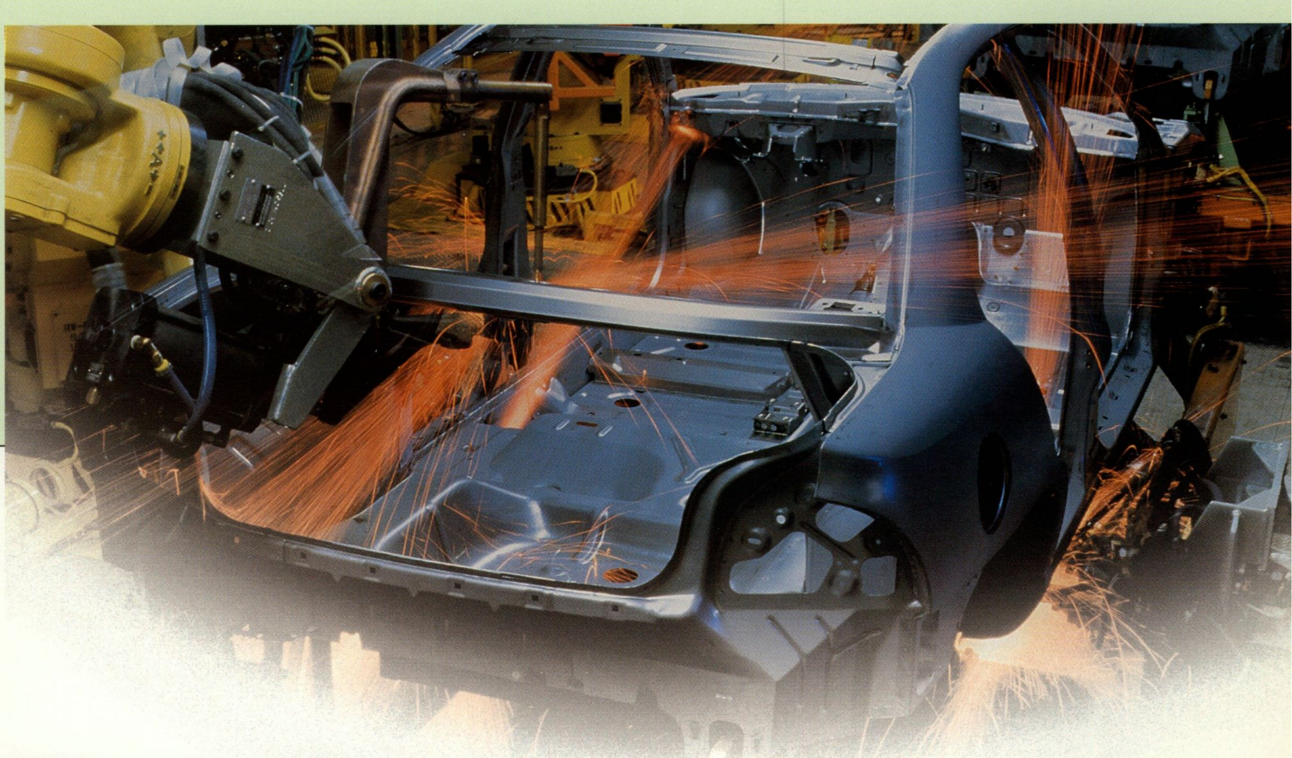
Federal Reserve Bank of Chicago



Can the Midwest Maintain its Momentum?

1996 Annual Report

The Federal Reserve Bank of Chicago is one of 12 regional Reserve Banks across the United States that, together with the Board of Governors in Washington, D.C., serve as the nation's central bank. The role of the Federal Reserve System, since its establishment by an act of Congress passed in 1913, has been to foster a strong economy, supported by a stable financial system.

To this end, the Federal Reserve Bank of Chicago participates in the formulation and implementation of national monetary policy, supervises and regulates banks and bank holding companies, and provides financial services to depository institutions and the U.S. government. Through its head office in Chicago, branch in Detroit, regional offices in Des Moines, Indianapolis and Milwaukee, and facility in Peoria, the Federal Reserve Bank of Chicago serves the Seventh Federal Reserve District, which includes major portions of Illinois, Indiana, Michigan and Wisconsin, plus all of Iowa.

OUR VISION

- Further the public interest by fostering a sound economy and stable financial system
- Provide products and services of unmatched value to those we serve
- Set the standard for excellence in the Federal Reserve System
- Work together, communicate openly, be creative and fair
- Live by our core values of integrity, respect, responsibility and excellence

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From left: Chairman Robert Healey, Deputy Chairman Lester McKeever, President Michael Moskow, and First Vice President William Conrad.

1996 was a good year—a year of achievement for the economy, the banking system, and the Federal Reserve Bank of Chicago.

The economy grew at a very respectable pace, with low inflation and high levels of employment. The Midwest, in particular, prospered as it continued to demolish its old image as the nation's "Rust Belt."

The banking system also enjoyed another solid year, as indicated by steady loan growth and a healthy return on assets. The outlook for financial institutions nationally and in the Midwest remains quite positive.

Like the economy and the banking sector, the Federal Reserve Bank of Chicago had another successful year. We made significant progress toward setting the standard of excellence in the Federal Reserve System, progress that will leave the Bank well-positioned to do even better in the future.

The Bank's many accomplishments during 1996 are the result of the outstanding efforts of our staff members. In addition, our directors in Chicago and Detroit provided invaluable guidance, unselfishly giving their time and expertise to the Bank. I would like to thank six individuals who completed their service on the board in 1996: David Fox, Robert Healey, and Charlene Sullivan from our Chicago board, and Charles Allen, John Forsyth, and William Odom from our Detroit board. In particular, I would like to extend my appreciation to Robert Healey, who served as chairman for two years and as deputy chairman for three years. He provided outstanding leadership and insight during his service on the board.

Many of the Chicago Fed's initiatives during 1996 illustrate the Bank's efforts to prepare for future challenges. Perhaps the premier example is the Bank's comprehensive study of the regional economy, *The Midwest Economy: Looking Back for the Future*. The following article highlights the study, outlining some of the major findings and offering a variety of perspectives on how regional policymakers can help sustain the Midwest's momentum. Through such efforts, we hope we can contribute to a vibrant regional economy that is firmly positioned to thrive in the coming years.

Michael H. Moskow
President
March 24, 1997

Can the Midwest Maintain its Momentum?

Written off as the "Rust Belt" during the 1970s and 1980s, the Midwest has a distinctive new shine to it these days. The region has transformed itself into a lean and agile center of industrial productivity, with unemployment rates that are the envy of most of the U.S.

The Midwest has made a remarkable comeback. But can the region maintain its momentum? At the Federal Reserve Bank of Chicago, we decided that question was worthy of a closer look. Working with a diverse group of experts, Chicago Fed economists in 1996 carried out a comprehensive study of the Midwestern economy. They focused on the states of the Seventh Federal Reserve District: Illinois, Indiana, Iowa, Michigan, and Wisconsin.

The goal of the study was to gain a clearer understanding of why the Midwest rebounded in order to determine what the region needs to do to continue its success. The study has a two-fold benefit: it will put regional policymakers in a better position to develop public policy to sustain the Midwest's momentum; and it will help the Chicago Fed contribute to national monetary policy, the most important responsibility of the Federal Reserve System.

To carry out the study, we brought together a wide variety of researchers, academics, government decision-makers, and business, community, and labor leaders. Providing guidance was an advisory group, which included as honorary members the governors of the five states of the Seventh District. We examined the numerous forces that contributed to the region's success, studying changes — both inside and outside the Midwest — that affected the economy. We also attempted to build consensus on what policies will help keep the economy strong.

As expected, we found that manufacturing and agriculture are still the driving forces within the Midwest economy. Those are the region's traditional strengths, and that has not changed. The difference is that the region is operating much more efficiently — at a world-class level — by taking advantage of new technology and cutting-edge production methods such as lean manufacturing.

This significant improvement in efficiency is the single most important reason for the Midwest's turnaround. It is true that the Midwest has benefited from a number of external trends such as falling energy prices, a depreciating dollar, and a shift in government expenditures away from defense spending. Nevertheless, the region's hard-earned progress in increasing its efficiency is the driving force behind its success.

The key question is how the Midwest arrived at a world-class standard, and what it will take to maintain it. We examined this question in-depth during the course of 1996, holding six individual seminars and a wrap-up session to discuss the results.

The following pages summarize some of the study's important findings and offer related viewpoints of a variety of conference participants. Also included are some strategic options for policymakers to consider as the Midwest positions itself for the future. The information is provided within the framework of six key questions:

- Is the work force prepared to sustain growth and development?
- How can the Midwest continue to improve industrial productivity?
- Can the Midwest continue to prosper in the global economy?
- What can state and local policy do to help sustain the region's current economic momentum?
- Will the Midwest's metropolitan areas be a source of strength or weakness?
- Can rural areas sustain their turnaround?

It's important to address these issues because regional economic advantage is fleeting. This is a window of opportunity for the Midwest to build on its success. The Chicago Fed can help the Midwest maintain its momentum by contributing a broad-based foundation of information about the regional economy—information that can serve as a building block for the development of effective regional policy. Simply put, by studying the past, we can prepare ourselves for a prosperous future.

Is the region's work force prepared to sustain growth and development?

Midwest workers are highly skilled and productive, but training methods and opportunities for certain segments of the work force need to be improved.

The productivity of the Midwest work force has clearly contributed to the region's turnaround. To maintain this productivity, the skills of all workers need to be continuously upgraded. Creating the highest-quality work force depends on giving individuals skills to be life-long learners. A key starting point is ensuring high-quality elementary and secondary education. For those already in the work force, new training methods that better meet the needs of employers are necessary. Finally, improving training and employment opportunities for the disadvantaged is also important to creating a work force that will sustain growth and development.

BRINGING THE DISADVANTAGED INTO THE WORK FORCE

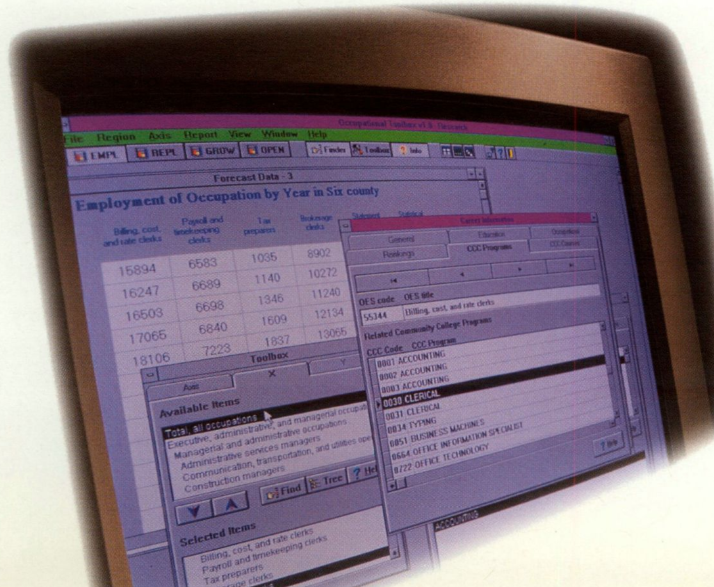
The demand for skilled workers and the recent restructuring of welfare have intensified the need to develop better methods for bringing the disadvantaged into the work force. Toby Herr of the Erikson Institute discussed the Project Match program, which places welfare recipients from Chicago's Cabrini Green housing project into jobs. This program has achieved favorable results by providing participants with immediate exposure to the workplace, supported by ongoing assistance to keep jobs, to advance to better jobs (often requiring a return to school), and to find re-employment if new jobs are lost. This approach often shows more promise than traditional methods of providing the training before a client takes the job.

MEETING THE NEEDS OF EMPLOYERS

Bob Jones of the National Alliance of Business discussed the need for policies to match more closely the new realities of the labor market. There is no question that the old model of one employer and one career for life is gone forever. Workers must have the education and training to adapt to new jobs within their company or their industry. They also must have portable health care and pension plans as well as industry-based, certifiable standards that give them recognized credentials that will make it easier to adapt to changing labor markets.

Options

- *Promote efforts to continually improve workers' skills, with training that reflects the new market realities that workers are likely to change jobs during the course of their career.*
- *Establish industry-based certified skills to benefit both workers changing jobs and the firms hiring those workers.*
- *Develop better information about labor market needs so that training programs can provide the skills needed by employers.*
- *Increase understanding of how to bring the disadvantaged into the work force by studying programs that reflect "best practices."*



PREPARING COLLEGE STUDENTS FOR THE JOB MARKET

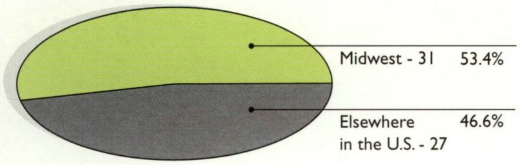
Students entering the work force often need information about labor markets and career prospects. The Federal Reserve Bank of Chicago's Phil Israilevich, in conjunction with the Regional Economics Applications Laboratory, is developing software that will allow students in the City Colleges of Chicago system to examine the earnings and growth potential for a wide range of careers in the Chicago area. The software also identifies college courses needed to enter these fields.

How can the Midwest continue to improve industrial productivity?

Many Midwestern industries have become more competitive by improving their productivity. A key for the future will be facilitating the spread of productivity-enhancing methods and technology throughout the region.

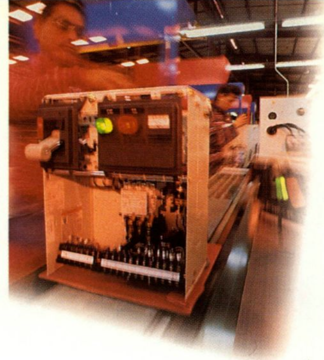
Much of the Midwest's resurgence is due to gains in two historically important sectors: manufacturing and agriculture. The region continues to have a higher concentration than the rest of the nation in these economic sectors. New production methods and technology have made Midwest producers more competitive, enabling the region to take advantage of trade opportunities and reclaim its share of the domestic market. The Midwest economy will continue to improve if all types of industries and firms can share in these efficiency improvements.

Where are U.S. auto assembly plants located?



RECLAIMING THE AUTO INDUSTRY

The auto industry's strong performance has been key to the region's turnaround. The auto industry reconcentrated in the Midwest, according to James Rubenstein of Miami University of Ohio. A total of 31 of 58 auto assembly plants nationally are in the Midwest. Although nine auto plants closed in the region from 1979-1996, 13 new plants opened, including a number of foreign producers. The innovations introduced by foreign producers have facilitated the development of new production techniques.



MAINTAINING THE MANUFACTURING MOMENTUM

Don Smith of Carnegie Mellon University discussed high-performance manufacturing systems that maximize the flow of information within companies and in their dealings with suppliers. The manufacturing approach was brought to the Midwest by Japanese auto transplants. The Midwest is well positioned to utilize these techniques as the best U.S., European, and Japanese manufacturers all have a presence in the region. To sustain the Midwest's manufacturing rebound, Smith suggested reducing intra-regional trade barriers and increasing the efficient flow of information about new technology to help implement innovative manufacturing techniques. Policymakers should also consider addressing potential labor shortages in key areas due to the aging of the region's work force.

Options

- *Study the best methods and models for transferring technology to all types of businesses.*
- *Enhance efficiency by strengthening relationships between suppliers and the manufacturers who buy their products.*
- *Develop a better understanding of how to apply new production methods, such as lean manufacturing.*

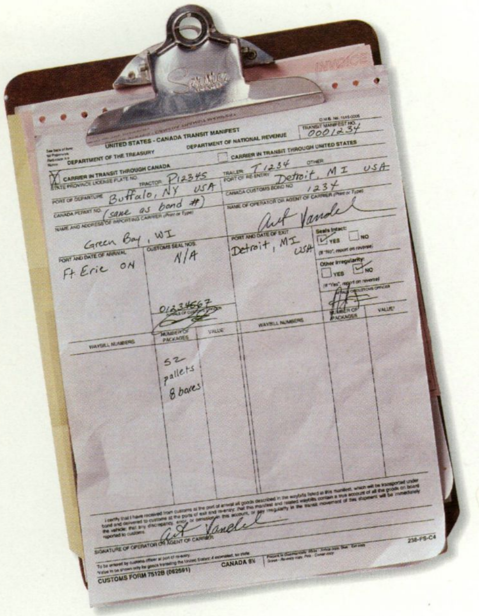
APPLYING NEW PRODUCTION METHODS — LEAN MANUFACTURING

Increased use of lean manufacturing techniques is partly responsible for the region's recovery, according to the Chicago Fed's Thomas Klier. Lean manufacturing is a production system that emphasizes teamwork on the shop floor, just-in-time inventory, flexible production equipment, and close relationships with suppliers. These productivity-enhancing methods are being applied at all types of manufacturing firms — old and new. The challenge is transferring these methods to even more companies to ensure that both large and small operations can take advantage of them.

How can the Midwest continue to prosper in the global economy?

The region will prosper if Midwestern companies continue to enhance productivity and compete aggressively overseas.

The Midwest has benefited from an inflow of foreign investment and an expansion of international trade, which has been facilitated by reduced barriers. The product mix of Midwestern businesses is well suited to the needs of high-growth emerging markets throughout the world. Durable goods and agricultural products are in high demand, and that has contributed to the region's recent strong performance. Additionally, foreign investment in the Midwest has brought the area new capital and in many cases new production methods. Overall, globalization has made Midwestern firms more competitive both at home and abroad.



OPPORTUNITIES IN THE NEW TRADE CLIMATE

Midwestern firms are well positioned to benefit from the growing liberalization of world trade, particularly in emerging markets, according to David Walters of the Office of the U.S. Trade Representative. Recent trade pacts have opened up new markets, offering an opportunity to Midwestern firms. Evidence suggests that firms that pursue these opportunities often grow faster and pay higher wages.

BENEFITING FROM TRADE AGREEMENTS

Who benefits from the North American Free Trade Agreement (NAFTA) was the focus of a study by Chicago Fed's Michael Kouparitsas. Given NAFTA's short history, that's a difficult question to answer. But by using a sophisticated type of modeling to study the international trade agreement, Kouparitsas suggested that all three North American trading partners will make economic gains and that the Midwest will benefit from an expansion in durable goods manufacturing activity.

Options

- *Develop a better understanding of which domestic and international markets are most closely linked to Midwestern products.*
- *Distribute the critical information that firms need to enter foreign markets.*
- *Investigate the effect of exchange rate movements on the competitive position of Midwestern firms.*

NEW APPROACHES TO UNDERSTANDING EXCHANGE RATES

U.S. goods have been widely viewed as a better buy overseas because of a decline in the value of the dollar relative to key foreign currencies, such as the Japanese yen and the German mark. Chicago Fed economists Jack Hervey and Bill Strauss took a regional approach to examining the effect of exchange rates on exports. They found that while the value of the dollar has tended to depreciate in many countries since 1974, it has generally appreciated in those countries that are most likely to trade with the Midwest. This suggests that the renewed demand for Midwestern goods is not simply due to a price advantage resulting from changes in the value of the dollar.

How can state and local policy help to sustain the region's momentum?

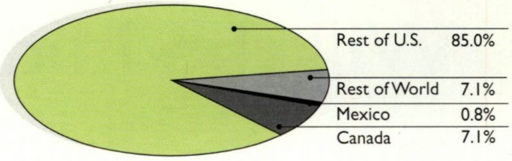
State and local governments need to continue pursuing innovative ways to provide essential services while keeping spending in check.

State and local policymakers in the Midwest have received national attention for their creative approaches, devising programs ranging from new welfare policies to changes in school funding. At the same time, prudent fiscal policies have restored the governments' financial stability, which is key to the well-being of the region's economy. As the federal government gives more responsibility to the states, these trends need to continue.

ADJUSTING TAX SYSTEMS TO SUPPORT GROWTH

Many states have worked hard to reverse the Midwest's image as a region with high taxes. In particular, a number of regional policymakers have introduced reforms to revamp their tax structures. Joint work by the Chicago Fed's Bill Testa and Tulane University's Bill Oakland suggests the need for more long-term improvements in state tax structures, such as taxing businesses based on the cost of the benefits they receive from their state. This could prompt future economic growth by reducing the distortionary effect taxes have on the choice of where to locate a business.

Where do metro Chicago exports go?



STRENGTHENING OPPORTUNITIES FOR REGIONAL TRADE

Although global trade is essential, it is important to consider the links between Midwestern firms and their domestic trading partners, said Geoff Hewings of the University of Illinois. The Chicago metropolitan area, for example, sends many more goods to other parts of the U.S. than to foreign countries. In some cases, differing rules and regulations in U.S. states may hamper such trade. Hewings suggested that barriers to intra-regional trade, such as varying occupational licenses and weight and length limits on trucks, should be examined to ensure that they are necessary.

Options

- *Continue to develop equitable and diversified tax systems that do not rely on one primary source of revenue.*
- *Continue prudent spending policies that support sustainable growth.*
- *Encourage the development of a wide range of state and regional economic information to ensure that policymakers are fully informed when crafting policy.*
- *Examine intra-regional trade barriers to ensure that they are necessary.*

RESTORING FISCAL BALANCE

Midwestern states have taken advantage of the resurgent regional economy to improve their fiscal position, according to the Chicago Fed's Rick Mattoon. These states have avoided major tax increases throughout the 1990s, building substantial budget reserves and avoiding the creation of expensive new spending programs. This prudent fiscal policy leaves the region's governments in good shape to accept new responsibilities from the federal government.

Will the Midwest's metropolitan areas be a source of strength or weakness?

To be a source of strength, the region's metropolitan areas need to continue their transformation to centers of key business services and high-tech manufacturing, while seeking solutions to serious social and economic problems.

While metropolitan areas continue to expand, the growth is more dispersed. Economic activity has been spreading out toward the urban fringe, leaving redevelopment problems for the core city. As metropolitan areas re-invent themselves, it is important to investigate the causes of dispersed growth. There is a healthy debate as to whether this trend is a result of artificial subsidies and government policies or is being driven by technological changes. A key to the region's continued success will be developing a better understanding of how the relationship between cities and their suburbs affects economic growth.

REDEVELOPING BROWNFIELDS

Charles Bartsch of the Northeast-Midwest Institute discussed policies geared toward improving the redevelopment prospects of environmentally contaminated land, often referred to as brownfields. A number of factors affect the development prospects of brownfields. The degree of environmental contamination is a key issue, but other factors such as size of available land parcels and related tax and regulatory burdens are also important. A number of policymakers at the state and federal levels are considering legislation to establish a liability standard for both lenders and property owners, which would make it easier to determine the economic feasibility of redeveloping brownfields.

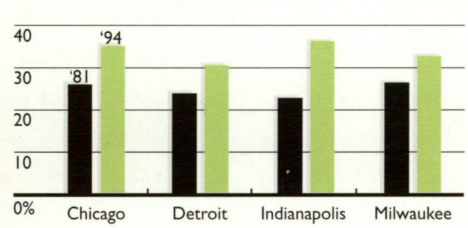
LINKING METRO WORKERS TO JOBS

A mismatch often exists in urban areas between where jobs are located and where potential workers live. Davis Jenkins from the Great Cities Institute of the University of Illinois at Chicago suggests that programs such as the Suburban Job-Link Corp., designed to transport urban workers to available suburban jobs, is one promising approach for addressing this mismatch.

Options

- *Develop a better understanding of what forms of urban development are realistic, and how land availability and environmental conditions can affect development opportunities.*
- *Investigate the different ways that metropolitan areas grow and devise policies that promote fair and efficient patterns of development.*
- *Encourage a better understanding of how technology affects the location of economic activity.*

Service Employment Growth for Selected Metropolitan Areas
(Percent of total employment 1981 and 1994)



CONVERTING TO A SERVICE ECONOMY

Urban areas have taken advantage of technology to convert from manufacturing to service economies, said Robert Atkinson of the U.S. Office of Technology Assessment. However, technological breakthroughs are now permitting some of these service jobs to move out of the central city. If metropolitan areas are to prosper, it is important to understand how technology and public policy affect the location of economic activity.

Can rural areas sustain their turnaround?

Agriculture will continue to dominate rural economies but will require fewer workers. To sustain growth, manufacturing and new industries will be needed to supplement agriculture.

Midwestern rural areas have shaken off much of the ill-effects of the farm crisis of the early 1980s. New production methods and technologies have made farms highly productive, and growth in export markets has sparked demand for Midwestern agricultural products. As the agricultural economy improved, population growth in rural areas rebounded in the early 1990s, reversing the downturn of the 1980s. Still, for rural areas to sustain their recovery, new types of industries need to be identified.

NEW INDUSTRIES IN RURAL AREAS

The movement of manufacturing to rural areas is a positive development, suggested Andrew Bernat of the U.S. Department of Commerce. Manufacturing growth in rural areas has greatly exceeded that found in metropolitan areas in recent years, according to Bernat. Fraser Hart of the University of Minnesota said that retirement and recreational services are also contributing to growth in rural areas of the Midwest. The increasing diversity of rural economies provides new employment opportunities as farming continues to shed labor.

NEW PRODUCTION METHODS ON THE FARM

The Chicago Fed's Gary Benjamin provided an example of how farm technology and production methods are changing the nature of hog production. A new entity, the mega-farm, has emerged, significantly increasing the size and scale of hog farms. The mega-farm has implications for where hogs are raised, as states such as North Carolina have been more willing than many Midwestern locations to accept them. To maintain its dominance in pork production, the Midwest will need to weigh the costs and benefits of mega-farms.

Options

- *Encourage the development of industries complementary to agriculture, such as food processing and agricultural services.*
- *Capitalize on advances in telecommunications to expand the quality of health care, educational, and business services in rural areas.*
- *Promote education and retraining of farm and rural residents to counter declining employment opportunities due to productivity gains in agriculture.*
- *Promote the Midwest's comparative agricultural advantage due to its highly productive farmland.*

KEEPING THE AGRICULTURE SECTOR HUMMING

Agriculture is a key ingredient in the Midwest success story. Farm productivity is up, as measured by higher crop yields and livestock production. The Chicago Fed's Mike Singer suggested this strong performance might be improved by increasing opportunities for industries, such as food processing, that complement the agricultural sector.

The Bank in 1996

1996 HIGHLIGHTS

- President Moskow and other senior officers outlined plans to transform the Bank's culture during a series of meetings attended by about 1,000 staff members.
- Research activity included studies on risk management and its impact on bank behavior, fair lending regulations, macroeconomic shocks and their aggregate effects, and the financing sources for small business investment companies.
- The Economic Research Department upgraded its index of Midwest manufacturing activity and distributed it on a regular basis in a new format.
- The Bank hosted the 32nd annual Conference on Bank Structure and Competition, with the theme "Rethinking Bank Regulation: What Should Regulators Do?"
- Economic Research staff had 43 papers published or accepted for publication in leading U.S. and international scholarly journals and presented 46 papers to professional groups.
- The Chicago Fed hosted numerous programs for foreign visitors, including economists and senior officials from foreign central banks.
- Research Statistics processed 244 applications and met more than 94,000 report deadlines.
- The Supervision and Regulation Department performed over 800 inspections and examinations, one of the heaviest workloads in the System.
- The Chicago Fed worked with foreign bank regulators as part of a Systemwide effort to strengthen global supervision.
- Supervision and Regulation introduced the Examiner Workstation, a new software application to help make examinations more efficient and risk-focused.
- The Bank provided significant input to the Board of Governors on regulatory changes, including revisions to Regulation Y, Bank Holding Companies, to help streamline the applications process.
- Supervision and Regulation worked with industry groups to develop an understanding of non-traditional banking products and their possible effects on financial institutions.
- A project group began establishing a new unit to improve service for the Bank's customers.
- The Bank fully recovered the cost of providing priced financial services.
- Over $34 trillion worth of wire transfers — 3½ times U.S. GDP — were completed at the Chicago Reserve Bank.
- Commercial automated clearinghouse (ACH) volume increased 24 percent. Contributing to the jump in volume were two ACH price decreases implemented to encourage the use of electronic payments and meet the demands of the market.
- The Chicago Fed played a significant role in implementing the Electronic Federal Tax Payment System.
- To encourage more efficient electronic alternatives, the Bank focused on expanding Fedline connections to customers, increasing electronic check processing, and encouraging the use of automated clearinghouse.
- The Milwaukee Office tested the use of imaging technology to process checks more efficiently and meet customer demand.
- The Detroit Branch installed FASTRAC, an automated tracking and adjustment resolution system, which increased productivity in check adjustment.
- Electronic cash letter (ECL) deposits increased by 60 percent, bringing ECL volume to 25 percent of total check volume deposited.
- The Detroit Branch's currency operation had the lowest unit cost in the Federal Reserve System.
- The Bank completed consolidation of its return-item notification service for large dollar checks.
- The Bank began distributing newly designed $100 bills.
- The Chicago Fed was named one of the System's processing sites for commercial tenders for purchasing government securities.
- Human Resources Services developed a new paid-time-off policy.
- A leadership development plan was initiated for managers.
- The Bank conducted tours of its operations for more than 9,600 visitors.
- A comprehensive assessment aimed at improving the efficiency of the Bank's support and overhead processes was completed by a review team.
- Bank staff continued to play a leadership role through participation in many System groups.

OPERATIONS VOLUMES	Dollar Amount 1996	Dollar Amount 1995	Number of Items 1996	Number of Items 1995
Check & Electronic Payments				
Checks, NOWs, & share drafts processed	1.3 trillion	1.2 trillion	1.8 billion	1.7 billion
Fine sort & packaged checks handled	77.7 billion	101.2 billion	152.8 million	217.2 million
U.S. government checks processed	48.1 billion	49.5 billion	48.1 million	50.2 million
Automated Clearinghouse (ACH) items processed*	2.2 trillion	2.5 trillion	657.9 million	626.3 million
Transfer of funds	33.8 trillion	31.5 trillion	15.6 million	14.3 million
Electronic checks processed	16.0 million	13.1 million	620.4 million	507.8 million
Cash Operations				
Currency received and counted	35.9 billion	32.7 billion	2.6 billion	2.4 billion
Unfit currency destroyed	9.6 billion	7.7 billion	801.9 million	958.3 million
Coin received and counted	777.4 million	836.2 million	5.8 billion	6.7 billion
Securities Services for Depository Institutions				
Safekeeping balance December 31:				
Definitive securities	11.7 billion	13.3 billion	16.9 thousand	24.4 thousand
Book-entry securities	349.0 billion	406.7 billion	-	-
Purchase & sale	2.9 billion	4.0 billion	12.7thousand	14.6 thousand
Collection of securities & other noncash items	110.2 million	167.0 million	232.2 thousand	194.7 thousand
Book-entry government securities	7.1 trillion	7.1 trillion	1.1 million	1.1 million
Loans to Depository Institutions				
Total loans made during year	3.1 billion	1.2 billion	1,270	855
Services to U.S.Treasury and Government Agencies				
Redemptions of definitive government securities	189.3 million	366.3 million	6.3 thousand	10.3 thousand
Government coupons paid	35.3 million	101.1 million	11.4 thousand	21.7 thousand
Federal tax deposits processed	87.9 billion	99.3 billion	874.5 thousand	883.6 thousand
Food stamps redeemed	2.2 billion	2.3 billion	435.3 million	443.0 million

**A consolidation of processing prompted a change in how ACH volume is calculated, resulting in lower volume growth for 1996 than would have been reported using the previous method.*

The Federal Reserve Bank of Chicago's volume of operations during 1996 reflected the System's continuing efforts to improve efficiency and encourage the use of electronic payments. The volume of funds transfers and Automated Clearinghouse (ACH) transactions continued to rise. The volume of electronic checks processed also increased, due in part to marketing efforts to encourage efficiency through electronic processing methods. The number of paper checks processed increased slightly, reflecting service enhancements and lower prices.

Year-to-year changes in Reserve Bank assets and liabilities largely reflect general economic developments and System monetary policy actions. By purchasing securities in the open market and making loans to depository institutions, the Federal Reserve increases reserves, providing a base for monetary and credit expansion in accord with the national economy's growth needs. In 1996, the Bank's total assets fell slightly as a large increase in currency outstanding was more than offset by a decline in deposits of depository institutions and day-to-day interdistrict fluctuations.

STATEMENT OF CONDITION

(in millions)	12/31/96	12/31/95
Assets		
Gold Certificates	$ 1,140	$ 1,220
Special Drawing Rights Certificates	979	1,079
Coin	70	35
Items in Process of Collection	1,537	519
Loans to Depository Institutions	18	1
U.S. Government and Federal Agency Securities, Net	42,727	44,024
Investments Denominated in Foreign Currencies	2,296	2,401
Accrued Interest Receivable	385	448
Interdistrict Settlement Account	157	0
Property and Equipment, Net	149	149
Other Assets	76	112
Total Assets	**$ 49,534**	**$ 49,988**
Liabilities and Capital		
Liabilities:		
Federal Reserve Notes Outstanding, Net	$ 44,858	$ 41,758
Deposits:		
Depository Institutions	2,574	3,539
Other Deposits	69	103
Deferred Credit Items	808	463
Statutory Surplus Transfer Due U.S. Treasury	68	0
Interest on Federal Reserve Notes Due U.S. Treasury	0	73
Interdistrict Settlement Account	0	3,016
Accrued Benefit Cost	74	71
Other Liabilities	22	19
Total Liabilities	$ 48,473	$ 49,042
Capital		
Capital Paid-in	537	473
Surplus	524	473
Total Capital	$ 1,061	$ 946
Total Liabilities and Capital	**$ 49,534**	**$ 49,988**

STATEMENT OF INCOME

For the years ended Dec. 31, 1996 and Dec. 31, 1995 (in millions)	**1996**	**1995**
Interest Income:		
Interest on U.S. Government Securities	$ 2,604	$ 2,721
Interest on Foreign Currencies	53	89
Interest on Loans to Depository Institutions	1	1
Total Interest Income	$ 2,658	$ 2,811
Other Operating Income:		
Income from Services	99	96
Reimbursable Services to Government Agencies	16	17
Foreign Currency Gains (Losses), Net	(199)	114
Government Securities Gains, Net	4	1
Other Income	3	3
Total Other Operating Income (Loss)	$ (77)	$ 231
Operating Expense:		
Salaries and Other Benefits	126	123
Occupancy Expense	19	19
Equipment Expense	18	18
Cost of Unreimbursed Treasury Services	4	4
Assessments by Board of Governors	61	60
Other Expense	89	90
Total Operating Expense	$ 317	$ 314
Income Before Cumulative Effect of Accounting Change	2,264	2,728
Cumulative Effect of Change in Accounting Principle	0	(7)
Net Income Prior to Distribution	$ 2,264	$ 2,721
Distribution of Net Income:		
Dividends Paid to Member Banks	$ 31	$ 27
Transferred to Surplus	64	54
Payments to U.S. Treasury as Interest on Federal Reserve Notes	1,587	2,640
Payments to U.S. Treasury as Required by Statute	582	0
	$ 2,264	$ 2,721

A Reserve Bank's income is largely a by-product of monetary policy rather than the pursuit of profit. Most of the Bank's income is interest on its share of the System's Open Market Account portfolio of securities, and appropriately, the vast majority of this income is turned over to the U.S. Treasury each year. Current income decreased compared to 1995, primarily because of a decrease in interest received from government securities and a loss in foreign currency. Operating expenses rose very slightly, with the cost of increased personnel and centralized automation largely offset by expense reductions in various areas.

Member banks in the Seventh Federal Reserve District are required to purchase capital stock in the Federal Reserve Bank of Chicago, as prescribed by the Federal Reserve Act. Member banks are required to purchase an amount of stock equal to six percent of their capital and surplus. A six percent annual dividend is provided on the paid-in stock, as specified by law. The holding of stock does not carry with it the control and financial interest conveyed to holders of common stock in for-profit organizations. During 1996, the value of Bank capital increased because member banks carried larger amounts of capital and surplus, requiring them to hold additional shares of capital stock.

STATEMENT OF CHANGES IN CAPITAL

For the years ended Dec. 31, 1996 and Dec. 31, 1995 (in millions)

	Capital Paid-in	Surplus	Total Capital
Balance at December 31, 1994 (8,380,307 shares)	$ 419	$ 419	$ 838
Net Income Transferred to Surplus		54	54
Net Change in Capital Stock Issued (Redeemed) (1,074,008 shares)	54		54
Balance at December 31, 1995 (9,454,315 shares)	$ 473	$ 473	$ 946
Net Income Transferred to Surplus		64	64
Statutory Surplus Transferred to U.S.Treasury		(13)	(13)
Net Change in Capital Stock Issued (Redeemed) (1,286,438 shares)	64		64
Balance at December 31, 1996 (10,740,753 shares)	$ 537	$ 524	$ 1,061

The statements of income, condition, and changes in bank capital are prepared by Bank management. Copies of full and final financial statements, complete with footnotes, are available by contacting the Federal Reserve Bank of Chicago's Public Information Center, P.O. Box 834, Chicago, Illinois 60690-0834, 312-322-5111.

DIRECTORS

Members of the Federal Reserve Bank of Chicago's board of directors are selected to represent a cross section of the Seventh District economy, including consumers, industry, agriculture, the service sector, labor, and commercial banks of various sizes.

The nine-member board includes three bankers and three nonbankers, all elected by member banks. Three additional nonbankers are appointed by the Board of Governors, which also designates the Reserve Bank chairman and deputy chairman from among its three appointees.

The Board of Governors also selects three nonbankers to serve on the seven-member board of the Bank's Detroit Branch. Four additional directors are selected by the Chicago Reserve Bank board. The Branch board selects its own chairman each year. All Reserve Bank and Branch directors serve three-year terms, with a two-term maximum.

Director appointments and elections at the Chicago Reserve Bank and its Detroit Branch effective in 1996 were:

- Robert M. Healey redesignated Chairman.
- Lester H. McKeever, Jr. designated Deputy Chairman.
- Arthur C. Martinez appointed to a three-year term as a director, replacing Richard G. Cline.
- Florine Mark designated Branch Chair, replacing John D. Forsyth.
- Richard M. Bell and Stephen R. Polk appointed to three-year terms as Branch directors replacing Norman F. Rodgers and J. Michael Moore.

At year-end 1996 the following appointments and elections to terms beginning in 1997 were announced:

- Lester H. McKeever, Jr. designated Chairman.
- Arthur C. Martinez designated Deputy Chairman.
- Robert J. Darnall, Chairman, President, and Chief Executive Officer of Inland Steel Industries, Inc., Chicago, Illinois; Verne G. Istock, Chairman, President, and Chief Executive Officer of First Chicago NBD Corporation, Chicago, Illinois; and Migdalia Rivera, Executive Director of the Latino Institute, Chicago, Illinois, appointed to three-year terms as directors replacing Robert M. Healey, David W. Fox, and A. Charlene Sullivan.
- Florine Mark redesignated Branch Chair.
- Irma B. Elder, President of Troy Motors, Troy, Michigan; Timothy D. Leuliette, President and Chief Operating Officer, Penske Corporation, Detroit, Michigan; and Denise Ilitch Lites, President, Olympia Development Inc., Detroit, Michigan, appointed to three-year terms as Branch directors, replacing Charles E. Allen, William E. Odom, and John D. Forsyth.

ADVISORY COUNCILS

The Federal Advisory Council, which meets quarterly to discuss business and financial conditions with the Board of Governors in Washington, D.C., is comprised of one member from each of the 12 Federal Reserve Districts. Each year the Chicago Reserve Bank's board of directors selects a representative to this group. Roger L. Fitzsimonds, who served as the Seventh District's representative in 1995 and 1996, was re-appointed to a third one-year term for 1997.

Members of the Bank's two advisory councils, who are selected from nominations by Seventh District small business and agricultural organizations, served for a third year in 1996. The councils provide a vital communication link between the Bank and these important sectors.

OFFICERS

The Bank's board of directors acted on the following promotions during 1996:

- James W. Nelson to vice president, Supervision and Regulation.
- David E. Ritter to vice president and culture transformation team leader.
- Yurii Skorin, to vice president and associate general counsel, Legal Department.
- Jeffrey S. Anderson to assistant vice president, Check Services.
- Guadalupe Garcia to assistant vice president, Cash Services.
- Mary H. Sherburne to assistant vice president, Check Services.
- Tyler K. Smith to assistant vice president, Support Services.

New officers appointed by the board in 1996 were:

- Thomas M. Matsumoto to assistant vice president, Automation Services.
- Ellen J. Bromagen to accounting officer, Accounting Services.

Thomas G. Ciesielski, vice president, Human Resource Services, served on the Management Committee during 1996.

Franklin D. Dreyer, senior vice president, Supervision and Regulation and Loans, retired after 38 years of service to the Bank. Richard P. Bush, vice president, Accounting Services, retired after 25 years of service.

1996 Board of Directors, Federal Reserve Bank of Chicago, from left to right: Robert Healey, Lester McKeever, Arthur Martinez, Stefan Anderson, Charlene Sullivan, David Fox, Donald Schneider, Arnold Schultz, and Thomas Dorr.

Reserve Bank directors have a general governance responsibility for the management of operations, which includes approving budgets, expenditures, and official appointments. In addition, directors provide advice and counsel to the Reserve Bank president on the state of the economy and financial system. Reserve Bank directors also determine, subject to review by the Board of Governors, the Bank's discount rate. The Chicago Reserve Bank and Detroit Branch directors are selected to represent a variety of interests and activities within the District and bring to their diverse duties a broad range of expertise and experience.

The Federal Advisory Council, consisting of one representative from each District, meets quarterly with the Board of Governors to discuss economic conditions. The Chicago Reserve Bank's advisory councils on small business and agriculture provide a vital communication link between the Bank and these important economic sectors.

BOARD OF DIRECTORS FEDERAL RESERVE BANK OF CHICAGO

Chairman

Robert M. Healey
Member
Illinois State Labor Relations Board
Chicago, Illinois

Deputy Chairman

Lester H. McKeever, Jr.
Managing Partner
Washington, Pittman & McKeever
Chicago, Illinois

Stefan S. Anderson
Chairman, President, and Chief Executive Officer
First Merchants Corporation
Muncie, Indiana

Thomas C. Dorr
President and Chief Executive Officer
Dorr's Pine Grove Farm Co.
Marcus, Iowa

David W. Fox
Retired Chairman and Chief Executive Officer
The Northern Trust Corporation
Chicago, Illinois

Arthur C. Martinez
Chairman and Chief Executive Officer
Sears, Roebuck and Co.
Hoffman Estates, Illinois

Donald J. Schneider
President
Schneider National, Inc.
Green Bay, Wisconsin

Arnold C. Schultz
Chairman, President, and Chief Executive Officer
The Grundy National Bank
Grundy Center, Iowa

A. Charlene Sullivan
Associate Professor of Management
Krannert Graduate School of Management
Purdue University
West Lafayette, Indiana

1996 Board of Directors, Detroit Branch, from left to right: William Odom, Charles Weeks, Florine Mark, Richard Bell, Charles Allen, and Stephen Polk (John Forsyth is not pictured).

BOARD OF DIRECTORS DETROIT BRANCH

Chair

Florine Mark
President and
Chief Executive Officer
The WW Group, Inc.
Farmington Hills, Michigan

Charles E. Allen
President and
Chief Executive Officer
Graimark Realty Advisors, Inc.
Detroit, Michigan

Richard M. Bell
President and
Chief Executive Officer
The First National Bank
of Three Rivers
Three Rivers, Michigan

John D. Forsyth
Executive Director
University of Michigan Hospitals
Ann Arbor, Michigan

William E. Odom
Chairman and
Chief Executive Officer
Ford Motor Credit Company
Dearborn, Michigan

Stephen R. Polk
Chairman and
Chief Executive Officer
R. L. Polk & Co.
Detroit, Michigan

Charles R. Weeks
Chairman
Citizens Banking Corporation
Flint, Michigan

ADVISORY COUNCIL ON AGRICULTURE

Reginald J. Clause
Jefferson, Iowa
Iowa Cattlemen's Association

George Crosby
Greensburg, Indiana
Milk Production Services
of Indiana, Inc.

David DeLong
Clinton, Wisconsin
Wisconsin Fertilizer and
Chemical Association

William D. Engelbrecht
Henry, Illinois
Illinois Beef Association

Donald W. Gillings
Bay City, Michigan
Michigan Agri-Business Association

Tim L. Kapucian
Keystone, Iowa
Iowa Pork Producers Association

Vic Riddle
Wapella, Illinois
Illinois Corn Growers Association

Gary Steiner
Mondovi, Wisconsin
Wisconsin Farm Bureau Federation

Richard Ward
Crawfordsville, Indiana
Indiana Pork Producers Association

Kam Washburn
Elsie, Michigan
Michigan Soybean Association

Kaye Whitehead
Muncie, Indiana
Member-at-Large

Patricia M. Yungclas
Ellsworth, Iowa
Women Involved in Farm Economics

ADVISORY COUNCIL ON SMALL BUSINESS

Gary E. Baker
Ann Arbor, Michigan
Small Business Association
of Michigan

James Bernstein
Sioux City, Iowa
Member-at-Large

Charles J. Garcia
Indianapolis, Indiana
Indiana Hispanic Chamber
of Commerce

Thomas Gearing
Milwaukee, Wisconsin
Independent Business Association
of Wisconsin

Sue Ling Gin
Chicago, Illinois
Member-at-Large

David W. Goodrich
Indianapolis, Indiana
National Federation
of Independent Business

Ray J. Green
Jacksonville, Illinois
National Automobile Dealers
Association

Linda M. Jolicoeur
Farmington Hills, Michigan
National Association
of Women Business Owners
Greater Detroit Chapter

Kendig K. Kneen
Ottumwa, Iowa
Iowa Association of Business
and Industry

Lucius Murray, Jr.
Detroit, Michigan
Booker T. Washington Business
Association

Eduardo Salse
Northbrook, Illinois
Latin American Chamber
of Commerce

P. Eric Turner
Gas City, Indiana
Indiana Chamber
of Commerce

Federal Reserve Bank of Chicago Management Committee,
from left to right: William Gram, David Ritter, Carl Vander Wilt, William Hunter, John Wixted,
Michael Moskow, Charles Furbee, William Conrad, Richard Anstee, Nancy Goodman,
George Coe, and David Allardice.

Appointments to and promotions within the Federal Reserve Bank's official staff are made by the Bank's board of directors. The board appoints the Bank's president (chief executive officer) and first vice president (chief operating officer) to five-year terms subject to approval by the Board of Governors.

The primary activities of the Chicago Reserve Bank are divided into nine functional areas overseen by senior vice presidents who report to the Bank's president and first vice president. An additional function, the Auditing Department, reports directly to the board of directors' Audit Committee. The Bank's senior officers form the Management Committee and determine the Chicago Reserve Bank's strategic direction.

Michael H. Moskow
President

William C. Conrad
First Vice President

CENTRAL BANK ACTIVITIES

Economic Research and Programs

William C. Hunter
Senior Vice President and Director of Research

Monetary Policy and Financial Markets Research

Elijah Brewer III
Senior Economist and Assistant Vice President

Douglas D. Evanoff
Senior Economist and Assistant Vice President

Charles L. Evans
Senior Economist and Assistant Vice President

Anne Marie L. Gonczy
Senior Economist and Assistant Vice President

Kenneth N. Kuttner
Senior Economist and Assistant Vice President

Daniel G. Sullivan
Senior Economist and Assistant Vice President

James T. Moser
Senior Research Economist and Research Officer

Paula R. Worthington
Senior Research Economist and Research Officer

Regional Economic Programs

Gary L. Benjamin
Economic Advisor and Vice President

Robert H. Schnorbus
Senior Economist and Assistant Vice President

William A. Testa
Senior Economist and Assistant Vice President

Philip R. Israilevich
Senior Regional Economist and Research Officer

Statistics

Jean L. Valerius
Vice President

Loretta C. Ardaugh
Statistical Reports Officer

Supervision and Regulation

John J. Wixted, Jr.
Senior Vice President

Regulation

James A. Bluemle
Vice President and Director of Regulation

David S. Epstein
Vice President

Douglas J. Kasl
Vice President

James W. Nelson
Vice President

Sheryn E. Bormann
Assistant Vice President

Maureen A. Cummings
Assistant Vice President

William H. Lossie, Jr.
Assistant Vice President

Anne M. Phillips
Assistant Vice President

Ronald A. Rolighed
Assistant Vice President

Philip G. Jackson
Applications Officer

Carl R. Quinn
Examining Officer

John A. Valenti
Information Support Officer

Supervision

Barbara D. Benson
Vice President and Director of Supervision

William A. Barouski
Vice President

Geoffrey C. Rosean
Vice President

A. Raymond Bacon
Assistant Vice President

Robert A. Bechaz
Assistant Vice President

Kathleen E. Benson
Assistant Vice President

Michael R. Jarrell
Assistant Vice President

Gay W. Whiting
Assistant Vice President

Charles A. Jeffrey
Examining Officer

Jeffrey A. Jensen
Examining Officer

SERVICES TO DEPOSITORY INSTITUTIONS

Retail Services

Charles W. Furbee
Senior Vice President

Check Services

Jerome F. John
Vice President

Yvonne H. Montgomery
Vice President

Jeffrey S. Anderson
Assistant Vice President

Cynthia L. Rasche
Operations Officer

Regional Offices

David R. Starin
Vice President

Des Moines Office
L. Edward Ketchmark
Assistant Vice President

Indianapolis Office
Donna M. Yates
Assistant Vice President

Milwaukee Office
Angelina S. Chin
Assistant Vice President

Peoria Facility
Mary H. Sherburne
Assistant Vice President

Retail Payment Services

Stephen M. Pill
Vice President

Kathleen H. Williams
Assistant Vice President

Wholesale, Cash, Fiscal, Facilities, and Interstate Marketing

Richard P. Anstee
Senior Vice President

Cash and Fiscal Services

William A. Bonifield
Vice President

Guadalupe Garcia
Assistant Vice President

Jerome D. Nicolas
Assistant Vice President

Lawrence J. Powaga
Assistant Vice President

Customer Service

Frank S. McKenna
Assistant Vice President

Facilities Management

Wayne R. Baxter
Vice President

Kenneth R. Berg
Assistant Vice President

Tyler K. Smith
Assistant Vice President

Wholesale and Interstate Marketing

Glen Brooks
Vice President

James M. Rudny
Assistant Vice President

Detroit Branch

David R. Allardice
Senior Vice President and Branch Manager

Valerie J. Van Meter
Vice President

Brian D. Egan
Assistant Vice President

Patrick A. Garrean
Assistant Vice President

Joseph R. O'Connor
Assistant Vice President

F. Alan Wells
Assistant Vice President

SUPPORT FUNCTIONS

Automation and Communications Services

George E. Coe
Senior Vice President

Automation Support

R. Steve Crain
Assistant Vice President

Brenda D. Ladipo
Assistant Vice President

Thomas M. Matsumoto
Assistant Vice President

Karen L. Rosenberg
Assistant Vice President and Information Security Officer

Anthony J. Tempelman
Assistant Vice President

Community and Information Services

Nancy M. Goodman
Senior Vice President

Consumer and Community Affairs

Alicia Williams
Vice President

John L. Bergstrom
Assistant Vice President

General Services

Kristi L. Zimmermann
Assistant Vice President

Public Affairs

James R. Holland
Public Affairs Officer

Culture Transformation

David E. Ritter
Vice President

Human Resource Services

Thomas G. Ciesielski
Vice President

Richard F. Opalinski
Assistant Vice President

Angela D. Robinson
Assistant Vice President

Legal Department and Office of the Secretary

William H. Gram
Senior Vice President, General Counsel and Secretary

Legal Services

Yurii Skorin
Vice President and Associate General Counsel

Elizabeth A. Knospe
Assistant Vice President and Assistant General Counsel

Anna M. Voytovich
Assistant Vice President and Assistant General Counsel

Office of the General Auditor

Glenn C. Hansen
General Auditor

Robert M. Casey
Assistant General Auditor

Joseph B. Green
Audit Officer

Support, Loans, and Risk Management

Carl E. Vander Wilt
Senior Vice President and Chief Financial Officer

Accounting Services

Ellen J. Bromagen
Accounting Officer

Loans and Risk Management

Gerard J. Nick
Vice President

William J. O'Connor
Assistant Vice President

Robert A. Lyon
Loans Officer

Management Services

Margaret K. Koenigs
Assistant Vice President

Jeffrey B. Marcus
Assistant Vice President

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313-961-6880

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317-244-7744

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FEDERAL RESERVE BANK
OF CHICAGO

For additional copies of this annual report, or for more information on the Bank's study of the Midwest Economy, contact the Public Information Center, Federal Reserve Bank of Chicago, at 312-322-5111, or access the Bank's web site at http://www.frbchi.org.