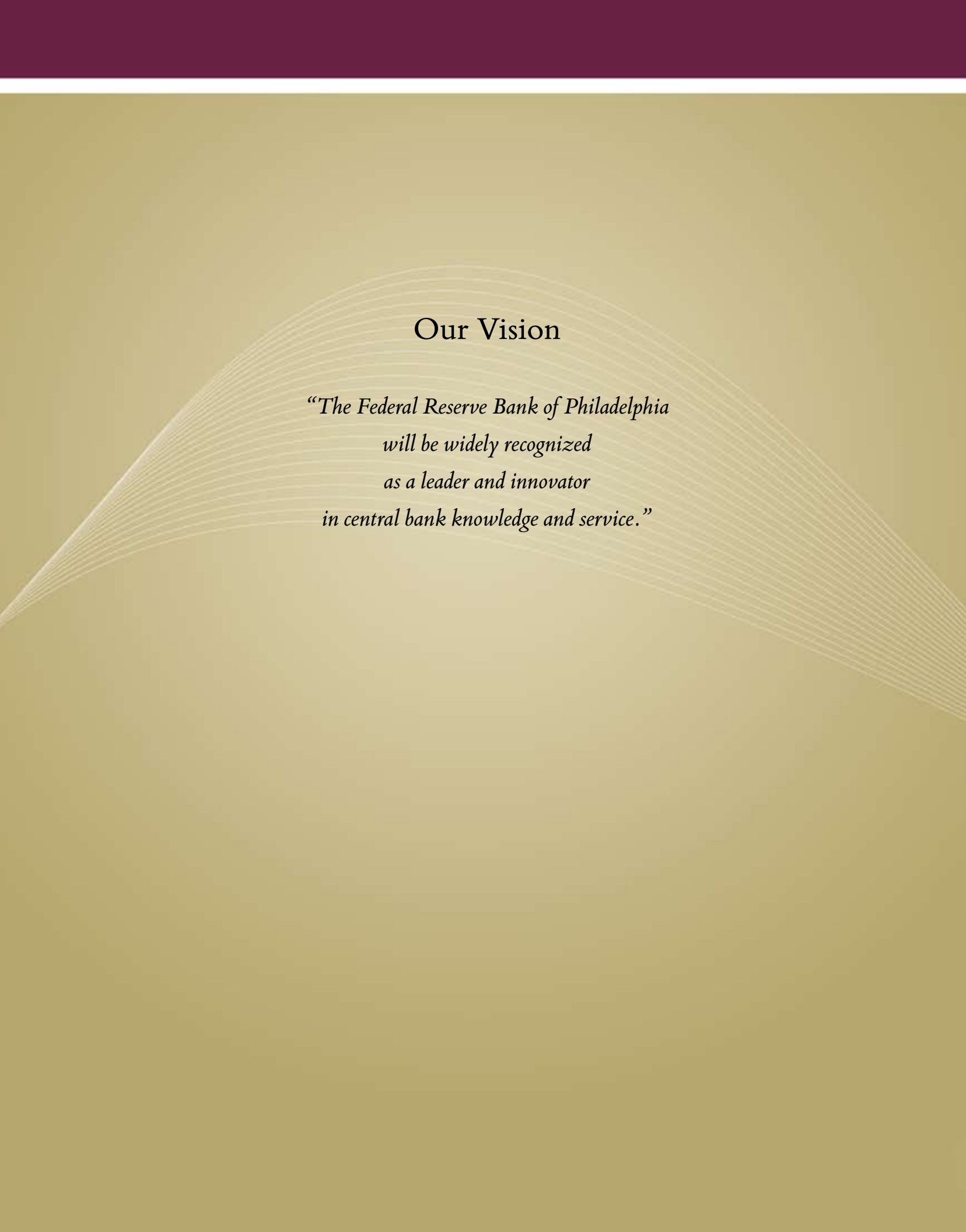


Commitment —— *and* —— Credibility





Our Vision

*“The Federal Reserve Bank of Philadelphia
will be widely recognized
as a leader and innovator
in central bank knowledge and service.”*

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A MESSAGE FROM PRESIDENT PLOSSER

Our Vision

At the Philadelphia Fed, we believe that in the current financial environment, it is vital to think creatively and find innovative solutions to problems. With this in mind, our Bank is proud to introduce a new vision statement:

The Federal Reserve Bank of Philadelphia will be widely recognized as a leader and innovator in central bank knowledge and service.

We have refined our vision to include the significance of innovation and leadership in the operation of this Bank. In last year's annual report, I said that to be leaders, we must be innovators. This message still holds true, since innovation is an important element in creating and sustaining a world-class institution.

Consistent with this vision, our Bank worked throughout the year on many new initiatives and contributed to a number of System projects. We have continued our work to consolidate our check processing business, and our Bank was chosen as one of four remaining check processing sites in the Federal Reserve System. We were selected to lead a major endeavor for the U.S. Treasury's collateral management and monitoring business. We also began the process of building a new off-site screening facility to ensure the safety and security of our Bank. In the pages that follow, you will learn additional details about these efforts.

Commitment and Credibility

This year's annual report also includes a new feature: an essay about the debate over rules versus discretion in monetary policymaking, which I co-authored with Vice President and Senior Economic Policy Advisor Michael Dotsey. This essay explores the benefits to the economy when monetary policy makes and fulfills promises to maintain low inflation. Rather than constraining policy, honoring such promises enables monetary policy to attain better economic outcomes than those achieved by a discretionary policy regime that does not make commitments and thus cannot anchor the public's expectations of future inflation.

2008: Philadelphia's Role on the FOMC

Federal Open Market Committee (FOMC) meetings involve intense deliberation and consensus-building on the part of all members. The analysis and viewpoints of each Committee member are influential and play a key role in monetary policy decisions. All voices matter.

But at the end of the meeting, there must be a vote on the proposed decision and the wording of the policy statement. While all seven Fed Governors vote at each meeting, only five of the 12 Reserve Bank presidents vote at a meeting. The president of the New York Fed is always a voting member, and the other Bank presidents vote on a rotating basis. The Philadelphia Fed is a voting member in 2008.

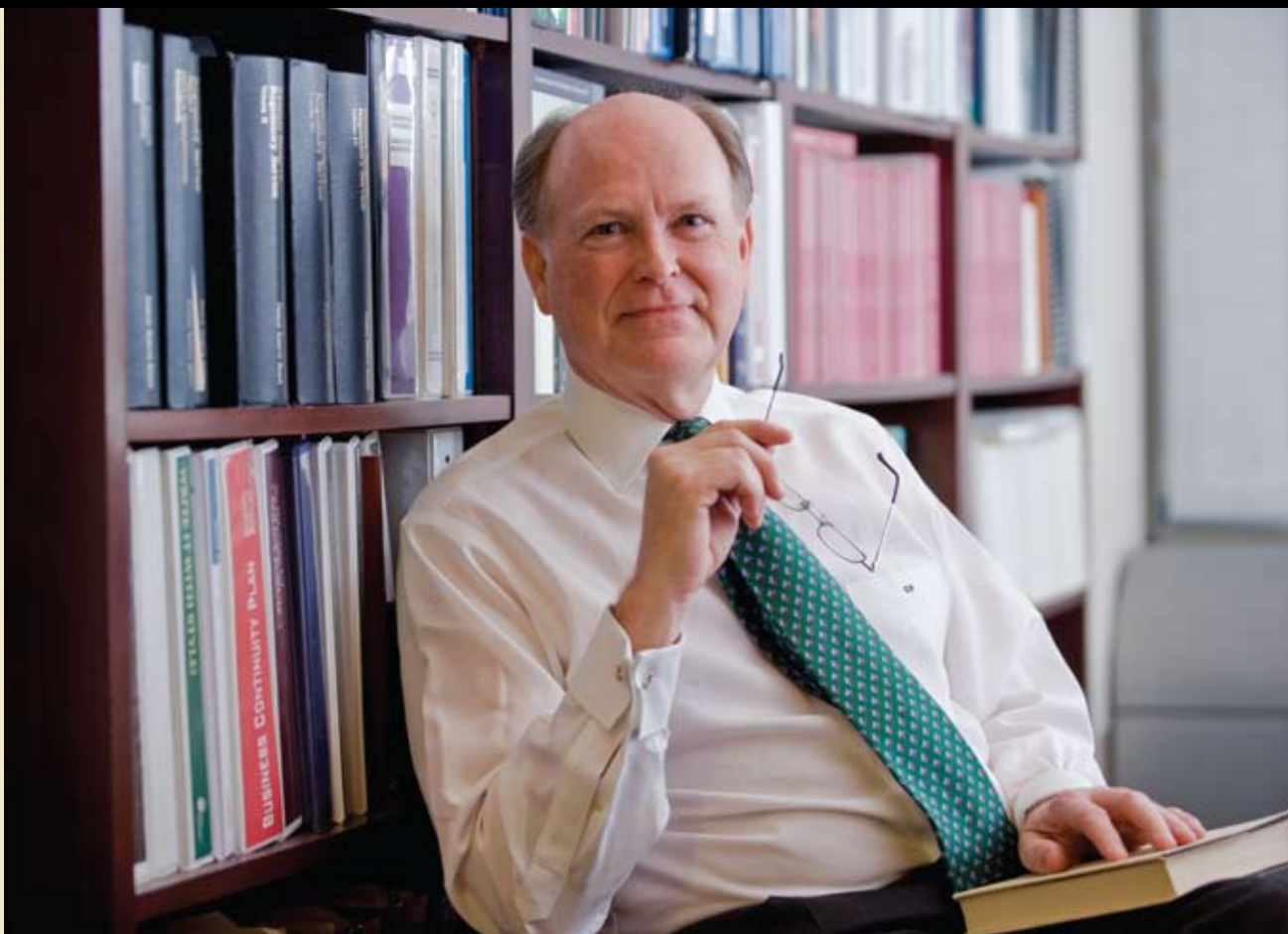
The Committee's ability to make thoughtful and sound policy choices is greatly strengthened by the interaction of members with different perspectives. I am fond of recounting the words of journalist Walter Lippman, who said, "Where all men think alike, no one thinks very much."

The Fed's decision last November to provide quarterly releases of information on the economic projections of the Fed presidents and Governors is a major step in providing a clearer picture of our deliberations. I see this as a very important step in making the central bank's decisions more transparent and the central bank more accountable, which is beneficial to the functioning of the economy.

Board of Directors

As always, the guidance and insight of our board of directors are invaluable to our Bank. We offer sincere gratitude to members of our board who have completed their terms of service: Doris Damm, president and CEO of ACCU Staffing Services; P. Coleman Townsend, Jr., chairman and CEO of Townsends, Inc.; and Wayne R. Weidner, chairman of National Penn Bank. Their counsel will be missed.

We are pleased to report that William F. Hecht, retired chairman, president, and CEO of PPL Corporation, has been appointed chairman of the board of directors, and Charles P. Pizzi, president and



CEO of Tasty Baking Company, has been appointed deputy chairman.

We welcome our newest board members and look forward to their contributions: Keith S. Campbell, chairman of Mannington Mills, Inc.; Ted Cecala, chairman and CEO of Wilmington Trust Corporation; and Jeremy Nowak, president and CEO of The Reinvestment Fund.

Thanks to Employees

Let me conclude by expressing sincere thanks to the dedicated employees of the Philadelphia Fed, who make our Bank's many successes possible.

We want to especially recognize our Retail Payments staff, who continue to do excellent work managing the evolution toward electronic payments. They have adapted admirably to the increased responsibility for servicing institutions as a result of the consolidation of Federal Reserve check operations. Also

deserving of our thanks are those in Cash Services, who have worked to meet the challenges of volume fluctuations with the implementation of pricing for cross-shipped currency. Finally, we appreciate the efforts of those involved in the planning for our new off-site screening facility, including our Facilities and Legal departments.

These employees — and all of our Philadelphia Fed employees — daily reaffirm our Bank's commitment to credibility and excellence.

Charles I. Plosser
President and CEO
April 2008

COMMITMENT VERSUS DISCRETION IN MONETARY POLICY

by Michael Dotsey and Charles I. Plosser

The late 1970s were arguably the nadir of post-World War II U.S. monetary policy. Accommodative monetary policy brought about rapidly rising inflation in an attempt to reduce unemployment. While the unemployment rate declined modestly, the cost was record-setting double-digit inflation. Then, between 1980 and 1984, the U.S. economy experienced two recessions in rapid succession and a number of what one prominent monetary economist has aptly called inflation scares.¹

In contrast, from 1990 through 2005, the U.S. economy experienced a period of relatively stable economic growth, low unemployment rates,

discretionary monetary policy and a lack of commitment to low inflation. In contrast, we believe that the subsequent improvement in economic outcomes is, in part, attributable to the Federal Open Market Committee's (FOMC) credibility for maintaining low inflation, which it acquired through its persistent actions to achieve and maintain low inflation beginning in the 1980s.²

The debate over rules versus discretion — that is, whether it is better for a policymaker to commit to a particular course of action or to approach each situation with unconstrained flexibility — has been and continues to be a central question in the design of monetary policy. In 1977,

two Nobel Prize-winning economists, Finn Kydland and Edward Prescott, wrote the seminal article analyzing the benefits of carrying out plans based on commitment to specific goals and the systematic and predictable actions necessary to achieve them, rather than relying on discretion. Since then, the benefits of com-

The debate over rules versus discretion — that is, whether it is better for a policymaker to commit to a particular course of action or to approach each situation with unconstrained flexibility — has been and continues to be a central question in the design of monetary policy.

and low to moderate inflation. The two recessions during this period were both mild and short-lived by historical standards.

This essay examines these contrasting episodes through the lens of commitment. In particular, we focus on the Federal Reserve's commitment to fulfilling its responsibility to maintain price stability. Our analysis places much of the responsibility for the poor economic outcomes in the 1970s on

commitment have been analyzed in many settings and in many economic models. These analyses have had a profound influence on the economic profession's views regarding the implementation of monetary policy and have shaped our views and policy prescriptions. The implications of these analyses is that the more the FOMC is perceived as a committed and credible planner — as opposed to a discretionary policymaker — the better will be both

policy and economic outcomes. Thus, we believe it is important that policy actions serve to protect and enhance the Fed's credibility.

We begin by revisiting the late 1970s and early 1980s. The lesson we draw from that experience is that the Fed was not committed to maintaining price stability or low and stable inflation, and that lack of commitment was a major factor contributing to the rapid rise in inflation and the economic consequences that followed. We then go on to discuss the role that commitment plays in enhancing the effectiveness of monetary policy and indicate how we think a credible commitment to low inflation has helped policymakers over the last 15 years. In closing, we highlight some of the implications of our analysis for appropriate monetary policy. We acknowledge that our views, while shared by many, are our own and that there is room for further analysis and debate. However, we believe it is useful and important to share our interpretation of both theory and practice as a contribution to that ongoing discussion.

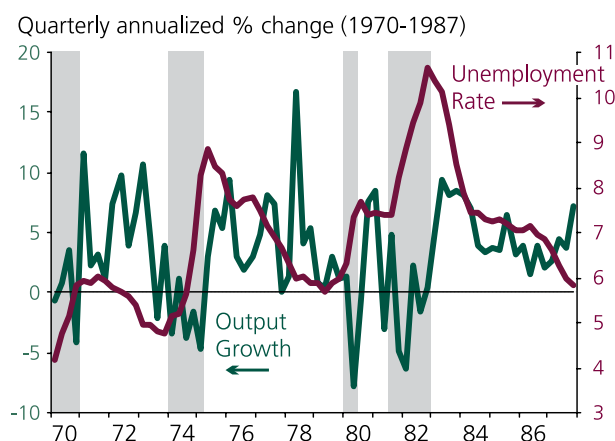
DISCRETIONARY POLICY IN THE 1970s AND ITS AFTERMATH

The oil-price shock of the early 1970s was

accompanied by double-digit inflation and high unemployment.³ However, by the end of 1976, inflation had fallen to about 5 percent, as measured by the consumer price index (CPI), and the unemployment rate stood at roughly 7.8 percent. The primary concern of monetary policymakers in this environment was to seek to reduce unemployment. The prevailing view was that with the high unemployment rate, there was ample excess capacity in the economy, so that the danger of exacerbating inflation through accommodative monetary policy was not a concern. This view was based on the Phillips curve, a theory that posited a negative relationship between inflation and unemployment.⁴ In conjunction with stimulus from fiscal policy, the goals of low unemployment and nonaccelerating inflation were thought to be readily attainable.⁵ As we can see from Figure 1, the unemployment rate (Panel A) declined modestly from 1976 through the end of 1979, but inflation, over that same period (Panel B), accelerated continuously, reaching 12.4 percent based on the CPI. Further, as shown in Figure 1, the Philadelphia Fed's Survey of Professional Forecasters indicated that expectations of inflation (Panel C), as measured by survey estimates of one-year-ahead increases in the gross domestic price

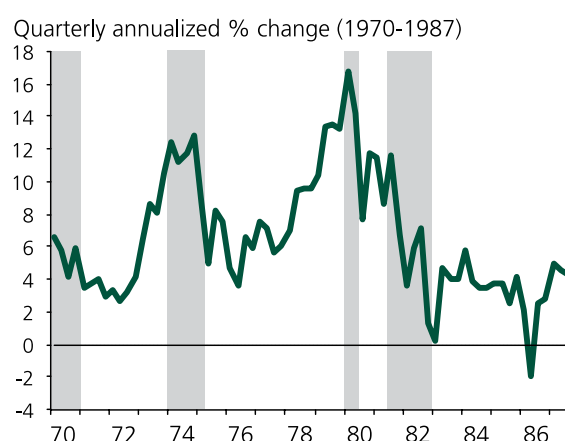
FIGURE 1

A: Output Growth and Unemployment Rate



Shaded areas indicate recessions.

B: CPI



deflator, accelerated and long-term bond rates (Panel D) moved up as well, with rates exceeding 10 percent near the end of 1979.⁶

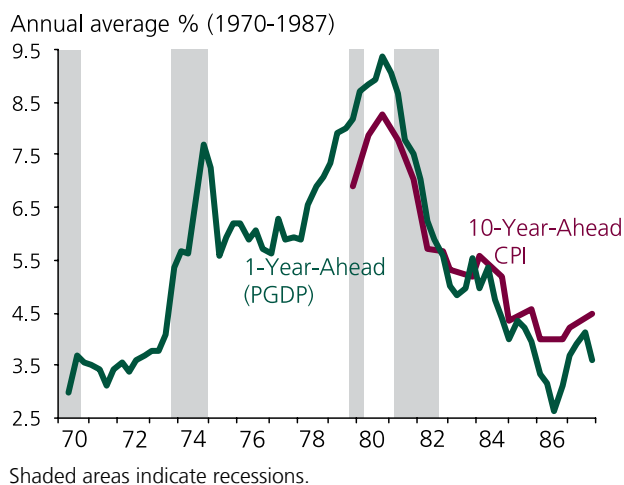
The overarching focus on managing the real economy is evident in Federal Reserve policy. Although the federal funds rate was raised from about 5 percent in 1976 to roughly 10 percent in the first half of 1979, it increased by less than the increase in inflation. Thus, the inflation-adjusted federal funds rate, or real fed funds rate, actually became negative, indicating that monetary policy was very accommodative and was not responding sufficiently to prevent the increase in inflation. Further, in achieving the decline in unemployment, monetary policy also fooled the public. Actual inflation turned out to be higher than the public expected in all but one quarter from the fourth quarter of 1976 to the fourth quarter of 1979.⁷ In what follows, we will show that such behavior is the hallmark of a discretionary policymaker.

When the second oil-price shock of the 1970s hit in the latter half of 1979, prices continued to rise. Paul Volcker was appointed Federal Reserve Chairman in August 1979, and the Fed began to aggressively raise the funds rate to bring down the double-digit

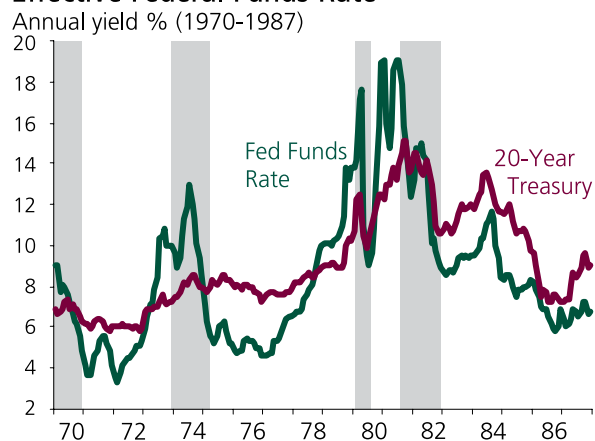
inflation. The economy officially went into recession in January 1980. Despite economic weakness, the primary concern of monetary policy remained focused on inflation as the federal funds rate rose from 10.9 percent in August 1979 to 17.6 percent by April 1980. These actions represented the most aggressive monetary policy in post-World War II history. Marvin Goodfriend attributes a significant portion of this tightening to the Fed's response to an inflation scare that occurred in the first quarter of 1980.⁸ In particular, with the funds rate hovering between 13 and 14 percent in early 1980, long-term interest rates increased roughly 2 percentage points in the first quarter of 1980. Most of this increase in the long-term bond rate was attributed to an increase in expected inflation. The Fed's response was an additional 3 percentage points of tightening in policy, which had little effect on the long-term bond rate, an indication that inflation expectations were finally beginning to decline. Generally, the theory of the term structure implies that an increase in the short-term interest rate is accompanied by an increase in the long-term rate as well. That the long-term rate did not move is an indication that inflation expectations were declining, and this decline in

FIGURE 1 Continued

C: Expected Inflation: SPF



D: 20-Year Treasury Bond and Effective Federal Funds Rate



inflation expectations is also evident in the behavior of the one-year-ahead inflation expectations depicted in Figure 1 (Panel C).

Despite these aggressive policy moves, inflation continued to increase, reaching 16.7 percent in the first quarter of 1980. At this point the economy weakened considerably and the U.S. experienced the deepest recession in postwar history with second-quarter real GDP declining by 7.8 percent at an annual rate. The severity of this decline was in large part due to the Carter administration's credit controls, but it nonetheless worried the FOMC.⁹ As a result, the Fed backed off its aggressive policy, reducing the funds rate from

over 17 percent to 9 percent by July 1980.

This aggressive easing over a mere three months was accompanied by a rise in long-term bond rates of over 2 percentage points in the second half of 1980, signaling another inflation scare. Again the Fed responded aggressively, raising the funds rate to 19.1 percent by January 1981 and holding it at very high levels through the summer of that year. This tightening once again threw the economy into recession. However, this time the Fed kept its resolve to reduce inflation. Inflation began to decline in the fall of 1981, and despite some ups and downs, the average inflation rate for 1983 was less than 4 percent.



Federal Reserve Board of Governors,
Eccles Building, Washington, D.C.

Interestingly, over this disinflationary period, one-year-ahead expectations of inflation systematically exceeded actual inflation as measured by the GDP deflator. Thus, the public remained dubious of the Federal Reserve's commitment to reducing inflation. This lack of credibility contributed to the loss of output that accompanied the reduction in inflation. Thus, the late 1970s and early 1980s should serve as a stern warning of the cost of low credibility.

COMMITMENT VERSUS DISCRETION

The late 1970s were a period in which monetary policy was not committed to maintaining price stability or low inflation, and we saw the damaging economic consequences that ensued from that lack of commitment. Why is such a commitment so important? Why does commitment yield better outcomes than discretion? After all, a discretionary policymaker can make the same decisions and choices as the committed policymaker at each point in time.

To understand why commitment dominates discretion, we must first define what we mean by commitment and how it differs from discretion. Commitment is the willingness and ability to make promises and to deliver on past promises no matter what the current situation is. However, it is very important to stress that under commitment, promised behavior is generally contingent on future events. Promises are not blanket commitments to be fulfilled irrespective of future situations. The key aspect of commitment is that the policymaker keeps his promise to act in a certain systematic way when a particular future event comes to pass. The absence of this willingness or ability is called discretion. Under discretion, a policymaker does not make promises about future behavior. Since the discretionary planner does not make commitments to behave in any particular way, it would appear that discretion offers more flexibility and thus would seem preferable to a policy in which the policymaker honors past promises.

The idea that it is better for a central bank to make commitments and to follow through on them, rather than being free to respond in any way



that seems appropriate at the time, is a subtle and perhaps surprising one. But not only are better long-run outcomes achieved under such commitments, monetary policy is also better able to respond to economic shocks. As we'll discuss later, a central bank that commits to a goal of maintaining low inflation and acts in a way consistent with that commitment can achieve the goal with no adverse consequences for employment or output. Moreover, such a policy can achieve less volatility in both inflation and output. Indeed, as we have already seen, the central bank's inability or unwillingness to commit to price stabil-

ity often leads to problems for policymakers and the economy.

The comparison of policymaking under discretion and under commitment is an analysis of two polar cases. It sidesteps the question of how a central bank can convince the public that it is operating in a manner consistent with commitment when the institutional setting places little restriction on future policies. For instance, the members of the FOMC change over time, as do the legislators who monitor the behavior of monetary policy. Full commitment requires tying the hands of future policymakers, and in reality, we don't even know who they will be.

Research analyzing ways that policy can come close to the ideal of full commitment has generally proceeded along two lines. One is institutional design. How does one set up institutions that will improve on discretionary outcomes? The other is the role of reputation and the credibility an institution can achieve by behaving like a committed planner over time. While of tremendous interest, investigations into these areas are beyond the scope of this essay. But we cannot hope to understand these more advanced investigations without first understanding the different nature of policy under commitment and under discretion.

Economists refer to the desire to alter previously made plans as the time-consistency problem because, at each date, a policymaker finds it tempting to depart from what an earlier plan dictated. The temptation to alter strategies affects how the public and market participants view a proposed plan, and it is the interaction between the public's expectations and the policymaker's decisions that leads to problems for a policymaker who cannot commit. Economics has many examples of the time-consistency problem, but we will confine our discussion to monetary policy.

BENEFITS OF COMMITMENT IN MONETARY POLICY

What are the economic benefits arising from a central bank's commitment to price stability? Let's analyze the benefits that commitment confers on average inflation and average output. A key ingredi-

ent in the analysis is the forward-looking behavior of individuals. In particular, many people's economic decisions today are affected by their expectations about the future course of monetary policy. As a result, the central bank faces a time-consistency problem. That is, it may be tempted to pursue policies that deliver temporary economic benefits that may be inconsistent with its longer-term goals. Realizing that a discretionary central bank will have the latitude to give in to this temptation, people will make decisions today based on the central bank's discretionary behavior and the result is sub-optimal economic outcomes.

To illustrate this point, we use a simple framework of how monetary policy works. One of the fundamental tenets of monetary theory is that in the long run, monetary policy cannot raise the level of output or employment. However, it is also widely believed that because of various rigidities in the economy, the monetary authority may face a short-term tradeoff. That is, by generating unexpectedly high inflation, the central bank may be able to temporarily boost employment and output. The late 1970s appear to represent

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just such an environment. As mentioned, from the fourth quarter of 1976 through the fourth quarter of 1979, expectations of future inflation were systematically lower than the inflation that ensued, indicating that the public did not anticipate the rapid increase in inflation. As a consequence, output and employment were temporarily increased.

Similarly, unexpectedly low inflation may temporarily reduce output and employment. This is consistent with the situation in the early 1980s. As monetary

policy tightened, the public experienced an unanticipated decline in inflation, output and employment declined, and the economy suffered two recessions.

Economic analysis tells us that as long as the prospect of exploiting this short-term tradeoff exists, a central bank conducting discretionary monetary policy will not be able to achieve its desired or preferred rate of inflation. Only under commitment can the monetary policymaker deliver on its desired inflation rate.

To see why, imagine that the monetary authority announces that it is going to maintain an average inflation rate at some desired level. We could

fare will be thwarted by the behavior of individuals, who will eventually catch on to what the policymaker is doing, and he will end up producing more inflation with no sustained increase in output or employment.

If, however, individuals immediately recognize the temptation facing the policymaker, they will accurately anticipate the higher inflation and not even a temporary increase in output will be possible. All that will ensue is higher inflation. Either way, higher inflation with little or no economic gain will occur, and this type of behavior has emerged many times in many countries. Generally, the process ends with a change

in monetary regime, and a policy designed to reduce inflation is put in place.

However, at this point, implementing the new policy of reducing inflation poses a problem. It is generally not credible; the public is dubious that the new policy will be carried out. Thus, to re-establish the desired inflation rate, the policymaker must generate unexpectedly low inflation,

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think of this as the economy's optimal rate of inflation, but it need not be, nor is it important for our purposes what that rate is.¹⁰ If policy successfully maintains this desired inflation rate, output would grow at its efficient rate.¹¹

But a discretionary policymaker will be tempted to generate a bit more output in the short run by unexpectedly increasing inflation. If it takes time for the public to catch on, the policymaker will initially be successful. However, once the higher inflation rate associated with this strategy is recognized, the public will revise upward its expectations of future inflation and push wages and prices up. At that point, the output boost will vanish. The policymaker might be tempted to try the same experiment again, but it will generate the same outcome — a temporary boost in output followed by higher inflation. Thus, the policymaker's attempt to permanently increase public wel-

risking a temporary decline in output and employment and perhaps a painful recession. This seems to be the story of the early 1980s. If the policymaker decides against such action, the economy is stuck with a permanently higher inflation rate than it desires. Thus, discretionary monetary policy fails to deliver on the desired objective and places significant subsequent costs on the economy.

Now consider the outcomes if the monetary authority could credibly commit itself, in some way, to delivering the desired inflation rate that it had announced. With such a credible commitment, the public would expect the central bank to maintain inflation at the announced desired rate. There would be no policy-generated surprises to inflation that would move output and employment and so the economy would grow efficiently. So a monetary authority that could commit to its desired inflation policy would out-



FOMC Meeting at the Federal Reserve Board, Washington, D.C.

perform a monetary authority that is free to exercise discretion — that is, it would deliver the same output growth, but lower inflation.

Many people find this result counterintuitive. But we can see the importance of commitment in everyday life. Almost all of us at one time or another have said that we would like to lose weight. We know that we would be healthier and happier by doing so. Yet most of us at some point make choices inconsistent with those desirable goals. We eat that piece of cake sitting in the refrigerator, or we eat too much at our favorite restaurant. We receive some short-run enjoyment from this behavior, even though we know it is not compatible with our long-term goal to lose weight. Pretty soon the diet is abandoned. Having the discretion to yield to temptation does not yield the

desired outcome. We would be better off if we could figure out some way to commit to eating in a way that is consistent with our goal. People often look for ways to help them pre-commit to staying on their diet. For example, they go to the grocery store and buy only food that is on the diet, so they won't be tempted to snack. Some will make commitments to their spouse or friend to form some kind of mutual support group that makes it harder to deviate from the diet.

People often think that keeping monetary policy from deviating from a desired inflation goal is like tying the policymakers' hands and that doing so must yield worse outcomes. Yet, as in the case of the dieter who benefits from the ability to commit to sticking with a diet, commitment in fact results in better outcomes.

The above examples make clear the long-run benefits of commitment and of devising institutional arrangements that prevent the central bank from using discretionary policy. Some economists have argued, for example, that the gold standard was such an arrangement. Currently, there is a good deal of interest in whether explicit forms of inflation targeting help to achieve the better outcomes associated with commitment.¹²

THE RESPONSE TO SHOCKS UNDER COMMITMENT AND DISCRETION

The desire to respond to economic shocks, such as sharp oil-price increases or changes in productivity, so as to limit their effects on economic volatility is one of the most difficult challenges confronting central banks. It is this aspect of monetary policy that most often elicits arguments extolling the importance and benefits of discretion. Those in favor of discretion argue that monetary policymakers must be allowed a free hand to respond in a flexible way to each situation as it arises and not be constrained by prior commitments or goals. Discretion, it is argued, is needed to adequately guide the economy through turbulent times.

However, the notion that commitment to behave in a systematic manner unduly constrains the policymaker from reacting in the best way to economic shocks is intuitively appealing but is actually mistaken. The ability to make commitments and to keep them anchors expectations, which allows a central bank operating under a policy of commitment to take actions and achieve outcomes that the discretionary planner cannot. In fact, a policy under commitment can achieve all of the outcomes of a policy under discretion and can also achieve outcomes unobtainable under discretion. The committed policymaker cannot do worse than the discretionary policymaker.¹³

Although policymaking that achieves perfect commitment is the ideal, we acknowledge that it is a bit unrealistic to expect that it will be achieved.

However, when a policymaker can commit to follow through on promised actions, he can influence the public's expectations in a desirable way. People generally make plans for the future. Firms deciding on whether to expand or contract capacity think about future demand. Consumers buying cars or houses take into account their future income prospects. Thus, expectations of the future affect the current actions of households and businesses. Expectations of how policymakers will behave in the future can have an important impact on future economic conditions and thus on current behavior. As a result, influencing expectations can be a powerful policy tool. The discretionary policymaker makes decisions period by period, makes no promises regarding future behavior, and, as a result, cannot shape the public's expectations. By making well-designed promises about the goals of policy and the way policy will respond to the environment, a committed policymaker can influence expectations in ways that elicit better economic outcomes.

However, it is not just about making commitments. Along with these promises comes the constraint to honor them in the future and also to honor past promises today. In this sense, the committed policymaker is not free to base today's policy only on

The policymaker is not free to manipulate the public's expectations – rather he must act in a way consistent with previous, current, and future commitments.

current economic conditions; he must also take account of what was promised in the past. Those promises depended on the economic situation at the time they were made and imply that the policy committed to depends on history as well as current circumstances. Put another way, the policymaker is not free to manipulate the public's expectations — rather he must act in a way consistent with previous, current, and future commitments.

But having policy constrained in this way should not be viewed as a negative attribute of commitment. These constraints, if designed appropriately, can actually lead to better outcomes through their influence on expectations that allow for better economic decisions. Moreover, this result holds true in a variety of models that economists now use to characterize the macroeconomy.¹⁴ Research has shown that in a range of environments, a central bank that is committed to price stability, or low and stable inflation, has an easier time dealing with economic shocks.

For example, consider a positive shock to the inflation rate. Responding to this unexpected shock, a committed policymaker can achieve a better outcome: less inflation as a result of the shock with less variability in output while, at the same time, acting less aggressively. Thus, economic welfare is unambiguously higher under commitment than under discretion.

What makes it possible for the policymaker to accomplish this? The answer is that expectations of

future inflation affect current inflation. When policymakers make a commitment to keep inflation low and stand behind that commitment, individuals take into account the policymaker's promise to keep inflation down and to not exploit the output gains arising from an unexpected increase in inflation. As a result, expectations about inflation are stable or well-anchored and thus do not increase as much under commitment, implying that firms do not raise their current prices as aggressively as they would in an environment where expectations are not well-anchored, as would be the case when policymakers act with discretion. The stability of inflation expectations under commitment implies that policy does not have to be as aggressive in order to bring down inflation, and as a result, output does not have to decline by as much. Contrary to intuition, the constraint of abiding by past promises actually allows the committed policymaker to achieve superior economic outcomes for both inflation and output in response to economic shocks.



AN EXAMPLE: OIL-PRICE SHOCKS

To make our point a bit more concrete, we will contrast two episodes, both involving oil-price shocks. Although we cannot give definitive proof for the following argument, one can view the differential economic impact of oil-price shocks in the late 1970s and 2000s through the lens of commitment.^{15, 16} As we have already seen, in the first instance the Fed lacked credibility for maintaining low inflation. In contrast, we will argue that by the early years of the new century, the Fed had achieved greater credibility with the public that it would act to maintain low inflation. Economists' theoretical and empirical investigations suggest that the effects of the oil-price shocks on economic activity and inflation will be different under these two settings. In fact, they were quite different.

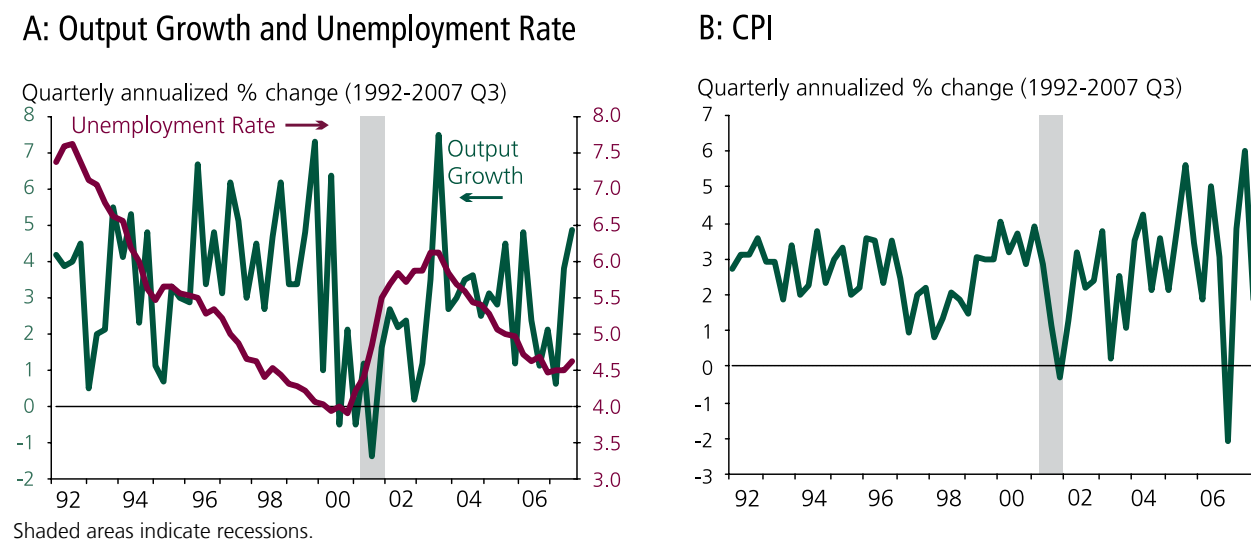
Recall that by the time the oil-price shock of 1979 hit, more than doubling oil prices over the course of the year, inflation had already reached 9 percent. As we discussed, these historically high inflation rates were caused by overly easy monetary policy. Moreover, the Federal Reserve had, by the time of the oil shock, lost any credibility it may have had for maintaining low inflation. The rise in oil prices further

ignited inflationary pressures, and the Fed was put in the situation of ratifying the higher expected inflation or trying to contain inflation with a potentially large loss of output. Lacking credibility, the Fed also lacked the public's confidence that it would keep inflation low; therefore, the public placed significant weight on the former scenario, and by the first quarter of 1980, inflation had increased to more than 15 percent. Eventually the Fed did rein in inflation, and our previous account of this episode described the economic pain that ensued. It was a painful price to pay for the lack of credibility, but it eventually helped the Fed to earn a more believable reputation for maintaining low inflation.

Indeed, throughout the remainder of the 1980s and 1990s, the Fed continued to act in a way that reinforced and enhanced its new credible commitment to price stability. The benefits of that hard-won reputation bore fruit in the face of the renewed round of oil-price increases in the current decade, which saw the price of oil more than double from the end of 2003 to the end of 2005. During this period, inflation remained contained without any significant adverse effect on output.

The main difference, we believe, between the

FIGURE 2



experience of the late 1970s and early 1980s and the period from 2003 through 2005 is the credibility that the Federal Reserve enjoyed in the latter period for maintaining low and stable inflation. This credibility is illustrated by the stability of various measures of inflation expectations during the period. For example, the 10-year expected inflation rate in the Survey of Professional Forecasters hardly moved over this period (Figure 2, Panel C) and expected inflation, as represented by the difference between the yield on 10-year nominal and inflation-indexed Treasury bonds, remained quite stable. In sum, as shown in Figure 2, the oil-price shock of 2003-2005 had very little impact on inflation expectations (Panel C), and as a result, there has been no need for exceedingly aggressive monetary policy actions. In turn, there was very little impact on output (Panel A).

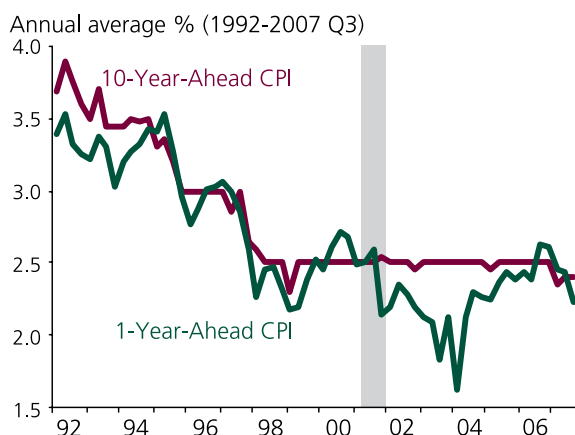
SUMMARY

This essay has explored the benefits of policy under commitment versus under discretion. In particular, it has highlighted the added benefits policymakers and the economy derive from making and fulfilling past promises to keep inflation low and stable. Rather than constraining policy, honoring such past promises

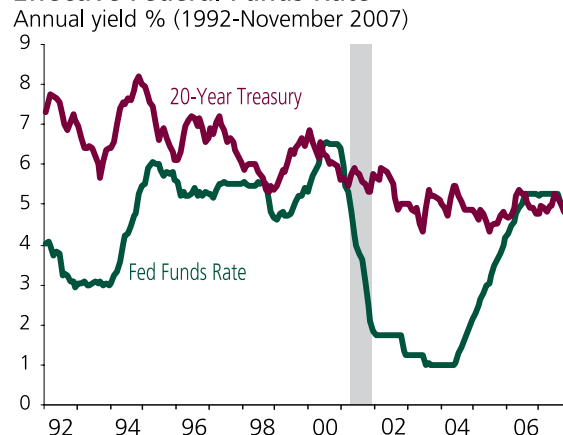
enables monetary policy to attain better outcomes than those achieved by a discretionary policy regime that does not make commitments and thus cannot anchor expectations. Committed policy generates lower long-run inflation without any adverse effects on economic activity and ameliorates the effects of economic shocks.

In practice, achieving and maintaining the credibility of the Fed's commitment to low inflation is not easy or straightforward. The credibility the Fed achieved in the 1980s and 1990s was due, in no small part, to the leadership of Fed Chairmen Paul Volcker and Alan Greenspan. They frequently spoke about the importance of maintaining the central bank's commitment to low and stable inflation, as has Chairman Ben Bernanke in this decade. The benefits of following a committed plan to maintain low inflation are now so entrenched in policy-making circles that most central banks aggressively strive to maintain their credibility. They are constantly aware of the dangers of inflation expectations becoming unanchored and the loss of credibility that represents. Such a loss of credibility would pose grave problems for monetary policymakers because it puts the achievement of their dual mandate at risk and must be avoided.

C: Expected Inflation: SPF



D: 20-Year Treasury Bond and Effective Federal Funds Rate



ENDNOTES

¹ See the article by Marvin Goodfriend.

² For a discussion of the benefits of low and stable inflation, see the article by Anthony Santomero.

³ Economists use the term shock to refer to unanticipated changes in economic variables.

⁴ For an interesting and readable discussion of the theory of the Phillips curve, see the Richmond Fed's annual report essay by Jeffrey Lacker and John Weinberg.

⁵ For a detailed discussion of the politics and deliberations surrounding Fed policy, see the article by Robert Hetzel.

⁶ The one-year-ahead expected inflation measures come from the SPF data series. Prior to the third quarter of 1981, inflation expectations were collected only in terms of the GDP deflator. Ten-year-ahead expectations for the SPF began in the fourth quarter of 1991. Prior to that, they were taken from the Blue Chip Consensus forecasts.

⁷ The difference between actual and expected inflation is calculated using actual one-year-ahead inflation rates as measured by increases in the gross domestic price deflator minus the corresponding expectation of inflation.

⁸ Marvin Goodfriend defines an inflation scare as a significant rise in long-term interest rates in the absence of a rise in the federal funds rate. Thus, the rise in long-term rates is interpreted as mostly a rise in long-run inflation expectations. Goodfriend's account of the disinflation and inflation scares that plagued monetary policy even after the successful disinflation is fascinating reading for anyone interested in the consequences that low central bank credibility for maintaining low inflation has on the evolution of policy.

⁹ See the article by Stacey Schreft for a detailed analysis of the Carter administration's credit control program.

¹⁰ Depending on one's view of the structure of the economy, the optimal rate could be slightly negative, zero, or even perhaps slightly positive.

¹¹ By efficient growth we mean the rate of growth at which the economy is optimally employing resources conditional on the economic shocks occurring at the time. Thus, an economy that experienced a rapid increase in new technologies would grow faster than one that was subject to less technological innovation, and it would also use productive resources more intensely. In the absence of any economic shocks, the economy would grow at its long-term trend.

¹² For a survey of inflation targeting and its effects, see the 2006 article by Michael Dotsey.

¹³ For a more formal exposition, see the article by Richard Clarida, Jordi Gali, and Mark Gertler and the forthcoming article by Michael Dotsey.

¹⁴ See the article by Clarida, Gali, and Gertler and Dotsey's forthcoming article for examples.

¹⁵ Recent evidence outlined in the article by Sylvain Leduc, Keith Sill, and Tom Stark is consistent with the interpretation of events described here.

¹⁶ There are many other documented episodes. Some are discussed in the speech by Charles Plosser, and the history of inflation scares is documented in the article by Marvin Goodfriend. Also, for a more detailed analysis of appropriate monetary policy in the face of shocks to oil prices, see the article by Sylvain Leduc and Keith Sill.

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by William H. Stone, Jr., First Vice President

Restructuring Checks

As most of you know, paper checks continue to give way to electronic payment methods. A recent Federal Reserve study shows that two-thirds of all payments in the United States are made electronically. This evolution has significant implications for the Fed's check processing infrastructure. As consumers and businesses continue the steady shift from paper to electronics, the Federal Reserve has responded by consolidating its check processing businesses.

This restructuring is part of the evolutionary process as check volumes decline. It allows us to fulfill our traditional role of payments processor while maintaining efficiency in this new environment. Having fewer Reserve Bank locations in the check business continues to bring about substantial cost savings.

The Philadelphia Fed is one of four regional check processing sites that will provide a full range of check processing services through at least mid-2011. Philadelphia, along with the Cleveland, Atlanta, and Dallas Reserve Banks, was selected based on perfor-

a changing industry environment, Federal Reserve cash processing services have become more efficient and effective than ever before.

Our new currency recirculation policy represents a significant shift in the dynamic between depository institutions and the Fed and is expected to have a significant impact on operating policies at depository institutions that handle large volumes of currency. These institutions are moving away from traditional currency activity toward greater reliance on Reserve Bank cash processing. The primary reason for this behavioral change was depository institutions' desire to reduce the dollar value of currency on their books, since cash is a nonearning asset and many banks hold more cash than they need to meet reserve requirements.

Under the new currency recirculation policy, the Federal Reserve expects depository institutions to recirculate to their customers fit currency deposited with them and to deposit only excess or unfit currency with Federal Reserve Banks. To promote this policy, we have implemented a custodial inventory program, which will permit depository institutions to transfer a percentage of the \$10 and \$20 notes in their vaults to the Fed's books. In addition, the Federal Reserve's Cash Services began billing for additional handling and processing of currency deposited and withdrawn from the Federal Reserve in the same week. This program will allow the institutions to reduce the size and frequency of their deposits of currency and orders from the Reserve Banks. For our part, we will continue to meet the needs of our cash customers while avoiding the unnecessary handling of currency.

The Philadelphia Fed will continue to develop new and better ways to improve its work and build its capabilities.

mance, market conditions, and geographic location.

We have a long history of strong performance in payments processing. While the restructuring of our check operations will continue to present challenges, we are confident that our Bank is up to the task. Our Retail Payments staff is dedicated, experienced, and innovative, and we will continue to support our customers' needs. As always, we are fully committed to the Federal Reserve's mission to promote the efficiency and integrity of our nation's payments system.

Changing Cash Services

Like our checks business, our cash business has also been undergoing an evolution. In response to

Working with the Treasury

Because of Philadelphia's already successful and long-standing working relationship with the U.S. Treasury as well as our well-known expertise in managing collateral, the Philadelphia Fed has been chosen to head the Treasury's collateral management and monitoring business. This effort is part of the Treasury's Collections and Cash Management Modernization (CCMM) project — a key element of structural change in the way the Treasury does business. The Bank will develop a new application to handle collateral monitoring for new investment options and existing Treasury collateral programs.

For many years, our talented and experienced staff has supported the delivery of collateral, credit risk management, and monitoring activities, and we're now excited for the opportunity to be part of this effort.

In addition to leading the collateral management and monitoring business for the Treasury, the Bank will be responsible for developing a new collateral application that will provide external access to financial institutions, agencies, and the Treasury and will support new Treasury investment options. Philadelphia will also play an instrumental role in analyzing guidelines for collateral eligibility and valuation methods.



William H. Stone, Jr.

Enhancing Security

The strength of the financial system depends on the effectiveness of the Federal Reserve System. Accordingly, the Philadelphia Fed works hard to create sound contingency plans. Our safeguards ensure there will be no disruptions to America's payments system. Over the past several years, our nation has been required to react to a number of threats, including terrorism, natural disasters, and financial crises. This has led us to review our response procedures as well as to increase our information security to prevent the likelihood of a cyber attack.

As part of our preparedness, we started thinking harder about security — an issue that has always been of the utmost importance to the Fed. As the central bank, the Fed must make certain that people feel secure. This includes our customers' security about business continuity as well as our employees' assurance of physical security at work. Our customers and the public at large must be confident in the Fed's ability to supply liquidity and maintain a sound financial system. Our employees' safety ensures they will be able to perform their jobs, which, in many of our busi-

ness units, are critical to a smoothly functioning payments system.

In our ongoing efforts to enhance our Bank's physical security, we have increased training and resources for our federal law enforcement officers. We are also in the process of building an off-site screening facility on a 31,500-square-foot parcel of land located directly across from the Bank's 7th Street entrance. Equipped with state-of-the-art technology, this facility will allow us to identify and mitigate potential threats a safe distance from the main Bank building.

Strength Through Change

The changing environment within the financial services industry challenges us to be continually innovative, to strengthen our processes, and to prove our technical and project management skills.

In 2008 and beyond, the Philadelphia Fed will continue to develop new and better ways to improve its work and build its capabilities. Through change, we've continued to show strong performance and strong customer service. We have proven we can adapt to change and grow stronger in the process.

PHILADELPHIA MAKES THE FINAL FOUR

Philadelphia emerged as a key player when it was chosen as one of four Federal Reserve Banks that will continue to provide full-service check processing for the country's commercial banks until at least mid-2011. Philadelphia's long-term leadership in processing paper checks — and, more recently, electronic images — gave it a clear advantage as the Federal Reserve System was evaluating Reserve Banks that met the criteria to continue full-service operations.

"Our high performance paid off in terms of customer service, efficiency, products, and innovation," said Arun Jain, vice president of the Philadelphia Fed's Retail Payments Department. The Cleveland, Atlanta, and Dallas Reserve Banks were also selected as full-service check locations in June 2007 based on their performance ratings, market conditions, and location.

The Fed's latest check consolidation announcement is part of a multi-year strategy to manage check processing capacity with declining check volumes. Consumers and businesses are writing fewer paper checks and using credit and debit cards more, circumstances that have led the Fed to reduce its check processing sites from 45 to 19 since 2003. This transition to electronic collection of paper checks allows paper checks to be collected more efficiently with fewer geographically dispersed offices. The Fed's underlying goal is to meet its statutory requirements for long-term cost recovery while still providing the best possible check collection service for the nation.

Each of the four full-service regional sites will be somewhat similar in size and will have the flexibility to accommodate additional processing to absorb closing offices' volume without increasing staff or adding equipment. These four offices will process paper checks and electronic images, print substitute checks,

and provide reconciliation and settlement services. Other Federal Reserve check sites that have closed or will close their full-scale operations will most likely retain limited service capacities depending on market demand.

Our Bank's primary strengths in meeting this challenge will be the experience, dedication, and in-

"Philadelphia has long been recognized as a leader, and we are doing everything we can to continue to be a top service provider. We are striving to achieve the ultimate status as the sole check site when that day comes."

novativeness of its staff. "Philadelphia has long been recognized as a leader, and we are doing everything we can to continue to be a top service provider. We are striving to achieve the ultimate status as the sole check site when that day comes," Jain said.

But for now, Philadelphia will assume check processing for sites in New York, Connecticut, and Maryland in consolidations planned through 2009. The transition to a regional site began in 2006 when the Bank began processing checks for FRB New York's main operations center and continued in early 2008 with the consolidation of its Utica, N.Y., office. "We are incorporating the lessons learned from the consolidation of the New York Federal Reserve's East Rutherford Operations Center (EROC) in 2006. EROC was a huge undertaking that resulted in a 60 percent increase in check volumes," Jain said. But unlike with EROC, the workload for Utica's consolidation will add roughly 10 percent more volume and will not require additional staff or equipment.

Later this year, most of Philadelphia's check adjustments function will move to one of the three other regional adjustment sites. As a result, staffing in

the adjustments area will be slightly reduced, but the Bank will handle the reductions through attrition and employee reassignments. Jain explained, "We took steps during hiring for EROC to manage our staff so there would be as few job reassignments as possible."

The Philadelphia Fed has kept its employees and its customers aware of how changes in the Fed's operations will affect them. "We have been aggressively promoting electronic payments to consumers and banks to foster a more efficient system," Jain said. The Fed was a supporter of a law commonly known as Check 21 that encourages the use of electronically transmitted check images to increase efficiency. The law, which went into effect in 2004, allowed banks to use substitute checks created from original paper checks as the legal equivalent, with the ultimate objective of achieving end-to-end electronification of the paper check.

Financial institutions are moving toward depositing transactions electronically because it's fast and efficient and can reduce certain errors. The Fed reports that over 50 percent of check deposits are sent electronically. However, only about 30 percent of check presentments are made electronically. The Fed prints substitute paper checks for institutions that do not yet receive payments electronically.

There is no telling when the balance of banks

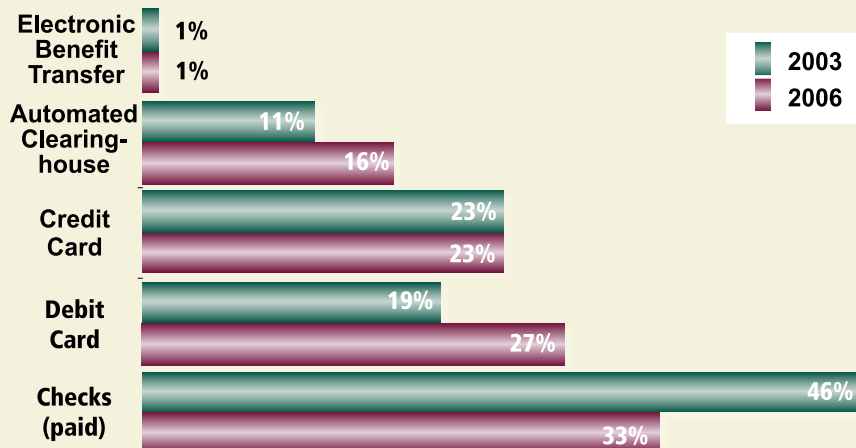


will adopt electronic collection methods, but the Fed is seeing an acceleration in the adoption of electronic receipt. Research shows that improved costs and convenience are driving businesses and consumers to electronic payments. In fact, a 2007 study by the Federal Reserve showed that two-thirds of all noncash payments in the United States are made electronically and that these payments grew 12.4 percent per year from 2003 to 2006. Around 62.7 billion electronic payments were made, totaling \$34.1 trillion in value. "Checks are continuing to decline at an even faster pace than we saw two or three years ago," Jain said. However, even though electronic payments comprise

more than two-thirds of all noncash payments by number, they represent less than half by value. Checks still have considerable volume. In 2006, 30.6 billion checks were paid, with a value of \$41.7 trillion.

The Federal Reserve remains committed to providing high-quality check processing and aligning its services with market demands. The Fed will continue to research trends and review its own check processing services each year to promote the long-term integrity, efficiency, and accessibility of our nation's evolving payments system.

DISTRIBUTION OF THE NUMBER OF NONCASH PAYMENTS



Source: The 2007 Federal Reserve Payments Study: Noncash Payment Trends in the United States: 2003-2006

TREASURY TAPS PHILADELPHIA'S EXPERTISE AGAIN

In 2006, the Treasury's Financial Management Service (FMS) office announced that it was embarking on a comprehensive, multi-year effort to streamline, modernize, and improve the processes and systems supporting Treasury's collections and cash management programs. This new project is the Collections and Cash Management Modernization (CCMM) initiative.

In June 2007, Treasury Secretary Henry M. Paulson, Jr., stated that "to maintain our capital markets' leadership, we need a modern regulatory structure complemented by market leaders embracing best practices. The steps we are announcing today will help to strengthen our global competitiveness." One of those steps includes the modernization of Treasury's cash and debt management. The department will strengthen the U.S. government's cash and debt management systems

through a broad series of public initiatives, further improving the efficiency, integrity, transparency, and competitiveness of the U.S. Treasury market.

Also in June 2007, the Treasury chose the Federal Reserve Bank of Philadelphia to lead its collateral management and monitoring business line. Being chosen to lead this project was not a matter of chance. The Philadelphia Fed's First Vice President, Bill Stone, said, "Our Bank was selected to lead the Treasury's collateral management and monitoring business because of the talented and experienced staff in Philadelphia, who, for many years, have supported the delivery of collateral, credit risk management, and monitoring activities."

Background

In 2003, the Subcommittee on Credit Risk

Management asked the Federal Reserve Bank of Philadelphia to help streamline and modernize the Reserve Banks' collateral management system. Completed in 2006, that project entailed converting a complex centralized system to a web-based portal platform that paved the way for portal technology to be implemented throughout the Federal Reserve System. That effort resulted in the new Collateral Management System (CMS), which administers the collateral that financial institutions post when they borrow from the Fed and values collateral held on behalf of the Treasury.

The Bank's management took a significant step on behalf of the credit risk management community when it began to develop the CMS using portal technology, an application that had never before been used by the Federal



Pictured left to right (seated): Marie Tkaczyk, Assistant Vice President, and John Ackley, Assistant Vice President; (standing): Bob Mucerino, Collateral Management National Support Service Manager; Wendy Fasbinder, Project Manager; and Chris DeYoung, Group Manager, Systems Development.

Reserve at the national level. In July 2006, the CMS team successfully completed the project that upgraded and modernized the system. The project team's design meets the needs not only of the Fed but also of certain collateral programs for the U.S. Treasury.

The CMS staff, in partnership with an experienced development staff, maintains the software application that allows Federal Reserve Banks to calculate

The Bank will be responsible for developing a new collateral application that will provide external access to financial institutions, agencies, and the Treasury and support new Treasury investment options.

accurate collateral values for assets financial institutions pledge as collateral when they borrow from the Federal Reserve and assets pledged for Treasury collateral programs. Just as those who get loans for a house may put up collateral as security for the money they borrow, banks must also supply collateral for money borrowed from the Federal Reserve Banks. Collateral valuation methodologies are based, in part, on current market prices for these assets and a complex set of algorithms using characteristics of securities such as interest rates, time to maturity, duration, and asset quality. Since asset values can also change depending on area conditions, CMS also allows Reserve Banks to adjust values based on geographic conditions. The Federal Reserve System holds collateral with a current value of \$1.34 trillion.

The New Business

This successful completion of the CMS project, combined with the Bank's well-known expertise in managing collateral, resulted in the Philadelphia Fed's expanded responsibility as the leader of the Treasury's collateral management and monitoring business, which is part of the CCMM initiative. In a letter to First Vice President Bill Stone announcing the decision, then FMS Commissioner Kenneth Papaj said that after

evaluating a number of other Reserve Banks, "we felt that the Philadelphia Reserve Bank was the best, most highly qualified candidate."

The Philadelphia Fed will be modernizing the Treasury's collateral management and monitoring business line. The Bank will be responsible for developing a new collateral application that will provide external access to financial institutions, agencies, and the

Treasury and support new Treasury investment options. Furthermore, Philadelphia will play an integral role in analyzing guidelines for collateral eligibility and valuation methods.

Although this particular aspect of the Treasury's program is new to Philadelphia, the business line is really an extension of work that the

Bank has been doing for quite some time, dating back to the 1980s. At that time, the Philadelphia Fed managed the largest customer safekeeping service in the Federal Reserve System. In the 1990s, the Bank developed a PC-based local area network application to update older mainframe technology. And, of course, for the new project, the Bank can also call on its experience in developing the CMS.

The collateral management and monitoring project is still in the early stages. "Right now," says Assistant Vice President John Ackley, "we're in fact-gathering mode in partnership with FMS staff. We need to identify current processes, what the Treasury, federal agencies, and financial institutions want to enhance, and what current and new investment options the Treasury is planning. Then we'll define our project plan accordingly. We're also studying the Treasury's project management and development methodologies."

To support the new business line, the Bank will also add an operations group to handle day-to-day collateral management and monitoring functions and will establish a Central Business Administration Function (CBAF). The CBAF will direct program changes, test and implement enhancements, oversee and test software and hardware upgrades, and monitor system performance.

SCREENING FACILITY WILL DELIVER INCREASED SECURITY

The Federal Reserve Bank of Philadelphia is designing a sophisticated screening facility to conduct more vigilant inspections of vehicles off-site, which will deliver better protection for employees and increased security for the Bank. Construction is expected to get underway this spring to transform the former parking lot across from the Bank's Seventh Street entrance into a 6,300-square-foot screening annex. The project is expected to be completed in 2009.

Plans call for the screening site to employ the most advanced technology and highly trained employees to identify and mitigate potential threats, such as explosives lurking in the largest pallets or hazardous chemicals hiding in the smallest parcels. When the new building opens, the Bank's law enforcement officers will be able to scrutinize every vehicle, from armored cash carriers to ordinary office supply trucks, in a more controlled environment and at a safer distance from the building. It is a tremendous responsibility that involves inspecting about 7,000 to 10,000 vehicles each year.

"In today's security-conscious world, we must look for everything from explosives to powders to biological agents. Our job is to deter potential threats and minimize risks. The off-site screening facility is a very significant step in making the whole building safer," said James Welch,

assistant vice president of the Bank's Law Enforcement Department.

The Federal Reserve began enhancing its security after the 9/11 terrorist attacks and has continued to boost its controls. "We are a guardian of the country's banking and payments system, and we will diligently carry out our responsibilities. We value our employees, and we work hard to both keep them safe and ensure that they feel safe," said Welch. The Bank's security measures have obviously made an impression on employees: According to a recent Bank survey, 89 percent of employees feel that the Bank is a safe and secure place to work.

"We are satisfying all of the most important physical requirements for a safer, more secure building," said Richard A. Elliott, vice president of Facilities Management, Records, and Document Services, who is overseeing the project. Before he



Architect's rendering of the new screening facility

joined the Philadelphia Fed in 2004, Elliott was part of the team charged with building a security command center at the Federal Reserve Board of Governors in Washington, D.C. He emphasized the importance of using more sophisticated technology to identify potential threats.

Technology coupled with a well-trained staff has become an integral part of the Bank's expanding security program. "As we use more sophisticated detection equipment, we need more thorough training. It is more complicated than standing at a post," Welch explained. Just how many employees will be needed to handle all of the various deliveries — ranging from check pallets to cafeteria food — is being carefully studied.

The off-site screening structure's design calls for brighter lighting, better shelter, and more security features. One of the new features is an X-ray machine large enough to examine entire pallets. As a result, the complete inspection process and the off-loading of packages are expected to become easier and faster. Furthermore, ample parking space will permit unexpected deliveries to be handled more effectively. Additional parking, traffic lights, and signage will help traffic flow.

Elliott stressed the importance of striking a balance between providing security and minimally interrupting the Bank's business lines, particularly the check and cash operations. The Philadelphia Fed is one of four full-service regional check processing sites in the Federal Reserve System handling large volumes of checks daily. The larger staging area for checks will further streamline the process. In 2006, the Bank's existing loading dock was renovated to accommodate the increase in checks after the Bank acquired the New York Reserve Bank's check processing.

Elliott is convinced that we have a tremendous opportunity to become even more efficient. Why?

"We are integrating state-of-the-art technology with minimal staffing and minimal costs. We'll have more flexibility and a screening process that is easier, faster, and even more secure," he said.

Land for the site was purchased for \$4.2 million from the Redevelopment Authority of the City of Philadelphia. The price tag for the former parking lot in addition to the land also covered the required geographic studies, legal fees, and closing costs.

Architectural firm Ewing Cole, well known regionally for its role in constructing Citizens Bank Park, the home of the Philadelphia Phillies, is under contract to design the annex. Probably less well

"We are integrating state-of-the-art technology with minimal staffing and minimal costs. We'll have more flexibility and a screening process that is easier, faster, and even more secure."

known is the fact that the firm also designed the Philadelphia Reserve Bank's building and redesigned the Bank's loading dock.

Ewing Cole's design will incorporate green, or environmentally sound, features. For example, lighting will minimize light pollution and energy consumption. Philadelphia's Percent for Art ordinance requires that a percentage of construction costs be earmarked for public art. Representatives from the Bank and the city's Redevelopment Authority will decide on the theme and commission the work from artists with a connection to the Bank's Third District.

The exterior of the annex is an important consideration. But what the public doesn't see is even more important as the Philadelphia Fed continues to execute a more comprehensive security program that will ultimately help protect employees, mitigate imminent threats, and safeguard our role in the nation's economy and payment system.

Last year, Philadelphia Fed staff contributed to a large number of significant Bank and System projects. Here are some of the highlights for 2007:

AUDIT

The Bank's information technology audit manager made a presentation in April in Ljubljana, Slovenia, at a workshop on "Information Technology Audit in Central Banks: Best Practice and International Standards." The department also hosted the 10th annual Bank-wide Audit Symposium, which offers staff continued professional development through information sharing and interaction with Bank, professional, and community leaders.

CASH SERVICES

In May, Cash Services hosted the first regional cash customer meeting in conjunction with four contiguous Federal Reserve Districts: Boston, New York (EROC), Cleveland, and Richmond. In September, the national Cash Customer Advisory Council held its meeting at the Bank. Cash Services also began billing for additional handling and processing of currency deposited and withdrawn from the Federal Reserve in the same week. This billing is part of a national effort to encourage recirculation of currency by depository institutions.



COMMUNITY AFFAIRS



The Community Affairs and Research departments jointly planned the fifth biennial Federal Reserve System Community Affairs Research Conference held in March 2007 in Washington, D.C. In addition, Community Affairs initiated a study of the effectiveness of homeownership counseling on long-term financial management. The study, which will follow participants for five years after they've received housing counseling, is important, since many borrowers are in foreclosure in the current financial environment. The department also helped housing advocates understand options for refinancing and how to work with loan servicers. The department's economic education staff reached 600+ educators through seminars and classes at the Bank or in our District.

ENTERPRISE RISK MANAGEMENT

The Philadelphia Reserve Bank hosted the International Operational Risk Working Group conference. The department's assistant vice president chaired the key risk indicator group for the meeting. ERM also hosted the System's planning meeting for the 2007 Internal Control Assessment process, which supports compliance with Auditing Standard No. 2 (AS2). AS2 sets requirements for external auditors in conducting engagements and issuing opinions for organizations registered with the Securities and Exchange Commission.

FACILITIES MANAGEMENT

The department completed the acquisition of a property for an off-site screening facility. The new building will be used for screening general delivery trucks, check courier vehicles, and armored carriers before the vehicles proceed to the main Bank building.

FINANCIAL MANAGEMENT SERVICES

Staff in FMS chaired several System groups, including the COSO Coordination group, the Cost Accounting Group, and the Enterprise Risk Management group. The Bank's chief financial officer traveled to Rabat, Morocco, to help the Moroccan central bank with its risk management efforts. Staff in the division's accounts payable function achieved designation as certified accounts payable specialists and managers. The Bank's budget and procurement officer taught classes for the Institute of Internal Auditors.

FINANCIAL STATISTICS

In 2007, the Financial Statistics Department made important contributions to the Federal Reserve System's Statistics and Reserves Technology Roadmap Initiative; System-level training; and development and testing of enhancements to the Statistics and Reserves application and the Federal Financial Institutions Examination Council's central data repository application. Department staff contributed to testing and evaluating proposed operational changes and identified and resolved often complex financial reporting issues.

HUMAN RESOURCES

HR established a work group consisting of Bank officers and managers to develop a talent management program for the Bank. The Bank also established a Diversity Council and charter to support its objective of a work environment in which all employees can succeed. Seventeen summer interns, representing 10 universities, worked at the Bank over the summer. The department's ePEP group received a first place award for excellence in e-learning from the Pennsylvania, New Jersey, and Delaware Distance Learning Association.



INFORMATION TECHNOLOGY SERVICES

ITS managed scores of internal Bank projects, supporting most business lines and hosting several major Federal Reserve System assignments, including Treasury Services, Retail Payments, and information security. The Bank's Groupware Leadership Center serves as one of many national information technology operators and has specific responsibility for the Federal Reserve's collaboration suite of services. These include e-mail and instant messaging, the calendar function, web conferencing, unified messaging, team workplace sites, community services, and enterprise content management. The video conferencing team supports an enterprise-wide service for all Federal Reserve offices and can connect to business partners in governments and industries worldwide. This service was expanded to pilot desktop video conferencing.

LAW ENFORCEMENT

The Bank hired a former FBI agent to lead the Law Enforcement Department. The new assistant vice president supervised the public corruption squad and the white collar crime unit in the FBI's Philadelphia office. The department also now occupies newly renovated and expanded space to better meet staff needs.

LEGAL

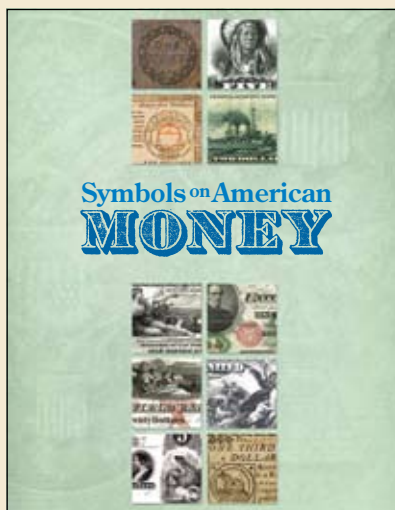
The Legal Department provided timely support for the complex transactions involved in the Bank's acquisition of property for an off-site screening facility. The Bank's general counsel has for many years chaired the System's Subcommittee of Ethics Officers, which provides information, guidance, and support to the ethics programs of all the Reserve Banks. Another department officer chairs the System work group reviewing legal issues related to verifying the identity of those seeking physical or electronic access to federal government sites.

PAYMENT CARDS CENTER

Center staff worked with the Bank's Community Affairs Department in sponsoring a conference on the financial services behavior of low- and moderate-income households. Staff also joined with the Bank's Research Department to host the fourth biennial conference on "Recent Developments in Consumer Credit and Payments." The staff also made presentations at an unprecedented 11 industry-sponsored conferences and forums and numerous presentations in the Bank and the System.



PUBLIC AFFAIRS



The department produced a new publication, *Symbols on American Money*, as part of the Bank's public information and economic education efforts. The redesign of the Bank's external website is now well underway. The redesign will improve the site's performance and technical capabilities and provide even better service to our widely diverse audience. The "Money in Motion" exhibit, which opened in July 2003, has now welcomed over 120,000 visitors. In 2007 a new element, "Supervision Mission," was added to help explain the Bank's regulatory role.

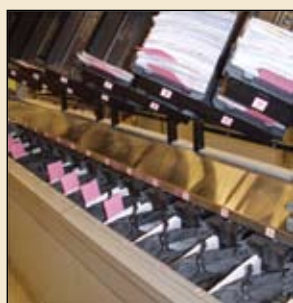
RESEARCH

The Research Department worked with Community Affairs to organize the fifth biennial Federal Reserve System Community Affairs Research Conference. The research director then served as editor for a special issue of the *Journal of Economics and Business* in which selected papers from the conference were published. Research also organized and hosted the sixth annual Philadelphia Fed Policy Forum, as well as several other conferences, including the System Committee on International Analysis and a conference on analysis and methods using real-time data.



Annette L. Nazareth
Former SEC Commissioner

RETAIL PAYMENTS



Philadelphia was chosen in 2007 as one of four remaining Federal Reserve check processing sites and will absorb the workload from the current Baltimore, Utica, and Windsor Locks offices. The Customer Relations unit assisted financial institutions in their efforts to implement Check 21 deposit (FedForward and FedReturn) and presentment (FedReceipt) services. This is part of an evolution from a paper-based check collection system to an increasingly electronic check payments system.

SUPERVISION, REGULATION AND CREDIT

SRC spearheaded the System's "Partnership for Progress: A Program for Minority-Owned and De Novo Institutions," the first of its kind to address the unique challenges facing minority-owned institutions. The department also played a lead role for retail credit on the System's Basel II qualification team. SRC also prepared to launch its consumer compliance newsletter as a System-wide publication.

In December 2007, for the first time, the Federal Reserve offered a unique lending program through its discount window called the Term Auction Facility (TAF). The TAF is designed to supply term loans through an auction method to those financial institutions eligible to borrow from the Fed under primary credit. Working under a short time frame with other Federal Reserve Banks and the Subcommittee on Credit and Risk Management, SRC's discount window staff facilitated the design, development, and testing of appropriate procedures to implement the TAF in the Third District.



TREASURY SERVICES

The U.S. Treasury selected the Philadelphia Reserve Bank to lead the Treasury's collateral management and monitoring business line as part of the government's project to modernize its collections and cash management activities.

Doris M. Damm

Chairman, Federal Reserve Bank of Philadelphia Board of Directors. Board member since January 2001. President and CEO of ACCU Staffing Services. Director of Our Lady of Lourdes Medical Center. Member of the Executive Advisory Council, Rutgers University School of Business. Panelist for the Rutgers Quarterly Economic Outlook Panel. Member of the Women's Business Enterprise National Council, the Cherry Hill Chamber of Commerce, and the Chamber of Commerce of Southern New Jersey.

William F. Hecht

Deputy Chairman, Federal Reserve Bank of Philadelphia Board of Directors. Board member since January 2004. Member Audit and Nominating & Governance Committees. Retired President, Chairman and CEO of PPL Corporation. Serves on the Board of Trustees of Lehigh University and of Lehigh Valley Hospital and Health Network. Serves on the board of directors of Dentsply International and RenaissanceRe Holdings, Ltd. President of Lehigh Valley Partnership.

Michael F. Camardo

Board member since January 2007. Member of Management & Budget Committee. Retired Executive Vice President Lockheed Martin Information & Technology Services. Chairman of Our Lady of Lourdes Healthcare Services, Inc., Symphony in C, and Greater Camden Partnership. Serves on boards for the Franklin Institute, Executive Advisory Council for Rutgers University, and Day & Zimmerman.

John G. Gerlach

Board member since January 2006. Member of the Audit Committee. President and CEO of Pocono Community Bank. Member of the boards of First Keystone Corporation, First Keystone National Bank, and Pocono Mountains Economic Development Corporation.

Aaron L. Groff

Board member since January 2007. Member of the Audit Committee. Chairman, President, and CEO of Ephrata National Bank. Serves on the boards of the Ephrata Area Educational Foundation, FURST CEO Network, and the Ephrata Community Hospital. Treasurer of Ephrata Township Sewer Authority.

Garry L. Maddox

Board member since January 2003. Member of the Audit Committee. President and CEO of A. Pomerantz & Company. Founding President of World Wide Concessions, Inc. Founder and President of Youth Golf and Academics Program. Serves on boards of Boys and Girls Club of Camden County, Corporate Alliance for Drug Education, Greater Philadelphia Chamber of Commerce, Fairmount Park Commission, Neumann College, and Philadelphia Sports Congress. Director Emeritus of Philadelphia Child Guidance Center. Member of Board of Governors of National Adoption Center.

Charles P. Pizzi

Board member since January 2006. Member Management & Budget and Nominating & Governance Committees. President and CEO of Tasty Baking Company. Chairman of the Allegheny West Foundation. Serves on the boards of Drexel University, Independence Blue Cross, Greater Philadelphia Chamber of Commerce, Philadelphia Stock Exchange, Brandywine Realty Trust, and Grocery Manufacturers of America.

P. Coleman Townsend, Jr.

Board member since January 2002. Member Management & Budget and Nominating & Governance Committees. Chairman and CEO of Townsends, Inc. Member of Board of Trustees of University of Delaware and Winterthur Museum. Member Winterthur Museum Garden, Collections and Library Committees. Serves on the Council of Advisors for Delaware Center of Horticulture and the Advisory Board for Lehman Art Center - Brooks School. Active participant on Delaware Art Museum Collections Committee.

Wayne R. Weidner

Board member since January 2005. Member Management & Budget and Nominating & Governance Committees. Chairman of the Board National Penn Bancshares, Inc. Serves as a director of National Penn Bank, National Penn Investors Trust Company, and Hawk Mountain Council Boy Scouts of America.



Standing left to right: Wayne Weidner, Aaron Groff, John Gerlach, Michael Camardo, and Coleman Townsend.
Seated left to right: Charles Pizzi, Doris Damm, and William Hecht. Not pictured: Garry Maddox.

2007 ADVISORY COUNCILS

FEDERAL RESERVE BANK OF PHILADELPHIA

Business Council

Reneé Amooore
President & CEO
The Amooore Group
King of Prussia, PA

Daniel Blaschak
Treasurer
Blaschak Coal, Inc.
Mahanoy City, PA

Keith S. Campbell
Chairman
Mannington Mills, Inc.
Salem, NJ

Robert L. Gronlund
Chairman & CEO
Wood Mode, Inc.
Kreamer, PA

James J. Hargadon
Executive Vice President & CFO
Oki Data Americas
Mount Laurel, NJ

Melinda K. Holman
President
Holman Enterprises
Pennsauken, NJ

Eric May
President & Owner
Pen-Fern Oil Co., Inc.
Dallas, PA

Kenneth Tuckey
President
Tuckey Mechanical Services, Inc.
Carlisle, PA

Rodman Ward
President
Speakman Company
Wilmington, DE

David C. Wenger
President & CEO
Transport Decisions
Churchville, PA

Community Bank Council

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President & CEO
Willow Financial Bank
Wayne, PA

Allan R. Dennison
President & CEO
AmeriServ Financial
Johnstown, PA

Mark E. Huntley
CEO
Delaware National Bank
Georgetown, DE

John T. Parry
President & CEO
First National Bank & Trust Co.
Newtown, PA.

Michael M. Quick
Executive Vice President
Susquehanna Bancshares, Inc.
Lititz, PA

Peter C. Zimmerman
Executive Vice President
Orrstown Bank
Shippensburg, PA

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President & CEO
Campbell Employees FCU
Camden, NJ

Maurice Dawkins
President & CEO
American Spirit FCU
Newark, DE

Alfreda A. Earnest
President & CEO
Deepwater Industries FCU
Deepwater, NJ

James E. Everhart, Jr.
President & CEO
Louviers FCU
Newark, DE

Ben Griffith
President
South Jersey FCU
Deptford, NJ

Jeff March
President & CEO
Citadel FCU
Thorndale, PA

Larry D. Miller
President & CEO
Mennonite Financial FCU
Lancaster, PA

Glen Potteiger
President & CEO
CTCE FCU
Reading, PA

Richard Stipa
CEO
TruMark Financial Credit Union
Trevose, PA

Edwin L. Williams
President & CEO
Discovery FCU
Wyomissing, PA

EXECUTIVE COMMITTEE

FEDERAL RESERVE BANK OF PHILADELPHIA



The Bank's Executive Committee consists of the president, first vice president, and key senior officers. They meet regularly to discuss issues facing the Bank or the Federal Reserve System. Pictured clockwise from left: Loretta J. Mester, Senior Vice President and Director of Research; Richard W. Lang, Executive Vice President; Donna L. Franco, Senior Vice President and Chief Financial Officer; D. Blake Prichard, Executive Vice President; Michael E. Collins, Senior Vice President and Lending Officer; Milissa M. Tadeo, Senior Vice President; Charles I. Plosser, President and Chief Executive Officer; and William H. Stone, Jr., First Vice President.

CURRENT OFFICERS

FEDERAL RESERVE BANK OF PHILADELPHIA

Charles I. Plosser
President & CEO

William H. Stone, Jr.
First Vice President

Richard W. Lang
Executive Vice President

D. Blake Prichard
Executive Vice President

Michael E. Collins
Senior Vice President
and Lending Officer
Supervision, Regulation
and Credit

Donna L. Franco
Senior Vice President and
Chief Financial Officer

Loretta J. Mester
Senior Vice President and
Director of Research
Research

Milissa M. Tadeo
Senior Vice President
Cash Services, Treasury
Services, and Facilities
Management

John G. Bell
Vice President
Financial Statistics

Mitchell S. Berlin
Vice President and
Economist
Research

Robert J. Bucco
Vice President
Wholesale Product Office

Peter P. Burns
Vice President and Director
Payment Cards Center

John J. Deibel
Vice President and Senior
Examination Officer
Supervision, Regulation
and Credit

Michael Dotsey
Vice President and Senior
Economic Policy Advisor
Research

Richard A. Elliott
Vice President
Facilities Management,
Records, and Document
Services

Faith P. Goldstein
Vice President
Public Affairs

Mary Ann Hood
Vice President
Human Resources

Arun K. Jain
Vice President
Retail Payments

William W. Lang
Vice President
Supervision, Regulation
and Credit

Edward M. Mahon
Vice President and General
Counsel, Ethics Officer
Legal

Alice Kelley Menzano
Vice President
Information Technology
Services

Stephen A. Meyer
Vice President and Senior
Economic Policy Advisor
Research

Mary DeHaven Myers
Vice President and
Community Affairs Officer
Community Affairs

A. Reed Raymond, III
Vice President and Chief
Administrative Officer
Supervision, Regulation
and Credit

Patrick M. Regan
Vice President
Information Technology
Services

Michelle M. Scipione
Vice President
Cash Services

Richard A. Sheaffer
Vice President and
General Auditor

Herbert E. Taylor
Vice President and
Corporate Secretary

Vish P. Viswanathan
Vice President and
Discount Officer
Supervision, Regulation
and Credit

Kei-Mu Yi
Vice President and
Economist
Research

John D. Ackley
Assistant Vice President
Treasury Services

Aileen C. Boer
Assistant Vice President
Research

Donna Brenner
Assistant Vice President
Enterprise Risk
Management

Brian Calderwood
Assistant Vice President
Information Technology
Services

Jennifer E. Cardy
Assistant Vice President
Financial Management
Services

Shirley L. Coker
Assistant Vice President
and Counsel
Legal

Maryann T. Connelly
Assistant Vice President
and Counsel
Legal

Cynthia L. Course
Assistant Vice President
Supervision, Regulation
and Credit

Frank J. Doto
Assistant Vice President
Supervision, Regulation
and Credit

Michael T. Doyle
Assistant Vice President
and Technical Services
Officer
Information Technology
Services

Gregory Fanelli
Assistant Vice President
Treasury Payments

Suzanne W. Furr
Assistant Vice President
Assistant General Auditor
Audit

William L. Gaunt
Assistant Vice President
Supervision, Regulation
and Credit

Stephen G. Hart
Assistant Vice President
Human Resources

John P. Kelly
Assistant Vice President
Retail Payments

Elisabeth V. Levins
Assistant Vice President
Supervision, Regulation
and Credit

Leonard Nakamura
Assistant Vice President
and Economist
Research

Camille M. Ochman
Assistant Vice President
Cash Services

Anthony T. Scafide, Jr.
Assistant Vice President
Customer Relations

Stephen J. Smith
Assistant Vice President
and Counsel
Legal

Eric A. Sonnheim
Assistant Vice President
Supervision, Regulation
and Credit

Marie Tkaczyk
Assistant Vice President
Information Technology
Services

Patrick Turner
Assistant Vice President
Information Technology
Services

Todd Vermilyea
Assistant Vice President
Supervision, Regulation
and Credit

Constance H. Wallgren
Assistant Vice President
Supervision, Regulation
and Credit

James K. Welch
Assistant Vice President
Law Enforcement

Thomas J. Lombardo
Financial Services Industry
Relations Officer
Customer Relations

Wanda Preston
Check Adjustments Officer
Retail Payments

OPERATING STATISTICS

In 2007, Philadelphia's total volume of commercial checks processed decreased 2 percent and the dollar value of transactions decreased 28 percent as a result of the general decline in check processing in the nation's payment system. The volume of commercial checks received as Check 21 electronic images increased 259 percent, and the dollar value increased 120 percent in 2007.

The volume and dollar value of U.S. government checks decreased 40 percent in 2007. This trend follows the same pattern as the decline in commercial checks due to the Treasury's increased use of electronic payments and because depositing banks are converting government paper checks to Check 21 electronic images. As part of the reorganization of check processing due to the decline in government paper checks, Philadelphia's government check operation is scheduled to be transferred to the St. Louis Reserve Bank in July 2008. The Philadelphia Reserve Bank will

remain a contingency site for U.S. government check processing.

In 2007, Philadelphia continued to be a major processor of cash in the Federal Reserve System, although the volume of currency processed decreased almost 15 percent. Because the Bank processed a greater proportion of larger denomination notes, the actual dollar value of currency processed did not decrease as significantly (4 percent). In 2007, off-site terminal holdings were increased; therefore, the volume of coin bags processed on site declined 32 percent. The processed coin value decreased less significantly (17 percent) because the Bank processed an increased proportion of presidential dollar coins.

In 2007, both the number and value of loans to depository institutions were significantly higher than in the previous year because of increased volume in seasonal loans.

SERVICES TO DEPOSITORY INSTITUTIONS

	2007 Volume	2007 Dollar Value	2006 Volume	2006 Dollar Value
Check services:				
Commercial checks – Paper processed	998.3 million checks	\$2,174.9 billion	1,020.3 million checks	\$3,019.9 billion
Check 21 received	583.7 million checks	\$1,677.0 billion	162.6 million checks	\$763.3 billion
U.S. government checks	51.4 million checks	\$63.5 billion	85.9 million checks	\$105.4 billion
Cash operations:				
Currency processed	1,903.9 million notes	\$37.1 billion	2,236.5 million notes	\$38.6 billion
Coin paid and received	375.5 thousand bags	\$195.8 million	549.0 thousand bags	\$236.8 million
Loans to depository institutions during the year				
	107 loans	\$991.9 million	75 loans	\$86.3 million

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2007 was Deloitte & Touche LLP (D&T). Fees for these services totaled \$4.7 million. To ensure auditor independence, the Board of Governors requires that D&T be independent in all matters relating to the audit. Specifically, D&T may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2007, the Bank did not engage D&T for any material advisory services.

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LETTER TO DIRECTORS

FEDERAL RESERVE BANK OF PHILADELPHIA



FEDERAL RESERVE BANK
OF PHILADELPHIA

March 20, 2008

To the Board of Directors

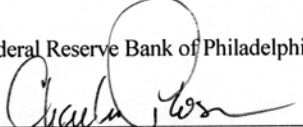
The management of the Federal Reserve Bank of Philadelphia ("FRBP") is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statements of Income and Comprehensive Income, and Statement of Changes in Capital as of December 31, 2007 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on management judgments and estimates. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

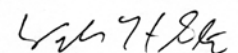
The management of the FRBP is responsible for establishing and maintaining effective internal control over financial reporting as it relates to the Financial Statements. Such internal control is designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of the Financial Statements in accordance with the Manual. Internal control contains self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in internal control are reported to management and appropriate corrective measures are implemented.

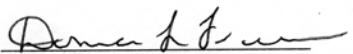
Even effective internal control, no matter how well designed, has inherent limitations, including the possibility of human error, and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The management of the FRBP assessed its internal control over financial reporting reflected in the Financial Statements, based upon the criteria established in the "Internal Control -- Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, we believe that the FRBP maintained effective internal control over financial reporting as it relates to the Financial Statements.

Federal Reserve Bank of Philadelphia

by 
Charles I. Plosser, President

by 
William H. Stone, First Vice President

by 
Donna L. Franco, Chief Financial Officer



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REPORT OF INDEPENDENT AUDITORS

To the Board of Governors of the Federal Reserve System
and the Board of Directors of the Federal Reserve Bank of Philadelphia:

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

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

FRB Philadelphia's internal control over financial reporting is a process designed by, or under the supervision of, FRB Philadelphia's principal executive and principal financial officers, or persons performing similar functions, and effected by FRB Philadelphia's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System. FRB Philadelphia's internal control over financial reporting includes those policies and

Member of
Deloitte Touche Tohmatsu

Continued on next page

REPORT OF INDEPENDENT AUDITORS

FEDERAL RESERVE BANK OF PHILADELPHIA

ANNUAL REPORT 2007

procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of FRB Philadelphia; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System, and that receipts and expenditures of FRB Philadelphia are being made only in accordance with authorizations of management and directors of FRB Philadelphia; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of FRB Philadelphia's assets that could have a material effect on the financial statements.

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

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

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



March 20, 2008



PricewaterhouseCoopers LLP
1800 Tysons Boulevard
McLean, VA 22102-4261
Telephone (703) 918 3000
Facsimile (702) 918 3100

Report of Independent Auditors

To the Board of Governors of the Federal Reserve System
and the Board of Directors of the Federal Reserve Bank of Philadelphia:

We have audited the accompanying statement of condition of the Federal Reserve Bank of Philadelphia (the "Bank") as of December 31, 2006, and the related statements of income and changes in capital for the year then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As described in Note 3, these financial statements were prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These principles, policies, and practices, which were designed to meet the specialized accounting and reporting needs of the Federal Reserve System, are set forth in the *Financial Accounting Manual for Federal Reserve Banks* which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2006, and the results of its operations for the year then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

March 12, 2007

STATEMENTS OF CONDITION

FEDERAL RESERVE BANK OF PHILADELPHIA

As of December 31, 2007 and December 31, 2006 (in millions)

ASSETS

Gold certificates	\$455	\$463
Special drawing rights certificates	83	83
Coin	88	53
Items in process of collection	317	649
Securities purchased under agreements to resell	2,057	-
U.S. government securities, net	32,987	34,021
Investments denominated in foreign currencies	5,587	1,152
Accrued interest receivable	281	292
Interdistrict settlement account	794	836
Bank premises and equipment, net	87	81
Interest on Federal Reserve notes due from U.S. Treasury	-	305
Other assets	56	58

Total assets

\$42,792

\$37,993

LIABILITIES AND CAPITAL

Liabilities:

Federal Reserve notes outstanding, net	\$34,165	\$31,700
Securities sold under agreements to repurchase	1,946	1,286

Deposits:

Depository institutions	2,664	584
Other deposits	5	3
Deferred credit items	215	718
Interest on Federal Reserve notes due to U.S. Treasury	91	-
Accrued benefit costs	69	70
Other liabilities	11	12

Total liabilities

39,166

34,373

Capital:

Capital paid-in	1,813	1,810
Surplus (including accumulated other comprehensive loss of \$19 million and \$24 million at December 31, 2007 and 2006, respectively)	1,813	1,810

Total capital

3,626

3,620

Total liabilities and capital

\$42,792

\$37,993

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

STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

FEDERAL RESERVE BANK OF PHILADELPHIA

For the years ended December 31, 2007 and December 31, 2006 (in millions)

	2007	2006
Interest income:		
Interest on U.S. government securities	\$1,703	\$1,454
Interest on securities purchased under agreements to resell	63	-
Interest on investments denominated in foreign currencies	65	20
Total interest income	1,831	1,474
Interest expense:		
Interest expense on securities sold under agreements to repurchase	74	56
Net interest income	1,757	1,418
Other operating income:		
Compensation received for services provided	38	32
Reimbursable services to government agencies	31	31
Foreign currency gains, net	243	66
Other income	6	3
Total other operating income	318	132
Operating expenses:		
Salaries and other benefits	96	90
Occupancy expense	11	11
Equipment expense	12	11
Assessments by the Board of Governors	67	51
Other expenses	41	42
Total operating expenses	227	205
Net income prior to distribution	1,848	1,345
Change in funded status of benefit plans	5	-
Comprehensive income prior to distribution	\$1,853	\$1,345
Distribution of comprehensive income:		
Dividends paid to member banks	\$109	\$80
Transferred to surplus and change in accumulated other comprehensive loss	3	1,090
Payments to U.S. Treasury as interest on Federal Reserve notes	1,741	175
Total distribution	\$1,853	\$1,345

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

STATEMENTS OF CHANGES IN CAPITAL

FEDERAL RESERVE BANK OF PHILADELPHIA

For the years ended December 31, 2007 and December 31, 2006 (in millions)

	Capital Paid-In	Net Income Retained	Surplus		Total Capital
			Accumulated Other Comprehensive Loss	Total Surplus	
Balance at January 1, 2006 (14.9 million shares)	\$ 744	\$ 744	\$ -	\$ 744	\$ 1,488
Net change in capital stock issued (21.3 million shares)	1,066	-	-	-	1,066
Transferred to surplus	-	1,090	-	1,090	1,090
Adjustment to initially apply SFAS No. 158	-	-	(24)	(24)	(24)
Balance at December 31, 2006 (36.2 million shares)	\$ 1,810	\$ 1,834	\$ (24)	\$ 1,810	\$ 3,620
Net change in capital stock issued (0.1 million shares)	3	-	-	-	3
Transferred to surplus and change in accumulated other comprehensive loss	-	(2)	5	3	3
Balance at December 31, 2007 (36.3 million shares)	\$ 1,813	\$ 1,832	\$ (19)	\$ 1,813	\$ 3,626

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

1. Structure

The Federal Reserve Bank of Philadelphia (“Bank”) is part of the Federal Reserve System (“System”) and one of the twelve Reserve Banks (“Reserve Banks”) created by Congress under the Federal Reserve Act of 1913 (“Federal Reserve Act”), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank in Philadelphia serves the Third Federal Reserve District, which includes Delaware and portions of New Jersey and Pennsylvania.

In accordance with the Federal Reserve Act, supervision and control of the Bank is exercised by a board of directors. The Federal Reserve Act specifies the composition of the board of directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors of the Federal Reserve System (“Board of Governors”) to represent the public, and six directors are elected by member banks. Banks that are members of the System include all national banks and any state-chartered banks that apply and are approved for membership in the System. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

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

(“FRBNY”), and on a rotating basis four other Reserve Bank presidents.

2. Operations and Services

The Reserve Banks perform a variety of services and operations. Functions include participation in formulating and conducting monetary policy; participation in the payments system, including large-dollar transfers of funds, automated clearinghouse (“ACH”) operations, and check collection; distribution of coin and currency; performance of fiscal agency functions for the U.S. Treasury, certain federal agencies, and other entities; serving as the federal government’s bank; provision of short-term loans to depository institutions; service to the consumer and the community by providing educational materials and information regarding consumer laws; and supervision of bank holding companies, state member banks, and U.S. offices of foreign banking organizations. Certain services are provided to foreign and international monetary authorities, primarily by the FRBNY.

The FOMC, in the conduct of monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and annually issues authorizations and directives to the FRBNY for its execution of transactions. The FRBNY is authorized and directed by the FOMC to conduct operations in domestic markets, including the direct purchase and sale of U.S. government securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY executes these open market transactions at the direction of the FOMC and holds the resulting securities and agreements in the portfolio known as the System Open Market Account (“SOMA”).

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or

to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. The FRBNY is authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange ("FX") and securities contracts for, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements ("FX swaps") with four central banks and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks. In connection with its foreign currency activities, the FRBNY may enter into transactions that contain varying degrees of off-balance-sheet market risk that result from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

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

Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include Collateral Management System, Electronic Cash Letter System, Groupware Leadership Center, Treasury Check Information Services Central Business Administration Function, and Treasury Direct Central Business Administration Function.

3. Significant Accounting Policies

Accounting principles for entities with the unique powers and responsibilities of the nation's central bank have not been formulated by accounting standard-setting bodies. The Board of Governors has developed specialized accounting principles and practices that it considers to be appropriate for the nature and function of a central bank, which differ significantly from those of the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* ("Financial Accounting Manual"), which is issued by the Board of Governors. All of the Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual and the financial statements have been prepared in accordance with the Financial Accounting Manual.

Differences exist between the accounting principles and practices in the Financial Accounting Manual and generally accepted accounting principles in the United States ("GAAP"), primarily due to the unique nature of the Bank's powers and responsibilities as part of the nation's central bank. The primary difference is the presentation of all securities holdings at amortized cost, rather than using the fair value presentation required by GAAP. U.S. government securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Amortized cost more appropriately reflects the Bank's securities holdings given the System's unique responsibility to conduct monetary policy. While the application of current market prices to the securities holdings may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Bank earnings or capital. Both the domestic and foreign components of the

SOMA portfolio may involve transactions that result in gains or losses when holdings are sold prior to maturity. Decisions regarding securities and foreign currency transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such securities and currencies are incidental to the open market operations and do not motivate decisions related to policy or open market activities.

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

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

a. Gold and Special Drawing Rights Certificates

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

Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. The gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S.

Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged, and the Reserve Banks' gold certificate accounts are reduced. The value of gold for purposes of backing the gold certificates is set by law at \$42 2/9 a fine troy ounce. The Board of Governors allocates the gold certificates among Reserve Banks once a year based on the average Federal Reserve notes outstanding in each Reserve Bank.

SDR certificates are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDR certificates serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates somewhat like gold certificates to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding year. There were no SDR transactions in 2007 or 2006.

b. Loans to Depository Institutions

Depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Bank. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. The Bank offers three discount

window programs to depository institutions: primary credit, secondary credit, and seasonal credit, each with its own interest rate. Interest is accrued using the applicable discount rate established at least every fourteen days by the board of directors of the Reserve Bank, subject to review and determination by the Board of Governors.

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

Outstanding loans are evaluated for collectibility. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. There were no outstanding loans to depository institutions at December 31, 2007 and 2006.

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

Interest income on U.S. government securities and investments denominated in foreign currencies comprising the SOMA is accrued on a straight-line basis. Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Foreign-currency-denominated assets are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency gains, net" in the Statements of Income and Comprehensive Income.

Activity related to U.S. government securities, including the premiums, discounts, and realized and unrealized gains and losses, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of the interdistrict settlement account that occurs in April of each year. The settlement also

equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding in each District. Activity related to investments denominated in foreign currencies is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31.

d. Securities Purchased Under Agreements to Resell, Securities Sold Under Agreements to Repurchase, and Securities Lending

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

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

U.S. government securities held in the SOMA are lent to U.S. government securities dealers in order to facilitate the effective functioning of the domestic securities market. Securities-lending transactions are fully collateralized by other U.S. government securities and the collateral taken is in excess of the market value of the securities loaned. The FRBNY charges the dealer a fee for borrowing securities and the fees are

reported as a component of “Other income.”

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

e. FX Swap Arrangements and Warehousing Agreements

FX swap arrangements are contractual agreements between two parties, the FRBNY and an authorized foreign central bank, whereby the parties agree to exchange their currencies up to a prearranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to the foreign currencies it may need to support its international operations and give the authorized foreign central bank temporary access to dollars. Drawings under the FX swap arrangements can be initiated by either party and must be agreed to by the other party. The FX swap arrangements are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. Foreign currencies received pursuant to these agreements are reported as a component of “Investments denominated in foreign currencies” in the Statements of Condition.

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

FX swap arrangements and warehousing agreements are revalued daily at current market exchange rates. Activity related to these agreements,

with the exception of the unrealized gains and losses resulting from the daily revaluation, is allocated to each Reserve Bank based on the ratio of each Reserve Bank’s capital and surplus to aggregate capital and surplus at the preceding December 31. Unrealized gains and losses resulting from the daily revaluation are recorded by FRBNY and not allocated to the other Reserve Banks.

f. Bank Premises, Equipment, and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are depreciated over the remaining useful life of the asset or, if appropriate, over the unique useful life of the alteration, renovation, or improvement. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred.

Costs incurred for software during the application development stage, either developed internally or acquired for internal use, are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which range from two to five years. Maintenance costs related to software are charged to expense in the year incurred.

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

g. Interdistrict Settlement Account

At the close of business each day, each Reserve Bank assembles the payments due to or from

other Reserve Banks. These payments result from transactions between Reserve Banks and transactions that involve depository institution accounts held by other Reserve Banks, such as Fedwire funds and securities transfers, and check and ACH transactions. The cumulative net amount due to or from the other Reserve Banks is reflected in the "Interdistrict settlement account" in the Statements of Condition.

h. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the chairman of the board of directors of each Reserve Bank and their designees) to the Reserve Banks upon deposit with such agents of specified classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be at least equal to the sum of the notes applied for by such Reserve Bank.

Assets eligible to be pledged as collateral security include all of the Bank's assets. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, for which the collateral value is equal to the par value of the securities tendered. The par value of securities pledged for securities sold under agreements to repurchase is deducted.

The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes issued to all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and

paramount lien on all the assets of the Reserve Banks. Finally, Federal Reserve notes are obligations of the United States government. At December 31, 2007, all Federal Reserve notes issued to the Reserve Banks were fully collateralized.

"Federal Reserve notes outstanding, net" in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the Bank's currency holdings of \$7,564 million and \$6,957 million at December 31, 2007 and 2006, respectively.

i. Items in Process of Collection and Deferred Credit Items

Items in process of collection in the Statements of Condition primarily represents amounts attributable to checks that have been deposited for collection and that, as of the balance sheet date, have not yet been presented to the paying bank. Deferred credit items are the counterpart liability to items in process of collection, and the amounts in this account arise from deferring credit for deposited items until the amounts are collected. The balances in both accounts can vary significantly.

j. Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. These shares are nonvoting with a par value of \$100 and may not be transferred or hypothecated. As a member bank's capital and surplus changes, its holdings of Reserve Bank stock must be adjusted. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

By law, each Reserve Bank is required to pay each member bank an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. To reflect the Federal Reserve Act requirement that annual dividends are

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

k. Surplus

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31 of each year. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital.

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

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

l. Interest on Federal Reserve Notes

The Board of Governors requires the Reserve Banks to transfer excess earnings to the U.S. Treasury

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

In the event of losses or an increase in capital paid-in at a Reserve Bank, payments to the U.S. Treasury are suspended and earnings are retained until the surplus is equal to the capital paid-in.

In the event of a decrease in capital paid-in, the excess surplus, after equating capital paid-in and surplus at December 31, is distributed to the U.S. Treasury in the following year.

m. Income and Costs Related to U.S. Treasury Services

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services.

The Treasury and other government agencies reimbursement process for all Reserve Banks is centralized at the Bank. Each Reserve Bank transfers its Treasury reimbursement receivable to the Bank. The reimbursement receivable is reported in "Other assets" and totaled \$33 million and \$29 million at December 31, 2007 and 2006, respectively. The cost of unreimbursed Treasury services is reported in "Other expense" and was immaterial at December 31, 2007 and 2006.

n. Compensation Received for Services Provided

The Federal Reserve Bank of Atlanta ("FRBA") has overall responsibility for managing the Reserve Banks' provision of check and ACH services to depository institutions, and, as a result, recognizes total System revenue for these services on its Statements

of Income and Comprehensive Income. Similarly, the FRBNY manages the Reserve Banks' provision of Fedwire funds and securities transfer services, and recognizes total System revenue for these services on its Statements of Income and Comprehensive Income. The FRBA and FRBNY compensate the other Reserve Banks for the costs incurred to provide these services. The Bank reports this compensation as "Compensation received for services provided" in the Statements of Income and Comprehensive Income.

o. Assessments by the Board of Governors

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

p. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank's real property taxes were \$2 million for each of the years ended December 31, 2007 and 2006 and are reported as a component of "Occupancy expense."

q. Restructuring Charges

The Reserve Banks recognize restructuring charges for exit or disposal costs incurred as part of the closure of business activities in a particular location, the relocation of business activities from one location to another, or a fundamental reorganization that affects the nature of operations. Restructuring charges may include costs associated with employee separations, contract terminations, and asset impair-

ments. Expenses are recognized in the period in which the Bank commits to a formalized restructuring plan or executes the specific actions contemplated in the plan and all criteria for financial statement recognition have been met.

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

r. Recently Issued Accounting Standards

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

4. U.S. Government Securities, Securities Purchased Under Agreements to Resell, Securities Sold Under Agreements to Repurchase, and Securities Lending

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank's allocated share of SOMA balances was approximately 4.424 percent and 4.342 percent at December 31, 2007 and 2006, respectively.

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

	2007	2006
Par value:		
U.S. government:		
Bills	\$10,080	\$12,027
Notes	17,775	17,469
Bonds	4,910	4,321
Total par value	32,765	33,817
Unamortized premiums	353	378
Unaccreted discounts	(131)	(174)
Total allocated to the Bank	\$32,987	\$34,021

At December 31, 2007 and 2006, the fair value of the U.S. government securities allocated to the Bank, excluding accrued interest, was \$34,381 million and \$34,555 million, respectively, as determined by reference to quoted prices for identical securities.

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

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

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

	Securities purchased under agreements to resell	Securities sold under agreements to repurchase
Allocated to the Bank:		
Contract amount outstanding, end of year	\$ 2,057	\$ 1,946
Weighted average amount outstanding, during the year	1,552	1,542
Maximum month-end balance outstanding, during the year	2,278	1,946
Securities pledged, end of year		1,949
System total:		
Contract amount outstanding, end of year	\$ 46,500	\$43,985
Weighted average amount outstanding, during the year	35,073	34,846
Maximum month-end balance outstanding, during the year	51,500	43,985
Securities pledged, end of year		44,048

At December 31, 2006, the total contract amount of securities sold under agreements to repurchase was \$29,615 million, of which \$1,286 million was allocated to the Bank. The total par value of SOMA securities that were pledged for securities sold under agreements to repurchase at December 31, 2006 was \$29,676 million, of which \$1,288 million was allocated to the Bank.

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

The maturity distribution of U.S. government

securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2007, was as follows (in millions):

	U.S. Government Securities (Par Value)	Securities Purchased Under Agreements to Resell (Contract amount)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	\$ 1,208	\$ 2,057	\$ 1,946
16 days to 90 days	6,624		
91 days to 1 year	6,736		
Over 1 year to 5 years	10,643		
Over 5 years to 10 years	3,625		
Over 10 years	3,929		
Total allocated to the Bank	\$ 32,765	\$ 2,057	\$ 1,946

At December 31, 2007 and 2006, U.S. government securities with par values of \$16,649 million and \$6,855 million, respectively, were loaned from the SOMA, of which \$737 million and \$298 million, respectively, were allocated to the Bank.

5. Investments Denominated in Foreign Currencies

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

The Bank's allocated share of investments denominated in foreign currencies was approximately

11.814 percent and 5.626 percent at December 31, 2007 and 2006, respectively.

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

	2007	2006
Euro:		
Foreign currency deposits	\$ 3,248	\$ 351
Securities purchased under agreements to resell	301	125
Government debt instruments	551	229
Japanese Yen:		
Foreign currency deposits	332	146
Government debt instruments	674	301
Swiss Franc:		
Foreign currency deposits	481	-
Total allocated to the Bank	\$ 5,587	\$ 1,152

At December 31, 2007, the total amount of foreign currency deposits held under FX contracts was \$24,381 million, of which \$2,880 million was allocated to the Bank. At December 31, 2006, there were no open foreign exchange contracts.

At December 31, 2007 and 2006, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was \$5,585 million and \$1,150 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government securities discussed in Note 4, unrealized gains or losses have no effect on the ability of a Reserve Bank, as central bank, to meet its financial obligations and responsibilities.

Total System investments denominated in foreign currencies were \$47,295 million and \$20,482

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

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

	European Euro	Japanese Yen	Swiss Franc	Total
Within 15 days	\$ 591	\$ 353	\$ -	\$ 944
16 days to 90 days	2,729	48	481	3,258
91 days to 1 year	326	237	-	563
Over 1 year to 5 years	454	368	-	822
Total allocated to the Bank	\$ 4,100	\$ 1,006	\$ 481	\$ 5,587

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

6. Bank Premises, Equipment, and Software

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

	2007	2006
Bank premises and equipment:		
Land	\$ 7	\$ 3
Buildings	87	84
Building machinery and equipment	14	13
Construction in progress	3	1
Furniture and equipment	68	68
Subtotal	179	169
Accumulated depreciation	(92)	(88)
Bank premises and equipment, net	\$87	\$81
Depreciation expense, for the year ended December 31	\$ 10	\$ 9

The Bank leases space to an outside tenant with a remaining lease term of 3 years. Rental income from the lease was \$1 million for each of the years ended December 31, 2007 and 2006 and is reported as a component of "Other income." Future minimum lease payments that the Bank will receive under the noncancelable lease agreement in existence at December 31, 2007, are as follows (in millions):

2008	\$ 1
2009	2
2010	2
Total	\$ 5

The Bank has capitalized software assets, net of amortization, of \$6 million and \$8 million at December 31, 2007 and 2006, respectively. Amortization expense was \$2 million and \$3 million for the years ended December 31, 2007 and 2006, respectively. Capitalized software assets are reported as a component of "Other assets" and the related amortization is reported as a component of "Other expenses."

7. Commitments and Contingencies

At December 31, 2007, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from 1 to approximately 5 years. One equipment lease provides for increased rental payments based upon increases in operating quantity.

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 of the years ended December 31, 2007 and 2006. The Bank has no capital leases.

Future minimum rental payments under non-cancelable operating leases, net of sublease rentals, with remaining terms of one year or more, at December 31, 2007 are as follows (in thousands):

	Operating
2008	\$ 339
2009	104
2010	67
2011	67
2012	62
Future minimum rental payments	\$ 639

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

Under the Insurance Agreement of the Federal Reserve Banks, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio of a Reserve Bank's capital paid-in to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under the agreement at December 31, 2007 or 2006.

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

8. Retirement and Thrift Plans

Retirement Plans

The Bank currently offers three defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank's employees participate in the Retirement Plan for Employees of the Federal Reserve System ("System Plan"). Employees at certain compensation levels participate in the Benefit Equalization Retirement Plan ("BEP") and certain Reserve Bank officers participate in the Supplemental Employee Retirement Plan ("SERP").

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

The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2007 and 2006, and for the years then ended, were not material.

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled \$3 million for each of the years ended December 31, 2007 and 2006 and are reported as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income. The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2007 and 2006, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

9. Postretirement Benefits Other Than Pensions and Postemployment Benefits

Postretirement Benefits other than Pensions

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

The Bank funds benefits payable under the medical and life insurance plans as due and, accordingly, has no plan assets.

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

	2007	2006
Accumulated postretirement benefit obligation at January 1	\$ 63.1	\$ 46.2
Service cost-benefits earned during the period	1.9	1.4
Interest cost on accumulated benefit obligation	3.6	2.8
Net actuarial loss (gain)	(3.0)	15.2
Contributions by plan participants	1.3	1.0
Benefits paid	(4.3)	(3.6)
Medicare Part D subsidies	0.3	0.3
Plan amendments	-	(0.2)
Accumulated postretirement benefit obligation at December 31	\$ 62.9	\$ 63.1

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

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

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

	2007	2006
Fair value of plan assets at January 1	\$ -	\$ -
Contributions by the employer	2.7	2.3
Contributions by plan participants	1.3	1.0
Benefits paid, net of Medicare Part D subsidies	(4.0)	(3.3)
Fair value of plan assets at December 31	\$ -	\$ -
Unfunded obligation and accrued postretirement benefit cost	\$ 62.9	\$ 63.1

Amounts included in accumulated other comprehensive loss are shown below (in millions):

Prior service cost	\$ 3.7	\$ 5.0
Net actuarial loss	(22.6)	(28.8)
Total accumulated other comprehensive loss	\$ (18.9)	\$ (23.8)

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

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

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

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2007 (in millions):

	One Percentage Point Increase	One Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	\$ 0.1	\$ (0.3)
Effect on accumulated postretirement benefit obligation	4.5	(6.4)

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

	2007	2006
Service cost-benefits earned during the period	\$ 1.9	\$ 1.4
Interest cost on accumulated benefit obligation	3.6	2.8
Amortization of prior service cost	(1.3)	(1.3)
Amortization of net actuarial loss	3.2	1.6
Total periodic expense	7.4	4.5
Net periodic postretirement benefit expense	\$ 7.4	\$ 4.5

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

Prior service cost	\$ (1.3)
Net actuarial loss	2.4
Total	\$ 1.1

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

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

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 established a prescription drug benefit under Medicare ("Medicare Part D") and a federal subsidy to sponsors of retiree health care benefit plans that provide benefits that are at least actuarially equivalent to Medicare Part D. The benefits provided under the Bank's plan to certain participants are at least actuarially equivalent to the Medicare Part D prescription drug benefit. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic postretirement benefit expense.

There were no receipts of federal Medicare Part D subsidies in the year ended December 31, 2006. Receipts in the year ending December 31, 2007, related to benefits paid in the years ended December 31, 2006 and 2007, were \$.3 million and \$.2 million, respectively. Expected receipts in 2008, related to benefits paid in the year ended December 31, 2007 are \$.1 million.

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

	Without Subsidy	With Subsidy
2008	\$ 3.7	\$ 3.3
2009	3.9	3.5
2010	4.2	3.7
2011	4.4	3.9
2012	4.7	4.1
2013 - 2017	28.3	24.5
Total	\$ 49.2	\$ 43.0

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank at December 31, 2007 and 2006 were \$5 million and \$6 million, respectively. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expenses included in both 2007 and 2006 operating expenses were \$1 million and are recorded as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income.

10. Accumulated Other Comprehensive Income And Other Comprehensive Income

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

	Amount Related to Postretirement Benefits other than Pensions
Balance at January 1, 2006	\$ -
Adjustment to initially apply SFAS No. 158	(24)
Balance at December 31, 2006	\$ (24)
Change in funded status of benefit plans:	
Net actuarial gain arising during the year	3
Amortization of prior service cost	(1)
Amortization of net actuarial loss	3
Change in funded status of benefit plans - other comprehensive income	5
Balance at December 31, 2007	\$ (19)

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

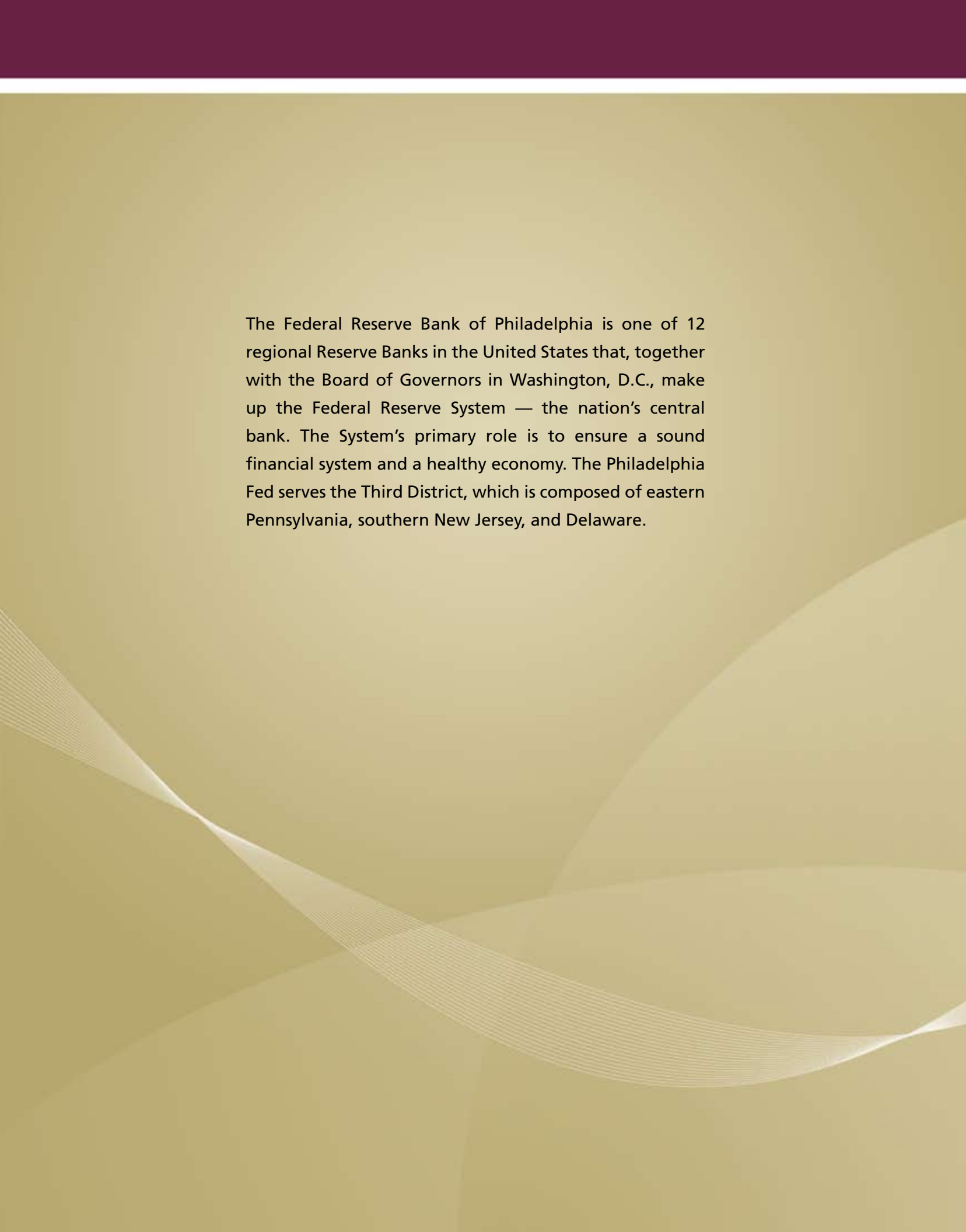
11. Business Restructuring Charges

In 2007, the Reserve Banks announced a restructuring initiative to align the check processing infrastructure and operations with declining check processing volumes. The new infrastructure will involve consolidation of operations into four regional Reserve Bank processing sites in Philadelphia, Cleveland, Atlanta, and Dallas. The Bank's costs associated with the restructuring were not material.

12. Subsequent Events

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

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The Federal Reserve Bank of Philadelphia is one of 12 regional Reserve Banks in the United States that, together with the Board of Governors in Washington, D.C., make up the Federal Reserve System — the nation's central bank. The System's primary role is to ensure a sound financial system and a healthy economy. The Philadelphia Fed serves the Third District, which is composed of eastern Pennsylvania, southern New Jersey, and Delaware.



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