and supervision elements	5	4
Operations and analysis	4	3
Bank management	4	2
Report writing	16	16
Management skills	10	9
Conducting meetings with management	13	13
Other schools		
Loan analysis	4	3
Examination management	5	5
Real estate lending seminar	3	3
Senior forum for current banking and regulatory issues	1	1
Banking applications	1	0
Principles of fiduciary supervision	2	1
Commercial lending essentials for consumer affairs	2	2
Introduction to consumer compliance examinations	2	0
Consumer compliance examinations II	2	2
CRA examination techniques	2	2
Fair lending examination techniques	2	2
Foreign banking organizations	2	2
Information systems continuing education	3	2
Capital markets seminars	8	6
Technology risk integration	8	8
Leadership dynamics	6	5
Seminar for senior supervisors of foreign central banks ¹	1	1
<i>Other agencies conducting courses²</i>		
Federal Financial Institutions Examination Council	44	1
The Options Institute	1	1

1. Conducted jointly with the World Bank.

2. Open to Federal Reserve employees.

Trends in Reserve Bank Supervision Levels, 1999–2003

Type of staff	2003	2002	2001	2000	1999
Field examination staff	1,239	1,234	1,242	1,172	1,216
Commissioned field staff	936	892	861	786	893

basic and advanced training in relation to various emerging issues as well as in specialized areas such as international banking, information technology, municipal securities dealing, capital markets, payment systems risk, white collar crime, and real estate lending. In addition, the System co-hosts the World Bank Seminar for students from developing countries.

In 2003, the Federal Reserve trained 1,952 students in System schools, 384 in schools sponsored by the FFIEC, and 19 in other schools, plus 283 representatives of foreign central banks, for a total of 2,638. (See accompanying table.) The number of training days in 2003 totaled 13,768.

The System gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program, 309 state examiners were trained—209 in Federal Reserve courses, 95 in FFIEC programs, and 5 in other courses.

A staff member seeking an examiner's commission is required to take a first proficiency examination and also a second proficiency examination in one of the following three specialty areas: safety and soundness, consumer affairs, or information technology. In 2003, 121 examiners passed the first proficiency examination. In the second proficiency examination, 55 examiners passed the safety and soundness examination, 41 passed the consumer affairs examination, and 1 passed the information technology examination. The overall pass rate for these proficiency examinations

was 79 percent. At the end of 2003, the System had 1,239 field examiners, of which 936 were commissioned (table).

Regulation of the U.S. Banking Structure

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

Bank Holding Company Act

Under the Bank Holding Company Act, a corporation or similar organization must obtain the Federal Reserve's approval before forming a bank holding company through the acquisition of one or more banks in the United States. Once formed, a bank holding company must receive Federal Reserve approval before acquiring or establishing additional banks. The act also identifies other activities permissible for bank holding companies; depending on the circumstances, these activities may or may not require Federal

Decisions by the Federal Reserve on Domestic and International Applications, 2003

Proposal	Direct action by the Board of Governors			Action under authority delegated by the Board of Governors					Total
				Director of the Division of Banking Supervision and Regulation		Office of the Secretary	Federal Reserve Banks		
	Approved	Denied	Permitted	Approved	Denied	Approved	Approved	Permitted	
Formation of bank holding company	14	0	0	0	0	3	152	53	222
Merger of bank holding company	6	0	0	0	0	4	25	12	47
Acquisition or retention of bank	27	0	0	0	0	2	95	33	157
Acquisition of nonbank	0	0	25	0	0	14	0	70	109
Merger of bank	6	0	0	0	0	7	59	0	72
Change in control	0	0	0	0	0	1	0	119	120
Establishment of a branch, agency, or representative office by a foreign bank	3	0	0	13	0	0	0	0	16
Other	287	0	0	53	0	131	1,106	348	1,925
Total	343	0	25	66	0	162	1,437	635	2,668

Reserve approval in advance of their commencement.

In 2003, the Board allowed bank holding companies engaged in permissible derivatives activities to transfer title to commodities underlying derivatives contracts on an instantaneous, pass-through basis. In addition, the Board expanded the degree to which bank holding companies may process, store, and transmit nonfinancial data as they process, store, and transmit financial data.

When reviewing a bank holding company application or notice that requires prior approval, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potential public benefits, the com-

petitive effects of the proposal, and the applicant's ability to make available to the Board information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. Data on decisions regarding domestic and international applications in 2003 are shown in the accompanying table.

Bank holding companies generally may engage in only those activities that the Board has previously determined to be closely related to banking under section 4(c)(8) of the act. Since 1996, the act has provided an expedited prior-notice procedure for certain permissible nonbank activities and for acquisitions

of small banks and nonbank entities. Since that time the act has also permitted well-run bank holding companies that satisfy certain criteria to commence certain other nonbank activities on a de novo basis without first obtaining Federal Reserve approval.

Since 2000, the Bank Holding Company Act has permitted the creation of a special type of bank holding company called a financial holding company. Financial holding companies are allowed to engage in a broader range of nonbank activities than are traditional bank holding companies. Among other things, they may affiliate with securities firms and insurance companies and engage in certain merchant banking activities. Bank holding companies seeking financial holding company status must file a written declaration with the Federal Reserve System; most declarations are acted upon by one of the Reserve Banks under delegated authority. In 2003, forty-one domestic financial holding company declarations and two foreign bank declarations were approved.

Financial holding companies do not have to obtain the Board's prior approval to engage in or acquire a company engaged in financial activities that are permissible under the Gramm-Leach-Bliley Act. Instead, the financial holding company must notify the Board within thirty days after commencing the new activity or acquiring the company. A financial holding company may also engage in certain other activities that have been determined to be financial in nature or incidental to a financial activity or that are determined to be complementary to a financial activity. In 2003, the Board determined that certain limited physical commodity trading activities are complementary to the financial activity of engaging regularly as principal in commodity derivatives activities.

Bank Merger Act

The Bank Merger Act requires that all proposals involving the merger of insured depository institutions be acted on by the appropriate federal banking agency. If the institution surviving the merger is a state member bank, the Federal Reserve has primary jurisdiction. Before acting on a merger proposal, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of the existing and combined institutions, the convenience and needs of the community to be served, and the competitive effects of the proposed merger. It also considers the views of certain other agencies regarding the competitive factors involved in the transaction. During 2003, the Federal Reserve approved seventy-two merger applications.

When the FDIC, the OCC, or the OTS has jurisdiction over a merger, the Federal Reserve is asked to comment on the competitive factors related to the proposal. By using standard terminology in assessing competitive factors in merger proposals, the four agencies have sought to ensure consistency in administering the Bank Merger Act. The Federal Reserve submitted 506 reports on competitive factors to the other agencies in 2003.

Change in Bank Control Act

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

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

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

In 2003, the Federal Reserve approved 120 changes in control of state member banks and bank holding companies.

International Banking Act

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

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

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

In 2003, the Federal Reserve approved sixteen applications by foreign banks to establish branches, agencies, and representative offices in the United States.

Overseas Investments by U.S. Banking Organizations

U.S. banking organizations may engage in a broad range of activities overseas. Many of the activities are conducted indirectly through Edge Act and agreement corporation subsidiaries. Although most foreign investments are made under general consent procedures that involve only after-the-fact notification to the Board, large and other significant investments require the prior approval of the Board. Excluding proposals related to large domestic mergers, the Board in 2003 approved sixteen proposals for significant overseas investments by U.S. banking organizations. The Federal Reserve also approved eleven applications to make additional investments through an Edge Act corporation, one application to extend the corporate existence of an existing Edge Act corpora-

tion, and no applications to establish or acquire a new agreement corporation.

Applications by Member Banks

State member banks must obtain Federal Reserve approval to establish domestic branches, and all member banks (including national banks) must obtain Federal Reserve approval to establish foreign branches. When reviewing proposals to establish domestic branches, the Federal Reserve considers the scope and nature of the banking activities to be conducted. When reviewing proposals for foreign branches, the Federal Reserve considers, among other things, the condition of the bank and the bank's experience in international banking. In 2003, the Federal Reserve acted on new and merger-related branch proposals for 1,646 domestic branches and granted prior approval for the establishment of 4 new foreign branches.

State member banks must also obtain Federal Reserve approval to establish financial subsidiaries. These subsidiaries may engage in activities that are financial in nature or incidental to financial activities, including securities- and insurance-agency-related activities. In 2003, no applications for financial subsidiaries were approved.

Stock Repurchases by Bank Holding Companies

A bank holding company may repurchase its own shares from its shareholders. When the company borrows money to buy the shares, the transaction increases the company's debt and decreases its equity. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's capital adequacy guidelines. In 2003,

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

Public Notice of Federal Reserve Decisions

Most decisions by the Federal Reserve that involve a bank holding company, a bank merger, a change in control, or the establishment of a new U.S. banking presence by a foreign bank are made known to the public by an order or an announcement. Orders state the decision, the essential facts of the application or notice, and the basis for the decision; announcements state only the decision. All orders and announcements are made public immediately; they are subsequently reported in the Board's weekly H.2 statistical release and in the *Federal Reserve Bulletin*. The H.2 release also contains announcements of applications and notices received by the Federal Reserve upon which action has not yet been taken. For each pending application and notice, the related H.2A contains the deadline for comments. In 2003, the Board's public web site (www.federalreserve.gov) continued to provide information on orders and announcements. The web site was also expanded to include an online guide for U.S. and foreign banking organizations submitting applications or notices to the Federal Reserve.

Timely Processing of Applications

The Federal Reserve sets internal target time frames for the processing of applications. The setting of internal targets promotes efficiency at the Board and the Reserve Banks and reduces the burden on applicants. Generally, the length of the target period ranges from twelve

days to sixty days, depending on the type of application or notice filed. In 2003, 83 percent of decisions were made within the target time period.

Enforcement of Other Laws and Regulations

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

Financial Disclosures by State Member Banks

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including annual and quarterly financial reports and proxy statements. By statute, the Board's financial disclosure rules must be substantially similar to those of the Securities and Exchange Commission. At the end of 2003, fifteen state member banks were registered with the Board under the Securities Exchange Act.

Securities Credit

Under the Securities Exchange Act, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. The Board's Regulation T limits the amount of credit that may be provided by securities brokers and dealers when the credit is used to trade debt and equity securities. The Board's Regulation U limits the amount of credit that may be provided by lenders other than brokers and dealers when the credit is used to purchase or carry publicly held equity securities if the loan is secured by those or other publicly held equity secu-

rities. The Board's Regulation X applies these credit limitations, or margin requirements, to certain borrowers and to certain credit extensions, such as credit obtained from foreign lenders by U.S. citizens.

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

Since 1990 the Board has published a nonexclusive list of foreign stocks that are eligible for margin treatment at broker-dealers on the same basis as domestic margin securities. In 2003 the foreign list was revised in March and September.

Anti-Money Laundering

The Department of the Treasury regulation (31 CFR 103) implementing the Currency and Foreign Transactions Reporting Act (commonly referred to as the Bank Secrecy Act, or BSA) requires banks and other types of financial institutions to file certain reports and maintain certain records. These documents record information on persons involved in large currency transactions and on suspicious activity related to possible violations of federal law, including money laundering, terrorism, and other financial crimes. The act is an important tool in the fight against money laundering; its requirements inhibit money laun-

dering by creating a paper trail of financial transactions that helps law enforcement and regulators identify and trace the proceeds of illegal activity.

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

The Board has a Special Investigations Section in the Division of Banking Supervision and Regulation that conducts financial investigations, provides expertise to the U.S. law enforcement community for investigation and training initiatives, and offers training to various foreign central banks and government agencies. In 2003, the division created an Anti-Money Laundering Policy and Compliance Section, which is responsible for BSA and USA Patriot Act matters and works closely with various units at the Treasury Department, including the Financial Crimes Enforce-

ment Network and the Office of Foreign Assets Control.

Staff of both sections also speak at banking conferences to promote best practices in the industry with respect to anti-money-laundering initiatives. Internationally, section staff have provided anti-money-laundering training and technical assistance to countries in eastern and southern Africa, Asia, South and Central America, and the Caribbean. Staff members have also participated in numerous multilateral anti-money-laundering initiatives such as the Financial Action Task Force.

In 2003, the Federal Reserve continued to provide expertise and guidance to the BSA Advisory Group, a committee established by Congress at the Treasury Department that seeks to reduce unnecessary burdens created by the BSA and to increase the utility of data gathered under the act to aid regulators and law enforcement. The Federal Reserve also assisted the Treasury Department in providing feedback to financial institutions on the reporting of suspicious activity.

Since the terrorist attacks of September 11, 2001, and continuing through 2003, the Federal Reserve has played an important role in many joint activities with bank supervisory and law enforcement authorities and the banking community, both domestically and abroad, to combat money laundering and terrorist financing. In the wake of the terrorist attacks, the FBI formed a multi-agency law enforcement task force to trace the transactions and assets of terrorists; staff of the Special Investigations Section continue to participate in the task force.

To address the mandates of the USA Patriot Act, the Federal Reserve issued a number of supervisory letters to domestic and foreign banking organizations

Extensions of Credit by State Member Banks to their Executive Officers, 2002 and 2003

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
<i>2002</i>			
October 1–December 31	650	74,514,000	0.0–19.8
<i>2003</i>			
January 1–March 31	618	82,776,000	0.0–20.0
April 1–June 30	751	80,895,000	0.0–21.0
July 1–September 30	649	74,584,000	0.0–18.0
October 1–December 31	590	66,901,000	0.0–18.0

SOURCE. Call Reports.

under its supervision on such topics as private and correspondent banking and the new information-sharing protocols. The letters described the act's requirements in these areas and the new rules that have been or will be issued.

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

Extensions of Credit to Executive Officers

Under section 22(g) of the Federal Reserve Act, a state member bank must include in its quarterly Call Report information on all extensions of credit by the bank to its executive officers since the date of the preceding report. The accompanying table summarizes this information for 2003.

Federal Reserve Membership

At the end of 2003, 2,890 banks were members of the Federal Reserve System and were operating 50,425 branches. These banks accounted for 37 percent of all commercial banks in the United States and for 70 percent of all commercial banking offices. ■

Federal Reserve Banks

The Federal Reserve Banks contribute to the setting of national monetary policy and are involved in the supervision and regulation of banks and other financial entities. They also operate a nationwide payments system, distribute the nation's currency and coin, and serve as fiscal agent and depository to the United States.

Major Initiatives

During 2003, the Federal Reserve Banks continued efforts to improve the efficiency of their operations through strategies aimed at standardizing and consolidating operations, information systems, and programs. Major milestones associated with two key initiatives in the check-processing operation were reached: the end of the check modernization project and the launch of a check restructuring effort to reduce the number of Federal Reserve check-processing locations.

The check modernization effort reengineered check-processing hardware and software to provide the Reserve Banks with common processing, imaging, and adjustment systems and to enable the Banks to offer services via the Internet.

Check restructuring, which was announced early in 2003, will better align the Federal Reserve check-processing infrastructure with the decline in the use of checks, provide greater flexibility in managing check operations, and improve resource allocation. The Reserve Banks expect to reduce, by year-end 2004, the number of check-processing locations from forty-

five to thirty-two and the number of check-adjustment locations from forty-three to twelve.

Spurred in part by aggressive multi-year cost-containment targets, the Reserve Banks also undertook a number of initiatives during the year to increase efficiency in the support services and customer support areas. In information technology, savings were realized through such initiatives as centralization of e-mail server administration and management, standardization of desktop PC configurations, and standardization of server management. In human resources, the Reserve Banks expect to have centralized most of their payroll and benefits functions by year-end 2004, and in accounting, the Banks have successfully adhered to a multiyear plan to hold costs to 1997 spending levels. In addition, the Banks have undertaken initiatives to reduce customer support costs. In early 2004, the Banks will complete an effort to consolidate electronic-access customer support at two sites.

The events of September 11, 2001, illustrated the interdependence among participants in the financial system and the way that market-based and geographic concentration can intensify disruptions. The New York Reserve Bank contributed to two efforts to address these matters, which the Board, together with other regulatory agencies, has been pursuing since September 11. One effort involved the development of sound practices to strengthen the resilience of critical U.S. financial markets in the face of a regional disaster. A final paper on sound practices was published jointly by the Board, the Office of the Comptroller

of the Currency, and the Securities and Exchange Commission in April 2003.

The other effort concerned strengthening the resilience of clearing and settlement in the government securities market. A private-sector working group created by the Board in 2002 to explore ways in which resilience might be strengthened submitted its report in December 2003 (and the Board published the report in early January 2004). The report contains recommendations for mitigating risks to the financial system resulting from the interruption or termination of the services of a clearing bank for government securities due to operational or non-operational problems. The Board endorsed the recommendations.

Developments in Federal Reserve Priced Services

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

years, the Federal Reserve Banks have recovered 97.8 percent of their priced services costs, including the PSAF (table).

Overall, the price index for priced services decreased 0.9 percent from 2002. Revenue from priced services amounted to \$886.9 million, other income related to priced services was $-\$5.2$ million, and costs related to priced services totaled \$931.3 million, resulting in net income of $-\$49.6$ million and a recovery rate of 85.1 percent of costs, including the PSAF.²

Commercial Check Collection Service

In 2003, operating expenses and imputed costs for the Reserve Banks’ commercial check collection service totaled \$803.2 million, while revenue amounted to \$742.2 million and other income was $-\$4.3$ million, resulting in net income of $-\$65.3$ million. In 2002, by comparison, operating expenses and imputed costs totaled \$751.2 million, while revenue amounted to \$759.2 million and other income was \$1.7 million, resulting in net income of \$9.7 million. The decline in check service revenue in 2003 was largely the result of declining volume and customers’ moving to lower-margin products. The Reserve Banks handled 15.8 billion checks, a decrease of 4.7 percent from the

1. In addition to income taxes and the return on equity, the PSAF is made up of three imputed costs: interest on debt, sales taxes, and assessments for deposit insurance by the Federal Deposit Insurance Corporation. Also allocated to priced services are assets and personnel costs of the Board of Governors that are related to priced services; in the pro forma statements at the end of this chapter, Board expenses are included in operating expenses and Board assets are part of long-term assets.

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

Priced Services Cost Recovery, 1994–2003

Millions of dollars except as noted

Year	Revenue from services ¹	Operating expenses and imputed costs ²	Targeted return on equity	Total costs	Cost recovery (percent) ³
1994	767.2	760.2	21.0	781.2	98.2
1995	765.2	752.7	31.5	784.2	97.6
1996	815.9	746.4	42.9	789.3	103.4
1997	818.8	752.8	54.3	807.1	101.5
1998	839.8	743.2	66.8	809.9	103.7
1999	867.6	775.7	57.2	832.9	104.2
2000	922.8	818.2	98.4	916.6	100.7
2001	960.4	901.9	109.2	1,011.1	95.0
2002	918.3	891.7	92.5	984.3	93.3
2003	881.7	931.3	104.7	1,036.1	85.1
1994–2003	8,557.7	8,074.0	678.5	8,752.6	97.8

NOTE. Here and elsewhere in this chapter, components may not sum to totals or yield percentages shown because of rounding.

1. For the ten-year period, includes revenue from services of \$8,312.7 million and other income and expense (net) of \$245.1 million.

2. For the ten-year period, includes operating expenses of \$7,382.6 million, imputed costs of \$440.3 million, and imputed income taxes of \$231.6 million. Also includes the effect of one-time accounting changes net of taxes of \$74.1 million for 1993 and \$19.4 million for 1995.

3. Revenue from services divided by total costs.

16.6 billion checks handled in 2002 (table). The decline in Reserve Bank check volume appears to be consistent with nationwide trends away from the use of checks and toward greater use of electronic payment methods.³ Overall, the price index for check services increased 3.2 percent from 2002.

In response to the apparent continuing decline in check volumes, the Reserve Banks took further steps in 2003 to reduce check service operating costs by implementing a business and

operational strategy that will position the service to achieve its financial and payment system objectives over the long term. The strategy will reduce operating costs through a combination of measures: streamlining management structures, reducing staff, decreasing the number of check-processing locations, and increasing processing capacity at some locations. The Banks will continue to provide check services nationwide, but by the end of 2004, the number of sites at which checks are processed will be reduced to thirty-two, down from forty-five. Additionally, the number of locations at which check adjustments are made will be reduced from forty-three to twelve. Of the thirteen offices that will no longer process checks, the five regional sites dedicated solely to processing checks will close. These changes are expected to reduce annual operating costs for the check service by about \$60 million in 2005.

The volume of checks for which the Federal Reserve office that serves the

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

Activity in Federal Reserve Priced Services, 2003, 2002, and 2001

Thousands of items

Service	2003	2002	2001	Percent change	
				2002 to 2003	2001 to 2002
Commercial check	15,805,894	16,586,804	16,905,016	-4.7	-1.9
Funds transfer	125,936	117,133	115,308	7.5	1.6
Securities transfer	10,071	8,480	6,708	18.8	26.4
Commercial ACH	5,588,381	4,986,152	4,448,361	12.1	12.1
Noncash	280	333	412	-15.8	-19.2

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

line; in *commercial ACH*, the total number of commercial items processed; and in *noncash*, the number of items on which fees were assessed.

depositing bank is not the office that serves the paying bank was slightly less than the 3.7 billion in 2002. Of all the checks presented by the Reserve Banks to paying banks, 22.7 percent (approximately 3.6 billion checks) were presented electronically, compared with 22.0 percent in 2002. The Banks captured images of 9.3 percent of the checks they collected, an increase from 8.1 percent in 2002.

In 2003, the Reserve Banks completed a multiyear check modernization project that standardized their software and hardware for check processing, check imaging, and check adjustments. They also made available to depository institutions web-based access to check services. These investments are expected to increase operating efficiency and to enhance the Reserve Banks' ability to offer additional services to depository institutions.

Commercial Automated Clearinghouse Services

Reserve Bank operating expenses and imputed costs for commercial automated clearinghouse (ACH) services totaled \$60.6 million in 2003. Revenue from ACH operations totaled \$68.7 million and other income totaled -\$0.4 million,

resulting in net income of \$7.7 million. The Reserve Banks processed 5.6 billion commercial ACH transactions (worth \$14.0 trillion), an increase of 12.1 percent from 2002. Overall, the price index for ACH services decreased 13.1 percent from 2002.

During 2003, the Reserve Banks increased the number of countries to which they provide international ACH funds transfers from the United States by initiating limited production services to Switzerland and the United Kingdom. The Banks also prepared to offer limited production services to Austria, Germany, the Netherlands, and Mexico in 2004.

Fedwire Funds and National Settlement Services

Reserve Bank operating expenses and imputed costs for the Fedwire Funds and National Settlement Services totaled \$47.1 million in 2003. Revenue from these operations totaled \$51.4 million, and other income amounted to -\$0.3 million, resulting in net income of \$4.0 million. During 2003, the Reserve Banks improved the resilience of the services by establishing a third level of backup personnel to support Fedwire applications.

Fedwire Funds Service

The Fedwire Funds Service allows participants to draw on their reserve or clearing balances at the Reserve Banks and transfer funds to other institutions that maintain accounts at the Banks. In 2003, the number of Fedwire funds transfers originated by depository institutions increased 7.5 percent from 2002, to approximately 125.9 million.

In May, the Board announced that it will expand the operating hours for the online Fedwire Funds Service. The service will open three and one-half hours earlier—at 9:00 p.m. eastern time the previous calendar day rather than the current opening time of 12:30 a.m. eastern time. Full implementation of the expanded operating hours will occur in May 2004. The impetus for the expansion of operating hours was industry requests to achieve greater overlap of U.S. wholesale payments system operating hours with those of Asia-Pacific markets.

National Settlement Service

Private clearing arrangements that exchange and settle transactions may use the Reserve Banks' National Settlement Service to settle their transactions. This service is provided to approximately seventy local and national private arrangements, primarily check clearinghouse associations but also other types of arrangements. In 2003, the Reserve Banks processed more than 422,000 settlement entries for these arrangements.

Fedwire Securities Service

The Fedwire Securities Service allows participants to electronically transfer securities issued by the U.S. Treasury, federal government agencies,

government-sponsored enterprises, and certain international organizations to other participants in the United States.⁴ Reserve Bank operating expenses and imputed costs for providing this service totaled \$18.4 million in 2003. Revenue from the service totaled \$21.9 million, and other income totaled $-\$0.1$ million, resulting in net income of \$3.4 million. Approximately 10.1 million transfers of Treasury and other securities were processed by the service during the year, an increase of 18.8 percent from 2002. Fedwire Securities Service transfer fees for both Treasury and non-Treasury securities were reduced in 2003, while the service incorporated new fees associated with automated claim adjustment processing and a joint custody origination surcharge (table).

Noncash Collection Service

The Reserve Banks provide a service to collect and process municipal bearer bonds and coupons issued by state and local governments (referred to as "non-cash" items). The service, which is centralized at one Federal Reserve office, processed 280,000 noncash transactions in 2003. In 2003, the Reserve Banks simplified the pricing structure for the Noncash Collection Service by charging a single price regardless of deposit size. The Banks now charge a single fee per cash letter of \$13.00 and a single fee per coupon envelope of \$4.50. The Banks also increased the return-item fee to

4. The expenses, revenues, and volumes reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and international institutions. When the Reserve Banks provide transfer, account maintenance, and settlement services for U.S. Treasury securities, they are acting as fiscal agents of the United States. The Treasury Department assesses fees on depository institutions for some of these services. For details, see the section "Fiscal Agency Services" later in this chapter.

Fees Paid by Depository Institutions for Selected Federal Reserve Priced Services, 2002 and 2003

Dollars

Item	2002	2003
FEDWIRE FUNDS TRANSFERS, BY VOLUME TIER¹		
Tier (<i>number of transfers per month</i> ²)		
1 (1 to 2,500) .....	.31	.30
2 (2,501 to 80,000) .....	.22	.20
3 (80,001 and more) .....	.15	.10
Off-line surcharge	15.00	15.00
NATIONAL SETTLEMENT SERVICES		
Entries, each .....	.80	.80
Files, each	14.00	14.00
Minimum per month	60-100	60-100
FEDWIRE SECURITIES TRANSFERS		
Account maintenance		
Per issue .....	.41	.40
Per account	15.00	15.00
Transfers, each ² .....	.66	.40
Off-line surcharge	25.00	25.00

1. Rates apply only to their specified volume tiers.

2. Originated and received.

\$35.00 and the bond-collection fee to \$55. Operating expenses and imputed costs for noncash operations totaled \$1.7 million in 2003, and revenue totaled \$2.3 million, resulting in net income of \$0.6 million.

Special Cash Services

The Reserve Banks charge fees for providing special cash-related services, such as packaging currency in a nonstandard way. These services—collectively referred to as “special cash services”—account for a very small proportion (less than 1 percent) of the total cost of cash services provided to depository institutions by the Banks. Operating expenses and imputed costs for special cash services totaled \$504,284 in 2003. Revenue and other income totaled \$400,112, resulting in

net income of −\$104,172. Two Reserve Banks provided special cash services during 2003 but had discontinued these services by year-end. The Banks will not provide special cash services in 2004.

Float

The Federal Reserve had daily average credit float of \$43.0 million in 2003 and \$318.6 million in 2002.⁵ The Federal Reserve includes the cost of or income from float associated with priced services as part of the fees for those services.

Developments in Currency and Coin

The Federal Reserve Banks received 35.7 billion notes from circulation in 2003, a 2.9 percent increase from 2002, and made payments of 36.6 billion notes to circulation during the year, a 3.2 percent increase from 2002. They received 48.1 billion coins from circulation in 2003, a 10.8 percent increase from 2002, and made payments of 61.5 billion coins to circulation, a 5.3 percent increase from 2002.⁶

In October the Reserve Banks began issuing to depository institutions the Department of the Treasury’s redesigned \$20 note, which features new and enhanced security features, including subtle background colors. In connection with the release of the new currency, the Federal Reserve and the Bureau of Engraving and Printing conducted a global campaign to raise public awareness of the new note’s design and security features.

5. Credit float occurs when the Reserve Banks receive settlement for items prior to providing credit to the depositing institution.

6. Percentages reflect restatements of previously reported data.

Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2003, 2002, and 2001

Thousands of dollars

Agency and service	2003	2002	2001
DEPARTMENT OF THE TREASURY			
<i>Bureau of the Public Debt</i>			
Savings bonds	66,403.7	68,888.3	69,569.8
TreasuryDirect and Treasury coupons	33,013.5	33,953.6	36,610.1
Commercial book entry	4,836.3	8,830.1	9,998.1
Marketable Treasury issues	16,802.6	14,597.6	11,366.8
Computer applications and infrastructure development and support	7,836.7	2,349.6	222.4
Other services	1,460.7	2,385.8	1,255.7
Total	130,353.4	131,005.0	129,022.9
<i>Financial Management Service</i>			
Treasury tax and loan and Treasury general account	27,083.2	30,111.0	31,106.0
Government check processing	25,624.7	30,284.4	30,310.2
Automated clearinghouse	6,253.9	6,280.0	9,665.2
Government agency deposits	2,217.6	2,082.2	2,272.9
Fedwire funds transfers	187.3	201.4	199.2
Computer applications and infrastructure development and support	75,511.9	46,782.6	27,281.3
Other services	10,602.8	8,173.1	3,490.2
Total	147,481.5	123,914.7	104,324.9
<i>Other Treasury</i>			
Total	13,913.5	14,471.2	13,149.8
Total, Treasury	291,748.5	269,390.9	246,497.5
OTHER ENTITIES			
Department of Agriculture			
Food coupons	7,791.4	10,240.8	13,197.2
U.S. Postal Service			
Postal money orders	10,959.5	12,381.6	11,255.0
All other entities			
Other services	16,508.2	16,494.1	14,434.0
Total, other entities	35,259.2	39,116.5	38,886.2
Total reimbursable expenses	327,007.7	308,507.4	285,383.7

Also during the year the Federal Reserve Board requested public comment on its proposed currency recirculation policy, which is designed to reduce depository institutions' overuse of Federal Reserve cash-processing services. The proposed policy, which would affect approximately one hundred institutions that have large cash businesses, includes two key elements: (1) a custodial inventory program that provides an incentive to depository institutions to hold currency in their vaults and (2) a fee to institutions that deposit and order currency within the same week.

Developments in Fiscal Agency and Government Depository Services

The total cost of providing fiscal agency and depository services to the Treasury and other entities in 2003 amounted to \$327.0 million, compared with \$308.5 million in 2002 (table). The majority of these costs were incurred on behalf of the Treasury. Treasury-related costs were \$291.7 million in 2003, compared with \$269.4 million in 2002, an increase of 8.3 percent. The cost of providing services to other entities was

\$35.3 million, compared with \$39.1 million in 2002. In 2003, as in 2002, the Treasury and other entities reimbursed the Reserve Banks for the costs of providing these services.

Fiscal Agency Services

As fiscal agents, the Reserve Banks provide to the Treasury services related to the federal debt. For example, they issue, transfer, reissue, exchange, and redeem marketable Treasury securities and savings bonds; they also process secondary market transfers initiated by depository institutions. Additionally, the Reserve Banks support Treasury and other government agencies in their efforts to modernize government payment systems.

Marketable Treasury Securities

Reserve Bank operating expenses for activities related to marketable Treasury securities (Fedwire Securities Service, TreasuryDirect, marketable issues, and Treasury coupons) totaled \$54.7 million, a 4.8 percent decrease from 2002. The Reserve Banks processed nearly 140,000 tenders for Treasury securities, compared with 167,000 in 2002, and handled 2.2 million reinvestment requests, compared with 2.5 million in 2002.

The Reserve Banks operate two book-entry securities systems for Treasury securities: the Fedwire Securities Service, which provides custody and transfer services, and TreasuryDirect, which provides custody services only.⁷ Almost 98 percent of the total par value of Treasury securities outstanding at year-end 2003 was held by the Fedwire Securities Service. The Reserve Banks in 2003 originated 9.4 million transfers of Treas-

ury securities, a 12.7 percent increase from 2002.

TreasuryDirect customers may sell their securities for a fee through Sell Direct, a program operated by one of the Reserve Banks. That Bank sold more than 14,000 securities worth \$671.6 million in 2003, compared with nearly 14,000 securities worth \$589.8 million in 2002. It collected more than \$491,000 in fees on behalf of the Treasury, an increase of 6 percent from the almost \$464,000 in fees collected in 2002.

Savings Bonds

Reserve Bank operating expenses for savings bond activities totaled \$66.4 million in 2003, a decrease of 3.6 percent from 2002. The Banks printed and mailed 40.1 million savings bonds on behalf of the Treasury's Bureau of the Public Debt, a 7.6 percent increase from 2002. They issued more than 7.0 million Series I (inflation-indexed) savings bonds and 28.6 million Series EE savings bonds. Reissued or exchanged bonds accounted for the remaining bonds printed. The Banks processed approximately 569,000 redemption, reissue, and exchange transactions, a 7.9 percent decrease from 2002. Reserve Bank staff responded to 1.7 million service calls from owners of savings bonds, a 4.9 percent increase from 2002. Starting in 2004, the Reserve Banks will reduce the number of Federal Reserve sites that provide savings bond and retail marketable Treasury securities services. The consolidation will be managed to minimize the effect on investors as these services move toward all-electronic processing.

Depository Services

The Reserve Banks maintain the Treasury's funds account, accept deposits of

7. TreasuryDirect was designed for individuals who plan to hold their securities until maturity.

federal taxes and fees, pay checks drawn on the Treasury's account, and make electronic payments on behalf of the Treasury.

Federal Tax Payments

Reserve Bank operating expenses related to federal tax payments in 2003 totaled \$27.1 million. These operations include the Treasury Tax and Loan program, which allows the Treasury to invest balances with qualifying depository institutions. The Federal Reserve enhanced the program in 2003 by making the Term Investment Option a permanent feature. The Term Investment Option allows the Treasury to place investments with depository institutions for a set term, the interest rate being determined by auction. The program added approximately \$2.8 million to the Treasury's investment income in 2003.

Payments Processed for the Treasury

Reserve Bank operating expenses related to government payments amounted to \$34.3 million in 2003. The Banks processed 914.0 million ACH transactions for the Treasury, an increase of 3.5 percent from 2002, and 667,000 Fedwire funds transfers, an increase of 55.1 percent from 2002.⁸ They also processed 266.9 million paper government checks, a decrease of 7.7 percent from 2002. In addition, the Banks issued 311,000 fiscal agency checks, a decrease of 15.5 percent from 2002.

The Reserve Banks also assist Treasury with its continued efforts to facilitate electronic payments. The Banks operate Pay.gov, a Treasury program that allows members of the public to make payments to the federal government over the Internet. They also oper-

ate the Treasury's Paper Check Conversion program, whereby checks written to government agencies are converted at the point of sale into ACH transactions. In 2003, the Reserve Banks originated nearly 1.2 million ACH transactions through the two programs, a significant increase from the nearly 215,000 originated in 2002, which was the first full year for both programs.

The Banks operate Treasury's Automated Standard Application for Payment (ASAP), which processed \$384.2 billion in Fedwire funds transfers and ACH payments in 2003, compared with \$360.0 billion in 2002. In December, the Reserve Banks implemented ASAP.gov, which allows grant recipients to request payments on the Internet. The Reserve Banks also operate Treasury's Intra-governmental Payments and Collection application (IPAC), which transfers funds and descriptive data between federal agencies. In 2003, IPAC processed nearly one million transactions, with a total value of nearly \$41.9 trillion, compared with nearly \$37.4 trillion in 2002.

Services Provided to Other Entities

The Reserve Banks provide fiscal agency and depository services to other domestic and international entities when required to do so by the Secretary of the Treasury or when required or permitted to do so by federal statute. One such service is the provision of food coupon services for the Department of Agriculture. In 2003, operating expenses for food coupon services declined to \$7.8 million, 24.0 percent lower than in 2002. The Banks redeemed 286.6 million food coupons, a decrease of 42.7 percent from 2002.

As fiscal agents of the United States, the Reserve Banks also process all postal money orders deposited by banks for collection. In 2003, they processed

8. The latter percentage reflects restatement of previously reported data.

198.3 million postal money orders, a decrease of 8.4 percent from 2002.

Electronic Access

The Federal Reserve continues to improve the ability of depository institutions to access an array of web-based applications for check imaging, cash ordering, savings bond processing, and accounting information. With improvements in the technology enabling the security of web applications, the Reserve Banks plan to continue to expand the delivery of web-based services to include funds transfer services through Fedwire and ACH and to complete the migration of all remaining services provided through FedLine DOS to FedLine for the Web.

To complement the move to web-based electronic access, the Reserve Banks are completing consolidation of the electronic-access customer support function to two offices. The consolidation will improve the efficiency and consistency of customer support while ensuring the continued delivery of high-quality electronic-access support services.

Information Technology

In 2003, the Federal Reserve Banks continued several major cost-reduction initiatives to centralize or standardize common information technology utilities and resources. Projects are under way to standardize certain local area network components, telephone private branch exchange systems, remote access, and desktop hardware and software. In addition to reducing costs over the long term, these initiatives are expected to facilitate interoperability, improve network efficiency, and increase productivity.

During the year, the Federal Reserve also expanded its criteria for participation in the telecommunications national

security/emergency preparedness programs offered by the National Communications System. In partnership with the Securities and Exchange Commission and the Commodity Futures Trading Commission, the Federal Reserve extended sponsorship to clearing and settlement utilities, key financial institutions, and key market participants.

The Reserve Banks initiated efforts to improve the resilience of the Fedwire telecommunications network and are working with telecommunications vendors and other government agencies to identify policies that would improve the resilience of the telecommunications infrastructure for critical financial services functions.

Examinations of the Federal Reserve Banks

Section 21 of the Federal Reserve Act requires the Board of Governors to order an examination of each Federal Reserve Bank at least once a year. The Board engages a public accounting firm to perform an annual audit of the combined financial statements of the Reserve Banks (see the section “Federal Reserve Banks Combined Financial Statements”). The public accounting firm also audits the annual financial statements of each of the twelve Banks. The Reserve Banks use the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in assessing their internal controls over financial reporting, including the safeguarding of assets. Within this framework, management of each Reserve Bank provides an assertion letter to its board of directors annually confirming adherence to COSO standards, and a public accounting firm certifies management’s assertion and issues an attestation report to the Bank’s board of directors and to the Board of Governors.

Income, Expenses, and Distribution of Net Earnings
of the Federal Reserve Banks, 2003 and 2002

Millions of dollars

Item	2003	2002
Current income	23,793	26,760
Current expenses	2,463	2,227
Operating expenses ¹	2,342	2,071
Earnings credits granted	121	156
Current net income	21,330	24,533
Net additions to (deductions from, -) current net income	2,481	2,149
Assessments by the Board of Governors	805	635
For expenditures of Board	297	205
For cost of currency	508	430
Net income before payments to Treasury	23,006	26,048
Dividends paid	518	484
Transferred to surplus	467	1,068
Payments to Treasury ²	22,022	24,496

1. Includes net periodic pension costs of \$60 million in 2003 and a credit for net periodic pension costs of \$157 million in 2002.

2. Interest on Federal Reserve notes.

The firm engaged for the audits of the individual and combined financial statements of the Reserve Banks for 2003 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$1.4 million. To ensure auditor independence, the Board requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve 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 2003 the Reserve Banks did not engage PwC for non-audit services other than a miscellaneous purchase of educational and research materials at a rate available to the general public.

The Board's annual examination of the Reserve Banks in 2003 included a wide range of off-site and on-site oversight activities conducted by the Division of Reserve Bank Operations and Payment Systems. Division personnel monitor the activities of each Reserve Bank on an ongoing basis and conduct

on-site reviews based on the division's risk-assessment methodology. The 2003 examinations also included assessing the efficiency and effectiveness of the internal audit function.

Each year, to assess compliance with the policies established by the Federal Reserve's Federal Open Market Committee (FOMC), the division also examines the accounts and holdings of the System Open Market Account at the Federal Reserve Bank of New York and the foreign currency operations conducted by that Bank. In addition, a public accounting firm certifies the schedule of participated asset and liability accounts and the related schedule of participated income accounts at year-end. Division personnel follow up on the results of these audits. The FOMC receives the external audit reports and the report on the division's follow-up.

Income and Expenses

The accompanying table summarizes the income, expenses, and distributions of

Securities and Loans of the Federal Reserve Banks, 2001–2003

Millions of dollars except as noted

Item and year	Total	U.S. government securities ¹	Loans ²
<i>Average daily holdings³</i>			
2001	559,323	558,926	397
2002	621,834	621,721	113
2003	683,438	683,294	144
<i>Earnings⁴</i>			
2001	30,536	30,523	13
2002	25,527	25,525	2
2003	22,598	22,597	1
<i>Average interest rate (percent)</i>			
2001	5.46	5.46	3.18
2002	4.11	4.11	1.94
2003	3.31	3.31	1.00

1. Includes federal agency obligations.

2. Does not include indebtedness assumed by the Federal Deposit Insurance Corporation.

3. Based on holdings at opening of business.

4. Earnings have not been netted with the interest expense on securities sold under agreements to repurchase.

net earnings of the Federal Reserve Banks for 2002 and 2003.

Income in 2003 was \$23,793 million, compared with \$26,760 million in 2002. Expenses totaled \$3,268 million (\$2,342 million in operating expenses, \$121 million in earnings credits granted to depository institutions, \$297 million in assessments for expenditures by the Board of Governors, and \$508 million for the cost of new currency). Revenue from priced services was \$887 million. The profit and loss account showed a net profit of \$2,481 million. The profit was due primarily to unrealized gains on assets denominated in foreign currencies revalued to reflect current market exchange rates. Statutory dividends paid to member banks totaled \$518 million, \$34 million more than in 2002; the increase reflects an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Reserve Banks.

Payments to the U.S. Treasury in the form of interest on Federal Reserve notes totaled \$22,022 million in 2003,

down from \$24,496 million in 2002; the payments equal net income after the deduction of dividends paid and of the amount necessary to bring the surplus of the Reserve Banks to the level of capital paid in.

In the “Statistical Tables” section of this volume, table 5 details the income and expenses of each Reserve Bank for 2003 and table 6 shows a condensed statement for each Bank for the years 1914 through 2003. A detailed account of the assessments and expenditures of the Board of Governors appears in the section “Board of Governors Financial Statements.”

Holdings of Securities and Loans

The Federal Reserve Banks’ average daily holdings of securities and loans during 2003 amounted to \$683,438 million, an increase of \$61,604 million from 2002 (table). Holdings of U.S. government securities increased \$61,573 million, and holdings of loans increased \$31 million. The average rate of interest

earned on the Reserve Banks' holdings of government securities declined to 3.31 percent, from 4.11 percent in 2002, and the average rate of interest earned on loans declined to 1.00 percent, from 1.94 percent.

Volume of Operations

Table 8 in the "Statistical Tables" section shows the volume of operations in the principal departments of the Federal Reserve Banks for the years 2000 through 2003.

Federal Reserve Bank Branches

In 2003, the Board voted to approve a proposal by the St. Louis Federal Reserve Bank to change substantively the nature of the Louisville and Little Rock Branches to a community outreach focus with no operations. Both Branches will maintain their presence in leased office space to accommodate the boards of directors and the community outreach programs, thereby eliminating the need for the existing Branch buildings. The Reserve Bank's board of directors and the Financial Services Policy Committee reviewed and endorsed the proposal. In the past, Reserve Bank Branch responsibilities typically included a larger array of operations than is the case today. For example, most Branches in the 1980s performed ACH, off-line Fedwire, and fiscal services and processed food coupons in addition to cash and checks. Reserve Banks have since consolidated many of their operations, and operations at most Branches are limited to cash and check processing.

Check operations at the Louisville and Little Rock Branches will be eliminated as part of the ongoing check restructuring initiative. With the elimination of check operations, cash would

have been the only operation remaining at the two Branches. Management at the St. Louis Reserve Bank concluded that the most cost-effective solution would be to consolidate currency processing at two other Reserve Bank offices and outsource the paying and receiving functions to a cash depot (to be carried out by either an armored carrier or a financial institution).

With this consolidation and outsourcing arrangement, the Louisville and Little Rock Branches will operate on a public and community affairs model and will be responsible for such activities as director recruitment, economic information gathering, community outreach, and economic and financial education. Each Branch will maintain its economic policy input through meetings of the Branch board of directors, will arrange strategic opportunities for public appearances by senior Federal Reserve officials, and will maintain contacts with local politicians and business leaders.

Federal Reserve Bank Premises

In 2003, the final designs for the Dallas Federal Reserve Bank's new Houston Branch and the Chicago Bank's Detroit Branch buildings were approved, and construction of both new buildings began. Also, the Board approved the purchase of property for the new Kansas City Bank building, the Bank retained design and construction consultants for the project, and the project's design was initiated.

The Board also approved the purchase of a parking garage and a warehouse for the St. Louis Reserve Bank to be used for staff parking and for remote screening of deliveries, as well as the Bank's long-term plan to construct an addition to its current headquarters facility. In addition, the Board approved the Richmond Reserve Bank's purchase of

an office building as a relocation site for critical System staff. Internal renovation of the building was essentially completed in 2003.

Also during the year the Board approved a building program for the San Francisco Bank's Seattle Branch that includes a new building for the Branch's cash operation and Branch administration and the lease or purchase of a building for the Branch's retail payments operation. The Bank continued to interview potential design consultants and evaluate possible sites for the project.

In addition, the Board approved the purchase of property behind the Dallas Bank for construction of a remote vehicle-screening and shipping/

receiving facility and projects at several Banks to prepare facilities for the consolidation of certain retail payments activities.

The multiyear renovation program continued at the New York Bank's headquarters building, and the cleaning and repair of the exterior stonework was completed.

Security enhancement programs were undertaken in 2003 at several facilities as a result of the events of September 11, 2001. The programs included a project to improve external perimeter security for the Boston Bank that involved restoration of Bank property necessitated by construction of the recently completed Central Artery/Tunnel, an underground roadway. ■

Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 2003 and 2002

Millions of dollars

Item	2003	2002
<i>Short-term assets (Note 1)</i>		
Imputed reserve requirements on clearing balances	1,296.4	1,047.8
Investment in marketable securities ...	11,332.5	9,051.3
Receivables	77.1	78.7
Materials and supplies	2.3	3.4
Prepaid expenses	35.6	34.8
Items in process of collection	<u>5,271.9</u>	<u>6,958.6</u>
Total short-term assets	18,015.8	17,174.7
<i>Long-term assets (Note 2)</i>		
Premises	494.6	475.0
Furniture and equipment	179.4	179.2
Leases and leasehold improvements ..	103.2	91.2
Prepaid pension costs	<u>787.9</u>	<u>809.2</u>
Total long-term assets	<u>1,565.1</u>	<u>1,554.6</u>
Total assets	19,580.9	18,729.3
<i>Short-term liabilities</i>		
Clearing balances and balances arising from early credit of uncollected items	11,788.1	10,550.2
Deferred-availability items	6,448.3	6,886.4
Short-term debt .....	.0	.0
Short-term payables	<u>78.1</u>	<u>83.9</u>
Total short-term liabilities	18,314.4	17,520.5
<i>Long-term liabilities</i>		
Long-term debt .....	.0	.0
Postretirement/postemployment benefits obligation	<u>287.5</u>	<u>272.3</u>
Total long-term liabilities	<u>287.5</u>	<u>272.3</u>
Total liabilities	18,601.9	17,792.8
Equity	<u>979.0</u>	<u>936.4</u>
Total liabilities and equity (Note 3) ...	19,580.9	18,729.3

NOTE. Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

Pro Forma Income Statement for Federal Reserve Priced Services, 2003 and 2002

Millions of dollars

Item	2003		2002	
Revenue from services provided to depository institutions (Note 4)		886.9		916.3
Operating expenses (Note 5)		<u>941.6</u>		<u>876.0</u>
Income from operations		-54.7		40.2
Imputed costs (Note 6)				
Interest on float	-7		-6.8	
Interest on debt .....	.0		.0	
Sales taxes	12.1		11.4	
FDIC insurance	<u>.0</u>	<u>11.4</u>	<u>.0</u>	<u>4.6</u>
Income from operations after imputed costs		-66.1		35.6
Other income and expenses (Note 7)				
Investment income	108.0		148.9	
Earnings credits	<u>-113.2</u>	<u>-5.2</u>	<u>-146.8</u>	<u>2.1</u>
Income before income taxes		-71.3		37.7
Imputed income taxes (Note 8)		<u>-21.7</u>		<u>11.0</u>
Net income		-49.6		26.6
MEMO: Targeted return on equity (Note 9) ...		104.7		92.5

NOTE. Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 2003

Millions of dollars

Item	Total	Com- mercial check collection	Fedwire funds	Fedwire securities	Com- mercial ACH	Noncash services	Cash services
Revenue from services (Note 4)	886.9	742.2	51.4	21.9	68.7	2.3	.4
Operating expenses (Note 5)	<u>941.6</u>	<u>822.0</u>	<u>44.8</u>	<u>16.6</u>	<u>56.4</u>	<u>1.4</u>	<u>.5</u>
Income from operations	-54.7	-79.8	6.7	5.3	12.3	.9	-1
Imputed costs (Note 6)	<u>11.4</u>	<u>9.7</u>	<u>.6</u>	<u>.3</u>	<u>.8</u>	<u>.0</u>	<u>.0</u>
Income from operations after imputed costs	-66.1	-89.5	6.0	5.1	11.5	.9	-1
Other income and expenses, net (Note 7)	<u>-5.2</u>	<u>-4.3</u>	<u>-.3</u>	<u>-.1</u>	<u>-.4</u>	<u>-.0</u>	<u>-.0</u>
Income before income taxes ..	-71.3	-93.8	5.7	4.9	11.1	.9	-1
Imputed income taxes (Note 8)	<u>-21.7</u>	<u>-28.5</u>	<u>1.7</u>	<u>1.5</u>	<u>3.4</u>	<u>.3</u>	<u>-.0</u>
Net income	-49.6	-65.3	4.0	3.4	7.7	.6	-1
MEMO: Targeted return on equity (Note 9)	104.7	89.4	5.4	2.2	7.5	.2	.1

NOTE. Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

FEDERAL RESERVE BANKS

NOTES TO PRO FORMA FINANCIAL STATEMENTS FOR PRICED SERVICES

(1) SHORT-TERM ASSETS

The imputed reserve requirement on clearing balances held at Reserve Banks by depository institutions reflects a treatment comparable to that of compensating balances held at correspondent banks by respondent institutions. The reserve requirement imposed on respondent balances must be held as vault cash or as non-earning balances maintained at a Reserve Bank; thus, a portion of priced services clearing balances held with the Federal Reserve is shown as required reserves on the asset side of the balance sheet. Another portion of the clearing balances is used to finance short-term and long-term assets. The remainder of clearing balances is assumed to be invested in three-month Treasury bills, shown as investment in marketable securities.

Receivables are (1) amounts due the Reserve Banks for priced services and (2) the share of suspense-account and difference-account balances related to priced services.

Materials and supplies are the inventory value of short-term assets.

Prepaid expenses include salary advances and travel advances for priced-service personnel.

Items in process of collection is gross Federal Reserve cash items in process of collection (CIPC) stated on a basis comparable to that of a commercial bank. It reflects adjustments for intra-System items that would otherwise be double-counted on a consolidated Federal Reserve balance sheet; adjustments for items associated with non-priced items, such as those collected for government agencies; and adjustments for items associated with providing fixed availability or credit before items are received and processed. Among the costs to be recovered under the Monetary Control Act is the cost of float, or net CIPC during the period (the difference between gross CIPC and deferred-availability items, which is the portion of gross CIPC that involves a financing cost), valued at the federal funds rate.

(2) LONG-TERM ASSETS

Consists of long-term assets used solely in priced services, the priced-services portion of long-term assets shared with nonpriced services, and an estimate of the assets of the Board of Governors used in the development of priced services. Effective Jan. 1, 1987, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). Accordingly, the Reserve Banks recognized expenses of \$21.3 million in 2003 and credits to expenses of \$48.4 million in 2002 and corresponding decrease or increase in this asset account.

(3) LIABILITIES AND EQUITY

Under the matched-book capital structure for assets, short-term assets are financed with clearing balances in 2002 and short-term payables and short-term debt in 2001. Long-term assets are financed with clearing balances in 2003 and 2002. The PSAF consists of the taxes that would have been paid and the return on capital that would have been provided had priced services been fur-

nished by a private-sector firm. Other short-term liabilities include clearing balances maintained at Reserve Banks and deposit balances arising from float. Other long-term liabilities consist of accrued postemployment and postretirement benefits costs and obligations on capital leases.

(4) REVENUE

Revenue represents charges to depository institutions for priced services and is realized from each institution through one of two methods: direct charges to an institution's account or charges against its accumulated earnings credits.

(5) OPERATING EXPENSES

Operating expenses consist of the direct, indirect, and other general administrative expenses of the Reserve Banks for priced services plus the expenses for staff members of the Board of Governors working directly on the development of priced services. The expenses for Board staff members were \$6.4 million in 2003 and \$5.1 million in 2002. The credit to expenses under SFAS 87 (see note 2) is reflected in operating expenses.

The income statement by service reflects revenue, operating expenses, and imputed costs. Certain corporate overhead costs not closely related to any particular priced service are allocated to priced services in total based on an expense-ratio method, but are allocated among priced services based on management decision. Corporate overhead was allocated among the priced services during 2003 and 2002 as follows (in millions):

	2003	2002
Check	38.9	40.3
ACH	3.3	4.1
Fedwire funds	2.1	3.3
Fedwire securities	1.1	1.9
Noncash services .....	.1	.1
Special cash services .....	.0	.1
Total	53.4	49.7

(6) IMPUTED COSTS

Imputed costs consist of interest on float, interest on debt, sales taxes, and the FDIC assessment. Interest on float is derived from the value of float to be recovered, either explicitly or through per-item fees, during the period. Float costs include costs for checks, book-entry securities, noncash collection, ACH, and funds transfers.

Interest is imputed on the debt assumed necessary to finance priced-service assets. There was no debt in 2003 because clearing balances fund short-term and long-term debt. The sales taxes and FDIC assessment that the Federal Reserve would have paid had it been a private-sector firm are among the components of the PSAF (see note 3).

Float cost or income is based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses less shipping expenses for each ser-

vice to the total expenses for all services less the total shipping expenses for all services.

The following list shows the daily average recovery of actual float by the Reserve Banks for 2003 in millions of dollars:

Total float	285.2
Unrecovered float	<u>6.9</u>
Float subject to recovery	278.3
Sources of recovery of float	
Income on clearing balances	27.9
As-of adjustments	-328.3
Direct charges	624.8
Per-item fees	-702.7

Unrecovered float includes float generated by services to government agencies and by other central bank services. Float recovered through income on clearing balances is the result of the increase in investable clearing balances; the increase is produced by a deduction for float for cash items in process of collection, which reduces imputed reserve requirements. The income on clearing balances reduces the float to be recovered through other means. As-of adjustments and direct charges refer to float that is created by interterritory check transportation and the observance of non-standard holidays by some depository institutions. Such float may be recovered from the depository institutions through adjustments to institution reserve or clearing balances or by billing institutions

directly. Float recovered through direct charges and per-item fees is valued at the federal funds rate; credit float recovered through per-item fees has been subtracted from the cost base subject to recovery in 2003.

(7) OTHER INCOME AND EXPENSES

Consists of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances represents the average coupon-equivalent yield on three-month Treasury bills applied to the *total* clearing balance maintained, adjusted for the effect of reserve requirements on clearing balances. Expenses for earnings credits granted to depository institutions on their clearing balances are derived by applying the average federal funds rate to the *required* portion of the clearing balances, adjusted for the net effect of reserve requirements on clearing balances.

(8) INCOME TAXES

Imputed income taxes are calculated at the effective tax rate derived from the PSAF model (see note 3).

(9) RETURN ON EQUITY

The after-tax rate of return on equity that the Federal Reserve would have earned had it been a private business firm, as derived from the PSAF model (see note 3).

The Board of Governors and the Government Performance and Results Act

Under the Government Performance and Results Act of 1993 (GPRA), federal agencies are required to prepare, in consultation with the Congress and outside stakeholders, a strategic plan covering a multiyear period and to submit annual performance budgets and performance reports. Though not covered by the act, the Board of Governors is voluntarily complying with many of the act's mandates.

Strategic Plan, Performance Budget, and Performance Report

The Board's latest strategic plan in the GPRA format, to be released in early 2004, covers the period 2004–08. The document articulates the Board's mission, sets forth major goals for the period, outlines strategies for achieving those goals, and discusses the environment and other factors that could affect their achievement. It also addresses issues that cross agency jurisdictional lines, identifies key quantitative measures of performance, and discusses performance evaluation.

The 2004–05 performance budget and the 2002–03 performance report will be posted on the Board's public web site in early 2004 for access by the Congress, the public, and the General Accounting Office. The performance budget sets forth specific targets for some of the performance measures identified in the strategic plan. The performance budget also describes the operational processes and resources needed to meet those targets and discusses data validation and verification of results. The performance

report for 2002-03 should be completed in April 2004.

When completed, the strategic plan, performance budget, and performance report will be available on the Board's public web site (www.federalreserve.gov/boarddocs/rptcongress). The Board's mission statement and a summary of the goals and objectives set forth in the strategic plan and performance budget are given below.

Mission

The mission of the Board is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems so as to promote optimal macroeconomic performance.

Goals and Objectives

The Federal Reserve has five primary goals with interrelated and mutually reinforcing elements:

Goal

To conduct monetary policy that promotes the achievement of maximum sustainable long-term growth and the price stability that fosters that goal.

Objectives

- Stay abreast of recent developments and prospects in the U.S. economy and financial markets and in those abroad, so that monetary policy decisions will be well informed.
- Enhance our knowledge of the structural and behavioral relationships in

the macroeconomic and financial markets, and improve the quality of the data used to gauge economic performance, through developmental research activities.

- Implement monetary policy effectively in rapidly changing economic circumstances and in an evolving financial market structure.
- Contribute to the development of U.S. international policies and procedures, in cooperation with the Department of the Treasury and other agencies.
- Promote understanding of Federal Reserve policy among other government policy officials and the general public.

Goal

To promote a safe, sound, competitive, and accessible banking system and stable financial markets.

Objectives

- Promote overall financial stability, manage and contain systemic risk, and ensure that emerging financial problems are identified early and successfully resolved before they become crises.
- Provide a safe, sound, competitive, and accessible banking system through comprehensive and effective supervision of U.S. banks, bank and financial holding companies, foreign banking organizations, and related entities.
- Enhance efficiency and effectiveness, while remaining sensitive to the burden on supervised institutions, by addressing the supervision function's procedures, technology, resource allocation, and staffing issues.
- Promote adherence by domestic and foreign banking organizations supervised by the Federal Reserve with

applicable laws, rules, regulations, policies, and guidelines through a comprehensive and effective supervisory program.

Goal

To enforce the consumer financial services laws fully and fairly, protect and promote the rights of consumers under these laws, and encourage banks to meet the credit needs of consumers, including those in low- and moderate-income neighborhoods.

Objectives

- Maintain a strong consumer compliance supervision and complaint investigation program that protects consumers and reflects the rapidly changing financial services industry.
- Implement statutes designed to inform and protect consumers that reflect congressional intent while achieving the proper balance between consumer protection and industry costs.
- Promote equal access to banking services.
- Promote community development in historically underserved areas.

Goal

To foster the integrity, efficiency, and accessibility of U.S. payment and settlement systems.

Objectives

- Develop sound, effective policies and regulations that foster payment system integrity, efficiency, and accessibility.
- Conduct research and analysis that contributes to policy development and increases the Board's and others'

understanding of payment system dynamics and risk.

Goal

To provide high-quality professional oversight of Reserve Banks.

Objective

- Produce high-quality assessments of Federal Reserve Bank operations, projects, and initiatives in order to help Federal Reserve management foster and strengthen sound internal control systems and efficient and effective performance.

Interagency Coordination

Interagency coordination helps focus efforts to eliminate redundancy and lower costs. As mandated by the Government Performance and Results Act and in conformance with past practice, the Board has worked closely with other federal agencies to consider plans and strategies for programs, such as bank supervision, that transcend the jurisdiction of each agency. Coordination with the Department of the Treasury and other agencies is evident throughout both the strategic plan and the performance budget. Much of the Board's formal effort to plan jointly has been made through the Federal Financial Institu-

tions Examination Council (FFIEC), a group made up of the five federal agencies that regulate depository institutions.¹ In addition, a coordinating committee has been created to address and report on issues related to those general goals and objectives that cross agency functions, programs, and activities. This working group has been meeting since June 1997. These and similar planning efforts can eliminate redundancy and significantly lower the government's costs for data processing and other activities, as well as lower depository institution costs for complying with federal regulations, while enhancing public access to the data.

1. The FFIEC consists of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. It was established in 1979 pursuant to title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978. The FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions and to make recommendations to promote uniformity in the supervision of financial institutions. The FFIEC also provides uniform examiner training and has taken a lead in developing standardized software needed for major data collection programs to support the requirements of the Home Mortgage Disclosure Act and the Community Reinvestment Act.

Federal Legislative Developments

Check 21 Act

On October 28, 2003, President Bush signed the Check Clearing for the 21st Century Act (the Check 21 Act) into law. The Check 21 Act, which becomes effective on October 28, 2004, will facilitate check truncation and the exchange of checks in electronic format.¹ The act authorizes the creation and use of a new negotiable instrument called a “substitute check.” A substitute check is a paper reproduction of an original check that contains an image of the front and back of the original check, is MICR-encoded, and is otherwise able to be processed in the same way as the original check. The act provides that a properly prepared substitute check is the legal equivalent of the original check for all purposes. The act does not require banks to create substitute checks or to accept delivery of electronic check images; instead, the act simply requires banks to accept properly prepared substitute checks. By empowering banks to create machine-readable substitute checks that are legally equivalent to original checks, the Check 21 Act enables banks to truncate original paper checks early in the collection process, process them electronically, and, where necessary, create substitute checks for delivery to banks that do not accept checks electronically.

The Check 21 Act includes new warranties and an indemnity that protect recipients of substitute checks, includ-

ing both banks and customers, in the event of losses arising from the use of substitute checks. The Check 21 Act also includes expedited recredit procedures to help consumers who receive substitute checks resolve problems related to those checks. Furthermore, the act requires banks to provide a consumer awareness disclosure regarding substitute checks and substitute-check rights to consumers who receive those checks.

Within nine months of its enactment, the Check 21 Act also requires the Board to publish model language to assist banks in complying with the act’s consumer notice requirement. Further, the Check 21 Act empowers the Board to prescribe such regulations as it deems necessary to implement, prevent evasion of, or facilitate compliance with the provisions of the Check 21 Act.

FACT Act

On December 4, 2003, President Bush signed the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act) into law. The act amends the Fair Credit Reporting Act (FCRA) to (1) enhance the ability of consumers to combat identity theft and (2) increase the accuracy of consumer reports. The FACT Act also imposes obligations on institutions that sell or share certain consumer information and restricts the use and disclosure of sensitive medical information. In addition, the FACT Act includes other provisions that are designed to limit the use of certain information received from affiliates for marketing purposes. Lastly, the FACT Act establishes uniform national standards

1. *Check truncation* refers to any of a number of arrangements in which the original paper checks are removed from the collection or return process before reaching either paying or depository banks, respectively, or reaching their customers.

in key areas of regulation regarding consumer report information to further promote the efficient operation of national credit markets. To allow a reasonable time to implement the newly enacted requirements, the act sets delayed effective dates for some provisions and, for other provisions, requires the Board and the Federal Trade Commission (FTC) to set effective dates through joint regulations. Certain provisions of the act require implementing regulations. The dates for compliance with those regulations will be established by the federal banking agencies, the National Credit Union Administration (NCUA), the Securities and Exchange Commission (SEC), and the FTC, as appropriate.

The Board is charged with performing various responsibilities under the FACT Act. Certain sections of the act require the Board to prescribe regulations or guidelines that implement the newly enacted requirements with respect to entities subject to the Board's jurisdiction. To develop many of these rules, the Board must consult and coordinate with the other federal banking agencies, the NCUA, the SEC, and the FTC. The act also requires the Board to undertake several studies on issues regarding the uses of information about consumers and the delivery of financial products and services to consumers, particularly products involving credit or insurance.

Identity Theft Prevention

The FACT Act includes several provisions that are designed to prevent identity theft and assist a consumer who has been a victim of identity theft restore the accuracy of his or her credit history. For example, the FACT Act requires the following:

- A consumer reporting agency, upon a request from a consumer and subject

to certain conditions, must place a fraud alert in the consumer's file and provide the alert along with any credit score generated from that file. Active-duty military personnel also may request that a consumer reporting agency place an "active-duty alert" in their files.

- A consumer reporting agency, upon a request from a consumer and subject to certain conditions, must block the reporting of any information which the consumer identifies as resulting from an incident of identity theft that has been reported to the appropriate law enforcement authority. The consumer reporting agency also must promptly notify the furnisher of the information identified by the consumer that the information may be a result of identity theft.
- A consumer reporting agency must notify a user of a consumer report about a discrepancy in a consumer's address if the user requests the report using an address for the consumer that substantially differs from the address in the file the consumer reporting agency maintains. The federal banking agencies, the NCUA, and the FTC are directed to prescribe guidance that describes reasonable policies and procedures that, in general, a user of a consumer report must employ to reconcile a discrepancy in a consumer's address.
- Businesses accepting credit cards or debit cards must print no more than the last five digits of the card number or the expiration date of the card on any electronically printed receipt provided to the cardholder at the point of sale.

The act charges the federal banking agencies, the NCUA, and the FTC with

establishing “red flag guidelines” for use by financial institutions to identify possible instances of identity theft and to protect account holders, customers, and institutions from the risks associated with identity theft. The act also requires the FTC, in consultation with the federal banking agencies, to prepare a model summary of the rights of consumers with respect to identity theft prevention, and mandates that the consumer reporting agencies provide the summary when a consumer expresses a belief that he or she is the victim of identity theft.

Accuracy of Consumer Credit Reports

The FACT Act includes several provisions that are designed to enhance a consumer’s access to information in his or her consumer report and to improve the accuracy of that information. For example, the FACT Act

- allows a consumer to request that any nationwide consumer reporting agency or nationwide specialty consumer reporting agency provide the consumer with one free consumer credit report during any twelve-month period, if certain conditions are satisfied;
- allows a consumer to obtain his or her credit score, as well as certain information relating to the credit score, from any consumer reporting agency;
- requires any person who makes or arranges consumer loans and uses a credit score in connection with a consumer’s application for a loan to make the credit score, as well as certain information about the score, available to the consumer;

- requires a financial institution that regularly furnishes information to a nationwide consumer reporting agency regarding credit extended to a customer to provide a notice, in writing, to the customer if the institution has furnished or will furnish negative information about him or her to a consumer reporting agency;
- requires a person that furnishes information about a consumer to a consumer reporting agency to maintain reasonable policies and procedures to ensure the accuracy and integrity of the furnished consumer information, in accordance with regulatory guidelines prescribed by the federal banking agencies, the NCUA, and the FTC, as appropriate; and
- requires a person that furnishes information about a consumer to a consumer reporting agency, upon request by the consumer, to reinvestigate a dispute concerning the accuracy of information contained in a consumer report under certain circumstances, as prescribed by the federal banking agencies, the NCUA, and the FTC.

Limits on the Use and Sharing of Medical Information

The FACT Act adds to the existing provisions of the FCRA that govern the sharing and use of medical information. Among other things, the FACT Act

- prohibits a consumer reporting agency from providing a third party with a consumer report containing medical information about a consumer unless the information is relevant to the consumer’s employment or a credit transaction involving the consumer and the consumer specifically consents, in

writing, to the release of such information; and

- generally prohibits a creditor from obtaining or using medical information about a consumer in connection with any determination of the consumer's eligibility for credit.

Promotion of Financial Literacy and Education

The FACT Act establishes the Financial Literacy and Education Commission, to be composed of a representative from each of the federal banking agencies. The commission is charged with developing a national strategy for improving the financial literacy and education of persons in the United States. The commission also is authorized to take appropriate actions to streamline, improve, or

augment the financial literacy and education programs, grants, and materials of the federal government, including developing financial education curricula for all Americans.

Relation to State Laws

The FACT Act makes permanent the preemption provisions of the FCRA that were scheduled to terminate, or "sunset," on December 31, 2003, including the provision that generally preempts any state law requirement regarding the exchange of information about a consumer among affiliated persons. Section 711 of the FACT Act also specifies that several of the act's new protections preempt state laws "with respect to the conduct required by" those provisions of the act. ■

Records

Record of Policy Actions of the Board of Governors

Regulation B

Equal Credit Opportunity
[Docket No. R-1008]

On February 19, 2003, the Board approved amendments that, among other things, retain the general prohibition against inquiring about or noting applicant characteristics (such as race, national origin, religion, age, or sex) in nonmortgage credit transactions and create an exception when such data are collected as part of a creditor's self-test to determine compliance with the Equal Credit Opportunity Act. The amendments also require creditors to retain certain records related to prescreened credit solicitations for twenty-five months. The amendments are effective April 15, 2003, with mandatory compliance by April 15, 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Olson, Bernanke, and Kohn. Absent and not voting: Governor Bies.

Regulation D

Reserve Requirements of
Depository Institutions
[Docket No. R-1163]

On October 1, 2003, the Board approved amendments to reflect the annual indexing of the low reserve tranche and of the reserve requirement exemption for use in reserve requirement calculations in 2004. The amendments increase the 3 percent low reserve tranche for net transaction accounts to \$45.4 million (from \$42.1 million in 2003) and increase the reserve requirement exemption to \$6.6 million (from \$6 million in 2003).

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Regulation H

Membership of State Banking
Institutions in the Federal Reserve
System
[Docket No. R-1129]

On January 23, 2003, the Board approved amendments to administer and enforce several reporting, disclosure, and corporate-governance provisions of the Sarbanes-Oxley Act of 2002, which are applicable to state member banks that have securities registered under the Securities Exchange Act of 1934 (registered banks). The amendments generally require registered banks to comply with the rules, regulations, and forms adopted by the Securities and Exchange Commission to implement the provisions of

NOTE. Full texts of the policy actions are available from the electronic reading room on the Board's Freedom of Information Act web page (www.federalreserve.gov/generalinfo/foia/) by using the "Policy Statements and Staff Manuals" link or on request from the Board's Freedom of Information Office (Tel: 202-452-3684; TDD: 202-263-4869; Fax: 202-872-7565). Internet access to the Board's public web site is also available during regular business hours at the Freedom of Information Office, Martin Building, Room M-P-500, 20th and C Streets NW, Washington, DC 20551.

the Sarbanes–Oxley Act specified in section 12(i) of the Securities Exchange Act of 1934, unless those requirements are modified by the Board. The amendments are effective April 1, 2003.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Regulation H
Membership of State Banking
Institutions in the Federal Reserve
System

Regulation K
International Banking Operations
[Docket No. R-1127]

On April 21, 2003, the Board, acting with the Department of the Treasury and the federal financial institutions regulatory agencies, approved interagency amendments to implement section 326 of the USA Patriot Act of 2001 concerning customer identification programs. The amendments require that banks, savings associations, credit unions, private banks, and trust companies (1) implement reasonable procedures to verify the identity of any person who seeks to open an account, to the extent reasonable and practicable; (2) maintain records of the information used to verify the person’s identity; and (3) determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency. The amendments are effective June 9, 2003, with mandatory compliance by October 1, 2003.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, Bernanke, and

Kohn. Absent and not voting: Governor Gramlich.

Regulation H
Membership of State Banking
Institutions in the Federal Reserve
System

Regulation Y
Bank Holding Companies and
Change in Bank Control
[Docket No. R-1156]

On September 12, 2003, the Board, acting with the federal bank and thrift regulatory agencies, approved interim interagency amendments (with a request for comment) that provide an interim capital treatment for assets in asset-backed commercial paper programs that are consolidated on the balance sheets of sponsoring banks, bank holding companies, and thrifts as a result of a recently issued Financial Accounting Standards Board Interpretation (FASB No. 46). The interim capital treatment is in effect only for the regulatory reporting periods ending September 30 and December 31, 2003, and March 31, 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Regulation K
International Banking Operations
[Docket No. R-1143]

On February 7, 2003, the Board issued an interpretation of Regulation K to clarify that a foreign bank planning to engage in underwriting securities to be distributed in the United States must either be a financial holding company or have the authority to engage in underwriting activity under section 4(c)(8) of the Bank Holding Company Act. The

interpretation is effective February 19, 2003.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Regulation V
Fair Credit Reporting
[Docket No. R-1172]

On December 16, 2003, the Board, acting with the Federal Trade Commission, approved new interim interagency rules (with a request for comment) that establish December 31, 2003, as the effective date for provisions of the Fair and Accurate Credit Transactions Act of 2003 that determine the relationship between the Fair Credit Reporting Act and state laws and provisions that authorize rulemakings or other implementing actions by various agencies.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Regulation Y
Bank Holding Companies and
Change in Bank Control
[Docket Nos. R-1146 and R-1092]

On June 27, 2003, the Board approved amendments that permit bank holding companies to enter into (1) commodity derivative contracts that are settled by the bank holding company receiving and transferring title to the underlying commodity instantaneously, by operation of contract, and without taking physical possession of the commodity and (2) certain commodity derivative contracts that do not require cash settlement or specifically provide for assignment, termination, or offset before delivery.

The amendments are effective August 4, 2003.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

On November 26, 2003, the Board approved amendments to expand the ability of all bank holding companies, including financial holding companies, to process, store, and transmit nonfinancial data in connection with their financial data processing, storage, and transmission activities by raising the revenue limit on nonfinancial data processing activities from 30 percent to 49 percent of the company's total annual revenues derived from data processing, data storage, and data transmission activities. The Board also announced that it would consider, case by case in accordance with applicable procedures, proposals by financial holding companies to engage in, or acquire a company engaged in, other nonfinancial data processing, information portal, and technology-related activities that the financial holding company believes are complementary to financial activities. The amendments are effective January 8, 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, and Bernanke. Absent and not voting: Governor Kohn.

Rules of Organization
[Docket No. R-1149]

On April 29, 2003, the Board amended its definition of a quorum to provide that a majority of the members in office constitutes a quorum of the Board, except that four members constitute a quorum if there are five members in office. The

revised definition enhances the Board's ability to function in a national emergency, but does not alter the number of Board members required to constitute a quorum during normal operations when the Board has five or more members. The amendment is effective April 29, 2003.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Rules of Practice for Hearings
Subpart J—Removal, Suspension,
and Debarment of Accountants
from Performing Audit Services
[Docket No. R-1139]

On August 6, 2003, the Board, acting with the federal bank and thrift regulatory agencies, approved interagency amendments that establish procedures for removing, suspending, or debarring accountants, for good cause, from performing the audit services required under section 36 of the Federal Deposit Insurance Act for insured depository institutions with total assets of \$500 million or more. The amendments are effective October 1, 2003.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, Bernanke, and Kohn. Absent and not voting: Governor Gramlich.

**Rules Regarding Equal
Opportunity**
[Docket No. R-1096]

On April 9, 2003, the Board approved amendments, adopted in January 2001 as interim amendments, to incorporate changes that the Equal Employment Opportunity Commission made to its parallel regulation on equal employment

opportunity in the federal government generally. The amendments also incorporate changes to provisions of the commission's parallel regulation that address the Rehabilitation Act; the commission adopted these changes after the Board's interim rule. The amendments are effective April 15, 2003.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

**Policy Statements and
Other Actions**

Interagency Paper on Sound
Practices to Strengthen the
Resilience of the U.S. Financial
System
[Docket No. R-1128]

On April 7, 2003, the Board, acting with the Office of the Comptroller of the Currency and the Securities and Exchange Commission, approved an interagency paper that, among other things, identifies (1) new business continuity objectives that have special importance for all financial firms and (2) sound practices to ensure the resilience of the U.S. financial system, with a focus on minimizing the immediate systemic effects of a wide-scale disruption on critical financial markets.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Expansion of the Operating Hours
for the Online Fedwire Funds
Service
[Docket No. R-1138]

On May 20, 2003, the Board approved an expansion of the operating hours for

the online Fedwire Funds Service from eighteen to twenty-one and one-half hours each business day. The new opening time, 9:00 p.m. eastern time for online funds transfers with a business date of the following calendar day, is three and one-half hours earlier than the current 12:30 a.m. opening time. The closing time remains 6:30 p.m. eastern time. The new hours are effective in the second quarter of 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Imputed Investment Income on Clearing Balances [Docket No. R-1152]

On October 22, 2003, the Board modified the method for imputing priced-services income from clearing-balance investments that is used each year when the Reserve Banks set fees for Federal Reserve priced services and measure priced-services' cost recovery. The new method, which expresses the imputed investment return as a constant annual spread over the rate for three-month Treasury bills, is based on an optimized underlying hypothetical investment portfolio that reflects the broader range of investments available to banks and bank holding companies. Selection of the portfolio investments is subject to a risk-management framework. The new method is effective in January 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Discount Rates in 2003

On October 31, 2002, the Board amended its Regulation A to establish two new forms of Reserve Bank dis-

counts and advances, primary and secondary credit, that would replace adjustment and extended credit, effective January 9, 2003. On January 6, 2003, the Board voted to approve for all the Reserve Banks an initial primary credit rate of $2\frac{1}{4}$ percent and a formula for calculating a secondary credit rate that yielded an initial rate of $2\frac{3}{4}$ percent.

In 2003, the rates for primary and secondary credit consistently exceeded the federal funds rate target, which is set by the Federal Open Market Committee (FOMC), by 100 and 150 basis points respectively. On June 25, a reduction of $\frac{1}{4}$ percentage point in the federal funds rate target was accompanied by a similar reduction in both discount rates to levels of 2 percent and $2\frac{1}{2}$ percent. The seasonal credit program was not affected by the Regulation A amendments. The rate for such credit in 2003 continued to be set on the basis of a market-related formula and was equal or close to the FOMC's target federal funds rate throughout the year.

Primary Credit Rate

The Board reached its decisions on the primary credit rate in conjunction with the FOMC's decisions on the target federal funds rate and related economic and financial developments. These developments are referenced below and are reviewed more fully in other parts of this report, including the compilation of minutes of FOMC meetings held in 2003.

Reduction in the Primary Credit Rate in June 2003

Against the background of a sluggish economic expansion but already stimulative monetary and fiscal policies, the Board took no action before June 25 on requests by various Federal Reserve

Banks to lower their primary credit rate by $\frac{1}{4}$ or $\frac{1}{2}$ percentage point. The number of such requests increased from two in mid-March to eight by the latter part of June amid persisting indications that an anticipated strengthening in the expansion of economic activity was being held back by a high degree of business caution in investment and hiring decisions. On June 25 the Board approved a $\frac{1}{4}$ percentage point reduction, to a level of 2 percent, in the primary credit rate of the Federal Reserve Banks in conjunction with the FOMC's decision to reduce its target for the federal funds rate by the same amount. The Board and the FOMC concluded that a slightly more expansive monetary policy would add support for an economy that was expected to improve over time in the context of robust underlying growth in productivity, markedly improved financial conditions, and signs that labor and product markets were stabilizing.

In July and August, the Board took no action on biweekly requests by one Federal Reserve Bank to lower its primary credit rate by an additional $\frac{1}{4}$ percentage point. In light of increasing indications of a pronounced acceleration in economic activity, no further requests for changes in their credit rates were submitted by any of the Federal Reserve Banks over the remainder of the year.

Structure of Discount Rates

Under the new discount rate program that went into effect on January 9, 2003, primary credit is made available for very short terms as a backup source of liquidity to depository institutions that, in the judgment of the lending Federal Reserve Bank, are in generally sound financial condition. Primary credit is extended at a rate above the federal funds rate. Secondary credit is available in appropriate

circumstances to depository institutions that do not qualify for primary credit; it is set on the basis of a formula that in 2003 produced a rate that was $\frac{1}{2}$ percentage point higher than the primary credit rate. Seasonal credit, another type of discount window credit, is available under limited conditions to assist smaller depository institutions in managing liquidity needs that arise from regular swings in their loans and deposits. Rates on seasonal credit are calculated every two weeks in accordance with a formula based on market interest rates. Under that formula, the rates charged for seasonal credit in 2003 were close to the FOMC's target rate for the federal funds rate and ranged from 1.05 percent to 1.25 percent. Discount rates were as follows at year-end: primary credit at 2 percent, secondary credit at 2.50 percent, and seasonal credit at 1.05 percent.

Board Votes

Under the Federal Reserve Act, the boards of directors of the Federal Reserve Banks are required to establish rates on discounts and advances to depository institutions at least every fourteen days and must submit the rates to the Board of Governors for review and determination. Votes on the biweekly establishment of the prime credit rate without change and on the renewal of the formulas for calculating the rates on secondary and seasonal credit are not shown in this summary. All votes on discount rates taken by the Board of Governors in 2003 were unanimous.

Votes on Changes in the Primary Credit Rate

January 6, 2003. Effective January 9, 2003, the Board approved the establish-

ment by the twelve Federal Reserve Banks of a primary credit rate of 2¼ percent and approved a formula for calculating a secondary credit rate that yielded a rate of 2¾ percent.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

June 25, 2003. Effective this date, the Board approved actions taken by the

directors of the Federal Reserve Banks of Boston, New York, Kansas City, and San Francisco to reduce their primary credit rate from 2¼ percent to 2 percent. The same decrease was approved for the remaining Federal Reserve Banks, effective June 26, 2003.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn. ■

Minutes of Federal Open Market Committee Meetings

The policy actions of the Federal Open Market Committee, contained in the minutes of its meetings, are presented in the Annual Report of the Board of Governors pursuant to the requirements of section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each policy action, and that it shall include in its annual report to the Congress a full account of such actions.

The minutes of the meetings contain the votes on the policy decisions made at those meetings as well as a résumé of the information and discussions that led to the decisions. The summary descriptions of economic and financial conditions are based on the information that was available to the Committee at the time of the meetings rather than on data as they may have been revised later.

Members of the Committee voting for a particular action may differ among themselves as to the reasons for their votes; in such cases, the range of their views is noted in the minutes. When members dissent from a decision, they are identified in the minutes and a summary of the reasons for their dissent is provided.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to

execute transactions for the System Open Market Account. In the area of domestic open market operations, the Federal Reserve Bank of New York operates under three sets of instructions from the Federal Open Market Committee: an Authorization for Domestic Open Market Operations, Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues, and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Committee operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations. These policy instruments are shown below in the form in which they were in effect at the beginning of 2003. Changes in the instruments during the year are reported in the minutes for the individual meetings.

Authorization for Domestic Open Market Operations

In Effect January 1, 2003

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the

United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than \$12.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account;

(c) To sell U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding but that in no event shall be less than 1.0 percent per annum of the market value of the securities lent. The Federal Reserve Bank of New York shall apply reasonable limitations on the total amount of a specific issue that may be auctioned, and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat

in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues

In Effect January 1, 2003

1. System open market operations in Federal agency issues are an integral part of total System open market operations designed to influence bank reserves, money market conditions, and monetary aggregates.

2. System open market operations in Federal agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

Domestic Policy Directive

In Effect January 1, 2003¹

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¼ percent.

The Committee also approved the sentence below for inclusion in the press statement to be released shortly after the December 10, 2002, meeting:

1. Adopted by the Committee at its meeting on December 10, 2002.

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are balanced with respect to prospects for both goals in the foreseeable future.

Authorization for Foreign Currency Operations

In Effect January 1, 2003

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Canadian dollars	Mexican pesos
Danish kroner	Norwegian kroner
Euro	Swedish kronor
Pounds sterling	Swiss francs
Japanese yen	

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding \$25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada	2,000
Bank of Mexico	3,000

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at nonmarket exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In mak-

ing operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account ("Manager"), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or

understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

Foreign Currency Directive

In Effect January 1, 2003

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular

currencies and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

Procedural Instructions with Respect to Foreign Currency Operations

In Effect January 1, 2003

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$300 million on any day or \$600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net posi-

tion in a single foreign currency exceeding \$150 million, or \$300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

Meeting Held on January 28–29, 2003

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, January 28, 2003, at 2:30 p.m. and continued on Wednesday, January 29, 2003, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
Mr. Gynn
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Parry

Mr. Hoenig, Mses. Minehan and Pianalto, Messrs. Poole and Stewart, Alternate Members of the Federal Open Market Committee

Messrs. McTeer, Santomero, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia and Minneapolis respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Eisenbeis, Goodfriend, Howard, Hunter, Judd, Lindsey, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs, respectively, Board of Governors

Messrs. Slifman and Oliner, Associate Directors, Division of Research and Statistics, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Messrs. Clouse and Reifschneider,²
Assistant Directors, Divisions of
Monetary Affairs and Research
and Statistics, respectively, Board
of Governors

Mr. Simpson, Senior Adviser, Division
of Research and Statistics, Board
of Governors

Mr. Skidmore, Special Assistant to the
Board, Office of Board Members,
Board of Governors

Mr. Fallon,³ Senior Counsel, Legal
Division, Board of Governors

Ms. Haltmaier,⁴ Section Chief,
Division of International Finance,
Board of Governors

Messrs. Lebow,⁴ Sack,² and Tetlow,²
Senior Economists, Divisions of
Research and Statistics, Monetary
Affairs, and Research and
Statistics, respectively, Board
of Governors

Mr. Zakrajšek,⁴ Economist, Division
of Monetary Affairs, Board of
Governors

Ms. Low, Open Market Secretariat
Assistant, Division of Monetary
Affairs, Board of Governors

Mr. Lyon, First Vice President, Federal
Reserve Bank of Minneapolis

Messrs. Fuhrer and Hakkio,
Ms. Mester, Messrs. Rasche and
Rosenblum, Senior Vice
Presidents, Federal Reserve
Banks of Boston, Kansas City,
Philadelphia, St. Louis, and
Dallas respectively

Messrs. Altig and Croushore,
Ms. Hargraves, Messrs. Miller
and Rudebusch, Vice Presidents,
Federal Reserve Banks of
Cleveland, Philadelphia,
New York, Minneapolis, and
San Francisco respectively

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 2003, and ending December 31, 2003, had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

William J. McDonough, President of the Federal Reserve Bank of New York, with Jamie B. Stewart, Jr., First Vice President of the Federal Reserve Bank of New York, as alternate.

J. Alfred Broaddus, Jr., President of the Federal Reserve Bank of Richmond, with Cathy E. Minehan, President of the Federal Reserve Bank of Boston, as alternate.

Jack Guynn, President of the Federal Reserve Bank of Atlanta, with William Poole, President of the Federal Reserve Bank of St. Louis, as alternate

Michael H. Moskow, President of the Federal Reserve Bank of Chicago, with Sandra Pianalto,⁵ President of the Federal Reserve Bank of Cleveland, as alternate.

Robert T. Parry, President of the Federal Reserve Bank of San Francisco, with Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City, as alternate

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until

2. Attended portion of meeting relating to discussion of gradualism in policymaking.

3. Attended portion of meeting relating to FOMC rule changes.

4. Attended portion of meeting relating to the FOMC's review of the economic outlook.

5. Election effective February 1, 2003.

the election of their successors at the first regularly scheduled meeting of the Committee after December 31, 2003, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee:

Alan Greenspan	Chairman
William J. McDonough	Vice Chairman
Vincent R. Reinhart	Secretary and Economist
Normand R.V. Bernard	Deputy Secretary
Gary P. Gillum	Assistant Secretary
Michelle A. Smith	Assistant Secretary
J. Virgil Mattingly, Jr.	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Karen H. Johnson	Economist
David J. Stockton	Economist

Thomas A. Connors, Christine Cumming, Robert A. Eisenbeis, Marvin S. Goodfriend, David H. Howard, William C. Hunter, John P. Judd, David E. Lindsey, Charles S. Struckmeyer, and David W. Wilcox, Associate Economists

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first regularly scheduled meeting of the Committee after December 31, 2003.

By unanimous vote, Dino Kos was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.⁶

6. Secretary's note: Advice subsequently was received that the selection of Mr. Kos as Manager was satisfactory to the board of directors of the New York Reserve Bank.

By unanimous vote, the Committee approved an amendment to paragraph 2 of the Authorization for Domestic Open Market Operations to give the Federal Reserve Bank of New York discretion to set the minimum lending fee for the System Open Market Account securities lending program below the existing 1.0 percent per annum rate. The Authorization as amended read as follows:

Authorization for Domestic Open Market Operations (Amended January 28, 2003)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than \$12.0 billion during the period commencing with the opening of business on the day following such a meeting and ending with the close of business on the day of the next such meeting;

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agree-

ments for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

(c) To sell U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding. The Federal Reserve Bank of New York shall set a minimum lending fee consistent with the objectives of the program and apply reasonable limitations on the total amount of a specific issue that may be auctioned and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securi-

ties in 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

With Mr. Broaddus dissenting, the Authorization for Foreign Currency Operations and the Foreign Currency Directive were reaffirmed as shown below.

Authorization for Foreign Currency Operations (Reaffirmed January 28, 2003)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Canadian dollars	Mexican pesos
Danish kroner	Norwegian kroner
Euro	Swedish kronor
Pounds sterling	Swiss francs
Japanese yen	

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding \$25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada	2,000
Bank of Mexico	3,000

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at nonmarket exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcom-

mittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account ("Manager"), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

Mr. Broadus dissented in the votes on the Authorization for Foreign Currency Operations and the Foreign Currency Directive because they provide the foundation for foreign exchange market intervention. For the same reasons he had given in the past when he had dissented on these policy instruments, he continued to believe that the Federal Reserve's participation in foreign exchange market intervention compromises its ability to conduct monetary policy effectively.

Foreign Currency Directive (Reaffirmed January 28, 2003)

1. System operations in foreign currencies shall generally be directed at countering

By unanimous vote, the Procedural Instructions with Respect to Foreign Currency Operations were reaffirmed in the form shown below.

Procedural Instructions with Respect to Foreign Currency Operations (Reaffirmed January 28, 2003)

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account (“Manager”), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System’s overall open position in foreign currencies exceeding \$300 million on any day or \$600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System’s net position in a single foreign currency exceeding \$150 million, or \$300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System’s net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System’s overall open position

in foreign currencies exceeding \$1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

By unanimous vote, the Committee approved the repeal of paragraphs 3 through 6 of the Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues. The Committee initially suspended these paragraphs in August 1999 and subsequently extended the suspension annually for the years through 2002. Paragraphs 1 and 2, which provide general guidance for the conduct of System open market operations in federal agency obligations, were retained in their existing form.

Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues (Amended January 28, 2003)

1. System open market operations in Federal agency issues are an integral part of total System open market operations designed to influence bank reserves, money market conditions, and monetary aggregates.

2. System open market operations in Federal agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

By unanimous vote, the Committee amended its Program for Security of FOMC Information on January 28, 2003, to update references to the classification of confidential documents and to clarify some of its instructions for safeguarding confidential information.

By unanimous vote, the Committee amended the Temporary Authority to Operate the System Account to authorize the Chairman to appoint an interim manager of the System Open Market Account in emergency circumstances. The amended Temporary Authority read as follows:

**Temporary Authority to Operate the System Account
(Amended January 28, 2003)**

The Chairman of the Committee is authorized to appoint a Federal Reserve Bank as agent to operate the System Account temporarily in case the Federal Reserve Bank of New York is unable to function. In the event the Chairman exercises such authority, the Chairman also is authorized to appoint a Federal Reserve official to act temporarily as Manager of the System Account.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on December 10, 2002, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period December 10, 2002, through January 28, 2003. By unanimous vote, the Committee ratified these transactions.

At this meeting the Committee discussed staff presentations on whether policy adjustments incorporating gradual movements in the federal funds rate were desirable in terms of optimally

achieving the Committee's macroeconomic objectives. The staff presentations examined whether policy adjustments historically had been implemented gradually or whether, instead, the observed tendency for the federal funds rate to move slowly through time reflected the behavior of the underlying variables to which policy was responding. Members expressed a range of views regarding the evidence and its implications for policy, including potential situations that might call for relatively aggressive policy actions.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting suggested that economic growth was very slow in the fourth quarter. Housing demand and consumer spending firmed toward the end of the year, but capital spending remained quite weak in an environment of substantial business uncertainty and pessimism. A sharp drop in motor vehicle output held down overall industrial production, and the labor market deteriorated further. Core consumer price inflation continued to decline through the end of the year.

Private nonfarm payroll employment fell again in December and was at its lowest level since September 1999. Job losses in manufacturing continued to be sizable, and employment in retail trade plunged, although part of that decline might have been attributable to lower-than-usual hiring of temporary sales help for the holiday season. By contrast, hiring in the services industry picked up, and employment in the finance, insurance, and real estate group continued to expand. The unemployment rate held at 6 percent in December, a level consistent with other labor market indicators.

Industrial production slowed a little further in December, reflecting another sharp drop in motor vehicle assemblies and a decline in electricity generation. Excluding motor vehicles and parts, manufacturing output increased slightly following small declines in October and November. Production of high-tech goods continued to rise in December, and output in industries other than high-tech and transportation increased for the first time since August. Despite the uptick in production in some areas of manufacturing, capacity utilization in manufacturing fell again in December and was substantially below its long-run average.

Retail sales increased appreciably in November and December even though disposable personal income posted relatively modest gains and readings on consumer confidence were generally low. Purchases of new motor vehicles were brisk and were accompanied by moderate further increases in other categories of retail sales.

Residential housing activity remained strong through the end of the year, despite continued sluggish employment and additional declines in household wealth. With mortgage rates remaining near historical lows, single-family housing starts increased further in November and December, and the backlog of unused permits along with other information suggested that starts likely would remain strong in coming months. New home sales reached yet another record high in December, and existing home sales neared their record level established in January 2002. In the multifamily sector, starts rebounded in November and December from a sharp drop in October. Nonetheless, multifamily homebuilding was at a relatively low level at year-end, reflecting falling rents and high vacancy rates.

Business spending on equipment and software appeared to have little or no forward momentum in the fourth quarter and to have been weaker than might have been suggested by the recent pattern of business output, corporate cash flow, and the user cost of capital. Both shipments of and orders for nondefense capital goods turned down in the fourth quarter, with aircraft and communications equipment registering the steepest declines in shipments. In the non-residential sector, construction activity slowed only a little further in October and November following a sharp drop in the third quarter. However, current weakness in rents and property values suggested continued deterioration in activity.

The book value of manufacturing and trade inventories excluding motor vehicles dropped sharply in October and changed little in November. Manufacturers trimmed stocks in both months, though durable goods manufacturers increased their inventories sharply in December. Wholesalers cut their inventories substantially in October and held them steady in November. Retail inventories changed little over the two-month period. Aggregate inventory–sales ratios in all three categories remained at very low levels.

The U.S. trade deficit in goods and services widened significantly in November, with the value of imports rising more than that of exports. Combining October and November, imports increased from the third-quarter average while exports declined somewhat. Available information on economic activity abroad in the fourth quarter suggested slower growth on average in the major foreign economies. Economic expansion in Japan appeared to have slowed markedly, and growth in the euro area remained sluggish. By contrast, the Canadian economy continued to expand

briskly while activity in the United Kingdom seemed to be growing more moderately. In the emerging market economies, conditions in South America were generally still fragile, the pace of economic recovery in Mexico appeared to have slowed, and growth had softened in much of emerging Asia. Economic growth in China remained strong.

Core consumer price inflation, as measured by the consumer price index (CPI) and the chain-weighted personal consumption expenditure (PCE) index, continued to edge lower through the end of the year. However, the sizable run-up in energy prices last year boosted overall consumer price inflation somewhat on a year-over-year basis. At the producer level, core prices for finished goods declined in November and December, but for the year as a whole the jump in energy prices pushed overall producer prices for finished goods up slightly. With regard to labor costs, average hourly earnings of production or nonsupervisory workers increased moderately in December, but the change in those earnings over the year was considerably smaller than in 2001, evidently reflecting the slack in labor markets.

At its meeting on December 10, 2002, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the federal funds rate around 1¼ percent and retained an assessment that the risks to its longer-term objectives were balanced. The Committee noted that monetary policy was quite accommodative and well positioned to support a strengthening economic expansion in line with the members' expectations for coming quarters. The Committee's decision was widely anticipated and elicited little reaction. Financial markets were sensitive, however, to shifting perceptions of global risks, economic releases that generally were seen as having a

disappointing tone, pessimistic expectations for fourth-quarter corporate profits, and the Administration's announcement of an economic stimulus package larger than had been anticipated. Against that backdrop, longer-term Treasury yields declined somewhat while, in private debt markets, a sense of reduced concern about governance issues and perhaps some increased appetite for risk-taking led to a substantial decline in yields across the credit spectrum that further narrowed risk spreads. Major stock price indexes moved widely during the intermeeting period, but most finished the period a little lower.

The dollar depreciated substantially in terms of an index of major foreign currencies, with particularly large declines against the euro, the yen, and the Swiss franc. Market worries about growing tensions over Iraq and North Korea appeared to be a key factor, but concerns about the downbeat tone of recent U.S. economic data and the potential vulnerability of the dollar to a general pullback of international capital further damped market sentiment. The drop of the dollar occurred despite continued signs of weak growth in the euro area and Japan and sizable reductions in the yields of their long-term government securities.

Growth of M2 fell considerably in December. Much of the deceleration was concentrated in the liquid components of the aggregate, likely reflecting in part an adjustment in the volume of mortgage refinancings and the associated prepayments on mortgage-backed securities.

The staff forecast prepared for this meeting suggested that the expansion of economic activity would be muted in the very near term. Faced with intensified geopolitical tensions as well as continuing pessimism about the near-term course of economic activity, labor mar-

ket conditions, and corporate earnings, businesses and consumers were likely to hold down their spending. In addition, continued sluggish economic growth among most major trading partners would tend to damp U.S. exports. However, those restraining influences were expected to abate over time. The considerable monetary ease already in place, the prospect of significantly more fiscal stimulus, the continuing strong gains in structural productivity, and the anticipated improvement in business confidence would provide significant impetus to spending. Inventory overhangs had been largely eliminated, and business capital stocks had moved closer to desired levels. As a consequence, a slowly improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to gradually boost business investment spending. The persistence of underutilized resources would tend to foster some moderation in core price inflation.

In the Committee's discussion of current and prospective economic developments, members emphasized that their forecasts were subject to substantial uncertainties, dominated at this point by the geopolitical situation, but they continued to view a pickup in economic growth as a reasonable expectation for the year ahead. Household spending had been well maintained over the course of recent months, but a high degree of caution had induced business firms to continue to hold down their spending and hiring. It was suggested that the uncertainties relating to geopolitical tensions and possible war in Iraq, important factors contributing to business caution, might be at least partly resolved in the near term, helping to roll back some of the recent increase in oil prices and likely having favorable implications for

consumer and business spending. Even so, the response of the economy was hard to anticipate because of the difficulty of disentangling the effects of current geopolitical tensions from the underlying momentum of the economy. Moreover, even a short and successful military campaign could give rise to a variety of disruptions that might limit at least for a time an improvement in business and consumer confidence.

The members nonetheless saw a number of favorable factors that could be expected to foster a relatively robust economic expansion over time. These included a stimulative monetary policy along with generally accommodative financial conditions, the prospect of additional fiscal stimulus, an increasing need for expenditures by business firms to replace depreciated equipment and to maintain acceptable inventory levels, and continued vigorous growth in productivity that would support profits and incomes. With regard to the outlook for inflation, prospective growth of spending in line with the members' forecasts likely would continue to be associated with only muted pressures on labor and other resources over the year ahead, and given current trends in productivity, members anticipated that consumer price inflation would remain subdued; indeed, modest further disinflation might occur over the year ahead.

In preparing for the semiannual monetary policy report to Congress, the Board members and Reserve Bank presidents provided individual projections of the growth of GDP, civilian unemployment, and consumer price inflation for the year 2003. The members agreed that because of the unusual uncertainties that clouded their current forecasts, the latter should be viewed as having extremely wide confidence bands. Their forecasts envisaged a strengthening economic recovery but

not one that was likely to induce a material, if any, decline in the unemployment rate over the year ahead. Their forecasts of growth in real GDP for 2003 had a central tendency of $3\frac{1}{4}$ to $3\frac{1}{2}$ percent and a full range of 3 to $3\frac{3}{4}$ percent, measured as the change between the fourth quarter of 2002 and the fourth quarter of 2003. Their projections of the civilian unemployment rate in the fourth quarter of the year were all in a range of $5\frac{3}{4}$ to 6 percent. Their forecasts of consumer price inflation for the year, as measured by the PCE chain-type price index, were centered in a range of $1\frac{1}{4}$ to $1\frac{1}{2}$ percent, with a full range of $1\frac{1}{4}$ to $1\frac{3}{4}$ percent.

In the Committee's discussion of developments in key sectors of the economy, members continued to place emphasis on the critical role of business spending and hiring decisions in determining the strength of the expansion. An elevated level of business caution clearly was holding back investment spending, and there were few signs of a pickup in the near term. Given an eventual reduction in prevailing uncertainties, however, a number of members noted that the outlook for business spending was favorable, and they did not rule out a sharp snapback in business expenditures as the year progressed. Factors cited in support of this view included the wide availability and low cost of capital, the increasing need for replacing worn and outdated capital equipment with the passage of time, a decline in overall stocks of capital in relation to the economy's growing potential, and the anticipated continuation of what appeared to be an upward trend in sales, cash flows, and profits. Some members also referred to the positive effects on some business decisions of the temporary federal tax incentives for expenditures on business equipment and software. The members agreed that

the strength and timing of the prospective improvement remained subject to a high degree of uncertainty. Indeed, a number of members commented that it was possible that some easing of geopolitical tensions would not lead to a major near-term upturn in business confidence and business expenditures. Such an outcome would be especially likely if oil supplies were disrupted, a threat that could not be ruled out, with adverse consequences for oil prices and business costs. Moreover, the current excess capacity would permit many firms to meet likely demands for some period of time without a significant increase in capital investments.

The evident uncertainty and pessimism in the business community were also reflected in tight inventory control policies. Despite continuing gains in final sales, inventories were estimated to have changed little in the fourth quarter and currently were at levels that were widely viewed as unusually low in relation to sales. In these circumstances, an easing at some point of current uncertainties and strengthening confidence should induce inventory rebuilding, with positive implications, at least for a time, for the expansion of economic activity.

The household sector had continued to provide vital support to overall demand in recent months despite a deteriorating trend in consumer confidence. While numerous contacts reported generally disappointing holiday sales in an environment of atypically large and widespread discounting, a surge in motor vehicle sales in December fostered by aggressive sales incentives and some pickup in retail sales late in the holiday season helped to sustain moderate overall growth in consumer spending through the year-end. Looking ahead, a number of factors seemed likely to undergird consumer spending, including the positive effects on perma-

ment incomes of robust ongoing growth in productivity, the possibly accelerated phase-in of tax reductions stemming from earlier legislation, the prospects for additional reductions in federal taxes affecting household incomes, and more generally the continued favorable effects of low interest rates and widely available financing on consumer purchases of motor vehicles and other durables. At the same time, some members expressed concern about the potential for adverse effects on consumer incomes and confidence should stagnant conditions persist in labor markets and equity markets weaken further. Reference also was made to the possibility suggested by some analysts that the value of housing wealth might be leveling off. In that event mortgage refinancings might moderate once mortgage rates stabilized, reducing the impetus to consumer spending from this source.

Statistical indicators of housing activity and anecdotal reports from numerous parts of the country pointed to persisting strength in homebuilding, with no signs of a slowdown in most areas. Members generally anticipated that activity in this sector of the economy would be well maintained in the context of low mortgage rates and further growth in incomes, but a few expressed reservations about forecasts of a further pickup this year.

The members anticipated the enactment of new legislation that would add to the fiscal stimulus that was already incorporated in earlier legislation. While greater fiscal stimulus appeared to be desirable to counter near-term weakness in the economy, the new legislation probably could not be enacted in time to begin to exert an expansionary impact on the economy before the latter part of this year when the anticipated strengthening of the economy might already be well under way. Members also observed

that, given the competing legislative proposals currently under consideration, the eventual components and size of that legislation were very uncertain at this point, though they were likely to be importantly influenced by the performance of the economy and especially labor market conditions over coming months. A number of members expressed the hope that the legislation would not encompass provisions that would lead to permanently large federal deficits with negative consequences for the economy over the longer term.

As they had at previous meetings, members also commented on the severe fiscal problems being experienced by numerous state and local governments. It was noted that state revenue shortfalls were being aggravated by federally mandated costs related to homeland security that were not, at least currently, being reimbursed by the federal government. Another problem related to certain tax proposals under consideration in the Congress, notably the exclusion of dividends from income, that could have adverse consequences for the revenues of numerous state and local governments that linked their taxable incomes to those reported on federal returns. More generally, while state and local efforts to redress budget imbalances were likely to offset only a small part of the probable stimulus in forthcoming federal legislation, some members commented that those efforts might well involve more fiscal restraint than was currently foreseen by some analysts.

Largely reflecting their expectations of ongoing, albeit diminishing, slack in labor and product markets, the members anticipated that consumer price inflation probably would edge down over the next several quarters from an already low level. Members also referred to a number of crosscurrents bearing on the outlook for prices that included the adverse

effects of recent declines in the dollar and higher oil prices but also the opposing effects of a strong uptrend in productivity and highly competitive markets in holding down prices and costs. With regard to labor costs, members cited anecdotal evidence of persisting weakness in numerous regional labor markets and, given the current reluctance of employers to add to their workforces, the prospect that job gains and labor compensation would tend to lag the anticipated strengthening in economic activity, as they often had in the past.

In the Committee's discussion of policy for the intermeeting period, all the members supported a proposal to maintain an unchanged policy stance. While the economy had continued to grow slowly, monetary policy and overall financial conditions had remained accommodative and the prospects for an appreciable strengthening of the economic expansion over time were favorable. As some of the prevailing uncertainties currently impairing spending began to lift, possibly in the near term with regard to military developments in the Middle East, the Committee should be in a much better position to assess the underlying strength of the economy and the appropriate policy response. At this point, the Committee could not rule out a range of plausible economic outcomes, including the possibility of a persisting subpar economic performance or a much stronger than forecast acceleration of the expansion. Indeed, the Committee could envision circumstances when it might find it desirable to adjust its policy stance substantially and promptly in one direction or the other in the months ahead. The members concluded that a wait-and-see policy stance was desirable pending an improved basis for judging the ongoing performance of the economy. They also agreed that the accommodative stance of policy, devel-

opments over the intermeeting period, and their current forecasts in the context of tensions abroad argued for retaining a balanced risks assessment to be included in the statement that would be made public shortly after this meeting.

At the conclusion of this discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¼ percent.

The votes encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting.

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are balanced with respect to prospects for both goals in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, and Bernanke, Ms. Bies, Messrs. Broadus, Ferguson, Gramlich, Guynn, Kohn, Moskow, Olson, and Parry.
Vote against this action: None.

It also was agreed that the next meeting of the Committee would be held on Tuesday, March 18, 2003.

The meeting adjourned at 12:55 p.m. on January 29, 2003.

Vincent R. Reinhart
Secretary

Meeting Held on March 18, 2003

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, March 18, 2003, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
Mr. Guynn
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Parry

Mr. Hoenig, Ms. Minehan and Pianalto, and Mr. Poole, Alternate Members of the Federal Open Market Committee

Messrs. McTeer, Santomero, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Eisenbeis, Goodfriend, Howard, Hunter, Lindsey, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Madigan, Deputy Director, Division of Monetary Affairs, Board of Governors

Messrs. Slifman and Oliner, Associate Directors, Division of Research and Statistics, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Clouse, Assistant Director, Division of Monetary Affairs, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Connolly, First Vice President, Federal Reserve Bank of Boston

Messrs. Fuhrer and Hakkio, Ms. Mester and Perelmuter, Messrs. Rasche, Rosenblum, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Boston, Kansas City, Philadelphia, New York, St. Louis, Dallas, and Cleveland respectively

Mr. Rudebusch, Vice President, Federal Reserve Bank of San Francisco

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on January 28–29, 2003, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets

and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period January 29, 2003, through March 17, 2003. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period.

The information reviewed at this meeting suggested that growth of economic activity remained subpar in the opening months of the year. While the underlying demand for residential housing continued to be robust and government outlays evidently were rising, the expansion of consumer spending seemed to have slowed, and outlays for capital spending were still very sluggish in an environment of business uncertainty and pessimism. Declining motor vehicle output held down overall industrial production, and the labor market weakened further. Consumer price inflation as measured by the core CPI decelerated over the past year, but steep increases in energy prices boosted overall price inflation.

Private nonfarm payroll employment had fallen sharply on balance in recent months, though the quite large February decline may have been exaggerated by bad weather, military reserve call-ups, and seasonal adjustment difficulties. February job losses in manufacturing were at about the same pace as seen over the past year. However, layoffs in construction surged, likely reflecting the unusually adverse winter weather conditions over much of the country. There were widespread declines in employment in the service sector, particularly in industries that had experienced steady growth last year. Job losses in the transportation industry seemed to have been associated in part with higher fuel costs.

The unemployment rate inched up to 5.8 percent in February, and the most recent readings on initial claims for unemployment insurance suggested that labor market conditions remained soft in March.

Industrial production edged up in February after a sharp rise in January. Electricity generation increased substantially in response to unseasonably cold weather in much of the East, and mining production picked up. Manufacturing was pulled down in February by a slump in motor vehicle assemblies, but the output of high-tech goods registered another sizable gain, reflecting continuing growth in the production of semiconductors and computers, and output of goods other than motor vehicles and high-tech goods was unchanged. With manufacturing production lower, capacity utilization in manufacturing slipped somewhat in February to a rate substantially below its long-run average.

Retail sales were lower on balance in January and February, partly reflecting a decline in motor vehicle sales in both months and snowstorms that kept many consumers at home in February. In addition, rising energy prices eroded part of the sluggish gains in consumer incomes, and both consumer sentiment and net worth deteriorated noticeably.

With mortgage rates remaining near historical lows, strength in residential housing demand carried through the early part of this year. However, bad weather in February disrupted single-family construction activity and single-family starts fell sharply from January's very high level. Sales of both new and existing homes slipped noticeably in January but remained at elevated levels. In the multifamily sector, where vacancy rates are high and rents have fallen, starts dropped considerably to about the average pace recorded over the past three years.

Business investment on equipment and software increased briskly in the fourth quarter of last year as outlays for aircraft climbed sharply and other major categories recorded gains. In January, a rise in shipments of nontransportation capital equipment suggested that the demand for such goods on the part of businesses was beginning to respond to continued increases in output and further declines in the cost of capital. In the high-tech sector, shipments of computing equipment surged in January, and shipments of communications equipment registered sizable gains. Outside the high-tech sector, however, shipments edged down. Data on orders for durable equipment placed in December and January suggested that shipments could strengthen in the coming months. In the nonresidential sector, construction activity slowed further in the fourth quarter, with most categories recording sizable declines in expenditures. Many indicators of market conditions in the nonresidential sector continued to weaken, with vacancy rates rising and rents generally falling, but an upturn in property values suggested that a turnaround in rents might be near.

The book value of manufacturing and trade inventories excluding motor vehicles edged down in January following buildups of stocks in the third and fourth quarters of last year. The aggregate inventory–sales ratio for this sector had trended down from the high levels recorded in mid-2001 and reached a new low in January, with few imbalances evident across industries.

The U.S. trade deficit in goods and services narrowed substantially in January as the value of exports partially reversed a large December decline and the value of imports fell from elevated November and December levels. The rise in exports and the drop in imports were broadly spread across goods cate-

gories. Available information on economic activity abroad indicated that most of the major foreign economies experienced sluggish growth late in 2002 that seemed likely to persist in the first quarter. Economic expansion in the euro area weakened further in the fourth quarter and Canadian output decelerated sharply, but growth in Japan was relatively well sustained at a modest pace. In the emerging-market economies, conditions in South America generally remained fragile, the pace of economic recovery in Mexico appeared to have slowed somewhat, and growth was generally restrained in much of emerging Asia. Economic growth in China remained strong.

Most measures of core consumer prices and labor costs decelerated in the twelve-month period ended in January. However, the recent jump in gasoline and heating oil prices, reflecting a sharp run-up in crude oil prices and unusually cold weather in the Midwest and East, significantly boosted overall consumer price inflation in the twelve months ended in January. At the producer level, core price inflation for finished goods eased in the twelve-month interval ending in February. With regard to labor costs, hourly compensation for private industry workers decelerated noticeably in 2002, with growth of both the salary and benefits components slowing on a year-over-year basis. Growth in average hourly earnings of production or non-supervisory workers also slowed in the twelve months ending in February. The deceleration in both labor measures likely reflected in part the slack in labor markets.

At its meeting on January 28–29, 2003, the Committee agreed on a directive that called for maintaining conditions in reserve markets consistent with keeping the federal funds rate around 1¼ percent and retained a balanced risks

assessment. The Committee noted that the economy continued to grow slowly, but monetary policy and financial conditions were quite accommodative and the prospects for an appreciable strengthening of the economic expansion over time remained favorable. The Committee concluded that a wait-and-see policy stance was desirable pending an improved basis for judging the ongoing performance of the economy. The Committee's decision was widely anticipated and elicited little reaction in financial markets. However, with the likelihood of war perceived to have increased, investor wariness apparently intensified downward pressure on equity prices and interest rates over the intermeeting period. Treasury bond yields declined somewhat, perhaps reflecting both expectations of lower policy rates and greater investor demands for safety. Rates in private debt markets fell by somewhat more than comparable-maturity Treasury yields. Declines in major equity indexes were amplified by lackluster earnings reports and disappointing data on auto sales, labor market conditions, and consumer confidence.

The dollar changed little on balance over the intermeeting period in terms of an index of major foreign currencies, though the dollar fluctuated widely in the latter part of the period in reflection of market concerns about geopolitical uncertainties. The dollar depreciated against the Canadian dollar, which was supported by a small monetary tightening action by the Bank of Canada to trim inflationary pressures. By contrast, the dollar appreciated slightly against the British pound, partly in response to an unexpected easing by the Bank of England to counter downward pressures on economic activity. The European Central Bank also cut its key policy rates in response to further signs of eco-

nomie weakness in major euro-area countries. The dollar was also little changed against an index of the currencies of other important U.S. trading partners.

M2 grew rapidly in February, owing mainly to robust inflows to liquid deposits. Earlier filings for tax refunds and hefty mortgage prepayments associated with refinancing activity likely were factors in the strength of M2. In addition, investors might have seen liquid deposits as a safe haven at a time of considerable volatility in equity markets.

The staff forecast prepared for this meeting continued to suggest that economic expansion would be muted for a time. Faced with the likely onset of war in the very near term and the large uncertainties relating to its aftermath, businesses and consumers were likely to hold down their spending. In addition, continued sluggish economic growth among most major U.S. trading partners was expected to damp U.S. exports. Nonetheless, those restraining influences were expected to abate over time. The considerable monetary ease already in place and the likely prospect of significantly more fiscal stimulus would combine with expected continuing strong gains in structural productivity and improving business and consumer confidence to provide significant impetus to spending. Inventory overhangs had been largely eliminated and business capital stocks had moved closer to desired levels. As a consequence, a slowly improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to gradually boost business investment spending. The persistence of underutilized resources was expected to maintain some downward pressure on core price inflation over the forecast period.

In the Committee's discussion of current and prospective economic developments, members commented that an unusually high degree of uncertainty had made it very difficult to assess the factors underlying the performance of the economy. Widespread indications of a strengthening economy near the end of last year through the first part of this year had given way to a disappointing economic performance more recently. It seemed clear that an outbreak of war with Iraq was imminent and that this prospect was having a damping effect on the economy. Uncertainty about the effects of the war had contributed to higher energy prices, lower equity prices, declines in measures of household confidence, and a tendency for households and especially businesses to postpone making commitments. But it was also possible that a part of the recent weakness might reflect underlying economic conditions. In the circumstances, some clarification of the Iraqi situation, which might occur in the relatively near future, should improve the Committee's ability to assess ongoing developments, though uncertainties would remain. Beyond the near term, members acknowledged that relatively subdued growth for a time could not be ruled out, but many commented that the conditions were in place for a strengthening expansion. In this regard they referred to the positive effects on business profits and consumer incomes of persisting gains in productivity, stimulative monetary and fiscal policies, and accommodative financial and bank lending markets. The likelihood of continued low or even declining inflation was high, especially given expectations of persisting slack in resource utilization.

In the course of the Committee's review of developments in key sectors of the economy, members underscored the retarding effects of reduced confi-

dence and heightened caution on household and business spending but noted that it was difficult to attribute the relative contributions of geopolitical risk and worries about the economy to the emergence of weaker spending. In any event, consumer expenditures appeared to have been held back recently by the impact of higher energy costs, weak labor markets, and severe winter weather in the eastern part of the United States. Sales of motor vehicles had declined substantially since the start of the year despite the introduction of enhanced sales incentives. Non-automotive retail sales, after a pickup at the end of 2002 that had extended through the first several weeks of this year, had weakened more recently. Whether the recent experience augured further softening in consumer spending was uncertain, but some members commented that this weak performance was not reassuring with regard to forecasts of substantial strengthening of the expansion later this year. Many observed, however, that a favorable outcome to the hostilities in the Middle East and lower oil prices in line with quotations in futures markets should generate a positive response in equity markets, boost consumer sentiment, and foster a rebound in consumer spending as the year progressed.

Housing activity had held up well on the whole, despite a negative report on housing starts for February, and indeed was displaying continued strength in many parts of the nation. In numerous areas, however, sales of high-end homes had continued to lag and there were reports of a softening in the middle-market single-family sector in some areas. Members also cited indications of overbuilding in some parts of the country, notably of multifamily housing. On balance, generally robust homebuilding activity was expected to persist against

the backdrop of low mortgage interest rates and rising household incomes.

With regard to the outlook for business capital expenditures, members commented that a variety of factors likely would induce business firms to continue to hold back on new investment initiatives, at least over the near term. Indeed, there was as yet no persuasive evidence that business fixed investment would provide the needed support for the strengthening in overall economic activity. Geopolitical uncertainties, notably those relating to developments in Iraq, frequently were cited by business contacts as a major reason for caution, but other factors inhibiting capital expenditures evidently included excess capacity and limited prospects for profits because of increased energy, insurance, pension, and other costs and a concomitant inability to raise selling prices. At the same time, there was only limited evidence thus far that the partial-expensing tax incentive, scheduled to expire in September 2004, was having a measurable effect on outlays for new equipment and software. The outlook for commercial construction activity was especially downbeat because of high vacancy rates in industrial and office structures in many areas, and a general upturn in such construction was viewed as unlikely to occur for an extended period of time. While resolution of some of the uncertainties relating to Iraq seemed likely in the relatively near term, many business contacts reported that they would continue to hold down their capital investments until demand for their goods and services and related profit opportunities displayed clear signs of significant improvement. Some members nonetheless referred to indications of increasing expenditures for various categories of high-tech equipment and software, and they noted that impetus to demand from

a positive outcome in the war against Iraq should have a favorable effect on business capital spending, especially if it were accompanied by a rally in the stock market.

Many firms were trying to keep their inventories at especially low levels in light of their concerns that projected sales might not materialize. Members cited the resulting lean inventories as a positive element in the outlook for economic activity, given likely efforts by business firms to maintain inventories in broad alignment with anticipated growth over time in final sales.

Federal government spending continued to rise rapidly, led by large increases in defense and homeland security expenditures, and members noted that the resulting impetus to growth might be augmented by passage of a fiscal stimulus package in line with that proposed by the Administration. Considerable uncertainty surrounded the eventual size of such a package or even whether it would be enacted this year. A partial offset to the federal fiscal stimulus stemmed from efforts to address deepening budget crises in a number of states and their adverse implications for many local economies.

Against the background of persistent strength in productivity growth and continued low levels of capital and labor utilization, inflation would likely remain subdued going forward. Indeed, members saw further disinflation in core prices as a distinct possibility over the next several quarters. At the same time, the outlook for oil prices and energy prices more generally was uncertain and, despite market expectations, oil prices might remain relatively high in the event of adverse developments in Iraq and in some other major oil producing countries that were experiencing serious economic and political problems. However, high oil prices, should

they persist, were likely to have more of an effect in damping demand than in raising inflation, given well-entrenched expectations of low inflation.

In the Committee's discussion of policy for the intermeeting period ahead, the members unanimously supported a proposal to maintain an unchanged policy stance. While the economic expansion had displayed signs of faltering in recent weeks, the reasons for and hence the duration of any period of weakness could not be reliably ascertained. In that regard, members commented that as key geopolitical uncertainties diminished or were resolved, the Committee would be in a much better position to assess economic trends and a desirable course for monetary policy. Monetary policy was positioned to accommodate a strengthening economic performance that seemed likely to materialize once key uncertainties and related concerns began to decrease, perhaps in the relatively near future, and business and consumer sentiment started to improve. To be sure, the timing and speed of a pickup in economic activity were not clear, and some members saw continued growth below potential as the primary risk for the near term. The members concluded that the prudent course in current circumstances was to maintain a steady policy stance, a high degree of vigilance, and a readiness to respond promptly as needed to the emergence of clearer evidence relating to the performance of the economy. In the latter regard, some members cautioned that the Committee might well need to adjust its policy in circumstances that continued to be characterized by a substantial degree of uncertainty.

The Committee decided to omit its usual statement regarding the balance of risks from the press release to be made public shortly after the meeting. Most members believed that the major uncer-

tainties surrounding the geopolitical situation made it impossible to assign reasonable probabilities to plausible alternative economic outcomes and that any effort to do so would provide a misleading impression of the Committee's confidence and knowledge about the economic outlook. In light of these considerable uncertainties, the members agreed that heightened surveillance of evolving economic trends would be especially useful in the weeks ahead. At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¼ percent.

Votes for this action: Messrs. Greenspan, McDonough, Bernanke, Ms. Bies, Messrs. Broaddus, Ferguson, Gramlich, Guynn, Kohn, Moskow, Olson, and Parry. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 6, 2003.

The meeting adjourned at 12:50 p.m.

Following the outbreak of war in Iraq, the members of the Committee participated in a series of conference calls held on March 25, April 1, April 8, and April 16 in order to keep abreast of the latest information and to exchange views regarding the possible implications of current developments for the economic outlook and monetary policy.

No policy decisions were made in this period.

Vincent R. Reinhart
Secretary

Meeting Held on May 6, 2003

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 6, 2003, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
Mr. Gynn
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Parry

Mr. Hoenig, Ms. Minehan and Pianalto, Messrs. Poole and Stewart, Alternate Members of the Federal Open Market Committee

Messrs. McTeer, Santomero, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming,
Messrs. Eisenbeis, Goodfriend,
Howard, Hunter, Judd, Lindsey,
Struckmeyer, and Wilcox,
Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

Messrs. Slifman and Oliner, Associate Directors, Division of Research and Statistics, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Clouse, Assistant Director, Division of Monetary Affairs, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Fuhrer and Hakkio, Ms. Mester and Perelmuter, Messrs. Rasche, Rosenblum, Rolnick, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Boston, Kansas City, Philadelphia, New York, St. Louis, Dallas, Minneapolis, and Cleveland respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 18, 2003, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period March 18, 2003, through May 5, 2003. By unanimous vote, the Committee ratified these transactions.

With Mr. Broaddus dissenting, the Committee voted to extend for one year beginning in mid-December 2003 the reciprocal currency (“swap”) arrangements with the Bank of Canada and the Bank of Mexico. The arrangement with the Bank of Canada is in the amount of \$2 billion equivalent and that with the Bank of Mexico in the amount of \$3 billion equivalent. Both arrangements are associated with the Federal Reserve’s participation in the North American Framework Agreement. The vote to renew the System’s participation in the swap arrangements maturing in December was taken at this meeting because of the provision that each party must provide six months prior notice of an intention to terminate its participation. Mr. Broaddus dissented because he believed that the swap lines exist primarily to facilitate foreign exchange market intervention, and he was opposed to such intervention for the reasons he had expressed at the January meeting.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period.

The information reviewed at this meeting suggested that economic activity continued to grow at a subpar pace in recent months. Consumer spending advanced slightly in the first quarter and housing activity remained at a high level, but business investment slowed. Industrial production was sluggish, and additional slack accumulated in the labor market. Core consumer inflation

had moved lower, but overall consumer prices had been pushed up recently by sharp rises in energy prices.

Private nonfarm payroll employment continued to fall in April. Manufacturing employment registered widespread losses, and the retail trade, transportation, and utilities industries extended their declines of prior months. The unemployment rate rose to 6 percent in April, with increases spread widely across most demographic groups. Initial claims for unemployment insurance remained at an elevated level, suggesting further labor market weakness in May.

Industrial production fell in March, and weekly physical product data and other indicators pointed to another drop in April. Lower output at utilities accounted for some of the decline in overall production in March but manufacturing output, especially motor vehicle assemblies, fell again. Total industrial capacity utilization declined in March, with capacity utilization in manufacturing reaching a twenty-year low.

Real personal consumer expenditures rose in March and for the first quarter as a whole. Spending on durable goods increased in March but was down a bit for the full quarter. By contrast, spending on services and nondurable goods fell in March but was up on balance in the first quarter. Disposable income was unchanged in March. Measures of consumer confidence rebounded sharply in April after sizable declines in February and March.

Residential housing activity remained solid, though some signs of potential moderation emerged. Supported by continued low mortgage rates, first-quarter housing starts in the single-family sector stayed at the high level of the fourth quarter. Multifamily starts also changed little in the first three months of the year

and vacancy rates in the sector remained high. Sales of existing homes were off a bit in March, but sales for the first quarter as a whole edged up from the fourth-quarter rate. New home sales, however, were down from their fourth-quarter pace.

Real outlays on equipment and software declined in the first quarter after rising moderately over the three preceding quarters. A sharp drop in purchases of transportation equipment more than accounted for the first-quarter decline. The weakness in the transportation category reflected sluggish expenditures for aircraft, medium and heavy trucks, and light vehicles. By contrast, the high-tech category recorded strong growth owing to a surge in spending for computer and peripheral equipment and an upturn in purchases of communications equipment. Although investment fundamentals, such as corporate cash flows and reduced costs of capital, remained favorable, reports from businesses were downbeat. The extended decline in real investment spending on nonresidential structures moderated further in the first quarter, with the smallest decline since the first quarter of 2001.

Real nonfarm inventories excluding motor vehicles appeared to have declined a little in the first quarter after accumulating in recent quarters. The buildup of manufacturing and trade inventories, however, continued in January and February at an average pace similar to that of the second half of 2002. Relative to sales, non-auto inventory stocks in most sectors were low by recent standards. According to industry reports, inventories in the motor vehicle industry apparently had risen above desired levels.

The U.S. trade deficit in goods and services narrowed slightly in February and brought the average deficit for January and February to an annual rate near

that of the fourth quarter. The narrowing in February was accounted for by a small decline in imports and a marginal rise in exports. Recent indicators suggested continued sluggish economic growth in most foreign industrial nations. The Japanese economy was about flat in the early months of the year, activity in the euro area remained subdued, and first-quarter growth in the United Kingdom was lackluster. Canadian domestic demand remained relatively robust but appeared to be slowing. Economic conditions in other countries were mixed. In Latin America, Mexican data releases pointed toward increases in economic activity, and the Argentine economy continued to show signs of recovery. In contrast, Venezuela remained in crisis, and economic activity in Brazil appeared to have moderated despite improved financial market conditions. In developing Asia, indicators suggested that economic growth had slowed in much of the region. China, however, registered robust growth in the first quarter.

Core consumer price inflation moved down further in the first quarter from its already low level. A sharp run-up in energy prices, however, pushed up overall consumer prices in the first quarter and in the year ended in March (measured by both the consumer price index and the chain-type personal consumption expenditure index). Producer prices also were boosted significantly by the jump in energy prices in recent months. Core producer prices were up appreciably in the first quarter but at a slower pace than overall producer prices. With regard to labor costs, the employment cost index for hourly compensation of private industry workers rose at a faster rate during the three months ended in March, reflecting increases in wages and salaries and in benefit costs. The expansion of compensation costs over the

twelve months ended in March was virtually the same as in the previous twelve-month period.

When the Committee met on March 18, 2003, the nation appeared to be on the brink of war. At the end of that meeting, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the federal funds rate around 1¼ percent. The Committee agreed to indicate in its announcement that in light of the unusually large uncertainties clouding the geopolitical situation in the short run and their apparent effects on economic decisionmaking, it could not at that time usefully characterize the current balance of risks with respect to the prospects for its long-run goals of price stability and sustainable economic growth. The Committee also agreed that heightened surveillance would be particularly informative. It was noted that while the recent economic data were mixed, the hesitancy of the economic expansion appeared to owe significantly to oil price premiums and other aspects of geopolitical uncertainties. The Committee believed that as those uncertainties lifted, the accommodative stance of monetary policy, coupled with the ongoing growth in productivity, would provide vital support toward fostering improving economic performance over time.

The decision to leave policy on hold had been largely anticipated by market participants, but the inclusion in the policy announcement of a reference to “heightened surveillance” led initially to downward revisions to expectations for the future path of the federal funds rate. The abatement of war-related risks was reflected in sizable declines in forward-looking measures of uncertainty in short- and long-term interest rates, exchange rates, and oil and equity prices. Nearer-term Treasury yields

had fallen, but longer-term Treasury yields had changed little since the March meeting. Risk spreads on corporate debt securities narrowed across the credit quality spectrum. Broad equity indexes registered notable gains related to better-than-expected corporate earnings reports.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies declined over the intermeeting period. The dollar depreciated somewhat more against the euro and the Canadian dollar and only slightly against the Japanese yen. The dollar also declined against an index of currencies of other important trading partners. Equity markets in the major industrial economies, except Japan, had risen significantly since the March FOMC meeting.

Growth in M2 slowed over March and April, but most of the deceleration appeared to be attributable to temporary tax-related flows of funds. A movement toward earlier electronic filing apparently weakened M2 in March by shifting refund distributions into February. Reduced M2 growth in April reflected, in part, slower-than-average buildups of deposits associated with final tax payments by individuals. Substantial net inflows to equity mutual funds occurred during the same period.

The staff forecast prepared for this meeting continued to suggest that economic expansion would be sluggish in the near term. Faced with persisting weakness in product and labor markets, businesses and consumers were likely to hold down their spending. In addition, continued slow economic growth in most of the nation’s major trading partners would tend to restrain U.S. exports, though those restraints were expected to abate over time. The cumulative effects of an accommodative monetary policy, likely further reduction

in taxes, and robust gains in structural productivity would provide significant impetus to spending. Inventory overhangs had been substantially reduced, and business capital stocks had moved closer to desired levels. As a consequence, a slowly improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to gradually boost business investment spending. Given the ongoing slack in resource utilization, downward restraint on core price inflation was expected to persist over the forecast period.

In the Committee's discussion, members commented that the recent information bearing on the economic outlook was mixed. The latest reports on economic activity generally were disappointing, notably those relating to employment and production, but members noted that most of these reports covered developments occurring before the end of hostilities in Iraq. The successful prosecution of the war had served to reduce geopolitical uncertainties and in turn had helped to foster a marked strengthening of domestic financial markets, a sizable decline in oil prices, and an apparent upturn in consumer confidence. In this improved environment, members anticipated that near-term sluggishness in economic growth would give way to more vigorous expansion as the year progressed. In support of this expectation, it was noted that if the substantial gains in financial markets experienced recently persisted, experience indicated that a stronger economic performance generally would follow. Favorable factors in the outlook mentioned by members included an accommodative monetary policy, prospective legislation that would increase an already stimulative fiscal policy, and evidence of a persisting uptrend in pro-

ductivity that provided enhanced investment opportunities and ongoing support for household incomes. Continued progress in lifting various constraints on economic growth, including the unwinding of excessive or misdirected capital expenditures undertaken in earlier years and the steps taken to address corporate governance and credit problems were also working to strengthen the expansion. Against that backdrop, it was noteworthy that many private-sector forecasters predicted a pronounced upturn in economic growth in the third quarter. Despite underlying factors that seemed increasingly conducive to an accelerating expansion, members noted that the timing and vigor of a pickup in economic activity remained uncertain, especially in the context of a persistently high degree of caution in the business community with regard to investment and hiring decisions. With the removal of key uncertainties associated with the Iraqi war, the information that would become available in the weeks ahead was expected to provide a clearer basis for assessing future trends in business spending and, more generally, the underlying strength of the economy. Members anticipated that inflation would remain at a low level for an extended period and indeed that the probability of further disinflation was higher than that of a pickup in inflation, given the current high levels of excess capacity in labor and product markets, which seemed likely to diminish only gradually.

Business fixed investment remained a key factor in the prospects for overall economic activity, and persisting weakness in such spending in association with gloomy sentiment and a high degree of risk aversion among business decisionmakers did not bode well for the capital investment outlook, at least for the near term. Anecdotal reports by business contacts tended to emphasize

widespread excess capacity as a reason for holding down business capital spending, including high vacancy rates in office and other business structures. In this atmosphere, most business decisionmakers evidently preferred to rely on the increasingly efficient or fuller utilization of existing producer facilities rather than expanding the latter to meet growth in demand. Indeed, according to business contacts, investment expenditures generally were limited to replacement and to some extent to upgrading of existing facilities rather than for expansion. In some cases, businesses reportedly were acquiring used capital equipment and unoccupied building space at greatly reduced costs, thereby holding down the current production of new capital but also relieving selling firms of some excess capacity.

Members nonetheless saw a number of favorable elements in the outlook for business investment expenditures. These included a decline in the cost of business capital, a recent rise in orders and backlogs of nondefense capital goods, persisting gains in productivity that undoubtedly pointed to growing profit opportunities, progress in strengthening business balance sheets, and reduced capital overhangs. With regard to business attitudes, members reported very recent but also widespread indications from their contacts that business confidence might be in the process of improving, though the upturn in confidence was not likely to show through to investment outlays for some time.

In the household sector, an appreciable decline in sales of motor vehicles and slower growth in other consumer spending in the first quarter appeared to reflect concerns relating to the Iraqi war and adverse weather conditions in some parts of the country. More recently, attractive sales incentives had boosted consumer purchases of motor vehicles,

albeit not as much as some industry contacts had hoped, and members referred to tentative signs of a pickup in retail sales. On balance, however, the members did not see any firm indications of significant acceleration in consumer spending. More positively, they cited recent survey and anecdotal evidence of improving consumer confidence and referred to the gains in the stock market as a source of potential impetus going forward. In the housing markets, activity currently was somewhat uneven across the nation but had remained at a high overall level. While favorable financing would help to sustain the housing sector, members anticipated that any further impetus to growth from that sector was likely to be limited.

The members expected economic activity to be supported by substantial fiscal stimulus in coming quarters, with that already built into existing federal legislation likely to be augmented by further initiatives under active consideration in the Congress. However, budgets of numerous state and local governments remained under severe pressure, and efforts to contain spending and raise taxes by those governments would offset some of the federal stimulus this year and next. It was not clear at this point how some state and local governments would resolve their current budgetary crises and what the effects would be on many local economies.

A weakening dollar and sluggish economic conditions abroad were key factors impinging on the prospective contribution of the foreign sector to U.S. economic activity. While foreign demand for U.S. products and services would be supported by the dollar's depreciation, relatively weak foreign economic activity would tend to hold down such demand. On balance, the nation's trade deficit was likely to remain at an elevated level, with moder-

ate gains in exports more than offset by larger increases in imports if forecasts of relatively robust U.S. growth in fact materialized.

Even assuming a pickup in the expansion of economic activity in line with current forecasts for this year and next, excess capacity in labor and product markets would remain elevated and might well foster further disinflation over coming quarters. The decline in inflation might be limited to some extent by the depreciated value of the dollar in foreign exchange markets and by the anticipated effects of further large increases in worker benefit costs. Given the pressure of a considerable amount of unused resources, any adverse developments that held down economic expansion would increase the probability of further disinflation. Members commented that substantial additional disinflation would be unwelcome because of the likely negative effects on economic activity and the functioning of financial institutions and markets, and the increased difficulty of conducting an effective monetary policy, at least potentially in the event the economy was subjected to adverse shocks. Members also agreed that there was only a remote possibility that the process of disinflation would cumulate to the point of a decline for an extended period in the general price level.

In the Committee's discussion of policy for the intermeeting period ahead, all the members indicated that they could support a proposal to maintain an unchanged policy stance. The members acknowledged that a case could be made for easing policy immediately in light of the generally disappointing reports on the recent performance of the economy, the ongoing disinflation trend in a period of already low inflation, and forecasts of persisting excess capacity. Nonetheless, they concluded that, on balance, an eas-

ing action was not desirable at this time. They noted that not enough time had elapsed since the end of the Iraqi war to sort out the underlying forces at work in the economy. In particular, the lifting of key uncertainties relating to the war would provide an improved opportunity to assess whether the favorable factors in the outlook would in fact lead to the anticipated strengthening in economic activity and, at the same time, diminish the risk of appreciable further disinflation. Some members cautioned that persisting uncertainty regarding economic trends should not provide a basis for prolonged inaction in light of the risks of further disinflation and subpar economic growth. In the absence of convincing indications of an appreciable pickup in economic growth, an easing move might be desirable in the near term, perhaps at the June meeting.

With regard to the press announcement to be released shortly after this meeting, the members supported new language that provided separate assessments of the risks to the goal for acceptable economic growth and the risks to the goal of price stability. They recognized that the usual summary statement did not allow for the circumstances in which the Committee saw some probability, albeit minor, of a significant further decline in inflation to an unwelcome level. After discussion, the members generally agreed on separate sentences indicating that the risks to its goal of sustainable economic growth were about balanced but that the probability of some disinflation from an already low level exceeded that of a pickup in inflation. The members also accepted a summary statement stating that, taken together, the balance of risks to the Committee's dual goals was tilted toward the downside over the foreseeable future. There was some concern that including such a summary sentence

in the press release might be mistakenly interpreted as an indication of Committee concern about the outlook for economic activity rather than a judgment about the relative odds on further inflation. Two members saw merit in adopting a balanced risks assessment at this meeting despite the evident shortcomings in present circumstances of the form of such statements in use in recent years.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive. Consistent with the decision made at the March meeting, the vote did not formally encompass the wording of the press statement to be released shortly after this meeting.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¼ percent.

Votes for this action: Messrs. Greenspan, McDonough, Bernanke, Ms. Bies, Messrs. Broaddus, Ferguson, Gramlich, Guynn, Kohn, Moskow, Olson, and Parry. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, June 24–25, 2003.

The meeting adjourned at 1:25 p.m.

Notation Vote

By notation vote completed on May 20, 2003, the Committee authorized Vice Chairman McDonough to accept the

“Order of the Aztec Eagle” honor to be awarded by the government of Mexico.

Votes for this action: Messrs. Greenspan, Bernanke, Ms. Bies, Messrs. Broaddus, Ferguson, Gramlich, Guynn, Kohn, Moskow, Olson, and Parry. Votes against this action: None. Abstention: Mr. McDonough.

Vincent R. Reinhart
Secretary

Meeting Held on June 24–25, 2003

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., starting on Tuesday, June 24, 2003, at 2:30 p.m. and continuing on Wednesday, June 25, 2003, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Bernanke
Ms. Bies
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
Mr. Guynn
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Parry

Mr. Hoenig, Mses. Minehan and Pianalto, Messrs. Poole and Stewart, Alternate Members of the Federal Open Market Committee

Messrs. McTeer, Santomero, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel

Ms. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming,
Messrs. Eisenbeis, Goodfriend,
Howard, Judd, Lindsey,
Struckmeyer, and Wilcox,
Associate Economists

Mr. Kos, Manager, System Open
Market Account

Messrs. Ettin and Madigan, Deputy
Directors, Divisions of Research
and Statistics and Monetary
Affairs respectively, Board of
Governors

Messrs. Slifman and Oliner, Associate
Directors, Division of Research
and Statistics, Board of Governors

Messrs. Clouse and Whitesell, Deputy
Associate Directors, Division of
Monetary Affairs, Board of
Governors

Mr. Reifschneider,⁷ Assistant Director,
Division of Research and
Statistics, Board of Governors

Mr. Orphanides,⁸ Adviser, Division
of Monetary Affairs, Board of
Governors

Mr. Elmendorf,⁷ Section Chief,
Division of Research and
Statistics, Board of Governors

Ms. Kusko,⁷ Senior Economist,
Division of Research and
Statistics, Board of Governors

Messrs. Bassett⁷ and Wood,⁷
Economists, Divisions of
Monetary Affairs and International
Finance respectively, Board of
Governors

Mr. Skidmore, Special Assistant to the
Board, Office of Board Members,
Board of Governors

Mr. Luecke, Senior Financial Analyst,
Division of Monetary Affairs,
Board of Governors

Ms. Low, Open Market Secretariat
Assistant, Division of Monetary
Affairs, Board of Governors

Mr. Barron, First Vice President,
Federal Reserve Bank of Atlanta

Messrs. Fuhrer and Hakkio,
Ms. Mester, Messrs. Rasche,
Rolnick, Rosenblum, and
Sniderman, Senior Vice
Presidents, Federal Reserve
Banks of Boston, Kansas City,
Philadelphia, St. Louis,
Minneapolis, Dallas, and
Cleveland respectively

Messrs. Evans, Hilton, and Kuttner,⁸
Vice Presidents, Federal Reserve
Banks of Chicago, New York, and
New York respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on May 6, 2003, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period May 6, 2003, through June 24, 2003. By unanimous vote, the Committee ratified these transactions.

The Committee discussed at length alternative means of providing mone-

7. Attended portion of meeting relating to the discussion of economic developments.

8. Attended portion of meeting relating to the discussion of the conduct of monetary policy in a period of very low interest rates.

tary stimulus should the target federal funds rate be reduced to a point where there was little or no latitude for additional easing through this conventional policy instrument. The members agreed that current economic conditions and the prevailing stances of monetary and fiscal policy made the need to use unusual monetary policy tools a quite remote possibility. Even so, they believed it was useful to discuss that possibility because of the implications for financial markets and institutions and for the conduct of monetary policy of reducing short-term interest rates to very low levels. An environment involving such interest rates could have adverse repercussions on the functioning of some sectors of the money market, but the members agreed that the potential extent of such disruptions would not be sufficient to prevent the Committee from taking advantage of the full scope of conventional easing of the federal funds rate, should that become necessary. Beyond that, a variety of nonconventional measures for further easing was available. In this regard, the members discussed the advantages and disadvantages of various approaches that, possibly employed in some combination, would alter the size and composition of the System's balance sheet. They also considered aspects of the Committee's communications as a means of underscoring to the public its willingness to follow a sufficiently accommodative path of monetary policy for as long as necessary to foster improved economic performance. The members did not see the need at this time to reach a consensus on the desirability of any specific nontraditional approach to the implementation of monetary policy, particularly given the low probability of its near-term use. As experience had shown, at times of economic and financial market stress the specific policy tools used would depend

on circumstances. For now, however, they believed that arriving at an understanding of the various options that might be employed prepared them to respond more flexibly and effectively to unanticipated developments. While considerable uncertainty surrounded each individual policy option, the members agreed that the effectiveness of these alternative tools, along with the 125 basis points of conventional easing still available, would allow monetary policy to combat economic weakness and forestall any unexpected tendency for a pernicious deflation to develop.

The information reviewed at this meeting suggested that the economy continued to expand at a subpar pace in recent months. Consumer spending increased moderately, housing activity held at a high level, and government outlays grew substantially. Business investment, however, was still soft. Industrial production and employment appeared to have stabilized after an extended period of weakness. Consumer price inflation remained at a very low level.

Private nonfarm payrolls changed little on balance in April and May after declines earlier in the year. Although employment in manufacturing continued to fall in May, hiring in temporary help services, which supplies many of its workers to manufacturing, picked up noticeably. Construction and financial services continued to add jobs. Unemployment edged up further in May, to 6.1 percent, and the number of both short-term job losers and longer-term unemployed increased as well. Initial claims for unemployment insurance remained high.

Industrial production increased slightly in May after sizable declines in the preceding two months. The manufacturing sector recorded broad-based improvement, though automobile

assemblies and the output of communications equipment continued to slide. The effects of strength in the mining sector on the industrial production index were more than offset by a reduction in utility output. Overall capacity utilization remained very low, with manufacturing utilization near a twenty-year low.

Real consumer outlays, excluding cars and trucks, were flat in April but turned up in May. Spending on motor vehicles rose over the two months from the first-quarter pace. At the same time, the fundamentals underlying household spending became more favorable: Real disposable income posted solid gains, and both the stock market and consumer confidence recovered from earlier in the year.

Activity in the housing market was reasonably well maintained in April and May. Despite unusually wet weather in many areas, starts of single-family and multifamily units in the two months were just a little below their strong first-quarter levels. Building permits for new single-family and multifamily homes were up from a depressed March level. Sales of both existing and new homes in April and May were above the high levels recorded in recent quarters.

Orders and shipments of nondefense capital goods were lackluster in April and May. This sluggish performance followed a first-quarter decline in real outlays on equipment and software that had more than reversed the fourth-quarter gains. Excluding purchases of transportation equipment, however, outlays grew a bit over the first quarter. Real investment in nonresidential structures dropped further in that quarter, though the rate of decline slowed. Outlays for office buildings and industrial structures were down sharply, and falling rents and rising vacancy rates in April suggested further weakness in the second quarter.

The book value of manufacturing inventories rose moderately further in the first quarter and in April. Relative to shipments and sales, inventories of manufacturers, wholesalers, and retailers have remained at quite low levels thus far this year.

The U.S. trade deficit in goods and services edged up in April from the first-quarter rate. Real GDP growth in the major foreign industrial countries remained weak in the first quarter as external demand sagged amid heightened geopolitical uncertainties. Real GDP growth continued to slow in the first quarter in Japan and the United Kingdom, and economic activity in the euro area was flat. By contrast, economic activity accelerated in Canada in the first quarter.

Sharp declines in energy prices pulled down overall consumer prices in April and May, but core consumer prices edged up. On a year-over-year basis, however, core consumer price inflation eased noticeably. Core producer price inflation also declined over the year ending in May. With regard to labor costs, average hourly earnings of production or nonsupervisory workers were flat in April and increased moderately in May. The twelve-month change was somewhat above that for the year earlier.

At its May 6, 2003, meeting the Federal Open Market Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the federal funds rate at around 1¼ percent. The Committee discussed a post-meeting release to the press stating that over the next few quarters the upside and downside risks to the attainment of sustainable growth were roughly equal, but that, in contrast, over the same period the probability of an unwelcome substantial fall in inflation, though minor, exceeded that of a pickup in inflation from its already low level.

The Committee also agreed to a statement that, taken together, the balance of risks to achieving its goals was weighted toward weakness over the foreseeable future. The Committee noted that, while the geopolitical tensions that had inhibited economic expansion in earlier months appeared to have diminished, the timing and extent of an improving economic performance could not be reliably ascertained. In the current circumstances, the members concluded the prudent course was to maintain a steady policy stance, a high degree of vigilance, and a readiness to respond promptly as needed to the emergence of clearer evidence relating to the performance of the economy.

The Committee's decision at the May meeting relating to the federal funds rate was not a surprise to most market participants. However, splitting the balance of risks statement into separate assessments about growth and inflation, in addition to noting a concern about a further possible decline of inflation from an already low level, led market participants to mark down their expectations for the federal funds rate. Consistent with those expectations, Treasury coupon yields declined 35 to 60 basis points. Yields on corporate bonds also fell about in line with rates on Treasuries even though capital markets absorbed a surge in bond issuance by highly rated firms. Equity prices, buoyed by the decline in bond yields as well as the improved outlook for economic growth, registered sizable gains over the intermeeting period.

The dollar continued to depreciate in terms of an index of major foreign currencies amid growing concerns about the financing burden of the large and growing U.S. current account deficit and questions by market participants about the commitment of U.S. authorities to a "strong dollar" policy. Long-term inter-

est rates fell in all major industrial economies, while equity prices rose substantially.

Growth of M2 surged in May. At least part of the acceleration was due to special factors related to strong mortgage refinancing activity and to the flow of funds associated with tax payments.

The staff forecast prepared for this meeting once again suggested that the economic expansion would strengthen substantially as the year progressed. Accommodative financial conditions, recent additional fiscal stimulus, and robust gains in structural productivity would provide significant impetus to spending over the months ahead. Inventory overhangs had been substantially reduced, and business capital stocks likely had moved closer to desired levels. As a consequence, improving sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected gradually to boost business investment spending. Given the ongoing slack in resource utilization, downward pressure on core price inflation was expected over the forecast period.

In the Committee's discussion of current and prospective economic developments, members referred to signs of improvement in some sectors of the economy, but they saw no conclusive evidence of an appreciable overall strengthening in the sluggish economic expansion. On the positive side, they pointed to reports of some pickup in retail sales, indications that labor and product markets might be stabilizing, continued robust activity in housing markets, and ongoing impetus from the federal government sector. Concurrently, however, weakness persisted in business capital expenditures, which members continued to view as the critical factor inhibiting the economic

expansion. Looking ahead, they emphasized that favorable underlying conditions were in place to support a substantial acceleration of the expansion, though the timing and dimensions of a significantly improved economic performance remained uncertain. Positive factors bearing on the outlook mentioned by members included the accommodative stance of monetary policy and supportive financial conditions more generally, the persistence of rapid growth in labor productivity, sizable declines in energy prices from elevated levels earlier in the year, and indications of rising consumer confidence and of less negative business sentiment. Members also gave considerable emphasis to the anticipated effects of recent legislation that in short order would add substantially to the degree of fiscal stimulus.

In their review of the outlook for inflation, members commented that currently elevated levels of unused labor and other resources were likely to persist for an extended period, even if economic growth turned out to be robust. And until it was substantially reduced, the output gap would undoubtedly preclude any significant acceleration in inflation and could well cause inflation to edge down from its already low level. At the same time, a substantial further decline in inflation was viewed as having a low probability, though disinflation would remain a matter of concern until a sustained pickup in overall economic activity was firmly established.

In preparation for the midyear monetary policy report to Congress, the members of the Board of Governors and the presidents of the Federal Reserve Banks submitted individual projections of the growth of GDP, the rate of unemployment, and the rate of inflation for the years 2003 and 2004. The members based these forecasts on their individual views as to the appropriate path of pol-

icy over the projection period and had the opportunity to update them until July 3. The forecasts of the rate of expansion in real GDP had central tendencies of $2\frac{1}{2}$ to $2\frac{3}{4}$ percent for 2003, implying that economic growth would accelerate noticeably in the second half of the year, and $3\frac{3}{4}$ to $4\frac{3}{4}$ percent for 2004. These rates of growth were associated with central tendencies for the civilian rate of unemployment of 6 to $6\frac{1}{4}$ percent in the fourth quarter of 2003 and $5\frac{1}{2}$ to 6 percent in the fourth quarter of 2004. Forecasts of inflation, as measured by the chain-type price index for personal consumption expenditures, pointed to the persistence of quite low inflation rates centered on ranges of $1\frac{1}{4}$ to $1\frac{1}{2}$ percent for this year and 1 to $1\frac{1}{2}$ percent in 2004.

Despite some differences with regard to the timing and strength of the anticipated upturn in the expansion, the members agreed that accommodative monetary and fiscal policies along with much improved financial conditions were likely to foster a better economic performance over time. Growing market perceptions that monetary policy would remain stimulative for a longer period than previously anticipated appeared to have contributed to significant declines in interest rates across maturities and risk classes, and to rising prices in equity markets. The gains in equity prices and a narrowing of risk spreads also appeared to reflect more upbeat assessments of underlying business conditions and, partly in concert with reduced geopolitical risks since the end of major military activity in Iraq, growing convictions that the downside vulnerability of the domestic economy had diminished. Both business firms and households had continued to take advantage of generally improving financial conditions to strengthen their balance sheets through debt restructuring activ-

ities, thereby helping to buttress the economy's financial underpinnings and foster sustained expansion.

The ongoing stimulative effects of earlier tax cuts and large increases in defense spending had recently been enhanced by added fiscal stimulus that would provide households with more spendable income in the months immediately ahead than had been anticipated earlier. The expected result would be a relatively prompt and sizable boost to consumer expenditures and, over time, to business spending. Some members expressed reservations, however, about the extent of the near-term effects of tax rate reductions on overall consumer spending, given the likelihood that some portion of the funds transferred to households would be used to reduce personal debts or to add to various savings vehicles. Members also noted that measures taken by many state and local governments to raise taxes and trim spending in order to resolve fiscal crises would offset an uncertain—though in the view of most a small—part of the federal sector stimulus over the period ahead. On balance, given the combined effects of lower tax rates and the outlook for continued high levels of defense spending, the federal sector generally was seen as an important source of stimulus to the economy, both in the near term and over the forecast horizon.

With regard to the outlook for key expenditure sectors of the economy, members again commented that the prospects for robust and sustained expansion would depend importantly on business fixed investment, a sector where significant recovery had thus far failed to materialize. A high degree of caution continued to dominate business decisionmaking in the context of weak markets for the output of numerous firms and the related absence of pricing

power. And while the low cost and ample availability of financing for most business firms along with the recently raised partial tax expensing provision for certain investment outlays were positive factors, reports from business executives indicated that a key factor inhibiting decisions to invest at this point was the unfavorable outlook for sales growth in the context of substantial margins of excess capacity. Members also noted that the attention of many boards of directors and other senior corporate officials remained focused on corporate governance and accounting issues rather than potential capital projects, and that concerns about vulnerabilities relating to such issues had damped appetites for taking risks. In this environment, investment outlays tended to be limited to the replacement and upgrading of existing facilities rather than expansion. A number of members nonetheless cited faint signs of more positive investment prospects, though not of currently increasing investment expenditures, gleaned from anecdotal commentary and responses to recent capital spending surveys. The latest readings on orders and shipments of durable goods were also seen as a favorable, though not a conclusive, sign of higher investment spending. In general, the members anticipated that current restraints on business investment spending would lift slowly as the expansion gathered momentum and business caution in investing and hiring diminished further in response to increasing demand.

Outside the motor vehicle industry, business inventories appeared to be at generally low levels, with many retailers and others reported to be following cautious inventory policies in anticipation of sluggish sales over coming months. As a consequence, some inventory accumulation appeared likely if final

demand accelerated in line with the members' current forecasts.

Consumer spending, though elevated, had grown at a reduced pace in recent quarters and the members generally saw some acceleration as a likely but not inevitable prospect. An important factor in this outlook was the anticipated effects of sizable additions to disposable incomes stemming from the recent tax legislation. Other favorable factors referenced by the members included indications of growing consumer confidence, the effects of rising stock market wealth on consumer balance sheets, continued opportunities for many consumers to extract equity from the appreciated value of their homes and to reduce interest service burdens by refinancing mortgages, and more fundamentally a continuing uptrend in disposable personal incomes associated in part with robust gains in labor productivity. Some members nonetheless raised a note of caution regarding the potential strength of consumer spending. They commented in particular that the lack of significant job growth resulting from persisting business reluctance to hire new workers could undermine consumer confidence and spending at some point, though they noted that there was little evidence of this as yet. Some members also referred to the drain on disposable incomes stemming from rising local taxes and fees intended to address the severe budget problems of many state and local governments. On balance, while they acknowledged the risks of a weaker outcome, the members generally expected the consumer sector to play a key role in their forecasts of a significantly strengthening expansion.

The members continued to report a high level of housing demand in numerous parts of the country, with housing construction described as a notably robust sector in many regional econo-

mies. The strong performance of the housing industry continued to be attributed in large measure to the lowest mortgage interest rates in several decades. On a more negative note, multifamily construction was reported to be weak in a number of areas, evidently reflecting low occupancy rates and rents.

Although current growth in demand from abroad was being held down by the relatively sluggish economies of major U.S. trading partners, the weaker dollar was expected to foster somewhat faster expansion in U.S. exports. However, downward revisions to foreign growth forecasts for the balance of this year implied continuing restraint on the expansion in foreign demand for U.S. goods and services. Members nonetheless cited some anecdotal evidence of a pickup in foreign orders from U.S. manufacturers. At the same time, many U.S. business contacts continued to express concern about the strength of foreign competition for their products in domestic markets.

With the economy thought likely to continue to operate below its potential for an extended period and productivity growth expected to remain robust, the members believed that the current low-inflation environment would persist over the next several quarters and indeed that some further disinflation could be in store. In this regard, there was concern that inflation could be approaching a level that would begin to complicate the implementation of monetary policy if economic weakness unexpectedly persisted or the economy was subjected to another negative demand shock. However, in the view of at least some members, recent developments had reduced the unwelcome prospect of substantial additional disinflation. Those developments included a recent uptick in core measures of consumer prices, a drop in

the dollar on foreign exchange markets, and still elevated energy prices—all against the backdrop of longer-term inflation expectations that were firmly anchored. More importantly, however, the outlook for a strengthening expansion, which might well materialize in the near future, should limit any further disinflationary trend.

In the Committee's discussion of policy for the intermeeting period ahead, all but one of the members indicated that they could support a proposal to reduce the target federal funds rate $\frac{1}{4}$ percentage point to a level of 1 percent. While a significant step-up in the pace of the expansion appeared to be a likely prospect, such an outcome was still a forecast whose eventual realization, including both its timing and extent, remained uncertain. In the circumstances and given currently large margins of unemployed labor and other resources, the members agreed that an easing move was desirable to provide additional insurance that a stronger economy would in fact materialize. Some members noted that at the May meeting they had contemplated the need for an easing action at this meeting unless compelling evidence developed in the interim that the hoped-for acceleration in economic activity was clearly under way. The incoming information since the May meeting, while mildly encouraging, did not provide compelling evidence to warrant forestalling an easing action.

Members saw virtually no prospect that the proposed easing, though it would reinforce an already accommodative monetary policy, would incur any significant risk of contributing to rising inflationary pressures, even if the strengthening of the economy proved to be somewhat greater than they had incorporated in their forecasts. Indeed, the proposed reduction in the nominal

federal funds rate would about offset the apparent increase in the real federal funds rate stemming from a recent decline in inflation. In this regard, further disinflation seemed likely to be a more significant concern than rising inflation for a considerable period of time.

Most of the members expressed a preference for limiting the reduction to $\frac{1}{4}$ percentage point. Some commented that a good case could be made for a $\frac{1}{2}$ percentage point easing, though all but one of these members could support the smaller decrease. Views cited in favor of the $\frac{1}{4}$ percentage point easing included the emergence of firmer signs of a possible upturn in economic activity, the near-term prospect of substantial added fiscal stimulus, and an already very accommodative stance of monetary policy. No member expressed the opinion that a smaller move should be favored because of concerns about dislocations resulting from a very low level of the overnight interest rate. However, some members commented that a larger reduction might be misread as an indication of more concern among policymakers about the economic outlook than was in fact the case. Moreover, a 50 basis point reduction that was associated with the communication of a Committee view that the risks to achieving its objectives for economic activity were balanced might be mistakenly interpreted in the view of some members as a signal that the Committee had come to the end of its policy easing moves—a judgment they were not prepared to make at this time. The case for a larger 50 basis point reduction in the target federal funds rate focused on the desirability of a relatively forceful policy move that would be more likely to promote a strengthening economic expansion and at the same time provide greater assurance of countering any significant disinflation. One

member, who interpreted recent economic developments as providing fairly persuasive indications that an upturn in the expansion was already under way, saw merit in keeping policy unchanged but did not oppose a $\frac{1}{4}$ percentage point easing.

Concerning the press statement to be released to the public shortly after today's meeting, the members agreed that it should include a reference to signs of firming economic activity and should highlight the key factors underlying the members' outlook for a more robust economic performance over time. Nonetheless, inflation could edge lower and the Committee needed to be cognizant of the risk of substantial further disinflation, which could have potentially adverse effects. With regard to the Committee's assessment of the risks to be incorporated in the press release, the members generally agreed that the risks to the goal of sustainable economic growth were about balanced for the next few quarters and that the probability of appreciable further disinflation from an already low level of inflation exceeded the probability of a rise in inflation. The members also endorsed a general statement stating that, taken together, the balance of risks to the Committee's dual goals was tilted toward the downside for the foreseeable future. During the discussion, several members also stressed the importance of communicating clearly the reasons for the Committee's decisions, thereby helping to assure the success of the Committee's policymaking efforts.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 1 percent.

The vote encompassed the following statement whose substance would be included in the press release to be made available shortly after the meeting:

The risks to the Committee's outlook for sustainable economic growth over the next several quarters are balanced; the risks to its outlook for inflation over the next several quarters are weighted toward the downside; and, taken together, the balance of risks to its objectives is weighted toward the downside in the foreseeable future.

Votes for this action: Messrs. Greenspan, Bernanke, Ms. Bies, Messrs. Broadus, Ferguson, Gramlich, Guynn, Kohn, Moskow, Olson, and Stewart. (Mr. Stewart voted as an alternate member.) Votes against this action: Mr. Parry.

Mr. Parry dissented because he preferred a 50 basis point reduction in the federal funds rate target as insurance against continued sluggishness in economic activity and further declines in inflation measures to undesirably low rates. While he believed that a significant increase in the pace of activity over the next several quarters was likely, he had not yet seen convincing evidence that this process was under way. Moreover, the current slack in labor and product markets was likely to persist for some time even with a significant pickup in real GDP growth, and this prospect threatened to reduce inflation further. Finally, recent declines in inflation expectations had raised the real federal funds rate. In order to offset that increase and provide additional stimulus, he saw a 50 basis point reduction in the rate as desirable.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 12, 2003.

The meeting adjourned at 1:25 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on August 12, 2003

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 12, 2003, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Bernanke
Ms. Bies
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
Mr. Guynn
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Parry

Mr. Hoenig, Ms. Minehan and Pianalto, Messrs. Poole and Stewart, Alternate Members of the Federal Open Market Committee

Messrs. McTeer, Santomero, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Gillum, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Eisenbeis, Evans, Goodfriend, Howard, Judd, Madigan, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Divisions of Research and Statistics, Board of Governors

Messrs. Slifman and Oliner, Associate Directors, Division of Research and Statistics, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Clouse, Assistant Director, Division of Monetary Affairs, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Moore, First Vice President, Federal Reserve Bank of Cleveland

Mr. Hakkio, Ms. Mester, Messrs. Rasche and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Kansas City, Philadelphia, St. Louis, and Cleveland respectively

Ms. Hargraves and Mr. Tootell, Vice Presidents, Federal Reserve Banks of New York and Boston respectively

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on June 24–25, 2003, were approved.

By unanimous vote, Charles L. Evans and Brian F. Madigan were elected as Associate Economists of the Committee to serve until the election of their successors at the first regularly scheduled meeting of the Committee after December 31, 2003, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period May 6, 2003, through June 24, 2003. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that economic activity was mixed in late spring and early summer. The labor market remained weak, and industrial production improved only slightly. Consumer spending, however, advanced further, with brisk growth in expenditures on autos and other durables and more modest expansion in other categories. Homebuilding continued at a robust rate, business spending improved somewhat, and federal government expenditures remained elevated, but these gains were partially offset by fiscal restraint at the state and local government levels. Despite a recent uptick in consumer prices, year-over-year consumer inflation remained at a very low level.

Private nonfarm payroll employment fell in both June and July. Notable losses occurred in manufacturing over the two months, continuing the trend of previous months. Wholesale and retail trade, transportation and utilities, as well as information sectors also reduced their workforces further, while the construction, financial activities, and temporary help sectors continued to add jobs. The average workweek edged down, on net, over June and July. After rising to 6.4 percent in June, the unemployment rate fell to 6.2 percent in July.

Industrial production edged up again in June, with gains in manufacturing offset to some extent by significant weather-related declines in utility production. Available data for July indicated advances in motor vehicle assemblies and in iron and steel output, and also a surge in energy production that was due to abnormally warm weather. Overall industry capacity utilization was about unchanged in June as higher usage in manufacturing and mining was balanced by a sharp decrease at utilities.

Real personal consumption expenditures grew in June and in the second quarter as a whole, largely reflecting a brisk rise in purchases of motor vehicles and other durable goods. Consumption of other goods rose more moderately. Declines in spending on energy in June held down growth in services expenditures. Real disposable income posted a modest gain in the second quarter, and likely was lifted further in July by reduced tax withholding and by refund checks that were mailed out. Consumer confidence readings were mixed in June and July but remained well above their lows earlier in the year.

Boosted by declining mortgage rates, housing construction and sales were robust through June. Single-family housing starts rose in June to one of the highest levels in the past twenty-five

years, and new permit issuance was also strong. Multifamily housing starts stayed at about the average level of the previous year and a half. New home sales surged in June, but existing home sales edged down.

Business outlays on equipment and software jumped in the second quarter following a lackluster performance over the preceding half year. Spending on computers and software accelerated sharply, and purchases of communications equipment increased considerably. The transportation category, by contrast, contracted as business spending on motor vehicles stagnated and investment in aircraft decreased. Data on orders and shipments for nondefense capital goods in June pointed to growth in nearly all categories. Expenditures on nonresidential structures turned up in the second quarter as increases in spending on institutional and other structures more than offset declines in expenditures for office and industrial buildings. Office building vacancy rates changed little in the second quarter, while vacancies in industrial buildings rose to record levels.

Nonfarm inventories shrank in the second quarter, with notable declines in manufacturing and wholesale stocks. Inventories relative to shipments and sales were at low levels by historical standards.

The U.S. international trade deficit edged up in May as imports of goods and services increased slightly more than exports. Recent data generally indicated that growth in foreign industrial countries was weak in the second quarter. The economies of Japan and the euro area appeared to have remained stagnant. Canadian economic growth was held back by both the SARS outbreak and the discovery of mad cow disease, although a rebound in employment in June suggested that

the weakness was temporary. GDP growth in the United Kingdom showed a moderate rebound in the second quarter.

Overall consumer prices rose a bit in June, led by increases in the volatile food and energy categories. Core consumer prices, however, were unchanged for the month. Over the twelve-month period ending in June, the increase in core consumer prices as measured by both the consumer price index and the chain-type personal consumption expenditure index was notably lower than the rise of the previous year. Higher energy costs pushed up the producer price index in June, but core producer prices ticked down for the month, leaving them slightly below their levels twelve months prior. With regard to labor costs, July average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls advanced at about the same rate as in June. The employment cost index for hourly compensation of private industry workers rose less in the second quarter than in the first quarter. The twelve-month increase was somewhat lower than that for the previous year.

At its meeting on June 24–25, the Committee adopted a directive that called for lowering the target for the intended federal funds rate 25 basis points, to 1 percent. In reaching this decision, the Committee members generally perceived the upside and downside risks to the attainment of sustainable growth for the next few quarters as roughly equal; however, they viewed the probability, though minor, of a substantial and unwelcome fall in inflation as exceeding that of a pickup in inflation from its already low level. On balance, the Committee believed that the concern about appreciable disinflation was likely to predominate for the foreseeable future.

Longer-term interest rates began to back up after the announcement of the Committee's decision, as market participants had placed substantial odds on a larger policy move and, perhaps, even the release of details on potential unconventional policy actions. Ten-year Treasury yields rose dramatically over the following weeks. The increase appeared to be based on a number of factors, including investors' interpretation of the Chairman's congressional testimony, the release of Committee members' relatively bullish economic projections, and incoming news regarding the economy and corporate earnings that was seen as signaling a more likely upturn in economic growth. In these circumstances, substantial further disinflation probably would not materialize, and the need for further reductions in the federal funds rate or unconventional policy measures would thus be obviated. Yields on high-grade corporate bonds moved up roughly in line with those on Treasury securities, leaving spreads about unchanged. Rates on low-grade corporate bonds rose much less, and spreads over Treasuries on such obligations narrowed significantly. Despite the sharp step-up in Treasury yields, broad equity indexes advanced over the intermeeting period, supported by positive earning reports, strong profit forecasts, and increased confidence regarding economic prospects.

The exchange value of the dollar, as measured by the major foreign currencies index, rose over the intermeeting period as long-term interest rate differentials moved sharply in favor of dollar-denominated assets. Yields on longer-dated government debt of major foreign economies also increased as did many foreign equity indexes.

M2 continued to grow briskly in June and July, reflecting in large part the near-zero opportunity cost of holding

money, the effects of mortgage refinancing activity, and the reduction in personal income tax withholdings.

The staff forecast prepared for this meeting continued to suggest that the economic expansion would strengthen substantially as the year progressed. Accommodative financial conditions, recent additional fiscal stimulus, and robust gains in structural productivity would provide significant impetus to business and consumer spending over the months ahead. Concurrently, household expenditures, buoyed by recent tax cuts, were expected to be well maintained. Inventory levels had been substantially reduced, and business capital stocks apparently had continued to move closer to acceptable levels. As a consequence, improving sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to boost business investment spending gradually. Given the substantial ongoing slack in resource utilization, some downward pressure on core price inflation was considered a risk in the staff forecast.

In their review of current and prospective economic developments, members commented that they were encouraged by the recent data on economic activity and the tone of related anecdotal commentary. In their view these developments, in the context of stimulative fiscal and monetary policies, receptive financial conditions, and apparently improving business and consumer confidence, had brightened the prospects for substantial further strengthening of the economy. The members acknowledged that the magnitude of the improvement remained subject to considerable uncertainty, notably with regard to the prospects for business expenditures, and they cited both upside and downside risks to forecasts of a more vigorous

expansion. Concerning the prospects for inflation, members expressed the view that even if growth somewhat above the economy's potential were to materialize over the next several quarters, which many regarded as a likely scenario, substantial excess margins of labor and other resources would remain and would continue to hold down overall inflation. Indeed, a number of members saw merit in the staff forecast that some further disinflation was a likely prospect in such circumstances.

Members commented that current financial conditions remained a positive factor in the outlook for the economy even after the recent rise in long-term interest rates. To be sure, the increase would have some restraining effect. Indeed, mortgage refinancing activity appeared to have declined substantially according to some reports, prospectively lessening the support for some consumer and other spending fostered by the extraction of equity from housing. Even so, a number of factors suggested that the risks from higher interest rates might not be large. These included the possibility that the higher rates in part reflected growing optimism about the economic outlook that would engender a faster pace of business spending, more than offsetting the effects of the higher rates on consumer spending. Moreover, long-term interest rates were still relatively low, risk spreads had narrowed in recent months, and stock prices had held firm recently, perhaps in part as a result of several upside surprises in second-quarter profit reports.

Several members reiterated that business spending was the critical factor that would govern to a substantial degree the timing and extent of the acceleration in overall economic activity. Since the year 2000, business capital expenditures had been mostly limited to replacement demand for equipment and software

and, with nonresidential construction activity displaying pronounced weakness, total business fixed investment had until recently been on a declining trend. Members were encouraged, however, by evidence in recent months that an upswing in spending for capital equipment and software might be under way, including more purchases by firms of non-high-tech equipment as well as an ongoing rise in purchases of computing equipment and related peripherals. Members also reported some signs of renewed venture capital activity. Several noted that nonresidential building appeared to have stabilized in various parts of the country after a long period of decline, and there were reports that new construction projects had been initiated in some areas. It was clear, nonetheless, that business sentiment toward capital expenditures remained exceptionally cautious. Looking ahead, much would depend on further growth in demand for business products and services and associated evidence of rising profits, building on indications of strengthening in both in recent months. For now, survey and anecdotal reports on business capital spending intentions were somewhat more encouraging than earlier but were still generally mixed, with only a small number of firms planning robust capital spending programs. Indeed, in light of the persistence of substantial margins of underutilized capital, many business contacts indicated that they intended to meet growing demand by adding staff before increasing output capacity.

The weakness in business inventories that had damped the expansion thus far this year appeared to be continuing in the current quarter according to numerous business contacts. However, cautious inventory policies generally had reduced stocks to very low levels in relation to growing sales, and members

saw inventory accumulation, starting perhaps late this year, as a plausible expectation. Indeed, in the view of some members, a normal cyclical swing in the accumulation of inventories that would bring the latter into a more usual alignment with growing sales could begin relatively soon and might well be markedly more pronounced than many now anticipated. The potential for such a development constituted a sizable upside risk to current economic forecasts for the quarters ahead.

Consumer spending, buttressed by sales of motor vehicles and other consumer durables, had accelerated in the second quarter from an already elevated level and appeared more recently to be increasing considerably further. The available data pointing to improvement in early summer were limited but were supported by anecdotal information from around the country. Positive factors mentioned with regard to the outlook for the consumer sector included the recent tax cuts, the improved performance of the stock market, the ample availability of household credit, and more generally the effects of rapidly rising productivity in sustaining growth in household incomes. A potential negative cited by some members was the possibility that a weak job market, should it persist, would at some point adversely affect overall consumer sentiment and willingness to spend.

Residential housing sales and construction had remained at elevated levels, evidently stimulated to an important extent by earlier declines in mortgage rates to unusually low levels. Although the appreciable upturn in those rates since midyear appeared to have slowed mortgage refinancing activity, at least in some areas, housing demand had remained buoyant perhaps in part because many homebuyers were attempting to lock in mortgage financ-

ing while rates were still low in relation to historical norms. The potential extent of retardation in housing activity stemming from higher mortgage rates was uncertain, but demand for housing was expected to be relatively well maintained, assuming the realization of forecasts of accelerating economic activity and associated growth in personal incomes.

In their comments about the outlook for the foreign sector of the economy, members referred to recent signs of some strengthening in the economies of the nation's important trading partners. However, domestic demand in most of those economies remained relatively weak, and developments abroad were likely to provide little impetus to demand for U.S. exports in the near term. At this point, business contacts tended to emphasize the persistence of strong foreign competition that was constraining their sales in both foreign and domestic markets.

In their review of the outlook for prices, members generally anticipated that key inflation measures would remain near their currently low levels for an extended period. Their assessment focused on the likely persistence of substantial margins of unemployed labor and other resources even if, in line with their expectations, business activity strengthened substantially over coming quarters. Indeed, a number of members expressed the view that some further disinflation was probable over the year ahead. To be sure, inflation would remain subject to a number of crosscurrents. Upward pressures on prices would continue to be exerted by increasing medical insurance and pension costs and, for many manufacturing firms, the rising cost of materials. At the same time, the persistence of very strong competitive pressures, including those arising from foreign competitors, was

preventing most business firms from passing on higher costs by raising prices, and this lack of pricing power did not appear to be diminishing. Concurrently, however, many firms were able to maintain or even to increase their profit margins through a variety of cost-cutting and productivity-enhancing measures.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal to maintain an unchanged policy stance involving reserve conditions consistent with a target federal funds rate of 1 percent. Members noted that the current stance of monetary policy remained quite accommodative and, given the tenor of the latest information on the performance of the economy in the context of generally favorable financial conditions, they believed that policy was appropriately positioned to foster further strengthening of the economic expansion. While the Committee could not commit itself to a particular policy course over time, many of the members referred to the likelihood that the Committee would want to keep policy accommodative for a longer period than had been the practice in past periods of accelerating economic activity. Reasons for such an approach to policy stemmed from the need to encourage progress toward closing the economy's currently wide output gap and, with inflation already near the low end of what some members regarded as an acceptable range, to resist significant further disinflation. In the view of these members, appreciable added disinflation would potentially blunt the effectiveness of further policy easing in the event of strong adverse shocks to the economy. At the same time, maintaining an accommodative policy stance was seen as involving little risk of inducing rising inflation so long as high levels of excess

capacity and very competitive markets continued to characterize economic conditions.

The members agreed that, although economic activity had shown signs of firming, the risks to the outlook remained about the same as they had indicated in the previous statement issued after the June meeting. In particular, the risks to the goal of sustainable economic growth were about balanced for the next few quarters and the probability of an unwelcome fall in inflation, though minor, exceeded that of a rise in inflation from its currently low level. On balance, the risk of undesirably low inflation was likely to be the Committee's predominant concern for the foreseeable future. The Committee also decided to include a reference in the announcement to its judgment that under anticipated circumstances policy accommodation could be maintained for a considerable period.

Several members commented that the nature of the Committee's communications had evolved substantially over recent meetings and that it might be useful to schedule a separate session to review current practices. They agreed to do so prior to the next scheduled meeting on September 16.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1 percent.

Votes for this action: Messrs. Greenspan, Bernanke, Ms. Bies, Messrs. Broaddus, Ferguson, Gramlich, Guynn, Kohn, Moskow, Olson, Parry, and Stewart. (Mr. Stewart voted as an alternate member.) Votes against this action: None.

The vote encompassed the substance of the following statements concerning risks that would be conveyed in the Committee's press release to be made available shortly after the meeting:

The risks to the Committee's outlook for sustainable economic growth over the next several quarters are balanced; the risks to its outlook for inflation over the next several quarters are weighted toward the downside; and, taken together, the balance of risks to its objectives is weighted toward the downside in the foreseeable future.

It was agreed that the next regular meeting of the Committee would be held on Tuesday, September 16, 2003.

The meeting adjourned at 1:15 p.m.

On September 15, 2003, the Committee met to review its practices regarding the communication of its policy decisions and its assessment of the risks to its objectives of fostering sustainable economic growth and price stability. After a detailed discussion of the issues, the Committee elected not to make substantial changes in its current approach to the policy announcement at this time. Although a variety of views was expressed, most members felt that current practices were generally appropriate in providing information to the public about the rationale for the Committee's decisions and its views about the risks to future economic performance. Nonetheless, members recognized that going forward they might, from time to time, consider changes that might improve the Committee's com-

munication of its assessment of the economic situation.

Vincent R. Reinhart
Secretary

Meeting Held on September 16, 2003

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 16, 2003, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Bernanke
Ms. Bies
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
Mr. Guynn
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Parry

Mr. Hoenig, Mses. Minehan and Pianalto, Messrs. Poole and Stewart, Alternate Members of the Federal Open Market Committee

Messrs. McTeer, Santomero, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Eisenbeis, Evans, Goodfriend, Howard, Judd, Madigan, Struckmeyer, and Wilcox, Associate Economists

- Mr. Kos, Manager, System Open Market Account
- Mr. Hambley, Assistant to the Board, Congressional Liaison Office, Board of Governors
- Messrs. Slifman and Oliner, Associate Directors, Division of Research and Statistics, Board of Governors
- Messrs. Clouse, Kamin, and Whitesell, Deputy Associate Directors, Divisions of Monetary Affairs, International Finance, and Monetary Affairs respectively, Board of Governors
- Mr. English, Assistant Director, Division of Monetary Affairs, Board of Governors
- Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors
- Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors
- Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors
- Messrs. Fuhrer and Hakkio, Mses. Mester and Perelmuter, Messrs. Rolnick, Rosenblum, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Boston, Kansas City, Philadelphia, New York, Minneapolis, Dallas, and Cleveland respectively
- Mr. Bullard, Vice President, Federal Reserve Bank of St. Louis

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 12, 2003, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange mar-

kets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period August 12, 2003, through September 15, 2003. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that economic activity had been picking up in recent months, although the data were not uniformly positive. Domestic final demand had strengthened appreciably, with solid gains in both household and business spending. While industrial production was growing, job losses continued. Inventories were again drawn down. Consumer prices had edged up in recent months, but year-over-year consumer inflation remained at a very low level.

Private nonfarm payroll employment fell again in August, with a decline similar to those in June and July. Employment continued to fall in the manufacturing, wholesale and retail trade, transportation and utilities, and information categories. Employment in the service industry was about unchanged as job losses in professional and business services largely offset expansion in non-business services. Growth in construction employment continued. Aggregate hours of private production workers edged down in August, reflecting the employment declines, while the average workweek was unchanged. The unemployment rate fell to 6.1 percent in August.

Industrial production posted a solid increase in July after no change in June. Data available for August suggested increased output at utilities, reflecting

abnormally hot weather, but little net change in manufacturing. Overall capacity utilization rose in July, led by the increase in utility production.

Retail sales rose a bit further in August after surging in July. Real personal consumption spending advanced briskly through July (latest data) as all major categories of outlays recorded increases. Real disposable income rose substantially in July largely because of the reduction in tax withholdings and the delivery of advance refund checks relating to higher childcare deductions. The further delivery of such checks in August was expected to have a positive effect on spending in that month as well. Although the index of consumer sentiment ticked down in August and early September, it remained well above its March low.

Housing construction and sales remained very strong in July. Single-family housing starts rose a bit further from the record level in June, while multifamily housing starts were unchanged. Sales of existing homes were up sharply in July, and new home sales remained robust but were off slightly from their rapid June advance.

Data on orders and shipments of non-defense capital goods in July suggested that the upward trend in real business outlays for equipment and software had carried into the third quarter. Total shipments of nondefense capital goods rose moderately in July, with continued notable strength in computers and peripheral equipment. Shipments of communications equipment were off only slightly in July after a surge in June. Orders for nondefense capital goods overall were little changed in July. A drop in nonresidential construction expenditures in July reversed the gains made in the second quarter, with declines in all categories except non-office commercial structures.

Inventories contracted in the second quarter, and partial data for July suggested that the runoff continued into the third quarter. The book value of manufacturing inventories declined for the month, led by stocks of durable goods. However, inventories of wholesale goods edged up. Inventory shipment ratios for the manufacturing sector at book value moved down considerably in July, and book value inventory-sales ratios for wholesalers remained at very low levels by historical standards.

The U.S. international trade deficit edged down in June as exports of goods and services increased and imports were unchanged. For the major foreign industrial countries, economic data for the second quarter were mixed. While real GDP grew strongly in Japan and growth picked up in the United Kingdom, real GDP edged down in Canada and the euro area.

Core consumer prices rose slightly less in August than in July. Both consumer food and energy prices rose somewhat faster than the core components, leaving the overall consumer inflation rate in August slightly higher than in July. Over the twelve-month period ending in August, overall consumer prices were up a bit from the previous year, while core consumer prices decelerated. After significant declines during the second quarter, overall producer prices edged up in July and rose a bit further in August. Core producer prices, however, were little changed for the two months and posted only a slight increase over the twelve-month period. With regard to labor costs, average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls ticked up in August. The twelve-month change in average hourly earnings was about the same as that in the previous year.

At its meeting on August 12, 2003, the Federal Open Market Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the federal funds rate at around 1 percent. In reaching this decision, the Committee members generally perceived the upside and downside risks to the attainment of sustainable growth for the next few quarters to be roughly equal; however, they viewed the probability, though minor, of an unwelcome fall in inflation as exceeding that of a rise in inflation from its already low level. The Committee judged that, on balance, the risk of inflation becoming undesirably low would remain the predominant concern for the foreseeable future. In those circumstances, the Committee believed that policy accommodation could be maintained for a considerable period.

The Committee's decision to leave its target for the federal funds rate and assessment of risks unchanged at the August meeting was widely anticipated. On net over the intermeeting period, market expectations for the federal funds rate changed little. However, intermediate- and longer-term interest rates were volatile over the period, with yields on Treasury coupons declining slightly on balance. Yields on most investment-grade securities moved in line with those on Treasury obligations, but a more optimistic economic outlook among investors contributed to a substantial decline in speculative-grade yields. Broad stock price indexes rose notably, boosted by improved economic growth prospects and the associated upwardly revised expectations for earnings.

On balance, the nominal value of the dollar changed little on a broad trade-weighted basis over the intermeeting period. Optimism about global recovery reportedly prompted gains in the

equity markets of major industrial countries. Benchmark government bond yields rose in most foreign industrial economies.

M2 grew briskly again in August, boosted by the effects of mortgage refinancing activity, a temporary bulge in liquid deposits caused by payment delays related to power outages, and tax rebate disbursements.

The staff forecast prepared for this meeting continued to suggest a substantially stronger economic expansion than had occurred earlier in the year. Accommodative financial conditions, recent additional fiscal stimulus, and robust gains in structural productivity would provide significant impetus to business and consumer spending over the months ahead. Concurrently, household expenditures, buoyed by recent tax cuts, were expected to be well maintained. Inventory levels had been substantially reduced, and the size of business capital stocks apparently had continued to move closer to acceptable levels. As a consequence, improving sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to boost business investment spending over time. Given the substantial ongoing slack in resource utilization, some slight downward pressure on core consumer price inflation was anticipated in the staff forecast.

In the Committee's discussion of current and prospective economic developments, the members focused both on the increased evidence of a pickup in the pace of the expansion and on the persisting weakness in labor markets. The advance in economic activity in recent months reflected continued strength in household spending, reinforced by an increasing contribution from business investment expenditures. The members viewed these and related developments

as supporting forecasts of robust growth in economic activity over coming quarters, consistent with the stimulative monetary and fiscal policies, accommodative conditions in financial markets, and the positive implications of strong productivity growth for both incomes and investment outlays. Members nonetheless cited a number of factors that had the potential to retard the expansion, including the persistence of notably cautious business sentiment, the potential that weak employment conditions, should they persist, would at some point depress consumer spending, and the prospect that sluggish economic activity abroad would curb the growth in U.S. exports. On balance, the members saw favorable prospects for strong economic growth over the forecast horizon, though they also expected that the gap between actual output and potential output would close only slowly and that growth in employment would remain limited. Against this background and taking into account the outlook for continued strength in productivity, members anticipated that inflation would remain subdued and perhaps even edge lower despite the expected strength in economic activity.

In their comments about developments in various parts of the country, members cited increased examples of an upturn in confidence among their business contacts. This improvement was not universal, notably within manufacturing sectors of the economy, and overall business attitudes toward hiring and investment decisions continued to be described as exceptionally cautious. Members anticipated, however, that such business attitudes would give way to optimism at some point, possibly quite suddenly, as uncertainties relating to the outlook for final demand were replaced by concerns about missing profit opportunities in a strengthening

expansion. Comments by many contacts in the banking sector were already quite upbeat with regard to the outlook for business spending and optimism in financial markets clearly had been improving for several months. In general, financial markets were viewed as well positioned to support more vigorous expansion in economic activity.

In their comments about prospective developments in the major components of aggregate demand, members anticipated that the household sector would remain the mainstay of the expansion and that it would be significantly reinforced going forward by an acceleration in business expenditures and, at least over the next several quarters, by substantial further increases in federal government spending. Some softening in motor vehicle sales from the exceptional pace in recent months seemed likely, but overall consumer spending probably would be sustained at a high level by further anticipated gains in disposable incomes bolstered by the stimulus from recent federal tax cuts. A potential negative in this outlook was the possibility that weakness in employment, if it continued, would at some point exert a more pronounced negative effect on consumer sentiment.

In the housing area, residential sales and construction stayed at elevated levels during the summer months, with at least some portion of the strength reportedly stemming from efforts by many homebuyers to move ahead of further increases in mortgage interest rates. The run-up in mortgage rates since the latter part of June was expected to curb housing demand to a limited extent in coming months, but the outlook for housing activity remained favorable, given an overall economic performance in line with current forecasts of a robust expansion, related growth in incomes, and still

relatively attractive mortgage interest rates.

Business fixed investment remained a critical factor and also a major source of uncertainty in the outlook for overall economic activity, with the strength of such investment having a key bearing on the pace of the overall expansion. In this regard, the second-quarter increase in expenditures for equipment and software was an encouraging sign and the available evidence pointed to a larger advance in the third quarter. Looking beyond the near term, members mentioned a number of developments that supported an optimistic outlook for capital expenditures. These included an appreciable acceleration in final sales since the first quarter, sizable increases in business profits and cash flow this year, the ready availability of business financing on attractive terms, and the temporarily accelerated expensing provision in the tax code. On the constraining side were the persistence of high levels of excess capacity and significant business uncertainty and caution regarding the extent and durability of the acceleration in final sales. To date, businesses had displayed only limited signs of undertaking any investments other than for replacement and cost-cutting purposes. Even so, the recent firming of orders and shipments along with somewhat more upbeat anecdotal reports and surveys of business spending plans pointed to a relatively brisk further advance in business spending for equipment and software, at least over the near term. Nonresidential construction activity remained at a generally depressed level but appeared to have bottomed out, with signs of an upturn in new or planned construction in some areas.

Increasing business inventory expenditures to accommodate strengthening final sales were seen as a likely positive factor in the expansion of overall

economic activity in coming quarters, though the degree and timing of the impetus from a prospective buildup in inventories were subject to considerable uncertainty. Pointing to anticipated strength in inventory accumulation was the substantial drawdown in stocks that had occurred as final sales picked up this year, a marked resulting drop in inventory-sales ratios, and expectations of accelerating final demand. At the same time, however, the persistence of business uncertainty and related caution were, with some exceptions, continuing to inhibit inventory investment. Moreover, the trend toward improved communication and delivery systems was encouraging business firms to hold inventories at increasingly low levels in relation to expected sales. According to anecdotal reports, even service firms were now increasingly adopting advanced management techniques to hold down their inventories of items used in the process of providing their services. Against this background, it seemed unlikely that businesses would seek to rebuild their inventories sufficiently to restore earlier inventory-sales ratios. Even so, further increases in sales would eventually lead to improved business confidence and induce efforts to accumulate inventories, though probably to a lesser extent than had occurred in earlier cyclical recoveries.

Fiscal policy was likely to remain a key source of stimulus to the expansion. Federal spending was expected to increase substantially further, albeit at a diminishing pace over the next year and beyond, and reduced taxes should buoy both consumer and business expenditures. It was not clear at this point to what extent the partial expensing provision was boosting business investment in equipment and software, but the high level of consumer spending clearly was playing a role in fostering such invest-

ment. Members commented that the current degree of fiscal stimulus was at its highest level since the World War II period, and some expressed concern in this regard that little legislative consideration was being given to reapplying fiscal restraint as changing economic conditions would warrant over time. The fiscal condition of many state and local governments remained severely stressed, and ongoing efforts by these governments to curb spending and increase tax and other revenues provided a partial offset to the federal sector stimulus. Some members reported, however, that tax receipts recently had improved noticeably in a number of states.

In their comments about the outlook for the foreign sector of the economy, members referred to indications of some overall improvement in foreign economic activity, which augured well for the growth in exports. They also noted that the prospective performance of foreign economies would depend to a significant extent on the strength of the U.S. economy. With the latter displaying relative vigor, the value of domestic imports was likely to continue to exceed that of exports by a substantial margin, thereby tending to perpetuate the large current account deficits that had worrisome implications for the future. Members also expressed concern about indications of growing protectionism, which characteristically tended to increase in periods of substantial underutilization of labor and other resources, and the adverse effects of that development on competition and inflation.

The members agreed that inflation was likely to remain subdued for an extended period, given current forecasts of economic activity and labor productivity trends. Specific views regarding the most probable course of inflation differed to some degree, but many mem-

bers expected little change over the year ahead and even beyond. Several saw a significant risk of some further disinflation over that period even assuming economic growth at a pace that somewhat exceeded the economy's long-run potential. In this regard, members referred to their expectations that the gap between actual and potential output was likely to narrow only slowly and possibly not close completely over their forecast horizon. They also noted that the substantial margins of excess capacity in question likely would continue to characterize the international as well as the domestic economy for a considerable period. Tending to counter the resulting disinflationary effects were signs that the expansion in globalization might be slowing. In particular, difficulties in reaching global trade agreements along with a rise in protectionism could tend to inhibit the increasingly strong competition in worldwide markets that had been a key factor in holding down inflation. The members also cited other factors that would tend to maintain some upward pressure on prices, notably the relatively rapid rise in costs of labor benefits, especially medical and pension benefits. Increases in the prices of some raw materials were also noted. In general, the members concluded that the economy would need to grow at a pace above potential for a time before they could be confident that the risks of further unwelcome disinflation had materially diminished.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal to maintain an unchanged policy stance involving reserve conditions consistent with a target rate of 1 percent for the federal funds rate. The members agreed that despite the increasing evidence of some acceleration in the expansion of economic activity, an accommodative

policy stance remained appropriate in the context of the currently large and persisting margins of unemployed labor and other resources and very low inflation. Several commented that the recent strengthening of the economy had served to alleviate but had not eliminated their concerns about the possibility of further disinflation. While both downside and upside risks continued to cloud the outlook for economic activity and thus for monetary policy, the economy's sizable output gap strongly suggested that inflation would remain muted over coming quarters even assuming relatively robust economic growth in line with current forecasts. Accordingly, the economy might well expand at a brisk pace for an extended period before inflationary pressures began to emerge and call for an adjustment to monetary policy.

In their discussion of the press statement to be issued shortly after this meeting, the members indicated that the Committee's risk assessments relating to economic activity and inflation to be referenced in that statement should remain the same as those in use since the May meeting. In particular, the risks to the goal of sustainable economic growth were about balanced for the next few quarters and the probability of an unwelcome fall in inflation, though minor, exceeded that of a rise in inflation from its currently low level. On balance, the risk of undesirably low inflation was likely to be the Committee's predominant concern for the foreseeable future.

The members also reviewed the further use of the reference concerning the maintenance of an accommodative policy stance "for a considerable period" that was included in the press statement issued for the August meeting. Given the uncertainties that characteristically surround the economic outlook

and the need for an appropriate policy response to changing economic conditions, the members generally agreed that the Committee should not usually commit itself to a particular policy stance over some pre-established, extended time frame. The course of policy would be determined by the evaluation of the outlook, not the passage of time. The unusual configuration of already low interest rates and reservations about the strength of the expansion had justified the inclusion of the phrase "for a considerable period" in the statement issued in August. While changing circumstances would call for removal of that reference at some point, doing so at this meeting might suggest the members' views on the economy had changed markedly. Accordingly, the Committee decided to release a statement after this meeting that was virtually identical to that used after the August meeting apart from some minor updating to reflect ongoing economic developments.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1 percent.

Votes for this action: Messrs. Greenspan, Bernanke, Ms. Bies, Messrs. Broadus, Ferguson, Gramlich, Gynn, Kohn, Moskow, Olson, Parry, and Stewart. (Mr. Stewart voted as an alternate member.) Votes against this action: None.

The vote encompassed the substance of the following statements concerning risks that would be conveyed in the Committee's press release to be made available shortly after the meeting:

The risks to the Committee's outlook for sustainable economic growth over the next several quarters are balanced; the risks to its outlook for inflation over the next several quarters are weighted toward the downside; and, taken together, the balance of risks to its objectives is weighted toward the downside in the foreseeable future.

It was agreed that the next meeting of the Committee would be held on Tuesday, October 28, 2003.

The meeting adjourned at 1:05 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on October 28, 2003

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, October 28, 2003, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Bernanke
Ms. Bies
Mr. Broadus
Mr. Ferguson
Mr. Gramlich
Mr. Gynn
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Parry

Mr. Hoenig, Mses. Minehan and Pianalto, Messrs. Poole and Stewart, Alternate Members of the Federal Open Market Committee

Messrs. McTeer, Santomero, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming,
Messrs. Goodfriend, Howard,
Madigan, Struckmeyer, and
Wilcox, Associate Economists

Mr. Kos, Manager, System Open
Market Account

Mr. Ettin, Deputy Director, Division
of Research and Statistics,
Board of Governors

Messrs. Slifman and Oliner, Associate
Directors, Division of Research
and Statistics, Board of Governors

Messrs. Clouse, Kamin, and Whitesell,
Deputy Associate Directors,
Divisions of Monetary Affairs,
International Finance, and
Monetary Affairs respectively,
Board of Governors

Mr. English, Assistant Director,
Division of Monetary Affairs,
Board of Governors

Mr. Hambley, Assistant to the Board
and Director for Congressional
Liaison, Office of Board
Members, Board of Governors

Mr. Skidmore, Special Assistant to the
Board, Office of Board Members,
Board of Governors

Mr. Luecke, Senior Financial Analyst,
Division of Monetary Affairs,
Board of Governors

Ms. Low, Open Market Secretariat
Assistant, Division of Monetary
Affairs, Board of Governors

Messrs. Fuhrer and Hakkio,
Ms. Mester, Messrs. Rasche,
Rolnick, Rosenblum, and
Sniderman, Senior Vice
Presidents, Federal Reserve
Banks of Boston, Kansas City,
Philadelphia, St. Louis,
Minneapolis, Dallas, and
Cleveland respectively

Mr. Dwyer, Ms. Hargraves,
Messrs. Krane and Rudebusch,
Vice Presidents, Federal Reserve
Banks of Atlanta, New York,
Chicago, and San Francisco
respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on September 16, 2003, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period September 16, 2003, through October 27, 2003. By unanimous vote, the Committee ratified these transactions.

The pace of the economic expansion appeared to have picked up substantially. Consumer spending and the demand for housing were quite strong in the third quarter and business outlays for capital evidently accelerated. At the same time, labor markets seemed to be leveling out, and industrial production had firmed in recent months. While core consumer prices had risen faster in recent months than earlier in the year, the twelve-month increase through Sep-

tember was notably lower than during the preceding year.

Labor markets appeared to be stabilizing as private nonfarm payrolls grew in September for the first time since January, and employment losses in July and August turned out to be smaller than data initially had indicated. The largest employment gain in September was in the business services sector, which includes temporary help supply firms. Employment also increased in most other major industries in September, with the exceptions of manufacturing and wholesale trade. Even in these sectors, the pace of job loss was somewhat slower than the declines of previous months. Aggregate hours of private production workers and the average workweek were both unchanged in September. The unemployment rate in September remained at 6.1 percent.

Conditions in the industrial sector had improved somewhat in the previous months. Industrial output displayed solid growth in the third quarter after declining earlier in the year. A downturn in motor vehicle assemblies depressed overall manufacturing somewhat in August, but a step-up in auto production boosted it significantly in September. The strength in manufacturing in September was somewhat offset, however, by a decrease in energy production as temperatures returned to more normal ranges after being unusually high in July and August. In line with these patterns in output, capacity utilization in manufacturing, which had been at historically low levels, decreased slightly in August, then firmed in September.

Real personal consumption expenditures surged in July and August, but available data suggested that consumer spending had fallen back in September, largely reflecting a swing in consumer purchases of motor vehicles. Even apart from motor vehicles, outlays rose at a

solid pace in August, and they seemed to have declined only slightly in September. Spending was supported in recent months by the sizable boost to disposable personal income from tax cuts as well as by levels of wealth and confidence that were considerably above their values earlier in the year.

Housing construction and sales remained very strong in August and September despite some rise in mortgage rates from the very low levels reached in the early summer. The rapid pace of new single-family home construction eased slightly in August but advanced again in September. Multifamily home construction remained around its pace of the past several years. Sales of existing homes reached a record high in August and then climbed further in September. New home sales rose in August and September at a rate just a bit below the record set in June.

Real outlays for equipment and software in the third quarter appeared to have advanced at a faster rate than in the second quarter. Shipments of non-defense capital goods excluding aircraft moved up in September, more than reversing a decline in August. Orders for these goods rose moderately in September after being flat in August. Nominal outlays for construction of privately owned buildings were about unchanged, on net, during the twelve months ending in August. Continued strength in the construction of private institutional structures such as schools, churches, and hospitals was about offset by weakness in other areas of nonresidential construction.

Manufacturing and trade inventories excluding motor vehicles fell further in August after edging down in July. Manufacturers ran off stocks at a fairly rapid pace in both months, while wholesalers and retailers excluding motor vehicle and parts dealers recorded small

declines in stocks in August after accumulations in July. Generally small changes in shipments and sales in the July–August period kept book-value inventory–sales ratios about flat at very low levels.

The U.S. international trade deficit declined in August to its lowest level since February as imports fell more than exports. Available data for the third quarter generally suggested moderate growth in the major foreign industrial countries. Evidence pointed to a likely resumption of real GDP growth in the third quarter in Canada and the euro area and continued expansion in Japan and the United Kingdom.

Core consumer prices rose slightly in August and September, but headline consumer inflation was up a bit more, largely reflecting a run-up in gasoline prices. Energy prices also boosted overall consumer inflation over the past twelve months, while core consumer inflation moved lower over the same period. At the producer level, core prices were about unchanged during August and September, but rising energy and food prices led to somewhat larger increases in the prices of total finished goods. With regard to labor costs, average hourly earnings of production or nonsupervisory workers on private non-farm payrolls edged down in September. The increase in earnings during the previous twelve months was a bit below that during the previous year.

At its meeting on September 16, 2003, the Federal Open Market Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the federal funds rate at around 1 percent. In reaching this decision, the Committee members generally perceived the upside and downside risks to the attainment of sustainable growth for the next few quarters to be roughly equal; however, they

viewed the probability, though minor, of an unwelcome fall in inflation as exceeding that of a rise in inflation from its already low level. The Committee judged that, on balance, the risk of inflation becoming undesirably low would remain the predominant concern for the foreseeable future. In those circumstances, the Committee believed that policy accommodation could be maintained for a considerable period.

The Committee's decision to leave its target for the federal funds rate and assessment of risks unchanged at the September meeting was widely anticipated. Although there was relatively little shift in market expectations for the federal funds rate following the policy decision, longer-dated federal funds futures rates rose significantly in the weeks before the October meeting in the context of better-than-expected economic data, positive announcements of corporate earnings, and a pronounced weakening of the dollar. Short- and intermediate-term Treasury yields also increased somewhat over the intermeeting period, but yields on longer-term Treasuries were about unchanged. While rates on investment-grade securities moved about in line with those on Treasuries, yields and spreads on lower-tier obligations registered further significant and broad-based declines. Major equity indexes rose roughly 2 percent over the intermeeting period.

The exchange value of the dollar, as measured by the major currencies index, fell significantly over the intermeeting period. Negative market sentiment toward the dollar, apparently reinforced by market participants' interpretation of the G-7 communiqué from Dubai on September 20, was not overcome by several better-than-expected U.S. economic reports, though there were some short-lived gains related to the data releases during the period.

M2 contracted moderately in September after growing rapidly in July and August. The reversal appears to have stemmed mainly from a contraction in deposits resulting from reduced mortgage refinancing activity. In addition, the temporary effects of a major power blackout in August had boosted M2 growth in that month, and the subsequent runoff of those deposits likely depressed M2 in September.

The staff forecast prepared for this meeting continued to point to a substantial strengthening in the economic expansion during the second half of the year. Accommodative financial conditions, recent additional fiscal stimulus, and robust gains in structural productivity were evidently providing significant impetus to business and consumer spending. Inventory levels had been substantially reduced, and the size of business capital stocks apparently had continued to move closer to acceptable levels. As a consequence, improving sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were projected to boost business investment spending over time. Given the substantial ongoing slack in resource utilization, the staff forecast anticipated some slight downward pressure on core consumer price inflation.

In the Committee's discussion of current and prospective economic developments, members referred to widespread indications of a marked strengthening in the growth of economic activity. While views regarding the probable vigor of the expansion differed to some extent, the members generally anticipated growth at a pace near or somewhat above the economy's potential over the forecast horizon, assuming no major shocks to the economy. Factors cited as likely to encourage robust and sustained economic growth included substantial

fiscal and monetary policy stimulus, accommodative financial conditions, indications of strengthening foreign economies, much improved business earnings and cash flows, and the favorable implications of strongly rising productivity for business investment and worker earnings. Members nonetheless saw some factors that could restrain the degree of vigor in household and business spending and present downside risks to their forecasts. Among the negatives mentioned were the still-cautious business attitudes that continued to inhibit hiring and investment decisions, the potentially adverse effect on household confidence if appreciable further gains in employment should fail to materialize, and the waning impetus over time of the tax reductions that had taken effect this year. On balance, while the factors pointing to a vigorous expansion seemed to predominate, members acknowledged that the economy was emerging from an atypical period that limited the guidance that historical experience provided for evaluating the economic outlook. Developments in the next few months, notably including the strength of holiday sales, should provide an improved basis for judging the underlying momentum of the expansion.

In contrast to the usual experience in economic recoveries during recent decades, the expansion appeared to be gathering momentum at a time when key measures of inflation suggested that price stability had essentially been achieved. Looking ahead, members generally anticipated that an economic performance in line with their expectations would not entirely eliminate currently large margins of unemployed labor and other resources until perhaps the latter part of 2005 or even later. Accordingly and given the presumed persistence of strong worldwide competition, signifi-

cant inflationary pressures were not seen as likely.

Members commented that the strengthening in final sales had fostered some firming in industrial production and had led purchasing managers to report an improvement in current and anticipated business conditions. Moreover, labor demand had begun to show signs of stabilizing after an extended period of weakness. Anecdotal reports of plans to increase hiring and of actual increases had multiplied. However, the extent to which recently positive labor market developments might be harbingers of substantial further employment gains was unclear at this point, given evidently continuing business efforts to respond to growing demand by improving productivity rather than hiring new workers. Members nonetheless expressed optimism regarding the prospects for substantial employment gains once business firms were persuaded that a major uptrend in final sales was firmly established.

In their comments about the outlook for demand in key sectors of the economy, members continued to view business capital spending as a critical factor in the prospects for the performance of the overall economy. Business expenditures for new equipment and software clearly had turned up since earlier in the year, but anecdotal reports from around the nation continued to suggest that much of this spending was for replacement and upgrading purposes rather than expansion. Such reports also indicated that business contacts, while more confident, remained very cautious, with most firms hesitant to expand their facilities or hire permanent workers until they saw firmer indications that the recent upturn in business activity would be sustained. Some firms reportedly were directing capital investments to foreign markets rather than domestically, appar-

ently largely to take advantage of lower labor costs abroad. Members nonetheless expressed the view that in the context of further anticipated increases in profits and sales, business confidence would continue to improve and induce greater investment and workforce expansions. On the negative side, there were few indications of a possible upturn in commercial construction activity.

The recent strength in final sales was associated with sizable inventory liquidation by business firms, and recent surveys and anecdotal commentary suggested that inventories were at unusually low levels in relation to sales, notably in manufacturing. In the circumstances, a continuation of robust final demand could be expected to foster efforts to rebuild inventories, with potentially substantial short-run stimulus to the economy. However, the timing and extent of such restocking were subject to uncertainty, and for now available reports indicated that business firms were continuing to follow a highly cautious approach to inventory investment.

As had been true for an extended period, household spending had continued to be the mainstay of what until recent months had been a sluggish economic recovery. Personal consumption expenditures had posted quarterly increases throughout the recent period of limited economic growth. During the summer months, consumer spending evidently was boosted by a surge of disposable income generated by the federal tax cuts, but how long that income effect would stimulate increases in consumer spending remained uncertain. On the encouraging side, according to a number of reports retailers were optimistic about the outlook for sales during the holiday period and about the economy more generally. However, some members expressed concern that unless

the recent improvement in labor market conditions was sustained, there could be adverse repercussions on consumer attitudes and spending.

Propelled by still low mortgage interest rates, housing demand had remained at a very high level in recent months. Indeed, record sales were being reported in some regions. There were, however, indications of concern about the longer-term outlook for housing on the part of some real estate contacts.

Fiscal policy was expected to be somewhat less expansionary next year, though still an important contributor to economic growth. Members again mentioned concerns on the part of business contacts regarding the adverse economic implications of very large deficits for the economy over the longer term.

In their comments about the external sector of the economy, members referred to indications of strengthening economic activity abroad that in conjunction with a weaker dollar was fostering some improvement in exports. At the same time, imports continued to expand rapidly, reflecting not only growth in U.S. domestic demand but also the increased availability of foreign products at attractive prices stemming from the rapid expansion of output capacity in a number of foreign countries. In this regard, many business contacts continued to note pressures on their domestic operations from foreign competition.

In their review of the outlook for inflation, members emphasized that the prospects for persisting slack in labor and other resources in combination with substantial further increases in productivity were likely to hold inflation to very low levels over the next year or two. Indeed, many saw modest further disinflation as likely, at least over the year ahead, though they also agreed that the probability of substantial and

worrisome disinflation had become increasingly remote in light of the recent strengthening in economic activity. Members also cited the weakness in the dollar as a factor that would tend to reduce the degree of any domestic disinflation. Some members emphasized that the outlook for inflation was clouded by a high degree of uncertainty about the underlying trend in productivity. The growth in productivity could remain higher than had earlier been anticipated, damping employment, labor costs, and price pressures. On balance, the members did not view changes in inflation in either direction as likely to generate significant policy concerns over the forecast horizon.

In the Committee's discussion of policy for the intermeeting period ahead, all the members agreed that an unchanged target of 1 percent remained appropriate for the federal funds rate. The current degree of policy ease evidently was contributing to an upturn in the expansion of economic activity. The strengthening economy had reduced concerns of significant further disinflation, but those concerns had not been eliminated. The pickup in demand had yet to materially narrow currently wide margins of idle labor and other resources, and these margins along with the uncertainties that still surrounded current forecasts of robust economic growth suggested that an accommodative monetary policy might remain desirable for a considerable period of time. Members referred to the contrast between their current policy expectations and the typical experience during earlier cyclical upturns when it was felt that policy adjustments needed to be made quite promptly to gain greater assurance that inflation would not rise from what were already relatively elevated levels. In present circumstances, the degree of slack in resources and a rate of inflation that was essen-

tially consistent with price stability suggested that the Committee could wait for more definitive signs that economic expansion would otherwise generate inflationary pressures before making a significant adjustment to its current policy stance.

In their discussion of the press statement to be issued shortly after this meeting, the members indicated that the Committee's risk assessments relating to economic activity and inflation to be referenced in that statement should remain the same as those in use since the May meeting. Some members, while expressing support for this view, also commented that the time for some changes in the current risk assessments might be approaching if the economy continued to strengthen in line with recent experience. At this meeting, the members agreed that the risks to the goal of sustainable economic growth were roughly balanced for the next few quarters and the probability of an unwelcome fall in inflation, though minor, exceeded that of a rise in inflation from its currently low level. On balance, the risk of undesirably low inflation was likely to remain the Committee's predominant concern for the foreseeable future. At the conclusion of this discussion, the Committee agreed to the release of a press statement after this meeting that was virtually identical to the one used after the September meeting apart from some updating to reflect ongoing economic developments.

The Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sus-

tainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1 percent.

Votes for this action: Messrs. Greenspan, Bernanke, Ms. Bies, Messrs. Broaddus, Ferguson, Gramlich, Guynn, Kohn, Moskow, Olson, Parry, and Stewart. (Mr. Stewart voted as an alternate member.) Votes against this action: None.

The vote encompassed the substance of the following statements concerning risks that would be conveyed in the Committee's press release to be made available shortly after the meeting:

The risks to the Committee's outlook for sustainable economic growth over the next several quarters are balanced; the risks to its outlook for inflation over the next several quarters are weighted toward the downside; and, taken together, the balance of risks to its objectives is weighted toward the downside in the foreseeable future.

At this meeting the members continued their earlier discussion of how best to communicate the Committee's general assessment of the outlook for economic activity and inflation. The members recognized that changing circumstances required adaptations in the Committee's communications with the ultimate objective of fostering the best possible public understanding of monetary policy decisions. A number of alternative approaches and specific suggestions were discussed, and in the absence of a consensus at this meeting the members agreed that further study under the guidance of a working group comprised of Committee members was desirable. The working group would develop a limited number of specific proposals for consideration at a later meeting.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 9, 2003.

The meeting adjourned at 2:00 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on December 9, 2003

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 9, 2003, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
Mr. Guynn
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Parry

Mr. Hoenig, Mses. Minehan and Pianalto, Messrs. Poole and Stewart, Alternate Members of the Federal Open Market Committee

Messrs. McTeer and Santomero, Presidents of the Federal Reserve Banks of Dallas and Philadelphia respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming,
Messrs. Eisenbeis, Goodfriend,
Howard, Madigan, Struckmeyer,
and Wilcox, Associate Economists

Mr. Kos, Manager, System Open
Market Account

Mr. Ettin, Deputy Director, Division
of Research and Statistics,
Board of Governors

Messrs. Slifman and Oliner, Associate
Directors, Division of Research
and Statistics, Board of Governors

Messrs. Clouse, Kamin, and Whitesell,
Deputy Associate Directors,
Divisions of Monetary Affairs,
International Finance, and
Monetary Affairs, respectively,
Board of Governors

Mr. English, Assistant Director,
Division of Monetary Affairs,
Board of Governors

Mr. Hambley, Assistant to the Board
and Director for Congressional
Liaison, Office of Board
Members, Board of Governors

Mr. Skidmore, Special Assistant
to the Board, Office of Board
Members, Board of Governors

Mr. Nelson, Senior Economist,
Division of Monetary Affairs,
Board of Governors

Mr. Luecke, Senior Financial Analyst,
Division of Monetary Affairs,
Board of Governors

Mr. Kumasaka, Financial Analyst,
Division of Monetary Affairs,
Board of Governors

Ms. Low, Open Market Secretariat
Assistant, Division of Monetary
Affairs, Board of Governors

Messrs. Lyon and Werkema, First Vice
Presidents, Federal Reserve Banks
of Minneapolis and Chicago
respectively

Messrs. Fuhrer and Hakkio,
Ms. Mester, Messrs. Rasche
and Rosenblum, Senior Vice
Presidents, Federal Reserve
Banks of Boston, Kansas City,
Philadelphia, St. Louis, and
Dallas respectively

Messrs. Bryan, Elsasser, Sullivan,
and Weber, Vice Presidents,
Federal Reserve Banks of
Cleveland, New York, Chicago,
and Minneapolis respectively

Mr. Trehan, Economist, Federal
Reserve Bank of San Francisco

By unanimous vote, the minutes of
the meeting of the Federal Open Market
Committee held on October 28, 2003,
were approved.

Advice had been received that
Mr. Timothy F. Geithner had been
elected by the directors of the Federal
Reserve Bank of New York as a member
of the Federal Open Market Committee
for the period commencing Novem-
ber 14, 2003, and ending December 31,
2003, and that he had executed his oath
of office.

By unanimous vote, Timothy F.
Geithner was elected to serve as Vice
Chairman until the first regularly sched-
uled meeting of the Committee after
December 31, 2003, with the under-
standing that in the event of the discon-
tinuance of his official connection with
a Federal Reserve Bank or the Board of
Governors, he would cease to have any
official connection to the Committee.

The Manager of the System Open
Market Account reported on recent
developments in foreign exchange mar-
kets. There were no open market opera-
tions in foreign currencies for the Sys-
tem's account in the period since the
previous meeting.

The Manager also reported on devel-
opments in domestic financial markets
and on System open market transactions

in government securities and securities issued or fully guaranteed by federal agencies during the period October 28, 2003, through December 8, 2003. By unanimous vote, the Committee ratified these transactions.

Real GDP appeared to be advancing at a solid rate in the fourth quarter, albeit well below its extraordinary pace in the third quarter. Consumer spending appeared to be on a flatter trajectory, but spending for equipment and software and residential construction continued to surge. Meanwhile, the labor market had finally shown signs of some improvement in recent months, and activity in the industrial sector was continuing to rise. Consumer price inflation remained quiescent: The twelve-month change in core consumer prices was notably lower than the increase during the preceding year.

Private nonfarm payrolls rose moderately in November, although by less than the substantial gains in September and October. The increases in November were fairly widespread, with notable advances in temporary help services, nonbusiness services, and construction. Although employment continued to fall in manufacturing, the losses had tapered off since the first half of the year. The average workweek and aggregate hours worked by nonfarm employees increased significantly, and the average level of nonfarm employee hours in October and November was noticeably above the average in the third quarter. The unemployment rate fell to 5.9 percent in November, down from a recent peak of 6.4 percent at midyear.

Industrial production grew solidly in the third quarter, and the momentum continued in October apart from the production of motor vehicles and parts, which fell back from an elevated third-quarter level. High-tech output accelerated in the third quarter to the fastest

pace since the middle of 2000, and production gains continued at a rapid pace in October. Outside the manufacturing sector, unseasonably warm weather contributed to an increase in output at utilities in October, while mining production declined a bit, largely reflecting a decrease in the production of crude oil. Capacity utilization edged up in October but remained well below its longer-term average.

Consumer spending slipped a little on balance in September and October after soaring in July and August. Much of the recent decline was the result of a pullback in purchases of motor vehicles; elsewhere, expenditures were about unchanged in September and rose modestly in October. Spending was supported by the upturn in employment, continued impetus from the recently enacted tax cuts, improved confidence, and a level of wealth that was considerably above that of earlier in the year.

Housing activity surged in October. Single-family housing starts reached a record high, while multifamily starts moved down but remained in line with the average pace during the previous two years. Sales of existing single-family homes in October were only a bit below the record level set in September. The pace of new home sales also remained brisk in October, albeit down somewhat from September.

The data on orders for, and shipments of, nondefense capital goods through October suggested continued momentum in spending on equipment and software, which grew in the third quarter at the fastest pace since 1998. Robust gains in spending were posted in the third quarter in all the major categories except aircraft. The gains were associated with recent increases in business output and corporate cash flow and with a decline this year in the user cost of capital. Shipments of high-tech equip-

ment climbed further in October, while shipments in other nondefense sectors excluding aircraft edged down. New orders of nondefense equipment excluding aircraft in October continued the upward trend in place since the beginning of the year and were consistent with ongoing gains in equipment spending. Outlays for the construction of private-sector nonresidential buildings fell a bit in October, but the extended contraction in spending on nonresidential construction appeared to be ending. Nominal spending on office space edged up in September and October, while outlays for the construction of other commercial buildings moved lower. Expenditures on institutional buildings changed little in recent months.

Real nonfarm inventories fell moderately in the third quarter after declining substantially in the second. Manufacturers liquidated stocks by a larger amount in the third quarter than in the previous quarter but added slightly to their inventories in October. Wholesalers and retailers (excluding those selling motor vehicles and parts) built up inventories in the third quarter, and, for wholesalers, the stockbuilding continued in October (data on retail inventories in October were unavailable). Still, inventory–sales ratios in all three categories declined a bit further in the third quarter from already very low levels.

The international trade deficit increased in September as imports of goods and services rose more than exports. Recent data suggested that a recovery had taken hold in the major foreign industrial countries. Growth in real GDP picked up in the third quarter in the euro area, the United Kingdom, and Canada, and indicators in Japan were consistent with continued economic expansion.

Core consumer price inflation remained subdued in October, although

it was up from even lower levels in the first part of the year, when it was depressed by transitory factors. Over the twelve months ending in October, core consumer prices rose only slightly and noticeably less than in the previous twelve-month period. Total twelve-month consumer inflation was unchanged over the period owing to accelerations in food and energy prices. Producer prices for both core and total finished goods posted unusually large increases in October, reflecting in part a sizable advance in the prices of motor vehicles. Twelve-month core producer price inflation, however, was on balance unchanged over the year ending October, although the twelve-month change in overall producer prices stood well above its year-earlier level owing to a jump in food and energy price inflation. With regard to labor costs, the average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls rose slightly in the twelve months ending in November; the increase was a bit below that in the previous twelve months. By contrast, the increase in the employment cost index for hourly compensation in private industry for the twelve months ending in September was a bit higher than a year earlier, reflecting a pickup in benefit costs.

At its meeting of October 28, 2003, the Federal Open Market Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the federal funds rate at around 1 percent. In reaching this decision, the Committee members generally perceived the upside and downside risks to the attainment of sustainable growth for the next few quarters to be roughly equal; however, they viewed the probability, though minor, of an unwelcome fall in inflation as exceeding that of a rise in inflation

from its already low level. The Committee judged that, on balance, the risk of inflation becoming undesirably low remained the predominant concern for the foreseeable future. In those circumstances, the Committee believed that policy accommodation could be maintained for a considerable period.

The Committee's decision at the October meeting to leave its target for the federal funds rate unchanged had been widely anticipated, and rates on near-dated federal funds futures were virtually unchanged. However, the Committee's retention of both an unchanged risk assessment and its indication that policy could remain accommodative for a considerable period, which market participants apparently had seen as less certain outcomes, precipitated a brief rally in Treasury markets. Over the intermeeting period as a whole, intermediate- and longer-term Treasury yields were basically unchanged. Upward movements in response to data releases showing an economy building momentum were offset by the market response to several statements by policymakers reiterating that policy could remain accommodative and to the November employment report, which included a smaller gain in private non-farm payrolls than market participants had expected. Yields on investment-grade corporate securities were also essentially unchanged, while yields on speculative-grade securities declined, continuing the narrowing of their risk spreads. Major equity indexes were up moderately over the intermeeting period.

The exchange value of the dollar, as measured by the major currencies index, declined somewhat, on net, over the intermeeting period. The dollar had appreciated in late October and early November following several stronger-than-expected U.S. economic data releases. But the dollar depreciated, on

net, over the remainder of the intermeeting period, reflecting concerns about an escalation of trade frictions prompted by the U.S. imposition of import quotas on Chinese textiles, the ability of the United States to continue to finance its current account deficit, and risks stemming from developments in Afghanistan, Iraq, and Turkey.

M2 contracted significantly in November for the third consecutive month. A sizable part of the declines in these three months appeared to be due to the falloff in mortgage refinancing activity and the resulting reductions in associated deposit balances. In addition, rising equity markets may have made M2 accounts relatively less attractive.

The staff forecast prepared for this meeting indicated that the economic expansion was likely to be sufficiently robust to reduce economic slack substantially in coming quarters. Accommodative financial conditions, fiscal stimulus, and substantial gains in structural productivity would continue to provide significant impetus to business and consumer spending over the months ahead. In addition, businesses appeared to be shedding some of the caution that had characterized their behavior for the previous three years. As a consequence, with sales, profits, and stock prices higher, the liquidation of inventories appeared to be ending, and the strengthening of capital investment and pickup in hiring already evident in the data were projected to continue. Even though the unemployment rate was projected to decline over coming quarters, some slight downward pressure on core consumer price inflation was anticipated in the forecast, given ongoing slack in resource utilization.

In the Committee's discussion of current and prospective economic developments, members referred to widespread indications that the pickup in the eco-

conomic expansion was broadening and becoming more entrenched. The members noted that spending by households had remained strong even as the effects of tax cuts and mortgage refinancing began to wane. And with business confidence on the mend, investment outlays had increased rapidly and employment had revived. While assessments by individual members of the likely pace of the expansion going forward differed somewhat, they generally expected growth to run at a rate that would trim slack in labor and goods markets over the forecast period, assuming no major shocks to the economy. Factors supporting this view included stimulative monetary and fiscal policies, accommodative conditions in financial markets, building business confidence, a rebound in profits, and the effects on the external sector of the weaker dollar and pickup in growth abroad. While downside risks to the outlook had diminished, some members remained concerned that spending could slow somewhat next year as the effects of fiscal stimulus and mortgage refinancing faded. Rapid productivity growth also could limit employment gains and so weigh on consumer confidence. With relatively strong economic growth nonetheless seemingly more assured, members regarded the risks to inflation as more nearly balanced than earlier in the year.

In their comments about recent developments around the nation, members reported improving economic conditions in virtually all regions, with strength in household spending increasingly augmented by gains in business outlays. Consumer spending remained firm, and residential construction continued at a high level. Committee members' business contacts generally expressed increasing confidence that the expansion would be sustained, and they anticipated further increases in invest-

ment outlays and employment going forward. Even in manufacturing, which had lagged the recovery in the rest of the economy until recently, output was rising in many subsectors and employment displayed signs of stabilizing. Some members reported an easing of downward pressures on prices in selected industries, but anecdotal reports suggested that competition, including especially competition from foreign producers, continued to constrain pricing.

In their comments about the outlook for demand in key sectors of the economy, members indicated greater confidence that the sizable gains in business spending in recent quarters would continue. It now appeared that the increase in outlays for equipment and software in the third quarter was even larger than had been thought, and data on orders and shipments, as well as anecdotal reports, pointed to further increases. These gains owed to rising business confidence, substantial gains in profits and cash flow, and accommodative financial markets. In addition, businesses were expected to step up investment outlays next year in advance of the expiration of temporary tax incentives. Some members noted that the commercial real estate sector, which had been very weak with high vacancy rates and falling rents, was showing signs of bottoming, as the strengthening economy boosted demand for office and retail space.

An easing of business caution was also suggested by growing indications that business firms were shifting from inventory liquidation to restocking. With the level of inventories still quite low relative to sales and sales expected to strengthen further, a number of members noted that inventory investment could be expected to contribute to growth in aggregate demand in coming quarters.

Household spending had remained solid even as the effects of tax refunds and mortgage refinancing, which had boosted spending substantially in the summer, waned. While consumption spending had slowed earlier in the fall, retail contacts suggested some strengthening more recently and reported that holiday sales appeared to be running somewhat above last year's pace. Looking forward, members anticipated that consumer spending would be supported by further gains in employment as well as by substantial tax refunds in the first half of next year. And with the expansion picking up momentum, the risk of a slowdown in such spending clearly seemed to have diminished. Some members pointed, however, to signs of increased financial stress that could limit the ability of many households to hold spending at recent levels, especially if incomes did not rise at a robust pace in line with current forecasts. In the housing sector, activity remained elevated despite some increase in mortgage rates since early summer.

Members anticipated that growth in federal government spending, which had been boosted in recent quarters by a buildup in defense outlays, would slow going forward, while budget pressures would continue to limit increases in state and local spending. Although fiscal policy more generally would probably continue to strengthen aggregate demand next year, this effect was expected to diminish somewhat even though very large deficits were likely to persist. Over a longer horizon, some members expressed concern about the possible adverse effects of such deficits on financial markets and the economy.

In their remarks about the external sector of the economy, members noted that an improvement in the economic outlook in many foreign economies, as well as the lower dollar, was likely to

foster a pickup in exports. While some of the improvement abroad was probably the result of faster growth in the United States, domestic demand in several major trading partners appeared to be strengthening. Nonetheless, the value of U.S. imports was likely to continue to exceed that of exports by a wide margin, and the resulting large current account deficits and their potential correction added to uncertainty about the longer-term prospects for the U.S. economy.

In their review of the outlook for prices, members generally anticipated that persisting, though decreasing, margins of slack in labor and goods markets and further gains in productivity would keep inflation low, with a number of members seeing a small further decline in inflation as a distinct possibility. Even if growth proved fairly robust, downward pressure on prices could come from a narrowing of profit margins, which were currently quite high, or from further surprising strength in productivity, which would reduce labor costs. In addition, some members noted that the current unemployment rate likely understated the slack in labor markets, since the labor market participation rate had fallen significantly of late, and changes in payment and hiring practices had perhaps reduced the level of unemployment that could be sustained without upward pressure on wages. However, with growth now seen as more assured, downward risks to inflation were viewed as considerably reduced relative to earlier in the year, and the risk of a pernicious deflation in which declining prices reinforced weakness in demand—a risk that the members had always viewed as small—was now regarded by most as virtually nil. Indeed, the weaker dollar, higher commodity prices, and outsized increases in benefit costs were seen as suggesting some countervailing upward pressure on costs and prices even though

changes in exchange rates and commodity prices generally had not had a large effect on retail prices in the past. Members also expressed concern about the potential for an increase in inflation expectations given highly stimulative macroeconomic policies and economic growth that seemed to be gathering momentum. Some noted that the rise in recent months in inflation compensation, as measured by the difference between the yields on nominal and indexed Treasury securities, could potentially point in this direction. Nonetheless, on balance, most members currently considered the upside risks to inflation to be a bit less pressing than those on the downside for the next few quarters.

In the Committee's discussion of policy for the intermeeting period ahead, all the members favored an unchanged policy that continued to incorporate a target of 1 percent for the federal funds rate. The data and anecdotal evidence becoming available since the last meeting had made the members more confident that robust growth in economic activity would persist. Nonetheless, they felt that the currently accommodative policy stance remained appropriate in a period characterized by very low inflation, wide margins of unused labor and other resources, and still considerable uncertainty about the speed with which those margins would be worked down. In these circumstances, inflationary pressures appeared likely to remain subdued well into the future. To be sure, the Committee needed to remain attentive to any indications of rising inflation pressures and to be prepared to adjust its policy stance if emerging economic conditions warranted such a move. At some point, a move in the direction of a less accommodative and more neutral policy posture might well be necessary should the apparently vigorous expansion con-

tinue and over time promote fuller utilization of resources. For the near term, however, members saw substantial benefit in maintaining an unchanged policy stance and considerable risk in taking preemptive action that could prove to be unneeded against potential inflation, with associated costs to economic performance.

In their discussion of the announcement to be issued shortly after this meeting, the members agreed that in addition to updating to reflect recent economic developments, some rewording was needed to reflect their evolving assessment of the risks to the economy. In light of the recent acceleration in economic activity and their expectations of relatively robust growth ahead, the members believed that the clearest way to convey their changed assessment was to note that the risks of substantial disinflation had diminished appreciably. While a number of members saw some slight further disinflation as the most plausible outcome, no one expected a material change in inflation. All could agree that the risks of further disinflation were substantially reduced and close to balance for overall inflation. In the circumstances, most members endorsed a proposal to delete as no longer necessary the previous summary statement relating to the risks to growth and inflation taken together.

Views differed with regard to the reference in recent statements to maintaining an accommodative monetary policy "for a considerable period." A number of members argued that its deletion would serve to enhance the Committee's flexibility to adjust monetary policy at a later date when that was deemed appropriate on the basis of evolving economic circumstances. A majority, however, preferred to retain the phrase, at least for now. They noted that the changes in their assessment of risk

would convey the evolving views of the Committee and they believed the “considerable period” reference still accurately conveyed the Committee’s policy intentions. Given the decision to retain the reference in question, all the members saw merit in associating it more clearly with economic conditions, specifically the persistence of quite low inflation and slack in resource use, as opposed to having it appear to be linked only to the passage of time.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive.

“The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1 percent.”

The vote encompassed the following statements concerning the risks to the Committee’s outlook for economic growth and inflation. These statements would be included in the press release to be made available shortly after the meeting.

The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwell-

come fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Broaddus, Ferguson, Gramlich, Guynn, Kohn, Moskow, Olson, and Parry. Vote against this action: None.

At this meeting Mr. Ferguson reported on the progress of the working group that was charged at the October 28 meeting with developing some specific proposals regarding how best to communicate the Committee’s assessment of the outlook for economic activity and inflation. The working group had solicited and received comments from the members of the Board of Governors and from the presidents of the Federal Reserve Banks regarding potential approaches for improving communications with the public and enhancing thereby the latter’s understanding of monetary policy decisions. It was agreed that the working group, with the assistance of staff at the Board of Governors and the Federal Reserve Banks, would prepare more detailed proposals together with supporting staff documentation for consideration at a later meeting of the Committee.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, January 27–28, 2004.

The meeting adjourned at 2:00 p.m.

Vincent R. Reinhart
Secretary

Litigation

During 2003, the Board of Governors was a party in six lawsuits or appeals filed that year and was a party in six other cases pending from previous years, for a total of twelve cases; in 2002, the Board had been a party in a total of ten cases. None of the lawsuits or appeals filed in 2003 raised questions under the Bank Holding Company Act. As of December 31, 2003, nine cases were pending.

Litigation under the Financial Institutions Supervisory Act

Ulrich v. Board of Governors, No. 03-73854 (9th Circuit, filed October 24, 2003), and *Diehl McCarthy v. Board of Governors*, No. 03-73997 (9th Circuit, filed October 28, 2003), are petitions for review of orders of prohibition issued by the Board on October 15, 2003. On December 12, 2003, the court consolidated these cases with related petitions for review of orders issued by the Office of the Comptroller of the Currency imposing civil money penalties and restitution against the petitioners.

Other Actions

Laigo v. Board of Governors, No. 03-CV-03576-MJP (W.D. Washington, filed November 19, 2003), is a claim regarding redemption of U.S. savings bonds.

In *Tavera v. Von Nothaus, et al.*, No. 03-763 (D. Oregon, filed June 5, 2003), the plaintiff claimed that his civil rights were violated when he was prosecuted for passing "Liberty dollar coins" as lawful money. On December 10, 2003, the court granted the Board's motion to dismiss the action.

Apffel v. Board of Governors, No. 03-343 (S.D. Texas, filed May 20, 2003), is a case brought under the Freedom of Information Act.

Carter v. Greenspan, No. 03-1026 (D. District of Columbia, filed May 9, 2003), is an employment discrimination action.

Sedgwick v. United States, No. 02-5378 (D.C. Circuit, filed November 26, 2002), was an appeal of the dismissal of appellant's claim for a declaratory judgment under the Federal Tort Claims Act and the Constitution regarding the banking agencies' alleged failure to intervene on his behalf in civil litigation involving a regulated institution. On March 20, 2003, the court of appeals summarily affirmed the district court's dismissal.

Albrecht v. Board of Governors, No. 02-5235 (D.C. Circuit, filed October 18, 2002), is an appeal of a district court order dismissing a challenge to the pension funding method applicable to certain Board employees under the Board's retirement plan.

Caesar v. United States, No. 02-0612 (EGS) (D. District of Columbia, removed April 1, 2002, from the Superior Court of the District of Columbia), was an action seeking damages for personal injury. On March 30, 2003, the court granted the government's motion to dismiss the action.

Community Bank & Trust v. United States, No. 01-571C (Court of Federal Claims, filed October 3, 2001), is an action challenging on constitutional grounds the failure to pay interest on reserve accounts held at Federal Reserve Banks.

Artis v. Greenspan, No. 01-0400

(D. District of Columbia, filed February 22, 2001), is an employment discrimination action. An identical action, No. 99-2073 (EGS) (D. District of Columbia, filed August 3, 1999), was consolidated with this action on August 15, 2001.

Fraternal Order of Police v. Board of Governors, No. 98-3116 (D. District of Columbia, filed December 22, 1998), is an action seeking a declaratory judgment regarding the Board's labor policy governing Federal Reserve Banks. ■

*Federal Reserve System
Organization*

Board of Governors

December 31, 2003

Members

	<i>Term expires January 31,</i>
Alan Greenspan, of New York, <i>Chairman</i> ¹	2006
Roger W. Ferguson, Jr., of Massachusetts, <i>Vice Chairman</i> ¹	2014
Edward M. Gramlich, of Virginia ..	2008
Mark W. Olson, of Maryland	2010
Susan S. Bies, of Tennessee	2012
Ben S. Bernanke, of New Jersey	2018
Donald L. Kohn, of Virginia	2016

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1. The designations as Chairman and Vice Chairman expire on June 20, 2004, and October 28, 2007, respectively, unless the service of these members of the Board shall have terminated sooner.

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Federal Open Market Committee

December 31, 2003

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DINO KOS, *Manager, System Open Market Account*

During 2003 the Federal Open Market Committee held eight regularly scheduled meetings (see “Minutes of Federal Open Market Committee Meetings” in this volume).

Federal Advisory Council

December 31, 2003

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The Federal Advisory Council, which is composed of one representative of the banking industry from each of the twelve Federal Reserve Districts, is required by the Federal Reserve Act to meet in Washington at least four times each year and is authorized by the act to consult with, and advise, the Board of Governors on all matters within the jurisdiction of the Board. The council met on February 6–7, May 1–2, September 4–5, and December 4–5, 2003. The Board met with the council on February 7, May 2, September 5, and December 5, 2003.

Consumer Advisory Council

December 31, 2003

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ELIZABETH RENUART, *Staff Attorney*, National Consumer Law Center, Boston, Massachusetts

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California Department of Justice
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Managing Director and Chief
Compliance Officer
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Boston, Massachusetts

The Consumer Advisory Council was established pursuant to the 1976 amendments to the Equal Credit Opportunity Act to advise the Board of Governors on consumer financial services. It is composed of academics, state and local government officials, representatives of the financial industry, and representatives of consumer and community interests. The council met with members of the Board on March 13, June 26, and October 23, 2003.

Thrift Institutions Advisory Council

December 31, 2003

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GEORGE W. NISE, *President and Chief Executive Officer*, Beneficial Savings Bank, Philadelphia, Pennsylvania

KEVIN E. PIETRINI, *President and Chief Executive Officer*, Queen City Federal Savings Bank, Virginia, Minnesota

WILLIAM J. SMALL, *Chairman and Chief Executive Officer*, First Federal Bank, Defiance, Ohio

Officers

KAREN L. MCCORMICK, *President*

WILLIAM J. SMALL, *Vice President*

The Thrift Institutions Advisory Council, which is composed of representatives from credit unions, savings and loan associations, and savings banks, consults with, and advises, the Board of Governors on issues pertaining to the thrift industry and on various other matters within the Board's jurisdiction. The members of the council met with the Board on February 28, July 11, and December 12, 2003.

Federal Reserve Banks and Branches

December 31, 2003

Officers

BANK or Branch	Chairman ¹ Deputy Chairman	President First Vice President	Vice President in charge of Branch
BOSTON ²	James J. Norton Samuel O. Thier	Cathy E. Minehan Paul M. Connolly	
NEW YORK ²	Peter G. Peterson John E. Sexton	Timothy F. Geithner Jamie B. Stewart, Jr.	
Buffalo	Marguerite D. Hambleton		Barbara L. Walter ³
PHILADELPHIA	Glenn A. Schaeffer Ronald J. Naples	Anthony M. Santomero William H. Stone, Jr.	
CLEVELAND ²	Robert W. Mahoney Charles E. Bunch	Sandra Pianalto Robert Christy Moore	
Cincinnati	Dennis C. Cuneo		Barbara B. Henshaw
Pittsburgh	Roy W. Haley		Robert B. Schaub
RICHMOND ²	Wesley S. Williams, Jr. Thomas J. Mackell, Jr.	J. Alfred Broaddus, Jr. Walter A. Varvel	
Baltimore	Owen E. Herrnstadt		William J. Tignanelli ³
Charlotte	Michael A. Almond		Jeffrey S. Kane ³
ATLANTA	Paula Lovell David M. Ratcliffe	Jack Guynn Patrick K. Barron	James M. McKee ³
Birmingham	W. Miller Welborn		Lee C. Jones
Jacksonville	William E. Flaherty		Christopher L. Oakley
Miami	Brian E. Keeley		James T. Curry III
Nashville	Whitney Johns Martin		Melvyn K. Purcell ³
New Orleans	Dave Dennis		Robert J. Musso ³
CHICAGO ²	Robert J. Darnall W. James Farrell	Michael H. Moskow Gordon R.G. Werkema	
Detroit	Timothy D. Leuliette		Glenn Hansen ³
ST. LOUIS	Charles W. Mueller Walter L. Metcalfe, Jr.	William Poole W. LeGrande Rives	
Little Rock	Vick M. Crawley		Robert A. Hopkins
Louisville	Norman E. Pfau, Jr.		Thomas A. Boone
Memphis	Gregory M. Duckett		Martha Perine Beard
MINNEAPOLIS	Ronald N. Zweg Linda Hall Whitman	Gary H. Stern James M. Lyon	
Helena	Thomas O. Markle		Samuel H. Gane

Officers—Continued

BANK or Branch	Chairman ¹ Deputy Chairman	President First Vice President	Vice President in charge of Branch
KANSAS CITY	Richard H. Bard Robert A. Funk	Thomas M. Hoenig Richard K. Rasdall	
Denver	Robert M. Murphy		Pamela L. Weinstein
Oklahoma City	Patricia B. Fennell		Dwayne E. Boggs
Omaha	A. F. Raimondo		Steven D. Evans
DALLAS	Ray L. Hunt Patricia M. Patterson	Robert D. McTeer, Jr. Helen E. Holcomb	
El Paso	Gail S. Darling		Robert W. Gilmer ⁴
Houston	Lupe Fraga		Robert Smith III ³
San Antonio	Ron R. Harris		James L. Stull ³
SAN FRANCISCO	George M. Scalise Sheila D. Harris	Robert T. Parry John F. Moore	
Los Angeles	William D. Jones		Mark L. Mullinix ⁵
Portland	Karla S. Chambers		Richardson B. Hornsby
Salt Lake City	H. Roger Boyer		Andrea P. Wolcott
Seattle	Mic R. Dinsmore		Mark Gould

NOTE. A current list of these officers appears each quarter in the *Federal Reserve Bulletin*.

1. The Chairman of a Federal Reserve Bank serves, by statute, as Federal Reserve agent.

2. Additional offices of these Banks are located at Windsor Locks, Connecticut; Utica at Oriskany, New York; East Rutherford, New Jersey; Columbus, Ohio;

Charleston, West Virginia; Columbia, South Carolina; Indianapolis, Indiana; Milwaukee, Wisconsin; Des Moines, Iowa; and Peoria, Illinois.

3. Senior Vice President

4. Acting Vice President

5. Executive Vice President

Conference of Chairmen

The chairmen of the Federal Reserve Banks are organized into the Conference of Chairmen, which meets to consider matters of common interest and to consult with and advise the Board of Governors. The deputy chairmen of the Federal Reserve Banks also attend these meetings. Conference meetings were held in Washington on May 28 and 29, and on December 3 and 4, 2003.

The members of the executive committee of the Conference of Chairmen during 2003 were Robert J. Darnall, chair; Wesley S. Williams, Jr., vice chair; and Ronald N. Zwiag, member.

On December 4, 2003, the conference elected its executive committee for 2004, naming Wesley S. Williams, Jr., as chair; George M. Scalise as vice chair; and Walter L. Metcalfe, Jr., as the third member.

Conference of Presidents

The presidents of the Federal Reserve Banks are organized into the Conference of Presidents, which meets periodically to consider matters of common interest and to consult with and advise the Board of Governors.

Michael H. Moskow, President of the Federal Reserve Bank of Chicago, served as chair of the conference in 2003, and Cathy E. Minehan, President of the Federal Reserve Bank of Boston, served as its vice chair. Valerie J. Van Meter, of the Federal Reserve Bank of Chicago, served as its secretary, and Michael P. Malone, of the Federal Reserve Bank of Boston, served as its assistant secretary.

Conference of First Vice Presidents

The Conference of First Vice Presidents of the Federal Reserve Banks was organized in 1969 to meet periodically for the consideration of operations and other matters.

Paul M. Connolly, First Vice President of the Federal Reserve Bank of Boston, served as chair of the conference in 2003, and Walter A. Varvel, First Vice President of the Federal Reserve Bank of Richmond, served as its vice chair. David K. Park, of the Federal Reserve Bank of Boston, served as its secretary, and Janice E. Clatterbuck, of the Federal Reserve Bank of Richmond, served as its assistant secretary.

On September 29, 2003, the conference elected Walter A. Varvel as its chair for 2004–05, and Helen E. Holcomb, First Vice President of the Federal Reserve Bank of Dallas, as its vice chair.

Directors

Each Federal Reserve Bank has a nine-member board: three Class A and three Class B directors, who are elected by the stockholding member banks, and three Class C directors, who are appointed by the Board of Governors of the Federal Reserve System.

Class A directors represent the stockholding member banks in each Federal Reserve District. Class B and Class C directors represent the public and are chosen with due, but

not exclusive, consideration to the interests of agriculture, commerce, industry, services, labor, and consumers; they may not be officers, directors, or employees of any bank or bank holding company. In addition, Class C directors may not be stockholders of any bank or bank holding company.

For the election of Class A and Class B directors, the member banks of each Federal Reserve District are classified into three groups. Each group, which comprises banks with similar capitalization, elects one Class A director and one Class B director. Annually, the Board of Governors designates one of the Class C directors as chair of the board of each District Bank, and it designates another Class C director as deputy chair.

Federal Reserve Branches have either five or seven directors, a majority of whom are appointed by the parent Federal Reserve Bank; the others are appointed by the Board of Governors. One of the directors appointed by the Board is designated annually as chair of the board of that Branch in a manner prescribed by the parent Federal Reserve Bank. For the name of the chair and deputy chair of the board of directors of each Reserve Bank and of the chair of each Branch, see the preceding table, "Officers of Federal Reserve Banks and Branches."

A list of the directors of Federal Reserve Banks and Branches follows. For each director, the class of directorship, the director's principal organizational affiliation, and the date the director's term expires is shown.

Directors

BANK OR BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
DISTRICT 1—BOSTON		
RESERVE BANK		
<i>Class A</i>		
Richard C. White	Chairman, President, and Chief Executive Officer, Community National Bank, Derby, Vermont	2003
Lawrence K. Fish	Chairman, President, and Chief Executive Officer, Citizens Financial Group, Inc., Providence, Rhode Island	2004
David S. Outhouse	President and Chief Executive Officer, First and Ocean National Bank, Newburyport, Massachusetts	2005
<i>Class B</i>		
Sherwin Greenblatt	Past President, Bose Corporation, Bolton, Massachusetts	2003
Robert K. Kraft	Chairman and Chief Executive Officer, The Kraft Group, Foxborough, Massachusetts	2004
Orit Gadiesh	Chairman, Bain & Company, Inc., Boston, Massachusetts	2005
<i>Class C</i>		
James J. Norton	Vice President, AFL-CIO, Washington, D.C.	2003
Samuel O. Thier	Professor of Medicine and Professor of Health Care Policy—Harvard Medical School, Massachusetts General Hospital, Boston, Massachusetts	2004
Blenda J. Wilson	President and Chief Executive Officer, Nellie Mae Education Foundation, Quincy, Massachusetts	2005
DISTRICT 2—NEW YORK		
RESERVE BANK		
<i>Class A</i>		
Sanford I. Weill	Chairman, Citigroup Inc., New York, New York	2003
Jill M. Considine	Chairman and Chief Executive Officer, The Depository Trust Company, New York, New York	2004
Charles V. Wait	President, Chief Executive Officer, and Chairman, The Adirondack Trust Company, Saratoga Springs, New York	2005
<i>Class B</i>		
Jerry I. Speyer	President and Chief Executive Officer, Tishman Speyer Properties, New York, New York	2003
Ronay Menschel	Chairman, Phipps Houses, New York, New York	2004
Marta Tienda	Professor of Sociology and Public Affairs, Princeton University, Princeton, New Jersey	2005
<i>Class C</i>		
John E. Sexton	President, New York University, New York, New York	2003
Peter G. Peterson	Chairman, The Blackstone Group, New York, New York	2004
Loretta E. Lynch	Partner, Hogan & Hartson LLP, New York, New York	2005

Directors—Continued

BANK OR BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
BUFFALO BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Peter G. Humphrey	Chairman, President, and Chief Executive Officer, Financial Institutions, Inc., Warsaw, New York	2003
Maureen Torrey Marshall ..	Co-Owner, Torrey Farms, Inc., Elba, New York	2003
Emerson L. Brumback	President and Chief Operating Officer, Manufacturers and Traders Trust Company, Buffalo, New York	2004
Geraldine C. Ochocinska ...	Regional Director, Region 9, UAW, Buffalo, New York	2005
<i>Appointed by the Board of Governors</i>		
Katherine E. Keough	President, St. John Fisher College, Rochester, New York	2003
Marguerite D. Hambleton ..	President and Chief Executive Officer, AAA Western and Central New York, Buffalo, New York	2004
Brian J. Lipke	Chairman and Chief Executive Officer, Gibraltar, Buffalo, New York	2005
DISTRICT 3—PHILADELPHIA		
RESERVE BANK		
<i>Class A</i>		
Robert J. Vanderslice	President and Chief Operating Officer, Pennsville National Bank, Pennsville, New Jersey	2003
Walter E. Daller, Jr.	Chairman, President, and Chief Executive Officer, Harleysville National Corporation, Harleysville, Pennsylvania	2004
Kenneth R. Shoemaker	President and Chief Executive Officer, Orrstown Bank, Shippensburg, Pennsylvania	2005
<i>Class B</i>		
Garry L. Maddox	Chief Executive Officer, A. Pomerantz & Company, Philadelphia, Pennsylvania	2003
P. Coleman Townsend, Jr. ..	Chairman and Chief Executive Officer, Townsends, Inc., Wilmington, Delaware	2004
Robert E. Chappell	Chairman and Chief Executive Officer, Penn Mutual Life Insurance Co., Horsham, Pennsylvania	2005
<i>Class C</i>		
Glenn A. Schaeffer	President Emeritus, Pennsylvania Building and Construction Trades Council, Harrisburg, Pennsylvania	2003
Doris M. Damm	President and Chief Executive Officer, ACCU Staffing Services, Cherry Hill, New Jersey	2004
Ronald J. Naples	Chairman and Chief Executive Officer, Quaker Chemical Corporation, Conshohocken, Pennsylvania	2005

BANK OR BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
DISTRICT 4—CLEVELAND		
RESERVE BANK		
<i>Class A</i>		
Stephen P. Wilson	President and Chief Executive Officer, Lebanon Citizens National Bank, Lebanon, Ohio	2003
John R. Cochran	Chairman and Chief Executive Officer, FirstMerit Corporation, Akron, Ohio	2004
Bick Weissenrieder	Chairman of the Board and Chief Executive Officer, Hocking Valley Bank, Athens, Ohio	2005
<i>Class B</i>		
Cheryl L. Krueger	President and Chief Executive Officer, Cheryl&Co., Westerville, Ohio	2003
Wayne R. Embry	Former President and Chief Operating Officer, Cleveland Cavaliers, Cleveland, Ohio	2004
Tanny Crane	President and Chief Executive Officer, Crane Plastics Company, LP, Columbus, Ohio	2005
<i>Class C</i>		
Robert W. Mahoney	Retired Chairman and Chief Executive Officer, Diebold, Incorporated, Uniontown, Ohio	2003
Charles E. Bunch	President and Chief Operating Officer, PPG Industries, Inc., Pittsburgh, Pennsylvania	2004
Phillip R. Cox	President and Chief Executive Officer, Cox Financial Corporation, Cincinnati, Ohio	2005
CINCINNATI BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Charlotte W. Martin	President and Chief Executive Officer, Great Lakes Bankers Bank, Gahanna, Ohio	2003
James H. Booth	President, Czar Coal Corporation, Lovely, Kentucky	2004
Glenn D. Leveridge	President, Bank One, NA, Lexington, Kentucky	2005
V. Daniel Radford	Executive Secretary-Treasurer, Cincinnati AFL-CIO Labor Council, Cincinnati, Ohio	2005
<i>Appointed by the Board of Governors</i>		
Charles Whitehead	Retired President, Ashland Inc. Foundation, Covington, Kentucky	2003
Herbert R. Brown	Senior Vice President, The Western and Southern Life Insurance Company, Cincinnati, Ohio	2004
Dennis C. Cuneo	Senior Vice President, Toyota Motor Manufacturing North America Inc., Erlanger, Kentucky	2005
PITTSBURGH BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Kristine N. Molnar	President and Chief Executive Officer, WesBanco Bank, Inc., Wheeling, West Virginia	2003
Michael J. Hagan	President and Chief Executive Officer, Iron and Glass Bank, Pittsburgh, Pennsylvania	2004

Directors—Continued

BANK OR BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
Ronnie L. Bryant	President and Chief Operating Officer, Pittsburgh Regional Alliance, Pittsburgh, Pennsylvania	2005
Georgiana N. Riley	President and Chief Executive Officer, TIGG Corporation, Bridgeville, Pennsylvania	2005
<i>Appointed by the Board of Governors</i>		
James I. Mitnick	Senior Vice President, Turner Construction Company, Pittsburgh, Pennsylvania	2003
Robert O. Agbede	President and Chief Executive Officer, Advanced Technology Systems, Inc., Pittsburgh, Pennsylvania	2004
Roy W. Haley	Chairman and Chief Executive Officer, WESCO International, Inc., Pittsburgh, Pennsylvania	2005
DISTRICT 5—RICHMOND		
RESERVE BANK		
<i>Class A</i>		
William W. Duncan, Jr.	President and Chief Executive Officer, St. Michaels Bank, St. Michaels, Maryland	2003
Eddie Canterbury	President/CEO, Logan Bank & Trust Company, Logan, West Virginia	2004
Barry J. Fitzpatrick	Chairman, Chief Executive Officer, and President, Branch Banking & Trust Co. of Virginia, Falls Church, Virginia	2005
<i>Class B</i>		
James E. Haden	President and Chief Executive Officer, Martha Jefferson Hospital, Charlottesville, Virginia	2003
Joe Edens	Chairman, Edens & Avant, Columbia, South Carolina	2004
W. Henry Harmon	President and Chief Executive Officer, Columbia Natural Resources, LLC, Charleston, West Virginia	2005
<i>Class C</i>		
Wesley S. Williams, Jr.	Partner, Covington & Burling, Washington, D.C.	2003
Theresa M. Stone	Chief Financial Officer, Jefferson-Pilot Corporation, and President, Jefferson-Pilot Communications Company, Greensboro, North Carolina	2004
Thomas J. Mackell, Jr.	President and Chief Operating Officer, The Kamber Group, Washington, D.C.	2005
BALTIMORE BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
William L. Jews	President and Chief Executive Officer, CareFirst BlueCross BlueShield, Owings Mills, Maryland	2003
Kenneth C. Lundeen	President, C. J. Langenfelder & Son, Inc., Baltimore, Maryland	2003
Donald P. Hutchinson	President and Chief Executive Officer, SunTrust Bank, Maryland, Baltimore, Maryland	2004

BANK OR BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
Dyan Brasington	President, Technology Council of Maryland, Rockville, Maryland	2005
<i>Appointed by the Board of Governors</i>		
William C. Handorf	Professor of Finance, School of Business and Public Management, George Washington University, Washington, D.C.	2003
Owen E. Herrnstadt	Director, International Department, International Association of Machinists and Aerospace Workers, AFL-CIO, Upper Marlboro, Maryland	2004
Cynthia Collins Allner	Principal, Miles & Stockbridge, PC, Baltimore, Maryland	2005
CHARLOTTE BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Elleveen T. Poston	President, Quality Transport, Inc., Lake City, South Carolina	2003
Cecil W. Sewell, Jr.	Chairman Emeritus, RBC Centura Banks, Inc., Rocky Mount, North Carolina	2003
William H. Nock	President and Chief Executive Officer, Sumter National Bank, Sumter, South Carolina	2004
Lucy J. Reuben	Provost and Vice Chancellor for Academic Affairs, North Carolina Central University, Durham, North Carolina	2005
<i>Appointed by the Board of Governors</i>		
Jim Lowry	Dealer Operator, Crown Automotive, High Point, North Carolina	2003
James F. Goodman	President and Chief Executive Officer, Capitol Broadcasting Company, Inc., Raleigh, North Carolina	2004
Michael A. Almond	President and Chief Executive Officer, Charlotte Regional Partnership, Charlotte, North Carolina	2005
DISTRICT 6—ATLANTA		
RESERVE BANK		
<i>Class A</i>		
William G. Smith, Jr.	President and Chief Executive Officer, Capital City Bank Group, Inc., Tallahassee, Florida	2003
James F. Beall	Chairman, President, and Chief Executive Officer, Farmers & Merchants Bank, Centre, Alabama	2004
Richard G. Hickson	Chairman and Chief Executive Officer, Trustmark Corporation, Jackson, Mississippi	2005
<i>Class B</i>		
John Dane III	President and Chief Executive Officer, Trinity Yachts LLC, New Orleans, Louisiana	2003

Directors—Continued

BANK or BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
Suzanne E. Boas	President, Consumer Credit Counseling Service of Greater Atlanta, Inc., Atlanta, Georgia	2004
Egbert L. J. Perry	Chairman and Chief Executive Officer, The Integral Group, LLC, Atlanta, Georgia	2005
<i>Class C</i>		
Paula Lovell	President, Lovell Communications, Inc., Nashville, Tennessee	2003
David M. Ratcliffe	President and Chief Executive Officer, Georgia Power Company, Atlanta, Georgia	2004
V. Larkin Martin	Managing Partner, Martin Farm, Courtland, Alabama	2005
BIRMINGHAM BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Hundley Batts, Sr.	Owner and Managing General Agent, Hundley Batts & Associates, Huntsville, Alabama	2003
James A. Vickery	International Representative, Laborers' International Union of North America, Rainbow City, Alabama	2003
John B. Barnett III	Chairman, The Monroe County Bank, Monroeville, Alabama	2004
John H. Holcomb III	Chairman and Chief Executive Officer, Alabama National Bancorporation, Birmingham, Alabama	2005
<i>Appointed by the Board of Governors</i>		
W. Miller Welborn	President, Welborn and Associates, Inc., Lookout Mountain, Tennessee	2003
Catherine Sloss Crenshaw ..	President, Sloss Real Estate Group, Inc., Birmingham, Alabama	2004
James H. Sanford	Chairman of the Board, HOME Place Farms, Inc., Prattville, Alabama	2005
JACKSONVILLE BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Robert L. Fisher	President and Chief Executive Officer, MacDill Federal Credit Union, Tampa, Florida	2003
Michael W. Poole	Principal, Poole Carbone Eckbert, Inc., Winter Park, Florida	2003
Harvey R. Heller	President, Heller Brothers Packing Corp., Winter Garden, Florida	2004
Jerry M. Smith	Chairman and President, First National Bank of Alachua, Alachua, Florida	2005
<i>Appointed by the Board of Governors</i>		
William E. Flaherty	Retired Chairman, Blue Cross and Blue Shield of Florida, Inc., Jacksonville, Florida	2003
Julie K. Hilton	Vice President and Co-Owner, Paradise Found Resorts & Hotels, Panama City Beach, Florida	2004
Fassil Gabremariam	President and Founder, U.S.-Africa Free Enterprise Education Foundation, Tampa, Florida	2005

BANK or BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
MIAMI BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Miriam Lopez	President and Chief Executive Officer, TransAtlantic Bank, Miami, Florida	2003
Rudy E. Schupp	President and Chief Executive Officer, First United Bank, North Palm Beach, Florida	2004
Francis V. Gudorf	President and Executive Director, Jubilee Community Development Corporation, Miami, Florida	2005
Joseph C. Schwartzel	President, Meridian Broadcasting, Inc., Fort Myers, Florida	2005
<i>Appointed by the Board of Governors</i>		
Brian E. Keeley	President and Chief Executive Officer, Baptist Health South Florida, Coral Gables, Florida	2003
Rosa Sugranes	Chairman, Iberia Tiles Corp., Miami, Florida	2004
Edwin A. Jones, Jr.	President, Angus Investments, Inc., Belle Glade, Florida	2005
NASHVILLE BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
James W. Spradley, Jr.	President, Standard Candy Company, Inc., Nashville, Tennessee	2003
Vacancy		2003
Sam O. Franklin III	Chairman, SunTrust Bank, Nashville, Nashville, Tennessee	2004
Michael B. Swain	President and Chief Executive Officer, First National Bank, Oneida, Tennessee	2005
<i>Appointed by the Board of Governors</i>		
Whitney Johns Martin	Chairman and Chief Executive Officer, Capital Across America, Nashville, Tennessee	2003
F. Rodney Lawler	Co-Founder and Chief Executive Officer, Lawler-Wood, LLC, Knoxville, Tennessee	2004
Beth Dortch Franklin	President and Chief Executive Officer, Star Transportation, Inc., Nashville, Tennessee	2005
NEW ORLEANS BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Teri G. Fontenot	President and Chief Executive Officer, Woman's Hospital, Baton Rouge, Louisiana	2003
David Guidry	President and Chief Executive Officer, Guico Machine Works, Inc., Harvey, Louisiana	2003
David E. Johnson	Chairman and Chief Executive Officer, The First Bancshares, Inc., and the First National Bank of South Mississippi, Hattiesburg, Mississippi	2004
C. R. Cloutier	President and Chief Executive Officer, MidSouth Bank, Lafayette, Louisiana	2005

Directors—Continued

BANK OR BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
<i>Appointed by the Board of Governors</i>		
Ben Tom Roberts	Senior Executive Vice President, Roberts Brothers, Inc., Realtors, Mobile, Alabama	2003
Dave Dennis	President, Specialty Contractors & Assoc., Inc., Gulfport, Mississippi	2004
Earl L. Shipp	Vice President and Site Director, The Dow Chemical Company, Louisiana Operations, Plaquemine, Louisiana	2005
DISTRICT 7—CHICAGO		
RESERVE BANK		
<i>Class A</i>		
Robert R. Yohanan	Managing Director and Chief Executive Officer, First Bank & Trust, Evanston, Illinois	2003
Alan R. Tubbs	President, Maquoketa State Bank and Ohnward Bancshares Inc., Maquoketa, Iowa	2004
William A. Osborn	Chairman and Chief Executive Officer, Northern Trust Corporation and The Northern Trust Company, Chicago, Illinois	2005
<i>Class B</i>		
Jack B. Evans	President, The Hall-Perrine Foundation, Cedar Rapids, Iowa	2003
James H. Keyes	Chairman of the Board and Chief Executive Officer, Johnson Controls, Inc., Milwaukee, Wisconsin	2004
Connie E. Evans	President and Chief Executive Officer, WSEP Ventures, Chicago, Illinois	2005
<i>Class C</i>		
W. James Farrell	Chairman and Chief Executive Officer, Illinois Tool Works Inc., Glenview, Illinois	2003
Miles D. White	Chairman and Chief Executive Officer, Abbott Laboratories, Abbott Park, Illinois	2004
Robert J. Darnall	Retired Chairman and Chief Executive Officer, Inland Steel Industries, Inc., Chicago, Illinois	2005
DETROIT BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
David J. Wagner	Retired Chairman, Fifth Third Bank, Grand Rapids, Michigan	2003
Robert E. Churchill	Chairman and Chief Executive Officer, Citizens National Bank, Cheboygan, Michigan	2004
Mark T. Gaffney	President, Michigan AFL-CIO, Lansing, Michigan	2005
Tommi A. White	Chief Operating Officer, Compuware Corporation, Detroit, Michigan	2005
<i>Appointed by the Board of Governors</i>		
Timothy D. Leuliette	President and Chief Executive Officer, Metaldyne, Plymouth, Michigan	2003
Irvin D. Reid	President, Wayne State University, Detroit, Michigan	2004
Edsel B. Ford II	Director, Ford Motor Company, Dearborn, Michigan	2005

BANK OR BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
DISTRICT 8—ST. LOUIS		
RESERVE BANK		
<i>Class A</i>		
Bradley W. Small	President and Chief Executive Officer, The Farmers and Merchants National Bank, Nashville, Illinois	2003
Lewis F. Mallory, Jr.	Chairman and Chief Executive Officer, National Bank of Commerce, Starkville, Mississippi	2004
Lunsford W. Bridges	President and Chief Executive Officer, Metropolitan National Bank, Little Rock, Arkansas	2005
<i>Class B</i>		
Robert L. Johnson	Chairman and Chief Executive Officer, Johnson Bryce, Inc., Memphis, Tennessee	2003
Bert Greenwalt	Partner, Greenwalt Company, Hazen, Arkansas	2004
J. Stephen Barger	Executive Secretary-Treasurer, Kentucky State District Council of Carpenters, Frankfort, Kentucky	2005
<i>Class C</i>		
Walter L. Metcalfe, Jr.	Chairman, Bryan Cave LLP, St. Louis, Missouri	2003
Charles W. Mueller	Chairman and Chief Executive Officer, Ameren Corporation, St. Louis, Missouri	2004
Gayle P. W. Jackson	Managing Director, FondElec Clean Energy Group, Inc., St. Louis, Missouri	2005
LITTLE ROCK BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Raymond E. Skelton	Regional President, U.S. Bank, North Little Rock, Arkansas	2003
Lawrence A. Davis, Jr.	Chancellor, University of Arkansas at Pine Bluff, Pine Bluff, Arkansas	2004
Everett Tucker III	Chairman, Moses Tucker Real Estate, Inc., Little Rock, Arkansas	2005
David R. Estes	President and Chief Executive Officer, First State Bank, Lonoke, Arkansas	2005
<i>Appointed by the Board of Governors</i>		
Scott T. Ford	President and Chief Executive Officer, ALLTEL Corporation, Little Rock, Arkansas	2003
Vick M. Crawley	Retired Plant Manager, Baxter Healthcare Corporation, Mountain Home, Arkansas	2004
A. Rogers Yarnell II	President, Yarnell Ice Cream Co., Inc., Searcy, Arkansas	2005
LOUISVILLE BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Frank J. Nichols	Chairman, President, and Chief Executive Officer, Community Financial Services, Inc., Benton, Kentucky	2003

Directors—Continued

BANK or BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
David H. Brooks	Chairman and Chief Executive Officer, Stock Yards Bank & Trust Company, Louisville, Kentucky	2004
Thomas W. Smith	President, Thomas W. Smith & Associates, Inc., Danville, Kentucky	2005
Marjorie Soyugenc	Executive Director and Chief Executive Officer, Welborn Foundation, Evansville, Indiana	2005
<i>Appointed by the Board of Governors</i>		
Norman E. Pfau, Jr.	President and Chief Executive Officer, Geo. Pfau's Sons Company, Inc., Jeffersonville, Indiana	2003
Cornelius A. Martin	President and Chief Executive Officer, Martin Management Group, Bowling Green, Kentucky	2004
Maria Gerwing Hampton ...	President, The Housing Partnership, Inc., Louisville, Kentucky	2005
MEMPHIS BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
E. C. Neelly III	Management Consultant, First American National Bank, Iuka, Mississippi	2003
Walter L. Morris, Jr.	President, H&M Lumber Co., Inc., West Helena, Arkansas	2004
James A. England	Chairman, President, and Chief Executive Officer, Decatur County Bank, Decaturville, Tennessee	2005
Tom A. Wright	Chairman and Chief Executive Officer, Enterprise National Bank, Memphis, Tennessee	2005
<i>Appointed by the Board of Governors</i>		
Russell Gwatney	President, Gwatney Companies, Memphis, Tennessee	2003
Gregory M. Duckett	Senior Vice President and Corporate Counsel, Baptist Memorial Health Care Corporation, Memphis, Tennessee	2004
Meredith Baird Allen	Vice President, Marketing, Staple Cotton Cooperative Association, Greenwood, Mississippi	2005
DISTRICT 9—MINNEAPOLIS		
RESERVE BANK <i>Class A</i>		
Dan M. Fisher	Chief Information Officer, Community First Bankshares, Inc., Fargo, North Dakota	2003
Kay Clevidence	President, Farmers State Bank, Victor, Montana	2004
Robert Dickson	Chief Executive Officer, The First National Bank of Fairfax, Fairfax, Minnesota	2005
<i>Class B</i>		
D. Greg Heineman	Chairman, Williams Insurance Agency, Sioux Falls, South Dakota	2003
Jay F. Hoeschler	President, Hoeschler Corporation, La Crosse, Wisconsin	2004

BANK OR BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
Randy Peterson	General Manager, Precision Edge Surgical Products LLC, Sault Ste. Marie, Michigan	2005
<i>Class C</i>		
Ronald N. Zweg	President, United Food & Commercial Workers, Local 653, Plymouth, Minnesota	2003
Frank L. Sims	Corporate Vice President, Transportation, Cargill, Inc./Lake Office, Wayzata, Minnesota	2004
Linda Hall Whitman	Chief Executive Officer, MinuteClinic, Minneapolis, Minnesota	2005
HELENA BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Richard E. Hart	President, Senior Lender, and Director, Mountain West Bank, Kalispell, Montana	2003
Joy N. Ott	Regional President and Chief Executive Officer, Wells Fargo Bank Montana, N.A., Billings, Montana	2004
Marilyn F. Wessel	Former Dean and Director, Museum of the Rockies, Bozeman, Montana	2004
<i>Appointed by the Board of Governors</i>		
Tom Markle	President and Chief Executive Officer, Markle's Inc., Glasgow, Montana	2003
Dean Folkvord	President and Chief Executive Officer, Wheat Montana Farms and Bakery, Three Forks, Montana	2004
DISTRICT 10—KANSAS CITY		
RESERVE BANK		
<i>Class A</i>		
Bruce A. Schriefer	President, Bankers' Bank of Kansas, N.A., Wichita, Kansas	2003
Jeffrey L. Gerhart	President and Chief Executive Officer, First National Bank of Newman Grove, Newman Grove, Nebraska	2004
Rick L. Smalley	Chief Executive Officer, Dickinson Financial Corporation, Kansas City, Missouri	2005
<i>Class B</i>		
Hans C. Helmerich	President and Chief Executive Officer, Helmerich & Payne, Inc., Tulsa, Oklahoma	2003
Frank Moore	President, Spearhead Ranch Company, Douglas, Wyoming	2004
Dan L. Dillingham	Chief Executive Officer, Dillingham Insurance, Enid, Oklahoma	2005
<i>Class C</i>		
Robert A. Funk	Chairman of the Board and Chief Executive Officer, Express Personnel Services International, Oklahoma City, Oklahoma	2003

Directors—Continued

BANK OR BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
Richard H. Bard	Chairman and Chief Executive Officer, International Surface Preparation Corporation, Golden, Colorado	2004
Rhonda Holman	Interim Director, Entrepreneurial Growth Resource Center, University of Missouri–Kansas City, Kansas City, Missouri	2005
DENVER BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
John W. Hay III	President, Rock Springs National Bank, Rock Springs, Wyoming	2003
Kathryn A. Paul	President, Delta Dental Plan of Colorado, Denver, Colorado	2003
Thomas Williams	President and Chief Executive Officer, Williams Group LLC, Golden, Colorado	2004
Virginia K. Berkeley	President, Colorado Business Bank N.A., Denver, Colorado	2005
<i>Appointed by the Board of Governors</i>		
Robert M. Murphy	President, Sandia Properties Ltd., Co., Albuquerque, New Mexico	2003
James A. King	Chief Executive Officer, BT, Inc., Riverton, Wyoming	2004
Kathleen Avila	Managing Member, Avila Retail Development & Management, Albuquerque, New Mexico	2005
OKLAHOMA CITY BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Richard K. Ratcliffe	Chairman, Ratcliffe's Inc., Weatherford, Oklahoma	2003
Robert R. Gilbert III	President and Chief Operating Officer, The F&M Bank & Trust Company, Tulsa, Oklahoma	2004
W. Carlisle Mabrey III	President and Chief Executive Officer, Citizens Bank & Trust Co., Okmulgee, Oklahoma	2004
Tyree O. Minner	Plant Manager, General Motors, Oklahoma City, Oklahoma	2005
<i>Appointed by the Board of Governors</i>		
Patricia B. Fennell	Executive Director, Latino Community Development Agency, Oklahoma City, Oklahoma	2003
Vacancy		2004
Clifford Hudson	Chairman and Chief Executive Officer, Sonic Corp., Oklahoma City, Oklahoma	2005
OMAHA BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Frank L. Hayes	President, Hayes & Associates, LLC, CPAs, Omaha, Nebraska	2003
H. H. Kosman	Chairman, President, and Chief Executive Officer, Platte Valley National Bank, Scottsbluff, Nebraska	2003

BANK OR BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
Cynthia Hardin Milligan ...	Dean, College of Business Administration, University of Nebraska–Lincoln, Lincoln, Nebraska	2004
Judith A. Owen	President and Chief Executive Officer, Wells Fargo Bank Nebraska, N.A., Omaha, Nebraska	2005
<i>Appointed by the Board of Governors</i>		
A. F. Raimondo	Chairman and Chief Executive Officer, Behlen Mfg. Co., Columbus, Nebraska	2003
Vacancy		2004
James A. Timmerman	Chief Financial Officer and Secretary/Treasurer, Timmerman & Sons Feeding Co., Springfield, Nebraska	2005
DISTRICT 11—DALLAS		
RESERVE BANK		
<i>Class A</i>		
Matthew T. Doyle	Vice Chairman and Chief Executive Officer, Texas First Bank, Texas City, Texas	2003
David S. Barnard	Chairman and Chief Executive Officer, National Bank, Gatesville, Texas	2004
Richard W. Evans, Jr.	Chairman and Chief Executive Officer, Cullen/Frost Bankers, Inc., San Antonio, Texas	2005
<i>Class B</i>		
Judy Ley Allen	Owner, Allen Investments, Houston, Texas	2003
Julie Spicer England	Vice President, Texas Instruments, Dallas, Texas	2004
Malcolm Gillis	President, Rice University, Houston, Texas	2005
<i>Class C</i>		
Vacancy		2003
Ray L. Hunt	Chairman, President, and Chief Executive Officer, Hunt Consolidated, Inc., Dallas, Texas	2004
Patricia M. Patterson	President, Patterson Investments, Inc., Dallas, Texas	2005
EL PASO BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Gerald J. Rubin	President and Chief Executive Officer, Helen of Troy Limited, El Paso, Texas	2003
F. James Volk	Regional President, State National Bank, El Paso, Texas	2004
Pete Cook	Chief Executive Officer, First National Bank of Alamogordo, Alamogordo, New Mexico	2005
Fred Loya	Chairman, Fred Loya Insurance, El Paso, Texas	2005
<i>Appointed by the Board of Governors</i>		
Gail Darling	President, Gail Darling Staffing, El Paso, Texas	2003

Directors—Continued

BANK or BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
Cecilia O. Levine	President, MFI International Mfg., LLC, El Paso, Texas	2004
Ron C. Helm	Owner, Helm Cattle and Land Company, Van Horn, Texas	2005
HOUSTON BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Alan R. Buckwalter III	Retired Chairman and Chief Executive Officer, Chase Bank of Texas, Houston, Texas	2003
Richard W. Weekley	Chairman, Weekley Development Company, Houston, Texas	2004
Priscilla D. Slade	President, Texas Southern University, Houston, Texas	2005
S. Reed Morian	Chairman and President, DX Service Company, Inc., Houston, Texas	2005
<i>Appointed by the Board of Governors</i>		
Anthony R. Chase	Chairman and Chief Executive Officer, ChaseCom, LP, Houston, Texas	2003
James T. Hackett	President and Chief Executive Officer, Anadarko Petroleum Corporation, Houston, Texas	2004
Lupe Fraga	President and Chief Executive Officer, Tejas Office Products, Inc., Houston, Texas	2005
SAN ANTONIO BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Arthur R. Emerson	Chairman and Chief Executive Officer, Groves Rojas Emerson, San Antonio, Texas	2003
R. Tom Roddy	Chairman, Lone Star Capital Bank, N.A., San Antonio, Texas	2004
Matt F. Gorges	Chairman and Chief Executive Officer, Valley International Cold Storage, Harlingen, Texas	2005
Daniel B. Hastings, Jr.	President and Owner, Daniel B. Hastings, Inc., Laredo, Texas	2005
<i>Appointed by the Board of Governors</i>		
Marvin L. Ragsdale	President, Iron Workers District Council of the State of Texas, Georgetown, Texas	2003
Ron R. Harris	General Partner, Southwest Capital Partners, Austin, Texas	2004
Elizabeth Chu Richter	Chairman and Chief Executive Officer, Richter Architects, Corpus Christi, Texas	2005
DISTRICT 12—SAN FRANCISCO		
RESERVE BANK		
<i>Class A</i>		
Richard C. Hartnack	Vice Chairman, Union Bank of California, N.A., Los Angeles, California	2003
Richard W. Decker, Jr.	Chairman and Co-Founder, Belvedere Capital Partners LLC, San Francisco, California	2004
Candace H. Wiest	President, Inland Empire National Bank, Riverside, California	2005

BANK OR BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
<i>Class B</i>		
Barbara L. Wilson	Consultant and Regional Vice President (Retired), Qwest Corporation, Boise, Idaho	2003
Jack McNally	Principal, JKM Consulting, Sacramento, California	2004
David K. Y. Tang	Partner, Preston Gates & Ellis LLP, Seattle, Washington	2005
<i>Class C</i>		
Jay T. Harris	Wallis Annenberg Chair in Journalism and Communication, Annenberg School for Communication, University of Southern California, Los Angeles, California	2003
Sheila D. Harris	Director, Arizona Department of Housing, Phoenix, Arizona	2004
George M. Scalise	President, Semiconductor Industry Association, San Jose, California	2005
LOS ANGELES BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Linda Griego	Managing Partner, Engine Co. No. 28, Los Angeles, California	2003
D. Linn Wiley	President and Chief Executive Officer, Citizens Business Bank, Ontario, California	2003
Russell Goldsmith	Chairman and Chief Executive Officer, City National Bank, Beverly Hills, California	2004
Peter M. Thomas	Managing Partner, Thomas & Mack Co., Las Vegas, Nevada	2005
<i>Appointed by the Board of Governors</i>		
Lonnie Kane	President, Karen Kane, Inc., Los Angeles, California	2003
William D. Jones	Chairman, President, and Chief Executive Officer, CityLink Investment Corporation, San Diego, California	2004
Diane Donoghue	Executive Director, Esperanza Community Housing Corporation, Los Angeles, California	2005
PORTLAND BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Vacancy		2003
George J. Passadore	Chairman, Oregon Wells Fargo Bank, Portland, Oregon	2004
Judi Johansen	President and Chief Executive Officer, PacifiCorp, Portland, Oregon	2005
William D. Thorndike, Jr. ..	President, Medford Fabrication, Medford, Oregon	2005
<i>Appointed by the Board of Governors</i>		
Patrick Borunda	Principal, The Navigator Group, Vancouver, Washington	2003
Karla S. Chambers	Vice President and Co-Owner, Stahlbush Island Farms, Inc., Corvallis, Oregon	2004
Peter O. Kohler	President, Oregon Health & Science University, Portland, Oregon	2005

Directors—Continued

BANK OR BRANCH, <i>Category</i> Name	Title	Term expires Dec. 31
SALT LAKE CITY BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Vacancy		2003
Curtis H. Harris	Chairman, President, and Chief Executive Officer, Barnes Banking Company, Kaysville, Utah	2004
A. Scott Anderson	President and Chief Executive Officer, Zions First National Bank, Salt Lake City, Utah	2005
Deborah Bayle Nielsen	President and Chief Executive Officer, United Way of Salt Lake, Salt Lake City, Utah	2005
<i>Appointed by the Board of Governors</i>		
William C. Glynn	President, Intermountain Industries, Inc., Boise, Idaho	2003
Gary L. Crocker	President, Crocker Ventures, Inc., Salt Lake City, Utah	2004
H. Roger Boyer	Chairman, The Boyer Company, Salt Lake City, Utah	2005
SEATTLE BRANCH		
<i>Appointed by the Federal Reserve Bank</i>		
Betsy Lawer	Vice Chair and Chief Operating Officer, First National Bank Alaska, Anchorage, Alaska	2003
Peter H. van Oppen	Chairman and Chief Executive Officer, Advanced Digital Information Corp., Redmond, Washington	2004
Mary E. Pugh	President, Pugh Capital Management, Inc., Seattle, Washington	2005
Kenneth M. Kirkpatrick	President, Washington Commercial Banking, U.S. Bank, Seattle, Washington	2005
<i>Appointed by the Board of Governors</i>		
David W. Wyckoff	Chairman and Chief Executive Officer, Wyckoff Farms, Inc., Grandview, Washington	2003
Mic R. Dinsmore	Chief Executive Officer, Port of Seattle, Seattle, Washington	2004
James R. Gill	President, Pacific Northwest Title Holding Co., Seattle, Washington	2005

Members of the Board of Governors, 1913–2003

Appointed Members

Name	Federal Reserve District	Date initially took oath of office	Other dates ¹
Charles S. Hamlin	Boston	Aug. 10, 1914	Reappointed in 1916 and 1926. Served until Feb. 3, 1936. ²
Paul M. Warburg	New York	Aug. 10, 1914	Term expired Aug. 9, 1918.
Frederic A. Delano	Chicago	Aug. 10, 1914	Resigned July 21, 1918.
W.P.G. Harding	Atlanta	Aug. 10, 1914	Term expired Aug. 9, 1922.
Adolph C. Miller	San Francisco	Aug. 10, 1914	Reappointed in 1924. Reappointed in 1934 from the Richmond District. Served until Feb. 3, 1936. ²
Albert Strauss	New York	Oct. 26, 1918	Resigned Mar. 15, 1920.
Henry A. Moehlenpah	Chicago	Nov. 10, 1919	Term expired Aug. 9, 1920.
Edmund Platt	New York	June 8, 1920	Reappointed in 1928. Resigned Sept. 14, 1930.
David C. Wills	Cleveland	Sept. 29, 1920	Term expired Mar. 4, 1921.
John R. Mitchell	Minneapolis	May 12, 1921	Resigned May 12, 1923.
Milo D. Campbell	Chicago	Mar. 14, 1923	Died Mar. 22, 1923.
Daniel R. Crissinger	Cleveland	May 1, 1923	Resigned Sept. 15, 1927.
George R. James	St. Louis	May 14, 1923	Reappointed in 1931. Served until Feb. 3, 1936. ³
Edward H. Cunningham	Chicago	May 14, 1923	Died Nov. 28, 1930.
Roy A. Young	Minneapolis	Oct. 4, 1927	Resigned Aug. 31, 1930.
Eugene Meyer	New York	Sept. 16, 1930	Resigned May 10, 1933.
Wayland W. Magee	Kansas City	May 18, 1931	Term expired Jan. 24, 1933.
Eugene R. Black	Atlanta	May 19, 1933	Resigned Aug. 15, 1934.
M.S. Szymczak	Chicago	June 14, 1933	Reappointed in 1936 and 1948. Resigned May 31, 1961.
J.J. Thomas	Kansas City	June 14, 1933	Served until Feb. 10, 1936. ²
Marriner S. Eccles	San Francisco	Nov. 15, 1934	Reappointed in 1936, 1940, and 1944. Resigned July 14, 1951.
Joseph A. Broderick	New York	Feb. 3, 1936	Resigned Sept. 30, 1937.
John K. McKee	Cleveland	Feb. 3, 1936	Served until Apr. 4, 1946. ²
Ronald Ransom	Atlanta	Feb. 3, 1936	Reappointed in 1942. Died Dec. 2, 1947.
Ralph W. Morrison	Dallas	Feb. 10, 1936	Resigned July 9, 1936.
Chester C. Davis	Richmond	June 25, 1936	Reappointed in 1940. Resigned Apr. 15, 1941.
Ernest G. Draper	New York	Mar. 30, 1938	Served until Sept. 1, 1950. ²
Rudolph M. Evans	Richmond	Mar. 14, 1942	Served until Aug. 13, 1954. ²
James K. Vardaman, Jr.	St. Louis	Apr. 4, 1946	Resigned Nov. 30, 1958.
Lawrence Clayton	Boston	Feb. 14, 1947	Died Dec. 4, 1949.
Thomas B. McCabe	Philadelphia	Apr. 15, 1948	Resigned Mar. 31, 1951.
Edward L. Norton	Atlanta	Sept. 1, 1950	Resigned Jan. 31, 1952.
Oliver S. Powell	Minneapolis	Sept. 1, 1950	Resigned June 30, 1952.
Wm. McC. Martin, Jr.	New York	April 2, 1951	Reappointed in 1956. Term expired Jan. 31, 1970.
A.L. Mills, Jr.	San Francisco	Feb. 18, 1952	Reappointed in 1958. Resigned Feb. 28, 1965.
J.L. Robertson	Kansas City	Feb. 18, 1952	Reappointed in 1964. Resigned Apr. 30, 1973.
C. Canby Balderston	Philadelphia	Aug. 12, 1954	Served through Feb. 28, 1966.
Paul E. Miller	Minneapolis	Aug. 13, 1954	Died Oct. 21, 1954.

Appointed Members—Continued

Name	Federal Reserve District	Date initially took oath of office	Other dates ¹
Chas. N. Shepardson	Dallas	Mar. 17, 1955	Retired Apr. 30, 1967.
G.H. King, Jr.	Atlanta	Mar. 25, 1959	Reappointed in 1960. Resigned Sept. 18, 1963.
George W. Mitchell	Chicago	Aug. 31, 1961	Reappointed in 1962. Served until Feb. 13, 1976. ²
J. Dewey Daane	Richmond	Nov. 29, 1963	Served until Mar. 8, 1974. ²
Sherman J. Maisel	San Francisco	Apr. 30, 1965	Served through May 31, 1972.
Andrew F. Brimmer	Philadelphia	Mar. 9, 1966	Resigned Aug. 31, 1974.
William W. Sherrill	Dallas	May 1, 1967	Reappointed in 1968. Resigned Nov. 15, 1971.
Arthur F. Burns	New York	Jan. 31, 1970	Term began Feb. 1, 1970. Resigned Mar. 31, 1978.
John E. Sheehan	St. Louis	Jan. 4, 1972	Resigned June 1, 1975.
Jeffrey M. Bucher	San Francisco	June 5, 1972	Resigned Jan. 2, 1976.
Robert C. Holland	Kansas City	June 11, 1973	Resigned May 15, 1976.
Henry C. Wallich	Boston	Mar. 8, 1974	Resigned Dec. 15, 1986.
Philip E. Coldwell	Dallas	Oct. 29, 1974	Served through Feb. 29, 1980.
Philip C. Jackson, Jr.	Atlanta	July 14, 1975	Resigned Nov. 17, 1978.
J. Charles Partee	Richmond	Jan. 5, 1976	Served until Feb. 7, 1986. ²
Stephen S. Gardner	Philadelphia	Feb. 13, 1976	Died Nov. 19, 1978.
David M. Lilly	Minneapolis	June 1, 1976	Resigned Feb. 24, 1978.
G. William Miller	San Francisco	Mar. 8, 1978	Resigned Aug. 6, 1979.
Nancy H. Teeters	Chicago	Sept. 18, 1978	Served through June 27, 1984.
Emmett J. Rice	New York	June 20, 1979	Resigned Dec. 31, 1986.
Frederick H. Schultz	Atlanta	July 27, 1979	Served through Feb. 11, 1982.
Paul A. Volcker	Philadelphia	Aug. 6, 1979	Resigned August 11, 1987.
Lyle E. Gramley	Kansas City	May 28, 1980	Resigned Sept. 1, 1985.
Preston Martin	San Francisco	Mar. 31, 1982	Resigned April 30, 1986.
Martha R. Seger	Chicago	July 2, 1984	Resigned March 11, 1991.
Wayne D. Angell	Kansas City	Feb. 7, 1986	Served through Feb. 9, 1994.
Manuel H. Johnson	Richmond	Feb. 7, 1986	Resigned August 3, 1990.
H. Robert Heller	San Francisco	Aug. 19, 1986	Resigned July 31, 1989.
Edward W. Kelley, Jr.	Dallas	May 26, 1987	Resigned Dec. 31, 2001.
Alan Greenspan	New York	Aug. 11, 1987	Reappointed in 1992.
John P. LaWare	Boston	Aug. 15, 1988	Resigned April 30, 1995.
David W. Mullins, Jr.	St. Louis	May 21, 1990	Resigned Feb. 14, 1994.
Lawrence B. Lindsey	Richmond	Nov. 26, 1991	Resigned Feb. 5, 1997.
Susan M. Phillips	Chicago	Dec. 2, 1991	Served through June 30, 1998.
Alan S. Blinder	Philadelphia	June 27, 1994	Term expired Jan. 31, 1996.
Janet L. Yellen	San Francisco	Aug. 12, 1994	Resigned Feb. 17, 1997.
Laurence H. Meyer	St. Louis	June 24, 1996	Term expired Jan. 31, 2002.
Alice M. Rivlin	Philadelphia	June 25, 1996	Resigned July 16, 1999.
Roger W. Ferguson, Jr.	Boston	Nov. 5, 1997	Reappointed in 2001.
Edward M. Gramlich	Richmond	Nov. 5, 1997	
Susan S. Bies	Chicago	Dec. 7, 2001	
Mark W. Olson	Minneapolis	Dec. 7, 2001	
Ben S. Bernanke	Atlanta	Aug. 5, 2002	Reappointed in 2003.
Donald L. Kohn	Kansas City	Aug. 5, 2002	

Appointed Members—Continued

Name	Term
<i>Chairmen</i> ³	
Charles S. Hamlin	Aug. 10, 1914–Aug. 9, 1916
W.P.G. Harding	Aug. 10, 1916–Aug. 9, 1922
Daniel R. Crissinger	May 1, 1923–Sept. 15, 1927
Roy A. Young	Oct. 4, 1927–Aug. 31, 1930
Eugene Meyer	Sept. 16, 1930–May 10, 1933
Eugene R. Black	May 19, 1933–Aug. 15, 1934
Marriner S. Eccles	Nov. 15, 1934–Jan. 31, 1948 ⁴
Thomas B. McCabe	Apr. 15, 1948–Mar. 31, 1951
Wm. McC. Martin, Jr.	Apr. 2, 1951–Jan. 31, 1970
Arthur F. Burns	Feb. 1, 1970–Jan. 31, 1978
G. William Miller	Mar. 8, 1978–Aug. 6, 1979
Paul A. Volcker	Aug. 6, 1979–Aug. 11, 1987
Alan Greenspan	Aug. 11, 1987– ⁵
<i>Vice Chairmen</i> ³	
Frederic A. Delano	Aug. 10, 1914–Aug. 9, 1916
Paul M. Warburg	Aug. 10, 1916–Aug. 9, 1918
Albert Strauss	Oct. 26, 1918–Mar. 15, 1920
Edmund Platt	July 23, 1920–Sept. 14, 1930
J.J. Thomas	Aug. 21, 1934–Feb. 10, 1936
Ronald Ransom	Aug. 6, 1936–Dec. 2, 1947
C. Canby Balderston	Mar. 11, 1955–Feb. 28, 1966
J.L. Robertson	Mar. 1, 1966–Apr. 30, 1973
George W. Mitchell	May 1, 1973–Feb. 13, 1976
Stephen S. Gardner	Feb. 13, 1976–Nov. 19, 1978
Frederick H. Schultz	July 27, 1979–Feb. 11, 1982
Preston Martin	Mar. 31, 1982–Apr. 30, 1986
Manuel H. Johnson	Aug. 4, 1986–Aug. 3, 1990
David W. Mullins, Jr.	July 24, 1991–Feb. 14, 1994
Alan S. Blinder	June 27, 1994–Jan. 31, 1996
Alice M. Rivlin	June 25, 1996–July 16, 1999
Roger W. Ferguson, Jr.	Oct. 5, 1999–

NOTE. Under the original Federal Reserve Act, the Federal Reserve Board was composed of five appointed members, the Secretary of the Treasury (ex-officio chairman of the Board), and the Comptroller of the Currency. The original term of office was ten years; the five original appointed members had terms of two, four, six, eight, and ten years. In 1922 the number of appointed members was increased to six, and in 1933 the term of office was raised to twelve years. The Banking Act of 1935 changed the name to the Board of Governors of the Federal Reserve System and provided that the Board be composed of seven appointed members; that the Secretary of the Treasury and the Comptroller of the Currency continue to serve until Feb. 1, 1936; that the appointed members in

office on Aug. 23, 1935, continue to serve until Feb. 1, 1936, or until their successors were appointed and had qualified; and that thereafter the terms of members be fourteen years and that the designation of Chairman and Vice Chairman of the Board be for four years.

1. Date following “Resigned” and “Retired” denotes final day of service.

2. Successor took office on this date.

3. Before Aug. 23, 1935, Chairmen and Vice Chairmen were designated Governor and Vice Governor.

4. Served as Chairman Pro Tempore from February 3, 1948, to April 15, 1948.

5. Served as Chairman Pro Tempore from March 3, 1996, to June 20, 1996.

Ex-Officio Members

Name	Term
<i>Secretaries of the Treasury</i>	
W.G. McAdoo	Dec. 23, 1913–Dec. 15, 1918
Carter Glass	Dec. 16, 1918–Feb. 1, 1920
David F. Houston	Feb. 2, 1920–Mar. 3, 1921
Andrew W. Mellon	Mar. 4, 1921–Feb. 12, 1932
Ogden L. Mills	Feb. 12, 1932–Mar. 4, 1933
William H. Woodin	Mar. 4, 1933–Dec. 31, 1933
Henry Morgenthau, Jr.	Jan. 1, 1934–Feb. 1, 1936
<i>Comptrollers of the Currency</i>	
John Skelton Williams	Feb. 2, 1914–Mar. 2, 1921
Daniel R. Crissinger	Mar. 17, 1921–Apr. 30, 1923
Henry M. Dawes	May 1, 1923–Dec. 17, 1924
Joseph W. McIntosh	Dec. 20, 1924–Nov. 20, 1928
J.W. Pole	Nov. 21, 1928–Sept. 20, 1932
J.F.T. O'Connor	May 11, 1933–Feb. 1, 1936

Statistical Tables

1. Statement of Condition of the Federal Reserve Banks,
by Bank, December 31, 2003 and 2002

Millions of dollars

Item	Total		Boston	
	2003	2002	2003	2002
ASSETS				
Gold certificate account	11,039	11,039	495	533
Special drawing rights certificate account	2,200	2,200	115	115
Coin	722	988	23	45
<i>Loans</i>				
To depository institutions	62	40	0	0
Other	0	0	0	0
Securities purchased under agreements to resell (triparty)	43,750	39,500	0	0
<i>Federal agency obligations</i>				
Bought outright	0	10	0	1
Held under repurchase agreements	0	0	0	0
<i>U.S. Treasury securities</i>				
Bought outright ¹	666,665	629,406	32,230	36,062
Held under repurchase agreements	0	0	0	0
Total loans and securities	710,477	668,956	32,230	36,062
Items in process of collection	9,236	11,498	531	1,002
Bank premises	1,630	1,542	93	91
<i>Other assets</i>				
Denominated in foreign currencies ²	19,868	16,913	1,034	964
Other ³	18,722	20,112	762	973
Interdistrict settlement account	0	0	3,079	-6,558
Total assets	773,894	733,249	38,363	33,227
LIABILITIES				
Federal Reserve notes outstanding (issued to Bank)	799,933	759,256	38,627	32,969
Less: Notes held by Federal Reserve Bank	110,176	104,983	4,750	4,065
Federal Reserve notes, net	689,757	654,273	33,877	28,905
Securities sold under agreements to repurchase	25,652	21,091	1,240	1,208
<i>Deposits</i>				
Depository institutions	23,058	22,541	1,633	1,212
U.S. Treasury, general account	5,723	4,420	0	0
Foreign, official accounts	162	136	2	2
Other ⁴	730	1,156	19	61
Total deposits	29,673	28,254	1,653	1,274
Deferred credit items	9,026	10,666	576	832
Other liabilities and accrued dividends ⁵	2,092	2,205	119	135
Total liabilities	756,200	716,488	37,466	32,355
CAPITAL ACCOUNTS				
Capital paid in	8,847	8,380	448	436
Surplus	8,847	8,380	448	436
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	773,894	733,249	38,363	33,227
FEDERAL RESERVE NOTE STATEMENT				
Federal Reserve notes outstanding	799,933	759,256	...	...
Less: Held by Bank not subject to collateralization	110,176	101,559	...	...
Collateralized Federal Reserve notes	689,757	657,696	...	...
<i>Collateral for Federal Reserve notes</i>				
Gold certificate account	11,039	11,039	...	...
Special drawing rights certificate account	2,200	2,200	...	...
Other eligible assets	0	0	...	...
U.S. Treasury and federal agency securities	676,518	644,458	...	...
Total collateral	689,757	657,696	...	...

For notes see end of table.

1. Statement of Condition of the Federal Reserve Banks,
by Bank, December 31, 2003 and 2002—Continued

Millions of dollars

Item	Atlanta		Chicago	
	2003	2002	2003	2002
ASSETS				
Gold certificate account	863	926	982	1,080
Special drawing rights certificate account	166	166	212	212
Coin	82	103	90	126
<i>Loans</i>				
To depository institutions	5	8	17	6
Other	0	0	0	0
Securities purchased under agreements to resell (triparty)	0	0	0	0
<i>Federal agency obligations</i>				
Bought outright	0	1	0	1
Held under repurchase agreements	0	0	0	0
<i>U.S. Treasury securities</i>				
Bought outright ¹	45,037	44,816	67,367	74,069
Held under repurchase agreements	0	0	0	0
Total loans and securities	45,043	44,825	67,384	74,076
Items in process of collection	723	748	942	1,169
Bank premises	278	279	125	116
<i>Other assets</i>				
Denominated in foreign currencies ²	1,127	1,231	2,033	1,827
Other ³	1,108	1,258	1,571	1,980
Interdistrict settlement account	4,274	-1,692	-6,831	-14,583
Total assets	53,664	47,844	66,509	66,004
LIABILITIES				
Federal Reserve notes outstanding (issued to Banks)	66,711	59,126	66,835	63,905
Less: Notes held by Federal Reserve Banks	18,415	16,757	8,141	7,397
Federal Reserve notes, net	48,296	42,368	58,694	56,508
Securities sold under repurchase agreements	1,733	1,502	2,592	2,482
<i>Deposits</i>				
Depository institutions	1,608	1,735	2,349	3,943
U.S. Treasury, general account	0	0	0	0
Foreign, official accounts	2	2	3	3
Other ⁴	22	133	29	123
Total deposits	1,632	1,870	2,382	4,069
Deferred credit items	855	972	781	997
Other liabilities and accrued dividends ⁵	170	182	211	232
Total liabilities	52,686	46,894	64,660	64,289
CAPITAL ACCOUNTS				
Capital paid in	489	475	924	858
Surplus	489	475	924	858
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	53,664	47,844	66,509	66,004

NOTE. Components may not sum to totals because of rounding.

1. Includes securities loaned—fully guaranteed by U.S. Treasury securities pledged with Federal Reserve Banks—and excludes (1) for 2003, securities purchased under agreements to resell and (2) matched sale-purchase transac-

tions, which were accounted for as separate sale and purchase transactions until they were discontinued in December 2002.

2. Valued daily at market exchange rates.

3. The System total includes depository institution overdrafts of \$3 million for 2003 and 2002.

1.—Continued

St. Louis		Minneapolis		Kansas City		Dallas		San Francisco	
2003	2002	2003	2002	2003	2002	2003	2002	2003	2002
331	346	224	179	303	309	507	485	963	1,046
71	71	30	30	66	66	98	98	234	234
53	59	23	35	42	66	141	163	84	111
0	11	2	7	2	2	0	0	20	5
0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	1
0	0	0	0	0	0	0	0	0	0
20,974	22,380	14,881	9,839	17,916	18,605	26,126	13,969	53,563	54,001
0	0	0	0	0	0	0	0	0	0
20,974	22,392	14,883	9,846	17,919	18,608	26,126	13,969	53,583	54,006
341	695	426	612	596	870	383	624	2,689	2,608
49	44	125	127	56	50	187	142	179	176
472	343	805	343	476	440	442	378	2,058	1,833
516	624	368	295	439	526	641	434	1,287	1,484
-1,330	-3,554	-166	4,063	25	-2,244	6,997	14,306	11,391	-43
21,477	21,021	16,720	15,530	19,921	18,691	35,522	30,599	72,467	61,456
23,244	22,002	15,491	15,088	21,599	19,979	39,785	36,839	79,553	67,131
3,961	3,088	1,335	1,785	4,083	3,854	7,129	8,424	15,685	14,359
19,283	18,914	14,155	13,304	17,516	16,125	32,657	28,416	63,868	52,772
807	750	573	330	689	623	1,005	468	2,061	1,810
509	480	564	430	813	822	953	727	1,957	2,273
0	0	0	0	0	0	0	0	0	0
1	1	1	1	1	1	1	1	3	3
14	34	12	2	48	33	88	24	30	105
524	514	577	433	861	855	1,041	752	1,990	2,381
308	346	650	713	450	598	487	505	2,296	2,584
98	99	74	72	81	88	110	85	157	173
21,020	20,623	16,029	14,851	19,596	18,289	35,301	30,226	70,371	59,719
228	199	346	340	162	201	111	186	1,048	868
228	199	346	340	162	201	111	186	1,048	868
0	0	0	0	0	0	0	0	0	0
21,477	21,021	16,720	15,530	19,921	18,691	35,522	30,599	72,467	61,456

4. Includes international organization deposits of \$139 million for 2003 and \$100 million for 2002. These deposits are held solely by the Federal Reserve Bank of New York.

5. Includes exchange-translation account reflecting the monthly revaluation at market exchange rates of foreign exchange commitments.
 . . . Not applicable.

2. Federal Reserve Open Market Transactions, 2003

Millions of dollars

Type of security and transaction	Jan.	Feb.	Mar.	Apr.
U.S. TREASURY SECURITIES ¹				
<i>Outright transactions²</i>				
Treasury bills				
Gross purchases	0	4,161	1,863	3,543
Gross sales	0	0	0	0
Exchanges	71,075	53,860	47,424	51,834
For new bills	71,075	53,860	47,424	51,834
Redemptions	0	0	0	0
Others within 1 year				
Gross purchases	0	478	1,318	1,422
Gross sales	0	0	0	0
Maturity shifts	6,216	3,214	8,334	8,333
Exchanges	-6,834	-13,313	-8,211	-7,293
Redemptions	0	0	0	0
1 to 5 years				
Gross purchases	0	2,127	710	733
Gross sales	0	0	0	0
Maturity shifts	-6,216	2,160	-8,334	-8,333
Exchanges	6,834	11,817	8,211	7,293
5 to 10 years				
Gross purchases	0	769	522	0
Gross sales	0	0	0	0
Maturity shifts	0	-3,877	0	0
Exchanges	0	1,497	0	0
More than 10 years				
Gross purchases	0	0	50	0
Gross sales	0	0	0	0
Maturity shifts	0	-1,497	0	0
Exchanges	0	0	0	0
All maturities				
Gross purchases	0	7,534	4,463	5,699
Gross sales	0	0	0	0
Redemptions	0	0	0	0
Net change in U.S. Treasury securities	0	7,534	4,463	5,699

For notes see end of table.

2.—Continued

May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
1,684	1,032	808	981	780	880	925	1,494	18,150
0	0	0	0	0	0	0	0	0
76,354	60,706	68,544	56,098	60,835	75,566	56,871	59,719	738,886
76,354	60,706	68,544	56,098	60,835	75,566	56,871	59,719	738,886
0	0	0	0	0	0	0	0	0
786	0	0	0	0	0	2,561	0	6,565
0	0	0	0	0	0	0	0	0
0	14,759	6,662	0	20,174	5,435	0	23,307	96,433
0	-13,699	-4,996	0	-21,901	-6,368	0	-20,538	-103,153
0	0	0	0	0	0	0	0	0
1,057	0	0	0	0	1,447	1,503	237	7,814
0	0	0	0	0	0	0	0	0
0	-9,044	-6,662	0	-16,820	-5,435	0	-17,681	-76,364
0	13,447	4,996	0	19,386	6,368	0	18,905	97,256
234	0	0	0	1,232	280	787	283	4,107
0	0	0	0	0	0	0	0	0
0	-5,463	0	0	2,202	0	0	-3,993	-11,131
0	252	0	0	2,515	0	0	1,634	5,897
0	0	0	0	150	0	0	20	220
0	0	0	0	0	0	0	0	0
0	-252	0	0	-5,556	0	0	-1,634	-8,938
0	0	0	0	0	0	0	0	0
3,761	1,032	808	981	2,162	2,608	5,775	2,034	36,856
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
3,761	1,032	808	981	2,162	2,608	5,775	2,034	36,856

2. Federal Reserve Open Market Transactions, 2003—Continued

Millions of dollars

Type of security and transaction	Jan.	Feb.	Mar.	Apr.
FEDERAL AGENCY OBLIGATIONS				
<i>Outright transactions</i> ²				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Redemptions	0	0	0	0
Net change in federal agency obligations	0	0	0	0
TEMPORARY TRANSACTIONS				
<i>Repurchase agreements</i> ³				
Gross purchases	135,749	121,896	95,001	112,251
Gross sales	150,499	119,746	90,151	106,500
<i>Reverse repurchase agreements</i> ⁴				
Gross purchases	392,530	343,748	388,069	451,149
Gross sales	389,810	343,395	389,469	452,545
Net change in temporary transactions	-12,029	2,502	3,450	4,354
Total net change in System Open Market Account	-12,029	10,037	7,914	10,053

NOTE. Sales, redemptions, and negative figures reduce holdings of the System Open Market Account; all other figures increase such holdings. Components may not sum to totals because of rounding.

1. Transactions exclude changes in compensation for the effects of inflation on the principal of inflation-indexed securities. Transactions include the rollover of inflation compensation into new securities.

2. Excludes the effect of temporary transactions—repurchase agreements, matched sale–purchase agreements (MSPs), and reverse repurchase agreements (RRPs).

3. Cash value of agreements, which are collateralized by U.S. government and federal agency securities.

4. Cash value of agreements, which are collateralized by U.S. Treasury securities.

2.—Continued

May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	10	10
0	0	0	0	0	0	0	-10	-10
124,741	90,500	145,750	156,250	122,500	157,750	122,500	138,000	1,522,888
132,002	88,990	148,500	150,250	120,000	169,250	115,500	127,250	1,518,638
441,555	456,652	445,346	410,913	421,973	427,913	336,765	425,519	4,942,131
443,025	456,447	443,093	411,276	426,766	422,259	336,216	432,390	4,946,691
-8,731	1,715	-497	5,637	-2,293	-5,846	7,549	3,879	-310
-4,971	2,746	311	6,617	-131	-3,238	13,324	5,903	36,536

3. Federal Reserve Bank Holdings of U.S. Treasury and Federal Agency Securities, December 31, 2001–03

Millions of dollars

Description	December 31			Change	
	2003	2002	2001	2002 to 2003	2001 to 2002
U.S. TREASURY SECURITIES					
Held outright ¹	666,665	629,406	574,863	37,259	54,543
<i>By remaining maturity</i>					
<i>Bills</i>					
1–90 days	168,381	153,311	136,695	15,070	16,616
91 days to 1 year	76,452	73,372	68,567	3,080	4,805
<i>Notes and bonds</i>					
1 year or less	113,301	96,827	83,785	16,474	13,042
More than 1 year through 5 years	180,074	172,758	153,158	7,316	19,600
More than 5 years through 10 years	51,312	53,300	53,338	-1,988	-38
More than 10 years	77,146	79,840	79,320	-2,694	520
<i>By type</i>					
<i>Bills</i>	244,833	226,682	205,262	18,151	21,420
<i>Notes</i>	323,361	297,893	265,941	25,468	31,952
<i>Bonds</i>	98,471	104,832	103,660	-6,361	1,172
FEDERAL AGENCY SECURITIES					
Held outright ¹	0	10	10	-10	0
<i>By remaining maturity</i>					
1 year or less	0	10	0	-10	10
More than 1 year through 5 years	0	0	10	0	-10
More than 5 years through 10 years	0	0	0	0	0
More than 10 years	0	0	0	0	0
<i>By issuer</i>					
Federal National Mortgage Association	0	10	10	-10	0
TEMPORARY TRANSACTIONS					
Repurchase agreements ²	43,750	39,500	50,250	4,250	-10,750
Matched sale–purchase agreements					
Foreign official and international accounts	0	0	23,188	0	-23,188
Dealers	0	0	0	0	0
Reverse repurchase agreements ³	25,652	21,091	0	4,561	21,091
Foreign official and international accounts	25,652	21,091	0	4,561	21,091
Dealers	0	0	0	0	0

NOTE. Components may not sum to totals because of rounding.

1. Excludes the effect of temporary transactions—repurchase agreements, matched sale–purchase agreements (MSPs), and reverse repurchase agreements (RRPs).

2. Cash value of agreements, which are collateralized by U.S. government and federal agency securities.

3. Cash value of agreements, which are collateralized by U.S. Treasury securities.

4. Number and Annual Salaries of Officers and Employees of the Federal Reserve Banks, December 31, 2003

Federal Reserve Bank (including Branches)	President	Other officers		Employees			Total	
	Salary (dollars) ¹	Number	Salaries (dollars) ¹	Number		Salaries (dollars) ¹	Number	Salaries (dollars) ¹
				Full-time	Part-time			
Boston	258,600	71	10,091,861	1,026	129	61,176,769	1,227	71,527,230
New York	310,000	267	45,727,195	2,714	61	181,826,851	3,043	227,864,046
Philadelphia	235,300	54	7,381,810	1,098	59	52,245,179	1,212	59,862,289
Cleveland	231,500	61	7,901,500	1,238	42	58,039,087	1,280	66,172,087
Richmond	252,300	79	10,416,400	1,856	83	92,365,569	2,019	103,034,269
Atlanta	281,000	81	11,534,100	2,157	82	103,107,723	2,321	114,922,823
Chicago	283,800	88	12,296,140	1,762	63	98,502,151	1,914	111,082,091
St. Louis	238,000	78	9,948,997	1,109	66	51,471,604	1,254	61,658,601
Minneapolis	264,500	44	6,050,900	1,158	127	55,691,970	1,330	62,007,370
Kansas City	258,800	74	9,829,700	1,468	63	70,873,309	1,606	80,961,809
Dallas	249,800	54	6,959,900	1,298	45	61,072,195	1,398	68,281,895
San Francisco	341,900	72	11,073,470	1,979	39	116,739,742	2,091	128,155,112
Federal Reserve Information Technology .....	...	32	4,440,800	691	5	51,426,622	728	55,867,422
Office of Employee Benefits .....	...	6	1,214,900	30	0	2,254,713	36	3,469,613
Total	3,205,500	1,061	154,867,673	19,584	864	1,056,793,484	21,459	1,214,866,657

1. Annualized salary liability based on salaries in effect on December 31, 2003. . . . Not applicable.

5. Income and Expenses of the Federal Reserve Banks, by Bank, 2003

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
CURRENT INCOME					
Loans	1,442	63	83	12	173
U.S. Treasury and federal agency securities	22,596,569	1,134,099	9,620,170	742,129	1,096,974
Foreign currencies	259,557	13,641	55,735	7,274	21,932
Priced services	886,916	39,017	128,288	39,671	55,917
Other	48,241	891	30,708	549	1,807
Total	23,792,725	1,187,711	9,834,984	789,635	1,176,803
CURRENT EXPENSES					
Salaries and other personnel expenses	1,365,734	81,515	253,327	66,397	71,444
Retirement and other benefits ..	404,558	21,269	76,574	18,890	22,924
Net periodic pension costs ¹	60,252	165	58,443	126	140
Fees	79,215	3,579	6,326	879	4,816
Travel	55,234	2,434	5,738	1,820	3,963
Software expenses	114,502	4,255	10,965	4,069	13,106
Postage and other shipping costs	83,369	1,712	4,040	1,561	2,296
Communications	13,019	1,712	2,130	384	564
Materials and supplies	47,006	2,585	8,678	3,557	3,008
<i>Building expenses</i>					
Taxes on real estate	28,899	4,412	4,645	1,558	1,926
Property depreciation	87,270	4,655	14,523	3,402	7,776
Utilities	31,428	2,783	6,198	2,535	2,058
Rent	37,790	783	13,536	329	393
Other	32,404	771	6,358	1,356	2,543
<i>Equipment</i>					
Purchases	32,810	1,968	4,408	1,206	1,918
Rentals	34,385	1,763	3,041	708	280
Depreciation	105,224	4,777	13,441	5,732	4,449
Repairs and maintenance	90,554	5,944	9,108	5,543	6,236
Earnings-credit costs	120,791	8,463	39,262	7,007	8,608
Other	65,575	28,922	52,959	9,754	11,697
Recoveries	-78,873	-10,376	-9,493	-2,780	-2,787
Expenses capitalized ³	-20,743	-517	-6,916	-918	-1,017
Total	2,790,404	173,575	577,288	133,112	166,339
Reimbursements	-327,746	-24,913	-68,006	-20,411	-32,427
Net expenses	2,462,658	148,662	509,282	112,702	133,912

For notes see end of table.

5.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
5	82	414	123	256	96	12	124
1,722,125	1,529,573	2,357,531	727,266	456,220	616,167	768,265	1,826,050
64,000	15,146	26,713	6,073	9,983	6,270	5,773	27,017
71,976	165,371	107,795	44,509	45,083	57,848	50,786	80,655
2,575	1,777	3,116	896	363	448	697	4,412
1,860,681	1,711,950	2,495,569	778,867	511,906	680,828	825,532	1,938,259
180,364	129,968	130,058	71,542	68,553	91,349	75,178	146,039
56,031	37,085	39,052	23,206	20,225	21,299	26,983	41,021
226	169	155	148	140	167	143	232
37,756	6,209	6,564	1,577	4,967	1,867	2,341	2,336
7,475	6,807	6,134	3,004	3,396	4,578	3,179	6,706
47,272	6,201	5,112	3,600	2,624	4,979	4,840	7,481
3,933	48,279	4,070	2,473	2,793	3,434	2,294	6,484
1,536	1,092	1,541	869	834	687	690	982
5,676	5,456	4,352	2,505	1,871	2,710	3,060	3,548
2,168	2,936	4,378	420	-32	707	2,514	3,267
7,203	10,238	8,199	8,788	4,483	4,179	5,284	8,541
3,226	2,818	1,726	1,732	1,566	1,425	1,931	3,430
14,059	882	3,207	1,089	194	1,714	1,438	166
3,472	3,059	4,551	903	1,599	747	4,851	2,196
9,512	2,194	2,498	1,563	1,407	1,874	2,179	2,083
24,179	939	651	169	812	296	904	641
32,887	8,861	6,676	6,460	2,979	5,251	3,938	9,773
17,269	11,471	9,478	3,685	2,968	3,640	5,432	9,780
15,101	5,091	16,607	2,197	2,552	3,902	2,631	9,371
-203,842 ²	16,392	21,042	43,081	18,909	23,617	24,288	18,756
-30,168	-3,280	-5,186	-1,587	-824	-1,747	-5,582	-5,064
-4,944	-603	-851	-869	-1,727	-677	-561	-1,144
230,392	302,266	270,012	176,554	140,287	175,997	167,955	276,626
-35,186	-18,170	-6,064	-60,347	-20,945	-13,875	-11,133	-16,271
195,206	284,097	263,948	116,207	119,343	162,122	156,823	260,355

5. Income and Expenses of the Federal Reserve Banks, by Bank, 2003—Continued

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
PROFIT AND LOSS					
Current net income	21,330,067	1,039,049	9,325,701	676,934	1,042,891
<i>Additions to and deductions from (-) current net income⁴</i>					
Profits on sales of U.S. Treasury and federal agency securities	0	0	0	0	0
Profits on foreign exchange transactions	2,695,211	140,894	580,431	75,171	226,708
Other additions	185	4	64	5	0
Total additions	2,695,397	140,898	580,494	75,176	226,708
Losses on sales of U.S. Treasury and federal agency securities	0	0	0	0	0
Losses on foreign exchange transactions	0	0	0	0	0
Interest expense on reverse repurchase agreements	-214,148	-10,900	-89,519	-7,134	-10,543
Other deductions	-46	0	-13	-3	0
Total deductions	-214,194	-10,900	-89,532	-7,137	-10,543
Net addition to or deduction from (-) current net income	2,481,202	129,998	490,962	68,039	216,165
Cost of unreimbursed Treasury services	76	0	7	69	0
<i>Assessments by Board</i>					
Board expenditures ⁵	297,020	15,429	64,448	8,365	24,643
Cost of currency	508,144	31,132	124,116	27,212	27,253
Net income before payment to U.S. Treasury	23,006,300	1,122,486	9,628,093	709,327	1,207,159
Dividends paid	517,705	26,647	115,274	15,008	42,326
Payments to U.S. Treasury (interest on Federal Reserve notes)	22,021,528	1,083,616	9,291,164	668,584	1,139,927
Transferred to/from surplus	466,796	12,222	221,655	25,734	24,907
Surplus, January 1	8,380,120	436,200	1,808,902	232,826	702,337
Surplus, December 31	8,846,916	448,422	2,030,557	258,560	727,244

NOTE. Components may not sum to totals because of rounding.

1. Reflects the effect of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). The System Retirement Plan for employees is recorded on behalf of the System on the books of the Federal Reserve Bank of New York, resulting in an increase in expenses of \$57,960 thousand. The expenses related to the Benefit Equalization Retirement Plan and the Supplemental Employees Retirement Plan are recorded by each Federal Reserve Bank.

2. Includes Reserve Bank reimbursements of \$216 million in 2003 and \$187 million in 2002 to the Reserve

Bank of Richmond for support services provided to the System.

3. Includes expenses for labor and materials capitalized and depreciated or amortized as charges to activities in the periods benefited.

4. Includes reimbursement from the U.S. Treasury for uncut sheets of Federal Reserve notes, gains and losses on the sale of Reserve Bank buildings, counterfeit currency that is not charged back to the depositing institution, and stale Reserve Bank checks that are written off.

5. For additional details, see the chapter "Board of Governors Financial Statements."

5.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
1,665,475	1,427,853	2,231,621	662,660	392,563	518,706	668,709	1,677,904
0	0	0	0	0	0	0	0
665,801	154,818	276,517	63,591	106,756	64,786	59,925	279,813
20	5	25	15	35	3	1	8
665,821	154,823	276,542	63,607	106,791	64,790	59,926	279,821
0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0
-16,535	-14,690	-22,656	-6,988	-4,371	-5,919	-7,354	-17,539
-4	-8	-2	-2	-1	-5	-6	-3
-16,539	-14,698	-22,658	-6,989	-4,372	-5,924	-7,360	-17,542
649,282	140,125	253,884	56,617	102,419	58,866	52,567	262,279
0	0	0	0	0	0	0	0
72,893	16,724	30,651	7,266	12,013	6,964	6,513	31,111
37,111	62,212	44,358	16,903	10,496	17,547	42,015	67,788
2,204,753	1,489,042	2,410,496	695,108	472,473	553,061	672,747	1,841,284
124,627	28,679	53,674	13,191	20,727	11,626	10,682	55,243
2,079,449	1,446,554	2,290,195	652,695	445,852	579,706	737,777	1,606,008
677	13,809	66,626	29,222	5,894	-38,271	-75,712	180,032
2,073,211	475,244	857,601	199,035	339,637	200,652	186,282	868,193
2,073,888	489,053	924,227	228,257	345,531	162,382	110,570	1,048,225

6. Income and Expenses of the Federal Reserve Banks, 1914–2003

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (–) ¹	Assessments by Board of Governors	
				Board expenditures	Costs of currency
<i>All Banks</i>					
1914–15	2,173	2,018	6	302	...
1916	5,218	2,082	–193	192	...
1917	16,128	4,922	–1,387	238	...
1918	67,584	10,577	–3,909	383	...
1919	102,381	18,745	–4,673	595	...
1920	181,297	27,549	–3,744	710	...
1921	122,866	33,722	–6,315	741	...
1922	50,499	28,837	–4,442	723	...
1923	50,709	29,062	–8,233	703	...
1924	38,340	27,768	–6,191	663	...
1925	41,801	26,819	–4,823	709	...
1926	47,600	24,914	–3,638	722	1,714
1927	43,024	24,894	–2,457	779	1,845
1928	64,053	25,401	–5,026	698	806
1929	70,955	25,810	–4,862	782	3,099
1930	36,424	25,358	–93	810	2,176
1931	29,701	24,843	311	719	1,479
1932	50,019	24,457	–1,413	729	1,106
1933	49,487	25,918	–12,307	800	2,505
1934	48,903	26,844	–4,430	1,372	1,026
1935	42,752	28,695	–1,737	1,406	1,477
1936	37,901	26,016	486	1,680	2,178
1937	41,233	25,295	–1,631	1,748	1,757
1938	36,261	25,557	2,232	1,725	1,630
1939	38,501	25,669	2,390	1,621	1,356
1940	43,538	25,951	11,488	1,704	1,511
1941	41,380	28,536	721	1,840	2,588
1942	52,663	32,051	–1,568	1,746	4,826
1943	69,306	35,794	23,768	2,416	5,336
1944	104,392	39,659	3,222	2,296	7,220
1945	142,210	41,666	–830	2,341	4,710
1946	150,385	50,493	–626	2,260	4,482
1947	158,656	58,191	1,973	2,640	4,562
1948	304,161	64,280	–34,318	3,244	5,186
1949	316,537	67,931	–12,122	3,243	6,304
1950	275,839	69,822	36,294	3,434	7,316
1951	394,656	83,793	–2,128	4,095	7,581
1952	456,060	92,051	1,584	4,122	8,521
1953	513,037	98,493	–1,059	4,100	10,922
1954	438,486	99,068	–134	4,175	6,490
1955	412,488	101,159	–265	4,194	4,707
1956	595,649	110,240	–23	5,340	5,603
1957	763,348	117,932	–7,141	7,508	6,374
1958	742,068	125,831	124	5,917	5,973
1959	886,226	131,848	98,247	6,471	6,384
1960	1,103,385	139,894	13,875	6,534	7,455
1961	941,648	148,254	3,482	6,265	6,756
1962	1,048,508	161,451	–56	6,655	8,030
1963	1,151,120	169,638	615	7,573	10,063
1964	1,343,747	171,511	726	8,655	17,230
1965	1,559,484	172,111	1,022	8,576	23,603
1966	1,908,500	178,212	996	9,022	20,167
1967	2,190,404	190,561	2,094	10,770	18,790
1968	2,764,446	207,678	8,520	14,198	20,474
1969	3,373,361	237,828	–558	15,020	22,126

For notes see end of table.

6.—Continued

Dividends paid	Payments to U.S. Treasury		Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Statutory transfers ²	Interest on Federal Reserve notes		
217	...	...	...	...
1,743	...	...	...	...
6,804	1,134	...	...	1,134
5,541	...	...	...	48,334
5,012	2,704	...	...	70,652
5,654	60,725	...	...	82,916
6,120	59,974	...	...	15,993
6,307	10,851	...	...	-660
6,553	3,613	...	...	2,546
6,682	114	...	...	-3,078
6,916	59	...	...	2,474
7,329	818	...	...	8,464
7,755	250	...	...	5,044
8,458	2,585	...	...	21,079
9,584	4,283	...	...	22,536
10,269	17	...	...	-2,298
10,030	...	...	...	-7,058
9,282	2,011	...	...	11,021
8,874	...	...	...	-917
8,782	...	...	-60	6,510
8,505	298	...	28	607
7,830	227	...	103	353
7,941	177	...	67	2,616
8,019	120	...	-419	1,862
8,110	25	...	-426	4,534
8,215	82	...	-54	17,617
8,430	141	...	-4	571
8,669	198	...	50	3,554
8,911	245	...	135	40,327
9,500	327	...	201	48,410
10,183	248	...	262	81,970
10,962	67	...	28	81,467
11,523	36	75,284	87	8,366
11,920	...	166,690	...	18,523
12,329	...	193,146	...	21,462
13,083	...	196,629	...	21,849
13,865	...	254,874	...	28,321
14,682	...	291,935	...	46,334
15,558	...	342,568	...	40,337
16,442	...	276,289	...	35,888
17,712	...	251,741	...	32,710
18,905	...	401,556	...	53,983
20,081	...	542,708	...	61,604
21,197	...	524,059	...	59,215
22,722	...	910,650	...	-93,601
23,948	...	896,816	...	42,613
25,570	...	687,393	...	70,892
27,412	...	799,366	...	45,538
28,912	...	879,685	...	55,864
30,782	...	1,582,119	...	-465,823
32,352	...	1,296,810	...	27,054
33,696	...	1,649,455	...	18,944
35,027	...	1,907,498	...	29,851
36,959	...	2,463,629	...	30,027
39,237	...	3,019,161	...	39,432

6. Income and Expenses of the Federal Reserve Banks, 1914–2003—Continued

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (–) ¹	Assessments by Board of Governors	
				Board expenditures	Costs of currency
1970.....	3,877,218	276,572	11,442	21,228	23,574
1971.....	3,723,370	319,608	94,266	32,634	24,943
1972.....	3,792,335	347,917	–49,616	35,234	31,455
1973.....	5,016,769	416,879	–80,653	44,412	33,826
1974.....	6,280,091	476,235	–78,487	41,117	30,190
1975.....	6,257,937	514,359	–202,370	33,577	37,130
1976.....	6,623,220	558,129	7,311	41,828	48,819
1977.....	6,891,317	568,851	–177,033	47,366	55,008
1978.....	8,455,309	592,558	–633,123	53,322	60,059
1979.....	10,310,148	625,168	–151,148	50,530	68,391
1980.....	12,802,319	718,033	–115,386	62,231	73,124
1981.....	15,508,350	814,190	–372,879	63,163	82,924
1982.....	16,517,385	926,034	–68,833	61,813	98,441
1983.....	16,068,362	1,023,678	–400,366	71,551	152,135
1984.....	18,068,821	1,102,444	–412,943	82,116	162,606
1985.....	18,131,983	1,127,744	1,301,624	77,378	173,739
1986.....	17,464,528	1,156,868	1,975,893	97,338	180,780
1987.....	17,633,012	1,146,911	1,796,594	81,870	170,675
1988.....	19,526,431	1,205,960	–516,910	84,411	164,245
1989.....	22,249,276	1,332,161	1,254,613	89,580	175,044
1990.....	23,476,604	1,349,726	2,099,328	103,752	193,007
1991.....	22,553,002	1,429,322	405,729	109,631	261,316
1992.....	20,235,028	1,474,531	–987,788	128,955	295,401
1993.....	18,914,251	1,657,800	–230,268	140,466	355,947
1994.....	20,910,742	1,795,328	2,363,862	146,866	368,187
1995.....	25,395,148	1,818,416	857,788	161,348	370,203
1996.....	25,164,303	1,947,861	–1,676,716	162,642	402,517
1997.....	26,917,213	1,976,453	–2,611,570	174,407	364,454
1998.....	28,149,477	1,833,436	1,906,037	178,009	408,544
1999.....	29,346,836	1,852,162	–533,557	213,790	484,959
2000.....	33,963,992	1,971,688	–1,500,027	188,067	435,838
2001.....	31,870,721	2,084,708	–1,117,435	295,056	338,537
2002.....	26,760,113	2,227,078	2,149,328	205,111	429,568
2003.....	23,792,725	2,462,658	2,481,127	297,020	508,144
Total, 1914–2003.....	618,209,915	44,955,164	6,859,674	3,865,714	7,359,178
<i>Aggregate for each Bank, 1914–2003</i>					
Boston.....	33,463,647	3,005,698	290,567	161,168	425,648
New York.....	212,361,484	6,870,052 ⁴	1,951,651	946,845	2,455,966
Philadelphia.....	23,160,127	2,442,375	173,560	161,928	292,371
Cleveland.....	38,645,758	2,836,062	452,390	274,236	439,971
Richmond.....	47,860,768	3,961,878	793,611	467,872	604,392
Atlanta.....	32,171,370	4,619,301	498,627	301,672	474,684
Chicago.....	77,047,432	5,712,407	826,808	459,616	854,584
St. Louis.....	21,502,797	2,304,341	131,202	100,170	270,684
Minneapolis.....	10,244,883	2,187,933	176,653	119,322	117,526
Kansas City.....	22,904,109	2,936,408	184,167	134,620	270,383
Dallas.....	28,291,944	2,937,239	455,313	208,175	340,113
San Francisco.....	70,555,595	5,141,469	925,125	530,091	812,856
Total.....	618,209,915	44,955,164	6,859,674	3,865,714	7,359,178

NOTE. Components may not sum to totals because of rounding.

... Not applicable.

1. For 1987 and subsequent years, includes the cost of services provided to the Treasury by Federal Reserve Banks for which reimbursement was not received.

2. Represents transfers made as a franchise tax from 1917 through 1932; transfers made under section 13b of the Federal Reserve Act from 1935 through 1947; and transfers made under section 7 of the Federal Reserve Act for 1996 and 1997.

6.—Continued

Dividends paid	Payments to U.S. Treasury		Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Statutory transfers ²	Interest on Federal Reserve notes		
41,137	...	3,493,571	...	32,580
43,488	...	3,356,560	...	40,403
46,184	...	3,231,268	...	50,661
49,140	...	4,340,680	...	51,178
52,580	...	5,549,999	...	51,483
54,610	...	5,382,064	...	33,828
57,351	...	5,870,463	...	53,940
60,182	...	5,937,148	...	45,728
63,280	...	7,005,779	...	47,268
67,194	...	9,278,576	...	69,141
70,355	...	11,706,370	...	56,821
74,574	...	14,023,723	...	76,897
79,352	...	15,204,591	...	78,320
85,152	...	14,228,816	...	106,663
92,620	...	16,054,095	...	161,996
103,029	...	17,796,464	...	155,253
109,588	...	17,803,895	...	91,954
117,499	...	17,738,880	...	173,771
125,616	...	17,364,319	...	64,971
129,885	...	21,646,417	...	130,802
140,758	...	23,608,398	...	180,292
152,553	...	20,777,552	...	228,356
171,763	...	16,774,477	...	402,114
195,422	...	15,986,765	...	347,583
212,090	...	20,470,011	...	282,122
230,527	...	23,389,367	...	283,075
255,884	5,517,716	14,565,624	...	635,343
299,652	20,658,972	0	...	831,705
343,014	17,785,942	8,774,994	...	731,575
373,579	...	25,409,736	...	479,053
409,614	...	25,343,892	...	4,114,865
428,183	...	27,089,222	...	517,580
483,596	...	24,495,490	...	1,068,598
517,705	...	22,021,528	...	466,796
6,504,257	44,113,958	505,330,734	-4	12,940,589³
285,078	2,579,504	26,661,526	135	635,457
1,603,354	17,307,161	182,236,389	-433	2,893,803
279,888	1,312,118	18,444,043	291	400,674
476,237	2,827,043	31,231,128	-10	1,013,482
839,849	3,083,928	36,614,769	-72	3,081,763
481,003	2,713,230	23,296,905	5	783,197
757,290	4,593,811	64,194,378	12	1,302,143
169,768	1,833,837	16,624,418	-27	330,807
210,357	416,227	6,878,509	65	491,598
218,711	1,249,703	17,999,454	-9	279,006
322,551	1,510,802	23,178,019	55	250,303
860,171	4,686,594	57,971,197	-17	1,478,358
6,504,257	44,113,958	505,330,734	-4	12,940,589³

3. The \$12,940,589 thousand transferred to surplus was reduced by direct charges of \$500 thousand for charge-off on Bank premises (1927), \$139,300 thousand for contributions to capital of the Federal Deposit Insurance Corporation (1934), \$4 thousand net upon elimination of section 13b surplus (1958), and \$106,000 thousand (1996), \$107,000 thousand (1997), and \$3,752,000 thousand (2000) transferred to the Treasury

as statutorily required; and was increased by transfer of \$11,131 thousand from reserves for contingencies (1955), leaving a balance of \$8,846,916 thousand on December 31, 2003.

4. This amount is reduced \$2,711,874 thousand, which is related to the System Retirement Plan. See note 1, table 5.

7. Acquisition Costs and Net Book Value of Premises of the Federal Reserve Banks and Branches, December 31, 2003

Thousands of dollars

Federal Reserve Bank or Branch	Acquisition costs				Net book value	Other real estate ³
	Land	Buildings (including vaults) ¹	Building machinery and equipment	Total ²		
BOSTON	22,074	107,438	17,949	147,460	92,879	...
NEW YORK	20,103	201,382	60,179	281,664	185,179	...
Buffalo	888	4,307	3,662	8,857	3,914	...
PHILADELPHIA	2,561	72,770	11,085	86,416	52,531	...
CLEVELAND	3,112	119,058	23,630	145,799	115,831	...
Cincinnati	2,247	22,170	10,329	34,745	17,176	...
Pittsburgh	1,658	13,209	11,788	26,655	18,113	...
RICHMOND	12,979	83,005	37,504	133,488	95,973	...
Baltimore	6,482	27,868	4,929	39,280	23,518	...
Charlotte	3,130	27,653	6,635	37,417	26,054	...
ATLANTA	22,742	146,278	15,786	184,806	175,023	...
Birmingham	7,194	45,828	4,145	57,168	53,399	...
Jacksonville	1,730	20,054	3,241	25,025	17,336	48
Miami	3,746	15,842	4,159	23,747	14,698	...
Nashville	687	5,887	3,399	9,973	5,939	...
New Orleans	3,952	9,165	4,903	18,020	11,530	...
CHICAGO	4,994	139,047	18,491	162,533	105,739	...
Detroit	4,655	16,234	3,646	24,535	19,489	...
ST. LOUIS	4,086	37,568	9,003	50,657	30,320	...
Little Rock	1,148	4,557	2,124	7,830	4,932	...
Louisville	800	4,654	2,068	7,522	3,729	...
Memphis	1,136	9,086	4,151	14,372	9,763	...
MINNEAPOLIS	15,666	103,783	13,521	132,970	114,776	...
Helena	2,739	9,733	935	13,408	10,360	...
KANSAS CITY	7,586	22,218	8,121	37,925	21,281	...
Denver	3,511	8,556	4,832	16,899	9,483	...
Oklahoma City	977	11,932	3,488	16,397	9,286	...
Omaha	7,165	11,540	2,437	21,142	16,173	...
DALLAS	29,049	109,542	20,402	158,992	123,271	...
El Paso	262	3,585	1,259	5,107	2,538	...
Houston	19,908	33,872	0	53,781	53,781	7,188
San Antonio	826	7,414	3,103	11,343	7,217	...
SAN FRANCISCO	15,600	93,612	21,735	130,946	83,544	...
Los Angeles	4,981	70,177	11,429	86,586	60,573	...
Portland	2,884	12,184	3,251	18,318	13,200	...
Salt Lake City	495	9,754	2,451	12,699	8,917	...
Seattle	380	13,346	4,699	18,425	12,361	...
Total	244,132	1,654,309	364,468	2,262,909	1,629,823	7,236

NOTE. Components may not sum to totals because of rounding.

1. Includes expenditures for construction at some offices, pending allocation to appropriate accounts.

2. Excludes charge-offs of \$17,699 thousand before 1952.

3. Covers acquisitions for banking-house purposes and Bank premises formerly occupied and being held pending sale.

... Not applicable.

8. Operations in Principal Departments of the Federal Reserve Banks, 2000–2003

Operation	2003	2002	2001	2000
<i>Millions of pieces (except as noted)</i>				
Currency processed	34,832	34,208	33,740	31,505
Currency destroyed	7,375	8,363	7,850	8,179
Coin received ¹	48,138	43,445	39,735	33,738
Checks handled				
U.S. government checks	267	289	346	262
Postal money orders	198	216	229	230
Other	15,806	16,587	16,905	16,994
Government securities transfers	20	17	15	14
Transfer of funds	123	115	112	108
Automated clearinghouse transactions				
Commercial	5,588	4,986	4,448	3,812
Government	914	883	900	838
Food stamps redeemed	287	500	587	686
<i>Millions of dollars</i>				
Currency processed	584,915	565,302	540,746	542,567
Currency destroyed	101,338	92,511	86,298	112,164
Coin received ¹	4,879	4,579	4,296	3,902
Checks handled				
U.S. government checks	308,055	307,627	333,849	282,791
Postal money orders	29,197	30,161	30,461	30,036
Other	15,431,625	15,033,298	14,853,072	13,849,084
Government securities transfers	267,644,194	228,907,121	212,343,034	188,133,178
Transfer of funds	436,706,269	405,761,750	423,606,365	379,756,389
Automated clearinghouse transactions				
Commercial	13,951,600	13,135,350	12,707,247	11,619,954
Government	2,810,283	2,711,384	2,528,562	2,404,491
Food stamps redeemed	1,510	2,543	2,989	3,414

1. Amounts in bold are restatements due to the inclusion of coin activity at Federal Reserve off-site coin terminals.

9. Federal Reserve Bank Interest Rates on Loans to Depository Institutions,
December 31, 2003

Reserve Bank	Primary credit ¹	Secondary credit ²	Seasonal credit ³
All Federal Reserve Banks	2.00	2.50	1.05

1. Primary credit is available for very short terms as a backup source of liquidity to depository institutions that are in generally sound financial condition in the judgment of the lending Federal Reserve Bank.

2. Secondary credit is available in appropriate circumstances to depository institutions that do not qualify for primary credit.

3. Seasonal credit is available to help relatively small depository institutions meet regular seasonal needs for

funds that arise from a clear pattern of intra-yearly movements in their deposits and loans and that cannot be met through special industry lenders. The discount rate on seasonal credit takes into account rates charged by market sources of funds and ordinarily is reestablished on the first business day of each two-week reserve maintenance period.

10. Reserve Requirements of Depository Institutions, December 31, 2003

Type of deposit	Requirements	
	Percentage of deposits	Effective date
<i>Net transaction accounts</i> ¹		
\$0 million–\$6.6 million ²	0	12-25-03
More than \$6.6 million–\$45.4 million ³	3	12-25-03
More than \$45.4 million ⁴	10	12-25-03
Nonpersonal time deposits ⁵	0	12-27-90
Eurocurrency liabilities ⁶	0	12-27-90

NOTE. Required reserves must be held in the form of deposits with Federal Reserve Banks or vault cash. Non-member institutions may maintain reserve balances with a Federal Reserve Bank indirectly, on a pass-through basis, with certain approved institutions. For previous reserve requirements, see earlier editions of the *Annual Report* or the *Federal Reserve Bulletin*. Under the Monetary Control Act of 1980, depository institutions include commercial banks, savings banks, savings and loan associations, credit unions, agencies and branches of foreign banks, and Edge Act corporations.

1. Transaction accounts include all deposits against which the account holder is permitted to make withdrawals by negotiable or transferable instruments, payment orders of withdrawal, or telephone or preauthorized transfers for the purpose of making payments to third persons or others. However, accounts subject to the rules that permit no more than six preauthorized, automatic, or other transfers per month (of which no more than three may be by check, draft, debit card, or similar order payable directly to third parties) are savings deposits, not transaction accounts.

2. Under the Garn–St Germain Depository Institutions Act of 1982, the Board adjusts the amount of reservable liabilities subject to a zero percent reserve requirement each year for the succeeding calendar year by 80 percent of the percentage increase in the total reservable liabilities of all depository institutions, measured on an annual basis as of June 30. No corresponding adjustment is made in the event of a decrease. The exemption applies only to accounts that would be subject to a 3 percent reserve requirement. Effective with the reserve maintenance period beginning December 25, 2003, for depository institutions that report weekly, and with the reserve maintenance period beginning January 15, 2004, for institu-

tions that report quarterly, the exemption was raised from \$6.0 million to \$6.6 million.

3. The Monetary Control Act of 1980 requires that the amount of transaction accounts against which the 3 percent reserve requirement applies be modified annually by 80 percent of the percentage change in transaction accounts held by all depository institutions, determined as of June 30 each year. Effective with the reserve maintenance period beginning December 25, 2003, for depository institutions that report weekly, and with the reserve maintenance period beginning January 15, 2004, for institutions that report quarterly, the amount was increased from \$42.1 million to \$45.4 million.

4. The reserve requirement was reduced from 12 percent to 10 percent on April 2, 1992, for institutions that report weekly, and on April 16, 1992, for institutions that report quarterly.

5. For institutions that report weekly, the reserve requirement on nonpersonal time deposits with an original maturity of less than 1.5 years was reduced from 3 percent to 1.5 percent for the maintenance period that began December 13, 1990, and to zero for the maintenance period that began December 27, 1990. For institutions that report quarterly, the reserve requirement on nonpersonal time deposits with an original maturity of less than 1.5 years was reduced from 3 percent to zero on January 17, 1991.

The reserve requirement on nonpersonal time deposits with an original maturity of 1.5 years or more has been zero since October 6, 1983.

6. The reserve requirement on Eurocurrency liabilities was reduced from 3 percent to zero in the same manner and on the same dates as the reserve requirement on nonpersonal time deposits with an original maturity of less than 1.5 years (see note 5).

11. Initial Margin Requirements under Regulations T, U, and X

Percent of market value

Effective date	Margin stocks	Convertible bonds	Short sales, T only ¹
1934, Oct. 1	25-45	...	...
1936, Feb. 1	25-55	...	...
Apr. 1	55	...	...
1937, Nov. 1	40	...	50
1945, Feb. 5	50	...	50
July 5	75	...	75
1946, Jan. 21	100	...	100
1947, Feb. 1	75	...	75
1949, Mar. 3	50	...	50
1951, Jan. 17	75	...	75
1953, Feb. 20	50	...	50
1955, Jan. 4	60	...	60
Apr. 23	70	...	70
1958, Jan. 16	50	...	50
Aug. 5	70	...	70
Oct. 16	90	...	90
1960, July 28	70	...	70
1962, July 10	50	...	50
1963, Nov. 6	70	...	70
1968, Mar. 11	70	50	70
June 8	80	60	80
1970, May 6	65	50	65
1971, Dec. 6	55	50	55
1972, Nov. 24	65	50	65
1974, Jan. 3	50	50	50

NOTE. These regulations, adopted by the Board of Governors pursuant to the Securities Exchange Act of 1934, limit the amount of credit to purchase and carry "margin securities" (as defined in the regulations) when such value is collateralized by securities. Margin requirements on securities are the difference between the market value (100 percent) and the maximum loan value of collateral as prescribed by the Board. Regulation T was

adopted effective October 1, 1934; Regulation U, effective May 1, 1936; and Regulation X, effective November 1, 1971. The former Regulation G, which was adopted effective March 11, 1968, was merged with Regulation U, effective April 1, 1998.

1. From October 1, 1934, to October 31, 1937, the requirement was the margin "customarily required" by the brokers and dealers.

12. Principal Assets and Liabilities of Insured Commercial Banks in the United States,
by Class of Bank, June 30, 2003 and 2002

Millions of dollars, except as noted

Item	Total	Member banks			Nonmember banks
		Total	National	State	
2003					
ASSETS					
Loans and investments	5,375,585	4,237,950	3,008,884	1,229,066	1,137,635
Loans, gross	3,959,459	3,142,026	2,265,242	876,784	817,433
Net	3,957,137	3,140,316	2,263,814	876,502	816,821
Investments	1,416,126	1,095,925	743,642	352,282	320,202
U.S. Treasury and federal agency securities	289,306	186,268	101,919	84,349	103,038
Other	1,126,820	909,657	641,723	267,934	217,163
Cash assets, total	302,232	248,016	178,772	69,244	54,217
LIABILITIES					
Deposits, total	4,207,923	3,241,704	2,293,678	948,026	966,219
Interbank	68,208	56,529	40,813	15,716	11,679
Other transaction	684,982	505,422	361,669	143,753	179,560
Other nontransaction	3,454,733	2,679,753	1,891,195	788,557	774,980
Equity capital	671,071	539,467	383,717	155,751	131,603
Number of banks	7,816	2,999	2,048	951	4,817
2002					
ASSETS					
Loans and investments	4,841,229	3,798,070	2,717,307	1,080,763	1,043,159
Loans, gross	3,637,050	2,895,399	2,101,054	794,345	741,651
Net	3,634,318	2,893,348	2,099,281	794,067	740,970
Investments	1,204,179	902,671	616,253	286,418	301,508
U.S. Treasury and federal agency securities	248,547	153,104	78,286	74,819	95,443
Other	955,632	749,567	537,968	211,600	206,065
Cash assets, total	264,277	216,341	155,993	60,348	47,935
LIABILITIES					
Deposits, total	3,756,145	2,863,790	2,025,569	838,220	892,356
Interbank	55,221	45,409	31,554	13,855	9,812
Other transaction	605,442	450,366	325,944	124,422	155,076
Other nontransaction	3,095,482	2,368,014	1,668,071	699,943	727,468
Equity capital	616,280	469,910	355,889	141,021	119,370
Number of banks	7,949	3,052	2,104	948	4,897

NOTE. Data are domestic assets and liabilities (except for those components reported on a consolidated basis only). Components may not sum to totals because of rounding.

13A. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1984–2003 and Month-End 2003

Millions of dollars

Period	Factors supplying reserve funds								
	Federal Reserve Bank credit outstanding						Gold stock	Special drawing rights certificate account	Treasury currency outstanding ³
	Securities held outright ¹	Repurchase agreements ²	Loans	Float	Other Federal Reserve assets	Total			
1984	167,612	2,015	3,577	833	12,347	186,384	11,096	4,618	16,418
1985	186,025	5,223	3,060	988	15,302	210,598	11,090	4,718	17,075
1986	205,454	16,005	1,565	1,261	17,475	241,760	11,084	5,018	17,567
1987	226,459	4,961	3,815	811	15,837	251,883	11,078	5,018	18,177
1988	240,628	6,861	2,170	1,286	18,803	269,748	11,060	5,018	18,799
1989	233,300	2,117	481	1,093	39,631	276,622	11,059	8,518	19,628
1990	241,431	18,354	190	2,566	39,880	302,421	11,058	10,018	20,402 ^r
1991	272,531	15,898	218	1,026	34,524	324,197	11,059	10,018	21,014 ^r
1992	300,423	8,094	675	3,350	30,278	342,820	11,056	8,018	21,447 ^r
1993	336,654	13,212	94	963	33,394	384,317	11,053	8,018	22,095 ^r
1994	368,156	10,590	223	740	33,441	413,150	11,051	8,018	22,994 ^r
1995	380,831	13,862	135	231	33,483	428,543	11,050	10,168	24,003 ^r
1996	393,132	21,583	85	5,297	32,222	452,319	11,048	9,718	24,966 ^r
1997	431,420	23,840	2,035	561	32,044	489,901	11,047	9,200	25,543 ^r
1998	452,478	30,376	17	1,009	37,692	521,573	11,046	9,200	26,270
1999	478,144	140,640	233	407	34,799	654,223	11,048	6,200	28,013
2000	511,833	43,375	110	795	36,896	593,009	11,046	2,200	31,643 ^r
2001	551,685	50,250	34	698	36,885	639,552	11,045	2,200	33,017 ^r
2002	629,416	39,500	40	832	38,574	708,363	11,043 ^r	2,200	34,597 ^r
2003	666,665	43,750	62	211	40,214	750,901	11,043	2,200	35,475

For notes see end of table.

13A.—Continued

Factors absorbing reserve funds								
Currency in circulation	Reverse repurchase agreements ⁴	Treasury cash holdings ⁵	Deposits with Federal Reserve Banks, other than reserve balances			Required clearing balances	Other Federal Reserve liabilities and capital	Reserve balances with Federal Reserve Banks ⁶
			Treasury	Foreign	Other			
183,796	0	513	5,316	253	867	1,126	5,952	20,693
197,488	0	550	9,351	480	1,041	1,490	5,940	27,141
211,995	0	447	7,588	287	917	1,812	6,088	46,295
230,205	0	454	5,313	244	1,027	1,687	7,129	40,097
247,649	0	395	8,656	347	548	1,605	7,683	37,742
260,456	0	450	6,217	589	1,298	1,618	8,486	36,713
286,963 ^r	0	561	8,960	369	242	1,960 ^r	8,147	36,698 ^r
307,756 ^r	0	636	17,697	968	1,706	3,946 ^r	8,113	25,467 ^r
334,701 ^r	0	508	7,492	206	372	5,897 ^r	7,984	26,182 ^r
365,271 ^r	0	377	14,809	386	397	6,332	9,292	28,619
403,843 ^r	0	335	7,161	250	876	4,196 ^r	11,959	26,593 ^r
424,244 ^r	0	270	5,979	386	932	5,167	12,342	24,444
450,648 ^r	0	249	7,742	167	892	6,601	13,829	17,923
482,327 ^r	0	225	5,444	457	900	6,679 ^r	15,500	24,159 ^r
517,484	0	85	6,086	167	1,605	6,781 ^r	16,354	19,525 ^r
628,359	0	109	28,402	71	1,261	7,482 ^r	17,256	16,545 ^r
593,694 ^r	0	450	5,149	216	1,382	6,332	17,962	12,713
643,301 ^r	0	425	6,645	61	820	8,525 ^r	17,083	8,953 ^r
687,518 ^r	21,091	367	4,420	136	1,152	10,533	18,977	12,008 ^r
724,194	25,652	321	5,723	162	717	11,830	19,793	11,228

13A. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1984–2003 and Month-End 2003—Continued

Millions of dollars

Period	Factors supplying reserve funds								
	Federal Reserve Bank credit outstanding						Gold stock	Special drawing rights certificate account	Treasury currency outstanding ³
	Securities held outright ¹	Repurchase agreements ²	Loans	Float	Other Federal Reserve assets	Total			
2003									
Jan.	629,416	24,750	7	3,148	39,765	697,086	11,043	2,200	34,597
Feb.	636,921	26,900	5	102	37,299	701,227	11,043	2,200	34,710
Mar.	641,474	31,750	30	-233	38,747	711,767	11,043	2,200	34,798
Apr.	647,281	37,501	35	31	39,989	724,837	11,043	2,200	34,890
May	651,127	30,240	80	-478	38,268	719,238	11,044	2,200	34,976
June	652,128	31,750	768	-266	38,775	723,154	11,044	2,200	35,065
July	652,913	29,000	145	-123	39,589	721,523	11,043	2,200	35,145
Aug.	653,909	35,000	158	-158	37,319	726,228	11,043	2,200	35,237
Sept.	656,126	37,500	174	-266	39,233	732,767	11,043	2,200	35,293
Oct.	658,791	26,000	239	139	40,452	725,621	11,043	2,200	35,363
Nov.	664,615	33,000	28	872	38,601	737,117	11,043	2,200	35,419
Dec.	666,665	43,750	62	211	40,214	750,901	11,043	2,200	35,475

13A.—Continued

Factors absorbing reserve funds								
Currency in circulation	Reverse repurchase agreements ⁴	Treasury cash holdings ⁵	Deposits with Federal Reserve Banks, other than reserve balances			Required clearing balances	Other Federal Reserve liabilities and capital	Reserve balances with Federal Reserve Banks ⁶
			Treasury	Foreign	Other			
674,736	18,370	361	5,509	102	223	10,355	19,478	15,792
681,634	18,018	343	4,268	224	193	10,336	19,739	14,425
685,791	19,418	373	6,746	254	211	10,978	20,230	15,809
688,760	20,814	340	10,583	313	231	10,829	20,049	21,051
692,355	22,285	375	6,505	79	217	10,832	19,973	14,837
693,315	22,080	365	6,939	898	249	10,838	19,898	16,882
694,073	19,827	364	6,356	318	258	10,898	19,674	18,143
700,139	20,190	335	4,589	81	225	10,912	20,251	17,986
698,144	24,983	341	7,224	82	224	11,225	21,164	17,916
702,383	19,329	390	6,110	155	274	11,420	20,026	14,140
712,984	18,781	324	5,912	81	281	11,851	20,590	14,976
724,194	25,652	321	5,723	162	717	11,830	19,793	11,228

NOTE. Components may not sum to totals because of rounding.

1. Includes U.S. Treasury and federal agency securities. U.S. Treasury securities contain securities lent to dealers and are fully collateralized by other U.S. Treasury securities. Federal agency securities are included at face value.
2. Cash value of agreements, which are collateralized by U.S. Treasury and federal agency securities.
3. Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are

fractional and dollar coins. For details see "Currency and Coin in Circulation," *Treasury Bulletin*.

4. Cash value of agreements, which are collateralized by U.S. Treasury securities.
 5. Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.
 6. Excludes required clearing balances and adjustments to compensate for float.
- r. Revised.

13B. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1918-1983

Millions of dollars

Period	Factors supplying reserve funds									
	Federal Reserve Bank credit outstanding							Gold stock ⁶	Special drawing rights certificate account	Treasury currency outstanding ⁷
	Securities held outright ¹	Repurchase agreements ²	Loans	Float ³	All other ⁴	Other Federal Reserve assets ⁵	Total			
1918.....	239	0	1,766	199	294	0	2,498	2,873	...	1,795
1919.....	300	0	2,215	201	575	0	3,292	2,707	...	1,707
1920.....	287	0	2,687	119	262	0	3,355	2,639	...	1,709
1921.....	234	0	1,144	40	146	0	1,563	3,373	...	1,842
1922.....	436	0	618	78	273	0	1,405	3,642	...	1,958
1923.....	80	54	723	27	355	0	1,238	3,957	...	2,009
1924.....	536	4	320	52	390	0	1,302	4,212	...	2,025
1925.....	367	8	643	63	378	0	1,459	4,112	...	1,977
1926.....	312	3	637	45	384	0	1,381	4,205	...	1,991
1927.....	560	57	582	63	393	0	1,655	4,092	...	2,006
1928.....	197	31	1,056	24	500	0	1,809	3,854	...	2,012
1929.....	488	23	632	34	405	0	1,583	3,997	...	2,022
1930.....	686	43	251	21	372	0	1,373	4,306	...	2,027
1931.....	775	42	638	20	378	0	1,853	4,173	...	2,035
1932.....	1,851	4	235	14	41	0	2,145	4,226	...	2,204
1933.....	2,435	2	98	15	137	0	2,688	4,036	...	2,303
1934.....	2,430	0	7	5	21	0	2,463	8,238	...	2,511
1935.....	2,430	1	5	12	38	0	2,486	10,125	...	2,476
1936.....	2,430	0	3	39	28	0	2,500	11,258	...	2,532
1937.....	2,564	0	10	19	19	0	2,612	12,760	...	2,637
1938.....	2,564	0	4	17	16	0	2,601	14,512	...	2,798
1939.....	2,484	0	7	91	11	0	2,593	17,644	...	2,963
1940.....	2,184	0	3	80	8	0	2,274	21,995	...	3,087
1941.....	2,254	0	3	94	10	0	2,361	22,737	...	3,247
1942.....	6,189	0	6	471	14	0	6,679	22,726	...	3,648
1943.....	11,543	0	5	681	10	0	12,239	21,938	...	4,094
1944.....	18,846	0	80	815	4	0	19,745	20,619	...	4,131
1945.....	24,252	0	249	578	2	0	15,091	20,065	...	4,339
1946.....	23,350	0	163	580	1	0	24,093	20,529	...	4,562
1947.....	22,559	0	85	535	1	0	23,181	22,754	...	4,562
1948.....	23,333	0	223	541	1	0	24,097	24,244	...	4,589
1949.....	18,885	0	78	534	2	0	19,499	24,427	...	4,598
1950.....	20,725	53	67	1,368	3	0	22,216	22,706	...	4,636
1951.....	23,605	196	19	1,184	5	0	25,009	22,695	...	4,709
1952.....	24,034	663	156	967	4	0	25,825	23,187	...	4,812
1953.....	25,318	598	28	935	2	0	26,880	22,030	...	4,894
1954.....	24,888	44	143	808	1	0	25,885	21,713	...	4,985
1955.....	24,391	394	108	1,585	29	0	26,507	21,690	...	5,008
1956.....	24,610	305	50	1,665	70	0	26,699	21,949	...	5,066
1957.....	23,719	519	55	1,424	66	0	25,784	22,781	...	5,146
1958.....	26,252	95	64	1,296	49	0	27,755	20,534	...	5,234
1959.....	26,607	41	458	1,590	75	0	28,771	19,456	...	5,311

For notes see end of table.

13B.—Continued

Factors absorbing reserve funds											
Cur- rency in circula- tion	Treasury cash holdings ⁸	Deposits with Federal Reserve Banks, other than reserve balances			Other Federal Reserve accounts ⁵	Required clearing balances	Other Federal Reserve liabilities and capital ⁵	Member bank reserves ⁹			
		Treasury	Foreign	Other				With Federal Reserve Banks	Currency and coin ¹⁰	Re- quired ¹¹	Ex- cess ^{11, 12}
4,951	288	51	96	25	118	0	0	1,636	0	1,585	51
5,091	385	51	73	28	208	0	0	1,890	0	1,822	68
5,325	218	57	5	18	298	0	0	1,781	0	0	0
4,403	214	96	12	15	285	0	0	1,753	0	1,654	99
4,530	225	11	3	26	276	0	0	1,934	0	0	0
4,757	213	38	4	19	275	0	0	1,898	0	1,884	14
4,760	211	51	19	20	258	0	0	2,220	0	2,161	59
4,817	203	16	8	21	272	0	0	2,212	0	2,256	-44
4,808	201	17	46	19	293	0	0	2,194	0	2,250	-56
4,716	208	18	5	21	301	0	0	2,487	0	2,424	63
4,686	202	23	6	21	348	0	0	2,389	0	2,430	-41
4,578	216	29	6	24	393	0	0	2,355	0	2,428	-73
4,603	211	19	6	22	375	0	0	2,471	0	2,375	96
5,360	222	54	79	31	354	0	0	1,961	0	1,994	-33
5,388	272	8	19	24	355	0	0	2,509	0	1,933	576
5,519	284	3	4	128	360	0	0	2,729	0	1,870	859
5,536	3,029	121	20	169	241	0	0	4,096	0	2,282	1,814
5,882	2,566	544	29	226	253	0	0	5,587	0	2,743	2,844
6,543	2,376	244	99	160	261	0	0	6,606	0	4,622	1,984
6,550	3,619	142	172	235	263	0	0	7,027	0	5,815	1,212
6,856	2,706	923	199	242	260	0	0	8,724	0	5,519	3,205
7,598	2,409	634	397	256	251	0	0	11,653	0	6,444	5,209
8,732	2,213	368	1,133	599	284	0	0	4,026	0	7,411	6,615
11,160	2,215	867	774	586	291	0	0	12,450	0	9,365	3,085
15,410	2,193	799	793	485	256	0	0	13,117	0	11,129	1,988
20,499	2,303	579	1,360	356	339	0	0	12,886	0	11,650	1,236
25,307	2,375	440	1,204	394	402	0	0	14,373	0	12,748	1,625
28,515	2,287	977	862	446	495	0	0	15,915	0	14,457	1,458
28,952	2,272	393	508	314	607	0	0	16,139	0	15,577	562
28,868	1,336	870	392	569	563	0	0	17,899	0	16,400	1,499
28,224	1,325	1,123	642	547	590	0	0	20,479	0	19,277	1,202
27,600	1,312	821	767	750	106	0	0	16,568	0	15,550	1,018
27,741	1,293	668	895	565	714	0	0	17,681	0	16,509	1,172
29,206	1,270	247	526	363	746	0	0	20,056	0	19,667	389
30,433	1,270	389	550	455	777	0	0	19,950	0	20,520	-570
30,781	761	346	423	493	839	0	0	20,160	0	19,397	763
30,509	796	563	490	441	907	0	0	18,876	0	18,618	258
31,158	767	394	402	554	925	0	0	19,005	0	18,903	102
31,790	775	441	322	426	901	0	0	19,059	0	19,089	-30
31,834	761	481	356	246	998	0	0	19,034	0	19,091	-57
32,193	683	358	272	391	1,122	0	0	18,504	0	18,574	-70
32,591	391	504	345	694	841	0	0	18,174	310	18,619	-135

13B. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1918–1983—Continued

Millions of dollars

Period	Factors supplying reserve funds									
	Federal Reserve Bank credit outstanding							Gold stock ⁶	Special drawing rights certificate account	Treasury currency outstanding ⁷
	Securities held outright ¹	Repurchase agreements ²	Loans	Float ³	All other ⁴	Other Federal Reserve assets ⁵	Total			
1960.....	26,984	400	33	1,847	74	0	29,338	17,767	...	5,398
1961.....	30,478	159	130	2,300	51	0	31,362	16,889	...	5,585
1962.....	28,722	342	38	2,903	110	0	33,871	15,978	...	5,567
1963.....	33,582	11	63	2,600	162	0	36,418	15,513	...	5,578
1964.....	36,506	538	186	2,606	94	0	39,930	15,388	...	5,405
1965.....	40,478	290	137	2,248	187	0	43,340	13,733	...	5,575
1966.....	43,655	661	173	2,495	193	0	47,177	13,159	...	6,317
1967.....	48,980	170	141	2,576	164	0	52,031	11,982	...	6,784
1968.....	52,937	0	186	3,443	58	0	56,624	10,367	...	6,795
1969.....	57,154	0	183	3,440	64	2,743	64,584	10,367	...	6,852
1970.....	62,142	0	335	4,261	57	1,123	67,918	10,732	400	7,147
1971.....	69,481	1,323	39	4,343	261	1,068	76,515	10,132	400	7,710
1972.....	71,119	111	1,981	3,974	106	1,260	78,551	10,410	400	8,313
1973.....	80,395	100	1,258	3,099	68	1,152	86,072	11,567	400	8,716
1974.....	84,760	954	299	2,001	999	3,195	92,208	11,652	400	9,253
1975.....	92,789	1,335	211	3,688	1,126	3,312	102,461	11,599	500	10,218
1976.....	100,062	4,031	25	2,601	991	3,182	110,892	11,598	1,200	10,810
1977.....	108,922	2,352	265	3,810	954	2,442	118,745	11,718	1,250	11,331
1978.....	117,374	1,217	1,174	6,432	587	4,543	131,327	11,671	1,300	11,831
1979.....	124,507	1,660	1,454	6,767	704	5,613	140,705	11,172	1,800	13,083
1980.....	128,038	2,554	1,809	4,467	776	8,739	146,383	11,160	2,518	13,427
1981.....	136,863	3,485	1,601	1,762	195	9,230	153,136	11,151	3,318	13,687
1982.....	144,544	4,293	717	2,735	1,480	9,890	163,659	11,148	4,618	13,786
1983.....	159,203	1,592	918	1,605	418	8,728	172,464	11,121	4,618	15,732

NOTE. For a description of figures and discussion of their significance, see *Banking and Monetary Statistics, 1941–1970* (Board of Governors of the Federal Reserve System, 1976), pp. 507–23.

Components may not sum to totals because of rounding.

1. In 1969 and thereafter, includes securities loaned—fully guaranteed by U.S. government securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale–purchase transactions. On September 29, 1971, and thereafter, includes federal agency issues bought outright.

2. On December 1, 1966, and thereafter, includes federal agency obligations held under repurchase agreements.

3. In 1960 and thereafter, figures reflect a minor change in concept; see *Federal Reserve Bulletin*, vol. 47 (February 1961), p. 164.

4. Principally acceptances and, until August 21, 1959, industrial loans, the authority for which expired on that date.

5. For the period before April 16, 1969, includes the total of Federal Reserve capital paid in, surplus, other capital accounts, and other liabilities and accrued dividends, less the sum of bank premises and other assets, and is reported as “Other Federal Reserve accounts”; thereafter, “Other Federal Reserve assets” and “Other Federal Reserve liabilities and capital” are shown separately.

6. Before January 30, 1934, includes gold held in Federal Reserve Banks and in circulation.

7. Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are fractional and dollar coins. For details see “Currency and Coin in Circulation,” *Treasury Bulletin*.

13B.—Continued

Factors absorbing reserve funds											
Cur- rency in cir- cu- lation	Treasury cash holdings ⁸	Deposits with Federal Reserve Banks, other than reserve balances			Other Federal Reserve accounts ⁵	Required clearing balances	Other Federal Reserve liabilities and capital ⁵	Member bank reserves ⁹			
		Treasury	Foreign	Other				With Federal Reserve Banks	Currency and coin ¹⁰	Re- quired ¹¹	Ex- cess ^{11, 12}
32,869	377	485	217	533	941	0	0	17,081	2,544	18,988	637
33,918	422	465	279	320	1,044	0	0	17,387	2,544	18,988	96
35,338	380	597	247	393	1,007	0	0	17,454	3,262	20,071	645
37,692	361	880	171	291	1,065	0	0	17,049	4,099	20,677	471
39,619	612	820	229	321	1,036	0	0	18,086	4,151	21,663	574
42,056	760	668	150	355	211	0	0	18,447	4,163	22,848	-238
44,663	1,176	416	174	588	-147	0	0	19,779	4,310	24,321	-232
47,226	1,344	1,123	135	563	-773	0	0	21,092	4,631	25,905	-182
50,961	695	703	216	747	-1,353	0	0	21,818	4,921	27,439	-700
53,950	596	1,312	134	807	0	0	1,919	22,085	5,187	28,173	-901
57,903	431	1,156	148	1,233	0	0	1,986	24,150	5,423	30,033	-460
61,068	460	2,020	294	999	0	0	2,131	27,788	5,743	32,496	1,035
66,516	345	1,855	325	840	0	0	2,143	25,647	6,216	32,044	98 ¹²
72,497	317	2,542	251	1,419 ¹³	0	0	2,669	27,060	6,781	35,268	-1,360
79,743	185	2,113	418	1,275 ¹³	0	0	2,935	25,843	7,370	37,011	-3,798
86,547	483	7,285	353	1,090	0	0	2,968	26,052	8,036	35,197	-1,103 ¹⁴
93,717	460	10,393	352	1,357	0	0	3,063	25,158	8,628	35,461	-1,535
103,811	392	7,114	379	1,187	0	0	3,292	26,870	9,421	37,615	-1,265
114,645	240	4,196	368	1,256	0	0	4,275	31,152	10,538	42,694	-893
125,600	494	4,075	429	1,412	0	0	4,957	29,792	11,429	44,217	-2,835
136,829	441	3,062	411	617	0	0	4,671	27,456	13,654	40,558	675
144,774	443	4,301	505	781	0	117	5,261	25,111	15,576	42,145	-1,442
154,908	429	5,033	328	1,033	0	436	4,990	26,053	16,666	41,391	1,328
171,935	479	3,661	191	851	0	1,013	5,392	20,413	17,821	39,179	-945

8. Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

9. In November 1979 and thereafter, includes reserves of member banks, Edge Act corporations, and U.S. agencies and branches of foreign banks. On November 13, 1980, and thereafter, includes reserves of all depository institutions.

10. Between December 1, 1959, and November 23, 1960, part was allowed as reserves; thereafter, all was allowed.

11. Estimated through 1958. Before 1929, data were available only on call dates (in 1920 and 1922 the call date was December 29). Since September 12, 1968, the amount has been based on close-of-business figures for the reserve period two weeks before the report date.

12. For the week ending November 15, 1972, and thereafter, includes \$450 million of reserve deficiencies on which Federal Reserve Banks are allowed to waive penalties for a transition period in connection with bank adaptation to Regulation J as amended, effective November 9, 1972. Allowable deficiencies are as follows (beginning with first statement week of quarter, in millions):

1973—Q1, \$279; Q2, \$172; Q3, \$112; Q4, \$84; 1974—Q1, \$67; Q2, \$58. The transition period ended with the second quarter of 1974.

13. For the period before July 1973, includes certain deposits of domestic nonmember banks and foreign-owned banking institutions held with member banks and redeposited in full with Federal Reserve Banks in connection with voluntary participation by nonmember institutions in the Federal Reserve System program of credit restraint.

As of December 12, 1974, the amount of voluntary nonmember bank and foreign-agency and branch deposits at Federal Reserve Banks that are associated with marginal reserves is no longer reported. However, two amounts are reported: (1) deposits voluntarily held as reserves by agencies and branches of foreign banks operating in the United States and (2) Eurodollar liabilities.

14. Adjusted to include waivers of penalties for reserve deficiencies, in accordance with change in Board policy, effective November 19, 1975.

. . . Not applicable.

14. Banking Offices and Banks Affiliated with Bank Holding Companies (BHCs) in the United States, December 31, 2002 and 2003

Type of office	Total	Commercial banks ¹					State-chartered savings banks
		Total	Member			Nonmember	
			Total	National	State		
All banking offices							
BANKS							
Number, Dec. 31, 2002 ..	8,240	7,838	2,979	2,033	946	4,859	402
<i>Changes during 2003</i>							
New banks	120	116	23	14	9	93	4
Banks converted into branches	-219	-210	-99	-57	-42	-111	-9
Ceased banking operation ²	-25	-20	-10	-7	-3	-10	-5
Other ³	-2	-1	-3	-22	19	2	-1
Net change	-126	-115	-89	-72	-17	-26	-11
Number, Dec. 31, 2003 ..	8,114	7,723	2,890	1,961	929	4,833	391
BRANCHES AND ADDITIONAL OFFICES							
Number, Dec. 31, 2002 ..	71,283	67,834	50,228	35,877	14,351	17,606	3,449
<i>Changes during 2003</i>							
New branches	1,572	1,465	1,018	585	433	447	107
Branches converted from banks	219	212	111	71	40	101	7
Discontinued ²	-677	-649	-532	-370	-162	-117	-28
Other ³	-9	41	-400	162	-562	441	-50
Net change	1,105	1,069	197	448	-251	872	36
Number, Dec. 31, 2003 ..	72,388	68,903	50,425	36,325	14,100	18,478	3,485
Banks affiliated with BHCs							
BANKS							
Number, Dec. 31, 2002 ..	6,428	6,318	2,529	1,709	820	3,789	110
<i>Changes during 2003</i>							
BHC-affiliated new banks	174	162	51	34	17	111	12
Banks converted into branches	-178	-174	-87	-50	-37	-87	-4
Ceased banking operation ²	-26	-25	-11	-8	-3	-14	-1
Other ³	-1	0	-1	-18	17	1	-1
Net change	-31	-37	-48	-42	-6	11	6
Number, Dec. 31, 2003 ..	6,397	6,281	2,481	1,667	814	3,800	116

1. For purposes of this table, banks are entities that are defined as banks in the Bank Holding Company Act, as amended, which is implemented by Federal Reserve Regulation Y. Generally, a bank is any institution that accepts demand deposits and is engaged in the business of making commercial loans or any institution that is

defined as an insured bank in section 3(h) of the FDIC Act. Covers entities in the United States and its territories and possessions (affiliated insular areas).

2. Institutions that no longer meet the Regulation Y definition of bank.

3. Interclass changes and sales of branches.

Federal Reserve System Audits

Audits of the Federal Reserve System

The Board of Governors, the Federal Reserve Banks, and the Federal Reserve System as a whole are all subject to several levels of audit and review. The Board's financial statements, and its compliance with laws and regulations affecting those statements, are audited annually by an outside auditor retained by the Board's Office of Inspector General. The Office of Inspector General also audits and investigates the Board's programs and operations, as well as those Board functions delegated to the Reserve Banks.

The financial statements of the Reserve Banks are also audited annually

by an independent outside auditor. In addition, the Reserve Banks are subject to annual examination by the Board. As discussed in the chapter "Federal Reserve Banks," the Board examination includes a wide range of ongoing oversight activities conducted on and off site by staff of the Board's Division of Reserve Bank Operations and Payment Systems.

Federal Reserve operations are also subject to review by the General Accounting Office. ■

Board of Governors Financial Statements

The financial statements of the Board for 2003 and 2002 were audited by KPMG LLP, independent auditors.



KPMG LLP
2001 M Street NW
Washington, DC 20036

Independent Auditors' Report on Financial Statements

To the Board of Governors of the Federal Reserve System:

We have audited the accompanying balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2003 and 2002, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Board at December 31, 2003 and 2002, and the results of its operations, and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our reports dated April 2, 2004, on our consideration of the Board's internal control over financial reporting and its compliance with certain provisions of laws and regulations. Those reports are an integral part of an audit conducted in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

KPMG LLP

April 2, 2004



KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
BALANCE SHEETS

ASSETS	As of December 31,	
	2003	2002
CURRENT ASSETS		
Cash	\$ 56,179,654	\$ 8,635,164
Accounts receivable	1,251,117	871,626
Prepaid expenses and other assets	2,614,354	801,031
Total current assets	60,045,125	10,307,821
NONCURRENT ASSETS		
Property and equipment, net (Note 2)	149,595,059	143,971,006
Collections (Note 1)		
Total noncurrent assets	149,595,059	143,971,006
Total assets	\$209,640,184	\$154,278,827
LIABILITIES AND CUMULATIVE RESULTS OF OPERATIONS		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	\$ 15,347,390	\$ 11,450,099
Accrued payroll and related taxes	5,056,647	8,102,710
Accrued annual leave	13,428,993	11,873,527
Capital lease payable (current portion)	206,590	50,546
Unearned revenues and other liabilities	390,698	442,066
Total current liabilities	34,430,318	31,918,948
LONG-TERM LIABILITIES		
Capital lease payable (non-current portion)	763,699	32,153
Accumulated retirement benefit obligation (Note 3)	595,601	614,108
Accumulated postretirement benefit obligation (Note 4)	5,322,053	4,917,787
Accumulated postemployment benefit obligation (Note 5)	4,949,892	4,299,252
Total long-term liabilities	11,631,245	9,863,300
Total liabilities	46,061,563	41,782,248
CUMULATIVE RESULTS OF OPERATIONS		
Working capital	25,821,397	(21,560,581)
Unfunded long-term liabilities	(10,867,546)	(9,831,147)
Net investment in property and equipment	148,624,770	143,888,307
Total cumulative results of operations	163,578,621	112,496,579
Total liabilities and cumulative results of operations	\$209,640,184	\$154,278,827

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF REVENUES AND EXPENSES
AND CHANGES IN CUMULATIVE RESULTS OF OPERATIONS

	For the years ended December 31,	
	<u>2003</u>	<u>2002</u>
BOARD OPERATING REVENUES		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures	\$297,020,200	\$205,110,800
Other revenues (Note 6)	<u>8,835,440</u>	<u>9,039,417</u>
Total operating revenues	<u>305,855,640</u>	<u>214,150,217</u>
BOARD OPERATING EXPENSES		
Salaries	156,547,392	146,022,212
Retirement and insurance contributions	28,263,776	25,560,734
Contractual services and professional fees	17,501,035	18,073,228
Depreciation and net losses on disposals	12,194,612	12,426,581
Postage and supplies	8,175,120	5,961,699
Utilities	7,664,716	7,218,999
Travel	5,981,254	5,925,674
Software	5,910,128	6,822,066
Repairs and maintenance	4,029,441	4,666,439
Printing and binding	1,864,006	2,026,370
Other expenses (Note 6)	<u>6,642,118</u>	<u>5,141,590</u>
Total operating expenses	<u>254,773,598</u>	<u>239,845,592</u>
RESULTS OF OPERATIONS	<u>51,082,042</u>	<u>(25,695,375)</u>
ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES		
Assessments levied on Federal Reserve Banks for currency costs	508,144,248	429,568,393
Expenses for currency printing, issuance, retirement, and shipping	<u>508,144,248</u>	<u>429,568,393</u>
CURRENCY ASSESSMENTS OVER (UNDER) EXPENSES	<u>0</u>	<u>0</u>
TOTAL RESULTS OF OPERATIONS	51,082,042	(25,695,375)
CUMULATIVE RESULTS OF OPERATIONS, Beginning of year	<u>112,496,579</u>	<u>138,191,954</u>
CUMULATIVE RESULTS OF OPERATIONS, End of year	<u>\$163,578,621</u>	<u>\$112,496,579</u>

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
STATEMENTS OF CASH FLOWS

	For the years ended December 31,	
	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES		
RESULTS OF OPERATIONS	\$51,082,042	\$(25,695,375)
Adjustments to reconcile results of operations to net cash provided by (used in) operating activities:		
Depreciation and net losses on disposals	12,194,612	12,426,581
(Increase) decrease in assets:		
Accounts receivable, prepaid expenses, and other assets	(2,192,814)	518,815
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	3,897,291	(4,675,698)
Accrued payroll and related taxes	(3,046,063)	794,956
Accrued annual leave	1,555,466	1,141,171
Unearned revenues and other liabilities	(51,368)	50,494
Accumulated retirement benefit obligation	(18,507)	(37,520)
Accumulated postretirement benefit obligation	404,266	362,300
Accumulated postemployment benefit obligation	650,640	707,681
Net cash provided by (used in) operating activities	<u>64,475,565</u>	<u>(14,406,595)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from disposals	15,790	5,200
Capital expenditures	(16,809,964)	(17,507,186)
Net cash provided by (used in) investing activities	<u>(16,794,174)</u>	<u>(17,501,986)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital lease payments	(136,901)	(244,819)
Net cash provided by (used in) financing activities	<u>(136,901)</u>	<u>(244,819)</u>
NET INCREASE (DECREASE) IN CASH	47,544,490	(32,153,400)
CASH BALANCE, Beginning of year	8,635,164	40,788,564
CASH BALANCE, End of year	<u>\$56,179,654</u>	<u>\$ 8,635,164</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Capital lease obligations incurred	\$ 1,024,491	\$ 0

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED
DECEMBER 31, 2003 AND 2002

(1) SIGNIFICANT ACCOUNTING POLICIES

Organization—The Federal Reserve System was established by Congress in 1913 and consists of the Board of Governors (Board), the Federal Open Market Committee, the twelve regional Federal Reserve Banks, the Federal Advisory Council, and the private commercial banks that are members of the System. The Board, unlike the Reserve Banks, was established as a federal government agency and is supported by Washington staff numbering approximately 1,800, as it carries out its responsibilities in conjunction with other components of the Federal Reserve System.

The Board is required by the Federal Reserve Act to report its operations to the Speaker of the House of Representatives. The Act also requires the Board, each year, to order a financial audit of each Federal Reserve Bank and to publish each week a statement of the financial condition of each such Reserve Bank and a consolidated statement for all of the Reserve Banks. Accordingly, the Board believes that the best financial disclosure consistent with law is achieved by issuing separate financial statements for the Board and for the Reserve Banks. Therefore, the accompanying financial statements include only the operations and activities of the Board. Combined financial statements for the Federal Reserve Banks are included in the Board's annual report to the Speaker of the House of Representatives.

Basis of Accounting—The financial statements have been prepared on the accrual basis of accounting.

Revenues—Assessments for operating expenses and additions to property are based on expected cash needs. Amounts over or under assessed due to differences between actual and expected cash needs flow in to or out of "Cumulative Results of Operations" during the year.

Issuance and Redemption of Federal Reserve Notes—The Board incurs expenses and assesses the Federal Reserve Banks for currency printing, issuance, retirement, and shipping of Federal Reserve Notes. These assessments and expenses are separately reported in the statements of revenues and expenses because they are not Board operating transactions.

Property and Equipment—The Board's property, buildings and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 3 to 10 years for furniture and equipment and from 10 to 50 years for building equipment and structures. Upon the sale or other disposition of a depreciable asset, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is recognized.

Collections—The Board has collections of works of art, historical treasures, and similar assets. These collections are maintained and held for public exhibition in furtherance of public service. Proceeds from any sales of collections are used to acquire other items for collections. As permitted by FAS 116, the cost of collections purchased by the Board is charged to expense in the year

purchased and donated collection items are not recorded. The value of the Board's collections has not been determined.

Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications—Certain 2002 amounts have been reclassified to conform with the 2003 presentation.

(2) PROPERTY AND EQUIPMENT

The following is a summary of the components of the Board's property and equipment, at cost, net of accumulated depreciation.

	As of December 31,	
	2003	2002
Land and improvements ...	\$ 18,640,314	\$ 18,640,314
Buildings	129,161,957	113,309,775
Furniture and equipment	43,890,215	37,044,828
Software	11,425,411	9,830,112
Construction in process	0	9,467,020
	<u>203,117,897</u>	<u>188,292,049</u>
Less accumulated depreciation	(53,522,838)	(44,321,043)
Property and equipment, net ...	<u>\$149,595,059</u>	<u>\$143,971,006</u>

Furniture and equipment includes \$1,156,000 and \$864,000 for capitalized leases as of December 31, 2003 and 2002, respectively. Accumulated depreciation includes \$195,000 and \$654,000 for capitalized leases as of December 31, 2003 and 2002, respectively. The Board paid interest related to these capital leases in the amount of \$76,007 and \$15,731 for 2003 and 2002, respectively.

The Board began the Eccles Building Infrastructure Enhancement Project in July 1999. This \$12.5 million project, scheduled for nineteen phases over three and a half years, included asbestos removal, lighting and plumbing improvements, cabling and other enhancements. This project was completed in 2003.

During 2002, fully depreciated furniture and equipment totaling \$22,350,000 was retired.

(3) RETIREMENT BENEFITS

Substantially all of the Board's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). The System Plan is a multi-employer plan which covers employees of the Federal Reserve Banks, the Board, and the Plan Administrative Office.

Employees of the Board who became employed prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who became employed after 1983 are covered by a non-

contributory defined benefits program under the System Plan. Contributions to the System Plan are actuarially determined and funded by participating employers at amounts prescribed by the System Plan's administrator. Based on actuarial calculations, it was determined that employer funding contributions were not required for the years 2003 and 2002, and the Board was not assessed a contribution for these years. Excess Plan assets are expected to continue to fund future years' contributions. Because the plan is part of a multi-employer plan, information as to vested and nonvested benefits, as well as plan assets, as it relates solely to the Board, is not readily available.

A relatively small number of Board employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). The Board matches employee contributions to these plans. These defined benefit plans are administered by the Office of Personnel Management. The Board's contributions to these plans totaled \$312,000 and \$327,000 in 2003 and 2002, respectively. The Board has no liability for future payments to retirees under these programs, and it is not accountable for the assets of the plans.

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan. Under the Thrift Plan, members may contribute up to a fixed percentage of their salary. Board contributions are based upon a fixed percentage of each member's basic contribution and were \$7,692,000 and \$7,185,000 in 2003 and 2002, respectively.

Effective January 1, 1996, Board employees covered under the System Plan are also covered under a Benefits Equalization Plan (BEP). Benefits paid under the BEP are limited to those benefits that cannot be paid from the System Plan due to limitations imposed by Sections 401(a)(17), 415(b) and 415(e) of the Internal Revenue Code of 1986. Pension costs attributed to the BEP reduce the pension costs of the System Plan. Activity for the BEP for 2003 and 2002 is summarized in the following table:

	2003	2002
<i>Change in benefit obligation</i>		
Projected benefit obligation at beginning of year ..	\$ 12,866	\$ 2,125
Service cost	13,689	3,363
Interest cost	3,412	561
Plan participants' contributions	0	0
Plan amendments	0	2,852
Actuarial (gain)/loss	44,989	3,965
Benefits paid	0	0
Projected benefit obligation at end of year	<u>\$ 74,956</u>	<u>\$ 12,866</u>

<i>Change in plan assets</i>		
Fair value of plan assets at beginning of year	\$ 0	\$ 0
Actual return on plan assets	0	0
Employer contributions to Plan participants'	0	0
contributions	0	0
Benefits paid	0	0
Fair value of plan assets at end of year	<u>\$ 0</u>	<u>\$ 0</u>

<i>Reconciliation of funded status at end of year</i>		
Funded status	\$ (74,956)	\$ (12,866)
Unrecognized net actuarial (gain)/loss	(231,189)	(297,773)
Unrecognized prior service cost	(289,456)	(303,469)
Retirement benefit liability	<u>\$ (595,601)</u>	<u>\$ (614,108)</u>

<i>Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31</i>		
Discount rate	6.75%	7.00%
Expected asset return ..	N/A	N/A
Salary scale	4.25%	4.50%
Corridor	10.00%	10.00%

<i>Components of net periodic benefit cost</i>		
Service cost	\$ 13,689	\$ 3,363
Interest cost	3,412	561
Expected return on plan assets	0	0
Amortization of prior service cost ..	(14,013)	(14,013)
Recognized actuarial (gain)/loss	<u>\$ (21,595)</u>	<u>\$ (27,431)</u>
Net periodic benefit cost	<u>\$ (18,507)</u>	<u>\$ (37,520)</u>

(4) POSTRETIREMENT BENEFITS

The Board provides certain life insurance programs for its active employees and retirees. Activity for 2003 and 2002 is summarized in the following table:

	2003	2002
<i>Change in benefit obligation</i>		
Benefit obligation at beginning of year ..	\$ 6,134,395	\$ 5,868,425
Service cost	170,636	158,179
Interest cost	414,319	386,215
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss	673,998	(63,554)
Benefits paid	(227,202)	(214,870)
Benefit obligation at end of year	<u>\$ 7,166,146</u>	<u>\$ 6,134,395</u>

Change in plan assets

Fair value of plan assets at beginning of year	\$ 0	\$ 0
Actual return on plan assets	0	0
Employer contributions	227,202	213,958
Plan participants' contributions	0	0
Benefits paid	(227,202)	(213,958)
Fair value of plan assets at end of year	\$ 0	\$ 0

Reconciliation of funded status at end of year

Funded status	\$(7,166,146)	\$(6,134,395)
Unrecognized net actuarial (gain)/loss	1,760,246	1,126,688
Unrecognized prior service cost	83,847	89,920
Prepaid/(accrued) postretirement benefit liability	\$(5,322,053)	\$(4,917,787)

Components of net periodic cost for year

Service cost	\$ 170,636	\$ 158,179
Interest cost	414,319	386,215
Amortization of prior service cost	6,073	6,073
Amortization of (gains)/losses	40,440	26,706
Total net periodic cost	\$ 631,468	\$ 577,173

The liability and costs for the postretirement benefit plan were determined using discount rates of 6.25 percent and 6.75 percent as of December 31, 2003 and 2002, respectively. Unrecognized losses of \$1,760,246 and \$1,126,688 as of December 31, 2003 and 2002, respectively, result from changes in the discount rate used to measure the liabilities. Under Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, the Board may have to record some of these unrecognized losses in operations in future years. The assumed salary trend rate for measuring the increase in postretirement benefits related to life insurance was an average of 4.00 percent.

The above accumulated postretirement benefit obligation is related to the Board sponsored life insurance programs. The Board has no liability for future payments to employees who continue coverage under the federally sponsored life and health programs upon retiring. Contributions for active employees participating in federally sponsored health programs totaled \$7,188,000 and \$6,205,000 in 2003 and 2002, respectively.

(5) POSTEMPLOYMENT BENEFIT PLAN

The Board provides disability and survivor income benefits to eligible employees after employment but before retirement. Effective January 1, 1994, the Board adopted Statement of Financial Accounting Standards No. 112, *Employers' Accounting for Postemployment Benefits*, which requires that employers providing postemployment benefits to their employees accrue the cost of such benefits. Prior to January 1994, postemployment benefit expenses were recognized on a pay-as-you-go basis.

	2003	2002
<i>Change in benefit obligation</i>		
Benefit obligation at beginning of year	\$4,299,252	\$3,591,571
Service cost	955,926	891,192
Interest cost	157,545	166,520
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss	(156,797)	(76,282)
Benefits paid	(306,034)	(273,749)
Benefit obligation at end of year	\$4,949,892	\$4,299,252

Weighted-average assumptions as of December 31

Discount rate	6.25%	6.75%
Expected asset return	N/A	N/A
Salary scale	4.00%	4.25%
Corridor	10.00%	10.00%

(6) OTHER REVENUES AND OTHER EXPENSES

The following are summaries of the components of Other Revenues and Other Expenses.

	As of December 31,	
	2003	2002
<i>Other revenues</i>		
Data processing revenue	\$4,639,084	\$4,830,600
Rent	2,029,514	1,996,893
Subscription revenue	799,356	810,032
Reimbursable services to other agencies	588,894	788,095
Board sponsored conferences	275,110	115,965
National Information Center	24,422	30,334
Miscellaneous	479,060	467,498
Total Other Revenues	\$8,835,440	\$9,039,417

<i>Other expenses</i>		
Tuition, registration, and membership fees	\$1,615,074	\$1,642,013
Public transportation subsidy	732,124	745,973
Contingency operations	704,699	264,232
Subsidies and contributions	627,854	900,049
Meals and representation ...	534,618	378,387
Former employee related payments	507,082	158,066
Security investigations	473,659	229,387
Equipment and facilities rental ...	439,751	318,132
Administrative law judges	307,173	147,830
Miscellaneous	<u>700,084</u>	<u>357,521</u>
Total Other Expenses	<u>\$6,642,118</u>	<u>\$5,141,590</u>

(7) COMMITMENTS

The Board has entered into several operating leases to secure office, training and warehouse space for remaining periods ranging from one to four years. In addition, the Board has entered into an agreement with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, through the Federal Financial Institutions Examination Council (the "Council") to fund a portion of enhancements for a central data repository project through 2013.

Minimum annual payments under the operating leases having an initial or remaining noncancelable lease term in excess of one year at December 31, 2003, are as follows:

2004	\$157,079
2005	163,363
2006	71,991
After 2006	0
	<u>\$392,433</u>

Rental expenses under the operating leases were \$156,000 in 2003 and 2002.

(8) FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

The Board is one of the five member agencies of the Council, and currently performs certain management functions for the Council. The five agencies which are represented on the Council are the Board, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision. The Board's financial statements do not include financial data for the Council. Activity related to the Board and Council for 2003 and 2002 is summarized in the following table:

	<u>2003</u>	<u>2002</u>
<i>Board paid to the Council:</i>		
Assessments for operating expenses of the Council	\$ 105,920	\$ 300,000
Central Data Repository	630,000	0
Uniform Bank Performance Report	<u>201,666</u>	<u>0</u>
Total Board paid to the Council	<u>\$ 937,586</u>	<u>\$ 300,000</u>
<i>Council paid to the Board:</i>		
Data processing related services	3,485,701	3,350,412
Administrative services	<u>72,250</u>	<u>69,593</u>
Total Council paid to the Board	<u>\$3,557,951</u>	<u>\$3,420,005</u>

(9) FEDERAL RESERVE BANKS

The Board performs certain functions for the Reserve Banks in conjunction with its responsibilities for the Federal Reserve System, and the Federal Reserve Banks provide certain administrative functions for the Board. Activity related to the Board and Reserve Banks for 2003 and 2002 is summarized in the following table:

	<u>2003</u>	<u>2002</u>
<i>Board paid to the Reserve Banks:</i>		
Assessments for employee benefits ..	\$ 2,137,781	\$ 2,014,839
Data processing and communication	1,963,247	2,154,087
Contingency site	<u>704,699</u>	<u>264,232</u>
Total Board paid to the Reserve Banks	<u>\$ 4,805,727</u>	<u>\$ 4,433,158</u>
<i>Reserve Banks paid to the Board:</i>		
Assessments for currency costs	\$508,144,248	\$429,568,393
Assessments for operating expenses of the Board	297,020,200	205,110,800
Data processing	<u>1,484,015</u>	<u>1,281,759</u>
Total Reserve Banks paid to the Board	<u>\$806,648,463</u>	<u>\$635,960,952</u>



KPMG LLP
2001 M Street NW
Washington, DC 20036

Independent Auditors' Report on Internal Control over Financial Reporting

To the Board of Governors of the Federal Reserve System:

We have audited the balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2003 and 2002, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended, and have issued our report thereon dated April 2, 2004. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

In planning and performing our fiscal year 2003 audit, we considered the Board's internal control over financial reporting by obtaining an understanding of the Board's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. The objective of our audit was not to provide assurance on the Board's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses under standards issued by the American Institute of Certified Public Accountants. Material weaknesses are conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the information and use of the members of the Board and its management, the Office of Inspector General, the U.S. Office of Management and Budget, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

April 2, 2004



KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.



KPMG LLP
2001 M Street NW
Washington, DC 20036

Independent Auditors' Report on Compliance with Laws and Regulations

To the Board of Governors of the Federal Reserve System:

We have audited the balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2003 and 2002, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended, and have issued our report thereon dated April 2, 2004. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

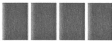
The management of the Board is responsible for complying with laws and regulations applicable to the Board. As part of obtaining reasonable assurance about whether the Board's 2003 financial statements are free of material misstatement, we performed tests of the Board's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the members of the Board and its management, the Office of Inspector General, the U.S. Office of Management and Budget, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

April 2, 2004



KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

Federal Reserve Banks Combined Financial Statements

The combined financial statements of the Federal Reserve Banks were audited by PricewaterhouseCoopers LLP, independent auditors, for the years ended December 31, 2003 and 2002.



REPORT OF INDEPENDENT AUDITORS

To the Board of Governors of the Federal Reserve System
and the Board of Directors of each of the Federal Reserve Banks:

We have audited the accompanying combined statements of condition of the Federal Reserve Banks (the "Reserve Banks") as of December 31, 2003 and 2002, and the related combined statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These financial statements are the responsibility of the Reserve Banks' management. Our responsibility is to express an opinion on the financial statements based on our audits.

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

As discussed in Note 3, the combined financial statements were prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These principles, policies, and practices, which were designed to meet the specialized accounting and reporting needs of the Federal Reserve System, are set forth in the *Financial Accounting Manual for Federal Reserve Banks* and constitute a comprehensive basis of accounting other than generally accepted accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of the Reserve Banks as of December 31, 2003 and 2002, and the combined results of their operations for the years then ended, in conformity with the basis of accounting described in Note 3.

Washington, D.C.
March 26, 2004

PRICEWATERHOUSECOOPERS LLP

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CONDITION
December 31, 2003 and 2002

(in millions)

ASSETS	2003	2002
Gold certificates	\$ 11,039	\$ 11,039
Special drawing rights certificates	2,200	2,200
Coin	722	988
Items in process of collection	7,793	10,291
Loans to depository institutions	62	40
Securities purchased under agreements to resell (tri-party)	43,750	39,500
U.S. government and federal agency securities, net	675,569	639,125
Investments denominated in foreign currencies	19,868	16,913
Accrued interest receivable	5,064	5,470
Bank premises and equipment, net	2,117	2,044
Other assets	3,303	3,367
Total assets	<u>\$771,487</u>	<u>\$730,977</u>
LIABILITIES AND CAPITAL		
LIABILITIES		
Federal Reserve notes outstanding, net	\$689,757	\$654,273
Securities sold under agreements to repurchase	25,652	21,091
Deposits		
Depository institutions	23,058	22,541
U.S. Treasury, general account	5,723	4,420
Other deposits	394	444
Deferred credit items	7,582	9,459
Interest on Federal Reserve notes due U.S. Treasury	428	838
Accrued benefit costs	956	915
Other liabilities	243	236
Total liabilities	<u>753,793</u>	<u>714,217</u>
CAPITAL		
Capital paid-in	8,847	8,380
Surplus	8,847	8,380
Total capital	<u>17,694</u>	<u>16,760</u>
Total liabilities and capital	<u>\$771,487</u>	<u>\$730,977</u>

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

**FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF INCOME
for the years ended December 31, 2003 and 2002**

(in millions)

	<u>2003</u>	<u>2002</u>
Interest income		
Interest on U.S. government and federal agency securities	\$22,597	\$25,525
Interest on investments denominated in foreign currencies	260	272
Interest on loans to depository institutions	1	2
Total interest income	<u>22,858</u>	<u>25,799</u>
Interest expense		
Interest expense on securities sold under agreements to repurchase	215	13
Net interest income	<u>22,643</u>	<u>25,786</u>
Other operating income		
Income from services	887	916
Reimbursable services to government agencies	328	309
Foreign currency gains, net	2,695	2,083
Government securities gains, net .....	..	77
Other income	79	80
Total other operating income	<u>3,989</u>	<u>3,465</u>
Operating expenses		
Salaries and other benefits	1,817	1,377
Occupancy expense	213	208
Equipment expense	257	263
Assessments by Board of Governors	805	635
Other expenses	534	720
Total operating expenses	<u>3,626</u>	<u>3,203</u>
Net income prior to distribution	<u>\$23,006</u>	<u>\$26,048</u>
Distribution of net income		
Dividends paid to member banks	\$ 518	\$ 484
Transferred to surplus	467	1,068
Payments to U.S. Treasury as interest on Federal Reserve notes	22,021	24,496
Total distribution	<u>\$23,006</u>	<u>\$26,048</u>

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

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CHANGES IN CAPITAL
for the years ended December 31, 2003 and 2002

(in millions)

	<u>Capital paid-in</u>	<u>Surplus</u>	<u>Total capital</u>
Balance at January 1, 2002			
(147 million shares)	\$7,373	\$7,312	\$14,685
Net income transferred to surplus .....	. . .	1,068	1,068
Net change in capital stock issued			
(20 million shares)	<u>1,007</u>	<u>. . .</u>	<u>1,007</u>
Balance at December 31, 2002			
(167 million shares)	\$8,380	\$8,380	\$16,760
Net income transferred to surplus .....	. . .	467	467
Net change in capital stock issued			
(9 million shares)	<u>467</u>	<u>. . .</u>	<u>467</u>
Balance at December 31, 2003			
(176 million shares)	<u>\$8,847</u>	<u>\$8,847</u>	<u>\$17,694</u>

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

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS

(1) STRUCTURE

The twelve Federal Reserve Banks (Reserve Banks) are part of the Federal Reserve System (System) created by Congress under the Federal Reserve Act of 1913 (Federal Reserve Act) which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. Other major elements of the System are the Board of Governors of the Federal Reserve System (Board of Governors), the Federal Open Market Committee (FOMC) and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York (FRBNY) and, on a rotating basis, four other Reserve Bank presidents. Banks that are members of the System include all national banks and any state-chartered bank that applies and is approved for membership in the System.

Although the Reserve Banks are chartered as independent organizations overseen by the Board of Governors, the Reserve Banks work jointly to carry out their statutory responsibilities. The majority of the assets, liabilities, and income of the Reserve Banks is derived from central bank activities and responsibilities with regard to monetary policy and currency. For this reason, the accompanying combined set of financial statements for the twelve independent Reserve Banks is prepared with adjustments to eliminate interdistrict accounts and transactions.

Board of Directors

The Reserve Banks serve twelve Federal Reserve Districts nationwide. In accordance with the Federal Reserve

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

(2) OPERATIONS AND SERVICES

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

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

In performing fiscal agency functions for the U.S. Treasury, seven Reserve Banks provide U.S. securities direct purchase and savings bond processing services. In December 2003, the U.S. Treasury announced plans to consolidate the provision of these services at FRB Cleveland and Minneapolis. An implementation plan is expected to be announced in March 2004. At this time, the Banks have not developed a detailed estimate of the financial effect of the consolidation.

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of U.S. government and federal agency securities, matched sale–purchase transactions, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. FRBNY is also authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange (F/X) and securities contracts in, nine foreign currencies, maintain reciprocal currency arrangements (F/X swaps) with various central banks, and “warehouse” foreign currencies for the U.S. Treasury and Exchange Stabilization Fund (ESF) through the Reserve Banks.

(3) SIGNIFICANT ACCOUNTING POLICIES

Accounting principles for entities with the unique powers and responsibilities of the nation’s central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared with the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks (Financial Accounting Manual)*, which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the *Financial Accounting Manual*.

These combined financial statements have been prepared in accordance with the *Financial Accounting Manual*. Differences exist between the accounting principles and practices of the System and generally accepted accounting principles in the United States of America (GAAP). The primary differences are the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP, and the accounting for matched sale–purchase transactions as separate sales and purchases, rather than secured borrowings with pledged collateral, as is generally required by GAAP. In addition, the Board of Governors and the Reserve Banks have elected not to present a Statement of Cash Flows. The Statement of Cash Flows has not been included, because the liquidity and cash position of the Reserve Banks are not of primary concern to users of these combined financial statements. Other information regarding the Reserve Banks’ activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. A Statement of Cash Flows, therefore, would not provide any additional useful

information. There are no other significant differences between the policies outlined in the *Financial Accounting Manual* and GAAP.

The preparation of the combined financial statements in conformity with the *Financial Accounting Manual* requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the combined financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

(A) Gold Certificates

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury’s account is charged and the Reserve Banks’ gold certificate account is lowered. The value of gold for purposes of backing the gold certificates is set by law at \$42% a fine troy ounce.

(B) Special Drawing Rights Certificates

Special drawing rights (SDRs) are issued by the International Monetary Fund (Fund) to its members in proportion to each member’s quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks’ SDR certificate account is increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. There were no SDR transactions in 2003 or 2002.

(C) Loans to Depository Institutions

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Banks, subject to review by the Board of Governors.

(D) *U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies*

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

In December 2002, matched sale-purchase (MSP) transactions were replaced with securities sold under agreements to repurchase. MSP transactions, accounted for as separate sale and purchase transactions, are transactions in which the FRBNY sells a security and buys it back at the rate specified at the commencement of the transaction. Securities sold under agreements to repurchase are treated as secured borrowing transactions with the associated interest expense recognized over the life of the transaction.

In addition to the aforementioned matched sale-purchase transactions and sales of securities under agreements to repurchase, the FRBNY may engage in tri-party purchases of securities under agreements to resell (tri-party agreements). Tri-party agreements are conducted with two custodial banks that manage the clearing and settlement of collateral. Acceptable collateral under tri-party agreements primarily includes U.S. government and agency securities, pass-through mortgage securities of 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 agreements.

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

F/X contracts are contractual agreements between two parties to exchange specified currencies, at a specified

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

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with two authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to foreign currencies that it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The Bank will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the Treasury, U.S. dollars for foreign currencies held by the Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury and ESF for financing purchases of foreign currencies and related international operations.

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts which contain varying degrees of off-balance-sheet market risk, because they represent contractual commitments involving future settlement, and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

While the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio from time to time involve transactions that can result in gains or losses when holdings are sold prior to maturity. Decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government and federal agency securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

is accrued on a straight-line basis and is reported as “Interest on U.S. government and federal agency securities” or “Interest on investments denominated in foreign currencies,” as appropriate. Income earned on securities lending transactions is reported as a component of “Other income.” Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Gains and losses on the sales of U.S. government and federal agency securities are reported as “Government securities gains, net.” Foreign-currency-denominated assets are revalued daily at current market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as “Foreign currency gains (losses), net.” Foreign currencies held through F/X swaps, when initiated by the counterparty, and warehousing arrangements are revalued daily with the unrealized gain or loss reported as a component of “Other assets” or “Other liabilities,” as appropriate.

In 2003, additional interest income of \$61 million, representing one day’s interest on the SOMA portfolio, was accrued to reflect a change in interest accrual methods. Interest accruals and the amortization of premiums and discounts are now recognized beginning the day that a security is purchased and ending the day before the security matures or is sold. Previously, accruals and amortization began the day after the security was purchased and ended on the day that the security matured or was sold. The effect of this change was not material; therefore, it was included in the 2003 interest income.

(E) Bank Premises, Equipment, and Software

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

(F) Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank. In 2003, the Federal

Reserve Act was amended to expand the assets eligible to be pledged as collateral security to include all Federal Reserve Bank assets. Prior to the amendment, only gold certificates, special drawing rights certificates, U.S. government and federal agency securities, securities purchased under agreements to resell, loans to depository institutions, and investments denominated in foreign currencies could be pledged as collateral. The collateral value is equal to the book value of the collateral tendered, with the exception of securities whose collateral value is equal to the par value of the securities tendered and securities purchased under agreements to resell, which are valued at the contract amount. The par value of securities pledged for securities sold under agreements to repurchase is similarly deducted. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides that certain assets of the Reserve Banks are jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The “Federal Reserve notes outstanding, net” account represents Federal Reserve notes outstanding reduced by the Reserve Banks’ currency holdings of \$110,176 million and \$104,983 million at December 31, 2003 and 2002, respectively.

At December 31, 2003 all Federal Reserve notes outstanding were fully collateralized. All gold certificates, all special drawing rights certificates, and \$676,518 million of domestic securities and securities purchased under agreements to resell were pledged as collateral. At December 31, 2003, no loans or investments denominated in foreign currencies were pledged as collateral.

(G) Capital Paid-In

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

(H) Surplus

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury as interest on Federal Reserve notes excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

In the event of losses, or a substantial increase in capital, a Reserve Bank will suspend its payments to the U.S. Treasury until such losses or increases in capital are recovered through subsequent earnings. Weekly payments to the U.S. Treasury may vary significantly.

(I) *Income and Costs Related to Treasury Services*

Reserve Banks are required by the Federal Reserve Act to serve as fiscal agents and depositories of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services.

(J) *Taxes*

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. Real property taxes were \$33 million and \$32 million for the years ended December 31, 2003 and 2002, respectively, and are reported as a component of "Occupancy expense."

(K) *Recent Accounting Developments*

In May 2003, the Financial Accounting Standards Board issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150, which will become applicable for the Reserve Banks in 2004, establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and imposes certain additional disclosure requirements. When adopted, there may be situations in which a Reserve Bank has not yet processed a member bank's application to redeem its Reserve Bank stock. In those situations, this standard requires that the portion of the capital paid-in that is mandatorily redeemable be reclassified as debt.

(L) *2003 Restructuring Charges*

In 2003, the System restructured several operations, primarily in the check and currency services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in the remaining locations.

Footnote 10 describes the restructuring and provides information about Reserve Bank costs and liabilities associated with employee separations and contract terminations. The costs associated with the write-down of certain Reserve Bank assets are discussed in footnote 6. Costs and liabilities associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in footnote 8 and those associated

with enhanced postretirement benefits provided by the Reserve Banks are discussed in footnote 9.

(4) U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES

Securities bought outright are held in the SOMA at the FRBNY.

Total securities held in the SOMA at December 31 that were bought outright, were as follows (in millions):

	2003	2002
Par value		
Federal agency	\$. . .	\$ 10
U.S. government		
Bills	244,833	226,682
Notes	323,361	297,893
Bonds	98,471	104,832
Total par value	666,665	629,417
Unamortized premiums	9,797	10,762
Unaccreted discounts	(893)	(1,054)
Total	<u>\$675,569</u>	<u>\$639,125</u>

As noted in footnote 3, the FRBNY replaced MSP transactions with securities sold under agreements to repurchase in December 2002. At December 31, 2003 and 2002, securities sold under agreements to repurchase with a contract amount of \$25,652 million and \$21,091 million, respectively, were outstanding. At December 31, 2003 and 2002, securities sold under agreements to repurchase with a par value of \$25,658 million and \$21,098 million, respectively, were outstanding.

The maturity distribution of U.S. government and federal agency securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase, which were held in the SOMA at December 31, 2003, was as follows (in millions):

Maturities of securities held	U.S. government securities (Par)	Securities purchased under agreements to resell (Contract amount)	Securities sold under agreements to repurchase (Contract amount)
Within 15 days ...	\$ 47,733	\$43,750	\$25,652
16 days to 90 days .	139,347	. . .	. . .
91 days to 1 year ..	164,071	. . .	. . .
Over 1 year to			
5 years	187,056	. . .	. . .
Over 5 years to			
10 years	51,312	. . .	. . .
Over 10 years	77,146	. . .	. . .
Total	<u>\$666,665</u>	<u>\$43,750</u>	<u>\$25,652</u>

At December 31, 2003 and 2002, U.S. government securities with par values of \$4,426 million and \$1,841 million, respectively, were loaned from the SOMA.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

(5) INVESTMENTS DENOMINATED IN
FOREIGN CURRENCIES

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and the Bank for International Settlements, and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities held under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

Total investments denominated in foreign currencies, valued at current exchange rates at December 31, were as follows (in millions):

	<u>2003</u>	<u>2002</u>
European Union Euro		
Foreign currency deposits	\$ 6,870	\$ 5,580
Government debt instruments including agreements to resell	4,090	3,298
Japanese Yen		
Foreign currency deposits	1,475	1,789
Government debt instruments including agreements to resell	7,341	6,164
Accrued interest	<u>92</u>	<u>82</u>
Total	<u>\$19,868</u>	<u>\$16,913</u>

The maturity distribution of investments denominated in foreign currencies at December 31, 2003, was as follows (in millions):

Maturities of Investments Denominated
in Foreign Currencies

Within 1 year	\$18,243
Over 1 year to 5 years	1,292
Over 5 years to 10 years	333
Over 10 years .....	.....
Total	<u>\$19,868</u>

At December 31, 2003 and 2002, there were no outstanding F/X swaps or material open foreign exchange contracts.

At December 31, 2003 and 2002, the warehousing facility was \$5,000 million, with no balance outstanding.

(6) BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	<u>2003</u>	<u>2002</u>
Bank premises and equipment		
Land	\$ 244	\$ 209
Buildings	1,559	1,514
Building machinery and equipment	364	345
Construction in progress	96	51
Furniture and equipment	<u>1,334</u>	<u>1,362</u>
Subtotal	3,597	3,481
Accumulated depreciation	<u>(1,480)</u>	<u>(1,437)</u>
Bank premises and equipment, net	<u>\$2,117</u>	<u>\$2,044</u>
Depreciation expense, for the years ended	<u>\$ 184</u>	<u>\$ 187</u>

Bank premises and equipment at December 31 include the following amounts for leases that have been capitalized (in millions):

	<u>2003</u>	<u>2002</u>
Bank premises and equipment	\$36	\$15
Accumulated depreciation	<u>(27)</u>	<u>(12)</u>
Capitalized leases, net	<u>\$ 9</u>	<u>\$ 3</u>

Certain of the Reserve Banks lease unused space to outside tenants. Those leases have terms ranging from 1 to 13 years. Rental income from such leases totaled \$20 million and \$21 million for the years ended December 31, 2003 and 2002, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2003, were (in millions):

2004	\$18
2005	16
2006	13
2007	9
2008	8
Thereafter	<u>34</u>
Total	<u>\$98</u>

The Reserve Banks have capitalized software assets, net of amortization, of \$158 million and \$141 million at December 31, 2003 and 2002, respectively. Amortization expense was \$54 million and \$45 million for the years ended December 31, 2003 and 2002, respectively.

Several Reserve Banks have impaired assets as a result of the System's restructuring plan, as discussed in footnote 10, or as a result of the System's decision to standardize check processing. Impaired assets include software, buildings, leasehold improvements, furniture, and equipment. Asset impairment losses related to the restructuring and check processing standardization of \$11 million and \$3 million, respectively, for the period ending December 31, 2003 were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

Three Reserve Banks are constructing new buildings, one to replace the head office and two to replace branch offices. At December 31, 2003, the contractual obligation for the property for the new head office building site was \$18 million, none of which has been recognized. The obligation was satisfied in February 2004.

(7) COMMITMENTS AND CONTINGENCIES

At December 31, 2003, the Reserve Banks were obligated under noncancelable leases for premises and equipment with terms ranging from 1 to 20 years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was \$71 million and \$70 million for the years ended December 31, 2003 and 2002, respectively. Certain of the Reserve Banks' leases have options to renew.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Future minimum rental payments under noncancelable operating and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 2003, were (in millions):

	<u>Operating</u>	<u>Capital</u>
2004	\$ 10.5	\$ 2.7
2005	8.2	2.1
2006	7.3	1.9
2007	6.5	.6
2008	6.5	. . .
Thereafter	<u>124.7</u>	<u>. . .</u>
	<u>\$163.7</u>	<u>\$ 7.3</u>
Amount representing interest ...		<u>(.5)</u>
		<u>\$ 6.8</u>

At December 31, 2003, the Reserve Banks had contractual commitments through the year 2008 totaling \$153 million for the maintenance of currency machines, check-processing-related services, and check transportation services, none of which has been recognized. Three Reserve Banks contract for these services on behalf of the System and two of them allocate the costs to the other Reserve Banks.

Three Reserve Banks have additional contractual commitments through the year 2008 for software development and maintenance, architectural and contracting services, and building maintenance. At December 31, 2003, these contractual commitments totaled \$169 million, none of which has been recognized.

The Reserve Banks are involved in certain legal actions and claims arising in the ordinary course of business. Although it is difficult to predict the ultimate outcome of these actions, in management's opinion, based on discussions with counsel, the aforementioned litigation and claims will be resolved without material adverse effect on the financial position or results of operations of the Reserve Banks.

(8) RETIREMENT AND THRIFT PLANS

Retirement Plans

The Reserve Banks currently offer two defined benefit retirement plans to their employees, based on length of service and level of compensation. Substantially all of the Reserve Banks', Board of Governors', and the Plan Administrative Office's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan) and the Benefit Equalization Retirement Plans offered by each individual Reserve Bank (BEP). In addition, certain Bank officers participate in a Supplemental Employee Retirement Plan (SERP).

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. Certain Board employees not covered by the Social Security Act also contribute to the plan. No separate accounting is maintained of assets contributed by the participating employers. FRBNY acts

as a sponsor of the Plan for the System and costs associated with the Plan are not redistributed to other participating employers. The prepaid pension cost includes amounts related to the participating employees of all employers who participate in the plans.

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

	<u>2003</u>	<u>2002</u>
Estimated actuarial present value of projected benefit obligation at January 1	\$3,523	\$3,091
Service cost—benefits earned during the period	109	104
Interest cost on projected benefit obligation	232	226
Actuarial loss	192	126
Contributions by plan participants ..	4	3
Benefits paid	(197)	(170)
Special termination loss/amendments	67	143
Estimated actuarial present value of projected benefit obligation at December 31	<u>\$3,930</u>	<u>\$3,523</u>

Following is a reconciliation of the beginning and ending balances of the System Plan assets, the funded status, and the prepaid pension benefit costs (in millions):

	<u>2003</u>	<u>2002</u>
Estimated fair value of plan assets at January 1	\$4,997	\$5,795
Actual return on plan assets	899	(631)
Contributions by plan participants ..	4	3
Employer contributions .....	. . .	. . .
Benefits paid	(197)	(170)
Estimated fair value of plan assets at December 31	<u>\$5,703</u>	<u>\$4,997</u>
Funded status	\$1,774	\$1,474
Unrecognized prior service cost	197	223
Unrecognized net actuarial loss	<u>710</u>	<u>1,042</u>
Prepaid pension benefit costs	<u>2,681</u>	<u>2,739</u>

Prepaid pension benefit costs are reported as a component of "Other assets."

The accumulated benefit obligation for the defined benefit pension plan was \$3,456 million and \$2,996 million at December 31, 2003, and 2002, respectively.

The weighted-average assumptions used in developing the pension benefit obligation for the System Plan as of December 31 are as follows:

	<u>2003</u>	<u>2002</u>
Discount rate	6.25%	6.75%
Rate of compensation increase	4.00%	4.25%

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

The weighted-average assumptions used in developing net periodic benefit cost for the System Plan for the years ending December 31 are as follows:

	<u>2003</u>	<u>2002</u>
Discount rate	6.75%	7.00%
Expected asset return	8.50%	9.00%
Rate of compensation increase	4.25%	4.50%

The long-term rate of return on assets was based on a combination of methodologies including the System Plan's historical returns, surveys of other plans' expected rates of return, building a projected return for equities and fixed income investments based on real interest rates, inflation expectations and equity risk premiums and finally, surveys of expected returns in equity and fixed income markets.

The components of net periodic pension benefit cost (credit) for the System Plan as of December 31 are shown below (in millions):

	<u>2003</u>	<u>2002</u>
Service cost—benefits earned during the period	\$ 109	\$ 104
Interest cost on projected benefit obligation	232	226
Amortization of prior service cost	26	27
Recognized net loss	42	...
Expected return on plan assets	(418)	(514)
Net periodic pension benefit credit ..	(9)	(157)
Special termination benefits	67	...
Net periodic pension benefit cost (credit)	<u>\$ 58</u>	<u>\$(157)</u>

The recognition of special termination benefits is the result of enhanced retirement benefits provided to 1,184 System employees in conjunction with the restructuring disclosed in footnote 10. Net periodic pension benefit cost (credit) is reported as a component of "Salaries and other benefits."

The Federal Reserve System's pension plan weighted-average asset allocations at December 31, by asset category are as follows:

	<u>2003</u>	<u>2002</u>
Equities	61.9%	64.6%
Fixed income	34.8%	32.2%
Cash	3.3%	3.2%
Total	<u>100.0%</u>	<u>100.0%</u>

The System's Committee on Investment Performance (CIP) contracts with investment managers who are responsible for implementing the System Plan's investment policies. The managers' performance is measured against a trailing 36-month-benchmark of 60 percent of a market value weighted index of predominantly large capitalization stocks trading on the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers Automated Quotation National Market System and 40 percent of a

broadly diversified investment-grade fixed income index (rebalanced monthly). The managers invest Plan funds within CIP-established guidelines for investment in equities and fixed income instruments. Equity investments can range between 40 percent and 80 percent of the portfolio. Investments, however, cannot be concentrated in particular industries and equity security holdings of any one company are limited. Fixed income securities must be investment grade and the effective duration of the fixed income portfolio must remain within a range of 67 percent and 150 percent of a broadly diversified investment-grade fixed income index. System Plan investment policies prohibit margin, short sale, foreign exchange, and commodities trading as well as investment in bank, bank holding company, savings and loan, and government securities dealer's stocks. In addition, investments in non-dollar denominated securities are prohibited; however, a small portion of the portfolio can be invested in American Depositary Receipts/Shares.

The Federal Reserve System does not expect to make a cash contribution to the Retirement Plan during 2004.

The Reserve Banks' projected benefit obligations and net pension costs for the BEP and the SERP at December 31, 2003 and 2002, and for the years then ended, are not material.

Thrift Plan

Employees of the Reserve Banks may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Reserve Banks' Thrift Plan contributions totaled \$64 million and \$63 million for the years ended December 31, 2003 and 2002, respectively, and are reported as a component of "Salaries and other benefits."

(9) POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits Other Than Pensions

In addition to the Reserve Banks' retirement plans, employees who have met certain age and length of service requirements are eligible for both medical benefits and life insurance coverage during retirement.

The Reserve Banks fund benefits payable under the medical and life insurance plans as due and, accordingly, have no plan assets. Net postretirement benefit costs are actuarially determined using a January 1 measurement date.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

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

	2003	2002
Accumulated postretirement benefit obligation at January 1	\$742	\$674
Service cost—benefits earned during the period	18	17
Interest cost of accumulated benefit obligation	50	47
Actuarial loss	157	49
Curtailment loss	7	...
Special termination loss	2	...
Contributions by plan participants	6	4
Benefits paid	(40)	(37)
Plan amendments	...	(12)
Accumulated postretirement benefit obligation at December 31	<u>\$942</u>	<u>\$742</u>

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

	2003	2002
Fair value of plan assets at January 1	\$...	\$...
Contributions by the employer	34	33
Contributions by plan participants	6	4
Benefits paid	(40)	(37)
Fair value of plan assets at December 31	<u>\$...</u>	<u>\$...</u>
Unfunded postretirement benefit obligation	\$942	\$742
Unrecognized net curtailment gain	2	...
Unrecognized prior service cost	122	141
Unrecognized net actuarial loss	(246)	(93)
Accrued postretirement benefit costs	<u>\$820</u>	<u>\$790</u>

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

At December 31, 2003 and 2002, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 6.25 percent and 6.75 percent, respectively.

For measurement purposes, a 10.00 percent annual rate of increase in the cost of covered health care benefits was assumed for 2004. Ultimately, the health care cost trend rate is expected to decrease gradually to 5.00 percent by 2011 and remain at that level thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2003 (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	\$ 10	\$ (8)
Effect on accumulated postretirement benefit obligation	110	(98)

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

	2003	2002
Service cost—benefits earned during the period	\$18	\$17
Interest cost of accumulated benefit obligation	50	47
Amortization of prior service cost	(15)	(14)
Recognized net actuarial loss	<u>4</u>	<u>2</u>
Total periodic expense	57	52
Curtailment loss	5	...
Special termination loss	<u>2</u>	<u>...</u>
Net periodic postretirement benefit costs	<u>\$64</u>	<u>\$52</u>

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

As a result of the enhanced retirement benefits provided to employees during the restructuring described in footnote 10, the postretirement plans of all of the Reserve Banks incurred special termination losses and the plans of four of the Reserve Banks were curtailed. The combined effect of the three curtailment losses and one gain on the benefit obligation was a loss of \$7 million reflected above. One of the curtailment losses was offset by unrecognized actuarial gains. As a result, there were only two Banks with net curtailment losses, both of which were recognized in 2003. The net curtailment gains at the other two Reserve Banks will be recognized when the affected employees terminate employment in 2004.

Following the guidance of the Financial Accounting Standards Board, the Reserve Banks elected to defer recognition of the financial effects of the Medicare Prescription Drug Improvement and Modernization Act of 2003 until further guidance is issued. Neither the accumulated postretirement benefit obligation at December 31, 2003 nor the net periodic postretirement benefit cost for the year then ended reflect the effect of the Act on the plan.

Postemployment Benefits

The Reserve Banks offer benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, disability benefits, and those workers' compensation expenses self-insured by individual Reserve Banks. Costs were projected using the

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Reserve Banks at December 31, 2003 and 2002, were \$130 million and \$121 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2003 and 2002 operating expenses were \$26 million.

10. RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check and currency operations and staff reductions in various functions of the Bank. These actions resulted in the following business restructuring charges:

Major categories of expense (in millions):

	Total estimated costs
Employee separation	\$37
Contract termination	1
Other	<u>2</u>
Total	<u>\$40</u>

Employee separation costs are primarily severance costs related to reductions of approximately 1,662 staff and are reported as a component of "Salaries and other benefits." Contract termination costs include the charges resulting from terminating existing lease and other contracts and other costs are primarily charges for System contract management. Contract termination and other costs are shown as a component of "Other expenses."

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

Future costs associated with the restructuring that are not estimable and are not recognized as liabilities will be incurred in 2004.

The Reserve Banks anticipate substantially completing announced plans by December 31, 2004.

	Accrued liability 12/31/02	Total charges	Total paid	Accrued liability 12/31/03
Employee separation	\$. . .	\$36	\$(7)	\$29
Contract termination	1	. . .	1
Other	<u>. . .</u>	<u>2</u>	<u>(2)</u>	<u>. . .</u>
Total	<u>\$. . .</u>	<u>\$39</u>	<u>\$(9)</u>	<u>\$30</u>

Office of Inspector General Activities

The Board's Office of Inspector General (OIG) functions in accordance with the Inspector General Act of 1978, as amended. In addition to retaining an independent auditor each year to audit the Board's financial statements, the OIG plans and conducts audits and investigations of the Board's programs and operations and its delegated functions at the Federal Reserve Banks. The OIG also reviews existing and proposed legislation and regulations for economy and efficiency. It recommends policies, and it supervises and conducts activities that promote economy and efficiency and that prevent and detect waste, fraud,

and abuse in Board and Board-delegated programs and operations, as well as in activities administered or financed by the Board. The OIG keeps the Congress and the Chairman of the Board fully informed about serious abuses and deficiencies and about the status of any corrective actions.

During 2003, the OIG completed seven audits, reviews, and other assessments and conducted a number of follow-up reviews to evaluate action taken on earlier recommendations. The OIG also closed ten investigations and performed numerous legislative and regulatory reviews.

Completed OIG Audits, Reviews, and Assessments, 2003

Report title	Report number	Month issued
Review of the Supervision of Hamilton Bancorp, Inc.	A0201	March
Audit of the FFIEC's Financial Statements (Years Ended 2001 and 2002) ..	A0210	March
Audit of the Board's Financial Statements (Years Ended 2001 and 2002) ...	A0210	March
Audit of the Retirement Plan Administration	A0208	July
Survey of Surveillance Activities	A0206	August
Report on the Evaluation of the Board's E-Government Initiatives	R0205	September
Audit of the Board's Information Security Program	A0302	September

General Accounting Office Reviews

Under the Federal Banking Agency Audit Act (Public Law 95–320), most of the operations of the Federal Reserve System are under the purview of the General Accounting Office (GAO). In 2003, the GAO completed six reports

on selected aspects of Federal Reserve operations. Six projects concerning the Federal Reserve were in various stages of completion at year-end. The reports are available directly from the GAO.

Completed GAO Reports Relating to the Federal Reserve System, 2003

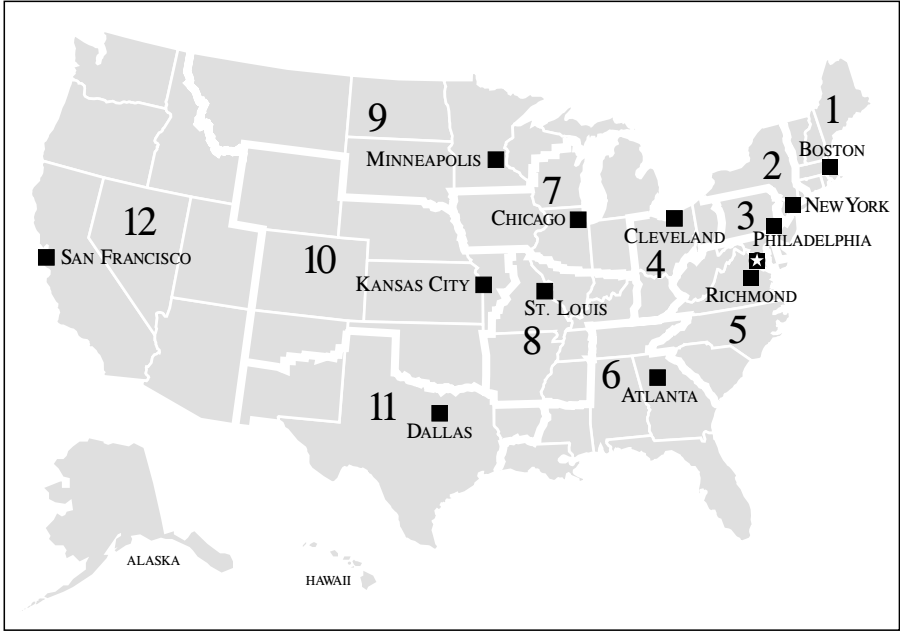
Report title	Report number	Date issued
Critical Infrastructure Protection: Efforts of the Financial Services Sector to Address Cyber Threats	GAO-03-173	1-30-03
Federal Reserve Banks: Areas for Improvement in Computer Controls	GAO-03-333R	2-10-03
Potential Terrorist Attacks: Additional Actions Needed to Better Prepare Critical Financial Market Participants	GAO-03-414	2-12-03
Information Security: Computer Controls Over Key Treasury Internet Payment System	GAO-03-837	7-30-03
Bank Tying: Additional Steps Needed to Ensure Effective Enforcement of Tying	GAO-04-3	10-10-03
Information Technology: Leadership Remains Key to Agencies Making Progress on Enterprise Architecture Efforts	GAO-04-40	11-17-03

Active GAO Projects Relating to the Federal Reserve System, Year-End 2003

Subject of project	Date initiated
Federal Reserve's relationship with U.S. Mint and BEP	7-30-02
Predatory home mortgage lending	1-23-03
Updates on impact of 9/11 attacks on U.S. financial markets	5-20-03
Illegal financial assets	5-23-03
Financial services regulation	7-17-03
Regulatory information sharing issues tied to insurance-related products	7-25-03

*Maps of the
Federal Reserve System*

The Federal Reserve System



LEGEND

Both pages

- Federal Reserve Bank city
- ☒ Board of Governors of the Federal Reserve System, Washington, D.C.

Facing page

- Federal Reserve Branch city
- Branch boundary

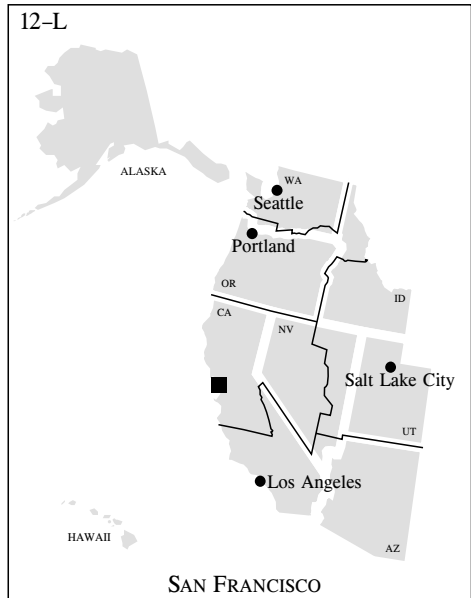
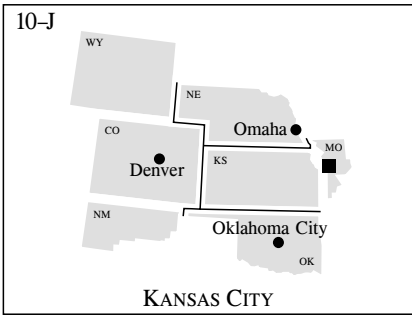
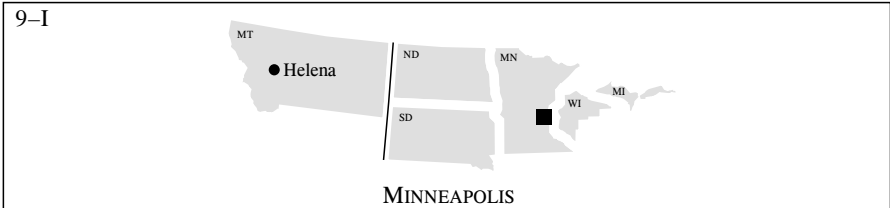
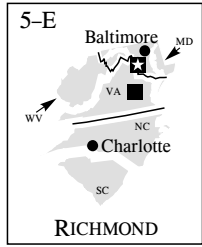
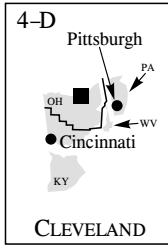
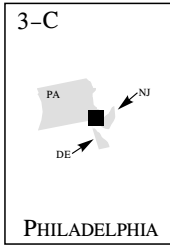
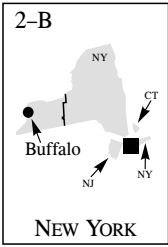
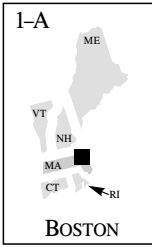
NOTE

The Federal Reserve officially identifies Districts by number and by Reserve Bank city (shown on both pages) and by letter (shown on the facing page).

In the 12th District, the Seattle Branch serves Alaska, and the San Francisco Bank serves Hawaii.

The System serves commonwealths and territories as follows: The New York

Bank serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands; the San Francisco Bank serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands. The maps show the boundaries within the System as of year-end 2003.





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