

How the U.S. Economy Recovers from a Crisis

A message from our president

I flew home from New York City the afternoon of September 10, 2001, not knowing that the world was about to change, not knowing that the building where I had given a speech that morning was one sunrise away from becoming Ground Zero for the most devastating terrorist attack in U.S. history.

In the days following the attacks on the World Trade Center, I was grateful to learn that my fellow attendees at the still-in-progress National Association for Business Economics annual meeting, being held at the Marriott World Trade Center Hotel, had all escaped with their lives.

MY CONSOLATION was tempered by the same feelings that we Americans and all civilized people across the planet experienced watching events unfold on that dreadful day: shock, disgust, sadness and unimaginable horror. My other emotion was great uncertainty about what the attacks might mean for the St. Louis Fed, the Federal Reserve System and the world economy.

Here at the St. Louis Fed, we thought of the well-being of our Eighth District colleagues who were working at the New York Fed, just a few blocks away from the World Trade Center, on September 11. People like Hillary Debenport, Kim Nelson, Bill Emmons and Ellen Eubank. Thankfully, all of them would return home safely.

President Bush would tell the press that despite the emotional toll the events were taking on him, “I have a job to do, and I intend to do it.” From those first harrowing moments, the employees at the St. Louis Fed adopted that same resolute attitude. Fear, outrage and stress made our jobs more difficult than ever. But we had a job to do, and we did it. Our job—our responsibility—was to help ensure the nation’s continued confidence in the integrity of the U.S. payments

system. We acted decisively in a number of ways:

- Our Cash Department processed its usual daily volumes of cash, handled all special requests for cash from financial institutions and made clear to them that we were prepared to provide emergency shipments if necessary.
- Our Credit Discount staff stayed on the job long after the normal closing hour and fulfilled all requests for additional liquidity from District financial institutions.
- Our Check Department processed high volumes and negotiated alternative transportation arrangements to ship checks to other Reserve districts in the absence of air transport.
- Our electronic services operated without a hitch and accommodated all requests for deadline extensions.
- Our Treasury staff met all processing deadlines for the U.S. Treasury’s tax collection and investment services.

The St. Louis Fed and the entire Federal Reserve System played a significant, but certainly not the only, role in ensuring the stability of our economy. In this annual



report, we examine four underpinnings of our economic system that, together, helped our nation absorb the shocks of September 11: competitive markets, a robust financial system, a strong government fiscal position and monetary stability.

We make the point that the United States has been able to move forward thanks to the strongest, most versatile and most balanced economy of any nation on Earth. The ability to move forward, however, should

not lead us to minimize the impact the attacks have had on our lives in so many ways.

Beyond the tragic loss of life, our economy—as well as our national psyche—took a blow. But as the following essay shows, the deep foundations upon which our economy stands have allowed us to remain firmly on our feet as we clean up our demolished buildings, repair our damaged institutions and meet the threats we face.

St. Louis Fed President and CEO **William Poole**

The world that might have been:

A terrorist attack devastates the financial nucleus of a great country, killing thousands of people and turning skyscrapers into dust and rubble in just a couple of hours.

THE NATION'S CITIZENS, who have lived their whole lives believing their homeland was immune to a scene of such horror, are paralyzed with fear. In the days and weeks that follow, the economic system that people had so comfortably put their faith in for generations begins to crumble to its own foundations:

- Producers of basic necessities take advantage of the situation to jack up their prices by as much as 1,000 percent, causing long lines and frayed tempers at gas stations and grocery stores in every city.
- Massive bank runs deplete scores of depository institutions of their liquid reserves, while the nation's banking system is unable to replenish the cash and credit needed to prevent hundreds of banks from failing within weeks.
- Heeding government warnings of additional terror attacks, people hunker down in their homes, skipping work and keeping their children home from school; airlines exhaust their cash reserves and shut down; and the federal government, grappling with soaring budget deficits and inflation, looks on helplessly, unable to offer any type of relief package that would prevent hundreds of thousands of employees from losing their jobs.

In summary, the shocking events of a single day have caused a seemingly strong nation to begin a plunge toward depression.

The world that is:

While no American will forget the events of September 11, 2001, it is equally important to be aware of how we avoided the catastrophic economic consequences described on the previous pages—to be aware of what makes the U.S. economy so unlike the fragile enterprise the terrorists mistook it to be.

THE U.S. RESPONSE reflects mutually reinforcing political and economic strengths. In this essay, we focus on the economic institutions and conditions that allowed us to successfully adjust to the shock and regain equilibrium. While further setbacks are certainly possible, the response of our economy to date and its inherent strengths provide us with great confidence that the final outcome will be favorable. Four main features of the U.S. economy justify this confidence. These are:

- Vigorously competitive markets
- A robust financial system
- A strong government fiscal position
- Low inflation and monetary stability

To reflect on these features is a valuable exercise, for they did not arise by accident. Given the routine pressures every family, firm and government faces, it would be all too easy to neglect the investments necessary to build resilient economic institutions. The components of the U.S. economy we discuss in this essay were built over time and with attention to a long horizon. They serve the nation well in ordinary times, but especially so in extraordinary times. In contrast, a country that accepts economic compromises, through an unwillingness to invest in the future, places itself at risk. The defects of a compromised structure usually become painfully apparent in a time of stress, too late to make the long-run investments that would permit a constructive response to the shock.



Competitive Markets

With high rewards for entrepreneurs, the competitive market system is the **engine of long-run growth** and the mechanism by which the economy absorbs short-run economic shocks.

THE U.S. ECONOMY contains powerful forces that promote growth and full employment. Our culture and institutions reward entrepreneurial activity. They are intact, completely undiminished by the events of September, as well as the anthrax scare that followed in October. People are motivated by the intellectual and financial rewards of building companies, developing new products and services, and serving markets. They continually look for opportunities to move the U.S. economy forward. With high rewards for entrepreneurs, the competitive market system is the engine of long-run growth and the mechanism by which the economy absorbs short-run economic shocks.

The role of competitive forces was apparent soon after September 11, as markets responded to changed demands and firms began searching for technical innovations to address the new security environment. The travel industry is the most obvious example: Airlines quickly cut flights and introduced promotional fares, while hotels and resorts offered discount rates. Other industries followed suit. By late September, the auto industry was advertising significant savings to consumers in



the form of zero-interest financing. Meanwhile, property insurance companies increased their premiums on commercial policies substantially, expanded deductibles for such coverage and, in some cases, added clauses to exclude losses resulting from acts of terror.

The United States is known around the world for its technology. In this time of stress, consider a few examples of how firms are bringing technology to bear on the problems we face: Manufacturers of equipment generally used to prevent bacterial contamination of food applied electron-beam technology to decontaminate mail sent through various Washington, D.C., postal facilities. Researchers at the Mayo Clinic announced the development of an apparently reliable one-day test for anthrax exposure. And at Saint Louis University, researchers are capable of adapting their studies of the dispersion patterns of dust and cat allergens to help determine how biological agents such as anthrax spores are dispersed. (See sidebar at right.)

Other opportunities abound for new approaches to help solve old problems or to define solutions for emerging prob-

Adapting to New Threats

Last October, Dr. Roger Lewis listened intently to a radio report about the anthrax spores enclosed with a letter addressed to Senate

Majority Leader Tom Daschle.



In his experiments on how materials like lead and cat allergens spread, Dr. Roger Lewis of Saint Louis University often uses silica. That same substance was found in the anthrax letter sent to Senate Majority Leader Tom Daschle.

The report mentioned that the anthrax was mixed with a substance called silica. The next day, Lewis read that the head of the laboratory examining the letter did not know why the letter contained silica. Lewis did.

An industrial hygienist and associate professor of Environmental and Occupational Health at Saint Louis University's School of Public Health, Lewis often uses silica in his experiments with materials like lead, dust mite allergens and cat allergens. He studies how these particles accumulate on surfaces and become dispersed through the air, how people come in contact with them, and what are the most effective ways to remove them.

Recalling the events of last October, Lewis says: "I phoned Greg Evans, the head of the bioterrorism center at SLU, and I told him that I know why that letter contained silica. It's because silica is a drying agent. I have used it for years to keep dust airborne. It keeps particles aerosolized and prevents them from clumping. It works fantastic."

To Lewis, the presence of silica in the Daschle letter indicated a highly sophisticated perpetrator whose intent was for the spores to spread easily and cause as much harm as

possible. Evans reported Lewis' information to the FBI.

Currently, Lewis is working on a two-pronged project funded by the U.S. Department of Housing and Urban Development: determining the best vacuum cleaning system for removing leaded dust from carpets and upholstery, and finding the best detergent for removing these same contaminants from hard surfaces like floors or windowsills.

Lewis says his kind of research could easily be adapted to exploring how anthrax spores are spread. In fact, Lewis says that he and his assistants considered halting their current research so they could perform experiments simulating the dispersal of anthrax spores from opening envelopes. Instead of using actual anthrax, they would use a safe surrogate that has nearly the same physical properties as anthrax.

"The only problem is that here at the university we're not top-heavy with staff; so we can't stop everything we're doing to do this," Lewis says.

When his schedule lightens up, Lewis plans to seek government funding to research and conduct experiments on anthrax spores—though he'd prefer to keep his distance from the real stuff.

"I'll work with a surrogate, thank you very much," he says.

Government to the Rescue?

In 1973, the Nixon administration began phasing out the wage and price controls it had imposed in April 1971.

One important control, however, was not lifted.

In response to the oil embargo imposed on the United States by OPEC in October 1973, the administration imposed more stringent price regulations on the oil industry. The purpose of this complicated set of regulations was to cushion domestic prices from the full impact of the higher prices on world markets.

The price control system entitled domestic refiners to domestically produced oil at controlled prices. The impact of the price controls and entitlement system was that products produced from crude oil were not available throughout the country to meet the local demand at the controlled prices. Long lines developed at gas stations, and economic activity was disrupted as households and business that were last in line or low in the allocation priority were unable to obtain the energy products they needed. Gas station owners were even arrested for selling fuel to willing purchasers at prices above the controlled levels.

How did this mess affect the economy in general? Economic activity started slowing in late 1973. And over the next two years, the oil price shock and the disruption of the market system caused by the price controls contributed to what at the time was the worst recession since the Great Depression. Consumer price inflation accelerated to 11 percent in 1974, and the unemployment rate rose to 8.5 percent in 1975.

Not Quite



lems. Providing security for our transportation systems, our food chain, our energy generation systems and our borders is an area ripe for innovation. For example, in the immediate aftermath of September 11, severe bottlenecks developed at the Canadian and Mexican border crossings as detailed inspections of thousands of trucks were implemented. Since the passage of NAFTA, some industries—one being, automobile production—have become highly integrated across the three North American economies. The traffic jams that emerged forced the temporary closure of a number of production facilities because parts could not be delivered “just-in-time.” Experts have concluded that thorough security inspections can not be completed efficiently at centralized border crossings. If true, then without substantial innovation, some of the cost savings that we have realized in recent years through reduced inventories will be lost.

What to do? One possible solution is to adapt satellite tracking technology, now in common use by trucking companies, to reduce such production disruptions. Conceivably, entrepreneurs could extend this technology to monitor vehicles that have been inspected and sealed at dispersed points-of-origin so that full truckloads can be cleared through border crossings electronically.

Passenger and baggage screening at major airports is another area with considerable potential for profitable innovation. Airlines now recommend that passengers arrive at major airports two hours in advance of their departure time to allow for check-in and security clearance, an increase of more than one hour from the recommended lead-time prior to September 11. This additional time substantially increases the cost of airline travel to consumers, above and beyond any higher ticket prices or user taxes needed to pay for more intensive security screening.

Over the long run, such cost increases, if sustained, can be expected to provoke significant substitution of other modes of travel, particularly for short- and intermediate-distance trips. Nevertheless, even after such substitution, the total costs of travel will be increased. And, to the extent that new security procedures permanently increase travel time and expense, we can expect to see people use other technologies, such as video conferencing, more frequently for conducting business.

Businesses and entrepreneurs working to develop new technologies in this environment can be successful because of government policies and the structure of our labor and capital markets. Firms and jobs are created and destroyed continually in our economy so that ultimately our resources are directed toward the most productive activities. Experts have noted this characteristic frequently in explaining why “high-tech” has penetrated production processes here more quickly and more intensively than in other countries. In such an environment, the transition to an economy that requires a higher level of security can be accomplished with little, if any, disruption of the long-term productivity trends that are the source of our increasing standard of living.

Compared with other industrialized economies, job entitlements in the United States are relatively low. Seniority practices, job security provisions of negotiated labor contracts, plant closure notification laws and the like provide some short-term job security to workers. However, in the face of a major shock that significantly shifts demand permanently away from the output of one industry toward another, these provisions affect only the transition from an old environment to a new one. For example, in the aftermath of September 11, lighter passenger loads caused airlines to

employ smaller planes more frequently, meaning senior pilots needed to be re-certified to fly those planes. Once the retraining has been accomplished, these firms will be able to operate efficiently at the lower level of demand.

Finally, regulatory conditions also help smooth the economy’s adjustment to the new threat of terrorism. A market system works most effectively when prices signal where resources should be used. In our current situation, we are much better positioned than we were in some significant historical situations. (See sidebar at left.) With the outbreak of the Korean War, the federal government instituted price controls and rationed critical materials. One effect of those policies was that investment in large structures and the production of automobiles were disrupted by steel rationing. The government also imposed credit controls on mortgage and consumer credit. All of these regulations interfered with the market system’s ability to direct resources to their most productive uses. ■





A Robust Financial System

Although some components of the financial system had their operations shut down by the collapse of the Twin Towers, **most continued to function normally.**

THE INFRASTRUCTURE of our nation's financial system proved to be vulnerable to the attacks of September 11. Key operations located at and near the World Trade Center included stock exchanges, clearing banks, several of the important dealers who made markets in federal government securities, traders who made markets in foreign exchange, and brokers who linked the banks that wanted to borrow and lend federal funds.

Following the attacks, all aircraft were grounded in U.S. airspace, except for military planes. The government bond market was closed and did not reopen until September 13. Equity markets were closed until September 17. The clearing of both wholesale payments and securities transactions was disrupted because of processing problems experienced by a major New York clearing bank, whose operations center was located near the World Trade Center. Communications were affected by the extensive damage suffered at a major telephone-switching center in Lower Manhattan. Also disrupted was our national system for clearing checks, a large share of which moves through air transport to the paying banks.



As severe as the interruption was, it is important to note that the vulnerability turned out to be the physical infrastructure of payments and trading systems, not the underlying strength of financial services firms. These firms and their suppliers proved to have the capital and the technical resources to restore damaged infrastructure. This fact is not a trivial one.

Developments during the first week after September 11 were especially important in limiting the impact of the attacks on our payments system and financial institutions. (See sidebar at right.) Although some components of the financial system had their operations shut down by the collapse of the Twin Towers, most continued to function normally. The depth of operational resources, the capacity to call on backup systems, and the role of the Federal Reserve in providing massive amounts of liquidity reflect the robustness of the U.S. financial system.

The electronic payment networks operated by the Federal Reserve System—Fedwire[®] and the Automated Clearing House (ACH)—hummed along without interrup-

[®] Fedwire is a registered service mark of the Federal Reserve banks.

Regaining Equilibrium

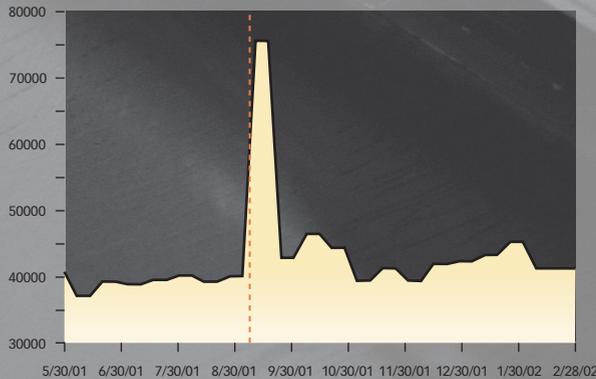
Few, if any, sectors of the U.S. economy were unaffected by the events of September 11.

The charts below show how four economic indicators—depository institutions' reserves, initial unemployment claims, retail sales, and M2 money supply—reacted to

the shock. Three of the charts indicate continued turbulence for several weeks or months before leveling off to pre-September 11 levels. The spike in M2 receded quickly and by the end of October, M2 returned to its pre-September 11 trend. The charts report weekly data, and the dashed lines indicate the week of September 11.

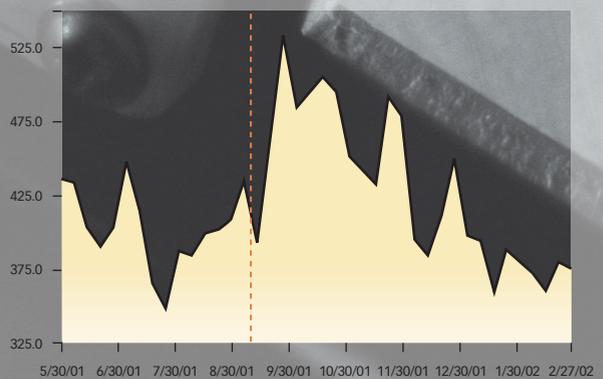
Reserves of Depository Institutions

Millions of Dollars



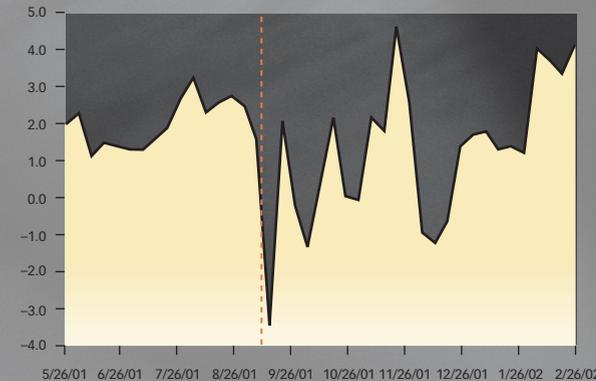
Initial Unemployment Claims

Thousands



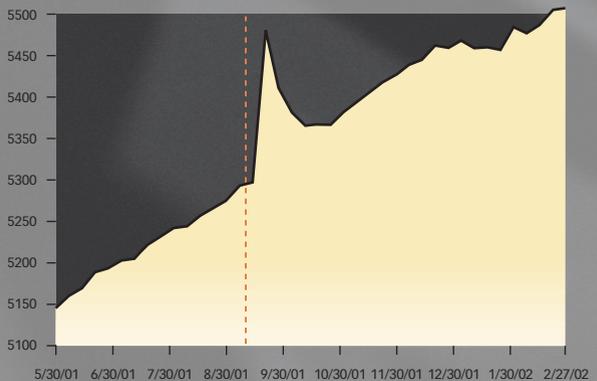
Redbook Retail Sales Average

Percent Change Year over Year



M2

Billions of Dollars



What Happens When Financial Institutions Are Not Strong

During times of crisis, people have often sought security by keeping their money close at hand.

Panic-stricken, they have rushed to their banks to withdraw cash, an act that can be detrimental to a bank's operations when performed in large numbers. Fortunately, bank runs did not occur after September 11. Why? Because people felt confident enough in the stability of the banking system to leave their money where it was.

Experience during the early 1930s in the United States illustrates what can happen when people lose confidence in the strength of their banks. Because of poor monetary policy, the money supply declined sharply during the early part of the decade, and large numbers of banks failed. Problems in the banking system reached a crisis stage by early 1933. Several states had declared banking holidays. During a banking holiday, the government closes all banks temporarily, generally to stop runs by depositors withdrawing their funds. In addition, customers could not use the funds they had on deposit to make payments. The banking holi-

days also caused a suspension in the operation of financial markets, including the securities and foreign exchange markets.

Shortly after his inauguration, President Franklin D. Roosevelt declared a federal banking holiday on March 6, closing every bank in the country. Even the Federal Reserve shut down for a few days. The temporary halt to bank operations disrupted commerce throughout the nation. The government began reopening banks a week later, but more than 5,000 banks—out of 17,800 banks as of year-end 1932—remained closed March 15. While many of these banks eventually reopened several months later, many others never did. The experience of our nation during the early 1930s is a reminder of the importance of government policies, including appropriate monetary policy, that keep our nation's banking system strong.



tion. These systems facilitated the operation of other segments of the payments system and the settlement of transactions among financial institutions.

The attacks temporarily disrupted market mechanisms through which banks trade their reserves, including borrowing in the federal funds market or selling federal government securities held as secondary reserves. In response, the Federal Reserve made large loans through its discount window to provide liquidity to banks that could not raise

The solid capital positions enjoyed by most banks permitted them to make it through.

The credit card, debit card and ATM networks functioned normally after the terrorist attacks. The flow of data among participants in these systems, including banks and merchants, occurs over electronic communication networks. Participants in these systems settled their net positions over the Fed's electronic payment networks in the usual manner.



Processing checks is an important, and hectic, component of America's economic engine. At the St. Louis Fed and Reserve banks throughout the country, this task became even more critical after the attacks of September 11. To help maintain confidence at all levels of the payments system, the Eighth District absorbed nearly \$800,000 in costs for the month of September. Most of these costs involved float the Fed granted to financial institutions because Reserve banks could not collect checks on the usual schedule for several days after the attacks. Check employees in St. Louis also logged overtime performing activities like processing checks for financial institutions that temporarily closed September 11.

adequate funds through normal mechanisms. Short-term discount window loans, which were \$99 million on September 5, rose to more than \$45 billion on September 12. By September 26, these loans dropped back to \$20 million; the system had returned to normal.

Extra liquidity injected into the banking system flowed to where it was needed. Banks increased their loans to other banks substantially. Interbank loans increased from \$300 billion on September 5 to \$442 billion on September 12. By early October, interbank loans had returned to about \$300 billion. The willingness of banks to increase their loans to one another by large amounts on short notice was based on the confidence that they were lending to banks that were strong financially. (See sidebar at left.)

Operating the nation's check collection system was a greater challenge. Because banks could not collect checks through air transport, the Fed adopted a policy to minimize disruptions to the use of checks. The Reserve banks accepted checks from banks for deposit to their reserve accounts and credited these reserve accounts for the proceeds of the checks on the usual availability schedule. "Check float" increased substantially because the Fed could not *collect* the checks on the usual schedule. Such float jumped to \$23 billion September 12. In comparison, it was only \$2 billion a week earlier. The Fed's policy of accepting checks for deposit and crediting the accounts of collecting banks on the established availability schedule facilitated the relatively smooth operation of one impor-

tant phase in check collection: banks accepting checks from their customers and crediting their accounts as usual.

Relatively few people withdrew more cash than usual from their accounts. The Fed was able to help banks meet this demand by providing additional cash from the vaults of the Reserve banks. Because the banks and the Fed made clear to the public that cash would remain readily available, an unusual demand for cash never materialized. What additional demand did surface quickly subsided.

Our nation's financial system returned to more normal operation during the week after September 11. Although stock market averages declined when the trading of equity shares resumed, the markets showed no signs of panic selling. Stock prices tended to change in a rational pattern, with the largest percentage declines in the share prices of companies that appeared most adversely affected by the attacks. Settlement of trades occurred in almost the usual orderly fashion. To provide extra time for processing in the Treasury securities market, trades conducted on September 13 and 14 were settled three days later, and five days after for trades made between September 17 and September 21; starting Monday, September 24, trades were settled on a normal next-day basis.

The large increases in bank reserves during the first days after September 11 were reversed during the following week, as more checks reached the paying banks and banks repaid their loans from the Fed's discount window. Inter-bank loans declined as the temporary disruptions in the operation of the financial markets ended.

Banks Were Prepared

One reason why payments systems worked in a crisis situation is that these systems contain arrangements that limit the risk assumed by each participant by extending credit to counterparties. In addition, banks have relatively high ratios of capital to total assets. Although large banks have experienced an increase in problem loans since 1997, bank capital ratios remain substantially higher than during the last period of major problems in the banking industry, in the late 1980s and early 1990s. One of the factors that could have adversely affected payments arrangements would have been an unwillingness of participants to extend credit to one another. There is no evidence that such credit restriction occurred.

The supervisory authorities in the United States are also committed to keeping our banking industry in sound condition. Banks that suffer losses that compromise their

capital positions are closed or reorganized unless their shareholders inject additional equity. The experience of the U.S. savings and loan industry in the 1980s and of other nations, especially Japan, demonstrates the problems inherent in the supervisory policy of forbearance when losses deplete the capital of financial firms. An economy cannot grow if its major financial institutions remain in weak financial condition for an extended period of time. Moreover, such firms would not have the strength to withstand a shock of the magnitude of September 11.

Dealing with Future Crises

While we cannot know whether we will have more terrorist attacks in our future, the operation of our payments system and financial institutions after September 11 gives us a basis for optimism about our nation's ability to cope with future events. This capacity rests on a continuing commitment to two basic principles:

First, the Fed as the central bank must be prepared to inject additional reserves into the banking system temporarily during a financial crisis. This point is so well understood, certainly within the Fed, that there can be no doubt that liquidity would flow freely as needed.

Second, our government supervisory agencies must maintain a commitment to policies that promote the strength of our financial institutions. This strength includes sound capital positions and comprehensive contingency plans for maintaining or restoring operations. The Fed and financial firms across the country had prepared extensively for possible economic disruptions in advance of Y2K. Because of those preparations, the century rollover occurred with practically no problems whatsoever. On September 11, the contingency plans were taken off the shelf. In the days that followed, these plans paid off handsomely. ■



Strong Government Fiscal Position

Despite the fiscal policy actions taken in response to September 11, the United States is **very far from being fiscally stretched.**

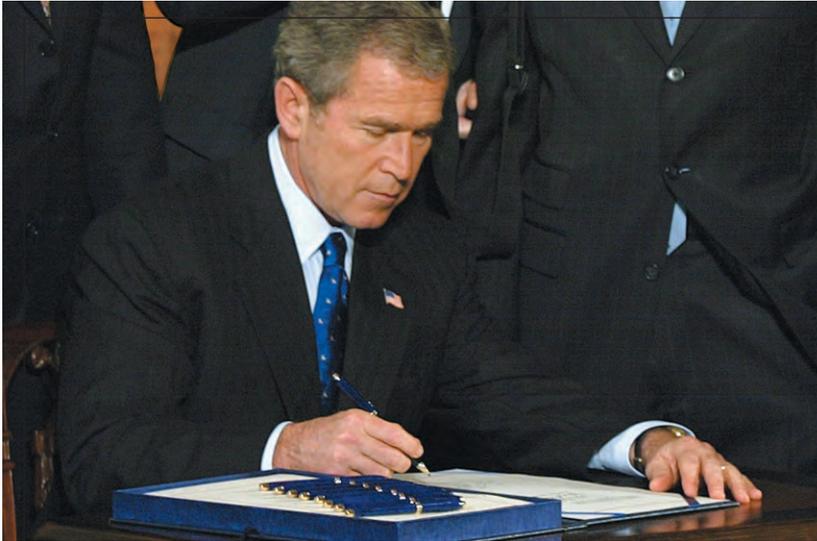
THE UNITED STATES has dealt with the terrorist attacks from a position of financial strength, namely, historically large federal, state and local government budget surpluses. Indeed, the ability to marshal significant resources during times of war is one of our country's great strengths. To be sure, the war on terrorism is decidedly unlike previous conflicts. No one now knows the scale of governmental resources that will be necessary to prosecute the war. But because the nation entered the conflict with a solid government financial position, the consequences for the economy are unlikely to include large tax increases and the uncertainty that would accompany them.

The federal government recorded a \$69.2 billion unified budget surplus in fiscal year 1998; by fiscal year 2000, the surplus had grown to just under \$240 billion, or 2.4 percent of GDP. The government attained this budget position through a combination of fiscal restraint and better-than-expected economic growth. The higher economic growth rate reflected an increase in the growth of labor productivity beginning around 1995, which most economists attribute to the marked rise in investment in high-tech capital equipment. That investment was financed in part through the surpluses in the federal

budget. Paying down federal debt released funds for private investment.

This virtuous cycle, in which a strong economy increased federal revenues, and a federal budget surplus helped to support private investment that boosted economic growth, continued until the recession of 2001 set in, starting in March. Previous growth had taken the economy to a much higher level than it would have achieved had growth remained relatively low in the late 1990s; as a consequence, despite the mild recession, the federal budget was in much better shape than it otherwise would have been.

In May of last year, passage of the Economic Growth and Tax Relief Reconciliation Act of 2001, reduced, but did not eliminate, prospective budget surpluses. Consequently, federal resources were deemed available to deal with circumstances that changed dramatically after the terrorist attacks. Soon after September 11, President Bush proposed a \$20 billion emergency aid package to assist those individuals, businesses and government administrators directly affected by the attacks. Congress quickly doubled the size of this package, which also authorized funds for increased military and security measures, and then sent it to the president, who signed the legislation into law September 18.



“With my signature, this law will give intelligence and law enforcement officials important new tools to fight a present danger.”

President George W. Bush signs the Patriot Act, Anti-Terrorism Legislation, October 26, 2001.

Some combination of modest tax increases and modest spending restraint in other areas of the federal budget will likely **provide the resources needed** to address security requirements.

Subsequently, emergency legislation totaling \$15 billion was signed into law to help stanch the losses suffered by domestic air carriers. Then, Congress passed and the president signed into law the Aviation Security Act of 2001, which authorized federal oversight and responsibility of most airport security measures, including inspection of passenger baggage; increased use of federal air marshals; and awarded grants to air carriers to improve in-flight security measures. Given that the traveling public will cover about half of the cost of these measures through increased fees, the Congressional Budget Office estimates the net cost of this legislation over the next five years at a little more than \$9 billion.

Going forward, it is possible that additional monies will be required if the war extends longer than expected, if threats of additional attacks crop up or if additional attacks are carried out successfully. Is the federal government positioned to cope with these new fiscal strains? What about state and local governments, which also have an important role to play?

The central question in this regard is whether the economy’s growth rate in coming years will be high enough to generate required revenues at current tax rates. The key issue is the rate of productivity growth, a subject of much

dispute and limited actual knowledge. The prevailing view among most forecasters and academic economists is that labor productivity has accelerated—perhaps sufficiently to push the economy’s sustainable rate of output growth up from the roughly 2.5 percent pace that prevailed between 1974 to 1995, to around 3.25 percent. If such estimates are correct, then budget surpluses may still be more likely than deficits over the next 10 years. Despite the fiscal policy actions taken in response to September 11, the United States is very far from being fiscally stretched. (See sidebar at right.) Should substantial additional security expenditures be required, some combination of modest tax increases and modest spending restraint in other areas of the federal budget will likely provide the resources needed to address security requirements.

The United States has benefited from a fiscal policy that focuses on efficient use of federal resources and attention to the policy’s effects on economic growth. This policy crosses both political parties and has been maintained over many years. Much more could be done to improve the efficiency of federal spending and tax policies, but the point here is that the strong U.S. fiscal position has served the nation well in dealing with the stresses of the terrorist attacks. ■

Will the War on Terrorism Bust the Budget?

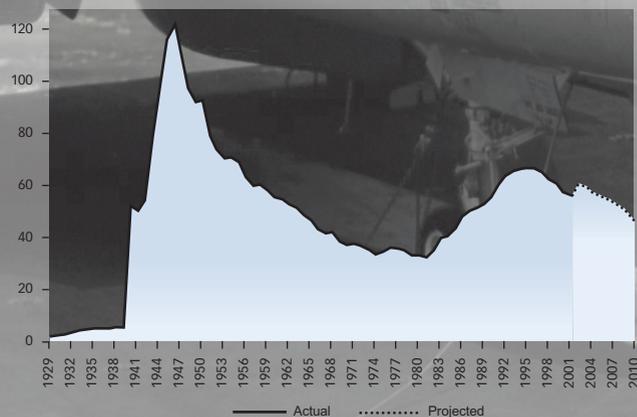
In waging the war on terrorism, the U.S. government will spend large sums in certain areas, particularly domestic security.

Even so, the ratio of debt to gross domestic product (GDP), after rising slightly, is projected to decline steadily over the next decade. The debt/GDP ratio compares total government debt with the entire output of the economy in one year.

As the chart shows, the United States emerged from World War II with a debt/GDP ratio well in excess of 100 percent. Over the ensuing 35 years—which included

the Korean and Vietnam wars—the ratio declined steadily to below 40 percent; budget deficits were small on average and GDP grew. In the 1980s, deficit spending financed a huge defense buildup. That effort, along with tax cuts, the transition to lower inflation and slow growth, pushed the ratio back up to about 70 percent, still a quite manageable situation. In the 1990s, the ratio fell to under 60 percent in the wake of strong economic growth and budget surpluses. Sustained low inflation contributed to both of these outcomes by increasing economic stability, keeping interest rates relatively low and encouraging a high rate of business investment that contributed to high productivity growth.

U.S. Debt (as a percent of GDP)
Percent



A Battle on Two Fronts

A little more than 50 years ago, while American forces were engaged in conflict thousands of miles away, consumers on the homefront were fighting their own enemy—inflation.

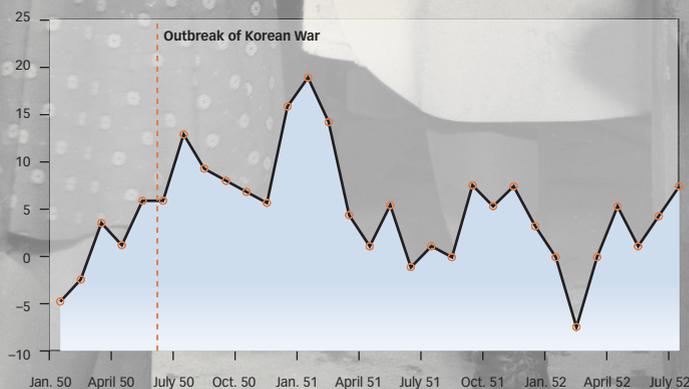
When the Korean War broke out in June 1950, inflation was subdued. The month-to-month inflation rate was generally in the range of 0 to 5 percent at annual rates. Inflation, however, began climbing rapidly and jumped to nearly 20 percent by early 1951. The fear of inflation was so real that people began resorting to “buy in advance” behavior in an attempt to beat anticipated future inflation and possible resumption of World War II-style rationing. These fears complicated the economic and political

problems that arose from the Korean War emergency. The Federal Reserve could not pursue an independent monetary policy to fight inflation because it was still honoring an agreement carried over from the war to maintain interest rates on U.S. Treasury securities at fixed, unchanging levels.

In 1951, the Fed-Treasury Accord was negotiated, re-establishing the independence of monetary policy in the United States. The improved monetary policy helped to reverse inflation’s course. Today, the Federal Reserve has both the authority and commitment to limit inflation. Thus, while many fears have gripped Americans since September 11, inflation has not been one of them.

CPI Inflation Rates, January 1950 to July 1952

Month-to-Month Percentage Change at Annual Rates





Low Inflation and Monetary Stability

That we now take **price stability** almost for granted is a great strength of our current condition.

A MARKET SYSTEM WORKS most effectively when price signals are not confused by inflationary expectations. Evidence shows that no consumer behavior has seemed motivated by fear of inflation since September 11. A few lines at gas stations emerged that day, based on unfounded fears of a physical shortage and sharply higher prices. In the weeks after the attacks, energy prices fell, reflecting reduced demand in the face of a global economic slowdown.

Consumer price inflation has not accelerated. Survey measures of longer-term inflation expectations have remained unchanged. The spreads between regular Treasury bonds and the Treasury's inflation-indexed bonds—another measure of inflation expectation—receded after the terrorist attacks and have remained low.

Indeed some commentaries in the immediate aftermath of September 11 raised concerns about *deflation*. Such fears arose out of short-run data that appeared immediately after the attacks and out of an inadequate understanding of deflation in Japan, where wholesale and consumer prices generally drifted downward starting in the mid-1990s and where asset prices (land and equities) collapsed. A more complete analysis indicates that the U.S. economy is in no danger of replicating Japan's experience in the 1990s.

One of the great economic accomplishments of the last 20 years is restoration of a climate of price stability in the United States. During the early 1980s, the Fed managed monetary policy to stabilize the inflation rate at a much lower rate than in the 1970s; in the 1990s, the Fed was able to put the inflation rate on a gentle downward trend. The outcome was accompanied by steadily declining unemployment, contrary to the forecasts of many.

By the middle of the 1990s, the objective of reducing inflation to a low-enough level that it was largely ignored in the day-to-day decision making of consumers and businesses was substantially achieved. That we now take price stability in this sense almost for granted is a great strength of our current condition. (See sidebar at left.) This environment gives the Fed flexibility in responding aggressively to situations where there is the potential for a liquidity crisis, such as on September 11 and the following days, or where there is evidence of an economic slowdown. As always, the Fed's responses must be tempered by consideration that an overreaction, or a failure to reverse short-run policy actions in a timely fashion, could result in a deterioration of expectations about future inflation. ■

Conclusion

There is **no reason to believe** that what served us well during this crisis would abandon us in the future.

THE PICTURE WE HAVE PAINTED of the U.S. economy in the wake of September 11 is encouraging. Yes, the attacks were damaging. But they were not crippling. In a society in which entrepreneurial initiative and risk-taking are rewarded, recovery from disaster is bound to be expedited. When citizens have faith in the soundness of their financial institutions, they have less reason to panic. Where a federal government spends taxpayers' monies wisely, a nation shows resilience during adversity. And where a central bank sets a goal of maintaining price stability, consumers feel confident that their money will retain its purchasing power, even in dire circumstances.

The United States embodies all of these qualities. The result? Its economy is, in many ways, shock-resistant.

Despite the devastating ramifications of the terrorist attacks, many key economic indicators began to regain equilibrium within weeks. Economic statistics for the period since September 11 have suggested that the economy is stabilizing quickly after initial declines caused by the attacks:

- Real GDP increased at an annual rate of 1.7 percent in the fourth quarter of 2001.
- Productivity in the nonfarm business sector increased 5.2 percent at an annual rate in the fourth quarter.
- Monthly CPI inflation came in at 0.2 percent in February and 1.1 percent for the 12 months ending with February.
- Payroll employment rose by 66,000 jobs in February.
- In February, real consumption rose 0.5 percent over January.

In the end, our economy passed one of the most challenging tests in the nation's history.

The question is, can it pass even tougher tests? Yes. There is no reason to believe that what served us well during this crisis would abandon us in the future.

Our competitive markets and strong financial system are deeply ingrained within our culture. And while



government fiscal policy and Federal Reserve actions evolve over time and depend to some degree upon the individuals in office, the benefits of prudent budgets and low inflation have become so obvious that they have become institutionalized within our society as well.

We have known for many years that an economy based on free markets and personal liberty performs better than one based on central planning and government compulsion. We now know also that a market economy and free people are remarkably resilient in the face of a severe shock. We hope that all of the new security precautions will thwart future terrorist attacks in the United States. But whatever the future may bring, we can be confident of our nation's capacity to weather the storm. ■



William Poole, President and CEO | **Charles W. Mueller**, Chairman

Thank You

We would like to express our deepest gratitude to those members of our Eighth District boards of directors who retired in 2001. For their distinguished service, our appreciation and best wishes go out to:

Roger Reynolds, chairman of the Louisville Board; **Orson Oliver** and **Edwin K. Page**, Louisville Board members; **John C. Kelley Jr.**, Memphis Board member; and **Thomas H. Jacobsen**, St. Louis Board member. We also thank **Katie S. Winchester**, who served as our District's Federal Advisory Council member.

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West Helena, Arkansas

Financial Statements

Financials

The Federal Reserve Bank of St. Louis
Financial Statements

for the years ended December 31, 2001 and 2000

March 4, 2002

To the Board of Directors:

The management of the Federal Reserve Bank of St. Louis (the "Bank") is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 2001, (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks, and as such, include amounts, some of which are based on judgments and estimates of management.

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

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

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

Federal Reserve Bank of St. Louis



William Poole, President and Chief Executive Officer



W. LeGrande Rives, First Vice President and Chief Operating Officer

To the Board of Directors of the Federal Reserve Bank of St. Louis:

We have examined management's assertion that the Federal Reserve Bank of St. Louis ("FRBSTL") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the Financial Statements as of December 31, 2001, included in the accompanying Management's Assertion. The assertion is the responsibility of FRBSTL management. Our responsibility is to express an opinion on the assertions based on our examination.

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

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

In our opinion, management's assertion that the FRBSTL maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the Financial Statements as of December 31, 2001, is fairly stated, in all material respects, based upon criteria described in "Internal Control—Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

The image shows a handwritten signature in black ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

March 4, 2002
St. Louis, Missouri

**To the Board of Governors of The Federal Reserve System and
the Board of Directors of The Federal Reserve Bank of St. Louis:**

We have audited the accompanying statements of condition of The Federal Reserve Bank of St. Louis (the "Bank") as of December 31, 2001 and 2000, and the related statements of income and changes in capital for the years then ended. These financial statements are the responsibility of the Bank's 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 financial statements were prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of The Federal Reserve System. These principles, policies, and practices, which were designed to meet the specialized accounting and reporting needs of The Federal Reserve System, are set forth in the "Financial Accounting Manual for Federal Reserve Banks" and constitute a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2001 and 2000, and results of its operations for the years then ended, on the basis of accounting described in Note 3.

The image shows a handwritten signature in black ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

March 4, 2002
St. Louis, Missouri

Financials

FEDERAL RESERVE BANK OF ST. LOUIS | STATEMENTS OF CONDITION (in millions)

	AS OF DECEMBER 31,	
	2001	2000
ASSETS		
Gold certificates	\$ 343	\$ 359
Special drawing rights certificates	71	71
Coin	58	51
Items in process of collection	215	539
Loans to depository institutions	3	8
U.S. government and federal agency securities, net	20,245	19,696
Investments denominated in foreign currencies	291	385
Accrued interest receivable	206	229
Interdistrict settlement account	721	–
Bank premises and equipment, net	67	57
Other assets	19	21
Total assets	\$ 22,239	\$ 21,416
LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve notes outstanding, net	\$ 21,435	\$ 19,410
Deposits:		
Depository institutions	344	596
Other deposits	1	2
Deferred credit items	79	296
Interest on Federal Reserve notes due U.S. Treasury	22	38
Interdistrict settlement account	–	740
Accrued benefit costs	55	52
Other liabilities	5	6
Total liabilities	21,941	21,140
Capital:		
Capital paid-in	149	138
Surplus	149	138
Total capital	298	276
Total liabilities and capital	\$ 22,239	\$ 21,416

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

Financials

FEDERAL RESERVE BANK OF ST. LOUIS | STATEMENTS OF INCOME (in millions)

	FOR THE YEARS ENDED DECEMBER 31,	
	2001	2000
Interest income:		
Interest on U.S. government and federal agency securities	\$ 1,082	\$ 1,151
Interest on investments denominated in foreign currencies	7	7
Interest on loans to depository institutions	–	3
Total interest income	1,089	1,161
Other operating income:		
Income from services	54	47
Reimbursable services to government agencies	26	28
Foreign currency gains losses, net	(30)	(35)
U.S. government securities gains, net	12	(3)
Other income	3	2
Total other operating income	65	39
Operating expenses:		
Salaries and other benefits	80	74
Occupancy expense	8	7
Equipment expense	10	9
Assessments by Board of Governors	18	20
Other expenses	35	52
Total operating expenses	151	162
Net income prior to distribution	\$ 1,003	\$ 1,038
Distribution of net income:		
Dividends paid to member banks	\$ 9	\$ 9
Transferred to surplus	11	72
Payments to U.S. Treasury as interest on Federal Reserve notes	983	957
Total distribution	\$ 1,003	\$ 1,038

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

Financials

FEDERAL RESERVE BANK OF ST. LOUIS | STATEMENTS OF CHANGES IN CAPITAL for the years ended December 31, 2001 and December 31, 2000 (in millions)

	Capital Paid-in	Surplus	Total Capital
Balance at January 1, 2000 (3.2 million shares)	\$ 158	\$ 158	\$ 316
Net income transferred to surplus		72	72
Surplus transfer to the U.S. Treasury		(92)	(92)
Net change in capital stock redeemed (0.4 million shares)	(20)		(20)
Balance at December 31, 2000 (2.8 million shares)	\$ 138	\$ 138	\$ 276
Net income transferred to surplus		11	11
Net change in capital stock issued (0.2 million shares)	11		11
Balance at December 31, 2001 (3.0 million shares)	\$ 149	\$ 149	\$ 298

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

FEDERAL RESERVE BANK OF ST. LOUIS | NOTE TO FINANCIAL STATEMENTS

1. ORGANIZATION

The Federal Reserve Bank of St. Louis ("Bank") is part of the Federal Reserve System ("System") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act") which established the central bank of the United States. The System consists of the Board of Governors of the Federal Reserve System ("Board of Governors") and twelve Federal Reserve Banks ("Reserve Banks"). The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. Other major elements of the System are the Federal Open Market Committee ("FOMC") and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York ("FRBNY") and, on a rotating basis, four other Reserve Bank presidents.

Structure

The Bank and its branches in Little Rock, Louisville and Memphis, serve the Eighth Federal Reserve District, which includes Arkansas, and portions of Illinois, Indiana, Kentucky, Mississippi, Missouri and Tennessee. In accordance with the Federal Reserve Act, supervision and control of the Bank are exercised by a Board of Directors. Banks that are members of the System include all national banks and any state chartered bank that applies and is approved for membership in the System.

Board of Directors

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

2. OPERATIONS AND SERVICES

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

Governors' operating costs are funded through assessments on the Reserve Banks.

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of securities, matched sale-purchase transactions, the purchase of securities under agreements to resell, and the lending of U.S. government securities. The FRBNY is also authorized by the FOMC to hold balances of and to execute spot and forward foreign exchange 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 to the private sector. These accounting principles and practices are documented in the Financial Accounting Manual for Federal Reserve Banks ("Financial Accounting Manual"), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual.

The financial statements have been prepared in accordance with the Financial Accounting Manual. Differences exist between the accounting principles and practices of the System and accounting principles generally accepted 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 Bank has elected not to present a Statement of Cash Flows. The Statement of Cash Flows has not been included as the liquidity and cash position of the Bank are not of primary concern to the users of these financial statements. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. Therefore, a Statement of Cash Flows would not provide any additional useful information. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

Effective January 2001, the System implemented procedures to eliminate the sharing of costs by Reserve Banks for certain services a Reserve Bank may provide on behalf of the System. Data for 2001 reflects the adoption of this policy. Major services provided for the System by this bank, for which the costs will not be redistributed to the other Reserve Banks, include operation of

the Treasury Relations and Support Office and Treasury Relations and Systems Support Department, which provide services to the U.S. Treasury. These services include: relationship management, strategic consulting, and oversight for fiscal and payments related projects for the Federal Reserve System; and operational support for the Treasury's tax collection, cash management and collateral monitoring.

The preparation of the financial statements in conformity with the Financial Accounting Manual requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

a. Gold Certificates

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

b. Special Drawing Rights Certificates

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDRs, at the direction of the U.S. Treasury, for the purpose of financing SDR certificate acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates amounts among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2001.

c. Loans to Depository Institutions

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If any loans were deemed to be uncollectible, an appropriate reserve would be established. Interest is 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. Reserve Banks retain the option to impose a surcharge above the basic rate in certain circumstances.

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.

Matched sale-purchase transactions are accounted for as separate sale and purchase transactions. Matched sale-purchase transactions are transactions in which the FRBNY sells a security and buys it back at the rate specified at the commencement of the transaction.

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.

Foreign exchange ("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 FRBNY will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the Treasury, U.S. dollars for foreign currencies held by the Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury and ESF for financing purchases of foreign currencies and related international operations.

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts 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. However, decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, earnings and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government and federal agency securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income is accrued on a straight-line basis and is reported as "Interest on U.S. government and federal agency securities" or "Interest on 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 “U.S. government securities gains (losses), 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 counter-party, and warehousing arrangements are revalued daily, with the unrealized gain or loss reported by the FRBNY as a component of “Other assets” or “Other liabilities,” as appropriate.

Balances of U.S. government and federal agency securities bought outright, securities loaned, investments denominated in foreign currency, interest income, securities lending fee income, amortization of premiums and discounts on securities bought outright, gains and losses on sales of securities, and realized and unrealized gains and losses on investments denominated in foreign currencies, excluding those held under an F/X swap arrangement, are allocated to each Reserve Bank. Income from securities lending transactions undertaken by the FRBNY are also allocated to each Reserve Bank. Securities purchased under agreements to resell and unrealized gains and losses on the revaluation of foreign currency holdings under F/X swaps and warehousing arrangements are allocated to the FRBNY and not to other Reserve Banks.

Statement of Financial Accounting Standards No. 133, as amended and interpreted, became effective on January 1, 2001. For the periods presented, the Reserve Banks had no derivative instruments required to be accounted for under the standard.

e. Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from 2 to 50 years. New assets, major alterations, renovations and improvements are capitalized at cost as additions to the asset accounts. Maintenance, repairs and minor replacements are charged to operations in the year incurred. Internally-developed software is capitalized based on the cost of direct materials and services and those indirect costs associated with developing, implementing, or testing software.

f. Interdistrict Settlement Account

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

g. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents to the Reserve Banks upon deposit with such Agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve Agent must be equal to the sum of the notes applied for by such Reserve Bank. In accordance with the Federal Reserve Act, gold certificates, special drawing rights certificates, U.S. government and federal agency securities, triparty agreements, loans to depository institutions, and investments denominated in foreign currencies are pledged as collateral for net Federal Reserve notes outstanding. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, whose collateral value is equal to the par value of the securities tendered. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. The Reserve Banks have entered into an agreement which provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks in order to satisfy their obligation of providing sufficient collateral for outstanding Federal Reserve notes. 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 reduced by currency held in the vaults of the Bank of \$2,586 million, and \$3,770 million at December 31, 2001 and 2000, respectively.

h. Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. As a member bank's capital and surplus changes, its holdings of 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.

i. Surplus

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

Financials

This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

The Consolidated Appropriations Act of 2000 (Public Law 106-113, Section 302) directed the Reserve Banks to transfer to the U.S. Treasury additional surplus funds of \$3,752 million during the Federal Government's 2000 fiscal year. Federal Reserve Bank of St. Louis transferred \$92 million to the U.S. Treasury. Reserve Banks were not permitted to replenish surplus for these amounts during fiscal year 2000, which ended September 30, 2000; however, the surplus was replenished by December 31, 2000.

In the event of losses or a substantial increase in capital, payments to the U.S. Treasury are suspended until such losses are recovered through subsequent earnings. Weekly payments to the U.S. Treasury may vary significantly.

j. Income and Costs Related to Treasury Services

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. The costs of

providing fiscal agency and depository services to the Treasury Department that have been billed but not paid are immaterial and included in "Other expenses."

k. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property, which are reported as a component of "Occupancy expense."

4. U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES

Securities bought outright are held in the SOMA at the FRBNY. An undivided interest in SOMA activity, with the exception of securities held under agreements to resell and the related premiums, discounts and income, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of inter-district clearings. The settlement, performed in April of each year, equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was 3.604 percent and 3.799 percent at December 31, 2001 and 2000, respectively.

The Bank's allocated share of securities held in the SOMA at December 31, that were bought outright, were as follows (in millions):

	2001	2000
PAR VALUE:		
Federal agency	\$ —	\$ 5
U.S. government:		
Bills	6,563	6,790
Notes	9,585	9,124
Bond	3,736	3,524
Total par value	19,884	19,443
Unamortized premiums	407	370
Unaccreted discounts	(46)	(117)
Total allocated to Bank	\$ 20,245	\$ 19,696

Total SOMA securities bought outright were \$561,701 million and \$518,501 million at December 31, 2001 and 2000, respectively.

Financials

The maturity distribution of U.S. government and federal agency securities bought outright, which were allocated to the Bank at December 31, 2001, were as follows (in millions):

	PAR VALUE		
	U.S. Government Securities	Federal Agency Obligations	Total
MATURITIES OF SECURITIES HELD			
Within 15 days	\$ 386	\$ –	\$ 386
16 days to 90 days	4,489	–	4,489
91 days to 1 year	4,708	–	4,708
Over 1 year to 5 years	5,520	–	5,520
Over 5 years to 10 years	1,922	–	1,922
Over 10 years	2,859	–	2,859
Total	\$ 19,884	\$ –	\$ 19,884

At December 31, 2001 and 2000, matched sale-purchase transactions involving U.S. government securities with par values of \$23,188 million and \$21,112 million, respectively, were outstanding, of which \$836 million and \$802 million were allocated to the Bank. Matched sale-purchase transactions are generally overnight arrangements.

At December 31, 2001 and 2000, U.S. government securities with par values of \$7,345 million and \$2,086 million, respectively, were loaned from the SOMA, of which \$265 million and \$79 million were allocated to the Bank.

5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and the Bank for International Settlements, and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities held under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized

and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on F/X swaps and warehousing transactions. This allocation is based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. The Bank's allocated share of investments denominated in foreign currencies was approximately 2.001 percent and 2.456 percent at December 31, 2001 and 2000, respectively.

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

	2001	2000
EUROPEAN UNION EURO:		
Foreign currency deposits	\$ 92	\$ 114
Government debt instruments including agreements to resell	54	67
JAPANESE YEN:		
Foreign currency deposits	38	67
Government debt instruments including agreements to resell	106	135
ACCRUED INTEREST	1	2
Total	\$ 291	\$ 385

Total investments denominated in foreign currencies were \$14,559 million and \$15,670 million at December 31, 2001 and 2000, respectively.

Financials

The maturity distribution of investments denominated in foreign currencies which were allocated to the Bank at December 31, 2001, was as follows (in millions):

MATURITIES OF INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

Within 1 year	\$	274
Over 1 year to 5 years		8
Over 5 years to 10 years		9
Over 10 years		—

Total	\$	291
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At December 31, 2001 and 2000, there were no open foreign exchange contracts or outstanding F/X swaps.

At December 31, 2001 and 2000, the warehousing facility was \$5 billion, with zero outstanding.

6. BANK PREMISES AND EQUIPMENT

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

	2001	2000
BANK PREMISES AND EQUIPMENT:		
Land	\$ 4	\$ 4
Buildings	46	36
Building machinery and equipment	16	15
Construction in progress	1	1
Furniture and equipment	56	52
	123	108
Accumulated depreciation	(56)	(51)

Bank premises and equipment, net	\$	67	\$	57
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Depreciation expense was \$8.6 million and \$8.7 million for the years ended December 31, 2001 and 2000, respectively.

The Bank leases unused space to outside tenants. Rental income from such leases was immaterial.

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2001, the Bank was obligated under non-cancelable leases for premises and equipment with terms ranging from 1 to approximately 5 years. These leases provide for increased rentals based upon increases in real estate taxes, operating costs or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was \$1 million for each year ended December 31, 2001 and 2000, respectively. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with terms of one year or more, at December 31, 2001, were (in thousands):

OPERATING		
2002	\$	276
2003		240
2004		64
2005		64
2006		48
Thereafter		—
	\$	692

At December 31, 2001, other commitments and long-term obligations in excess of one year were \$0.

Financials

Under the Insurance Agreement of the Federal Reserve Banks dated as of March 2, 1999, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of 1 percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 2001 or 2000.

The Bank is involved in certain legal actions and claims arising in the ordinary course of business. Although it is difficult to predict the ultimate outcome of these actions, in management's opinion, based on discussions with counsel, the aforementioned litigation and claims will be resolved without material adverse effect on the financial position or results of operations of the Bank.

8. RETIREMENT AND THRIFT PLANS

Retirement Plans

The Bank currently offers two defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank's employees participate in the Retirement Plan for Employees of the Federal Reserve System ("System Plan") and the Benefit Equalization Retirement Plan ("BEP"). The System Plan is a multi-employer plan with con-

tributions fully funded by participating employers. No separate accounting is maintained of assets contributed by the participating employers. The Bank's projected benefit obligation and net pension costs for the BEP at December 31, 2001 and 2000, and for the years then ended, are not material.

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled \$2 million for each year ended December 31, 2001 and 2000, respectively, and are reported as a component of "Salaries and other benefits."

9. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits Other Than Pensions

In addition to the Bank's retirement plans, employees who have met certain age and length of service requirements are eligible for both medical benefits and life insurance coverage during retirement.

The Bank funds benefits payable under the medical and life insurance plans as due and, accordingly, has no plan assets. Net postretirement benefit costs are actuarially determined using a January 1 measurement date.

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

		2001		2000
Accumulated postretirement benefit obligation at January 1	\$	42.9	\$	42.0
Service cost-benefits earned during the period		1.0		1.0
Interest cost of accumulated benefit obligation		3.5		2.9
Actuarial loss (gain)		9.5		(0.9)
Contributions by plan participants		0.1		0.1
Plan Amendment/Settlement		(9.4)		-
Benefits paid		(2.2)		(2.2)
Accumulated postretirement benefit obligation at December 31	\$	45.4	\$	42.9

Financials

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

	2001	2000
Fair value of plan assets at January 1	\$ —	\$ —
Contributions by the employer	2.2	2.0
Contributions by plan participants	0.1	0.2
Benefits paid	(2.3)	(2.2)
Fair value of plan assets at December 31	\$ —	\$ —
Unfunded postretirement benefit obligation	\$ 45.4	\$ 42.9
Unrecognized initial net transition asset (obligation)	—	—
Unrecognized prior service cost	10.0	0.7
Unrecognized net actuarial gain (loss)	(4.6)	4.8
Accrued postretirement benefit costs	\$ 50.8	\$ 48.4

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

At December 31, 2001 and 2000, the weighted average discount rate assumptions used in developing the benefit obligation were 7.0 percent and 7.5 percent, respectively.

For measurement purposes, a 10.0 percent annual rate of increase in the cost of covered health care benefits was assumed for 2002. Ultimately, the health care cost trend rate is expected to decrease gradually to 5.0 percent by 2008, 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, 2001 (in millions):

	1 Percentage Point Increase	1 Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	\$ 0.1	\$ 1.0
Effect on accumulated postretirement benefit obligation	3.0	4.4

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

	2001	2000
Service cost-benefits earned during the period	\$ 1.1	\$ 0.9
Interest cost of accumulated benefit obligation	3.5	2.9
Amortization of prior service cost	(0.1)	(0.2)
Recognized net actuarial loss	—	—
Net periodic postretirement benefit costs	\$ 4.5	\$ 3.6

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

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, and disability benefits. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment

benefit costs recognized by the Bank at both December 31, 2001 and 2000, were \$4 million. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2001 and 2000 operating expenses were \$1 million for each year.

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Summary of Operations

SUMMARY OF OPERATIONS

Summary of Key Operation Statistics for Services Provided to Depository Institutions and the U.S. Treasury

	Number of Items		Dollar Amount (Millions)	
	2001	2000	2001	2000
Government Checks Processed	28,046,000	21,625,000	\$ 22,710	\$ 20,151
Postal Money Orders Processed	229,427,000	230,133,000	\$ 30,461	\$ 30,036
Commercial Checks Processed	1,168,406,000	1,087,336,000	\$ 623,454	\$ 547,758
ACH Commercial Items Originated	116,041	167,204	\$ 254,231	\$ 302,412
Currency Processed	1,101,922,000	1,074,327,000	\$ 16,070	\$ 16,407
Funds Transfers	4,884,980	4,814,815	\$ 3,542,873	\$ 3,597,950
Loans to Depository Institutions	205	801	\$ 3,299	\$ 1,690
Transfer of Government Securities	116,206	126,077	\$ 625,845	\$ 768,228
Food Coupons Destroyed	21,039,000	18,783,000	\$ 104	\$ 95

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The Federal Reserve Bank of St. Louis is one of 12 regional Reserve banks, which together with the Board of Governors make up the nation's central bank. The Fed carries out U.S. monetary policy, regulates certain depository institutions, provides wholesale-priced services to banks and acts as fiscal agent for the U.S. Treasury. The St. Louis Fed serves the Eighth Federal Reserve District, which includes all of Arkansas, eastern Missouri, southern Indiana, southern Illinois, western Kentucky, western Tennessee and northern Mississippi. Branch offices are located in Little Rock, Louisville and Memphis.

