85th Annual Report 1998

Board of Governors of the Federal Reserve System

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Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., May 1999

THE SPEAKER OF
THE HOUSE OF REPRESENTATIVES

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

This report covers operations of the Board during calendar year 1998.

Sincerely,

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Contents

Part 1 Monetary Policy and Economic Developments

3 MONETARY POLICY AND THE ECONOMY IN 1998

9 ECONOMIC AND FINANCIAL DEVELOPMENTS IN 1998
9 The household sector
12 The business sector
14 The government sector
17 The external sector
19 The labor market
20 Prices
22 U.S. financial markets
28 Debt and the monetary aggregates
32 International developments
37 Foreign exchange operations

39 MONETARY POLICY REPORTS TO THE CONGRESS
39 Report on February 24, 1998
65 Report on July 21, 1998

Part 2 Records, Operations, and Organization

95 THE BOARD OF GOVERNORS AND THE GOVERNMENT PERFORMANCE AND RESULTS ACT
95 Strategic and performance plans
95 Goals and objectives
97 Interagency coordination

99 RECORD OF POLICY ACTIONS OF THE BOARD OF GOVERNORS
99 Regulation B (Equal Credit Opportunity)
99 Regulation C (Home Mortgage Disclosure)
99 Regulation D (Reserve Requirements of Depository Institutions)
101 Regulation E (Electronic Fund Transfers)

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RECORD OF POLICY ACTIONS OF THE BOARD OF GOVERNORS—Continued
101 Regulation H (Membership of State Banking Institutions in the Federal Reserve System)
102 Regulation H and Regulation P (Security Procedures)
102 Regulation H and Regulation Y (Bank Holding Companies and Change in Bank Control)
103 Regulation I (Issue and Cancellation of Federal Reserve Bank Capital Stock)
103 Regulation J (Collection of Checks and Other Items by Federal Reserve Banks) and Regulation CC (Availability of Funds and Collection of Checks)
104 Regulation K (International Banking Operations)
104 Regulation M (Consumer Leasing)
104 Regulation Y (Bank Holding Companies and Change in Bank Control)
105 Regulation Z (Truth in Lending)
106 Regulation DD (Truth in Savings)
106 Rules Regarding Delegation of Authority
107 Policy statements and other actions
109 1998 discount rates

113 MINUTES OF FEDERAL OPEN MARKET COMMITTEE MEETINGS
113 Authorization for Domestic Open Market Operations
115 Domestic Policy Directive
115 Authorization for Foreign Currency Operations
117 Foreign Currency Directive
118 Procedural Instructions with Respect to Foreign Currency Operations
118 Meeting held on February 3–4, 1998
135 Meeting held on March 31, 1998
143 Meeting held on May 19, 1998
153 Meeting held on June 30–July 1, 1998
164 Meeting held on August 18, 1998
174 Meeting held on September 29, 1998
184 Meeting held on November 17, 1998
197 Meeting held on December 22, 1998

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Federal Reserve Bank of St. Louis

207 CONSUMER AND COMMUNITY AFFAIRS
207 Applications
209 TILA and RESPA reform
210 Regulatory matters
212 HMDA data and lending patterns
214 Fair lending
215 Community development
218 Economic effects of the Electronic Fund Transfer Act
219 Compliance
220 Community Reinvestment Act
220 Agency reports on compliance with consumer regulations
224 Consumer complaints
226 Consumer policies
228 Consumer Advisory Council
229 Testimony and legislative recommendations
230 Recommendations of other agencies
230 Year 2000 initiatives

231 LITIGATION
231 Judicial review of Board orders under the Bank Holding Company Act
232 Litigation under the Financial Institutions Supervisory Act
232 Other actions

235 LEGISLATION ENACTED
235 Consumer Reporting Employment Clarification Act
235 Credit Union Membership Access Act
236 Examination Parity and Year 2000 Readiness for Financial Institutions Act
236 Federal Employees Health Care Protection Act
236 Homeowners Protection Act
237 Money Laundering and Financial Crimes Strategy Act
237 U.S. Holocaust Assets Commission Act

239 BANKING SUPERVISION AND REGULATION
240 Scope of responsibilities for banking supervision and regulation
241 Supervision for safety and soundness
250 Supervisory policy
261 Supervisory information technology
262 Staff training
264 Regulation of the U.S. banking structure
268 Recent regulatory changes
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Federal Reserve Bank of St. Louis

BANKING SUPERVISION AND REGULATION—Continued
268 Enforcement of other laws and regulations
271 Federal Reserve membership

273 REGULATORY SIMPLIFICATION
273 Comprehensive revisions adopted
274 Other revisions adopted
274 Comprehensive revisions proposed

275 FEDERAL RESERVE BANKS
275 Century date change
275 Developments in Federal Reserve priced services
281 Developments in currency and coin
282 Developments in fiscal agency and government depository services
287 Information technology
288 Financial examinations of Federal Reserve Banks
288 Income and expenses
289 Holdings of securities and loans
290 Volume of operations
290 Federal Reserve Bank premises
291 Pro forma financial statements for Federal Reserve priced services

295 FEDERAL RESERVE BANKS COMBINED FINANCIAL STATEMENTS

307 BOARD OF GOVERNORS FINANCIAL STATEMENTS

315 STATISTICAL TABLES
316 1. Statement of condition of each Federal Reserve Bank, December 31, 1998 and 1997
320 2. Federal Reserve open market transactions, 1998
322 3. Federal Reserve Bank holdings of U.S. Treasury and federal agency securities, December 31, 1996–98
323 4. Number and annual salaries of officers and employees of Federal Reserve Banks, December 31, 1998
324 5. Income and expenses of Federal Reserve Banks, 1998
328 6. Income and expenses of Federal Reserve Banks, 1914–98
332 7. Acquisition costs and net book value of premises of Federal Reserve Banks and Branches, December 31, 1998
333 8. Operations in principal departments of Federal Reserve Banks, 1995–98
334 9. Federal Reserve Bank interest rates on loans to depository institutions, December 31, 1998

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STATISTICAL TABLES—Continued

335 10. Reserve requirements of depository institutions, December 31, 1998
336 11. Initial margin requirements under Regulations T, U, and X
337 12. Principal assets and liabilities and number of insured commercial banks in the United States, by class of bank, June 30, 1998 and 1997
338 13. Reserves of depository institutions, Federal Reserve Bank credit, and related items—year-end 1918–98 and month-end 1998
344 14. Banking offices, and banks affiliated with bank holding companies in the United States, December 31, 1997 and 1998
345 15. Mergers, consolidations, and acquisitions of assets or assumptions of liabilities approved by the Board of Governors, 1998

365 FEDERAL RESERVE DIRECTORIES AND MEETINGS
366 Board of Governors of the Federal Reserve System
368 Federal Open Market Committee
369 Federal Advisory Council
370 Consumer Advisory Council
371 Thrift Institutions Advisory Council
372 Officers of Federal Reserve Banks and Branches
374 Conferences of chairmen, presidents, and first vice presidents
374 Directors

395 MAPS OF THE FEDERAL RESERVE SYSTEM

399 INDEX

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Part 1

Monetary Policy and Economic Developments

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Monetary Policy and the Economy in 1998

In 1998, the U.S. economy again performed impressively. Output expanded rapidly, the unemployment rate fell to its lowest level since 1970, and inflation remained subdued. Transitory factors, most recently falling prices for imports and commodities, especially oil, have helped produce the favorable outcomes of recent years, but technological advances and increased efficiency, likely reflecting in part heightened global competition and changes in business practices, suggest that some of the improvement will be more lasting.

Sound fiscal and monetary policies have contributed importantly to the good economic results of recent years: Budgetary restraint at the federal level has bolstered national saving and permitted the Federal Reserve to maintain lower interest rates than would otherwise have been possible. This policy mix and sustained progress toward price stability have fostered clearer price signals, more efficient resource use, robust business investment, and sizable advances in the productivity of labor and the real wages of workers. The more rapid expansion of productive potential has, in turn, helped keep inflation low even as aggregate demand surged and labor markets tightened.

Nonetheless, economic troubles abroad posed a significant threat to the economy's performance in 1998. Foreign economic growth slowed markedly, on average, as conditions in many countries deteriorated. The recession in Japan deepened, and several emerging market economies in Asia, which had started to weaken in the wake of the financial crises of 1997, contracted sharply. A worsening economic situation in Russia during the summer led to a devaluation of the ruble and a moratorium by that country on a substantial portion of its debt payments. As the year progressed, conditions in Latin America also weakened. Although some of the troubled foreign economies were showing signs of improvement by the end of the year, others either were not yet in recovery or were still contracting.

The Russian crisis in mid-August precipitated a period of unusual volatility in world financial markets. The losses incurred in Russia and other emerging market economies heightened investors' and lenders' concerns about other potential problems and led them to become substantially more cautious about taking on risk. The resulting effects on U.S. financial markets included a substantial widening of risk spreads on debt instruments, a jump in measures of market uncertainty and volatility, a drop in equity prices, and a reduction in the liquidity of many markets. To cushion the U.S. economy from the effects of financial strains here and abroad, and potentially to help reduce the strains as well, the Federal Reserve eased monetary policy on three occasions in the fall. Global financial market stresses lessened somewhat after mid-autumn, reflecting, in part, these policy steps as well as interest rate cuts in other industrial countries and international efforts to provide support to troubled emerg-

NOTE. The discussion here and in the next chapter is adapted from *Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978* (Board of Governors, February 1999). The data cited in these two chapters are those available as of mid-March 1999.

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ing market economies. Although some U.S. financial flows were disrupted for a time, most firms and households remained able to obtain sufficient credit, and the turbulence did not appear to constrain spending significantly.

The foreign exchange value of the dollar rose substantially against the currencies of the major foreign industrial countries over the first eight months of 1998, but it subsequently fell sharply, ending the year down a little on net. The dollar's appreciation in the first half of the year carried it to an eight-year high against the Japanese yen. In June, this strength prompted the first U.S. foreign exchange intervention operation in nearly three years, an action that appeared to slow the dollar's rise against the yen over the following weeks. Later in the summer, concerns about the possible impact on the U.S. economy of increasing difficulties in Latin America began to weigh on the dollar's exchange value against major foreign currencies. After peaking in mid-August, it fell sharply over the course of several weeks, reversing by mid-October the appreciation that had occurred earlier in the year. The depreciation during this period was particularly sharp against the yen. The reasons for this decline against the yen are not clear, but repayment of yen-denominated loans by international investors and decisions by Japanese investors to repatriate their assets in light of increased volatility in global markets seem to have contributed. The dollar's exchange value fluctuated moderately against the major currencies over the rest of the year. At year-end, the launch of the third stage of European Economic and Monetary Union fixed the eleven participating countries' conversion rates and created a new common currency, the euro.

With the U.S. economy expanding rapidly, the economies of many U.S. trading partners struggling, and the foreign exchange value of the dollar having risen over 1997 and the first part of 1998, the U.S. trade deficit widened considerably in 1998. Some domestic industries were especially affected by lower foreign demand or increased competition from imports. For example, a wide range of commodity producers, notably those in agriculture, oil, and metals, experienced sharp price declines. Parts of the manufacturing sector also suffered adverse consequences from the shocks from abroad. Overall, real net exports deteriorated sharply, as exports stagnated and imports continued to surge. The deterioration was particularly marked in the first half of the year; the second half brought a further, more modest, net widening of the external deficit.

Meanwhile, domestic spending continued to advance rapidly. Household expenditures were bolstered by gains in real income and a further rise in wealth, while a low cost of capital and optimism about future profitability spurred businesses to invest heavily in new capital equipment. Although securities markets were disrupted in late summer and early fall, credit generally remained available from alternative sources. Once the strains on securities markets had eased, businesses and households generally had ready access to credit and other sources of finance on relatively favorable terms, although spreads in some markets remained quite elevated, especially for lower-rated borrowers. All told, household and business outlays rose even more rapidly than in 1997, and that acceleration kept the growth of real GDP strong even as net exports were slumping.

Deteriorating economic conditions abroad, coupled with the strength of the dollar over the first eight months of the year, helped hold down inflation in

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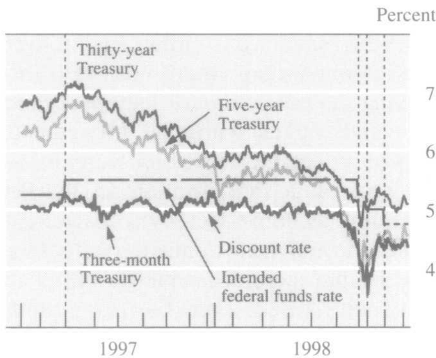
the United States by trimming the prices of oil and other imports. These declines reduced both the prices paid by consumers and the costs of production in many lines of business, and the competition from abroad kept businesses from raising prices as much as they might have otherwise. As a result of the reduced rate of price inflation, workers enjoyed a larger rise in real purchasing power even as increases in nominal hourly compensation picked up only slightly on average. Because of increased gains in productivity, corporations in the aggregate were able to absorb the larger real pay increases without suffering a serious diminution of profitability.

Monetary policy in 1998 needed to balance two major risks to the economic expansion. On the one hand, with the domestic economy displaying considerable momentum and labor markets tight, the Federal Open Market Committee (FOMC) was concerned about the possible emergence of imbalances that would lead to higher inflation and thereby, eventually, put the sustainability of the expansion at risk. On the other hand, troubles in many foreign economies and resulting financial turmoil both abroad and at home seemed, at times, to raise the risk of an excessive weakening of aggregate demand.

Selected Interest Rates



NOTE. The data are daily. Short ticks indicate days on which the Federal Open Market Committee held a scheduled meeting or a policy action was announced. Vertical lines mark days on which policy actions were announced: March 25, 1997; and September 29, October 15, and November 17, 1998.

Over the first seven months of the year, neither of these potential tendencies was sufficiently dominant to prompt a policy action by the FOMC. Although the incoming data gave no evidence of a sustained slowing of output growth, the Committee members believed that the pace of expansion would likely moderate as businesses began to slow the rapid rates at which they had been adding to their stocks of inventories and other investment goods, and as households trimmed the large advances in their spending on homes and consumer durable goods. Relatively firm real interest rates, buoyed by a high real federal funds rate resulting from the decline in the level of expected inflation, were thought likely to help restrain the growth of spending by businesses and households. Another check on growth was expected to come from the effects on imports and exports of the economic difficulties in emerging market economies in Asia and elsewhere. Indeed, production in the manufacturing sector slowed substantially in the first half of the year, and capacity utilization dropped noticeably. Moreover, inflation remained subdued, and a pickup was not expected in the near-to-intermediate term because of declining oil prices and because economic weakness abroad and the appreciation of the dollar were expected to trim the prices of imported goods and to increase price competition for many U.S. producers. Nonetheless, with labor markets already quite taut and aggregate demand growing rapidly—a combination that often has signaled the impending buildup of inflationary pressures—the Committee, at its meetings from March through July,

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judged conditions to be such that, if a policy action were to be taken in the period immediately ahead, it more likely would be a tightening than an easing; its directives to the Account Manager of the Domestic Trading Desk at the Federal Reserve Bank of New York noted that asymmetry.

By the time of the August FOMC meeting, however, the situation was changing. Although tight labor markets and rapid output growth continued to pose a risk of higher inflation, the damping influence of foreign economic developments on the U.S. economy seemed likely to increase. The contraction of the emerging market economies in Asia appeared to be deeper than had been anticipated, and the economic situation in Japan had deteriorated. Financial markets in some foreign economies also had experienced greater turmoil, and, the day before the Committee met, Russia was forced to devalue the ruble. These difficulties had been weighing on U.S. asset markets. Stock prices had fallen sharply in late July and into August as investors became concerned about the outlook for profits, and risk spreads in debt markets had widened, albeit from very low levels. Taking account of these circumstances, the Committee again left monetary policy unchanged at the August meeting, but it shifted to a symmetric directive, reflecting its perception that the risks to the economic outlook, at prevailing short-term rates, had become roughly balanced.

Over subsequent weeks, conditions in financial markets and the economic outlook in many foreign countries deteriorated further, increasing the dangers to the U.S. expansion. With investors around the world apparently reevaluating the risks associated with various credits and seemingly becoming less willing or less able to bear such risks, asset demands shifted toward safer and more liquid instruments. These shifts caused a sharp fall in yields on Treasury securities. Spreads of yields on private debt securities over those on comparable Treasury instruments widened considerably further, and issuance slowed sharply. Measures of market volatility increased, and liquidity in many financial markets was curtailed. Equity prices continued to slide lower, with most broad indexes falling back by early September to near their levels at the start of the year. Reflecting the weaker and more uncertain economic outlook, some banks boosted interest rate spreads and fees on new loans to businesses and tightened their underwriting standards.

Against this backdrop, the FOMC at its September meeting looked beyond incoming data suggesting that the economy was continuing to expand at a robust pace, and it lowered the intended level of the federal funds rate ¼ percentage point. The Committee noted that the rate cut would cushion the effects on prospective U.S. economic growth of increasing weakness in foreign economies and of less accommodative conditions in domestic financial markets. The directive adopted at the meeting suggested a bias toward further easing over the intermeeting period. In the days following the policy move, disturbances in financial markets worsened. Movements in the prices of securities were exacerbated by a deterioration in market liquidity, as some securities dealers cut back on their market-making activities, and by the increased anticipation of an unwinding of positions by hedge funds and other leveraged investors. In early October, Treasury yields briefly tumbled to their lowest levels in many years, reflecting efforts by investors to exchange other instruments for riskless and liquid Treasury securities.

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Although some measures of market turbulence had begun to ease a bit by mid-October, financial markets remained extremely volatile, and risk spreads were very wide. On October 15, consistent with the directive from the September meeting, the intended federal funds rate was trimmed another ¼ percentage point, to 5 percent. This policy move, which occurred between FOMC meetings, came at the initiative of Chairman Greenspan and followed a conference call with Committee members. At the same time, the Board of Governors approved a ¼ percentage point reduction in the discount rate. These actions were taken to buffer the domestic economy from the impact of the less accommodative conditions in domestic financial markets, perhaps in part by contributing to some stabilization of the financial situation.

Following the October policy move, strains in domestic financial markets diminished considerably. As safe-haven demands for Treasury securities ebbed, Treasury yields generally trended higher, and measures of financial market volatility and illiquidity eased. Nonetheless, risk spreads remained very wide, and liquidity in many markets continued to be limited. Moreover, although pressures on some emerging market economies had receded a bit, partly reflecting concerted international efforts to provide assistance to Brazil, the foreign economic outlook remained uncertain. With downside risks still substantial, and in light of the cumulative effect since August of the tightening in many credit markets and the weakening of economic activity abroad, the FOMC reduced the intended federal funds rate a further ¼ percentage point at its November meeting, bringing the total reduction during the autumn to ¾ percentage point. The Board of Governors also approved a second ¼ percentage point cut in the discount rate. The Committee believed that, with this policy action, financial conditions could reasonably be expected to be consistent with fostering sustained economic expansion while keeping inflationary pressures subdued. The action provided some insurance against an unexpectedly severe weakening of the expansion, and the Committee therefore established a symmetrical directive. By the time of the December meeting, the situation in financial markets had changed little, on balance, and the Committee decided that no further change in rates was desirable and that the directive should remain symmetrical. ■

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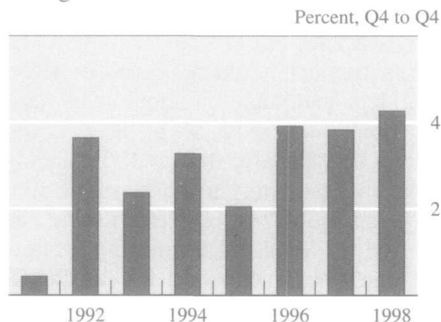
Economic and Financial Developments in 1998

The U.S. economy continued to display great vigor in 1998, despite a sharp slowing of growth in foreign economies and an unsettled world financial environment. Real GDP increased more than 4 percent over the four quarters of the year, according to the Commerce Department's preliminary estimate. The economic difficulties facing many U.S. trading partners, together with the strength of the dollar through much of the year, led to sluggishness in real exports of goods and services. However, the drag on the economy from that source was more than offset by exceptional strength in the real expenditures of households and businesses, which were powered by strong real income growth, large gains in the value of household wealth, ready access to finance during most of the year, and widespread optimism about the future of the economy. Although turmoil in financial markets seemed to threaten the economy for a time in late summer and early autumn, that threat later receded, in part because of the steps taken by the Federal Reserve to prevent the tightening of credit markets from impairing the expansion of activity. The final quarter of the year brought brisk expansion of employment and income.

Change in Real GDP



NOTE. The data are based on chained (1992) dollars and come from the Department of Commerce.

The increase in the general price level in 1998 was smaller than that of the preceding year, which had itself been among the smallest in decades. The chain-type price index for GDP rose slightly less than 1 percent. The further slowing of price increases was in large part a reflection of sluggish conditions in the world economy, which brought declines in the prices of many imported goods, including oil and other primary commodities. In the domestic economy, the nominal hourly compensation of workers picked up only slightly despite the tightness of the labor market, and much of the compensation increase was offset by gains in labor productivity. As a result, unit labor costs, the most important item in total business costs, rose only modestly.

The Household Sector

Personal consumption expenditures increased more than 5 percent in real terms in 1998, the largest gain in a decade and a half. Support for the large spending increase came from a combination of circumstances that, on the whole, were exceptionally favorable to households. Strong gains in employment and real hourly pay gave another appreciable boost to the growth of real labor income. At the same time, household wealth again rose substantially, bolstered in large part by the continued rise in equity prices. Household net worth at the end of 1998 was up more

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than 10 percent from the level at the end of 1997. The cumulative gain in household wealth from year-end 1994 to year-end 1998 was nearly 50 percent.

The rise in net worth probably accounts for much of the decline in the personal saving rate over the past few years, to an annual average of ½ percent in 1998. Households tend to increase their saving from current income when they feel that they must increase their wealth to meet their longer-run objectives, but they are willing to reduce their saving from current income when they feel that their wealth is already at satisfactory levels. The low level of the saving rate in 1998 is not so remarkable when gauged against a wealth-to-income ratio that has been running in a range well above its longer-run historical average.

Personal consumption expenditures in all three major categories—durables, nondurables, and services—recorded gains in 1998 that were the largest of the 1990s. Spending on durable goods rose more than 12 percent over the year. Within that category, expenditures on home computers once again stood out, rising nearly 75 percent in real terms, a gain that reflected both an increase in nominal outlays and a further substantial decline in computer prices. Consumer outlays on motor vehicles also rose sharply, despite some temporary limitations on supply from a midyear strike at a major automaker. Spending on most other types of durable goods registered gains well above the average annual increases of the past decade or so. Because durable goods are not consumed all at once—but, rather, add to stocks of such goods that will be yielding services to consumers for a number of years—they represent a form of economic saving that is not captured in the measure of the saving rate in the national income accounts.

The increases in income and net worth that led households to boost their consumption expenditures in 1998 also led them to invest heavily in additions to the stock of housing. Declines in mortgage interest rates weighed in as well, helping to maintain the affordability of housing even as house prices moved up somewhat faster than overall inflation. These developments brought the objective of owning a home within the reach of a greater number of households, and the home-ownership rate, which has been trending up over the decade, rose to another new high.

In the single-family sector, sales of new and existing homes surged, the former rising more than 10 percent from the preceding year and the latter about 13 percent. Construction of single-family houses strengthened markedly. The number of units started during the year was the largest since the late 1970s and exceeded the 1997 total by about 12 percent. In the fourth quarter, unusually mild weather permitted builders to maintain activity later into the season than they normally would have and gave an added kick to housing starts.

In contrast to the strength in the single-family sector, the number of multifamily units started in 1998 was up only a little from 1997. After bottoming out at a very low level early in the 1990s, construction of these units had been trending back up fairly briskly. But with vacancy rates for multifamily rental units running a touch higher in 1998, builders and their creditors may have become concerned about adding too many new units to the stock. Financing appeared generally to be in ample supply for promising projects; during the period of financial turmoil, the flow of credit was supported by substantial purchases of multifamily mortgages and mortgage-backed securities by Freddie Mac and Fannie Mae.

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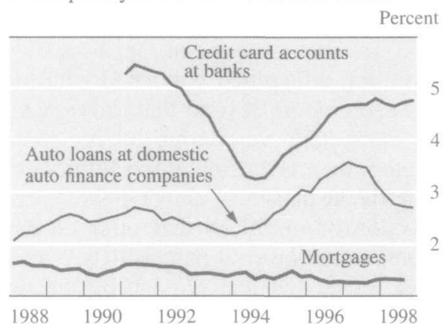
Total outlays for residential investment increased about 12¾ percent in real terms during 1998, according to the Commerce Department's preliminary tally. The large increase reflected not only the construction work on new residential units undertaken during the year but also sizable advances in real outlays for home improvements and in the volume of sales activity being carried on by real estate brokers, which generated substantial gains in commissions.

The robust growth in household expenditures in 1998 was accompanied by an expansion of household debt of nearly 9 percent, a larger rise than in other recent years. Nonmortgage debt increased 5½ percent, about 1 percentage point above the preceding year's pace but down considerably from the double-digit increases of 1994 and 1995. Home mortgage debt jumped nearly 10 percent, its largest annual advance since 1989, boosted in part by the strong housing market. In addition, with mortgage rates reaching their lowest levels in many years, many households refinanced existing mortgages, and some likely took the opportunity to increase the size of their mortgages, using the extra funds to finance current expenditures or to pay down other debts.

The growth in household debt reflected both supply and demand influences. With wealth rising faster than income over the year and with consumer confidence remaining at historically high levels, households were willing to boost their indebtedness to finance increased spending. In addition, lenders generally remained accommodative toward all but the most marginal households, even after the turmoil in many financial markets in the fall. After a more general tightening of loan conditions between mid-1996 and mid-1997 in response to a rise in losses on such loans, a smaller and declining fraction of banks tightened consumer lending standards and terms in 1998, according to Federal Reserve surveys. However, the availability of high loan-to-value and subprime home equity loans likely was reduced in the fall because of difficulties in the market for securities backed by such loans.

Despite the rapid increase in debt, measures of household financial stress were relatively stable in 1998, although some remained at high levels. The delinquency rate for home mortgages has stayed quite low in recent years, and that for auto loans at domestic auto finance companies has trended lower. The delinquency rate for credit card loans at banks fluctuated in a fairly narrow range in 1997 and 1998, but it remained elevated after having risen substantially over the previous two years. Personal bankruptcy filings have followed a broadly similar pattern: Growth ran at about a 3 percent annual rate, on average, from the spring of 1997 to the autumn of 1998, down from annual increases of roughly 25 percent between early 1995 and early 1997. The stability of these measures over the past couple of years is likely due in part to the earlier tightening of standards and

Delinquency Rates on Household Loans



NOTE. The data are quarterly. Data on credit card delinquencies are from bank Call Reports; data on auto loan delinquencies are from the Big Three automakers; data on mortgage delinquencies are from the Mortgage Bankers Association and are through 1998:Q3.

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terms on consumer loans. In addition, lower interest rates and longer loan maturities, which resulted from the shift toward mortgage finance, have helped mitigate the effects of increased borrowing on household debt-service burdens.

The Business Sector

Business fixed investment increased about 12¼ percent over 1998, with a 17 percent rise in equipment spending accounting for the entire advance. The strength of the economy and optimism about its longer-run prospects provided underpinnings for increased investment. Outlays were also bolstered by the efficiencies obtainable with new technologies, by the favorable prices at which many types of capital equipment could be purchased, and, except during the period of financial market turmoil, by the ready availability and low cost of finance, either through borrowing or through the issuance of equity shares.

Real expenditures on office and computing equipment, after having risen at an average rate of roughly 30 percent in real terms from 1991 through 1997, shifted into even higher gear in 1998, climbing about 65 percent. The outsized increase was likely due in part to the efforts of some businesses to put new computer systems in place before the end of the millennium, in hopes of avoiding difficulties associated with the Y2K problem. Beyond that, investment in computers was driven by the same factors that have been at work throughout the expansion—namely, the introduction of machines that offer greater computing power at increasingly attractive prices and that provide businesses new and more efficient ways of organizing their operations. Price declines in 1998 were especially large because the cost reductions associated with technical change were augmented by heightened international competition in the markets for semiconductors and other computer components and by price cutting to work down the stocks of some assembled products.

Investment in communications equipment—another high-tech category that is an increasingly important part of total equipment outlays—rose about 18 percent in 1998. After having traced out an erratic pattern of ups and downs through the latter part of the 1980s and the early 1990s, real outlays for this type of equipment began to record sustained large annual increases in 1994, and the advance in 1998 was one of the largest. Spending on other types of equipment displayed varying degrees of strength across different sectors but recorded a sizable gain overall. Investment in transportation equipment was strong across the board, spurred by the need to move greater volumes of goods or to carry more passengers in an expanding economy. Spending on industrial machinery advanced about 4¼ percent after having made larger gains in most previous years of the expansion, a pattern that mirrored a slowing of output growth in the industrial sector.

Business investment in nonresidential structures, which accounts for slightly more than 20 percent of total business fixed investment, was unchanged in 1998, according to the preliminary estimate. Sharply divergent trends were evident within nonresidential construction, ranging from considerable strength in the construction of office buildings to marked weakness in the construction of industrial buildings. The waxing and waning of industry-specific construction cycles appears to be the main explanation for the diverse outcomes of 1998. Although some of the more-speculative construction plans may have been shelved because of a tightening of lending terms and standards, partly in

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reaction to the financial turmoil, most builders appear to have been able to eventually obtain financing. Despite the sluggishness of spending on structures, the level of investment remained high enough in 1998 to generate continued moderate growth in the real stock of structures.

Business inventories increased about 4½ percent in real terms in 1998 after having risen more than 5 percent in 1997. Stocks grew at a 7 percent annual rate in the first quarter, appreciably faster than final sales, but inventory growth over the remainder of the year was considerably slower than in the first quarter. At year-end, stocks in most nonfarm industries were at levels that did not seem likely to cause firms to restrain production going forward. Inventories of vehicles may even have been a little on the lean side, as a result of both a strike that held down assemblies through the middle part of the year and exceptionally strong demand, which prevented the rebuilding of stocks later in the year. By contrast, year-end inventories appear to have been excessive in a few nonfarm industries that have been hurt by the sluggish world economy. Stocks of farm commodities also appear to have been excessive, having been boosted further during the year by large harvests and sluggish export demand.

The economic profits of U.S. corporations—that is, book profits adjusted so that inventories and fixed capital are valued at their current replacement cost—rose further, on net, over the first three quarters of 1998, but at a much slower pace than in most other years of the current expansion. Companies' earnings from operations in the rest of the world fell back a bit, as did the profits of private financial corporations from domestic operations. The profits of nonfinancial corporations from domestic operations increased at an annual rate of about 1¾ percent. Although the volume of output of the nonfinancial companies continued to rise rapidly, profits per unit of output were squeezed a bit by companies' difficulties in raising prices in step with costs in a competitive market environment.

With profits expanding more slowly and investment spending still on the upswing, businesses' external funding needs increased substantially in 1998. Aggregate debt of the nonfinancial business sector expanded 9¼ percent from the end of 1997 to the end of 1998, the largest increase in ten years. The rise reflected growth in all major types of business debt. Business borrowing was also boosted by substantial merger and acquisition activity. Indeed, mergers and acquisitions, share repurchases, and foreign purchases of U.S. firms in 1998 overwhelmed the high level of both initial and seasoned public equity issues, and net equity retirements exceeded $260 billion.

The financial market disruptions in late summer and early fall appear to have had little effect on total business borrowing but prompted a substantial temporary shift in the sources of credit. With investors favoring high credit quality and liquidity, yields on lower-rated corporate bonds rose despite declining Treasury rates; the spread of yields on junk bonds over those on comparable Treasury securities roughly doubled between mid-summer and mid-autumn before falling back somewhat as conditions in financial markets eased. The spread of rates on lower-tier commercial paper over those on higher-quality paper rose substantially during the fall but retraced much of the rise by year-end.

Reflecting these adverse market conditions, nonfinancial corporate bond issuance fell sharply in August and remained low through mid-October, with issuance of junk bonds virtually

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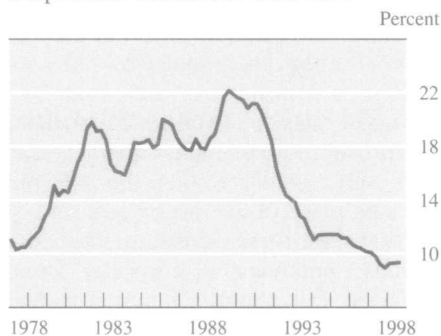
halted for a time. Commercial paper issuance rose sharply in August and September, as some firms apparently decided to delay bond issues, turning temporarily to the commercial paper market instead. Bond issuance picked up again in late October, however, and issuance was extremely heavy in November and remained strong in December. In conjunction with this rebound, commercial paper outstanding fell back in the fourth quarter.

During the period when financial markets were strained, some borrowers substituted bank loans—in some cases under credit lines priced before the markets became volatile—for other sources of credit, and business loans at banks expanded very rapidly for a time before tailing off late in the year. Federal Reserve surveys indicate that banks responded to the financial market turmoil by tightening their standards and terms on new loans and credit lines, especially on loans to larger customers and those to finance commercial real estate ventures; the tightening reflected the less favorable or more uncertain economic outlook as well as a reduced tolerance for risk at some banks.

Nonfinancial businesses remained strong financially in 1998 despite the rapid growth of debt and the relatively small gain in profits. Interest rates for many businesses fell, on balance, over the year, and bond yields for investment-grade firms reached their lowest level in many years. Reflecting these low borrowing costs, the aggregate debt-service burden for nonfinancial corporations, measured as the ratio of net interest payments to cash flow, remained about 9½ percent, near its low of 9 percent in 1997 and less than half the peak level reached in 1989. The delinquency rate for commercial and industrial loans extended by banks rose a bit from the trough reached in late 1997 but remained quite low, while that for commercial real estate loans fell a bit further, on net, from the already very low level posted in 1997. Although Moody's Investors Service downgraded more nonfinancial firms than it upgraded over the second half of the year, the downgraded firms were smaller on average, so the debt of those upgraded about equaled the debt of those downgraded. Through November, business failures remained at the low end of the range seen over the past decade.

Net Interest Payments of Nonfinancial Corporations Relative to Cash Flow



NOTE. The data are quarterly and are through 1998:Q3.

The Government Sector

In fiscal year 1998 the federal government recorded a surplus in the unified budget for the first time in nearly three decades. The surplus, amounting to $69 billion, was equal to about ¾ percent of GDP, a huge turnabout from the deficits of the early 1990s, which in some years were more than 4½ percent of GDP. The swing from deficit to surplus over the past few years was a result partly of fiscal policies aimed at lowering the deficit and partly of the strength of the economy and the stock market. Excluding net interest payments—a charge stemming from past deficits—the

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government recorded a surplus of more than $300 billion in fiscal 1998.

Because of the improvement in the government's saving position, national saving—the combined gross saving of households, businesses, and governments—increased about 3 percentage points as a share of GDP from 1993 to 1998, even though the personal saving rate was down sharply. The increase in national saving over that period helped facilitate the boom in investment spending—in contrast to the 1980s and early 1990s, when persistent large budget deficits tended to reduce national saving, boost interest rates higher than they otherwise would have been, and thereby crowd out private capital formation.

Federal receipts in the unified budget in fiscal year 1998 were up 9 percent from fiscal year 1997, with much of the gain attributable to personal income tax receipts, which rose more than 12 percent for a second consecutive year. These receipts have been rising faster than personal income in recent years, for several reasons: Rates for high-income taxpayers were raised by 1993 legislation intended to help reduce the deficit; more taxpayers have moved into higher brackets as their incomes have increased; and large increases in asset values have raised tax receipts from capital gains. Social insurance tax receipts, the second most important source of federal revenue, increased 6 percent in fiscal 1998, just a touch more than the fiscal 1997 increase and roughly in step with wage and salary growth. Receipts from the taxes on corporate profits, which account for about 10 percent of federal revenues, rose less rapidly than in other recent years, restrained by the slower growth of corporate profits. In the first three months of fiscal 1999, net receipts from corporate taxes dipped below year-earlier levels, but gains in individual income taxes and payroll taxes kept total federal receipts on a rising trajectory.

Unified outlays increased 3¼ percent in fiscal year 1998 after having risen 2½ percent in fiscal 1997. Net interest payments and nominal expenditures for defense fell slightly, and outlays for income security and Medicare rose only a little; social security expenditures increased moderately but somewhat less than in other recent fiscal years. By contrast, the growth of Medicaid payments picked up to about 6 percent after having increased less than 4 percent in each of the preceding two fiscal years; however, even the fiscal 1998 rise was not large compared with those in many earlier fiscal years when both medical costs and Medicaid caseloads were increasing rapidly and rates of federal reimbursement to the states were being raised. Emergency legislation that was passed in 1998, in an exception to statutory spending restrictions, will boost federal spending for a variety of functions in fiscal 1999, including defense, embassy security, disaster relief, preparation for Y2K, and aid to agriculture.

Real federal outlays for consumption and investment, the part of federal spending that is counted in GDP, increased about 1 percent, on net, from the final quarter of calendar year 1997 to the final quarter of 1998. A reduction in real defense outlays over that period was more than offset by a jump in nondefense spending.

With the budget balance shifting from deficit to surplus, the stock of publicly held federal debt declined in 1998 for the first time since 1969. From year-end 1997 to year-end 1998, U.S. government debt fell 1½ percent as the outstanding stock of both bills and coupon securities was reduced. Despite this reduction in debt, the federal government continued substantial gross borrowing to fund the retirement of maturing securities. With

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the need for funds trimmed substantially, however, the Treasury changed its auction schedules, discontinuing the three-year note auctions and moving to quarterly, rather than monthly, auctions of five-year notes. By reducing the number of coupon security issues, the Treasury is able to boost the size of each, thereby contributing to their liquidity. The decrease in the total volume of coupon securities is intended to boost the size of bill offerings over time, increasing liquidity in that market and also allowing, as the Treasury prefers, for balanced issuance across the yield curve. The Treasury also announced in October that all future bill and coupon security auctions would employ the single-price format that had already been adopted for the two-year and five-year note auctions and for auctions of inflation-indexed securities. The Treasury judged that the single-price format had reduced servicing costs and resulted in broader market participation.

The Treasury continued to auction inflation-indexed securities in substantial volume in 1998 in an effort to build up that part of the Treasury market. In April, the Treasury issued its first thirty-year indexed bond, and in September it announced a regular schedule of ten- and thirty-year indexed security auctions. The Treasury also began offering inflation-indexed savings bonds in September.

State and local governments recorded further increases in their budget surpluses in 1998, both in absolute terms and as a share of GDP. Revenue from the taxes on individuals' incomes has been growing very rapidly, keeping total receipts on a solid upward course. At the same time, the growth of transfer payments, which had threatened to overwhelm state and local budgets earlier in the decade, has slowed substantially in recent years. The growth of other types of spending has been trending up moderately, on balance. The 1998 rise in real expenditures for consumption and investment amounted to about 2¼ percent, according to the preliminary estimate; the annual gain has been in the range of 2 percent to 2¾ percent in each of the past seven years.

Despite the rising surpluses, state and local government debt increased 7¼ percent in 1998, a pickup of about 2 percentage points from growth in 1997. Somewhat more than half of the long-term borrowing by state and local governments in 1998 reflected new borrowing to fund current and anticipated capital spending on utilities, transportation, educational facilities, and other capital projects. The combination of budget surpluses and relatively heavy borrowing likely reflected several factors. First, some of these governments may have spent the newly raised funds on capital projects while at the same time building up surpluses in "rainy day funds" for later use. Second, because state and local governments under some circumstances are allowed to hold funds raised in the markets for as long as five years before spending them, some of the money raised in 1998 may not have been spent. Finally, there was a substantial volume of "advance refunding" in 1998. In an advance refunding, the borrower issues new bonds before existing higher-rate bonds may be called, in anticipation of calling the old bonds when that option becomes available. While this sort of refinancing temporarily boosts total debt, it allows the government entity to lock in a lower rate even if municipal bond yields rise over the period before the call date. The high level of advance-refunding activity in 1998 was the result of lower borrowing costs. Although yields on tax-exempt municipal securities did not decline nearly as much as those on compa-

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rable Treasury securities, they nonetheless reached their lowest levels in many years. In addition, rating agencies upgraded about five times as many state and local government issues as they downgraded, trimming borrowing costs further for the upgraded entities.

The External Sector

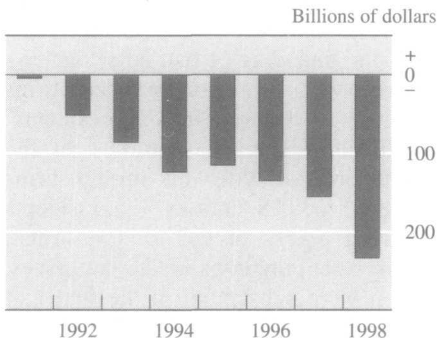
Trade and the Current Account

U.S. external balances deteriorated further in 1998, largely because of the disparity between the rapid growth of the U.S. economy and the sluggish growth of the economies of many U.S. trading partners. The nominal trade deficit for goods and services was $169 billion, considerably larger than the $110 billion deficit in 1997. At $233 billion, the current account deficit was also substantially larger than the 1997 deficit of $155 billion. The large current account deficits of recent years have been funded with increased net foreign saving in the United States. As a result, U.S. gross domestic investment has exceeded the level that could have been financed by gross national saving alone, but at the cost of a rise in net U.S. external indebtedness.

The increase in the current account deficit in 1998 was due to a decline in net exports of goods and services as well as a further weakening of net investment income from abroad. Until 1997, net investment income had partly offset persistent trade deficits. But as the U.S. net external debt has risen in recent years, net investment income has become increasingly negative, moving from a $14 billion surplus in 1996 to a $5 billion deficit in 1997 and reaching a deficit of more than $22 billion in 1998. Net income from portfolio investment became increasingly negative during that period as the net portfolio liability position of the United States grew larger. In addition, net income from direct investment declined in 1998 because slower foreign economic growth lowered U.S. earnings on investment abroad and the appreciation of the dollar reduced the value of those earnings, while healthy U.S. growth supported foreigners' earnings on direct investment in the United States.

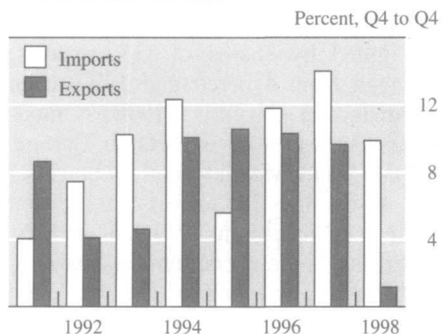
The rise of the trade deficit reflected an increase of about 10 percent in real imports of goods and services during 1998, according to the preliminary estimate from the Commerce Department. The increase was fueled by robust

U.S. Current Account



NOTE. The data are from the Department of Commerce.

Change in Real Imports and Exports of Goods and Services



NOTE. The data are from the Department of Commerce.

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growth of U.S. domestic demand and by continued declines in import prices, which stemmed in part from the strength of the dollar through mid-August and in part from the effects of recessions abroad. Of the major trade categories, increases in imports were sharpest for finished goods, especially capital equipment and automotive products. The quantity of imported oil rose appreciably as demand increased in response to the strength of U.S. economic activity and lower oil prices, while domestic production declined slightly. The price of imported oil fell about $6.50 per barrel over the four quarters of the year. World oil prices fell in response to reduced demand associated with the economic slowdown in many foreign nations and with unusually warm weather in the Northern Hemisphere; an increase in supply from Iraq also exerted downward pressure on oil prices.

Real exports of goods and services grew about 1 percent, on net, in 1998 after posting a 10 percent rise in 1997. Declines during the first three quarters (especially in machinery exports) were offset by a rebound in the fourth quarter, which was led by an increase in exports of automotive products. The price competitiveness of U.S. products decreased, reflecting the appreciation of the dollar through mid-August. In addition, economic activity abroad weakened sharply; total average foreign growth (weighted by shares of U.S. exports) plunged from 4 percent in 1997 to an estimated ½ percent in 1998. A moderate expansion of exports to Europe, Canada, and Mexico was about offset by a decline in exports associated with deep recessions in Japan and the emerging Asian economies (particularly in the first half of the year) and in South America (in the second half of the year).

Capital Flows

The financial difficulties in a number of emerging market economies had several noticeable effects on U.S. international capital flows in 1998. Financial turmoil put strains on official reserves in many emerging market economies. Foreign official assets in the United States fell $22 billion. This decline, which began in the fourth quarter of 1997, was largest for developing countries, as many of them drew down their foreign exchange reserves in response to exchange rate pressures. OPEC nations' foreign official reserves shrank in the first three quarters of 1998, as oil revenues dropped. Foreign official assets in the United States, especially those of industrial countries, generally rebounded in the fourth quarter.

Private capital flows also were affected by the widespread turmoil. On a global basis, capital flows to emerging market economies fell substantially in the first half of 1998 and then dropped precipitously in late summer and early fall in the wake of the Russian crisis. During the first half of the year, U.S. residents acquired about $35 billion of foreign securities. Net purchases virtually stopped in July, and in the August–October period U.S. residents, on net, sold about $40 billion worth of foreign securities. In the final two months of the year, as markets stabilized, U.S. residents resumed net purchases. (In addition, the financing of two large mergers between U.S. firms and European firms resulted in a surge in U.S. residents' holdings of foreign securities in the fourth quarter. When the foreign firms acquired the U.S. entities, U.S. residents received equity in the foreign firms.) Foreign net purchases of U.S. securities, which were substantial in the first half of the year, likewise fell off markedly in the July–October period but experi-

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enced a significant recovery in November and December. Thus, there is some evidence that the contraction in gross capital flows seen in late summer and early fall waned somewhat in the fourth quarter.

Private foreign purchases of U.S. Treasury securities were only $48 billion in 1998, compared with $147 billion for 1997. Small net sales in the first and third quarters partly offset large net purchases in the second and fourth quarters. Private foreigners' purchases of other U.S. securities shifted away from equities and toward bonds, relative to 1997.

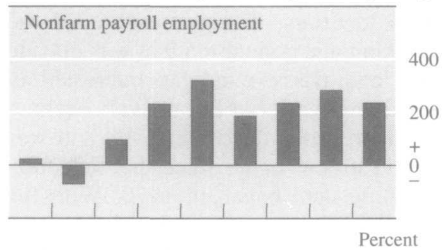
The contraction in private portfolio capital flows, though large, was overshadowed by huge direct investment capital flows, which resulted in part from the above-mentioned and other very large cross-border mergers. With the effects of the mergers, foreign direct investment into the United States totaled more than twice the previous record of $93 billion posted in 1997. Merger activity also buoyed U.S. direct investment abroad, bringing the annual total to $132 billion, surpassing the previous record of $122 billion in 1997.

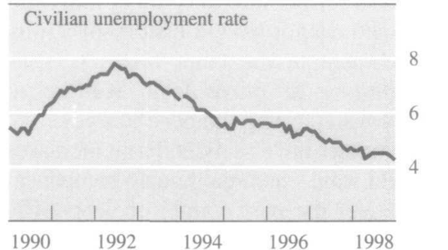
The Labor Market

The rapid growth of output in 1998 was associated with both increased hiring and continued healthy growth in labor productivity. The number of jobs on nonfarm payrolls rose about 2¼ percent from the end of 1997 to the end of 1998, a net increase of 2.8 million. Manufacturers reduced employment over the year, but the demand for labor in other parts of the economy continued to rise rapidly. The construction industry boosted employment about 6 percent over the year, and both the services industry and the finance, insurance, and real estate industry posted increases of more than 3½ percent. Stores selling building materials and home furnishings expanded employment rapidly, as did firms involved in computer services, communications, and managerial services.

Output per hour in the nonfarm business sector rose 2¾ percent in 1998 after having increased about 1¾ percent, on average, over the preceding two years; by comparison, the average rate of rise during the 1980s and the first half of the 1990s was just over 1 percent per year. Because productivity often picks up to a pace above its long-run trend when economic growth accelerates, the results of the past three years might well be overstating the rate of efficiency gain that can be maintained in coming years. However, reasons for thinking that the trend may have picked up somewhat are becoming more compelling in view of incoming data. The 1998 gain in output per hour was particularly impressive,

Labor Market Conditions





NOTE. The data are from the Department of Labor. The break in the unemployment rate data at January 1994 marks the introduction of a redesigned survey; data from that point on are not directly comparable with those of earlier periods.

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in part because it came at a time when many businesses were diverting resources to correct the Y2K problem, a move that likely imposed a bit of drag on the growth of output per hour. Higher rates of capital formation are raising the growth of capital per worker, and workers are likely becoming more skilled in using the new technologies. Businesses not only are increasing their capital inputs but also are continuing to implement changes to their organizational structures and operating procedures that may enhance efficiency and bolster profit margins.

The rising demand for labor continued to strain supply in 1998. The civilian labor force rose just a bit more than 1 percent from the fourth quarter of 1997 to the fourth quarter of 1998, and with the number of persons holding jobs rising somewhat faster than the labor force, the civilian unemployment rate fell still further. The unemployment rate was 4.3 percent at the end of 1998; the average for the full year—4.5 percent—was the lowest of any year in almost three decades. The percentage of the working age population that was outside the labor force and was interested in obtaining work but not actively seeking it edged down further in 1998 and was in the lowest range since the collection of these data began in 1970. With the supply of labor so tight, businesses reached further into the pool of individuals who do not have a history of strong attachment to the labor force; persons attempting to move from welfare to work were among the beneficiaries.

Workers have realized large increases in real wages and real hourly compensation over the past couple of years. The increases have come partly through faster gains in nominal pay than in the mid-1990s but also though reductions in the rate of price increase, which have been enhancing the real purchasing power of nominal earnings, perhaps to a greater degree than workers might have anticipated. According to the Labor Department's employment cost index, the hourly compensation of workers in private nonfarm industries rose 3½ percent in nominal terms during 1998, a touch more than in 1997 and ½ percentage point more than in 1996. Taking the consumer price index as the measure of price change, this increase in nominal hourly compensation translated into a 2 percent increase in real hourly pay, one of the largest on record in a series that goes back to the early 1980s; the gain was larger still if the chain-type price index for personal consumption expenditures is used as the measure of consumer prices. Moreover, the employment cost index does not capture some of the forms of compensation that employers have been using to attract and retain workers—stock options and signing bonuses, for example.

Because of the rapid growth in labor productivity, unit labor costs have been rising much less rapidly than hourly compensation in recent years. The increase in unit labor costs in the nonfarm business sector was only 1¼ percent in 1998. Businesses were unable to raise prices sufficiently to recoup even this small increase in costs, however. Labor gained a greater share of the income generated from production, and the profit share, though still high, fell back a little from its 1997 peak.

Prices

The broader measures of aggregate price change showed inflation continuing to slow in 1998. The consumer price index moved up 1½ percent over the four quarters of the year after having increased nearly 2 percent in 1997. A steep decline in energy prices in the CPI more than offset a small acceleration

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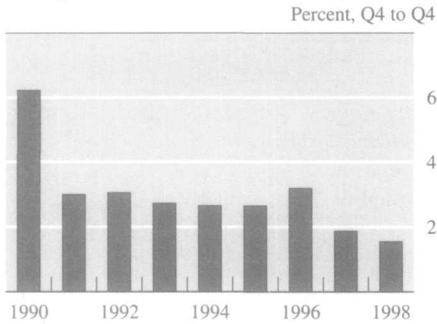
Change in Consumer Prices



NOTE. Consumer price index for all urban consumers. Based on data from the Department of Labor.

in the prices of other goods and services. Only part of the deceleration in the total CPI was attributable to technical changes in data collection and aggregation.[1]

Measures of aggregate price change from the national income and product accounts, which draw heavily on data from the CPI but also use data from other sources, showed a somewhat more pronounced deceleration of prices in 1998. The chain-type price index for personal consumption expenditures, the measure of consumer prices in the national accounts, rose ¾ percent after increasing 1½ percent in 1997. The chain-type price index for gross domestic purchases—the broadest measure of prices paid by U.S. households, businesses, and governments—increased less than ½ percent after moving up 1¼ percent over the preceding year. The rise in the chain-type price index for gross domestic product of slightly less than 1 percent was about one-half the 1997 increase of 1¾ percent.

Developments in the external sector helped bring about the favorable inflation outcome of 1998. Consumers benefited directly from lower prices of finished goods purchased from abroad. Lower prices for imports probably also held down the prices charged by domestic producers, not only because businesses were concerned about losing market share to foreign competitors but also because declines in commodity prices in sluggish world markets helped reduce domestic production costs to some degree.

In manufacturing, one of the sectors most heavily affected by the softness in demand from abroad, the rate of plant capacity utilization fell noticeably over the year—even as the unemployment rate continued to decline. The divergence of these two key measures of resource use—the capacity utilization rate and the unemployment rate—is unusual: They typically exhibit similar patterns of change over the course of the business cycle. Because the unemployment rate applies to the entire economy, it presumably should be a better indicator of the degree of pressure on resources in general. In 1998, however, slack in the goods-producing sector—a reflection of the sizable additions to capacity in this country and excess capacity abroad—seemingly enforced a discipline of competitive price and cost control that affected the economy more generally.

Prices in 1998 tended to be weakest in the sectors most closely linked to the external economy. The price of oil fell almost 40 percent from December 1997 to December 1998. This drop triggered steep declines in the prices of petroleum

1. Since the end of 1994, the Bureau of Labor Statistics has taken a number of steps to make the consumer price index a more accurate price measure. The agency also introduced new weights into the CPI at the start of 1998. In total, these changes probably reduced the 1998 rise in the CPI by slightly less than ½ percentage point, relative to the increase that would have been reported using the methodologies and weights in existence at the end of 1994. Without the changes that took effect in 1998, the deceleration in the CPI in 1998 would probably have been about half as large as was reported.

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products purchased directly by households. The retail price of motor fuel fell about 15 percent over the four quarters of the year, and the price of home heating fuel also plunged. With the prices of natural gas and electricity also falling, the CPI for energy was down about 9 percent over the year after having slipped 1 percent in 1997.

Large declines in the prices of internationally traded commodities other than oil pulled down the prices of many domestically produced primary inputs. The producer price index for crude materials other than energy, which reflects the prices charged by domestic producers of these goods, fell more than 10 percent over the year. However, because these non-oil commodities account for a small share of total production costs, the effect of their decline on inflation was much less visible further down the chain of production. Intermediate materials prices excluding food and energy fell about 1½ percent over the four quarters of the year, and the prices of finished goods excluding food and energy rose about 1½ percent. The latter index was boosted in part by an unusually large hike in tobacco prices that followed the settlement in the fall of states' litigation against tobacco companies. In the food sector as well, the effects of declining commodity prices became less visible further down the production chain; the PPI for finished foods was about unchanged, on net, over the year, and price increases at the retail level, though small, were somewhat larger than those of the preceding year.

Consumer prices excluding those for food and energy continued to rise in 1998, but not very rapidly. The CPI measure of these prices—the core CPI—increased about 2½ percent from the final quarter of 1997 to the final quarter of 1998, a shade more than in 1997. The chain-type price index for personal consumption expenditures excluding food and energy—the core PCE price index—decelerated a bit further, rising at roughly half the pace of the core CPI. Methodological differences between the two measures are numerous; some of the technical problems that have plagued the CPI are less pronounced in the PCE price measure, but the latter also depends partly on imputations of prices for which observations are not available. Both measures, however, seem to suggest that the underlying trend of consumer price inflation remained low. A similar message came from surveys of consumers, which showed expectations of future price increases easing a bit further in 1998—although, as in other recent years, the expected increases remained somewhat higher than actual increases.

Alternative Measures of Price Change

Percent

Price measure	1997	1998
Fixed-weight		
Consumer price index	1.9	1.5
Excluding food and energy	2.2	2.4
Chain-type		
Gross domestic product	1.7	.9
Gross domestic purchases	1.3	.4
Personal consumption expenditures	1.5	.7
Excluding food and energy	1.6	1.2

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

U.S. Financial Markets

U.S. interest rates fluctuated in fairly narrow ranges over the first half of 1998, and most equity price indexes posted substantial gains. However, after the financial crisis in Russia in August and subsequent difficulties in other emerging market economies, investors appeared to reassess the risks and uncertainties facing the U.S. economy and concluded

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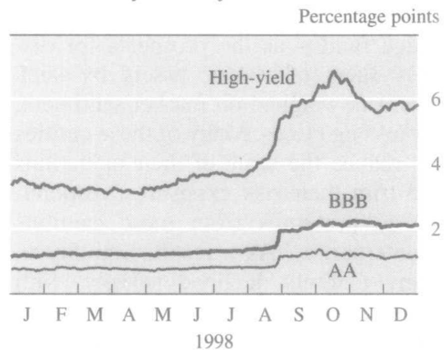
that more cautious postures were in order. That sentiment was reinforced by the prospect of an unwinding of positions by some highly leveraged investors. The resulting shift toward safe, liquid investments led to a substantial widening of risk spreads on debt instruments and to volatile changes in the prices of many assets. Financial market volatility and many risk spreads returned to more normal levels later in the year, as lower interest rates and robust economic data seemed to reassure market participants that the economy would remain sound, even in the face of additional adverse shocks from abroad. However, lenders remained more cautious than they had been in the first part of the year, especially in the case of riskier credits.

Interest Rates

Over the first half of 1998, short-term Treasury rates moved in a narrow range, anchored by unchanged monetary policy, while yields on intermediate- and long-term Treasury securities varied in response to the market's shifting assessment of the likely impact of foreign economic difficulties on the U.S. economy. In late 1997 and into 1998, spreading financial crises in Asia were associated with declines in U.S. interest rates, as investors anticipated that weakness abroad would constrain U.S. economic growth and cushion the impact of tight U.S. labor markets on inflation. However, interest rates moved back up later in the first quarter of 1998, as the U.S. economy continued to expand at a healthy pace, fueled by hefty gains in domestic demand. After a couple of months of small changes, Treasury rates fell in May and June, when concerns about foreign economies, particularly in Asia, once again led some observers to expect weaker growth in the United States and may also have boosted the demand for safe Treasury securities relative to other instruments.

Treasury rates changed little, on net, in the early summer, but they slipped lower in August, reflecting increased concern about the Japanese economy and financial problems in Russia. The default by Russia on some government debt obligations and the devaluation of the ruble in mid-August not only resulted in sizable losses for some investors but also undermined confidence in other emerging market economies. The currencies of many of these economies came under substantial pressure, and the market value of the international debt obligations of some countries declined sharply. U.S. investors shared in the resulting losses, and U.S. economic growth and the profits of U.S. companies were perceived to be vulnerable. In these circumstances, many investors, both here and abroad, appeared to reassess the riskiness of various counterparties and investments and to become less willing to bear risk. The resulting shift of demand toward safety and liquidity led to declines of 40 to 75 basis points

Spreads of Corporate Bond Yields over Treasury Security Yields



NOTE. The data are daily. The spread of high-yield bonds compares the yield on the Merrill Lynch Master II index with that on a seven-year Treasury; the other two spreads compare yields on the appropriate Merrill Lynch indexes with that on a ten-year Treasury.

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in Treasury coupon yields between mid-August and mid-September. In contrast, yields on higher-quality private securities fell much less, and those on issues of lower-rated firms increased sharply. As a result, spreads of private rates over Treasury rates rose substantially, reaching levels not seen for many years, and the issuance of corporate securities dropped sharply.

Investors' desire to limit risk-taking as markets became troubled in the late summer showed up clearly in mutual fund flows. High-yield bond funds, which had posted net inflows of more than $1 billion each month from May through July, saw a $3.4 billion outflow in August and inflows of less than $400 million in September and October before rebounding sharply in November. By contrast, inflows to government bond funds jumped from less than $1 billion in July to more than $2 billion a month in August and September. Equity mutual funds posted net outflows totaling nearly $12 billion in August, the first monthly outflow since 1990, and inflows over the rest of the year were well below those earlier in the year.

In part, the foreign difficulties were transmitted to U.S. markets by losses incurred by leveraged investors—including banks, brokerage houses, and hedge funds—as the prospects for distress sales of riskier assets by such investors weighed on market sentiment, depressing prices. Many of these entities did reduce the scale of their operations and trim their risk exposures, responding to pressures from more cautious counterparties. As a result, liquidity in many markets declined sharply, with bid-asked spreads widening and large transactions becoming more difficult to complete. Even in the market for Treasury securities, investors showed an increased preference for the liquidity offered by the most recent issues at each maturity, and the yields on these more actively traded "on-the-run" securities fell noticeably relative to those available on "off-the-run" issues, the ones that had been outstanding longer.

Conditions in U.S. financial markets deteriorated further following revelations in mid-September of the magnitude of the positions and the extent of the losses of a major hedge fund, Long-Term Capital Management. LTCM indicated that it sought high rates of return mostly by identifying small discrepancies in the prices of different instruments relative to historical norms and then taking highly leveraged positions in those instruments in the expectation that market prices would revert to such norms over time. In pursuing its strategy, LTCM took very large positions, some of which were in relatively small and illiquid markets.

LTCM was quite successful between 1995 and 1997, but the shocks hitting world financial markets in August of 1998 generated substantial losses for the firm. Losses mounted in September, and before new investors could be found, the firm encountered difficulties meeting liquidity demands arising from its collateral agreements with its creditors and counterparties. With world financial markets already suffering from heightened risk aversion and illiquidity, officials of the Federal Reserve Bank of New York judged that the precipitous unwinding of LTCM's portfolio that would follow the firm's default would compound market difficulties by distorting market prices and imposing potentially large losses, not just on LTCM's creditors and counterparties but also on other market participants not directly involved with LTCM.

In an effort to avoid these difficulties, the Federal Reserve Bank of New York contacted the major creditors and counterparties of LTCM to see if an alterna-

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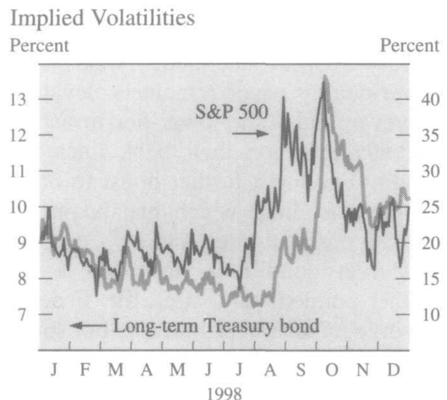
tive to forcing LTCM into bankruptcy could be found. At the same time, Reserve Bank officials informed some of their colleagues at the Federal Reserve Board, the Treasury, and other financial regulators of their activities. Subsequent discussions among LTCM's creditors and counterparties led to an agreement by the private-sector parties to provide an additional $3½ billion of capital to LTCM in return for a 90 percent equity stake in the firm.

Because of the potential for firms such as LTCM to have a large influence on U.S. financial markets, Treasury Secretary Robert Rubin asked the President's Working Group on Financial Markets to study the economic and regulatory implications of the operations of firms like LTCM and their relationships with their creditors. In addition, the extraordinary degree of leverage that LTCM was able to amass led the federal agencies responsible for the prudential oversight of the fund's creditors and counterparties to undertake reviews of the practices those firms employed in managing their risks. These reviews suggested significant weaknesses in the risk-management practices of many firms in their dealings with LTCM and—albeit to a lesser degree—in their dealings with other highly leveraged entities. Few counterparties seem to have had a complete understanding of LTCM's risk profile, and their credit decisions were heavily influenced by the firm's reputation and strong past performance. Moreover, LTCM's counterparties did not impose sufficiently tight limits on their exposures to LTCM, in part because they relied on collateral agreements requiring frequent marking to market to limit the risk of their exposures. Although these agreements generally provided for collateral with a value sufficient to cover current credit exposures, they did not deal adequately with the potential for future increases in exposures from changes in market values. This shortcoming was especially important in dealings with a firm like LTCM, which had such large positions in illiquid markets that its liquidation would likely have moved prices sharply against its creditors. In such cases, creditors need to take further steps to limit their potential future exposures, which might include requiring additional collateral or simply scaling back their activity with such firms.

The private-sector agreement to recapitalize LTCM allowed its positions to be reduced in an orderly manner over time, rather than in an abrupt fire sale. Nonetheless, the actual and anticipated unwinding of LTCM's portfolio, as well as actual and anticipated sales by other similarly placed leveraged investors, likely contributed materially to the tremendous volatility of financial markets in early October. Market expectations of asset price volatility going forward, as reflected in options prices, rose sharply, as bid-asked spreads and the premium for on-the-run securities widened. Long-term Treasury yields briefly dipped to their lowest levels in more than thirty years, in part because of large demand

Implied Volatilities



NOTE. The data are daily. Implied volatilities are calculated from options prices.

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shifts resulting from concerns about the safety and liquidity of private and emerging market securities. Spreads of rates on corporate bonds over those on comparable Treasury securities rose considerably, and issuance of corporate bonds, especially by lower-rated firms, remained very low.

By mid-October, however, market conditions had stopped deteriorating, and they began to improve somewhat in the days and weeks following the cut in the federal funds rate on October 15, between Federal Open Market Committee meetings. Internationally coordinated efforts to help Brazil cope with its financial difficulties, culminating in the announcement of an IMF-led support package in mid-November, contributed to the easing of market strains. In the Treasury market, bid-asked spreads narrowed a bit and the premium for on-the-run issues declined. With the earlier flight to quality and liquidity unwinding, Treasury rates backed up considerably. Corporate bond spreads reversed a part of their earlier rise, and investment-grade bond issuance rebounded sharply. In the high-yield bond market, investors appeared to be more hesitant, especially in regard to all but the best-known issuers, and the volume of junk bond issuance picked up less. In the commercial paper market, yields on higher-quality paper declined; yields on lower-quality paper remained elevated, however, and some lower-tier firms reportedly drew on their bank lines for funding, giving a further boost to bank business lending, which had begun to pick up during the summer.

Market conditions improved a bit further immediately after the Federal Reserve's November rate cut, but some measures of market stress rose again in late November and in December. The deterioration reflected in part widespread warnings of lower-than-expected corporate profits, a weakening economic outlook for Europe, and renewed concerns about the situation in Brazil. In addition, with risk a greater-than-usual concern, some market participants were likely less willing to hold lower-rated securities over year-end, when they would have to be reported in annual financial statements. As a result, liquidity in some markets appeared to be curtailed, and price movements were exaggerated. These effects were particularly noticeable in the commercial paper market: The spread between rates on top-tier and lower-tier thirty-day paper jumped almost 40 basis points on December 2, when that maturity crossed year-end, and then reversed the rise late in the month.

Equity Prices

Most equity indexes rose strongly, on balance, in 1998, with the Nasdaq Composite Index up nearly 40 percent, the S&P 500 Composite Index rising more than 25 percent, and the Dow Jones Industrial Average and the NYSE Composite Index advancing more than 15 percent. Small capitalization stocks underperformed the stocks of larger firms, with the Russell 2000 Index off 3 percent over the year. The variation in stock prices over the course of the year was extremely wide. Prices increased substantially over the first few months, as concerns eased that Asian economic problems could lead to a slowdown in the United States and to a consequent decline in profits. The major indexes declined, on balance, over the following couple of months before rising sharply, in some cases to new records, in late June and early July, on increasing confidence about the outlook for earnings. The main exception was the Russell 2000; small capitalization stocks fell

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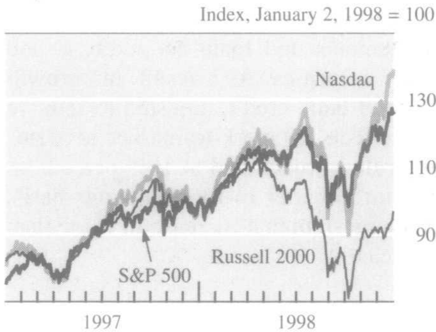
Major Stock Price Indexes



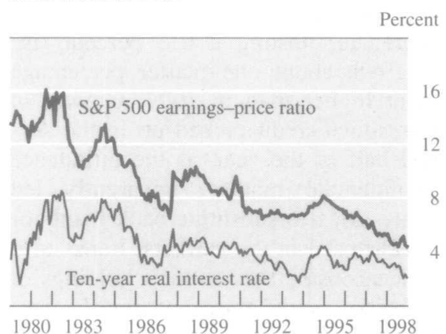
NOTE. The data are daily.

more substantially in the spring, and their rise in July was relatively muted.

Rising concerns about the outlook for Japan and other Asian economies, as well as the deepening financial problems in Russia, caused stock prices to retrace their July gains by early August. After Russia devalued the ruble and defaulted on some debts in mid-August, prices fell further, reflecting the general turbulence in global financial markets. By the end of the month, most equity indexes had dropped back to roughly their levels at the start of the year. Commercial bank and investment bank stocks fell particularly sharply, as investors became concerned about the effect on these institutions' profits of emerging market difficulties and of substantial declines in the values of some assets. Equity prices rose for a time in September but then fell back by early October before rebounding as market dislocations eased and interest rates on many private obligations fell. By December, most major indexes were back near their July highs, although the Russell 2000 remained below its earlier peak.

The increase in equity prices in 1998, coupled with the slowing of earnings growth, left many valuation measures beyond their historical ranges. After ticking higher in late summer and early autumn, the ratio of consensus estimates of earnings over the coming twelve months to prices in the S&P 500 fell back, ending the year below its level at the end of 1997. The decline in this measure likely reflected in part lower real long-term bond yields. For example, as measured by the difference between the ten-year nominal Treasury yield and inflation expectations reported in the Philadelphia Federal Reserve Bank's survey of professional forecasters, real yields fell appreciably between late 1997 and late 1998. (The yield on ten-year inflation-indexed Treasury securities actually rose somewhat over 1998. However, the increase may have reflected the securities' lack of liquidity and the substantial rise in the premium investors were willing to pay for liquidity.) From mid-1998 on, the real interest rate declined somewhat more than the forward earnings yield on stocks, and the spread between the two consequently increased a bit, perhaps reflecting the greater sense of risk in financial markets. Nonetheless, the spread remained quite small relative to historical norms: Investors may have been

Equity Valuation and Long-Term Real Interest Rate



NOTE. The data are monthly. The earnings–price ratio is based on the I/B/E/S International, Inc., consensus estimate of earnings over the coming twelve months. The real interest rate is the yield on the ten-year Treasury note less the ten-year inflation expectations from the Federal Reserve Bank of Philadelphia Survey of Professional Forecasters.

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anticipating rapid long-term earnings growth—consistent with the expectations of securities analysts—and they may still have been satisfied with a lower risk premium for holding stocks than they have demanded historically.

Debt and the Monetary Aggregates

Debt and Depository Intermediation

From the fourth quarter of 1997 to the fourth quarter of 1998, the total debt of the U.S. household, government, and nonfinancial business sectors increased about 6 percent, in the top half of the 3 percent to 7 percent range established by the FOMC and considerably faster than nominal GDP. Buoyed by strong spending on durable goods, housing, and business investment, as well as by merger and acquisition activity that substituted debt for equity, nonfederal debt expanded about 8½ percent in 1998, more than 2 percentage points faster than in 1997. By contrast, federal debt declined 1¼ percent, following a rise of ¾ percent over the preceding year.

Credit market instruments on the books of depository institutions rose at a somewhat faster pace than did the debt aggregate, posting a 6½ percent rise in 1998, about one-quarter percentage point higher than in 1997. Growth in depository credit picked up in the second half of the year, as the turbulence in financial markets apparently led many firms to substitute bank loans for funds raised in the markets. Banks also added considerably to their holdings of securities in the third and fourth quarters, in part reflecting the attractive spreads available on non-Treasury debt instruments.

Financial firms also appeared to turn to banks for funding when the financial markets were volatile, and U.S. banks substantially expanded their lending to financial firms through repurchase agreements and loans to purchase and carry securities. As a result, the growth of total bank credit, adjusted to remove the effects of mark-to-market accounting rules, accelerated to 10½ percent on a fourth-quarter to fourth-quarter basis, the largest annual increase in more than a decade.

The Monetary Aggregates

The broad monetary aggregates expanded very rapidly in 1998. From the fourth quarter of 1997 to the fourth quarter of 1998, M2 increased 8½ percent, placing it well above the upper bound of the 1 percent to 5 percent range established by the FOMC. However, as the Committee noted in February 1998, this range was intended as a benchmark for money growth under conditions of stable prices, real economic growth near trend, and historical velocity relationships. Part of the excess of M2 above its range was the result of faster growth in nominal spending than would likely be consistent with sustained price stability. In addition, the velocity of M2 (defined as the ratio of nominal GDP to M2) fell 3 percent. Some of the decline resulted from the decrease in short-term market interest rates in 1998—as usual, rates on deposits fell more slowly than market rates, reducing the opportunity cost of holding M2 (defined as the difference between the rate on Treasury bills and the average return on M2 assets).

However, the bulk of the decline cannot be explained on the basis of the historical relationship between the velocity of M2 and this measure of its opportunity cost. Three factors not captured in that relationship likely contributed to the drop in velocity. First, households seem to have allocated an

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Growth of Money and Debt

Percent

Period	M1	M2	M3	Domestic nonfinancial debt
Annual[1]				
1988	4.2	5.6	6.4	9.1
1989	.6	5.2	4.1	7.5
1990	4.2	4.2	1.9	6.7
1991	8.0	3.1	1.2	4.5
1992	14.3	1.8	.6	4.5
1993	10.6	1.3	1.0	4.9
1994	2.5	.6	1.7	4.9
1995	−1.6	3.9	6.1	5.4
1996	−4.5	4.6	6.8	5.3
1997	−1.2	5.8	8.8	4.9
1998	1.8	8.5	11.0	6.1
Quarterly (annual rate)[2]				
1998:1	3.2	7.6	10.3	5.8
2	1.0	7.5	10.1	6.0
3	−2.0	6.9	8.6	5.9
4	5.0	11.0	13.3	6.3

NOTE. M1 consists of currency, travelers checks, demand deposits, and other checkable deposits. M2 consists of M1 plus savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds. M3 consists of M2 plus large-denomination time deposits, balances in institutional money market funds, RP liabilities (overnight and term), and Eurodollars (overnight and term). Debt consists of the outstanding credit market debt of the U.S. government, state and local governments, households and nonprofit organizations, nonfinancial businesses, and farms.

1. From average for fourth quarter of preceding year to average for fourth quarter of year indicated.

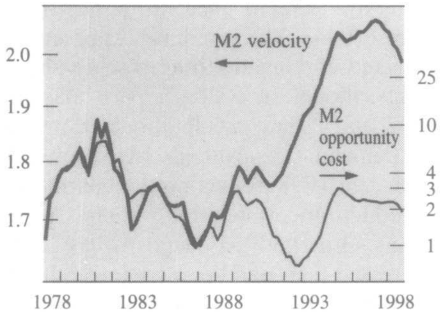
2. From average for preceding quarter to average for quarter indicated.

increased share of savings flows to monetary assets rather than equities following several years of outsized gains in stock market wealth. Second, some evidence suggests that in the 1990s the demand for M2 assets has become more sensitive to longer-term interest rates and to the slope of the yield curve; the decline in long-term Treasury yields in 1998, and the consequent flattening of the yield curve, may thereby have increased the relative attractiveness of M2 assets. Finally, a critical source of the especially rapid M2 expansion in the fourth quarter likely was an increased demand for safe, liquid assets as investors responded to the heightened financial market volatility.

M3 expanded even faster than M2 in 1998, posting an 11 percent rise on a fourth-quarter to fourth-quarter basis. Growth over the year was the fastest since 1981 and left the aggregate well above the top end of its 2 percent to 6 percent growth range. As with M2, however, the FOMC established the M3

M2 Velocity and M2 Opportunity Cost

Ratio scale — Percentage points, ratio scale



NOTE. The data are quarterly. The velocity of M2 is the ratio of nominal gross domestic product to the stock of M2. The opportunity cost of M2 is a two-quarter moving average of the three-month Treasury bill rate less the weighted average return on assets included in M2.

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range as a benchmark for growth under conditions of stable prices, sustainable output growth, and the historical behavior of velocity. The rapid growth of M3 in part simply reflected the rise in M2. In addition, the non-M2 components of M3 increased 18½ percent over the year, following an even larger advance in 1997. The substantial rise in these components in 1998 was partly the result of the funding of the robust growth in bank credit with managed liabilities, many of which are in M3. However, M3 growth was boosted to an even greater extent by flows into institution-only money funds, which have been expanding rapidly in recent years as such funds have increased their share of the corporate cash management business. Because investments in these money funds substitute for business holdings of short-term assets that are not in M3, their rise has generated an increase in M3 growth. In addition, institution-only funds pay rates that tend to lag movements in market rates; thus, their relative attractiveness was temporarily enhanced—and their growth rate boosted—by declines in short-term market interest rates late in 1998.

M1 increased 1¾ percent over the four quarters of 1998, its first annual increase since 1994. Currency expanded at an 8¼ percent pace, its largest rise since 1994. The increase apparently reflected continued strong foreign shipments, though at a slower pace than in 1997, and a sharp acceleration in domestic demand. Deposits in M1 declined further in 1998, reflecting the continued introduction of retail "sweep" programs. Growth of M1 deposits has been depressed for a number of years by these programs, which shift—or "sweep"—balances from household transactions accounts, which are subject to reserve requirements, into savings accounts, which are not. Because the funds are shifted back to transactions accounts when needed, depositors' access to their funds is not affected by these programs. However, banks benefit from the reduction in holdings of required reserves, which do not pay interest. Over 1998, sweep programs for demand deposit accounts became more popular, contributing to a 4¼ percent decline in such balances. By contrast, new sweep programs for other checkable deposits, which had driven double-digit declines in such deposits over the previous three years, were less important in 1998, and, with nominal spending strong and interest rates lower, other checkable deposits were about unchanged on the year.

As a result of the introduction of retail sweep accounts, the average level of required reserve balances (balances that must be held at Reserve Banks to meet reserve requirements) has trended lower over the past few years. The decline has been associated with an increase in banks' required clearing balances, which are balances that banks agree in advance to hold at their Federal Reserve Bank to facilitate the clearing of their payments. Unlike required reserve balances, banks earn credits on their required clearing balances that can be applied to the use of Federal Reserve priced services. Despite the increase in required clearing balances, required operating balances, which are the sum of required reserve balances and required clearing balances, have declined over the past few years and in late 1998 reached their lowest level in several decades.

The decline in required operating balances has generated concerns about a possible increase in the volatility of the federal funds rate. Because a bank's required level of operating balances must be met only on average over a two-week maintenance period, banks are

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free to allocate their reserve holdings across the days of a maintenance period in order to minimize their reserve costs. However, banks must also manage their reserves in order to avoid overdrafts, which the Federal Reserve discourages through administrative measures and financial penalties. Thus, as required operating balances decline toward the minimum level needed to clear banks' transactions, banks are less and less able to respond to fluctuations in the federal funds rate by lending funds when the rate is high and borrowing when the rate is low. As a result, when required operating balances are low, the federal funds rate is likely to rise further than it otherwise would when demands for reserves are unexpectedly strong or supplies weak; conversely, the federal funds rate is likely to fall more in the event of weaker-than-expected demand or stronger-than-expected supply. One way to ease this difficulty would be to pay interest on required reserve balances, which would reduce banks' incentives to expend resources on sweeps and other efforts to minimize these balances.

Despite the low level of required operating balances, the federal funds rate did not become noticeably more volatile over the spring and summer of 1998. This result reflected in part more frequent overnight open market operations by the Federal Reserve to better match the daily demand for and supply of reserves. Banks also likely improved the management of their accounts at the Federal Reserve Banks. Moreover, large banks apparently became more willing to borrow at the discount window. The Federal Reserve's decision to return to lagged reserve accounting at the end of July also likely contributed to reduced volatility in the federal funds market by enhancing somewhat the ability of both banks and the Federal Reserve to forecast reserve demand.

In the latter part of 1998, however, the federal funds rate was more volatile. The increase may have been due partly to further reductions in required operating balances resulting from new sweep programs, but other factors were probably more important, at least for a time. Market participants were scrutinizing borrowing banks more closely, and in some cases lenders pared or more tightly administered their counterparty credit limits, or shifted more of their placements from term to overnight maturities. The heightened attention to credit quality also made banks less willing to borrow at the discount window, out of concern that other market participants might detect their borrowing and interpret it as a sign of financial weakness. As a result, many banks that were net takers of funds in short-term markets attempted to lock in their funding earlier in the morning. On net, these forces boosted the demand for reserves and put upward pressure on the federal funds rate early in the day. To buffer the effect of these changes on volatility in the federal funds market, the Federal Reserve increased the supply of reserves and, at times, responded to the level of the federal funds rate early in the day when deciding on the need for market operations. Because demand had shifted to earlier in the day, however, the federal funds rate often fell appreciably below its target level by the end of the day.

At its November meeting, the FOMC amended the Authorization for Domestic Open Market Operations to extend the permitted maturity of System repurchase agreements from fifteen to sixty days. Over the remainder of 1998, the Domestic Trading Desk made use of this new authority on three occasions, arranging System repurchase agreements with maturities of thirty to forty-five days to meet anticipated seasonal

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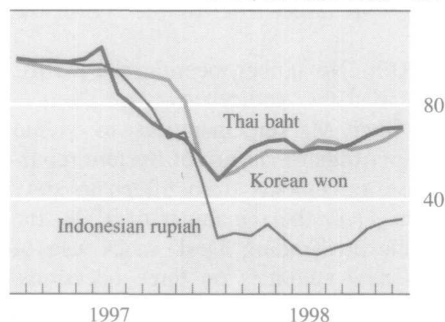
reserve demands over year-end. While the Desk had in the past purchased inflation-indexed securities when rolling over holdings of maturing nominal securities, it undertook its first outright open market purchase devoted solely to inflation-indexed Treasury securities in 1998, thereby according those securities the same status as other Treasury securities in open market operations.

International Developments

Emerging Economies

Developments in international financial markets in 1998 continued to be dominated by the unfolding crises in emerging markets that had begun in Thailand in 1997. Financial market turbulence spread to other emerging markets around the globe, spilling over from Korea, Indonesia, Malaysia, Singapore, the Philippines, and Hong Kong in late 1997 and the first part of 1998 to Russia in the summer, and to Latin America, particularly Brazil, shortly thereafter. The Asian crisis contributed to a deepening recession in Japan, and as the year progressed, growth in several other major foreign industrial economies slowed as well.

Exchange Value of Selected Asian Currencies versus the Dollar



NOTE. Dollars per unit of foreign currency. The data are monthly.

At the beginning of 1998, many Asian currencies were declining or were under pressure. The Indonesian rupiah dropped sharply in January, amid widespread rioting and talk of a coup, and fell again in May and June, as the deepening recession prompted more social unrest and, ultimately, the ouster of President Suharto. Some of the rupiah's losses were reversed in the second half of the year, following the relatively orderly transition of power to President Habibie. Tighter Indonesian monetary policy, which pushed short-term interest rates as high as 70 percent by July, contributed to the rupiah's recovery. On balance, between December 1997 and December 1998 the rupiah depreciated more than 35 percent against the dollar.

In contrast, the Thai baht and Korean won, which had declined sharply in 1997, gained more than 20 percent against the dollar over the course of 1998. Policy reforms and stable political environments helped boost these currencies. The currencies of the Philippines, Malaysia, Singapore, and Taiwan fluctuated in a narrower range and ended the year little changed against the dollar. In September, Malaysia imposed capital and exchange controls, fixing the ringgit's exchange rate against the dollar. The Hong Kong dollar came under pressure at times during the year, but its peg to the U.S. dollar remained intact, although at the cost of interest rates that were at times considerably elevated. Short-term interest rates in Asian economies other than Indonesia declined in 1998, and as some stability returned to Indonesian markets near the end of the year, short-term rates in that nation began to retreat from their highs.

As the year progressed, the financial storm moved from Asia to Russia. At first the Russian central bank was able to defend the ruble's peg to the dollar with interest rate increases and sporadic

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intervention. By midyear, however, the government's failure to reach a new assistance agreement with the International Monetary Fund, reported shortfalls in tax revenues, and the disruption of rail travel by striking coal miners protesting late wage payments brought to the fore the deep structural and political problems faced by Russia. In addition, declining oil prices were lowering government revenues and worsening the current account. As a result of these difficulties, the ruble came under renewed pressure, forcing Russian interest rates sharply higher, and Russian equity prices fell abruptly. A disbursement of $4.8 billion from the IMF in July was quickly spent to keep the currency near its level of 6.2 rubles per dollar, but the lack of progress on fiscal reform put the next IMF tranche in doubt.

On August 17, Russia announced a devaluation of the ruble and a moratorium on servicing official short-term debt. Subsequently, the ruble depreciated more than 70 percent against the dollar, the government imposed conditions on most of its foreign and domestic debt that implied substantial losses for creditors, and many Russian financial institutions became insolvent. The events in Russia precipitated a global increase in financial market turbulence, including a pullback of credit to highly leveraged investors and a widening of credit spreads in both emerging market economies and many industrial countries. The turmoil did not abate until after the central banks of a number of industrial countries eased policy in the fall.

Latin American financial markets were only moderately disrupted by the Asian and Russian problems during the first half of 1998. The reaction to the Russian default was swift and strong, however, and the prices of Latin American assets fell precipitously. The spreads between yields on Latin American Brady bonds and comparable U.S. Treasuries widened considerably (with increases ranging from 900 basis points in Argentina to 1500 basis points in Brazil), peaking in early September before retracing part of the rise. Latin American equity prices plunged 25 percent or more. Several currencies came under pressure despite sharp increases in short-term interest rates.

Anticipation of an IMF-led financial assistance package for Brazil helped spur a partial recovery in Latin American asset markets in late September and October. The details of the $41.5 billion loan package were announced in November. After the IMF approved the package in early December, however, Brazil's Congress rejected a part of the government's fiscal austerity plan, sparking renewed financial turmoil. In mid-December, $9.3 billion of the loan package was disbursed, but continuing pressure from investors seeking to take funds out of Brazil put the long-term viability of the *real*'s crawling exchange rate peg in doubt. Brazil's central bank defended the peg through the end of the year, drawing down a substantial portion of the $75 billion in foreign exchange reserves it had amassed as of April 1998.[2]

The Mexican peso, which was also weakened by the effects of falling oil prices, depreciated 18 percent against the dollar over the year. The Colombian peso and the Ecuadorian sucre were devalued, but Argentina's currency board arrangement survived.

The fallout from the financial crises that hit several Asian emerging market economies in late 1997 triggered a further decline in output in the region in

2. In mid-January 1999, the *real* was devalued and soon after was allowed to float.

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early 1998. In the countries most heavily affected—Thailand, Korea, Malaysia, and Indonesia—output dropped at double-digit annual rates in the first half of the year, as credit disruptions, widespread failures in the financial and corporate sectors, and a resulting high degree of economic uncertainty depressed activity severely. Output in Hong Kong also dropped in early 1998, as interest rates rose sharply amid pressure on its currency peg. Later in the year, with financial conditions in most of the Asian crisis countries stabilizing somewhat, output started to bottom out.

The Asian crisis had a relatively moderate effect on China. Growth remained fairly strong throughout the year despite a dramatic slowdown in the growth of exports. A salutary effect of the crisis may have been the encouragement that it seemed to give authorities in China to move ahead more quickly with various financial sector reforms.

Inflation in the Asian developing economies rose only moderately on average in 1998, as the inflationary effects of currency depreciations in the region were largely offset by the deflationary influence of very weak domestic activity. The current account balances of the Asian crisis countries swung into substantial surplus. These countries experienced a significant improvement in their competitive positions after the substantial depreciations of their currencies in late 1997 and early 1998. In addition, their imports fell sharply with the falloff in domestic demand.

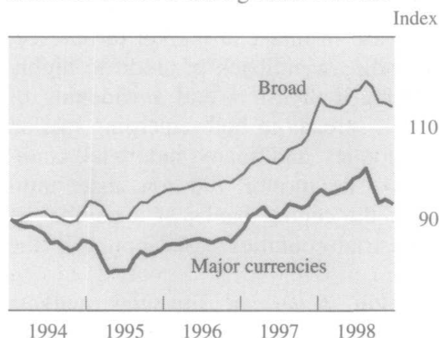
In Russia, economic activity declined in 1998 as interest rates were pushed up in an attempt to fend off pressure on the ruble. After the August debt moratorium and ruble devaluation, output dropped sharply, ending the year down about 10 percent from its year-earlier level. The ruble collapse triggered a surge in inflation to a triple-digit annual rate during the latter part of the year.

In Latin America, the pace of economic activity slowed only moderately in the first half of 1998, as the spillover from the Asian financial turbulence was limited. The Russian financial crisis in August, in contrast, had a strong impact on real activity in Latin America, particularly in Brazil and Argentina, where interest rates moved sharply higher in response to exchange rate pressures. Output in both countries is estimated to have declined in the second half of the year at annual rates of about 5 percent. Activity in Mexico and Venezuela was also depressed by lower oil export revenues. Inflation rates in Latin American countries were little changed in 1998 and ranged from 1 percent in Argentina and 3 percent in Brazil to 31 percent in Venezuela.

Industrial Economies

The dollar's value, measured on a trade-weighted basis against the currencies of a broad group of important U.S. trading partners, rose almost 7 percent during the first eight months of 1998 but then

Nominal Dollar Exchange Rate Indexes



NOTE. The data are monthly. Indexes are trade-weighted averages of the exchange value of the dollar in terms of major currencies (March 1973 = 100) and in terms of a broad group of important U.S. trading partners (January 1997 = 100).

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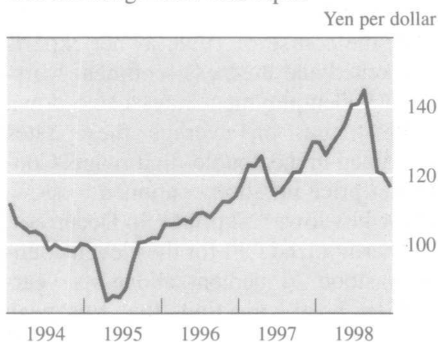
fell, returning by December to a level about 2 percent above that of a year earlier. (When adjusted for changes in U.S. and foreign consumer price levels, the value of the dollar in December 1998 was about 1 percent *below* its level in December 1997.) Before the Russian default, the dollar was supported by the robust pace of U.S. economic activity, which at times generated expectations that monetary policy would be tightened. Healthy U.S. growth also contrasted with weakening economic activity abroad, especially in Japan. Occasionally, however, the positive influence of the strong economy was countered by worries about growing U.S. external deficits. From August through October, in the aftermath of the Russian financial meltdown, concerns that increased difficulties in Latin America might affect the U.S. economy disproportionately, as well as expectations of lower U.S. interest rates, weighed on the dollar's value, and it fell sharply. The broad index of the dollar's exchange value eased a bit further during the fourth quarter of the year.

Against the currencies of the major foreign industrial countries, the dollar declined 2 percent in nominal terms over 1998, on balance, reversing some of its 10 percent appreciation over the preceding year. Among these currencies, the dollar's value fluctuated most widely against the Japanese yen. The dollar rose against the yen during the first half of the year as a result of concerns about the effects of the Asian crisis on the already-weak Japanese economy and further signs of deepening recession and persistent banking system problems in that country. It reached a level of almost 147 yen per dollar in mid-June, prompting coordinated intervention by U.S. and Japanese authorities in foreign exchange markets that helped to contain further downward pressure on the yen. The dollar resumed its appreciation against the yen, albeit at a slower pace, in July and early August.

The turning point in the dollar–yen rate came after the Russian collapse, amid the global flight from risk that caused liquidity to dry up in the markets for many assets. During the first week of October, the dollar dropped nearly 14 percent against the yen in extremely illiquid trading conditions. Although fundamental factors in Japan, such as progress on bank reform, fiscal stimulus, and the widening trade surplus may have helped boost the yen against the dollar, market commentary at the time focused on reports that some international investors were buying large amounts of yen. These large purchases reportedly were needed to unwind positions in which investors had used yen loans to finance a variety of speculative investments. On balance, the dollar depreciated almost 10 percent against the yen in 1998, reversing most of its net gain over 1997.

Japanese economic activity contracted in 1998, as the country remained in its most protracted recession of the postwar era. Business and residential investment plunged, and private consumption stagnated, more than offsetting positive contributions from govern-

U.S. Exchange Rate with Japan



NOTE. The data are monthly.

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ment spending and net exports. Core consumer prices declined slightly, while wholesale prices fell almost 4½ percent. In April, the Japanese government announced a large fiscal stimulus package. During the final two months of the year, the government announced another set of fiscal measures slated for implementation during 1999, which included permanent personal and corporate income tax cuts, incentives for investment, and further increases in public expenditures.

Against the German mark, the dollar depreciated about 6 percent, on net, over 1998. Late in the year the dollar moved up against the mark, as evidence of a slowdown of European growth raised expectations of easier monetary conditions in Europe. In the event, monetary policy was eased sooner than market participants had expected, with a coordinated European interest rate cut coming in early December.

A major event at the turn of the year was the birth of the euro, which marked the beginning of Stage Three of European Economic and Monetary Union (EMU). On December 31, the rates locking the euro with the eleven legacy currencies were determined; based on these rates, the value of the euro at the moment of its creation was $1.16675.

In the eleven European countries whose currencies were fixed against the euro, output growth slowed moderately over the course of 1998, as net exports weakened and business sentiment worsened. Unemployment rates came down slightly, but on average these rates remained in the double-digit range. Consumer price inflation continued to slow, helped by lower oil prices. In December, the harmonized CPI for the eleven countries stood ¾ percent above its year-earlier level, meeting the European Central Bank's primary objective of inflation below 2 percent.

Between December 1997 and December 1998, the average value of the dollar changed little against the British pound but rose 8 percent against the Canadian dollar. Weakness in primary commodity prices, including oil, likely depressed the value of the Canadian dollar. The Bank of Canada raised official rates in January 1998 and again in August, in response to currency market pressures. The Bank of England raised official rates in June 1998 to counter inflation pressures. Tighter monetary conditions in both countries, as well as a decline in net exports associated with global difficulties, contributed to a slowing of output growth in the second half of the year. The deceleration was sharper in the United Kingdom than in Canada. U.K. inflation eased slightly to near its target rate, while Canadian inflation remained near the bottom of its target range. In response to weaker economic activity as well as to the expected effects of the global financial turmoil, both the Bank of Canada and the Bank of England lowered official interest rates in the latter part of the year.

The general trend toward easier monetary conditions was reflected in declines in short-term interest rates in almost all the G-10 countries during 1998. Interest rates in the euro area converged to relatively low German levels in anticipation of the launch of the third stage of EMU. Yields on ten-year government bonds in the major foreign industrial countries declined significantly over the course of the year, as economic activity slowed, inflation continued to moderate, and investors sought safer assets. Between December 1997 and December 1998, ten-year interest rates fell 180 basis points in the United Kingdom and 150 basis points in Germany. The ten-year rate fell only 30 basis points in Japan, on balance, declining about 90 basis points over the

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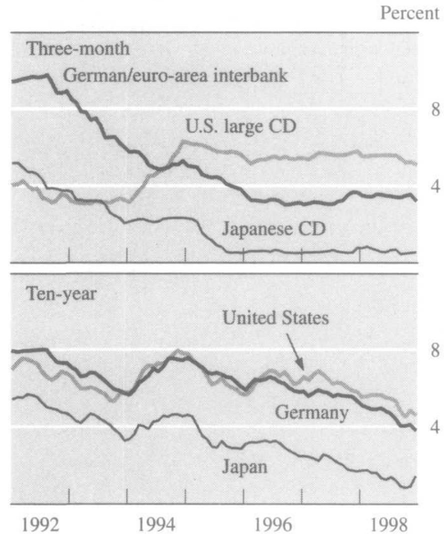
first ten months of the year but backing up in November and December, at least in part because of market participants' concerns that the demand for bonds would be insufficient to meet the surge in debt issuance associated with the latest fiscal stimulus package.

Share prices on European stock exchanges again posted strong advances in 1998, with price indexes rising 8 percent in the United Kingdom, about 15 percent in Germany, nearly 29 percent in France, and 41 percent in Italy. In contrast, Japanese equity prices fell more than 9 percent over the year, and Canadian share prices declined 4 percent. After a considerable run-up earlier in the year, share prices around the globe fell sharply in late summer, but they subsequently rebounded as the Federal Reserve and several other central banks eased monetary policy.

U.S. and Foreign Interest Rates



NOTE. The data are monthly.

Foreign Exchange Operations

On June 17, the U.S. monetary authorities intervened in foreign exchange markets, selling a total of $833 million for Japanese yen. The sales were split evenly between the Federal Reserve System and the U.S. Treasury. No other foreign exchange intervention operations for the accounts of the System or the Treasury were conducted during the year. Reported net sales of dollars by major central banks were $29 billion in 1998, versus $10 billion in 1997.

At the end of the year, the Federal Reserve held the equivalent of $19,769 million, valued at current exchange rates, in marks and yen.[3] With the dollar's depreciation versus both currencies in 1998, the cumulative gains on System foreign currency holdings increased $1,870 million, to $2,228 million. Absent sales of foreign currencies, the System did not realize any gains or losses.

On November 17, the FOMC voted unanimously to reauthorize Federal Reserve participation in the North American Framework Agreement (NAFA), established in 1994, and in the associated bilateral reciprocal currency swap arrangements with the Bank of Canada and the Bank of Mexico. On December 7, the Secretary of the Treasury authorized renewal of the Treasury's participation in the NAFA and of the associated Exchange Stabilization Agreement with Mexico. Other bilateral swap arrangements with the Federal Reserve—those with the Bank for International Settlements, the Bank of Japan, and many European central banks—were allowed to lapse in light of their disuse over the past fifteen years and in the presence of other well-established arrangements for international monetary cooperation. The swap arrangement between the Treasury's Exchange Stabilization Fund and the German Bundesbank was also allowed to lapse. ■

3. At the beginning of 1999, the System's holdings of marks were converted to euros.

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Monetary Policy Reports to the Congress

The reports in this chapter were submitted to the Congress on February 24 and July 21, 1998, pursuant to the Full Employment and Balanced Growth Act of 1978.

Report on February 24, 1998

Monetary Policy and the Economic Outlook

The U.S. economy turned in another excellent performance in 1997. Growth was strong, the unemployment rate declined to its lowest level in nearly a quarter-century, and inflation slowed further. Impressive gains were also made in other important respects: The federal budget moved toward balance much more quickly than almost anyone had anticipated; capital investment, a critical ingredient for long-run growth, rose sharply further; and labor productivity, the ultimate key to rising living standards, displayed notable vigor.

Among the influences that have brought about this favorable performance are the sound fiscal and monetary policies that have been pursued in recent years. Budgetary restraint at the federal level has raised national saving, easing the competition for funds in our capital markets and thereby encouraging greater private investment. Monetary policy, for its part, has sought to foster an environment of subdued inflation and sustainable growth. The experience of recent years has provided additional evidence that the less households and businesses need to cope with a rising price level, or worry about the sharp fluctuations in employment and production that usually accompany inflationary instability, the more long-term investment, innovation, and enterprise are enhanced.

The circumstances that prevailed through most of 1997 required that the Federal Reserve remain especially attentive to the risk of a pickup in inflation. Labor markets were already tight when the year began, and nominal wages had started to rise faster than previously. Persistent strength in demand over the year led to economic growth in excess of the expansion of the economy's potential, intensifying the pressures on labor supplies. In earlier business expansions, such developments had usually produced an adverse turn in the inflation trend that, more often than not, was accompanied by a worsening of economic performance on a variety of fronts, culminating in recession.

Robust growth of spending early in the year heightened concerns among members of the Federal Open Market Committee (FOMC) that growing strains on productive resources might touch off a faster rate of cost and price rise that could eventually undermine the expansion. Financial market participants seemed to share these concerns: Intermediate- and long-term interest rates began moving up in December 1996, effectively anticipating Federal Reserve action. When the FOMC firmed policy slightly at its March meeting by raising the intended federal funds rate from 5¼ percent to 5½ percent, the market response was small.

The economy slowed a bit during the second and third quarters, and inflation moderated further. In addition, the progress being made by the federal government in reducing the size of the defi-

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cit was becoming more apparent. As a consequence, by the end of September, longer-term interest rates fell ¾ percentage point from their peaks in mid-April, leaving them about ¼ percentage point below their levels at the end of 1996. The decline in interest rates, along with continued reports of brisk growth in corporate profits, sparked increases in broad indexes of equity prices of 20 percent to 35 percent between April and September.

Even with a more moderate pace of growth, labor markets continued to tighten, generating concern among the FOMC members over this period that rising costs might trigger a rise in inflation. Consequently, at its meetings from May through November, the Committee adopted directives for the conduct of policy that assigned greater likelihood to the possibility of a tightening of policy than to the possibility of an easing of policy. Even though the Committee kept the nominal federal funds rate unchanged, it saw the rise in the real funds rate resulting from declining inflation expectations, together with the increase in the exchange value of the dollar, as providing some measure of additional restraint against the possible emergence of greater inflation pressures.

In the latter part of the year, developments in other parts of the world began to alter the perceived risks attending the U.S. economic outlook. Foreign economies generally had seemed to be on a strengthening growth path when the Federal Reserve presented its midyear monetary policy report to the Congress last July. But over the remainder of the summer and during the autumn, severe financial strains surfaced in a number of advanced developing countries in Asia, weakening somewhat the outlook for growth abroad and thus the prospects for U.S. exports. Although the circumstances in individual countries varied, the problems they encountered generally resulted in severe downward pressures on the foreign exchange values of their currencies; in many cases, steep depreciations occurred despite substantial upward movement of interest rates. Asset values in Asia, notably equity and real estate prices, also declined appreciably in some instances, leading to losses by financial institutions that had either invested in those assets or lent against them; nonfinancial firms began to encounter problems servicing their obligations. In many instances the debts of nonfinancial and financial firms were denominated in dollars and unhedged. Concerted international efforts to bring economic and financial stability to the region are under way, and some progress has been made, but it is evident that in several of the affected economies the process of adjustment will be painful. Meanwhile, economic activity in Japan stagnated, in part because of the developments elsewhere in East Asia, and the weaknesses in the Japanese financial system became more apparent.

The steep depreciations of many Asian currencies contributed to a substantial further appreciation of the U.S. dollar. Measured against a broad set of currencies that includes those of the advanced developing countries of Asia, the exchange value of the dollar, adjusted for relative consumer prices, has moved up about 8 percent since October and has increased about 16 percent from its level at the end of 1996. The dollar has also appreciated, on balance, against an index of currencies of the G-10 (Group of Ten) industrial countries; this G-10 trade-weighted index of dollar exchange rates is up about 13 percent in nominal terms since the end of 1996.

The difficulties in Asia contributed to additional declines of ¼ to ½ percentage point in the yields on intermediate-

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and long-term Treasury securities in the United States between mid-autumn and the end of the year. These decreases were due in part to an international flight to the safe haven of dollar assets, but they also reflected expectations that these difficulties would exert a moderating influence on the growth of aggregate demand and inflation in the United States. Equity prices were quite volatile but showed little trend in the fourth quarter. In light of the ongoing difficulties in Asia and the possible effects on the United States, the FOMC not only left interest rates unchanged in December, but shifted its instructions to the Manager of the System Open Market Account to symmetry between ease and tightening in the near term.

Some spillover from the problems in Asia has recently begun to appear in reports on business activity in the United States. Customers in the advanced developing countries reportedly have canceled some of the orders they had previously placed with U.S. firms, and companies more generally are expressing concerns about the possibilities of both reduced sales to Asia and more intense price competition here as the result of the sharp changes in exchange rates. Nonetheless, the available statistics suggest on balance that overall growth of output and employment has remained brisk in the early part of 1998.

Confronted with the marked crosscurrents described above—involving both upside and downside risks to the growth of output and prospects for inflation—the FOMC earlier this month once again chose to hold its federal funds rate objective unchanged. In credit markets, interest rates have fallen further this year as the effects of the Asian turmoil seemed even more likely to restrain any tendencies toward unsustainable growth and greater inflation in the United States. With interest rates lower and the negative effects of the Asian problems seen by market participants as mostly limited to particular sectors, broad indexes of equity prices have risen appreciably, many to new highs.

Economic Projections for 1998

The outlook for 1998 is clouded with a greater-than-usual degree of uncertainty. Part of that uncertainty is a reflection of the financial and economic stresses that have developed in Asia, the full consequences of which are difficult to judge. But there are some other significant question marks as well, many of them growing out of the surprising performance of the U.S. economy in 1997: Growth was considerably stronger and inflation considerably lower than Federal Reserve officials and most private analysts had anticipated.

Some of the key forces that gave rise to this favorable performance can be readily identified. An ongoing capital spending boom, encouraged in part by declining prices of high-technology equipment, provided stimulus to aggregate demand and at the same time created the additional capacity to help meet that demand. A further jump in labor productivity that was fueled partly by the buildup of capital helped firms overcome the production and pricing challenges posed by tight labor markets. A surprisingly robust stock market bolstered the finances of households and enabled them to spend more freely. Falling world oil prices reduced the prices of petroleum products and helped hold down the prices of other energy-intensive goods. Finally, a rising dollar imposed additional restraint on inflation, as prices of imported goods fell appreciably. Circumstances as favorable as those of 1997 are not likely to persist, although several elements in the recent mix could help maintain, for some time,

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a more favorable economic performance than historical relationships would suggest.

In assessing the situation, the members of the Board of Governors and the Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, think that the most likely outcome for 1998 will be one of moderate growth, low unemployment, and low inflation. Most of them have placed their point estimates of the rise in real gross domestic product from the fourth quarter of 1997 to the fourth quarter of 1998 in the range of 2 percent to 2¾ percent. The civilian unemployment rate in the fourth quarter of 1998 is expected to be at about its recent level. For the most part, the forecasts have the total consumer price index for all urban consumers rising between 1¾ percent and 2¼ percent this year. These predictions do not differ appreciably from those recently put forth by the Administration.

Although developments in Asia over the past few months have not yet affected aggregate U.S. economic performance in a measurable way, these influences will likely become more visible in coming months. Growth of U.S. exports is expected to be restrained by weaknesses in Asian economies and by the lagged effects of the appreciation of the dollar since 1995. Moreover, with the rise in the dollar's value making imports less expensive, some U.S. businesses and consumers will likely switch from domestic to foreign sources for some of their purchases. But the timing and magnitude of these developments are hard to predict.

In contrast to the slower growth that seems to be in prospect for exports, domestic spending seems likely to maintain considerable strength in coming quarters. Households as a group are quite upbeat in their assessments of their personal finances—as might be expected in conjunction with expanding job opportunities, rising incomes, and huge gains in wealth. Recently, many households have taken advantage of lower long-term interest rates by refinancing their home mortgages, and this will provide a little additional wherewithal for spending. Moreover, the decline in mortgage rates is also bolstering housing construction.

Business outlays for fixed investment seem likely to advance at a relatively brisk pace in the coming year, although gains as large as those of the past couple

Economic Projections for 1998

Percent

Indicator	Federal Reserve governors and Reserve Bank presidents		Administration
	Range	Central tendency	
Change, fourth quarter to fourth quarter[1]			
Nominal GDP	3½–5	3¾–4½	4.0
Real GDP[2]	1¾–3	2–2¾	2.0
Consumer price index[3]	1½–2½	1¾–2¼	2.2
Average level, fourth quarter			
Civilian unemployment rate	4½–5	about 4¾	5.0

1. Change from average for fourth quarter of 1997 to average for fourth quarter of 1998.

2. Chain-weighted.

3. All urban consumers.

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of years may be difficult to match. Outlays for computers, which have dominated the investment surge of the past few years, should climb substantially further as businesses press ahead with new investment in the latest technologies, encouraged in part by ongoing price declines. With labor markets tight, firms continue to see capital investment as the key in efforts to increase efficiency and maintain competitiveness. Internally generated funds remain adequate to cover the bulk of businesses' investment outlays, and those firms turning to the debt and equity markets are most often finding financing generously available on good terms. Inventory growth will likely put less pressure on business cash flow this year; after adding to stocks at a substantial clip in 1997, businesses seem likely to scale back such investment somewhat, especially as they perceive a moderation in sales increases.

The Federal Reserve policymakers' forecasts of the average unemployment rate in the fourth quarter of 1998 are mostly around 4¾ percent. The persistence for another year of this degree of tightness in the labor market means that firms will likely continue to face difficulties in finding workers and that hiring and retaining workers could become more costly. Indeed, there are indications that wage inflation picked up further at the end of last year. Improvements in labor productivity have become more sizable in the past couple of years, and if such gains can be extended, wage increases of the magnitude of those of 1997 need not translate into greater price inflation. The more rapid growth in productivity is consistent with the high level of capital investment in recent years, but the extent to which the trend in productivity has picked up is still uncertain. Furthermore, if momentum in nominal wages continues to build, the pay increases will eventually squeeze profit margins and place upward pressures on prices, even with exceptional productivity gains. The strains in labor markets therefore constitute an ongoing inflationary risk that will have to be monitored closely.

In the near term, however, there are several factors that should lessen the risk of a step-up in inflation. Manufacturing capacity remains ample, and bottlenecks are not hampering production. The recent appreciation of the dollar should damp inflation both because of falling import prices and because the added competition from imports may induce domestic producers to hold down prices. Oil prices have weakened considerably since the latter part of 1997 in response to abundant supplies, the softening of demand in Asia, and a mild winter. Ample supplies and the prospect of softer global demand have been depressing the prices of many other commodities, both in agriculture and in industry. Perhaps most important, as the low level of inflation that has prevailed in recent years gets built into wage agreements, other contracts, and individuals' inflation expectations, it will provide an inertial force helping sustain the favorable price performance for a time.

Although many of the factors currently placing restraint on inflation are not necessarily long lasting, the Committee judged that their effect in 1998 would about offset the pressures from tight labor markets. Consequently, the Board members and Reserve Bank presidents anticipate that the rate of price inflation will change little this year. Again in 1998, the FOMC will be monitoring a variety of price measures in addition to the CPI for indications of changes in inflation and will be assessing movements in the CPI in the context of ongoing technical improvements by

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the Bureau of Labor Statistics that are likely to damp the reported 1998 rise in that index.

Money and Debt Ranges for 1998

In establishing the ranges for growth of broad measures of money over 1998, the Committee recognized the considerable uncertainty that still exists about the behavior of the velocities of these aggregates. The velocity of M3 (the ratio of nominal GDP to the monetary aggregate) in particular has proved difficult to predict. Last year, the growth of this aggregate relative to spending was affected by the rapid increase in depository credit and by the way in which that increase was funded, as well as by the changing cash management practices of corporations, which have been using the services of institution-only money funds in M3. These factors boosted M3 growth last year to 8¾ percent, 3 percentage points faster than nominal GDP—an unusually large decline in M3 velocity. Going forward, it seems likely that M3 growth will continue to be buoyed by robust credit growth at depositories and continuing shifts in cash management. Thus, its velocity is likely to decline further, though the amount of decline is difficult to predict.

The relationship of M2 to spending in recent years has come back more into line with historical patterns in which the velocity of M2 tended to be fairly constant, except for the effects of the changing opportunity cost of M2—the spread between yields that savers could earn holding short-term market instruments and those that they could earn holding M2. In the early 1990s, M2 velocity departed from this pattern, rising substantially and atypically. Even after the unusual shift of the early 1990s died out, M2 velocity continued to drift somewhat higher from 1994 into 1997. That drift probably reflected some continued, albeit more moderate, redirection of savings into bond and equity markets, especially through the purchase of mutual funds. However, last year the drift abated. There was little change, on balance, in the opportunity cost of holding M2, and M2 velocity also was about unchanged, as M2 grew 5½ percent, nearly the same as nominal GDP. Nevertheless, the upward drift could resume in the years ahead as financial innovations or perceptions of attractive returns lead households to further shift their savings away from M2 balances. Or velocity might be pushed downward if volatility or setbacks in bond and stock markets were to lead investors to seek the safety of M2 assets, which have stable principal.

In light of the uncertainties about the behavior of velocities, the Committee followed its practice of recent years and established the ranges for 1998 not as expectations for actual money growth, but rather as benchmarks for M2 and M3 behavior that would be consistent with sustained price stability, assuming velocity change in line with pre-1990 historical experience. Thus, the ranges for fourth-quarter to fourth-quarter growth are unchanged from those in 1997: 1 percent to 5 percent for M2, and 2 percent to 6 percent for M3. Given the central tendency of the Committee's forecast for growth of nominal GDP of

Ranges for Growth of Monetary and Debt Aggregates

Percent

Aggregate	1996	1997	1998
M2	1–5	1–5	1–5
M3	2–6	2–6	2–6
Debt	3–7	3–7	3–7

NOTE. Change from average for fourth quarter of preceding year to average for fourth quarter of year indicated.

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3¾ percent to 4½ percent, M2 is likely to be in the range, perhaps in the upper half, if short-term interest rates do not change much and velocity continues recent patterns. For M3, however, a continuation of recent velocity behavior could imply growth around the upper end of, if not above, the price-stability range.

Debt of the nonfinancial sectors grew 4¾ percent in 1997, near the middle of the range of 3 percent to 7 percent established by the Committee last February. As with the monetary aggregates, the Committee has left the range for debt unchanged for 1998. The range it has chosen encompasses the likely growth of debt given Committee members' forecasts of nominal GDP. Except for the 1980s, the growth of debt has tended to be reasonably in line with the growth of nominal GDP.

Although the ranges for money and debt are not set as targets for monetary policy in 1998, the behavior of these variables, interpreted carefully, can at times provide useful information about the economy and the workings of the financial markets. The Committee will continue to monitor the movements of money and debt—along with a wide variety of other financial and economic indicators—to inform its policy deliberations.

Economic and Financial Developments in 1997 and Early 1998

The past year has been an exceptionally good one for the U.S. economy. Initial estimates indicate that real GDP increased nearly 4 percent over the four quarters of 1997. Household and business expenditures continued to rise rapidly, owing in part to supportive financial conditions, including a strong stock market, ample availability of credit, and, from April onward, declining intermediate- and long-term interest rates. In the aggregate, private domestic spending on consumption and investment rose nearly 5 percent on an inflation-adjusted basis. The strength of spending, along with a further sizable appreciation of the foreign exchange value of the U.S. dollar, brought a surge of imports, the largest in many years. Export growth, while lagging that of imports, also was substantial despite the appreciation of the dollar and the emergence after midyear of severe financial difficulties in several foreign economies, particularly among the advanced developing countries in Asia.

Meanwhile, inflation slowed from the already reduced rates of the previous few years. Although wages and total hourly compensation accelerated in a tight labor market, the inflationary impulse from that source was more than offset by other factors, including rising competition from imports, the price restraint from increased manufacturing capacity, and a sizable gain in labor productivity.

The Household Sector

Consumption Spending, Income, and Saving

Bolstered by increases in income and wealth, personal consumption expenditures rose substantially during 1997—about 3¾ percent, according to the initial estimate. Expenditures strengthened for a wide variety of durable goods. Real outlays on home computers continued to soar, rising even faster than they did over the previous few years. Strength also was reported in purchases of furniture and home appliances—products that tend to do well when home sales are strong. Consumer expenditures on motor vehicles rose moderately, on

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net, more than reversing the small declines of the previous two years. Real expenditures on services increased more than 4 percent in 1997, the largest gain of recent years. Personal service categories such as recreation, transportation, and education recorded large increases. Consumers also boosted their outlays for business services, including outlays related to financial transactions.

Real disposable personal income—after-tax income adjusted for inflation—is estimated to have increased about 3¾ percent during 1997, a gain that was exceeded on only one occasion in the previous decade. Income was boosted this past year by sizable gains in wages and salaries and by another year of large increases in dividends.

Measured in terms of annual averages, the personal saving rate fell further in 1997, according to current estimates. The 1997 average of 3.8 percent was about ½ percentage point below the 1996 average and roughly a full percentage point below the 1995 average. It also was the lowest annual reading in several decades. Various surveys of households show consumers to have become increasingly optimistic about prospects for the economy, and this rising degree of optimism may have led them to spend more freely from current income. Support for additional spending came from the further rise in the stock market, as the capital gains accruing to households increased the chances of their meeting longer-run net worth objectives even as they consumed a larger proportion of current income.

Residential Investment

Preliminary data indicate that real residential investment increased nearly 6 percent during 1997. Real outlays for the construction of new single-family structures rose moderately, and outlays for the construction of multifamily units continued to recover from the extreme lows that were reached earlier in the decade. Real outlays for home improvements and brokers' commissions, categories that have a combined weight of more than 35 percent in total residential investment, moved up substantially from the final quarter of 1996 to the final quarter of 1997. Spending on mobile homes, a small part of the total, also advanced.

The indicators of single-family housing activity were almost uniformly strong during the year. Sales of houses surged, driven by declines in mortgage interest rates and the increasingly favorable economic circumstances of households. Annual sales of new single-family houses were up about 5½ percent from the number sold in the preceding year, and sales of existing homes moved up about 3 percent. House prices moved up more quickly than prices in general. Responding to the strong demand, starts of new single-family units remained at a high level, only a touch below that of 1996; the annual totals for single-family units have now exceeded 1 million units for six consecutive years, putting the current expansion in single-family housing construction nearly on a par with that of the 1980s in terms of longevity and strength. In January of this year, starts of and permits for single-family units were both quite strong.

Starts of multifamily units increased in 1997 for the fourth year in a row and were about double the record low of 1993. The increased construction of these units was supported by a firming of rents, abundant supplies of credit, and a reduction in vacancy rates in some markets. The national vacancy rate came down only slightly, however, and it has reversed only a portion of the sharp run-up that took place in the 1980s. This

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January, starts of multifamily units fell back to about the 1997 average after having surged to an exceptionally high level in the fourth quarter.

The home-ownership rate—the number of households that own their dwellings divided by the total number of households—moved up further in 1997, to about 65¾ percent, a historical high. The rate had fallen in the 1980s but has risen almost 2 percentage points in this decade.

Household Finance

Household net worth appears to have grown roughly $3½ trillion during 1997, ending at its highest multiple relative to disposable personal income on record. Most of this increase in net worth was the result of upward revaluations of household assets rather than additional saving. In particular, capital gains on corporate equities accounted for about three-fourths of the increase in net worth. Flows of household assets into mutual funds, pensions, and other vehicles for holding equities indirectly were exceeded by outflows from directly held equities.

Household borrowing not backed by real estate, including credit card balances, auto loans, and other consumer credit, increased 4¾ percent in 1997. These obligations grew at double-digit rates in 1994 and 1995, but their growth has slowed fairly steadily since then. Mortgage borrowing, by contrast, has experienced relatively muted swings in growth during the current expansion. Home mortgages are estimated to have grown 7 percent last year, only a bit slower than in 1996. Within this category of credit, however, home equity loans have advanced sharply, reflecting in part the use of these loans in refinancing and consolidating credit card and other consumer obligations.

An element in the slowing of consumer credit growth may have been assessments by some households that they were reaching the limits of their capacity for carrying debt and by some lenders that they needed to tighten selectively their standards for granting new loans. In the mid-1990s, the percentage of household income required to meet debt obligations rose to the upper end of its historical range, in large part because of a sharp rise in credit card debt. Between 1994 and 1996 personal bankruptcies grew at more than a 20 percent annual rate, to some extent because of households' rising debt burden; a change in the federal bankruptcy law and a secular trend toward associating less social stigma with bankruptcy also may have contributed. Over the same period, delinquency and charge-off rates on consumer loans increased significantly.

Last year, however, because the growth of household debt only slightly outpaced that of income while interest rates drifted lower, the household debt-service burden did not change. Reflecting in part the stability of the aggregate household debt burden, delinquency rates on many segments of consumer credit plateaued, although charge-off rates generally continued to rise somewhat. Personal bankruptcies advanced again last year but showed some signs of leveling off in the third quarter.

Some of the apparent leveling out of household debt-repayment problems may also have resulted from efforts by lenders to stem the growth of losses on consumer loans. For the past two years, a large percentage of the respondents to the Federal Reserve's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices have reported tightened standards on consumer loans. But the percentages reporting tightening have fallen a bit in the last few surveys,

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suggesting that many banks feel that they have now altered their standards sufficiently.

Although banks pulled back a bit from consumer lending, most households had little trouble obtaining credit in 1997. Bank restraint has most commonly taken the form of imposing lower credit limits or raising finance charges on outstanding balances; credit card solicitations continued at a record pace. Furthermore, many respondents to the Federal Reserve's January 1998 survey of loan officers said their banks had eased terms and standards on home equity loans, providing consumers easier access to an alternative source of finance.

Mortgage rates fell last month to levels that led many households to apply for loan refinancing. When households refinance, they may choose among options that have differing implications for cash flow, household balance sheets, and spending. Some households may decide to reduce their monthly payments, keeping the size of their mortgages unchanged. Others may keep their monthly payments unchanged, either speeding up their repayments or increasing their mortgages and taking out cash in the process, perhaps to augment current expenditures. In any case, the wave of refinancings is likely having only a small effect on the overall economy because the current difference between the average rate on outstanding mortgages and the rate on new ones is not very large.

The Business Sector

Investment Expenditures

Adjusted for inflation, businesses' outlays for fixed investment rose about 8 percent during 1997 after gaining about 12 percent during 1996. Spending continued to be spurred by rapid growth of the economy, favorable financial conditions, attractive purchase prices for new equipment, and optimism about the future. Business outlays for equipment, which account for more than three-fourths of total business fixed investment, moved up about 12 percent this past year, making it the fourth year of the last five in which the annual gains have exceeded 10 percent. As in previous years of the expansion, real investment rose fastest for computers, the power of which continued to advance rapidly at the same time their prices continued to decline. Spending also moved up briskly for many other types of equipment, including communications equipment, commercial aircraft, industrial machinery, and construction machinery.

Real outlays for nonresidential construction, the remaining portion of business fixed investment, declined somewhat in 1997 after moving up in each of the four previous years. Construction of office buildings continued to increase in 1997, but sluggishness was apparent in the expenditure data for many other types of structures. Nonetheless, a tone of underlying firmness was apparent in other indicators of market conditions. Vacancy rates declined, for example, and rents seemed to be picking up. In some areas of the country, more builders have been putting up new office buildings on "spec"—that is, undertaking new construction before occupants have been lined up. The new projects are apparently being spurred to some degree by the ready availability of financing.

Business inventory investment picked up considerably in 1997. According to the initial estimate, the level of inventories held by nonfarm businesses rose about 5 percent in real terms over the course of the year after increasing roughly 2 percent in 1996. Accumula-

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tion was especially rapid in the commercial aircraft industry, in which production has been ramped up in response to a huge backlog of orders for new jets. With the rate of inventory growth outpacing the growth of final sales last year, the stock-to-sales ratio in the nonfarm sector ticked up slightly, after a small decline in the preceding year. Although inventory accumulation does not seem likely to persist at the pace of 1997, businesses in general do not appear to be uncomfortable with the levels of stocks they have been carrying.

Corporate Profits and Business Finance

The economic profits of U.S. corporations (book profits after inventory valuation and capital consumption adjustments) increased at more than a 14 percent annual rate over the first three quarters of 1997, and the profits of nonfinancial corporations from their domestic operations grew at a 13½ percent annual rate. In the third quarter, nonfinancial corporate profits amounted to nearly 14 percent of that sector's nominal output, up from 7¼ percent in 1982 and the highest share since 1969. The elevated profit share reflects both the high level of cash flow before interest costs, which also stands at a multiyear peak relative to output, and the reductions in interest costs that have taken place in the 1990s. Fourth-quarter profit announcements indicate that year-over-year growth in earnings was fairly strong; few corporations reported that they had experienced much fallout yet from the events in Asia, but many warned that profits in the first half of 1998 will be significantly affected.

Despite the rapid growth in profits, the financing gap for nonfinancial corporations—capital expenditures less internal cash flow—widened, reflecting the strong expansion of spending on capital equipment and inventories. Furthermore, on net, firms continued to retire a large volume of equity, adding further to borrowing needs, as substantial gross issuance was swamped by stock repurchases and merger-related retirements. Given these financing requirements, the growth of nonfinancial corporate debt picked up to more than a 7 percent rate last year.

With the debt of nonfinancial corporations advancing briskly, the ratio of their interest payments to cash flow was about unchanged last year, after several years of decline that had left it at quite a low level. Consequently, measures of debt-repayment difficulties also were very favorable last year: The default rate on corporate bonds remained extremely low, and the number of upgrades of debt about equaled the number of downgrades. Similarly, only small percentages of business loans at banks were delinquent or charged off. The rate of business bankruptcies increased a bit but was still fairly low.

Businesses continued to find credit amply supplied at advantageous terms last year. The spread between yields on investment-grade bonds and yields on Treasury securities of similar maturities remained narrow, varying only a little during the year. The spreads on below-investment-grade bonds fell over the year, touching new lows before widening a bit in the fall and early this year; the widening occurred in large part because these securities benefited less from the flight to U.S. assets in response to events in Asia than did Treasury securities. Banks also appeared eager to lend to businesses. Large percentages of the respondents to the Federal Reserve's surveys, citing stiff competition as the reason, said they had eased terms—particularly spreads—on business loans last year. Much smaller percentages

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reported having eased standards on these loans. The high ratios of stock prices to earnings suggest that equity finance was also quite cheap last year. Nevertheless, the market for initial public offerings of equity was cooler than in 1996—new issues were priced below the expected range more often than above it, and first-day trading returns were smaller on average.

The pickup in business borrowing was widespread across funding sources. Outstanding commercial paper, which had declined a bit in 1996, posted strong growth in 1997, as did bank business loans. Gross issuance of bonds was extremely high, particularly bonds with ratings below investment grade. Such lower-rated bonds made up nearly half of all issuance, a new record. Although sales of new investment-grade bonds slowed a bit in the fall, corporations were apparently waiting out the market volatility at that time, and issuance picked back up in January. Banks, real estate investment trusts, and commercial-mortgage-backed securities were the most significant sources of funds for income properties—residential apartments and commercial buildings—the financing of which expanded further last year.

The Government Sector

Federal Expenditures, Receipts, and Finance

Nominal outlays in the unified budget increased about 2½ percent in fiscal year 1997 after moving up 3 percent in fiscal 1996. Fiscal 1997 was the sixth consecutive year that the growth of spending was less than the growth of nominal GDP. During that period, spending as a percentage of nominal GDP fell from about 22½ percent to just over 20 percent. The set of factors that have combined to bring about this result includes implementation of fiscal policies aimed at reducing the deficit, which has helped slow the growth of discretionary spending and spending on some social and health services programs, and the strength of the economy, which has reduced outlays for income support.

In nominal terms, small to moderate increases were recorded in most major expenditure categories in fiscal 1997. Net interest outlays, which have been accounting for about 15 percent of total unified outlays in recent years, rose only a small amount in 1997, as did nominal outlays for defense and those for income security. Expenditures on Medicaid rose moderately for a second year after having grown very rapidly for many years; spending in this category has been restrained of late by the strong economy, the low rate of inflation in the medical area, and policy changes in the Medicaid program. Policy shifts and the strong economy also cut into outlays for food stamps, which fell about 10 percent in fiscal 1997. By contrast, spending on Medicare continued to rise at about three times the rate of total federal outlays. Growth of outlays for social security also exceeded the rate of rise of total expenditures.

Real federal outlays for consumption and gross investment, the part of federal spending that is counted in GDP, were unchanged, on net, from the last quarter of 1996 to the final quarter of 1997. Real outlays for defense, which account for about two-thirds of the spending for consumption and investment, declined slightly, offsetting a small increase in nondefense outlays. Because of much larger declines in most other recent years, the level of real defense outlays at the end of 1997 was down about 22 percent from its level at the end of the 1980s; total real outlays for consump-

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tion and investment dropped about 14 percent over that period.

Federal receipts rose faster than nominal GDP for a fifth consecutive year in fiscal 1997; receipts were 19¾ percent of GDP last year, up from 17¾ percent in fiscal 1992. The ratio tends to rise during business expansions, mainly because of cyclical increases in the share of profits in nominal GDP. In the past couple of years, the ratio also has been boosted by the tax increases included in the Omnibus Reconciliation Act of 1993, by a rising income share of high-income taxpayers, and by receipts from surging capital gains realizations, which raise the numerator of the ratio but not the denominator because capital gains realizations are not part of GDP. In fiscal 1997, combined receipts from individual income taxes and social insurance taxes, which account for about 80 percent of total receipts, moved up about 9½ percent, even more than in fiscal 1996. Receipts from the taxes on corporate profits were up about 6 percent in fiscal 1997 after increasing about 9½ percent in the preceding fiscal year. The total rise in receipts in fiscal 1997, coupled with the subdued rate of increase in nominal outlays, resulted in a budget deficit of $22 billion, down from $107 billion in the preceding fiscal year.

With the budget moving close to balance, federal borrowing slowed sharply last year. The Treasury responded to the smaller-than-expected borrowing need by reducing sales of bills in order to keep its auctions of coupon securities predictable and of sufficient volume to maintain the liquidity of the secondary markets. The result was an unusually large net redemption of bills, which at times pushed yields on short-term bills down relative to yields on other Treasury securities and short-term private obligations.

Last year saw the first issuance by the Treasury of inflation-indexed securities. The Treasury sold indexed ten-year notes in January and April of last year and again this January, and sold five-year notes in July and October; it also announced that it would sell indexed thirty-year bonds this April. Investor interest in the securities at those auctions was substantial, with the ratios of received bids to accepted bids resembling those for nominal securities. As expected, most of the securities were quickly acquired by final investors, and the trading volume as a share of the outstanding amount has been much smaller than for nominal securities.

An important macroeconomic implication of the reduced federal deficit is that the federal government has ceased to be a negative influence on the level of national saving. The improvement in the federal government's saving position in recent years has more than accounted for a rise in the total gross saving of households, businesses, and governments, from about 14½ percent of gross national product earlier in the decade, when federal government saving was at a cyclical low and highly negative, to more than 17 percent in the first three quarters of 1997. This rise in domestic saving, along with increased borrowing from abroad, has financed the rise in domestic investment in this expansion. Still higher rates of saving and investment were the norm a couple of decades ago, when the personal saving rate was a good bit above its level in recent years.

State and Local Governments

The real outlays of state and local governments for consumption and investment moved up about 2 percent over the four quarters of 1997, similar to the average since the start of the 1990s.

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Investment expenditures, which have grown about 2½ percent per annum this decade, rose at only half that pace in 1997, according to the initial estimate. However, real consumption expenditures increased 2¼ percent last year, a touch above the average for the decade. Compensation of government employees, which accounts for about three-fifths of real consumption and investment expenditures, rose about 1¾ percent in 1997 and has increased at an annual rate of only about 1¼ percent since the end of the 1980s.

The efforts of state and local governments to hold down their labor expenses are also reflected in the recent data on nominal wages and hourly compensation. According to the employment cost indexes, hourly compensation of the workers employed by state and local governments increased 2¼ percent in 1997, a little less than in 1996 and the smallest annual increase in the seventeen-year history of the series. The increase in the average hourly wage of state and local employees amounted to about 2¾ percent in 1997, roughly the same as the gain in 1996. The average hourly cost of the benefit packages provided to state and local employees rose only 1¼ percent, a percentage point less than the increase in 1996.

With costs contained and receipts continuing to rise with the growth of the economy, financial pressures that were evident among state and local governments earlier in the expansion have diminished. The increased breathing room in the budgets of recent years is apparent in the consolidated current account of these governments: Surpluses in that account, excluding those that are earmarked for social insurance funds, had dipped to a low of about 1½ percent of nominal receipts in 1991, but they have been larger than 3 percent of receipts in each of the past three years.

State and local debt expanded about 5¾ percent last year after changing little in 1996 and declining in the two preceding years. In those earlier years, municipal debt outstanding had been held down by the retirement of bonds that were "advance refunded" in the early 1990s. In such operations, funds that had earlier been raised and set aside were used to refund debt as it became callable. By the end of 1996, however, the stock of such debt had apparently been largely worked down.

External Sector

Trade and the Current Account

The nominal trade deficit for goods and services was $114 billion in 1997, little changed from the $111 billion deficit in 1996. For the first three quarters of the year, the current account deficit reached $160 billion at an annual rate, somewhat wider than the 1996 deficit of $148 billion. This deterioration of the current account largely reflects continued declines in net investment income, which for the first time recorded deficits in each of the first three quarters of the year.

The quantity of imports of goods and services expanded strongly during 1997—about 13 percent according to preliminary estimates—as the very rapid growth experienced during the first half of the year moderated slightly during the second half. The expansion was fueled by continued vigorous growth of U.S. GDP. Additional declines in non-oil import prices—related in large part to the appreciation of the dollar—contributed as well. Of the major trade categories, increases in imports were sharpest for capital goods and consumer goods.

Export growth was also strong in 1997, particularly during the first half

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of the year. The quantity of exports of goods and services rose nearly 11 percent, after a rise of 9¼ percent the preceding year. Despite further appreciation of the dollar, exports accelerated in response to the strength of economic activity abroad. Output growth in most of our industrial-country trading partners firmed in 1997 from the moderate rates observed in 1996. Among our developing-country trading partners, robust growth continued through much of the year, but the onset of crises in several Asian economies late in 1997 led to abrupt slowdowns in economic activity. Growth of exports to Latin American countries and to Canada was particularly strong. Exports to Western Europe also increased at a healthy pace.

Capital Flows

In the first three quarters of 1997, large increases were reported in both foreign ownership of assets in the United States and U.S. ownership of assets abroad, reflecting the continued trend toward the globalization of both financial markets and the markets for goods. Little evidence of the gathering financial storm in Asia was apparent in the data on U.S. capital flows through the end of September. Foreign official assets in the United States rose $46 billion in the first three quarters of 1997. The increases were concentrated in the holdings of certain industrial countries and members of OPEC. Although substantial, these increases were below the pace for the first three quarters of 1996.

In contrast, increases in assets held by other foreigners in the first three quarters of 1997 surpassed those recorded in 1996. In particular, net purchases of U.S. Treasury securities by private foreigners rose to $130 billion, net purchases of U.S. corporate and other bonds reached $96 billion, and net purchases of U.S. stocks were a record $55 billion. In addition, foreign direct investment in the United States also posted a new high of $78 billion, as the strong pace of acquisitions of U.S. companies by foreigners continued.

U.S. direct investment abroad in the first three quarters of 1997 also exceeded the 1996 pace, with a record net outflow of $88 billion. U.S. net purchases of foreign securities in the first three quarters of 1997 were $74 billion, a little below the pace for 1996. However, net purchases of stocks in Japan and bonds in Latin America were up substantially. Banks in the United States reported a large increase in net claims on foreigners in the first quarter but only a modest increase in the next two quarters combined.

The Labor Market

Employment, Productivity, and Labor Supply

More than 3 million jobs were added to nonfarm payrolls in 1997—a gain of nearly 2¾ percent, measured from December to December. Patterns of hiring mirrored the broadly based gains in output and spending. Manufacturing, construction, trade, transportation, finance, and services all exhibited appreciable strength. In manufacturing, the 1997 rise in the job count followed two years of little change. Elsewhere, the gains in 1997 came on top of substantial increases in other recent years. Especially rapid increases were posted this past year in some of the services industries, including computer services, management services, education, and recreation. Employment at suppliers of personnel, a category that includes the agencies that supply help on a temporary basis, also increased appreciably in 1997, but the gains in this category fell

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considerably short of those seen in previous years of the expansion. Help-supply firms reported that shortages of workers were limiting the pace of their expansion.

Labor productivity has risen rapidly over the past two years. Revised data show the 1996 gain in output per hour in the nonfarm business sector to have been about 1¾ percent, and the increase in 1997 was larger still—about 2¼ percent, according to the first round of estimates. Although the average rate of productivity increase since the end of the 1980s still is only a little above 1 percent per year, the data for the past two years provide hopeful indications that sustained high levels of investment in new technologies may finally be translating into a stronger trend.

The civilian unemployment rate fell more than ½ percentage point from the fourth quarter of 1996 to the fourth quarter of 1997, to an average of just under 4¾ percent. The rate held steady at this level in January of this year. For most of the past year, the rate has been running somewhat below the minimum that was reached in the expansion of the 1980s. A variety of survey data indicate that firms have had increased difficulty filling jobs.

After moving up a step in 1996, the labor force participation rate continued to edge higher in 1997. Without the increment to labor supply from increased participation over these two years, the unemployment rate would have fallen to an even lower level. Changes in the welfare system perhaps contributed to some extent to the small rise in participation in 1997, although this effect is difficult to disentangle from the normal tendency of participation to rise when the labor market is tight. Even though one-third of the adult population remained outside the labor force in 1997, the vast majority of those individuals likely were in pursuits that tended to preclude their workforce participation, such as retirement, schooling, or housework. The percentage of the working age population interested in work but not actively seeking it moved down further in 1997, to 2¼ percent in the fourth quarter, a record low in the history of the series, which began in 1970.

Wages and Hourly Compensation

According to the employment cost indexes, hourly compensation in private industry increased 3.4 percent from December of 1996 to December of 1997. This rise exceeded that of the previous year by 0.3 percentage point and was 0.8 percentage point greater than the increase of 1995. Although the patterns of change in hourly pay have varied quite a bit by industry and occupation over the past two years, the overall step-up seems to have been prompted, in large part, by the tightening of labor markets. The implementation of a higher minimum wage also seems to have been a factor in some industries and occupations, although its impact is difficult to assess precisely.

The wage and salary component of hourly compensation rose faster in 1997 than in any previous year of the expansion. Annual increases in the employment cost index for wages and salaries in private industry amounted to 2.8 percent in both 1994 and 1995, but the increases of 1996 and 1997 were 3.4 percent and 3.9 percent respectively. Wages and salaries in the service-producing industries accelerated nearly a full percentage point in 1997, pushed up, especially, by sharp pay increases in the finance, insurance, and real estate sector, in which commissions and bonuses have recently been boosted by high levels of mortgage refinancing

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and trading activity. By contrast, hourly wages in the goods-producing industries slowed a couple of tenths of a percentage point in 1997; the annual gains in these industries have been around 3 percent, on average, in each of the past six years.

Although the costs of the fringe benefits that companies provide to their employees also picked up in 1997, the yearly increase of 2.3 percent was not large by historical standards. As in other recent years, benefit costs in 1997 were restrained by a variety of influences. Most notably, the price of health care continued to rise at a subdued pace, and the ongoing strength of the economy limited the need for payments by firms to state unemployment trust funds. Even though some firms reported seeing renewed sharp increases in health care costs during the year, the employment cost data suggest that most firms still were keeping those costs under fairly tight control.

With nominal hourly compensation in almost all industries moving ahead at a faster pace than inflation, workers' pay generally increased in real terms, and the real gains were substantial in many occupations. Indeed, the employment cost index does not capture some of the forms of compensation that employers have been using to attract and retain workers—stock options and signing bonuses, for example.

Prices

Indications of a slowing of inflation in 1997 were widespread in the various measures of aggregate price change. The consumer price index, which had picked up to more than a 3 percent rate of rise over the four quarters of 1996, increased slightly less than 2 percent over the four quarters of 1997 as energy prices turned down and increases in food prices slowed. The CPI excluding food and energy—a widely used gauge of the underlying trend of inflation—rose only 2¼ percent in 1997 after increases of 3 percent in 1995 and 2½ percent in 1996. The CPI for commodities other than food and energy rose about ½ percent over the four quarters of 1997 after moving up slightly more than 1 percent in 1996. Price increases for non-energy services, which have a much larger weight than commodities in the core CPI, also slowed a little in 1997; a 3 percent rise during the year was about ¼ percentage point less than the increase during 1996. Only small portions of the slowdowns between 1996 and 1997 in the total CPI and in the CPI excluding food and energy were the result of technical changes implemented by the Bureau of Labor Statistics.[1]

Other measures of aggregate price change also decelerated in 1997. The chain-type price index for gross domestic purchases—the broadest measure of prices paid by U.S. households, businesses, and governments—increased about 1½ percent during 1997 after moving up 2¼ percent in 1996. The chain-type price index for gross domestic product, a measure of price change for the goods and services produced in this country (rather than the goods and services purchased), increased 1¾ per-

1. Over the past three years, the Bureau of Labor Statistics has introduced a number of technical changes in its procedures for compiling the CPI, with the aim of obtaining a more accurate measure of price change. Typically, the changes have only a small effect on the results for any particular year, but their cumulative effects are somewhat larger and are tending to hold down the reported increases of recent years relative to what would have been reported with no changes in procedures. Apart from the procedural changes, the reported rate of rise from 1998 forward will also be affected by an updating of the CPI market basket, an action that the BLS undertakes approximately every ten years.

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Alternative Measures of Price Change
Percent

Price measure	1996	1997
Fixed-weight		
Consumer price index	3.2	1.9
Excluding food and energy	2.6	2.2
Chain-type		
Personal consumption expenditures	2.7	1.5
Excluding food and energy	2.3	1.6
Gross domestic purchases	2.3	1.4
Gross domestic product	2.3	1.8

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

cent in the latest year after rising 2¼ percent in 1996. The steeper slowing of the price index for aggregate purchases relative to that for aggregate production was largely a reflection of the prices of imports, which fell faster in 1997 than in 1996. Falling computer prices were an important influence on many of these measures of aggregate price change—more so than on the CPI, which gave small weight to computers through 1997 but has started weighting them more heavily this year.

In real terms, imports of goods and services account for approximately 15 percent of the total purchases of households, businesses, and governments located in the United States. But that figure probably understates the degree of restraint that falling import prices have imposed on domestic inflation, because the lower prices for imports also make domestic producers of competing products less likely to raise prices. Prices have also been restrained by large additions to manufacturing capacity in this country, amounting to more than 5 percent in each of the past three years; this capacity growth helped to stave off the bottlenecks that so often have developed in the more advanced stages of other postwar business expansions. A gain in manufacturing production of more than 6 percent this past year was accompanied by only a moderate increase in the factory operating rate, which, at year-end, remained well below the highs reached in other recent expansions and the peak for this expansion, which was recorded about three years ago.

Reflecting the ample domestic supply and the effects of competition from goods produced abroad, the producer price index for finished goods declined about ¾ percent from the fourth quarter of 1996 to the fourth quarter of 1997; excluding food and energy, it rose only fractionally. Prices of domestically produced materials (other than food and energy) also rose only slightly, on net. The prices of raw industrial commodities, many of which are traded in international markets, declined over the year; the weakness of prices in these markets was especially pronounced in late 1997, when the crises in Asia were worsening. Industrial commodity prices fell further in the first couple of weeks of 1998, but they since have changed little, on balance. The producer price index fell sharply in January of this year; the index excluding food and energy declined slightly.

After moving up more than 4 percent in 1996, the consumer price index for food increased only 1¾ percent in 1997. Impetus for the large increase of 1996 had come from a surge in the price of grain, which peaked around the middle of that year; since then, grain prices have dropped back considerably. An echo of the up-and-down price pattern for grains appeared at retail in the form of sharp price increases for meats, poultry, and dairy products in 1996 followed by small to moderate declines for most of those products in 1997. Moderate price increases were posted at retail for most other food categories last year.

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The CPI for energy has traced out an even bigger swing than the price of food over the past two years—a jump of 7½ percent over the four quarters of 1996 was followed by a decline of about 1 percent over the four quarters of 1997. As is usually the case in this sector, the key to these developments was the price of crude oil, which in 1997 more than reversed the run-up of the preceding year. Prices of oil have been held down in recent months by ample world supplies, the economic problems in Asia, and a mild winter.

Survey data on inflation expectations mostly showed moderate reductions during 1997 in respondents' views of the future rate of price increase, and some of the survey data for early 1998 have shown a more noticeable downward shift in inflation expectations. A lowering of inflation expectations has long been viewed as an essential ingredient in the pursuit of price stability, and the recent data are a sign that progress is still being made in that regard.

Credit, Money, Interest Rates, and Equity Prices

Credit and Depository Intermediation

The debt of the domestic nonfinancial sectors grew at a 4¾ percent rate last year, somewhat below the midpoint of the range established by the FOMC and less than in 1996, when it grew 5¼ percent. The deceleration was accounted for entirely by the federal component, which, because of the reduced budget deficit, rose less than 1 percent last year after having risen 3¾ percent in 1996. Nonfederal debt grew 6 percent, a bit more than in 1996, as the pickup in business borrowing more than offset the deceleration of household debt.

Depository institutions increased their share of credit flows in 1997, with credit on their books expanding 5¾ percent, up appreciably from growth in 1996. The growth of bank credit, adjusted to remove the effects of mark-to-market accounting rules, accelerated to an 8¼ percent pace, the largest rise in ten years; and banks' share of domestic nonfinancial debt outstanding climbed to its highest level since 1988. Bank credit accelerated in part because banks' holdings of securities—which had run off in 1995 and had been flat in 1996—expanded at a brisk pace last year; securities account for one-fourth of total bank credit. Loans, which make up the remainder of bank credit, also advanced a bit more quickly last year than in 1996, though more slowly than in 1995.

The increase in bank loans occurred despite a net decline in consumer loans on banks' books resulting both from sharply slower growth in loans originated by banks and from continued securitization of those loans. Real estate loans at banks, by contrast, posted solid growth last year. This category of credit benefited from a pickup in home mortgages, the rapid growth in home equity loans, which were substituting in part for consumer loans, an acceleration in commercial real estate lending, and the acquisition of thrift institutions by banks. Commercial and industrial loans expanded considerably last year, reflecting both the general rise in the demand by businesses for funds and an increase in banks' share of the nonmortgage business credit market as they competed vigorously for business loans by easing terms.

The rapid growth of banks' assets was facilitated by their continued high profitability and abundance of capital; at the end of the third quarter, nearly 99 percent of bank assets were at well-capitalized institutions. Problems with the repayment performance of consumer loans—which, while not deteriorating

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further, remained elevated by historical standards—hurt some banks; however, overall loan delinquency and charge-off rates stayed quite low, and measures of banks' profitability persisted at the elevated levels they have occupied for several years. Profits at a few large bank holding companies were reduced in the fourth quarter by trading losses resulting from the events in Asia. Nonetheless, the profits of the industry as a whole remained robust.

The profits and capital levels of thrift institutions, like those of banks, were high last year, and the thrifts also were aggressive lenders. The outstanding amount of credit extended by thrifts grew at about a 1½ percent pace last year, but this sluggishness reflected entirely the acquisitions of thrifts by commercial banks; among thrifts not acquired during the year, asset growth was similar to that of banks.

The Monetary Aggregates

Boosted in part by the need to fund substantial growth in depository credit, M3 shot up last year, expanding 8¾ percent; this growth was well above the 2 percent to 6 percent annual range, which was intended to suggest the rate of growth over the long run consistent with price stability. M3 was augmented by a shift in sources of funding—mostly at U.S. branches and agencies of foreign banks—from borrowings from related offices abroad, which are not included in M3, to large time deposits issued in the United States, which are. Also contributing to the strength in M3 was rapid growth in institution-only money funds, which reflected gains by these funds in the provision of corporate cash management services. Corporations that manage their own cash often keep their funds in short-term assets that are not included in M3.

Although growth of M2 did not match that of M3, it increased at a brisk 5½ percent rate last year. As the Committee had anticipated, the aggregate was somewhat above the upper bound of its 1 percent to 5 percent annual range, which also had been chosen to be consistent with expected M2 growth under conditions of price stability. Because short-term interest rates responded only slightly to System tightening in March, the opportunity cost of holding M2—the interest earnings forgone by owning M2 assets rather than money

Growth of Money and Debt

Percent

Period	M1	M2	M3	Domestic nonfinancial debt
Annual[1]				
1987	6.3	4.2	5.8	9.9
1988	4.3	5.7	6.3	8.9
1989	.5	5.2	4.0	7.8
1990	4.2	4.1	1.8	6.8
1991	7.9	3.1	1.2	4.5
1992	14.4	1.8	.6	4.7
1993	10.6	1.3	1.1	5.1
1994	2.5	.6	1.7	5.1
1995	−1.6	3.9	6.1	5.4
1996	−4.5	4.6	6.9	5.2
1997	−1.2	5.6	8.7	4.7
Quarterly (annual rate)[2]				
1997:Q1	−1.4	5.1	8.0	4.3
Q2	−4.5	4.4	7.7	4.7
Q3	.3	5.4	8.1	4.1
Q4	.8	6.8	9.8	5.2

NOTE. M1 consists of currency, travelers checks, demand deposits, and other checkable deposits. M2 consists of M1 plus savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds. M3 consists of M2 plus large-denomination time deposits, balances in institutional money market funds, RP liabilities (overnight and term), and Eurodollars (overnight and term). Debt consists of the outstanding credit market debt of the U.S. government, state and local governments, households and nonprofit organizations, nonfinancial businesses, and farms.

1. From average for fourth quarter of preceding year to average for fourth quarter of year indicated.

2. From average for preceding quarter to average for quarter indicated.

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market instruments such as Treasury bills—was about unchanged over the year. As M2 grew at about the same rate as nominal GDP, velocity was also essentially unchanged. The ups and downs of M2 growth last year mirrored those of the growth in nominal output. M2 expanded much more slowly in the second quarter than in the first, consistent with the cooling of nominal GDP growth and almost unchanged opportunity costs. In the second half of the year, M2 growth picked up, again pacing the growth of nominal GDP. In the fall, M2 may also have been boosted a little by the volatility in equity markets, which may have led some households to seek the relative safety of M2 assets.

For several decades before 1990, M2 velocity responded positively to changes in its opportunity costs and otherwise showed little net movement over time. This pattern was disturbed in the early 1990s in part by households' apparent decision to shift funds out of lower-yielding M2 deposits into higher-yielding stock and bond mutual funds, which raised M2 velocity even as opportunity costs were declining. The movements in the velocity of M2 from 1994 into 1997 appear to have again been explained by changes in opportunity costs, along with some residual upward drift. This drift suggests that some households may still have been in the process of shifting their portfolios toward non-M2 assets. There was no uptrend in velocity over the second half of last year, perhaps because of the declining yields on intermediate- and long-term debt and the greater volatility and lower average returns posted by stock mutual funds. However, given the aberrant behavior of velocity during the 1990s in general, considerable uncertainty remains about the relationship between the velocity and opportunity cost of M2 in the future.

M1 fell 1¼ percent last year. As has been true for the past four years, the growth of this aggregate was depressed by the adoption by banks of retail sweep programs, whereby balances in transactions accounts, which are subject to reserve requirements, are "swept" into savings accounts, which are not. Sweep programs benefit depositories by reducing their required reserves, which earn no interest. At the same time, they do not restrict depositors' access to their funds for transactions purposes, because the funds are swept back into transactions accounts when needed. The initiation of programs that sweep funds out of NOW accounts—until last year the most common form of retail sweep programs—appears to be slowing, but sweeps of household demand deposits have picked up, leaving the estimated total amount by which sweep account balances increased last year similar to that in 1996. Adjusted for the initial reduction in transactions accounts resulting from the introduction of new sweep programs, M1 expanded 6¼ percent, a little above its sweep-adjusted growth in 1996.

The drop in transactions accounts caused required reserves to fall 7¼ percent last year. Despite this decline, the monetary base grew 6 percent, boosted by a hefty advance in currency. Currency again benefited from foreign demand, as overseas shipments continued at the elevated levels seen in recent years. Moreover, domestic demand for currency expanded sharply in response to the strong domestic spending.

The Federal Reserve has been concerned that as the steady decline in required reserves of recent years is extended, the federal funds rate may become significantly more volatile. Required reserves are fairly predictable and must be maintained on only a two-week average basis. As a result, the

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unavoidable daily mismatches between reserves made available through open market operations and desired reserves typically have been fairly small, and their effect on the federal funds rate has been muted. However, banks also hold reserve balances at the Federal Reserve to avoid overdrafts after making payments for themselves and their customers. This component of the demand for reserves is difficult to predict, varies considerably from day to day, and must be fully satisfied each day. As required reserves have declined, the demand for balances at the Federal Reserve has become increasingly dominated by these more changeable daily payment-related needs. Nonetheless, federal funds volatility did not increase noticeably last year. In part this was because the Federal Reserve intervened more frequently than in the past with open market operations of overnight maturity in order to better match the supply of and demand for reserves each day. In addition, banks made greater use of the discount window, increasing the supply of reserves when the market was excessively tight. Significant further declines in reserve balances, however, do risk increased federal funds rate volatility, potentially complicating the money market operations of the Federal Reserve and of the private sector. One possible solution to this problem is to pay banks interest on their required reserve balances, reducing their incentive to avoid holding such balances.

Interest Rates and Equity Prices

Interest rates on intermediate- and long-term Treasury securities moved lower, on balance, last year. Yields rose early in the year as market participants became concerned that strength in demand would further tighten resource utilization margins and increase inflation unless the Federal Reserve took countervailing action. Over the late spring and summer, however, as growth moderated some and inflation remained subdued, these concerns abated significantly, and longer-term interest rates declined. Further reductions came in the latter part of the year as economic problems mounted in Asia. On balance, between the end of 1996 and the end of 1997, the yields on ten-year and thirty-year Treasury bonds fell about 70 basis points. Early this year, with the economic troubles in Asia continuing, the desire of investors for less risky assets, along with further reductions in the perceived risk of strong growth and higher inflation, pushed yields on intermediate- and long-term Treasury securities down an additional 25 to 50 basis points, matching their levels of the late 1960s and the early 1970s, when the buildup of inflation expectations was in its early stages.

Survey measures of expectations for longer-horizon inflation generally did move lower last year, but by less than the drop in nominal yields. As a result, estimates of the real longer-term interest rate calculated by subtracting these measures of expected inflation from nominal yields indicate a slight decline in real rates over the year. In contrast, yields on the inflation-indexed ten-year Treasury note rose about a quarter percentage point between mid-March (when market participants seem to have become more comfortable with the new security) and the end of the year. The market for the indexed securities is sufficiently small that their yields can fluctuate temporarily as a result of moderate shifts in supply or demand. Indeed, much of the rise in the indexed yield came late in the year, when, in an uncertain global economic environment, investors' heightened desire for liquidity may have made nominal securities relatively more attractive.

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With real interest rates remaining low and corporate profits growing strongly, equities had another good year in 1997, and major stock indexes rose 20 percent to 30 percent. Although stocks began the year well, they fell with the upturn in interest rates in February. As interest rates subsequently declined and earnings reports remained quite upbeat, the markets again advanced, with most broad indexes of stock prices reaching new highs in the spring. Advances were much more modest, on balance, over the second half of the year. Valuations seemed already to have incorporated very robust earnings growth, and in October, deepening difficulties in Asia evidently led investors to lower their expectations for the earnings of some U.S. firms, particularly high-technology firms and money center banks. More rapid price advances have resumed of late, as interest rates fell further and investors apparently came to see the earnings consequences of Asian difficulties as limited.

Despite the strong performance of earnings and the slower rise of stock prices since last summer, valuations seem to reflect a combination of expectations of quite rapid future earnings growth and a historically small risk premium on equities. The gap between the market's forward-looking earnings–price ratio and the real interest rate, measured by the ten-year Treasury rate less a survey measure of inflation expectations, was at the smallest sustained level last year in the eighteen-year period for which these data are available. Declines in this gap generally imply either that expected real earnings growth has increased or that the risk premium over the real rate investors use when valuing those earnings has fallen, or both. Survey estimates of stock analysts' expectations of long-term nominal earnings growth are, in fact, the highest observed in the fifteen years for which these data are available. Because inflation has trended down over the past fifteen years, the implicit forecast of the growth in real earnings departs even further from past forecasts. However, even with this forecast of real earnings growth, the current level of equity valuation suggests that investors are also requiring a lower risk premium on equities than has generally been the case in the past, a hypothesis supported by the low risk premiums evident in corporate bond yields last year.

International Developments

The foreign exchange value of the dollar rose during 1997 in terms of the currencies of most of the United States' trading partners. From the end of December 1996 through the end of December 1997, the dollar on average gained 13 percent in nominal terms against the currencies of the other G-10 countries when those currencies are weighted by multilateral trade shares. In terms of a broader index of currencies that includes those of most industrial countries and several developing countries, the dollar on balance rose nearly 14 percent in real terms during 1997.[2] The trading desk of the New York Federal Reserve Bank did not intervene in foreign exchange markets during 1997.

During the first half of 1997, the dollar appreciated in terms of the currencies of the other industrial countries, as the continuing strength of U.S. economic activity raised expectations of further tightening of U.S. monetary conditions. Concerns about the implications of the transition to European Monetary Union

2. This index weights currencies in terms of the importance of each country in determining the global competitiveness of U.S. exports and adjusts nominal exchange rates for changes in relative consumer prices.

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and perceptions that monetary policy was not likely to tighten significantly in prospective member countries also contributed to the tendency for the dollar to rise in terms of the mark and other continental European currencies. In response to varying indicators of the strength of the Japanese expansion, the dollar rose against the yen early in the year but then moved back down through midyear.

The crises in Asian financial markets dominated developments during the second half of the year and resulted in substantial appreciation of the dollar in terms of the currencies of Korea and several countries in Southeast Asia. The dollar also appreciated against the yen in response to evidence of financial sector fragility in Japan and faltering Japanese economic activity, which were likely to be exacerbated by the negative impact of the Asian situation on Japan. During the first weeks of 1998, the dollar has changed little, on average, in terms of the currencies of most other industrial countries, but it has moved down in terms of the yen.

Pronounced asset–price fluctuations in Southeast Asia began in early July when the Thai baht dropped sharply immediately following the decision by authorities to no longer defend the baht's peg. Downward pressure soon emerged on the currencies and equity prices of other southeast Asian countries, in particular Indonesia and Malaysia. Weakening balance sheet positions of nonfinancial firms and financial institutions, rising debt-service burdens, and financial market stresses that resulted in part from policies of pegging local currencies to the appreciating dollar prompted closer scrutiny of Asian economies. As foreign creditors came to realize the extent to which these Asian financial systems were undercapitalized and inadequately supervised, they became less willing to continue to lend, making it even more difficult for the Asian borrowers to meet their foreign currency obligations. Turbulence spread to Hong Kong in October. The depreciation of currencies elsewhere in Asia, in particular the decision by Taiwanese authorities to allow some downward adjustment of the Taiwan dollar, led market participants to question the commitment of Hong Kong authorities to the peg of the Hong Kong dollar to the U.S. dollar. In response, the Hong Kong Monetary Authority raised domestic interest rates substantially to defend the peg, driving down equity prices as a consequence. Near the end of the year, the crisis spread to Korea, whose economy and financial system were already vulnerable as a result of numerous bankruptcies of corporate conglomerates starting in January 1997; these bankruptcies of major nonfinancial firms further undermined Korean financial institutions and, combined with the depreciations in competitor countries, contributed to a loss of investor confidence. On balance, during 1997 the dollar appreciated significantly in terms of the Indonesian rupiah (139 percent), the Korean won (100 percent), and the Thai baht (82 percent), while it moved up somewhat less in terms of the Taiwan dollar (19 percent) and was unchanged in terms of the Hong Kong dollar, which remains pegged to the U.S. dollar. Since year-end, the dollar has appreciated significantly further, on balance, in terms of the Indonesian rupiah and is little changed in terms of the Korean won.

The emergence of the financial crisis is causing a marked slowdown in economic activity in these Asian economies. During the first half of last year, real output continued to expand in most of these countries at about the robust rates enjoyed in 1996. Since the onset of the crisis, domestic demand in these

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countries has been greatly weakened by disruption in financial markets, substantially higher domestic interest rates, sharply reduced credit availability, and heightened uncertainty. In addition, macroeconomic policy has been tightened somewhat in Thailand, the Philippines, Indonesia, and Korea in connection with international support packages from the International Monetary Fund (IMF) and other international financial institutions, and in connection with bilateral aid from individual countries. Announcement of agreement with the IMF on the support packages temporarily buoyed asset markets in each country, but concerns about the willingness or ability of governments to undertake difficult reforms and to achieve the stated macroeconomic goals remained. Additional measures to tighten the Korean program were announced in mid-December and included improved reserve management by the Bank of Korea, removal of certain interest rate ceilings, and acceleration of capital account liberalization and financial sector restructuring. With the encouragement of the authorities of the G-7 and other countries, banks in industrial countries have generally rolled over the majority of their foreign-currency-denominated claims on Korean banks during early 1998, as a plan for financing the external obligations of Korean financial institutions was being formulated. After the announcement on January 28 of an agreement in principle for the exchange of existing claims on Korean banks for restructured loans carrying a guarantee from the Korean government, the won stabilized. In the case of Indonesia, the support package was renegotiated and reaffirmed with the IMF in mid-January, though important elements of the approach of the Indonesian authorities remain in question as this report is submitted.

Signs that adjustment is proceeding within these Asian economies are already evident. For example, Thailand and Korea have registered strong improvements in their trade balances in recent months. Equity prices have recovered in Thailand, Indonesia, and Korea as well. At the same time, signs of rising inflation are beginning to emerge. In particular, consumer prices have accelerated in recent months in these three countries.

Spillover of the financial crisis to the economies of China, Hong Kong, and Taiwan has been limited to date. Steps to maintain the peg in Hong Kong have resulted in elevated interest rates, sharply lower equity prices, and increased uncertainty. However, in Taiwan, equity prices on balance rose nearly 18 percent in 1997 and have risen somewhat further so far this year. Real output growth in these three economies remained robust early in 1997 but may have slowed somewhat in China and Hong Kong in recent months.

Financial markets in some Latin American countries also came under pressure in reaction to the intensification of the crises in Asia in late 1997. After remaining quite stable earlier in the year, the Mexican peso dropped about 8 percent in terms of the U.S. dollar in late October; since then, it has changed little, on balance. In Brazil, exchange market turbulence abroad lowered market confidence in the authorities' ability to maintain that country's managed exchange rate regime; in response, short-term interest rates were raised 20 percentage points. The Brazilian exchange rate regime and the peg of the Argentine peso to the dollar have held. Real output growth in Mexico and Argentina remained healthy during 1997. In Brazil, growth fluctuated sharply during the year, with the high domestic interest rates and tighter macroeconomic policy

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stance that were put in place late in the year weakening domestic demand. During 1997, consumer price inflation slowed significantly in Mexico and Brazil and remained very low in Argentina.

In Japan, the economic expansion faltered in the second quarter as the effects on domestic demand of the April increase in the consumption tax exceeded expectations; in addition, crises in many of Japan's Asian trading partners late in the year weakened external demand and heightened concerns about the fragility of Japan's financial sector. The dollar rose about 10 percent against the yen during the first four months of 1997 as economic activity in the United States strengthened relative to that in Japan and as interest rate developments, including the FOMC policy move in March, favored dollar assets. These gains were temporarily reversed in May and June as market attention focused on the growing Japanese external surplus and tentative indications of improving real activity. However, subsequent evidence of disappointing output growth, revelations of additional problems in the financial sector, and concerns about the implications of turmoil elsewhere in Asia for the Japanese economy contributed to a rise in the dollar in terms of the yen during the second half of the year. On net, the dollar appreciated nearly 13 percent against the yen during 1997; so far in 1998, it has moved back down slightly, on balance.

In Germany and France, output growth rose in 1997 from its modest 1996 pace, boosted in both countries by the strong performance of net exports. Nevertheless, the dollar rose in terms of the mark and other continental European currencies through midyear, responding not only to stronger U.S. economic activity but also to concerns about the timetable for launching European Monetary Union (EMU), the process of the transition to a single currency, and the policy resolve of the prospective members. Later in the year the dollar moved back down slightly and then fluctuated narrowly in terms of the mark, as investors concluded that the transition to EMU was likely to be smooth, with the euro introduced on time on January 1, 1999, and with a broad membership. On balance, the dollar rose about 17 percent against the mark during 1997 and has varied little since then.

In the United Kingdom and Canada, real output growth was vigorous in 1997. All the components of U.K. domestic demand continued to expand strongly. In Canada, more robust private consumption spending and less fiscal restraint boosted real GDP growth from its moderate 1996 pace. Central bank official lending rates were raised in both countries during the year to address the threat of rising inflation. The value of the pound eased slightly in terms of the dollar over the year, whereas the Canadian dollar fell more than 4 percent in terms of the U.S. dollar. Much of the movement in the Canadian dollar came during the fourth quarter, as the crisis in Asia contributed to a weakening of global commodity prices and thus a likely lessening of Canadian export earnings. The Canadian dollar depreciated further early in 1998, reaching historic lows against the U.S. dollar in January, but it has rebounded with the tightening by the Bank of Canada in late January.

Long-term interest rates have generally declined in the other G-10 countries since the end of 1996. Japanese long-term rates have dropped about 90 basis points, with most of the decrease coming in the second half of last year as evidence of sluggish economic activity became more apparent. German long-

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term rates have also fallen about 80 basis points as expectations of tightening by the Bundesbank diminished, especially toward the end of the year. The turbulence in Asian asset markets likely contributed to inflows into bond markets in several of the industrial countries, including the United States. Long-term rates in the United Kingdom have declined about 150 basis points. Legislation to increase the independence of the Bank of England and repeated tightening of monetary policy during the year reassured markets that some slowing of the very rapid pace of economic growth was likely and that the Bank would be aggressive in resisting inflation in the future. Three-month market interest rates generally have risen in the other G-10 countries, although there have been exceptions. Rates have moved up the most in Canada (more than 180 basis points) and the United Kingdom (120 basis points), in response to several increases in official lending rates. German rates have risen about 40 basis points. Short-term rates in the countries that are expected to adopt a single currency on January 1 of next year converged toward the relatively low levels of German and French rates, with Italian rates declining more than 100 basis points over the year.

Equity prices in the foreign G-10 countries other than Japan moved up significantly in 1997. Despite some volatility in these markets, particularly in the fourth quarter following severe equity price declines in many Asian markets, increases in equity price indexes over 1997 ranged from 17 percent in the United Kingdom to almost 60 percent in Italy. In contrast, equity prices fell 20 percent in Japan. To date this year, equity prices in the industrial countries generally have risen.

The price of gold declined more than 20 percent in 1997 and fell further in early 1998, reaching lows not seen since the late 1970s. Open discussion and, in some cases, confirmation of central bank sales of gold contributed to the price decline. Downward adjustment of expectations of inflation in the industrial countries in general may have added to the selling pressure on gold. More recently, the price of gold has moved up slightly, on net.

Report on July 21, 1998

Monetary Policy and the Economic Outlook

The U.S. economy posted significant further gains in the first half of 1998. The unemployment rate dropped to its lowest level in nearly thirty years, and inflation remained subdued. Real output rose appreciably, on balance, although much of the advance apparently occurred early in the year. Household spending and business fixed investment, supported by the ongoing rise in equity prices and the continued low level of long-term interest rates, appear to have maintained considerable momentum this year. The sizable advance in capital spending and the resulting additions to the capital stock should help bolster labor productivity—the key to rising living standards.

Yet the news this year has not been uniformly good. The turmoil that erupted in some Asian countries last year has generated major concerns about the outlook for those economies and the repercussions for other nations, including the United States. Several Asian countries have had sharp contractions in economic activity, and others have experienced distinctly subpar growth. Heightened uneasiness among international investors has induced portfolio shifts away from Asia and, to some

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extent, from other emerging market economies.

These difficulties have created considerable uncertainty and risk for the U.S. economy, but they have also helped to contain potential inflationary pressures in the near term by reducing import prices and restraining aggregate demand. In particular, the substantial rise in the foreign exchange value of the dollar has boosted our real imports and—together with the slower growth in Asia—depressed our real exports. At the same time, the run-up in the dollar and slack economic conditions in Asia have helped produce a sharp drop in the dollar prices of oil and other commodities and have pushed down other import prices. Shifts in preferences toward dollar-denominated assets in combination with downward revisions to forecasts of inflation and demand have helped to reduce our interest rates; the lower interest rates have boosted household and business spending, offsetting a portion of the damping of demand from the foreign sector.

The Asian crisis is likely to continue to restrain U.S. economic activity in coming quarters. The size of the effect will depend in large part on how quickly the authorities in the Asian nations can put their troubled financial systems on a sounder footing and carry out other essential economic reforms. Deteriorating conditions in many countries during the past few months created added pressures for reform, and they underscored the depth and scope of the problems that must be addressed.

Despite the pronounced weakening of our trade balance, the already tight U.S. labor market has come under further strain this year owing to robust growth of domestic demand. As a result, the outlook for inflation has taken on a greater degree of risk. Consumer prices actually rose a bit less rapidly in the first half of 1998 than they did in 1997, but transitory factors—the drop in oil prices, the run-up in the dollar, and weak economic activity in Asia—exerted considerable downward pressure on domestic prices. These factors will not persist indefinitely. Meanwhile, the pool of individuals interested in working but who are not already employed has continued to shrink. The extraordinary tightness in labor markets has generated a rising trend of increases in wages and related costs, although faster productivity growth has damped the effect on business costs so far.

In conducting monetary policy in the first half of 1998, the Federal Open Market Committee (FOMC) closely scrutinized incoming information for signs that the strength of the economy and the taut labor market were likely to boost inflation and threaten the durability of the expansion. However, despite slightly larger increases in the consumer price index (CPI) in some months, inflation remained moderate on the whole. Moreover, the FOMC expected that aggregate demand would slow appreciably because of a rising trade deficit and a considerable slackening in domestic spending. Although the Committee was acutely aware of the uncertainties in the economic outlook, it believed that the deceleration in demand—and the associated modest easing of pressures on resources—could well be sufficient to limit any deterioration in underlying price performance. On balance, the FOMC chose to keep the intended federal funds rate at 5½ percent.

Monetary Policy, Financial Markets, and the Economy over the First Half of 1998

Output grew rapidly in the first quarter, with real gross domestic product (GDP)

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estimated to have risen 5½ percent at an annual rate. Business fixed investment soared after a weak fourth quarter, and consumption and housing expenditures expanded at a strong clip. In addition, contrary to the expectations of many forecasters, inventory investment rose substantially from its already hefty fourth-quarter pace, with the rise contributing more than 1½ percentage points to overall GDP growth. At the same time, the cumulative effect of the appreciation of the dollar and the faster growth of demand here than abroad resulted in a sharp drop in real net exports, with both rapid import growth and the first quarterly drop in exports in four years. Employment continued to advance briskly, and the unemployment rate held steady at 4¾ percent. Hourly compensation accelerated somewhat when measured on a year-over-year basis, but impressive productivity growth once again helped to restrain the increase in unit labor costs. The CPI rose only ¼ percent at an annual rate over the first three months of the year, as a sharp drop in energy prices offset price increases elsewhere.

Falling long-term interest rates and rising equity prices over the previous year provided substantial impetus to household and business spending in the first quarter. Interest rates dropped sharply further in early January, and although they moved up a little over the remainder of the quarter, nominal yields on long-term Treasury securities were among the lowest in decades. Interest rates continued to benefit from the improvement in the federal budget and the prospect of reduced federal borrowing in the future; rates were also restrained to a significant extent by the effects of the Asian crisis. Equity prices increased sharply in the first quarter, extending their remarkable gains of the previous three years in spite of disappointing news on corporate profits. Households and firms borrowed at a vigorous pace in the first quarter, and growth in the debt of domestic nonfinancial sectors picked up from the fourth quarter of 1997, as did the growth of the monetary aggregates.

At their March meeting, the members of the FOMC confronted unusual cross-currents in the economic outlook. On the price side, the FOMC noted that, although the incoming data were quite favorable, transitory factors were possibly masking underlying tendencies toward higher inflation. Moreover, the available data on household and business spending confirmed the impressive strength of domestic demand and highlighted the possibility that developments in the external sector might not provide sufficient offset in coming quarters to avoid a buildup of inflation pressures. At the same time, the FOMC noted the substantial uncertainty surrounding the prospects for the Asian economies. Balancing these considerations, the FOMC kept its policy stance unchanged but noted that recent information had altered the inflation risks enough to make tightening more likely than easing in the period ahead.

The second quarter brought both a marked further deterioration in the outlook for Asia and some indications that the U.S. economy might be cooling. In Asia, evidence of steep output declines in several countries was combined with mounting concern that economic and financial problems in Japan were not likely to be resolved as quickly as many observers had hoped or expected. One result was a further rise in the exchange value of the dollar and a decline in long-term U.S. interest rates. Increasing investor concern about emerging market economies raised risk spreads on external debts in Asia, Russia, and Latin America.

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The higher value of the dollar and the depressed income in many Asian countries continued to take their toll on U.S. exports and to boost imports in the second quarter. In addition, a marked slackening in the pace of inventory accumulation, which was amplified by the effects of a strike in the motor vehicle industry, was reflected in a sharp slowing in domestic demand. Nonetheless, the utilization of labor resources remained very high: In the second quarter, the unemployment rate averaged a bit less than 4½ percent, its lowest quarterly reading in nearly thirty years. The twelve-month change in average hourly earnings indicated that wages were rising somewhat more rapidly than they had a year earlier. And the CPI rose faster in the second quarter than in the first, mainly reflecting a smaller drop in energy prices.

Financial conditions in the second quarter and into July remained supportive of domestic spending. Yields on private securities declined, although less than Treasury yields, as quality spreads widened a bit. Equity prices rose further in early April before falling back over the next two months in response to renewed earnings disappointments. Prices then rebounded substantially, with most major indexes hitting record highs in July. The growth of money and credit slowed a little on balance from the first-quarter pace but remained buoyant. Banks and other lenders continued to compete vigorously, extending credit on generally favorable terms as they responded in part to the sustained healthy financial condition of most businesses and households.

The FOMC left the intended federal funds rate unchanged at its May and June–July meetings. At the May meeting, the FOMC reiterated its earlier concern that the robust expansion of domestic final demand, supported by very positive financial conditions, had raised labor market pressures to a point that might precipitate an upturn in inflation over time. Yet the FOMC believed that the growth of economic activity would slow. It also judged that the risk of significant further deterioration in Asia, which could disrupt global financial markets and impair economic activity in the United States, was rising somewhat.

Economic Projections for 1998 and 1999

The members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, expect economic activity to expand moderately, on average, over the next year and a half. For 1998 as a whole, the central tendency of their forecasts for real GDP growth spans a range of 3 percent to 3¼ percent. For 1999, these forecasts center on a range of 2 percent to 2½ percent. The civilian unemployment rate, which averaged a bit less than 4½ percent in the second quarter of 1998, is expected to stay near this level through the end of this year and to edge higher in 1999. With labor markets remaining tight and some of the special factors that helped restrain inflation in the first half of 1998 unlikely to be repeated, inflation is anticipated to run somewhat higher in the second half of 1998 and in 1999.

The economy is entering the second half of 1998 with considerable strength in household spending and business fixed investment. Consumers are enjoying expanding job opportunities, rising real incomes, and high levels of wealth, all of which are providing them with the confidence and wherewithal to spend. These factors, in conjunction with low mortgage interest rates, are also bolstering housing demand. Business fixed investment appears robust as well:

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Financial conditions remain conducive to capital spending, and firms no doubt are continuing to seek out opportunities for productivity gains in an environment of rapid technological change, falling prices for high-tech equipment, and tight labor markets.

Nonetheless, a number of factors are expected to exert some restraint on the expansion of activity in the quarters ahead. The demand for U.S. exports will continue to be depressed for a while by weak activity abroad, on average, and by the strong dollar, which will also likely continue to boost imports. The effects of these external sector developments on employment and income growth have yet to materialize fully. In addition, although financial conditions are generally expected to be supportive, real outlays on housing and business equipment have reached such high levels that gains from here are expected to be more moderate.

With the plunge in energy prices in early 1998 unlikely to be repeated, most FOMC participants expect the CPI for all urban consumers to rise more rapidly in the second half of 1998 than it did in the first half, resulting in an increase in the CPI of 1¾ percent to 2 percent for 1998 as a whole. The pickup in the second half should be limited, however, by further decreases in non-oil import prices, ample domestic manufacturing capacity, and low expected inflation. Looking ahead to next year, the central tendency is for an increase in the CPI of 2 percent to 2½ percent. Absent a further rise in the dollar, the fall in non-oil import prices should have run its course. Moreover, even with the expected edg-

Economic Projections for 1998 and 1999

Percent

Indicator	Federal Reserve governors and Reserve Bank presidents		Administration
	Range	Central tendency	
	1998		
Change, fourth quarter to fourth quarter[1]			
Nominal GDP	4¼–5	4½–5	4.2
Real GDP	2¾–3¼	3–3¼	2.4
Consumer price index[2]	1¼–2¼	1¾–2	1.6
Average level in the fourth quarter			
Civilian unemployment rate	4¼–4½	4¼–4½	4.8
	1999		
Change, fourth quarter to fourth quarter[1]			
Nominal GDP	4–5½	4¼–5	4.1
Real GDP	2–3	2–2½	2.0
Consumer price index[2]	1½–3	2–2½	2.1
Average level in the fourth quarter			
Civilian unemployment rate	4¼–4¾	4½–4¾	5.0

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

2. All urban consumers.

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ing higher of the unemployment rate next year, the labor market will remain tight, suggesting potential ongoing pressures on available resources that would tend to raise inflation a bit. The FOMC will remain alert to the possibility of underlying imbalances in the economy that could generate a persisting pickup in inflation, which would threaten the economic expansion.

As noted in past monetary policy reports, the Bureau of Labor Statistics is in the process of implementing a series of technical adjustments to make the CPI a more accurate measure of price change. These adjustments and the regular updating of the market basket are estimated to have trimmed CPI inflation somewhat over 1995–98, and a significant further adjustment is scheduled for 1999. All told, the published figures for CPI inflation in 1999 are expected to be more than ½ percentage point lower than they would have been had the Bureau retained the methods and formulas in place in 1994. In any event, the FOMC will continue to monitor a variety of price measures besides the CPI as it attempts to gauge progress toward the long-run goal of price stability.

Federal Reserve officials project somewhat faster growth in real GDP and slightly higher inflation in 1998 than does the Administration. The Administration's projections for the growth in real GDP and inflation in 1999 are around the lower end of the FOMC participants' central tendencies.

Money and Debt Ranges for 1998 and 1999

At its most recent meeting, the FOMC reaffirmed the ranges for 1998 growth of money and debt that it had established in February: 1 percent to 5 percent for M2, 2 percent to 6 percent for M3, and 3 percent to 7 percent for the debt of the domestic nonfinancial sectors. The FOMC set these same ranges for 1999 on a provisional basis.

Once again, the FOMC chose the growth ranges for the monetary aggregates as benchmarks for growth under conditions of price stability and historical velocity behavior. For several decades before 1990, the velocities of M2 and M3 (defined as the ratios of nominal GDP to the aggregates) behaved in a fairly consistent way over periods of a year or more. M2 velocity showed little trend but varied positively from year to year with changes in a traditional measure of M2 opportunity cost, defined as the interest forgone by holding M2 assets rather than short-term market instruments such as Treasury bills. M3 velocity moved down a bit over time, as depository credit and the associated elements in M3 tended to grow a shade faster than GDP. In the early 1990s, these patterns of M2 and M3 behavior were disrupted, and the velocities of both aggregates climbed well above the levels that were predicted by past relationships. However, since 1994 the velocities of M2 and M3 have again moved roughly in accord with their pre-1990 experience, although their levels remain elevated.

The recent return to historical patterns does not imply that velocity will be fully predictable or even that all

Ranges for Growth of Monetary and Debt Aggregates

Percent

Aggregate	1997	1998	Provisional for 1999
M2	1–5	1–5	1–5
M3	2–6	2–6	2–6
Debt	3–7	3–7	3–7

NOTE. Change from average for fourth quarter of preceding year to average for fourth quarter of year indicated.

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movements in velocity can be completely explained in retrospect. Some shifts in velocity arise from household and business decisions to adjust their portfolios for reasons that are not captured by simple measures of opportunity cost. Some shifts in velocity arise from decisions of depository institutions to create more or less credit or to fund credit creation in different ways. All these decisions are shaped by the rapid pace of innovation in financial institutions and instruments. Between 1994 and early 1997, M2 velocity drifted somewhat higher, probably owing to some reallocation of household savings into bond and equity markets. But M2 velocity has declined over the past year despite little change in its traditionally defined opportunity cost. One explanation may be that the flatter yield curve has reduced the return on longer-term investments relative to the bank deposits and money market mutual funds in M2. Another part of the story may be the booming stock market, which has reduced the share of households' financial assets represented by monetary assets and may have encouraged households to rebalance their portfolios by increasing their M2 holdings. M3 velocity has dropped more sharply over the past year, with strong growth in large time deposits and in institutional money funds that are increasingly used by businesses for cash management.

If the velocities of M2 and M3 follow their average historical patterns over the remainder of 1998 and the growth of nominal GDP matches the expectations of Federal Reserve policymakers, these aggregates will finish this year above the upper ends of their respective ranges. Part of this relatively rapid money growth reflects nominal GDP growth in excess of that consistent with price stability and sustainable growth of real output; the rest represents a decline in velocity. Absent unusual changes in velocity in 1999, policymakers' expectations of nominal GDP growth imply that M2 and M3 will be in the upper ends of their price-stability growth ranges next year. The debt of the domestic nonfinancial sectors is expected to remain near the middle of its range this year and in 1999.

In light of the apparent return of velocity changes to their pre-1990 behavior, some FOMC members have been giving the aggregates greater weight in assessing overall financial conditions and the thrust of monetary policy. However, velocity remains somewhat unpredictable, and all FOMC members monitor a wide variety of other financial and economic indicators to inform their policy deliberations. The FOMC decided that the money and debt ranges are best used to emphasize its commitment to achieving price stability, so it again set the ranges as benchmarks for growth under price stability and historical velocity behavior.

Economic and Financial Developments in 1998

The U.S. economy continued to perform well in the first half of the year. The economic difficulties in Asia and the strong dollar reduced the demand for our exports and intensified the pressures on domestic producers from foreign competition. But these effects were outweighed by robust domestic final demand, owing in part to supportive financial conditions, including a higher stock market, ample availability of credit, and long-term interest rates that in nominal terms were among the lowest in many years. Sharp swings in inventory investment were mirrored in considerable unevenness in the growth of real GDP, which appears to have slowed markedly in the second quarter after

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having soared to nearly 5½ percent at an annual rate in the first quarter. Nonetheless, over the first half as a whole, the rise in real output was large enough to support sizable gains in employment and to push the unemployment rate down to the range of 4¼ percent to 4½ percent, the lowest in decades.

The further tightening of labor markets in recent quarters has been reflected in a more discernible uptilt to the trend in hourly compensation. But price inflation remained subdued in the first half of the year, held down in part by a sharp decline in energy prices and lower prices for non-oil imports. Intense competition in product markets, ample plant capacity, ongoing productivity gains, and damped inflation expectations also helped to restrain inflation pressures in the face of tight labor markets.

The Household Sector

Consumer Spending

The factors that fueled the sizable increase in household expenditures in 1997 continued to spur spending in the first half of 1998: Growth in employment and real disposable income remained very strong, and households in the aggregate enjoyed significant further gains in net worth. Reflecting these developments, sentiment indexes suggest that consumers continued to feel extraordinarily upbeat about the current and prospective condition of the economy and their own financial situations.

In total, real consumer outlays rose at an annual rate of 6 percent in the first quarter, and the available data point to another large increase in the second quarter. Increases in spending were broad-based, but outlays for durable goods were especially strong. Declining prices and ongoing product innovation continued to stimulate demand for personal computers and other home electronic equipment. In addition, purchases of motor vehicles were sustained by a combination of solid fundamentals and attractive pricing. Indeed, since 1994, sales of light vehicles have been running at a brisk pace of 15 million units (annual rate), and in the second quarter, a round of very attractive manufacturers' incentives helped lift sales to a pace of 16 million units.

Spending on services also remained robust in the first half of the year, with short-run variations reflecting in part the effects of weather on household energy use; outlays on personal business services, including those related to financial transactions, and on recreation services continued to exhibit remarkable strength. In addition, real outlays for nondurable goods, which rose only moderately last year, grew about 6½ percent at an annual rate in the first quarter, and they appear to have posted another sizable increase in the second quarter.

Real disposable income—that is, after-tax income adjusted for inflation—remained on a strong uptrend in early 1998: It rose about 4 percent at an annual rate between the fourth quarter of 1997 and May 1998. This increase in part reflected a sharp rise in aggregate wages and salaries, which were boosted by sizable gains in both employment and real wage rates; dividends and nonfarm proprietors' incomes also rose appreciably. However, growth in after-tax income (as measured in the national income and product accounts) was restrained by large increases in personal income tax payments—likely owing in part to taxes paid on realized capital gains; capital gains—whether realized or not—are not included in measured income. Reflecting the movements in spending and measured income, the personal saving rate fell from an already

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low level of about 4 percent in 1997 to 3½ percent during the first five months of 1998.

Residential Investment

Housing activity continued to strengthen in the first half of 1998, especially in the single-family sector, where starts rose noticeably and sales of both new and existing homes soared. Indeed, the average level of single-family starts over the first five months of the year—1¼ million units at an annual rate—was 9 percent above the pace for 1997 as a whole. Moreover, surveys by the National Association of Homebuilders suggested that housing demand remained vigorous at midyear, and the Mortgage Bankers Association reported that loan applications for home purchases have been around all-time highs of late.

The strong demand for homes has contributed to some firming of house prices, which are now rising in the neighborhood of 3 percent to 5 percent per year, according to measures that control for shifts in the regional composition of sales and attempt to minimize the effects of changes in the mix of the structural features of houses sold. In nominal terms, these increases are well within the range of recent years; however, in real terms, they are among the largest since the mid-1980s—a development that should reinforce the investment motive for homeownership. Of course, rising house prices may make purchasing homes more difficult for some families. But, with income growth strong and mortgage rates around 7 percent (thirty-year conventional fixed-rate loans), homeownership is as affordable as it has been at any time in the past thirty years. Moreover, innovative programs that relax the standards for mortgage qualification are helping low-income families to finance home purchases. Also, stock market gains have probably boosted demand among higher-income groups, especially in the trade-up and second-home segments of the market.

After having surged in the fourth quarter of 1997, multifamily starts settled back to about 325,000 units (annual rate) over the first five months of 1998, a pace only slightly below that recorded over 1997 as a whole. Support for multifamily construction continued to come from the overall strength of the economy, which undoubtedly has stimulated more individuals to form households, as well as from low interest rates and an ample supply of financing. In addition, real rents picked up over the past year, and the apartment vacancy rate appears to be edging down.

Household Finance

Household net worth rose sharply in the first quarter, pushing the wealth-to-income ratio to another record high. Although the flow of new personal saving was quite small, the revaluation of existing assets added considerably to wealth, with much of these capital gains accumulated on equities held either directly or indirectly through mutual funds and retirement accounts. Of course, these gains have been distributed quite unevenly: The 1995 Survey of Consumer Finances reported that 41 percent of U.S. families own equities in some form, but that families with higher wealth own a much larger share of total equities.

In the first quarter of this year, the run-up in wealth, together with low interest rates and high levels of confidence about future economic conditions, supported robust household spending and borrowing. The expansion of household debt, at an annual rate of 7¾ percent, was above last year's pace and

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once again outstripped growth in disposable income. The consumer credit component of household debt grew 4½ percent at an annual rate in the first quarter, a pace roughly double that for the fourth quarter of last year but near the 1997 average. Preliminary data for April and May point to a somewhat smaller advance in the second quarter.

Mortgage debt increased 8¼ percent at an annual rate in the first quarter, the same as its fourth-quarter advance and a little above its 1997 growth rate. Fixed-rate mortgage interest rates were 15 basis points lower in the first quarter than three months earlier and 75 basis points lower than a year earlier, which encouraged both new home purchases and a surge of refinancing of existing mortgages. Within total gross mortgage borrowing, the flattening of the yield curve made adjustable-rate mortgages less attractive relative to fixed-rate mortgages, and their share of originations reached the lowest point in recent years. Net borrowing can be boosted by refinancings if households "cash out" some housing equity, but the magnitude of this effect is unclear. In any event, continued expansion of bank real estate lending and a high level of mortgage applications for home purchases suggest a further solid gain in mortgage debt in the second quarter. Home equity credit at banks increased only 2 percent at an annual rate from the fourth quarter of 1997 through June 1998 after having posted a 15½ percent gain last year; this slowdown may reflect a diminished substitution of mortgage debt for consumer debt or simply the increase in mortgage refinancings, which allowed households to pay down more expensive home equity debt or to convert housing equity into cash in a more advantageous manner.

Despite the further buildup of household indebtedness, financial stress among households appears to have stabilized after several years of deterioration. In the aggregate, estimated required payments of loan principal and interest have held about steady relative to disposable personal income—albeit at a high level—since 1996. Over this period, the effect on debt burdens of faster growth of debt than income has been roughly offset by declining interest rates and the associated refinancing of higher interest-rate debt, as well as by a shift toward mortgage debt (which has a longer repayment period). Various measures of delinquency rates on consumer loans leveled off or declined in 1997, and delinquency rates on mortgages have been at very low levels for several years. Personal bankruptcy filings reached a new record high in the first quarter of 1998, but this represented only 6 percent more filings than four quarters earlier, which is the smallest such change in three years.

These developments have apparently suggested to banks that they have sufficiently tightened terms and standards on consumer loans. In the Federal Reserve's May Senior Loan Officer Opinion Survey on Bank Lending Practices, relatively few banks, on net, reported tightening standards on credit card or other consumer loans. Little change was reported in the terms of consumer loans.

The Business Sector

Fixed Investment

Real business fixed investment appears to have posted another hefty gain over the first half of 1998 as spending continued to be boosted by positive sales expectations in many industries; favorable financial conditions; and a perceived opportunity, if not a necessity,

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for firms to install new technology in order to remain competitive. The exceptional growth of investment since the early 1990s has been facilitated in part by the increase in national saving associated with the elimination of the federal budget deficit. It has resulted in considerable modernization and expansion of the nation's capital stock, which have been important in the improved performance of labor productivity over the past few years and which should continue to lift productivity in the future. Moreover, rapid investment in the manufacturing sector in recent years has resulted in large additions to productive capacity, which have helped keep factory operating rates from rising much above average historical levels in the face of appreciable increases in output.

Real outlays for producers' durable equipment, which have been rising more than 10 percent per year, on average, since the early 1990s, moved sharply higher in the first half of 1998. All major categories of equipment spending recorded sizable gains in the first quarter; but, as has been true throughout the expansion, outlays for computers rose especially rapidly. Real computer outlays received particular impetus in early 1998 from extensive price-cutting. Purchases of communications equipment have also soared in recent quarters; the rise reflects intense pressures to add capacity to accommodate the growth of networking; the rapid pace of technological advance, especially in wireless communications; and regulatory changes. As for the second quarter, data on shipments, coupled with another steep decline in computer prices, point to a further substantial increase in real computer outlays. Spending on motor vehicles apparently continued to advance as well while demand for other types of capital equipment appears to have remained brisk.

In total, real outlays on nonresidential construction flattened out in 1997 after four years of gains, and they remained sluggish in early 1998. Construction of office buildings remained robust in the first half of this year, after having risen at double-digit rates in 1996 and 1997, and outlays for institutional buildings continued to trend up. However, expenditures for other types of structures were lackluster. Nonetheless, the economic fundamentals for the sector as a whole remain quite favorable: Vacancy rates for office and retail space have continued to fall; real estate prices, though still well below the levels of the mid-1980s in real terms, have risen appreciably in recent quarters; and funding for new projects remains abundant.

Inventory Investment

The pace of stockbuilding by nonfarm businesses picked up markedly in 1997 and is estimated to have approached $100 billion (annual rate) in the first quarter of 1998—equal to an annual rate increase of 8½ percent in the level of inventories and accounting for more than 1½ percentage points of that quarter's growth in real GDP. The first-quarter accumulation was heavy almost across the board. Among other things, it included a large increase in stocks of petroleum as the unusually warm weather reduced demand for refined products and low prices provided an incentive for refiners and distributors to accumulate stocks. However, overall sales were also very strong, and with only a few exceptions—notably, semiconductors, chemicals, and textiles—stocks did not seem out of line with sales. In any event, fragmentary data for the second quarter point to a considerable slowing in inventory investment that is especially evident in the motor vehicle sector, where stocks were

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depleted by the combination of strong sales and General Motors production shortfalls. In addition, petroleum stocks appear to have grown less rapidly than they did in the first quarter, and stock-building elsewhere slowed sharply in April and May.

Corporate Profits and Business Finance

Businesses have financed a good part of their investment this year through continued strong cash flow, but they have also increased their reliance on financial markets. Economic profits (book profits after inventory valuation and capital consumption adjustments) have run at 12 percent of national income over the past year, well above the 1980s peak of roughly 9 percent. However, the strength in profits has resulted partly from the low level of net interest payments, leaving total capital income at roughly the same share of national income as at the 1980s peak. Overall, a major portion of the increase in profits between the 1980s and the 1990s represents a realignment of returns from debt-holders to equity-holders.

Although their level remains high, the growth of profits has slowed: Economic profits rose 4¾ percent at an annual rate in the first quarter, compared with 9½ percent between the fourth quarter of 1996 and the fourth quarter of 1997. This slowdown may have resulted from various causes, including rising employee compensation and the Asian financial crisis. Quantifying the effect of the Asian turmoil is difficult: Although only a small share of the profits of U.S. companies is earned in the directly affected Asian countries, the crisis has reduced the prices of U.S. imports and thereby put downward pressure on domestic prices.

Nonfinancial businesses realized annualized economic profit growth of only 1¼ percent in the first quarter. Because capital expenditures (including inventory investment) grew much faster, the financing gap—the excess of capital expenditures over retained earnings—widened. As a result, these businesses used less of their cash flow to retire outstanding equity and continued to borrow at the rapid pace of the fourth quarter of 1997, with debt expanding at an annual rate of 9 percent in the first quarter of 1998. Outstanding amounts of both bonds and commercial paper rose especially sharply. The decline in long-term interest rates around year-end encouraged companies to lock in those yields, and gross bond issuance reached a record high in the first quarter of 1998. Borrowing by nonfinancial businesses increased at a slightly slower but still rapid clip in the second quarter, with little change in outstanding commercial paper but very strong net bond issuance and some rebound in bank loans.

Despite persistent high borrowing, external funding for businesses remained readily available on favorable terms. The spreads between yields on investment-grade bonds and yields on Treasury bonds widened a little from low levels, with investors favoring Treasury securities over corporate securities as a haven from Asian turmoil and, perhaps, with disappointing profits leading to some minor reassessment of the underlying risk of private obligations. The spreads on high-yield bonds also increased, in part because of heavy issuance of these bonds this spring, but they remain narrow by historical standards. In the Federal Reserve's May survey on bank lending practices, banks reported negligible change in business loan standards; moreover, yield spreads on bank loans remained low for both large and

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small firms. Surveys by the National Federation of Independent Business suggest that small firms have been facing little difficulty in obtaining credit.

The ready availability of credit has stemmed importantly from the healthy financial condition of many businesses, which have enjoyed an extended period of economic expansion and robust profits. The aggregate debt-service burden for nonfinancial corporations, measured as the ratio of net interest payments to cash flow, dropped substantially between 1990 and 1996 and remains modest, despite edging up in the first quarter of this year. In addition, most measures of financial distress have shown favorable readings. The delinquency rate on commercial and industrial bank loans has stayed very low since 1995, preserving the dramatic decline that occurred in the first half of the decade. After moving up a little in 1996 and 1997, business failures decreased in the first five months of 1998; the liabilities of failed businesses as a share of total liabilities was less than one-quarter the value reached in the early 1990s. At the same time, Moody's upgraded significantly more debt than it downgraded, and the rate of junk bond defaults stayed close to its low 1997 level.

Net equity issuance was less negative in the first quarter of this year than in the fourth quarter of last year, but nonfinancial corporations still retired, on net, about $100 billion of equity at an annual rate. The wave of merger announcements this spring will likely generate strong share retirements over the remainder of the year. Gross equity issuance in the first half of 1998 was close to its pace of the past several years, although investors seemed somewhat cautious about initial public offerings.

The Government Sector

Federal

The incoming news on the federal budget continues to be very positive. Over the twelve months ending in May 1998, the unified budget registered a surplus of $60 billion, compared with a deficit of $65 billion during the twelve months ending in May 1997. Soaring receipts continued to be the main force driving the improvement in the budget, but subdued growth in outlays also played a key role. If the latest projections from the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) are realized, the unified budget for fiscal year 1998 as a whole will show a surplus of roughly $40 billion to $65 billion.

With the federal budget having shifted into surplus, the federal government is now augmenting, rather than drawing on, the pool of national saving. In fact, the improvement in the government's budget position over the past several years has been large enough to generate a considerable rise in gross domestic saving despite a decline in the private saving rate; all told, gross saving by households, businesses, and governments increased from about 14½ percent of gross national product in the early 1990s, when federal saving was at a cyclical low, to more than 17 percent of GNP in recent quarters. This increase in domestic saving, along with increased borrowing from abroad, has financed the surge in domestic investment in this expansion. Moreover, this year's budgetary surplus will continue to pay benefits in future years because it allows the government to reduce its outstanding debt, which implies smaller future interest payments and, all else equal, makes it easier to keep the budget in surplus.

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If, in fact, the budget outcome over the next several years is as favorable as the OMB and the CBO now anticipate under current policies, the reduction in the outstanding debt could be substantial.

Federal receipts in the twelve months ending in May 1998 were 10 percent higher than in the same period a year earlier—roughly twice the percentage increase for nominal GDP over the past year. Individual income tax receipts, which have been rising at double-digit rates since the mid-1990s, continued to do so over the past year as the surge in capital gains realizations likely persisted and sizable gains in real income raised the average tax rates on many households (the individual income tax structure being indexed for inflation but not for growth in real incomes). In contrast to the ongoing strength in individual taxes, corporate tax payments increased only moderately over the past year, echoing the deceleration in corporate profits.

Federal expenditures in the twelve months ending in May 1998 were only 1½ percent higher in nominal terms than during the twelve months ending in May 1997, with restraint evident in most categories. Outlays for defense were about unchanged, as were those for income security programs. In the latter category, outlays for low-income support fell as economic activity remained robust, welfare reform capped outlays for family assistance, and enrollment rates in other programs dropped. In the health area, spending on Medicaid picked up somewhat after a period of extraordinarily small increases, whereas growth in spending for Medicare slowed, in part because of the programmatic changes that were legislated in 1997. And, with interest rates little changed and the stock of outstanding federal debt no longer rising, net interest payments stabilized.

Real federal outlays for consumption and gross investment, the part of federal spending that is counted in GDP, fell about 2 percent between the first quarters of 1997 and 1998. The decrease was concentrated in real defense spending, which fell about 2¾ percent, roughly the same as over the preceding four quarters; real nondefense spending was unchanged, on balance. In the first quarter, real federal outlays fell at a 10 percent annual rate; the drop reflected a plunge in defense spending, which appears to have been reversed in the second quarter.

With debt held by the public close to $4 trillion, the government will continue to undertake substantial gross borrowing to redeem maturing securities. The government will also continue to adjust its issuance of short-term debt to accommodate seasonal swings in receipts and spending. The surplus during the first half of calendar year 1998—boosted by the huge inflow of individual income tax receipts—enabled the Treasury to reduce its outstanding debt $57 billion while augmenting its cash balance $40 billion. The reduction in debt included net paydowns of coupon securities and bills.

Looking ahead to projected surpluses for coming years, the Treasury announced that it will no longer issue three-year notes and will auction five-year notes quarterly rather than monthly. Over the past several years, the Treasury has accommodated the surprising improvement in federal finances by substantially reducing both bill and coupon issuance. The Treasury hopes that concentrating future coupon offerings in larger, less-frequent auctions will maintain the liquidity of these securities while still allowing for sufficient issuance of bills to maintain their liquidity as well. These changes are also intended to prevent further upcreep in

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the average maturity of the outstanding debt held by private investors, now standing at sixty-five months. The Treasury continues to work on encouraging the market for inflation-indexed securities, issuing a thirty-year indexed bond in April to complement the existing five-year and ten-year indexed notes.

State and Local

The fiscal position of state and local governments in the aggregate has also remained quite favorable. Strong growth of household income and consumer spending has continued to lift revenues, despite numerous small tax cuts, and governments have continued to hold the line on expenditures. As a result, the consolidated current account of the sector, as measured by the surplus (net of social insurance funds) of receipts over current expenditures in the national income and product accounts, held steady in the first quarter at around $35 billion (annual rate), roughly where it has been since 1995. State governments, which have reaped the main benefits of rising income taxes, have fared especially well: Indeed, all of the forty-seven states whose fiscal years ended by June 30 appear to have achieved balance or to have run surpluses in their general funds budgets in fiscal year 1998.

Real expenditures for consumption and gross investment by states and localities have been rising about 2 percent per year, on average, since the early 1990s, and the increase in spending for the first half of 1998 appears to have been a bit below that trend. These governments added jobs over the first half of the year at about the same rate as they did over 1997 as a whole. However, real construction outlays, which have been drifting down since early 1997, posted a sizable decline in the first quarter, and monthly data suggest that spending dropped further in the spring. The weakness in construction spending over the past year has cut across the major categories of construction and is puzzling in light of the sector's ongoing infrastructure needs and the good financial shape of most governments.

State and local governments responded to the low interest rates during the first half of the year by borrowing at a rapid rate, both to refinance outstanding debt and to fund new capital projects. Because debt retirements eased in the first quarter relative to the fourth quarter of 1997, net issuance increased substantially. Meanwhile, credit quality of state and local debt continued to improve, with much more debt upgraded than downgraded in the first half of the year.

External Sector

Trade and the Current Account

The nominal trade deficit on goods and services widened to $140 billion at an annual rate in the first quarter from $114 billion in the fourth quarter of last year. The current account deficit for the first quarter reached $189 billion (annual rate), 2¼ percent of GDP, compared with $155 billion for the year 1997. A larger deficit on net investment income as well as the widening of the deficit on trade in goods and services contributed to the deterioration in the first quarter of the current account balance. In April and May, the trade deficit increased further.

The quantity of imports of goods and services again grew vigorously in the first quarter. The annual rate of expansion at 17 percent exceeded that for 1997 and reflected the continued strength of U.S. economic activity and

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the effects of past dollar appreciation. Imports of consumer goods, automotive products, and machinery were particularly robust. Preliminary data for April and May suggest that real import growth remained strong. Non-oil import prices fell sharply through the second quarter, reflecting the rise in the exchange value of the dollar over the past year.

The quantity of exports of goods and services declined at an annual rate of 1 percent in the first quarter, the first such absolute drop since the first quarter of 1994. The weakness of economic activity in a number of our trading partners, with absolute declines in several economies in Asia, and the strength of the dollar, which also partly resulted from the Asian financial crises, largely account for the abrupt halt in the growth of real exports after a 10 percent rise last year. Declines were recorded for machinery, industrial supplies, and agricultural products. Exports to the emerging market economies in Asia, particularly Korea, as well as exports to Japan were down sharply while exports to western Europe and Canada rose moderately. Preliminary data for April and May suggest that real exports declined further.

The Capital Account

Foreign direct investment in the United States and U.S. direct investment abroad continued at near record levels in the first quarter of 1998, spurred by strong merger and acquisition activity across national borders.

In the first quarter, the booming U.S. stock market continued to attract large foreign interest. Net purchases by private foreigners were $29 billion, following record net purchases of $66 billion in the year 1997. Foreign net purchases of U.S. corporate bonds remained substantial, and net purchases of U.S. government agency bonds reached a record $21 billion. In contrast, net sales of U.S. Treasury securities by private foreigners, particularly large net sales booked at a Caribbean financial center, were recorded in the first quarter. U.S. net purchases of foreign stocks and bonds were modest.

Foreign official assets in the United States increased $10 billion in the first quarter. However, the net increase in the second quarter was limited by large dollar sales by Japan.

The Labor Market

Employment and Labor Supply

Labor demand remained robust during the first half of 1998. Growth in payroll employment averaged 243,000 per month, only a little less than in 1997 and well above the rate consistent with the growth in the working-age population. The unemployment rate held steady in the first quarter at 4¾ percent but dropped to the range of 4¼ percent to 4½ percent in the second quarter.

The services industry, which accounts for about 30 percent of nonfarm employment, continued to be the mainstay of employment growth over the first half of 1998, posting increases of 115,000 per month, on average. Within services, hiring remained brisk at computer and data-processing firms and at firms providing engineering and managerial services, but payrolls at temporary help agencies rose much less rapidly than they had over the preceding few years—apparently in part reflecting difficulties in finding workers, especially for highly skilled and technical positions. Sizable increases were also posted at wholesale and retail trade establishments and in the finance, insurance, and real estate

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category. Construction payrolls were bounced around by unusual winter weather but, on average, rose a brisk 21,000 per month—about the same as in 1997.

In contrast to the robust gains elsewhere, manufacturing firms curbed their hiring in the first half of 1998 in the face of slower growth in factory output. After having risen a torrid 6¼ percent in 1997, factory output increased at an annual rate of about 2½ percent between the fourth quarter of last year and May 1998; the deceleration reflected the effects of the Asian crisis as well as a downshift in motor vehicle assemblies and the completion of the 1996–97 ramp-up in aircraft production. In June, factory output is estimated to have fallen ½ percent; the GM strike accounted for the decline.

The labor force participation rate—which measures the percentage of the working-age population that is either employed or looking for work—trended up mildly over the past couple of years and stood at 67.1 percent, on average, in the first half of 1998, slightly above the previous cyclical highs achieved in late 1989 and early 1990. Participation among adult women has picked up noticeably in recent years, after having risen only slowly in the first half of the 1990s, and participation among adult men, which had been on a gradual downtrend through mid-decade, appears to have leveled out. In contrast, participation rates for teenagers, for whom school enrollment rates have risen, have continued to sag after having dropped sharply in the early 1990s. Strong labor demand clearly contributed importantly to the rise in overall participation over the past several years, but the expansion of the earned income tax credit and changes in the welfare system probably provided added stimulus.

Labor Costs and Productivity

Firms no doubt are continuing to rely heavily on targeted pay increases and incentives like stock options and bonuses to attract and retain workers. But the tightness of the labor market also appears to be exerting some upward pressure on traditional measures of hourly compensation, which have exhibited a somewhat more pronounced uptrend of late. Indeed, the twelve-month change in the employment cost index (ECI) for private industry workers picked up to 3½ percent in March, compared with 3 percent for the twelve months ending in March 1997 and 2¾ percent for the twelve months ending in March 1996. Hourly compensation accelerated especially rapidly for employees of finance, insurance, and real estate firms, some of whom received sizable bonuses and commissions. However, the acceleration was fairly widespread across industries and occupations and, given the relatively small rise in consumer prices over the past year, implies a solid increase in real pay for many workers.

The acceleration in hourly compensation costs over the past year resulted mainly from faster growth of wages and salaries, which rose 4 percent over the twelve months ending in March; this increase was about ½ percentage point larger than the one recorded over the preceding twelve months. Separate data on average hourly earnings of production or nonsupervisory workers also show an ongoing acceleration of wages: The twelve-month change in this series was 4.1 percent in June, ½ percentage point above the reading for the preceding twelve months.

Benefits costs have generally remained subdued, with the increase over the year ending in March amounting to

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only about 2¼ percent. According to the ECI, employer payments for health insurance have picked up moderately in recent quarters after having been essentially flat over the previous couple of years, and indications are that further increases may be in the offing. Insurers whose profit margins had been squeezed in recent years by pricing strategies designed to gain market share reportedly are raising premiums, and many managed care plans are adding innovations that, while offering greater flexibility and protections to consumers, may boost costs. Additional upward pressure on premiums apparently has come from higher spending on prescription drugs. Among other major components of benefits, rising equity prices have reduced the need for firms to pay into defined benefit plans, and costs for state unemployment insurance and workers' compensation have fallen sharply.

Labor productivity in the nonfarm business sector posted another sizable advance in the first quarter of 1998, bringing the increase over the year ending in the first quarter to an impressive 2 percent.[3] Taking a slightly longer perspective, productivity has risen a bit more than 1½ percent per year, on average, over the past three years, after having risen less than 1 percent per year, on average, over the first half of the decade. At least in part, the recent strong productivity growth has likely been a cyclical response to the marked acceleration of output. But it is also possible that the high levels of business investment over the past several years—and the associated rise in the amount of capital per worker—are translating into a stronger underlying productivity trend. In addition, productivity apparently is being buoyed by the assimilation of new technologies into the workplace. In any event, the faster productivity growth of late is helping to offset the effects of higher hourly compensation on unit labor costs and prices, thereby allowing wages to rise in real terms.

Prices

Price inflation remained quiescent in the first half of this year. After having increased 1¾ percent in 1997, the consumer price index slowed to a crawl in early 1998 as energy prices plummeted, and it recorded a rise of only about 1½ percent at an annual rate over the first six months of the year. The increase in the CPI excluding food and energy—the so-called "core CPI"—picked up to 2½ percent (annual rate) over the first half of the year. However, this pickup follows some unusually small increases in the second half of 1997, and the

Alternative Measures of Price Change

Percent

Price measure	1996:Q1 to 1997:Q1	1997:Q1 to 1998:Q1
Fixed-weight		
Consumer price index	2.9	1.5
Excluding food and energy	2.5	2.3
Chain-type		
Personal consumption expenditures	2.6	1.0
Excluding food and energy	2.3	1.4
Gross domestic product	2.2	1.4

NOTE. Changes are based on quarterly averages.

3. According to the published data, productivity rose 1.1 percent at an annual rate in the first quarter. However, these data are distorted by inconsistencies in the measurement of hours associated with varying lengths of pay periods across months. Although the Bureau of Labor Statistics has already revised the monthly hours and earnings data to account for these inconsistencies, it will not update the productivity statistics until August. All else being equal, adjusting the productivity data to reflect the Bureau's revisions to hours would substantially raise productivity growth in the first quarter, but it would have little effect on the change over the four quarters ending in the first quarter.

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twelve-month change has held fairly steady at about 2¼ percent since late last summer. The chain-type price index for personal consumption expenditures on items other than food and energy rose only 1½ percent over the year ending in the first quarter of 1998—the most recent information available; this measure typically rises less rapidly than does the core CPI, in part because it is less affected by so-called "substitution bias."

The relatively favorable price performance in the first half of 1998 reflected a number of factors that, taken together, continued to exert enough restraint to offset the upward pressures from strong aggregate demand and high levels of labor utilization. One was the drop in oil prices. In addition, non-oil import prices continued to fall, thus further lowering input costs for many domestic industries and limiting the ability of firms facing foreign competition to raise prices for fear of losing sales to producers abroad. Prices of manufactured goods were also held in check by the sizable increase in domestic industrial capacity in recent years and by developments in Asia, which, among other things, led to a considerable softening of commodity prices. Moreover, the various surveys of consumers and forecasters suggest that inflation expectations stayed low—even declined in some measures. For example, according to the Michigan survey, median one-year inflation expectations dropped a bit further this year, after having held fairly steady over 1996 and 1997, and inflation expectations for the next five to ten years edged down from about 3 percent, on average, in 1996 and 1997 to 2¾ percent in the second quarter of 1998.

The CPI for goods other than food and energy rose at an annual rate of 1 percent over the first six months of 1998, only a bit above the meager ½ percent rise over 1997 as a whole. In the main, the step-up reflected a turnaround in prices of used cars and trucks, and prices of tobacco products and prescription drugs also rose considerably faster than they had in 1997. More generally, prices continued to be restrained by the effect of the strong dollar on prices of import-sensitive goods. For example, prices of new vehicles fell slightly over the first half of the year, while prices of other import-sensitive goods—such as apparel and audio-video equipment—were flat or down. In the producer price index, prices of capital equipment were little changed, on balance, over the first half of 1998; they, too, were damped by the competitive effects of falling import prices.

The CPI for non-energy services increased 3 percent over the first six months of 1998, about the same as last year's pace. After having fallen somewhat last year, airfares picked up in the first half of the year, and owner's equivalent rent seems to be rising a bit faster than it did in 1997. In addition, increases in prices of medical services, which had slowed to about 3 percent per year in 1996–97, have been running somewhat higher so far this year. Price changes for most other major categories of services were similar to or smaller than those recorded in 1997.

Energy prices fell sharply in early 1998, as the price of crude oil came under severe downward pressure from weak demand in Asia, a decision by key OPEC producers to increase output, and a relatively warm winter in the Northern Hemisphere. After having averaged about $20 per barrel in the fourth quarter of 1997, the spot price of West Texas intermediate dropped to a monthly average of $15 per barrel in March, where it more or less remained through the spring. Crude prices dropped sharply in June following reports of high levels

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of inventories and revised estimates of oil consumption in Asia but have since firmed in response to an agreement by major oil producers to restrict supply in the months ahead; they now stand at $14½ per barrel. Reflecting the decline in crude prices, retail energy prices fell at an annual rate of 12 percent over the first half of the year, led by a steep drop in gasoline prices.

Developments in the agricultural sector also helped to restrain overall inflation in the first half of this year. Excluding the prices of fruits and vegetables—which tend to be bounced around by short-term swings in the weather—food prices have been rising a scant 0.1 percent per month, on average, since late 1997. Although farmers in some regions of the country are experiencing more prolonged weather problems, conditions in the major crop-producing areas of the Midwest still look relatively favorable, and it appears that aggregate farm production will be sufficient to maintain ample supplies over the coming year, especially in the context of sluggish export demand.

Credit and the Monetary Aggregates

Credit and Depository Intermediation

The total debt of U.S. households, governments, and nonfinancial businesses increased at an annual rate of 5¾ percent from the fourth quarter of 1997 through May of this year. Domestic nonfinancial debt now stands a little above the midpoint of the 3 percent to 7 percent range established by the FOMC for 1998. Debt growth has picked up since 1997, as an acceleration of private credit associated with strong domestic demand and readily available supply has more than offset reduced federal borrowing. Indeed, federal debt declined 1¼ percent at an annual rate between the fourth quarter of 1997 and May 1998, whereas nonfederal debt increased 8¼ percent annualized over the same period. The growth of nonfederal debt has slowed only slightly over the past several months.

Credit on the books of depository institutions rose at roughly the same pace as total credit in the first half of the year. Commercial bank credit advanced rapidly in the first quarter and at a more subdued rate in the second. This slowdown was especially acute in securities holdings, which had surged in both the fourth quarter of 1997 and the first quarter of this year. Responses to the Federal Reserve's May survey on bank lending practices suggest that the earlier run-up in securities reflected the efforts of banks to boost returns on equity by increasing leverage; much of the rise in securities holdings was concentrated at banks that were constrained by recent mergers from using their profits to repurchase shares. Loan growth also slowed in the second quarter, although the various loan categories behaved quite differently: Real estate lending expanded most slowly in May and June, whereas business lending rebounded in those months after having stalled out in March and April. Outstanding loans at branches and agencies of foreign banks declined in the second quarter, and survey responses identified an actual or expected weakening in the capital position of the parent banks as the primary impetus for a tightening of loan terms and standards.

The Report of Condition and Income (the Call Report) showed that banks' return on equity was about unchanged in the first quarter, staying in the elevated range it has occupied since 1993. Call Report data also indicated that delinquency and charge-off rates on commercial and industrial loans and on real

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estate loans remain quite low, while delinquency and charge-off rates on consumer loans have leveled off after their previous rise. Indeed, bank profits have benefited importantly in recent years from a low level of provisioning for loan losses. Nevertheless, bank supervisors have been concerned that intense competition and favorable economic conditions might be leading banks to ease standards excessively. They reminded depositories that credit assessments should take account of the possibility of less positive economic circumstances in the future.

The trend toward consolidation in the banking industry continued in the first half of the year. Some of the announced mergers involve combinations of banks and nonbank financial institutions, such as thrifts and insurance companies. Many of the mergers were designed to capitalize on the economies of scale and diversification of risk in nationwide banking; other mergers were undertaken to expand the range of services offered to customers. Although some observers are concerned that consolidation might raise banks' market power, greater national concentration in banking over the past several years has not increased banking concentration in most local markets.

The Monetary Aggregates

The broad monetary aggregates grew more rapidly in the first half of 1998 than they did in 1997, although the pace of their expansion has slowed noticeably in recent months. M2 grew 7¼ percent at an annual rate between the fourth quarter of last year and June of this year, placing it well above the top of its 1 percent to 5 percent growth range. When the FOMC established this range in February, it noted that annual ranges represented benchmarks for money growth under conditions of stable prices and velocity behavior in accordance with its pre-1990 historical experience. In fact, nominal spending and income have grown more rapidly than is consistent with price stability and sustainable real growth, and the velocity of M2 (defined as the ratio of nominal GDP to M2) has fallen relative to the behavior predicted by the pre-1990 experience.

For several decades before 1990, M2 velocity showed little overall trend but varied positively from year-to-year with changes in M2 opportunity cost, which is generally defined as the interest forgone by holding M2 assets rather than short-term market instruments such as Treasury bills. The relationship was disturbed in the early 1990s by a sharp increase in velocity; however, since mid-1994, M2 velocity and opportunity

Growth of Money and Debt

Percent

Period	M1	M2	M3	Domestic nonfinancial debt
Annual[1]				
1988	4.3	5.7	6.3	9.1
1989	.5	5.2	4.0	7.5
1990	4.2	4.1	1.8	6.7
1991	7.9	3.1	1.2	4.5
1992	14.4	1.8	.6	4.5
1993	10.6	1.3	1.1	4.9
1994	2.5	.6	1.7	4.9
1995	−1.6	3.9	6.1	5.4
1996	−4.5	4.6	6.8	5.3
1997	−1.2	5.7	8.8	5.0
Quarterly (annual rate)[2]				
1998:Q1	3.0	8.0	11.0	6.2
Q2	.3	7.3	9.6	n.a.
Year-to-date[3]				
1998	.9	7.3	9.8	5.8

1. From average for fourth quarter of preceding year to average for fourth quarter of year indicated.

2. From average for preceding quarter to average for quarter indicated.

3. From average for fourth quarter of 1997 to average for June (May in the case of domestic nonfinancial debt).

n.a. Not available.

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cost have again been moving roughly together, though not in lockstep. Indeed, velocity has declined recently despite almost no change in the standard measure of opportunity cost. The dip in velocity may be partly attributable to the flatter yield curve, which has reduced the return on longer-term investments relative to M2 assets—bank deposits and money market mutual funds. Money demand may also be bolstered by the efforts of households to rebalance their portfolios in the face of a booming stock market. By the end of 1997, households' monetary assets had ebbed to the smallest share of their total financial assets in many years, and households may want to reduce the concentration of their assets in relatively risky equities and increase their holdings of less volatile M2 assets. However, in spite of both the flatter yield curve and the rebalancing motive, flows into both bond mutual funds and stock mutual funds have been quite heavy this year.

M2 increased 7¼ percent at an annual rate in the second quarter, compared with 8 percent in the first quarter. A buildup in household liquid accounts in preparation for individual income tax payments substantially boosted money growth in April; the clearing of these payments depressed May growth by a roughly equal amount. At an annual rate, M2 increased about 6 percent on average over April and May and about 5 percent in June, suggesting a larger deceleration than is shown by the quarterly average figures.

M3 grew 9¾ percent at an annual rate between the fourth quarter of last year and June, placing it far above the top of its 2 percent to 6 percent growth range. As with M2, the FOMC chose the growth range for M3 as a benchmark for growth under conditions of price stability and historical velocity behavior. The components of M3 not included in M2 increased 17½ percent at an annual rate over the first half of the year, following an even faster run-up in 1997. Rapid expansion of large time deposits in the first quarter was driven importantly by strong credit growth at depository institutions. More recently, gains in this category have diminished as bank credit growth has slowed. Holdings of institutional money market mutual funds climbed more than 20 percent in each of the past three years, and that strength has mounted in 1998 as businesses' interest in outsourcing their cash management evidently has intensified. Because in-house management often involves short-term assets that are not included in M3, the shift to mutual funds boosts M3 growth.

M1 rose 1 percent at an annual rate between the fourth quarter of 1997 and June of this year. Currency expanded 6½ percent annualized over that period, a bit below its increase last year. Foreign demand for U.S. currency apparently weakened substantially in the first five months of the year, with an especially large decline in shipments to Russia. Deposits in M1 declined in the first half of the year owing to the continued introduction of "sweep" programs. M1 growth has been depressed for several years by the spread of these programs, which sweep balances out of transactions accounts, which are subject to reserve requirements, and into savings accounts, which are not. Depositors are unaffected by this arrangement because the funds are swept back when needed; banks benefit because they can reduce their holdings of reserves, which earn no interest. New sweeps of other checkable deposits have slowed sharply, but sweeps of demand deposits into savings deposits—an activity that has become popular more recently—continue to spread. Because many banks have already reduced their required

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reserves to minimal levels, the total flow of new sweep programs is tapering off, although it remains considerable.

The drop in transactions accounts in the first half of the year caused required reserves to fall 3¾ percent at an annual rate, a much slower decline than in 1997. The monetary base grew 5½ percent over the same period, as the runoff in required reserves was more than offset by the increased demand for currency.

The substantial decline in required reserves over the past several years has raised concern that the federal funds rate might become more volatile. Required reserves are fairly predictable and must be maintained on only a two-week average basis. As a result, the Federal Reserve has generally been able to supply a quantity of reserves that is close to the quantity demanded at the federal funds rate intended by the FOMC, and banks have accommodated many unanticipated imbalances in reserve supply by varying the quantity demanded across days. Banks also hold reserve balances to avoid overdrafts after making payments to other banks. But this precautionary demand is more variable and difficult to predict than requirement-related demand, and it cannot be substituted across days. As required reserves drop, more banks will hold deposits at the Federal Reserve only to meet these day-to-day demands, reducing the potential for rate-smoothing behavior.

So far, however, the federal funds rate has not become noticeably more volatile on a maintenance-period average basis. This outcome has occurred partly because the Federal Reserve has responded to the changing nature of reserve demand by conducting open market operations on more days than had been customary and by arranging more operations with overnight maturity, thereby bringing the daily reserve supply more closely in line with demand. At the same time, banks have borrowed more reserves at the discount window and have improved the management of their accounts at Reserve Banks. Between 1995 and 1997, banks also significantly increased their required clearing balances, which they precommit to hold and which earn credits that can be applied to Federal Reserve priced services. Like required reserve balances, required clearing balances are predictable by the Federal Reserve and can be substituted across days within the two-week maintenance period. Going forward, the Federal Reserve's recent decision to use lagged reserve accounting rather than contemporaneous reserve accounting will increase somewhat the predictability of reserve demand by both banks and the Federal Reserve. Still, further declines in required reserves might increase funds-rate volatility. Moreover, one-third of the banks responding to the Federal Reserve's recent Senior Financial Officer Survey report that reserve management is more difficult today than in the past. One way to diminish these problems would be to pay interest on reserve balances, which would reduce banks' incentives to minimize those balances.

Financial Markets

Interest Rates

Yields on intermediate- and long-term Treasury securities moved in a fairly narrow band during the first half of 1998, centered a little below the levels that prevailed in the latter part of 1997. The thirty-year bond yield touched its lowest value since the bond was introduced to the regular auction calendar in 1977; it was also lower than any sustained yield on the twenty-year bond (the longest maturity Treasury security

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before the issuance of the thirty-year bond) since 1968. Meanwhile, the average yield on five-year notes in the first half of the year was the lowest since early 1994.

Several factors have contributed to the decline in intermediate- and long-term interest rates over the past year. For one, developments in the U.S. economy and overseas reduced expected inflation and, perhaps, uncertainty about future inflation. Between the second quarter of 1997 and the second quarter of 1998, the median long-term inflation expectation in the Michigan Survey Research Center survey of households dropped ¼ percentage point, and the average expectation in the Philadelphia Federal Reserve's Survey of Professional Forecasters fell almost ½ percentage point. Over the same period, the variance of long-term inflation expectations in the Michigan survey was halved. This greater consensus of expectations suggests that people may now place less weight on the possibility of a sharp acceleration in prices; a reduction in perceived inflation risk would tend to reduce term premiums and thereby cut long-term interest rates. A damping of expected growth in real demand here and abroad, triggered importantly by the Asian financial crisis, also has probably pulled rates lower, as has an apparent shift in desired portfolios away from Asia and, to some extent, from other emerging market economies. Lastly, diminished borrowing by the federal government has restrained interest rates by reducing the competition for private domestic saving and for borrowed funds from abroad.

Assessing the relative importance of some of these factors might be aided, in principle, by comparing yields on nominal and inflation-indexed Treasury notes. Between the second quarters of 1997 and 1998, the nominal ten-year yield fell more than 1 percentage point, whereas the inflation-indexed ten-year yield increased a bit. Unfortunately, the relatively recent introduction of inflation-indexed securities and the thinness of trading makes interpreting their yield levels and movements difficult. In particular, light trading may lead investors to view these new securities as providing less liquidity than traditional Treasury notes, and investors may value liquidity especially highly now in the face of uncertainty about developments in Asia.

The yield curve for Treasury securities has recently been flatter than at any point since the beginning of the decade. For example, the difference between the ten-year-note yield and the three-month-bill yield was smaller in the first half of 1998 than in any other half-year period since early 1990. In that earlier episode, the yield curve had been flattened by a sharp run-up in short-term interest rates as the Federal Reserve tried to check an upcreep in inflation. In the current episode, short rates have held fairly steady, while long-term rates have declined significantly. Some of the current flatness of the term structure probably stems from the apparent reduction in term premiums noted above. But the flat yield curve may also reflect the expectation that short-term real interest rates, which have been boosted by the decline in inflation over the past year, will drop in the future. Supporting that notion, the yield curve for inflation-indexed debt has become inverted this year, as the return on the five-year indexed note has risen above the return on the ten-year indexed note, which exceeds the return on the new thirty-year indexed bond.

Equity Prices

Equity markets have remained ebullient this year. The S&P 500 composite index

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rose sharply in the first several months of 1998; it then fell back a little before moving up to a new record in July. The NASDAQ composite, NYSE composite, and Dow Jones Industrial Average followed roughly similar patterns, and these indexes now stand about 17 to 28 percent above their year-end marks. Small capitalization stocks have not fared so well this year, with the Russell 2000 index up about a third as much on net.

The increase in equity prices combined with the recent slowdown in earnings growth has kept many valuation measures well above their historical ranges. The ratio of prices in the S&P 500 to consensus estimates of earnings over the coming twelve months reached a new high in April and has retreated only slightly from that point. At the same time, the real long-term bond yield—measured either by the ten-year indexed yield or by the difference between the ten-year nominal Treasury yield and inflation expectations in the Philadelphia Federal Reserve's survey—is little changed since year-end. As a result, the forward-earnings yield on stocks exceeds the real yield on bonds by one of the smallest amounts in many years. Apparently, investors share analysts' expectations of robust long-term earnings growth, or they are content with a much smaller equity premium than the historical average.

International Developments

Events in Asia, including in Japan, have continued to dominate developments in global asset markets so far in 1998. During the first months of the year, many financial markets in Asia appeared to stabilize, and progress in implementing economic and financial reform programs was made in most of the countries seriously affected by the crises. In early April, the agreement between Korean banks and their external bank creditors to stretch out short-term obligations was implemented, ending an interval of rollovers by creditors that was endorsed by the authorities in countries that had pledged to support the Korean program. Indonesia reached a second revised agreement with the International Monetary Fund (IMF) in April on a reform program, which was subsequently derailed by political strife and the resignation of the president in late May; the change in political regime was followed by calm, and a new agreement was reached with the IMF management in late June and approved by the IMF Executive Board on July 15.

After having risen sharply during the final months of 1997 through mid-January of 1998, the exchange value of the dollar in terms of the currencies of Korea, Indonesia, Thailand, and other ASEAN countries partly retraced those gains during February, March, and April. Since then, however, market pressures have again led to further sharp increases in the exchange value of the dollar in terms of the Indonesian rupiah while the dollar has changed little against most of the other Asian emerging-market currencies. Since the end of December, the dollar has declined, on balance, 24 percent against the Korean won and nearly 14 percent against the Thai baht and has risen moderately in terms of the Taiwan dollar and increased about 130 percent in terms of the Indonesian rupiah.

During the first weeks of the year, the dollar depreciated in terms of the Japanese yen as improved prospects elsewhere in Asia and market uncertainty regarding potential intervention by the Japanese monetary authorities lent support to the yen. Indications that significant measures for economic stimulus might be announced also put

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upward pressure on the yen. In February, the dollar resumed its appreciation with respect to the yen. The rise in the dollar was only temporarily interrupted by sizable intervention purchases of dollars by Japanese authorities in April. Upward pressure on the dollar relative to the yen intensified in late May and June. Renewed signs of cyclical weakness in the Japanese economy and lack of market confidence in the announced programs for addressing the chronic problems within the financial sector contributed to pessimism toward the yen. Persistent weakness in the Japanese economy and the yen, in turn, heightened concerns about prospects elsewhere in Asia; the lower yen adversely affected the competitiveness of goods produced in the Asian emerging-market economies and raised questions about the sustainability of current exchange rate policies in China and Hong Kong.

On June 17, the monetary authorities in the United States and Japan cooperated in foreign exchange intervention purchases of yen for dollars. This intervention operation was the first by U.S. authorities since August 1995. In announcing the market intervention, Treasury Secretary Rubin cited Japanese government plans to restore the health of their financial system and to strengthen Japanese domestic demand. He pointed to the stake of Asia and the international community as a whole in Japan's success. The yen rose somewhat following the exchange market intervention and has since partially given back that gain. In the wake of the recent election, which cost the Liberal Democratic Party numerous seats in the upper house of the Diet and precipitated the resignation of Prime Minister Hashimoto, the yen changed little. On balance, the dollar has appreciated about 7 percent in terms of the yen since the end of December.

Equity prices in the Asian emerging-market economies have been volatile so far this year as well. These prices recovered somewhat in the first weeks of the year in response to the market perception that the crisis was easing; after having fluctuated narrowly, they began moving back down in March and April, reaching new lows in June in Korea, Thailand, and Hong Kong. On balance, these equity prices have moved down about 25 percent (Singapore and Malaysia) to up about 20 percent (Indonesia) since the end of last year. Equity prices in Japan also rose early in the year on improved optimism but then gave back those gains over time with the release of indicators suggesting additional weakness in the Japanese economy. Since the middle of June, Japanese equity prices have rebounded on the perception that significant fiscal stimulus is now more likely. On balance, Japanese equity prices are up about 9 percent from their level at the end of last year. Japanese long-term interest rates continued through May on their downward trend that began in mid-1997, declining an additional 50 basis points during the first five months. Since then, long-term interest rates have retraced more than half of that decline, in part in response to the announcement of the plan for financial restructuring and in part in response to the outcome of the recent election, which heightened expectations of additional fiscal stimulus.

The Asian financial crises have resulted in a sharp drop in the pace of economic activity in the region. Output declined precipitously in the first quarter in those countries most affected, such as Korea, Indonesia, and Malaysia, and slowed in other Asian economies, such as China and Taiwan, that have suffered a loss of competitiveness and reduced external demand as a consequence of the crises. Data for recent months sug-

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gest that additional slowing has occurred and that the risk of further spread and deepening of cyclical weakness throughout the region cannot be ruled out. Depreciation of their respective currencies has led to acceleration of domestic prices in several of these economies, particularly in Indonesia and Thailand.

Real GDP in Japan also fell sharply in the first quarter, and output indicators suggest a further decline in the second quarter. Consumer price inflation remains very low. Japanese authorities have announced a series of fiscal measures that are expected to boost domestic demand during the second half of this year. In addition, officials have announced a package of steps directed at restoring the soundness of the financial sector, including (1) introduction of a bridge bank mechanism to facilitate the resolution of failed banks while permitting some of their borrowers to continue to receive credit, (2) measures to improve the disposal of bad bank loans, (3) enhanced transparency and disclosure by banks, and (4) strengthened bank supervision. These actions are intended to restore confidence in Japanese financial institutions and in the prospects for the economy more broadly.

In the other major industrial countries, economic developments so far this year have generally been favorable. The exchange value of the dollar in terms of the German mark has fluctuated narrowly and, on balance, is little changed since the end of December. Market perceptions that progress toward the start of the final stage of European Monetary Union (EMU) is going smoothly and signs of momentum in the U.S. and German economies resulted in little pressure in either direction on the exchange rate. The dollar also fluctuated narrowly against the U.K. pound with little net change so far this year. Moves to tighten monetary conditions in the United Kingdom lent support to the pound, countering some tendency for weak external demand to depress the currency. The Canadian dollar rebounded following a tightening of monetary conditions by the Bank of Canada on January 30. Since early March, however, it has tended to move down as market participants have come to believe that further upward shifts of official interest rates are unlikely and as weakness in global commodity markets, partly the result of reduced economic activity in Asia, have weighed on the currency. The exchange value of the U.S. dollar in terms of the Canadian dollar reached new highs in July and, on balance so far this year, has risen about 4 percent.

Long-term interest rates have declined, and equity prices have generally risen strongly in European and Canadian markets this year. Despite signs of strengthening activity in Germany and other continental European countries and continued healthy expansion in the United Kingdom and Canada, long-term rates have moved down since December; long rates are about 60 basis points lower in Germany and less than half that amount lower in Canada. Shifts of international portfolios away from Asian assets and toward those perceived to be safer have probably contributed to rate declines in Continental Europe and in the United States. Stock prices have also continued to rise in Europe and Canada. Since December, the gains have ranged from about 40 percent in Germany and France to about 10 percent in Canada.

The pace of real economic activity improved somewhat in the first quarter in Germany and on average in the eleven countries slated to proceed with currency union on January 1, 1999.[4]

4. Those countries are Austria, Belgium, Finland, France, Ireland, Italy, Germany, Luxembourg, the Netherlands, Portugal, and Spain.

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Production and employment data for more recent months suggest continued expansion. Business confidence has firmed as progress toward EMU has continued. Domestic demand is becoming more buoyant in several of these countries, offsetting weakening of external demand arising from events in Asia. On average, inflation remains subdued within the euro area. In the United Kingdom and Canada, real output continues to expand at a relatively rapid rate. U.K. inflation threatens to exceed the government's target of 2½ percent, and the Bank of England raised its official lending rate 25 basis points in June in order to lessen price pressures. Consumer price inflation in Canada remains very low.

Events in Asia have spilled over to affect developments in Latin American countries. Declines in global oil prices have contributed to downward pressure on the exchange value of the Mexican peso. The peso declined sharply in terms of the dollar at the start of the year but then stabilized in February through May as Asian markets partially recovered. It depreciated further in May and June, resulting in a net decline of about 9 percent in terms of the dollar so far this year. The Brazilian exchange rate regime of a controlled crawl and the Argentine regime of pegging the peso to the dollar remain in place, and Brazilian short-term interest rates have been lowered from the very high levels to which they were raised when the Asian crisis intensified in late 1997. Equity prices in these three Latin American countries have been volatile, rising early in the year and giving back those gains since April. On balance this year, equity prices have declined about 10 percent in Mexico and Argentina and have risen about 8 percent in Brazil.

Real output growth remains strong in Mexico and Argentina, but the rate has slowed somewhat from last year's vigorous pace. In Brazil, economic activity has weakened more sharply, in part in response to the tightening of monetary conditions that followed the outbreak of the Asian crisis.

Lower global oil prices have combined with a poorly functioning domestic tax system to trigger a financial crisis in Russia. Russian officials have reached agreement with IMF management on a revised program that includes proposed increased funds from the IMF and other sources. To help finance this program, the General Arrangements to Borrow are being activated in light of the inadequacy of IMF resources to meet actual or expected requests for financing and a need to forestall impairment of the international monetary system. The General Arrangements to Borrow provide the IMF with supplementary lines of credit from the G-10 countries. ■

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Part 2

Records, Operations, and Organization

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The Board of Governors and the Government Performance and Results Act

Under the Government Performance and Results Act of 1993, many federal agencies are required, in consultation with the Congress and outside stakeholders, to prepare a strategic plan covering a multiyear period and to submit annual performance plans and performance reports. Though not required to do so, the Board of Governors is voluntarily complying with the requirements of the act.

Strategic and Performance Plans

The Board sent its strategic plan for the period 1997–2002 to the Congress in October 1997. The document states the Board's mission, articulates major goals for the period, outlines strategies for achieving those goals, and discusses the environment and other factors that could affect their achievement. It also addresses issues that cut across agency jurisdictional lines, identifies key quantitative measures of performance, and discusses performance evaluation.

In September 1998, the Board sent to the Congress a performance plan for its 1998–99 budget.[1] The plan sets forth specific targets for some of the performance measures identified in the strategic plan. It also describes the operational processes and resources needed to meet those targets and discusses validation and verification of results.

The text of the strategic and performance plans is available on the Board's public web site. A summary of the goals and objectives set forth in those plans is given in the next section.

Goals and Objectives

The Federal Reserve has three interrelated and mutually reinforcing goals, with supporting objectives:

Goal

To conduct monetary policy toward the achievement of maximum sustainable long-term growth and stable prices

Objectives

- Stay abreast of recent developments and prospects in the U.S. economy and financial markets and in those abroad, so that monetary policy decisions will be well informed
- Enhance our knowledge of the structural and behavioral relationships in the macroeconomic and financial markets, and improve the quality of the data used to gauge economic performance, through developmental research activities
- Implement monetary policy effectively in rapidly changing economic circumstances and in an evolving financial market structure
- Contribute to the development of U.S. international policies and procedures, in cooperation with the Department of the Treasury and other agencies

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1. The act requires that a performance plan be submitted for each fiscal year beginning with fiscal 1999. The Board budgets over a calendar year, and its budget covers a two-year period. The budget for 1998–99 was approved in November 1997.

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- Promote understanding of Federal Reserve policy among other government policy officials and the general public.

Goal

To promote a safe, sound, competitive, and accessible banking system and stable financial markets through supervision and regulation of the nation's banking and financial systems, through its function as the lender of last resort, and through effective implementation of statutes designed to inform and protect the consumer

Objectives

- Maintain ability and capacity as a bank supervisor and central bank to ensure that emerging financial threats can be identified early and successfully resolved
- Provide comprehensive and effective supervision of U.S. banks, bank holding companies, U.S. operations of foreign banking organizations, and related entities by focusing supervisory efforts and resources on areas of highest risk to individual organizations and the financial system as a whole, and developing effective regulations to promote a safe and sound banking environment
- Promote sound practices for managing risk at banking organizations that provide for strong internal controls, active boards of directors, and senior management oversight and accountability
- Promote sound banking and effective supervisory practices among developed and emerging countries through ongoing coordination with international supervisory bodies and through training programs for international supervisors and bankers
- Heighten the positive effect of market discipline on banking organizations by encouraging improved disclosures, accounting standards, risk measurement, and overall market transparency
- Harness benefits of technology in carrying out responsibilities to improve supervisory efficiency and to reduce burden on banking organizations
- Maintain an understanding of the effect of financial innovation and technology (for example, new powers and products, new risk management and measurement methodologies, and electronic banking) on the operations and risk profile of banking organizations and the payment system. Ensure that supervisory programs accommodate prudent advances that benefit consumers and businesses or improve risk management
- Remove unnecessary banking restrictions consistent with safety and soundness. Refine or eliminate unnecessary or ineffective policies, procedures, regulations, or restrictions to ensure that reforms are effectively implemented, consistent with safety and soundness of banking organizations
- Assure fair access to financial services for all Americans through vigorous enforcement of the Equal Credit Opportunity, Fair Housing, Community Reinvestment, and Home Mortgage Disclosure Acts and by encouraging state member bank involvement in community development activities
- Administer and ensure compliance with consumer protection statutes relating to consumer financial transactions (such as the Truth in Lending, Truth in Savings, Consumer Leasing, and Electronic Fund Transfer Acts) to carry out congressional intent, striking the proper balance between protection of consumers and burden to the industry.

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Goal

To foster the integrity, efficiency, and accessibility of U.S. dollar payment and settlement systems, issue currency, and act as the fiscal agent and depository of the U.S. government

Objectives

- Provide Federal Reserve Bank priced payment services that maintain and improve the efficiency and integrity of the U.S. dollar payment mechanism
- Meet public demand for U.S. currency in the United States and abroad, work with Treasury to implement effective counterfeit-deterrence and detection features in U.S. currency, and provide for the smooth introduction of new-design currency
- Provide efficient and effective fiscal agency and depository services on behalf of Treasury and other government agencies
- Study and monitor U.S. dollar payment, clearing, and settlement systems and the risk issues pertaining to these systems to facilitate sound policy decisions that foster the integrity of the nation's payment systems.

Interagency Coordination

Interagency coordination helps focus efforts to eliminate redundancy and lower costs. As required by the Government Performance and Results Act and in conformance with past practice, the Board has worked closely with other federal agencies to consider plans and strategies for programs, such as bank supervision, that cross jurisdictional lines. In particular, coordination with the Department of the Treasury and other agencies is evident throughout both the strategic and performance plans.

Much of the Board's formal effort to plan jointly has been made through the Federal Financial Institutions Examination Council (FFIEC), a group made up of the five federal agencies that regulate depository institutions.[2] In addition, a coordinating committee of the chief financial officers of the five agencies has been created to address and report on strategic planning issues of mutual concern. This working group has been meeting since June 1997 and has established four subgroups to focus on examinations, outreach, performance planning, and planning/budget linkage. These and similar planning efforts can significantly lower data processing and other costs for the government and the costs for depository institutions of compliance with federal regulations. ■

2. The FFIEC member agencies are the Board of Governors, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. It was established in 1979 pursuant to title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978. The FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions and to make recommendations to promote uniformity in the supervision of financial institutions. The FFIEC also provides uniform examiner training and has taken a lead in developing standardized software needed for major data collection programs to support the requirements of the Home Mortgage Disclosure Act and the Community Reinvestment Act.

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Record of Policy Actions of the Board of Governors

Regulation B
Equal Credit Opportunity

March 23, 1998—Amendments

The Board amended certain model forms in Regulation B to reflect revisions to the disclosures provided under the Fair Credit Reporting Act that must be given to consumers who are denied credit on the basis of information from an affiliate of the creditor or a consumer reporting agency, effective April 30, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich.[1]

Regulation B requires creditors to provide consumers with a notice of action taken if an application for credit is denied, an account is terminated, or the terms of an account are unfavorably changed. The Fair Credit Reporting Act requires that disclosures be provided to consumers when credit is denied on the basis of information obtained from an affiliate of the creditor, or from a consumer reporting agency or a third party other than a consumer reporting agency. The Board revised the language in several model forms to reflect 1996 amendments to the act.

Regulation C
Home Mortgage Disclosure

September 21, 1998—Amendments

The Board amended Regulation C to require lenders to report dates on the loan application register using four digits for the year to bring Home Mortgage Disclosure Act reporting into compliance with Year 2000 data system standards, effective September 24, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

Regulation C, which implements the Home Mortgage Disclosure Act, requires most mortgage lenders in metropolitan statistical areas to report annually to federal supervisory agencies and to disclose to the public information about their home mortgage and home improvement lending. The Board amended Regulation C to modify the loan application register that is used to report this information to prepare for Year 2000 data systems conversion and to make certain other technical changes.

Regulation D
Reserve Requirements of Depository Institutions

March 23, 1998—Amendments

The Board amended Regulation D for institutions that report deposits weekly

1. In voting records throughout this chapter, Board members, except the Chairman and Vice Chair, are listed in order of seniority.

2. Throughout this chapter, note 2 indicates that one vacancy existed on the Board when the action was taken.

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to move from contemporaneous reserve maintenance to a system under which reserves are maintained on a lagged basis, effective as of the maintenance period beginning July 30, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich.

The Board revised Regulation D to improve the ability of the Federal Reserve and depository institutions to estimate accurately the quantity of reserves that will be needed to meet reserve requirements. The amendments introduce a lag of thirty days between the beginning of a reserve computation period and the beginning of a reserve maintenance period and a similar lag for computing the vault cash that can be applied to satisfy reserve requirements.

November 19, 1998— Amendments

The Board amended Regulation D to decrease the amount of net transaction accounts at depository institutions to which a lower reserve requirement applies and to increase the amount of reservable liabilities that is exempt from reserve requirements, for 1999. The Board also announced higher deposit cutoff levels for determining deposit reporting requirements.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Ferguson, and Gramlich. Absent and not voting: Mr. Meyer.[2]

Under the Monetary Control Act of 1980, depository institutions, Edge Act corporations, agreement corporations, and U.S. agencies and branches of foreign banks are subject to reserve requirements set by the Board. The act directs the Board to adjust annually the amount subject to the lower reserve requirement to reflect changes in net transaction accounts at depository institutions. Recent declines in net transaction accounts warranted a decrease to $46.5 million, and the Board amended Regulation D accordingly.

The Garn–St Germain Depository Institutions Act of 1982 establishes a zero percent reserve requirement on the first $2 million of an institution's reservable liabilities. The act also provides for annual adjustments to that exemption amount based on increases in reservable liabilities at depository institutions. Recent growth in reservable liabilities warranted an increase in the amount exempted from reserve requirements to $4.9 million, and the Board amended Regulation D accordingly.

For institutions reporting weekly, the amendments are effective with the reserve computation period beginning December 1, 1998, and the corresponding reserve maintenance period beginning December 31, 1998. For institutions reporting quarterly, the amendments are effective with the reserve computation period beginning December 15, 1998, and the corresponding reserve maintenance period beginning January 14, 1999.

To reduce the reporting burden on small institutions, depository institutions with total deposits below specified levels are required to report their deposits and reservable liabilities quarterly or less frequently. To reflect increases in the growth rate of total deposits at all depository institutions, the Board increased the deposit cutoff levels used in determining the frequency and detail of depository reporting to $81.9 million for nonexempt depository institutions and to $52.6 million for exempt depository institutions, beginning in September 1999.

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Regulation E
Electronic Fund Transfers

March 4, 1998—Interim Amendment

The Board approved an interim amendment to Regulation E to permit depository institutions and other entities to provide disclosures electronically if the customer agrees, effective March 25, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich.

Regulation E, which implements the Electronic Fund Transfer Act, requires depository institutions and other entities to provide consumers with disclosures about the terms and conditions of electronic fund transfer services, account activity, error resolution, and authorizations or confirmations concerning electronic fund transfers. The disclosures generally must be provided in writing. Under the interim amendment, depository institutions or other entities subject to the act are permitted to use electronic communication to satisfy written disclosure, documentation, notice, and other information requirements if the consumer agrees to such communication. The Board has sought comment on the interim amendment and on proposed rules similar to the interim amendment to address electronic communication under Regulations B (Equal Credit Opportunity), DD (Truth in Savings), M (Consumer Leasing), and Z (Truth in Lending).

September 21, 1998—Amendments

The Board amended Regulation E to revise the time periods for investigating certain errors, effective September 24, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

The Electronic Fund Transfer Act and Regulation E require a financial institution to investigate and resolve a consumer's claim of error within specified time limits. The amendments to Regulation E revise the time for claims involving point-of-sale and foreign-initiated transactions to require institutions to provide provisional credit within ten business days and to complete their investigation within ninety calendar days. For new accounts, the amendments revise Regulation E to allow an institution twenty business days to provide provisional credit and ninety calendar days to complete the investigation.

Regulation H
Membership of State Banking Institutions in the Federal Reserve System

February 13, 1998—Amendments

The Board amended Regulation H to lengthen the examination-frequency cycle for certain financial institutions, effective April 2, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich.

The Board, jointly with the other federal banking and thrift agencies, made certain financial institutions eligible to be examined on an eighteen-month cycle rather than a twelve-month cycle, consistent with provisions of the Riegle Community Development and Regulatory Improvement Act of 1994 and the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Insti-

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tutions with assets of $250 million or less and composite ratings of "1" or "2" under the uniform rating system that are well capitalized and well managed generally would qualify for the lengthened cycle. The amendments make final an interim rule approved by the Board on January 23, 1997.

September 28, 1998—Interim Guidelines

The Board amended Regulation H to include guidelines that establish safety and soundness standards applicable to efforts by insured depository institutions to achieve Year 2000 readiness, effective October 15, 1998.

> Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

The Board, jointly with the other federal banking and thrift agencies, adopted interim Interagency Guidelines Establishing Year 2000 Standards for Safety and Soundness. The guidelines apply only to insured depository institutions and incorporate standards for compliance that previously had been issued by the agencies in several guidance papers. Under powers granted by section 39 of the Federal Deposit Insurance Act, as amended, the Board may direct a state member bank that does not comply with the guidelines to submit an acceptable corrective action plan without the necessity of an administrative proceeding. The Board may also direct a state member bank that fails to submit an acceptable corrective action plan or does not comply with an acceptable plan to take immediate corrective action. The agencies sought public comment on the interim guidelines.

Regulation H
Membership of State Banking Institutions in the Federal Reserve System

Regulation P
Security Procedures

June 26, 1998—Amendments and Rescission of Regulation

The Board amended Regulation H to reduce regulatory burden by simplifying and updating the regulation, and rescinded Regulation P, which was incorporated into Regulation H, effective October 1, 1998.

> Votes for this action: Mr. Greenspan, Ms. Rivlin, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich. Absent and not voting: Mr. Kelley.

The amendments to Regulation H remove outdated material, update and reorganize the remaining material, incorporate provisions designed to reduce burden on state member banks, and eliminate several obsolete interpretations. The Board also rescinded Regulation P because its provisions were incorporated into Regulation H. These actions are consistent with provisions of the Riegle Community Development and Regulatory Improvement Act of 1994.

Regulation H
Membership of State Banking Institutions in the Federal Reserve System

Regulation Y
Bank Holding Companies and Change in Bank Control

June 26, 1998—Amendments

The Board amended Regulations H and Y

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to permit institutions to include in tier 2 capital up to 45 percent of their unrealized holding gains on certain equity securities, effective October 1, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich. Absent and not voting: Mr. Kelley.

The Board, jointly with the other federal banking and thrift agencies, amended the risk-based capital standards for banks, bank holding companies, and thrift institutions regarding the capital treatment of unrealized holding gains on certain equity securities. The amendments permit institutions to include in supplementary (tier 2) capital up to 45 percent of the before-tax net unrealized holding gains on certain available-for-sale equity securities.

July 24, 1998—Amendments

The Board approved amendments to Regulations H and Y to revise its capital adequacy standards for state member banks and bank holding companies to address the regulatory capital treatment of servicing assets on mortgage assets and financial assets other than mortgages, effective October 1, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Meyer, Ferguson, and Gramlich. Absent and not voting: Mr. Kelley.[2]

The amendments, adopted by the Board jointly with the other federal banking and thrift agencies, increase the maximum amount of servicing assets, when combined with purchased credit card relationships, that may be included in regulatory capital from 50 percent to 100 percent of tier 1 capital. The amendments apply a further limit of 25 percent of tier 1 capital to the aggregate amount of nonmortgage servicing assets and purchased credit card relationships and impose a 10 percent discount on the valuation of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships.

Regulation I
Issue and Cancellation of Federal Reserve Bank Capital Stock

June 26, 1998—Amendment

The Board amended Regulation I to reduce regulatory burden by simplifying and updating its requirements, effective October 1, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich. Absent and not voting: Mr. Kelley.

The amendments simplify, modernize, and condense the regulation; reflect the replacement of share certificates by a book-entry system; codify Board and staff interpretations; provide for carryover of small adjustments in Reserve Bank stock positions; adopt a 360-day year of 30-day months for dividend accruals; and clarify certain accounting issues. These actions are consistent with provisions of the Riegle Community Development and Regulatory Improvement Act of 1994.

Regulation J
Collection of Checks and Other Items by Federal Reserve Banks

Regulation CC
Availability of Funds and Collection of Checks

December 7, 1998—Termination of Proposed Rulemaking

The Board decided not to make regu-

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latory changes with respect to certain legal disparities that exist in the presentment and settlement of checks.

Votes for this action: Messrs. Greenspan, Kelley, Meyer, Ferguson, and Gramlich. Absent and not voting: Ms. Rivlin.[2]

In March 1998, the Board requested comment on an advance notice of proposed rulemaking on the reduction or elimination of the remaining legal disparities between Federal Reserve Banks and private-sector banks in the presentment and settlement of checks and on the advantages and disadvantages of the same-day settlement rule, which requires paying banks to settle in same-day funds for checks presented to them by private-sector banks by 8:00 a.m. local time at a location specified by the paying bank. On the basis of its analysis of the comments received, the Board concluded that the costs associated with further regulatory changes would outweigh any gains in efficiency for the payments system.

Regulation K
International Banking Operations

April 27, 1998—Interim Amendment

The Board approved an interim amendment to Regulation K to lengthen the examination-frequency cycle for certain U.S. branches and agencies of foreign banks, effective August 28, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich.

The interim rule, which was issued jointly with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, implements provisions of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 by making certain U.S. branches and agencies of foreign banks eligible for an eighteen-month examination cycle rather than a twelve-month cycle. U.S. branches and agencies of foreign banks with assets of $250 million or less qualify for the lengthened cycle if they meet the criteria provided in the interim amendment. The agencies also sought public comment on the interim amendment.

Regulation M
Consumer Leasing

September 21, 1998—Amendments

The Board amended Regulation M and its commentary to clarify rules on lease payments, advertisements, and rounding calculations, effective September 24, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

Regulation M implements the Consumer Leasing Act, which requires lessors to provide consumers with uniform cost and other disclosures about consumer lease transactions. The amendments to Regulation M make several technical changes to the regulation and commentary concerning lease payments, advertisements, and the treatment of taxes.

Regulation Y
Bank Holding Companies and Change in Bank Control

March 20, 1998—Clarification of Conditions

The Board clarified that a section 20 subsidiary that operates off the premises

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of a depository institution is not required to make certain oral disclosures to retail customers, effective March 27, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich.

The Board approved a clarification to the operating standard on customer disclosures applicable to the securities activities of section 20 subsidiaries. As modified, a section 20 subsidiary that operates off the premises of a depository institution may satisfy the disclosure requirements of that operating standard by providing a one-time written disclosure when an investment account is opened.

May 29, 1998—Amendments

The Board amended Regulation Y to simplify the tier 1 leverage capital standard for bank holding companies and to incorporate the market risk capital rule into the leverage standard, effective June 30, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich. Absent and not voting: Ms. Phillips.

Under the amended capital standard, a minimum ratio of tier 1 capital to total assets (leverage ratio) of 3 percent is established for bank holding companies that either are rated composite "1" under the rating system for bank holding companies or have implemented the Board's risk-based capital market risk measure. The minimum leverage ratio for all other bank holding companies is 4 percent. Bank holding companies are expected to maintain higher-than-normal capital ratios if they have supervisory, financial, operational, or managerial weaknesses, or if they are anticipating or experiencing significant growth.

November 19, 1998—Amendment

The Board amended Regulation Y to exempt from its appraisal requirements any transaction by a section 20 subsidiary involving underwriting and dealing in mortgage-backed securities, effective December 28, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Ferguson, and Gramlich. Absent and not voting: Mr. Meyer.[2]

The amendment permits section 20 subsidiaries to underwrite and deal in all types of mortgage-backed securities without confirming that the underlying loans met applicable appraisal requirements when they were originated or without obtaining new appraisals for loans that lack acceptable appraisals.

Regulation Z
Truth in Lending

February 2, 1998—Amendment

The Board amended Regulation Z to adjust the threshold amount of mortgage fees that triggers additional disclosures and certain limitations, effective January 1, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich.

The Home Ownership and Equity Protection Act of 1994 imposes additional disclosure requirements and certain substantive limitations on mortgages if total points and fees payable by the consumer exceed the greater of $400 or 8 percent of the total loan amount.

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The Board is required to adjust annually the $400 threshold based on the annual percentage change in the consumer price index (CPI) as of June 1 of the preceding year. On the basis of the CPI on June 1, 1997, the Board increased the threshold amount for 1998 to $435.

Regulation DD
Truth in Savings

July 9, 1998—Amendments

The Board made final an interim rule amending Regulation DD to permit institutions to disclose an annual percentage yield equal to the contract interest rate for certain deposit accounts with maturities longer than one year, effective August 28, 1998.

Votes for this action: Messrs. Greenspan, Kelley, Meyer, Ferguson, and Gramlich. Absent and not voting: Ms. Rivlin.[2]

The Truth in Savings Act requires depository institutions to provide disclosure of an annual percentage yield on interest-bearing accounts calculated under a method prescribed by the Board. The amendments, which make final an interim rule the Board adopted in January 1995, address an anomaly for certain certificates of deposit that occurs when the annual percentage yield disclosure is lower than the stated interest rate. Under the amendments, an institution is permitted to disclose an annual percentage yield equal to the contract interest rate for noncompounding time accounts with a maturity greater than one year if the accounts require interest distributions at least annually.

September 21, 1998—Amendments

The Board amended Regulation DD to modify rules affecting lobby signs and disclosures for certain time accounts, effective September 24, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

The amendments to Regulation DD implement changes to the Truth in Savings Act enacted in 1996. The changes modify the rules for indoor lobby signs, eliminate subsequent disclosure requirements for automatically renewable time accounts with terms of one month or less, and repeal civil liability provisions as of September 30, 2001.

Rules Regarding Delegation of Authority

November 18, 1998—Amendments

The Board amended its Rules Regarding Delegation of Authority to expand the authority of the Director of the Division of Consumer and Community Affairs to perform certain administrative duties and review certain technical matters under the Board's consumer statutes and regulations, effective November 25, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

The Board delegated to the director the authority to issue interpretations under the Fair Credit Reporting Act, to adjust annually the dollar amount of loans subject to the Home Ownership and Equity Protection Act and the threshold for exempting small depository institutions under the Home Mortgage Disclosure Act, to make certain determinations under Regulation BB (Community Reinvestment), and to conduct public hearings or other pro-

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ceedings under applicable statutes on consumer-law issues.

Policy Statements and Other Actions

March 4, 1998—Uniform Cash Access Policy

The Board revised its cash access policy to clarify the base level of free currency access to all depository institutions in an interstate branching environment, effective May 4, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich.

The Board clarified that each depository institution may designate up to ten endpoints to receive free currency access from each Reserve Bank office but may not designate an endpoint to receive free cash access from more than one Reserve Bank office. The Board also delegated to the Director of the Division of Reserve Bank Operations and Payment Systems the authority to interpret the policy, to approve changes in the base number of free endpoints and the volume thresholds, and to waive the policy for a limited period of time if warranted by special circumstances.

April 6, 1998—Fedwire Securities Transfer Operating Hours and Receiver Controls

The Board decided not to adopt an earlier opening time for the Fedwire securities transfer service and authorized the Federal Reserve Banks to design and implement an optional automatic securities transfer reversal feature for use by Fedline participants.

Votes for this action: Messrs. Greenspan and Kelley, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich. Absent and not voting: Ms. Rivlin.

The Board's decision not to implement an earlier opening time for the service at this time that had been proposed in January 1995 was based on the anticipated cost and technical difficulties identified by industry participants. In connection with this action, the Board authorized the Reserve Banks to design and implement an optional automatic securities transfer reversal feature for use by Fedline participants to give them better control over their use of intraday credit.

June 17, 1998—Policy Statement on Payments System Risk

The Board approved certain revisions to its policy on payments system risk in certain private multilateral settlement arrangements, effective January 4, 1999.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Messrs. Meyer, Ferguson, and Gramlich.

The Board adopted a policy statement on Privately Operated Multilateral Settlement Systems to provide a flexible, risk-based approach to risk management as part of its payments system risk reduction program. The policy integrates the "large-dollar" and "small-dollar" components of the Board's existing policy statement, which are being repealed concurrently with the effective date of the new policy, into one comprehensive policy.

October 27, 1998—Policy Statement on Income Tax Allocation in a Holding Company Structure

The Board approved a policy statement on intercompany tax allocation agree-

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ments among holding companies and their depository institution subsidiaries, effective November 23, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

Consistent with provisions of the Riegle Community Development and Regulatory Improvement Act of 1994, the Board, jointly with the other federal banking and thrift agencies, provided guidance on the allocation and payment of taxes for banking and thrift organizations that file income tax returns as members of a consolidated group. The guidance generally provides that tax settlements between parent and depository institution subsidiaries should be on terms that are no less favorable to the subsidiary than if it were a separate taxpayer.

October 29, 1998—Notice of Service Enhancement

The Board approved enhancements to the net settlement services that the Federal Reserve Banks offer to financial institutions, effective March 29, 1999.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

Under the enhanced service, the Reserve Banks will offer a fully automated settlement service that provides participants in clearing arrangements with finality of settlement intraday on the settlement date. The service will provide the agent in a clearing arrangement with an on-line mechanism to submit an electronic file of settlement information to the Federal Reserve. The enhanced service is intended to increase operational efficiency and to facilitate a reduction in the duration of settlement risk for participants.

November 23, 1998—Policy Statement on Loan Loss Reserves

The Board approved a policy statement on the allowance for loan losses of depository institutions, issued November 24, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Ferguson, and Gramlich. Absent and not voting: Mr. Meyer.[2]

The Board, jointly with the other federal banking and thrift agencies and the Securities and Exchange Commission, issued the statement to better ensure the consistent application of loan-loss accounting policy and to improve the transparency of financial statements.

December 7, 1998—Fedwire Funds Transfer Segmented Settlement Period

The Board decided to retain the current thirty-minute settlement period at the end of the Fedwire funds transfer operating day and not to implement restrictions on respondent bank transfers during the last fifteen minutes of the settlement period, from 6:15 p.m. to 6:30 p.m. eastern time.

Votes for this action: Mr. Greenspan, Ms. Rivlin, and Messrs. Kelley, Meyer, Ferguson, and Gramlich.[2]

The Board decided not to implement a segmented settlement period for the Fedwire funds transfer service that had been proposed in June 1998 because it was unclear that such an approach would significantly reduce uncertainty and volatility for the markets as a whole and because of potentially costly operational changes.

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1998 Discount Rates

During 1998, the Board of Governors approved two reductions of ¼ percentage point in the basic discount rate charged by the Federal Reserve Banks. These actions, taken in mid-October and mid-November, lowered the basic rate from 5 percent to 4½ percent. The rates for seasonal and extended credit, which are set on the basis of market-related formulas, were changed more frequently, and they exceeded the basic rate by varying amounts during the year.

Basic Discount Rate

The Board's decisions on the basic discount rate were made against the background of the policy actions of the Federal Open Market Committee (FOMC) and related economic and financial developments. These developments are reviewed more fully in part 1 of this REPORT and in the minutes of the 1998 FOMC meetings, which also appear in this REPORT.

January to September: No Changes

Economic activity expanded rapidly during the early months of 1998 after posting robust gains in the latter part of 1997. The expansion was paced by exceptionally strong growth in private domestic spending for consumption, housing, and business equipment. Despite indications of persisting pressures on compensation associated with continued rapid growth in employment and tightening labor markets, price inflation abated. Large declines in energy prices contributed to this favorable inflation result, but rapid growth in productivity helped to hold down the advance in labor costs. Against this background, most Federal Reserve Banks continued to favor an unchanged basic discount rate of 5 percent, its level since early 1996. However, two Banks concerned about what they viewed as strong prospects for rising inflation requested a ¼ percentage point increase during the first quarter, and they were joined by two other Banks by early spring. The Board took no action on these requests, but the Board members agreed on the need to monitor the economy for warning signs of mounting inflationary pressures.

Over the spring and summer, growth in economic activity moderated to a pace well below that experienced during the opening months of the year. Price inflation remained subdued, and wage inflation changed little during the period. By mid-summer only one Reserve Bank was proposing an increase in the basic rate, while another was requesting a decrease. Subsequently, the proposal for an increase was withdrawn and a growing number of Banks called for reductions of ¼ or ½ percentage point. The requests for lower rates were submitted in the context of rising concerns about the adverse effects of foreign economic and financial developments on the U.S. economy.

October and November: Basic Rate Reduced

The FOMC decided to ease the stance of monetary policy slightly in late September, thereby inducing a decline of ¼ percentage point in the federal funds rate to an average of about 5¼ percent. The easing was deemed to be desirable to cushion the likely adverse consequences on future domestic economic activity of the global financial turmoil that had weakened foreign economies and had contributed in large measure to the emergence of tighter conditions in U.S. financial markets. On October 15, the FOMC eased the stance of policy

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slightly further, with the federal funds rate expected to decline to an average of around 5 percent. In a companion action, the Board approved pending requests to reduce the basic rate ¼ percentage point, to 4¾ percent. These actions were taken in light of heightened concerns among lenders and the unsettled conditions in financial markets more generally that were seen as likely to restrain aggregate demand in the future. On November 17, the FOMC and the Board announced further slight easing actions that reduced the federal funds rate to an average of around 4¾ percent and the basic discount rate to 4½ percent. Although conditions in financial markets had become much more settled since mid-October, unusual strains remained. The further easing actions together with those taken since late September were expected to be sufficient to foster financial conditions that would promote sustained economic expansion and subdued inflation. Over the balance of the year, no Reserve Bank submitted further requests to change the basic discount rate.

Structure of Discount Rates

The basic discount rate is the rate normally charged on loans to depository institutions for short-term adjustment credit, while flexible, market-related rates generally are charged on seasonal and extended credit. These flexible rates are calculated every two weeks in accordance with formulas that are approved by the Board.

The purpose of the seasonal program is to help smaller institutions meet needs arising from a clear pattern of intra-yearly movements in their deposits and loans. Funds may be provided for periods longer than those permitted under adjustment credit. Since its introduction in early 1992, the flexible rate charged on seasonal credit has been closely aligned with short-term market rates; it is never less than the basic rate applicable to adjustment credit.

The purpose of extended credit is to assist depository institutions that are under sustained liquidity pressure and are not able to obtain funds from other sources. The rate for extended credit is 50 basis points higher than the rate for seasonal credit and is at least 50 basis points above the basic rate. In appropriate circumstances, the basic rate may be applied to extended-credit loans for up to thirty days, but any further borrowings would be charged the flexible, market-related rate.

Exceptionally large adjustment-credit loans that arise from computer breakdowns or other operating problems not clearly beyond the reasonable control of the borrowing institution are assessed the highest rate applicable to any credit extended to depository institutions; under the current structure, that rate is the flexible rate on extended credit.

At the end of 1998, the structure of discount rates was as follows: a basic rate of 4.50 percent for short-term adjustment credit, a rate of 4.85 percent for seasonal credit, and a rate of 5.35 percent for extended credit. During 1998, the rate for seasonal credit ranged from a low of 4.85 percent to a high of 5.65 percent, and that for extended credit ranged from a low of 5.35 percent to a high of 6.15 percent.

Board Votes

Under the Federal Reserve Act, the boards of directors of the Federal Reserve Banks must establish rates on loans to depository institutions at least every fourteen days and must submit such rates to the Board of Governors for review and determination. The Reserve Banks are also required to submit

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requests every fourteen days to renew the formulas for calculating the market-related rates on seasonal and extended credit. Votes relating to the reestablishment of the formulas for these flexible rates are not shown in this summary. All votes on discount rates taken by the Board of Governors during 1998 were unanimous.

Votes on the Basic Discount Rate

October 15, 1998. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, and San Francisco to reduce the basic discount rate by ¼ percentage point, to 4¾ percent.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Messrs. Kelley, Meyer, and Ferguson. Votes against this action: None. Absent and not voting: Mr. Gramlich.

The Board subsequently approved similar actions taken by the directors of the Federal Reserve Banks of Cleveland, Richmond, and Dallas, effective October 16, 1998.

November 17, 1998. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of New York, Philadelphia, Dallas, and San Francisco to reduce the basic discount rate by ¼ percentage point, to 4½ percent.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Messrs. Kelley, Meyer, Ferguson, and Gramlich. Votes against this action: None.

The Board subsequently approved similar actions taken by the directors of the Federal Reserve Banks of Boston, Richmond, Atlanta, St. Louis, and Kansas City, effective November 18, 1998, and by the Federal Reserve Banks of Cleveland, Chicago, and Minneapolis, effective November 19, 1998. ▪

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Minutes of Federal Open Market Committee Meetings

The policy actions of the Federal Open Market Committee, contained in the minutes of its meetings, are presented in the ANNUAL REPORT of the Board of Governors pursuant to the requirements of section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each such action, and that it shall include in its annual report to the Congress a full account of such actions.

The minutes of the meetings contain the votes on the policy decisions made at those meetings as well as a résumé of the discussions that led to the decisions. The summary descriptions of economic and financial conditions are based on the information that was available to the Committee at the time of the meetings rather than on data as they may have been revised later.

Members of the Committee voting for a particular action may differ among themselves as to the reasons for their votes; in such cases, the range of their views is noted in the minutes. When members dissent from a decision, they are identified in the minutes along with a summary of the reasons for their dissent.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market activities, the Federal Reserve Bank of New York operates under two sets of instructions from the Federal Open Market Committee: an Authorization for Domestic Open Market Operations and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Committee operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations. These policy instruments are shown below in the form in which they were in effect at the beginning of 1998. Changes in the instruments during the year are reported in the minutes for the individual meetings.

Authorization for Domestic Open Market Operations

In Effect January 1, 1998

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal

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Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $8.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) When appropriate, to buy or sell in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates, prime bankers acceptances with maturities of up to nine months at the time of acceptance that (1) arise out of the current shipment of goods between countries or within the United States, or (2) arise out of the storage within the United States of goods under contract of sale or expected to move into the channels of trade within a reasonable time and that are secured throughout their life by a warehouse receipt or similar document conveying title to the underlying goods; provided that the aggregate amount of bankers acceptances held at any one time shall not exceed $100 million;

(c) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers acceptances of the types authorized for purchase under 1(b) above, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the Committee may specify from time to time.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 15 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(c), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

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Domestic Policy Directive

In Effect January 1, 1998[1]

The information reviewed at this meeting suggests that economic activity continued to grow rapidly in recent months. Nonfarm payroll employment increased sharply in October and November; the civilian unemployment rate fell to 4.6 percent in November, its low for the current economic expansion. Industrial production continued to advance at a brisk pace in October and November. Retail sales were unchanged on balance over the two months after rising sharply in the third quarter. Housing starts increased slightly further in October and November. Available information suggests on balance that business fixed investment will slow from the exceptionally strong increases of the second and third quarters. The nominal deficit on U.S. trade in goods and services widened significantly in the third quarter from its rate in the second quarter. Price inflation has remained subdued, despite some increase in the pace of advance in wages.

Short-term interest rates have registered small mixed changes since the day before the Committee meeting on November 12, 1997, while bond yields have fallen somewhat. Share prices in U.S. equity markets recorded mixed changes over the period; equity markets in other countries, notably in Asia, have remained volatile. In foreign exchange markets, the value of the dollar has risen over the intermeeting period in terms of both the trade-weighted index of the other G-10 countries and the currencies of a number of Asian countries.

M2 and M3 grew rapidly in November. For the year through November, M2 expanded at a rate slightly above the upper bound of its range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt has expanded in recent months at a pace somewhat below the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in July reaffirmed the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1998, the Committee agreed on a tentative basis to set the same ranges as in 1997 for growth of the monetary aggregates and debt, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a slightly higher federal funds rate or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the growth in M2 and M3 over coming months.

1. Adopted by the Committee at its meeting on December 16, 1997.

Authorization for Foreign Currency Operations

In Effect January 1, 1998

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settle-

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ments, and with other international financial institutions:

Austrian schillings	Italian lire
Belgian francs	Japanese yen
Canadian dollars	Mexican pesos
Danish kroner	Netherlands guilders
Pounds sterling	Norwegian kroner
French francs	Swedish kronor
German marks	Swiss francs

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding $25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount (millions of dollars equivalent)
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	3,000
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,250

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1(A) above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non–market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

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5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board Members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account ("Manager"), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

Foreign Currency Directive

In Effect January 1, 1998

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks and with the Bank for International Settlements.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

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C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

Procedural Instructions with Respect to Foreign Currency Operations

In Effect January 1, 1998

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $300 million on any day or $600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding $150 million, or $300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System, and about any operations that are not of a routine character.

Meeting Held on February 3–4, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, February 3, 1998, at 2:30 p.m. and continued on Wednesday, February 4, 1998, at 9:00 a.m.

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Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Ms. Phillips
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Ms. Browne, Messrs. Cecchetti, Dewald, Hakkio, Lindsey, Promisel, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Mr. Slifman, Associate Director, Division of Research and Statistics, Board of Governors

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Assistant Director, Division of Monetary Affairs, Board of Governors

Messrs. Brayton[2] and Rosine,[2] Senior Economists, Division of Research and Statistics, Board of Governors

Ms. Garrett and Mr. Nelson,[2] Economists, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Rives, First Vice President, Federal Reserve Bank of St. Louis

Messrs. Beebe, Eisenbeis, Hunter, Ms. Krieger, Messrs. Lang, Rolnick, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Chicago, New York, Philadelphia, Minneapolis, and Dallas respectively

Mr. Hetzel, Vice President, Federal Reserve Bank of Richmond

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 1998, and ending December 31, 1998, had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

2. Attended portions of meeting relating to the Committee's review of the economic outlook and establishment of its monetary and debt ranges for 1998.

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William J. McDonough, President of the Federal Reserve Bank of New York, with Ernest T. Patrikis, First Vice President of the Federal Reserve Bank of New York, as alternate;
Cathy E. Minehan, President of the Federal Reserve Bank of Boston, with Edward G. Boehne, President of the Federal Reserve Bank of Philadelphia, as alternate;
Jerry L. Jordan, President of the Federal Reserve Bank of Cleveland, with Michael H. Moskow, President of the Federal Reserve Bank of Chicago, as alternate;
Robert D. McTeer, Jr., President of the Federal Reserve Bank of Dallas, as voting alternate pending the election of a President of the Federal Reserve Bank of St. Louis;
Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City, with Gary H. Stern, President of the Federal Reserve Bank of Minneapolis, as alternate.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first meeting of the Committee after December 31, 1998, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee:

Alan Greenspan	Chairman
William J. McDonough	Vice Chairman
Donald L. Kohn	Secretary and Economist
Normand R.V. Bernard	Deputy Secretary
Joseph R. Coyne	Assistant Secretary
Gary P. Gillum	Assistant Secretary
J. Virgil Mattingly, Jr.	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Michael J. Prell	Economist
Edwin M. Truman	Economist

Lynn E. Browne, Stephen G. Cecchetti, William G. Dewald, Craig S. Hakkio, David E. Lindsey, Larry J. Promisel, Thomas D. Simpson, Mark S. Sniderman, and David J. Stockton, Associate Economists

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first meeting of the Committee after December 31, 1998.

By unanimous vote, Peter R. Fisher was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.

Secretary's note: Advice subsequently was received that the selection of Mr. Fisher as Manager was satisfactory to the board of directors of the Federal Reserve Bank of New York.

On the recommendation of the Manager, the Committee at this meeting unanimously approved two changes in the Authorization for Domestic Open Market Operations.

First, the Committee amended paragraph 1(a) of the Authorization to raise from $8 billion to $12 billion the limit on intermeeting changes in System account holdings of U.S. government and federal agency securities. The increase was the first permanent change in the limit since February 1990, when it was raised from $6 billion to $8 billion. The Manager indicated that the Committee had approved temporary increases several times during the past year and that the existence of a permanent $12 billion limit would have obviated the need for most of the increases. A permanent increase to $12 billion would reduce the number of occasions requiring special Committee action, while still

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calling the need for particularly large changes to the Committee's attention. The Committee concurred in the Manager's view that a $4 billion increase was appropriate.

Second, the Committee terminated the Manager's authority to conduct transactions in bankers acceptances. This involved the deletion of paragraph 1(b), which authorized purchases or sales of prime bankers acceptances in the open market, and also the deletion of the reference in paragraph 1(c), which authorized repurchase agreements in such market instruments. The Manager indicate that operations in bankers acceptances were not a practical means of affecting reserves under current circumstances, given the ample availability of U.S. Treasury obligations in the market. Indeed, the Committee previously had decided in 1977 to suspend transactions on an outright basis in bankers acceptances and had completed the System's disengagement from this market in 1984 by instructing the Manager to discontinue the use of repurchase agreements involving bankers acceptances. While those decisions had left open the possibility of resuming transactions in bankers acceptances and no changes had been made in the Authorization, the Committee agreed that the existing authority no longer served a practical purpose. Accordingly, the amended Authorization for Domestic Open Market Operations was unanimously approved in the form shown below.

Authorization for Domestic Open Market Operations

Amended February 3, 1998

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $12.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy U.S. Government securities and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank,

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under such instructions as the Committee may specify from time to time.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 15 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

With Mr. Jordan dissenting, the Authorization for Foreign Currency Operations shown below was reaffirmed.

Authorization for Foreign Currency Operations

Reaffirmed February 3, 1998

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Austrian schillings	Italian lire
Belgian francs	Japanese yen
Canadian dollars	Mexican pesos
Danish kroner	Netherlands guilders
Pounds sterling	Norwegian kroner
French francs	Swedish kronor
German marks	Swiss francs

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding \$25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

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Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	3,000
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,250

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non-market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account ("Manager"), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations

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to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

With Mr. Jordan dissenting, the Foreign Currency Directive shown below was reaffirmed.

Foreign Currency Directive

Reaffirmed February 3, 1998

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks and with the Bank for International Settlements.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

Mr. Jordan dissented in the votes on the Foreign Currency Authorization and the Foreign Currency Directive because these policy instruments provide the basis for foreign exchange market transactions. He believes that the primary mission of the Federal Reserve is to achieve and maintain a stable purchasing power of the U.S. dollar. That objective is best achieved when open market transactions are restricted to purchases and sales of U.S. government securities. When compatible with the System's primary objective, foreign exchange transactions are redundant to open market operations. Often, however, foreign exchange transactions conflict with the System's primary objective, requiring opposite adjustments in System holdings of U.S. Treasury obligations. Moreover, holdings of foreign securities expose the Reserve Banks to foreign exchange translation losses resulting from the depreciation of foreign currencies relative to a strong and stable U.S. dollar.

By unanimous vote, the Procedural Instructions with Respect to Foreign Currency Operations shown below were reaffirmed.

Procedural Instructions with Respect to Foreign Currency Operations

Reaffirmed February 3, 1998

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the

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Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $300 million on any day or $600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding $150 million, or $300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

On January 16, 1998, the continuing rules, regulations, authorizations, and other instructions of the Committee were distributed with the advice that, in accordance with procedures approved by the Committee, they were being called to the Committee's attention before the February 3–4 organization meeting to give members an opportunity to raise any questions they might have concerning them. Members were asked to indicate if they wished to have any of the instruments in question placed on the agenda for consideration at this meeting, and no requests for consideration were received.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on December 16, 1997, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange and international financial markets in the period since the previous meeting on December 16, 1997. There were no System open market transactions in foreign currencies during this period, and thus no vote was required of the Committee.

The Manager of the System Open Market Account also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period from December 17, 1997, through February 3, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook, the ranges for the growth of money and debt in 1998, and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

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The information reviewed at this meeting suggested that the economy continued to expand at a robust pace during the closing months of 1997. Both employment and industrial output recorded substantial increases in the fourth quarter. While spending for final goods and services by U.S. residents decelerated noticeably, inventory investment strengthened and the deficit in international trade in goods and services appeared to have narrowed. Tighter labor markets brought some acceleration in wages, but falling import and energy prices helped to hold down price inflation over the closing months of the year.

Labor demand expanded rapidly in the fourth quarter; a sharp increase in nonfarm payroll employment in December followed large advances in October and November, and the average workweek edged up on balance over the three-month period. Job gains were widely spread across industries. In the fourth quarter, new hires in manufacturing accounted for more than half of that sector's total for the year, and construction employment also registered an unusually large rise compared with earlier in 1997. Job growth surged in retail trade and persisted at a rapid pace in service-producing industries. The civilian unemployment rate, at 4.7 percent in December, was near its low for the current economic expansion.

Industrial production continued to advance at a brisk pace in the fourth quarter. Growth in the manufacturing of durable goods remained strong despite sharply slower, though still substantial, expansion in the output of computing and office equipment. The production of nondurable goods picked up after having been sluggish earlier in the year. Capacity utilization in manufacturing was at a relatively high rate in the fourth quarter, but available information suggested few bottlenecks.

Consumer spending, in real terms, rose at a slower though still appreciable rate in the fourth quarter. Purchases of durable goods increased moderately after having surged in the third quarter, and spending on nondurables edged down. By contrast, expenditures for consumer services grew at a somewhat faster rate. Recent surveys indicated that consumer confidence remained at a very high level.

Housing demand continued to exhibit considerable strength at year-end in the context of sharp declines in fixed mortgage rates in recent months, further sizable gains in employment and household income, and very positive consumer assessments of homebuying conditions. Applications for mortgages to purchase homes increased to a new monthly high in December; the pace of sales of existing homes rose further in the fourth quarter; and sales of new homes in November (latest available monthly data) were at their highest monthly pace in more than ten years. Housing starts edged lower in December but remained close to the highs of the current expansion.

After unusually strong increases earlier in the year, real business fixed investment declined slightly in the fourth quarter. However, the outlook for further growth remained positive, with corporate cash flow still healthy and the user cost of capital still low. Data on shipments of nondefense capital goods in December indicated a rebound in business spending on capital goods, notably for office, computing, and communications equipment, after sizable declines in the October–November period. Business spending on nonresidential structures declined slightly in the fourth quarter despite rising real estate prices and falling vacancy rates.

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The pace of business inventory investment evidently picked up somewhat in the fourth quarter. In manufacturing, inventories climbed further in November (latest monthly data available), and the stock–shipments ratio was at the top of its narrow range for the past twelve months. The accumulation of wholesale stocks continued its strong upward trend, and by November the inventory–sales ratio for the wholesale sector had reversed its 1996 decline. In the retail sector, inventories declined slightly in November after having changed little in October; the inventory–sales ratio for this sector was near the bottom of its range for the last twelve months.

The nominal deficit on U.S. trade in goods and services narrowed substantially on average in October and November from its level in the third quarter. The value of exports rose appreciably in the October–November period, with the largest increases occurring in automotive and agricultural products. The average value of imports for October and November changed little from the third-quarter rate. Imports of consumer goods and machinery rose, but they were about offset by declines in automotive products, computers, and, to a lesser extent, a wide variety of other products. The available information indicated that economic expansion remained healthy in most of the foreign G-7 countries, although slowing somewhat from the third quarter. In Asia, weakness in economic activity in Japan continued into the fourth quarter, and persisting financial turmoil was having strong adverse effects on the economies of a number of developing countries.

Consumer price inflation remained low in December, damped by a sizable further drop in energy prices and a small decline in food prices. Excluding food and energy items, an acceleration in the costs of services, notably medical care and shelter, provided a slight boost to core consumer price inflation in December. For the year as a whole, prices of core consumer items rose considerably less than in 1996, in part reflecting the effect of declining import prices. At the producer level, prices of all finished goods and of the core finished goods component declined further in December. For the year 1997, the core producer price index was little changed after a relatively small rise the previous year; the total index, weighed down by falling prices of finished food and energy items, partially reversed its 1996 increase. Prices also remained subdued at earlier stages of processing in 1997, with prices of crude materials falling substantially. Labor costs, as measured by the hourly compensation of private industry workers, increased at appreciably faster rates in the fourth quarter and for the year.

At its meeting on December 16, 1997, the Committee adopted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate averaging around 5½ percent. In light of the increased uncertainties in the outlook and the possibility that the next change in policy might be in either direction, the Committee adopted a directive that did not include a presumption about the likely direction of any adjustment to policy during the intermeeting period. Reserve market conditions associated with this directive were expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining reserve conditions consistent with the intended federal funds rate average of around 5½ percent, and the effective rate averaged close to that level despite some largely

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anticipated upward pressures in reserve markets around year-end. Most other domestic market interest rates moved down on balance during the intermeeting period, apparently as a result of increased concerns over the turbulence in Asia and its potential implications for the U.S. economy. Share prices in U.S. equity markets moved up slightly on net, perhaps partly in response to the bond market rally, while equity markets in some other countries, notably in Asia, remained unsettled.

In foreign exchange markets, the dollar appreciated on balance over the intermeeting period. The dollar rose considerably further against the currencies of many of the emerging market economies in Asia amid continuing market concerns about the adequacy of reforms that would be undertaken in the affected countries and the magnitude and availability of international financial assistance that would be needed to support those efforts. The dollar also gained slightly on average in relation to the currencies of the other G-10 currencies. A sizable advance by the dollar relative to the German mark was largely reversed late in the intermeeting period; incoming information suggesting greater strength in the German economy lifted the value of the mark and tended to offset growing concern about the likely effect of the Asian crisis on Germany. The dollar declined somewhat on balance against the yen as heightened prospects for domestic fiscal stimulus in Japan fostered hopes of a less weak performance of the Japanese economy.

M2 and M3 continued to grow at relatively rapid rates in December and apparently also in January. Recent gains in nominal income evidently underpinned much of the greater-than-expected strength in M2 in January; also contributing were a pickup in mortgage refinancing activity and, perhaps, depositor transfers of funds from market instruments whose yields had declined relative to those on M2 assets. Large increases in repurchase agreements contributed to rapid growth of M3 in January; the rise in M3 helped to finance further solid expansion of bank credit. From the fourth quarter of 1996 to the fourth quarter of 1997, M2 increased at a rate somewhat above the upper bound of its range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt expanded in 1997 at a pace somewhat below the middle of its range, reflecting the slow rise in the federal debt.

The staff forecast prepared for this meeting indicated that the expansion of economic activity would slow appreciably during the next few quarters and remain moderate in 1999. The staff analysis suggested that slower growth abroad and the considerable rise that already had occurred in the foreign exchange value of the dollar would exert substantial restraint on the demand for U.S. exports and subject domestic producers to even stiffer competition from imports. An anticipated reduction in the desired rate of inventory accumulation would add to the restraint on the expansion. As output growth slowed, pressures on resources would be expected to diminish somewhat. Nonetheless, it was expected that, consistently measured, inflation would increase to some degree over the ensuing period through 1999, owing in part to an abatement of restraining forces from foreign exchange and oil markets.

In the Committee's discussion of current and prospective economic conditions, members commented that the performance of the economy continued to be quite favorable. They noted that the economy had entered the new year with considerable momentum and very few

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indications that growth was moderating from what appeared to be an unsustainable rate. Nonetheless, their assessments of the various factors bearing on the outlook led them to conclude that appreciably slower economic growth was in the offing for the year ahead, possibly to a pace in the vicinity of current estimates of the economy's long-run growth potential. Many emphasized that the prospects for declining net exports as a consequence of the dollar's appreciation and the crises in a number of Asian economies were a key factor in the outlook for some slowing in the expansion. In addition, a moderating rate of inventory accumulation appeared likely after the rapid buildup during 1997. At the same time, high levels of confidence and generally accommodative financial conditions supported expectations of persisting, though likely diminishing, strength in consumer spending and business fixed investment. The members acknowledged that their forecasts were subject to a great deal of uncertainty because there was little precedent to guide them in their evaluation of the extent and likely effect of Asian market turmoil. In the circumstances, the risks of a considerable deviation on the upside or the downside of their current forecasts were unusually high. Partly as a consequence, the outlook for inflation was quite tentative as well. Moreover, questions persisted about the level and growth of sustainable output. Members observed that price inflation had remained subdued, and by some measures had declined, in recent months despite very tight labor markets and indications of somewhat faster increases in labor compensation.

In keeping with the practice at meetings just before the Federal Reserve's semiannual monetary policy report to the Congress and the Chairman's associated testimony, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members had provided individual projections of the growth in real and nominal GDP, the rate of unemployment, and the rate of inflation for the year ahead. Based on developments over the second half of 1997, the central tendency of the projections for 1998 now pointed to slightly more strength in real GDP and appreciably less inflation than the forecasts prepared at the time of the July 1997 meeting. The forecasts of the rate of expansion in real GDP in 1998 had a central tendency of 2 to 2¾ percent and a full range of 1¾ to 3 percent. Such growth was expected to be associated with a civilian unemployment rate in a range of 4½ to 5 percent in the fourth quarter of this year, implying little or no change from the current level. With regard to nominal GDP growth in 1998, the forecasts were mainly in a range of 3¾ to 4½ percent, with an overall range of 3½ to 5 percent. Projections of the rate of inflation, as measured by the consumer price index, had a central tendency of 1¾ to 2¼ percent, on the high side of the outcome for 1997 when the rise in the index was held down by damped increases in food prices and declines in energy prices. These forecasts took account of likely further technical improvements in the CPI by the Bureau of Labor Statistics that would trim the reported rate. The projections were based on individual views concerning what would be an appropriate policy over the projection horizon to foster the Committee's longer-term goals.

The members stressed that the potential extent of the negative effects of developments in Asia on the nation's trade balance represented a key uncertainty in the economic outlook. On the whole, those effects had been quite limited thus far. Anecdotal reports indi-

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cated that a number of domestic producers, notably of agricultural, lumber, and wood products, had experienced some cancellations or postponements of orders from Asian customers and there was some evidence of increased imports from those nations. Exports to affected Asian nations were likely to be held back by declining incomes and rising prices of U.S. products in local currencies, and reportedly also by difficulties that importing firms in Asia were encountering in securing financing. The eventual effects of the Asian financial turmoil on the U.S. trade balance and the overall economy were unknown—in part because in some key countries needed reforms had yet to be implemented and markets to stabilize—but they clearly seemed likely to become more pronounced in coming months. Net exports also would be held down by the appreciation of the dollar against the currencies of the industrial countries that had occurred earlier in 1997 before the Asian crisis intensified.

Another factor viewed as likely to exert a moderating effect on the growth of economic activity was the expectation of some slowing in inventory investment. In the past year, businesses had added to inventories at a rate that exceeded the rise in final sales, and somewhat reduced accumulation to a pace more in line with that of final sales was seen as a reasonable expectation. Some members expressed reservations, however, about the extent of any weakening in inventory accumulation in light of the relatively favorable economic conditions that they believed were likely to persist over the year ahead.

Members viewed further growth in consumer spending as likely to remain the major factor in sustaining the expansion in overall economic activity. Consumer sentiment was at or close to historically high levels according to recent surveys, evidently reflecting the strong uptrend in employment and income and to some extent the very large cumulative increase in stock market wealth over the course of recent years. Some also noted that consumer debt burdens, while large, were manageable and that such burdens would be lessened for many consumers by their refinancing of home mortgages at the lower mortgage rates now prevailing. Evidence of strength in the consumer sector was supported by upbeat anecdotal reports of retail sales during the holiday season and more recently. While the growth in personal expenditures was likely to moderate somewhat from its recent pace, members did not rule out a more ebullient consumer sector in the context of substantial further growth in disposable incomes, favorable financing conditions for purchases of homes, automobiles, and other consumer durables, and the high level of stock market prices.

Business fixed investment also was expected to provide substantial support to continued economic expansion, though some moderation in purchases of business equipment seemed likely after the exceptionally rapid rates of growth in such investments in recent years. Business sentiment remained generally optimistic, and both debt and equity financing continued to be readily available on attractive terms to most business borrowers. However, early signs of faltering profit trends in some industries, in part related to developments in Asia, appeared to have introduced a cautionary note among some business planners. Members also referred to emerging signs of speculative overbuilding in some areas, especially of commercial structures. Even so, in the absence of unanticipated weakness in consumer expenditures, a variety of favorable factors seemed likely to sustain relatively robust spending on business structures

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and equipment over the year ahead. The latter included increased opportunities to cut costs and enhance efficiency by investing in relatively inexpensive high tech equipment in a period characterized by strong competition in many markets and rising labor compensation associated with tight labor markets.

Residential construction activity had remained relatively robust in recent months and was expected to be well maintained over coming quarters. Positive indications for the housing outlook included relatively low mortgage interest rates, very favorable measures of cash flow affordability, and quite positive homebuying attitudes as expressed in recent surveys. While these factors were expected to help sustain the housing sector over coming months, members noted that housing construction had been high for some time and some cited anecdotal evidence of softening activity in some parts of the country. On balance, only modest, if any, slippage from current levels of home construction activity seemed likely over the year ahead.

With regard to the outlook for inflation, members referred to widespread indications of increasingly tight labor markets and to statistical and anecdotal reports of faster increases in labor compensation. Labor cost increases in recent quarters had been especially rapid in a large segment of the service sector, where foreign competition was not a factor. Some members commented, however, that there were reasons to discount the sharp fourth-quarter increase in the employment cost index because to a large extent it was the result of nonrecurring developments in a limited number of industries. Despite the upward trend in labor compensation, gains in productivity clearly had kept increases in unit labor costs at a very modest level; and with unit nonlabor costs continuing to decline, overall unit cost increases had remained not far above zero. In these circumstances—and in the context of highly competitive conditions in many markets, declines in input prices and in the prices of many commodities, including oil—rising labor costs seemed to pose little risk of an upward impetus to inflation in coming months.

The longer-run outlook for inflation was more clouded and under some scenarios less promising. Inflation expectations had been moving down according to recent surveys, and in the context of relatively modest increases in consumer prices expected over coming months such expectations could continue to move lower, thereby constraining increases in compensation and prices. Nonetheless, some of the factors that had helped to moderate price increases—including declining oil prices, the appreciation of the dollar, and restrained increases in health insurance costs—were not likely to continue to exert benign effects on inflation as time went on. More fundamentally, the productivity improvement that had held down producer costs could not necessarily be counted on to continue to offset such costs, especially if the economic expansion remained sufficiently rapid to put additional pressures on available labor resources.

In keeping with the requirements of the Full Employment and Balanced Growth Act of 1978 (the Humphrey–Hawkins Act), the Committee reviewed the ranges for growth of the monetary and debt aggregates in 1998 that it had established on a tentative basis at its meeting in July 1997. Those ranges included expansion of 1 to 5 percent for M2 and 2 to 6 percent for M3, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The associated range for growth of total domestic non-

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financial debt was provisionally set at 3 to 7 percent for 1998. The tentative ranges for 1998 were unchanged from the ranges that had been adopted initially for 1995 (in July of that year for M3).

In reviewing the tentative ranges, the members took note of a staff projection indicating that, given the members' expectations for the performance of the economy and prices and assuming no major changes in interest rates, M2 likely would grow in 1998 in the upper half of its tentative range, and M3 somewhat above the top of its range. The staff analysis anticipated that the velocity of M2 would continue its recent pattern of relatively stable behavior that was more in line with historical experience than had been the case in the early 1990s. The velocity of M3 was projected to continue to decline at a somewhat faster rate than historical experience would indicate, reflecting the greater use by business firms of institution-only money market funds as a cash management tool and the needs of depository institutions for appreciable non-M2 funding to finance brisk loan growth. The staff projected that the debt of the domestic nonfinancial sectors would grow around or perhaps slightly above the middle of its tentative range, reflecting the credit needs of businesses facing a weaker earnings outlook and larger merger-related retirements of equity.

In their discussion of the ranges for M2 and M3, the members noted that the apparently greater predictability of velocity in recent years could not be counted on to persist, given changes in financial markets that had made investment alternatives more readily available. As a consequence, substantial uncertainty still surrounded projections of money growth consistent with the Committee's basic objectives for monetary policy. In this environment, the members did not see any firm basis for deviating from their recent practice of setting ranges that, assuming velocity behavior in line with historical patterns, would serve as benchmarks for monetary expansion consistent with longer-run price stability and a sustainable rate of real economic growth. The tentative ranges for 1998 had been derived in this way, and Committee members saw no reason to change those ranges at this time. Indeed, adjusting the ranges to center them more closely on growth rates deemed likely to be more consistent with the Committee's expectations for economic activity and prices could foster the misinterpretation that the Committee had become much more confident of the stability and predictability of velocity and was placing greater emphasis on M2 and M3 as gauges of the thrust of monetary policy. Several members commented, however, that the adoption of ranges centered on the Committee's expectations for growth of the monetary aggregates should be reconsidered in the future if the members were to become more confident about the relationship between the growth of the money and measures of aggregate economic performance. The Committee also agreed that the range for nonfinancial debt for 1998 should be left unchanged. The tentative range readily encompassed the pace seen as likely to be associated with the members' forecasts for economic activity and prices.

Accordingly, the following statement of longer-run policy for 1998 was approved for inclusion in the domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at this meeting established ranges for growth of M2

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and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Jordan, Kelley, McTeer, Meyer, and Mses. Minehan, Phillips, and Rivlin. Votes against this action: None.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal to maintain an unchanged policy stance. The economy currently was performing very well and the outlook over the near term was for subdued inflation and continued solid economic growth. Over a longer horizon, the range of possible outcomes was unusually wide, and the direction that policy would need to move to promote sustained expansion and damped inflation was unclear. At this point, the extent to which the still largely anticipated external drag from events in Asia would offset the strong upward momentum in domestic demand was a source of major uncertainty. In addition, it was impossible to predict whether or when the tightness in labor markets would exert a more pronounced effect on labor costs and ultimately on price inflation. Even the thrust of the current stance of monetary policy as it was transmitted through financial markets was open to some question. On the one hand, a real federal funds rate that was on the high side of historical experience and a substantially stronger dollar suggested some restraint. From a different perspective, however, financial conditions seemed to be quite stimulative as evidenced by lower nominal and perhaps real intermediate and long-term interest rates, rising equity prices, ready credit availability, and rapid growth of the broad measures of money and credit. While the members differed to some extent in their forecasts of major trends in the economy and in the risks of alternative outcomes, they agreed that, under foreseeable circumstances, needed adjustments to policy probably could be made on a timely basis once the balance of underlying forces became more evident. Accordingly, a steady policy would not incur an unacceptable risk of a seriously deteriorating economic performance. In the interim, the greater risk would be to make a preemptive policy move on the basis of inadequate evidence regarding underlying economic trends.

In the Committee's discussion of possible intermeeting adjustments to policy, all the members agreed that prevailing uncertainties indicated the desirability of retaining a symmetric instruction in the directive. While a number of members expressed the view that the next policy move was likely to be a tightening action and one member saw a greater probability of an easing action, the uncertainties were sufficiently great to warrant remaining sensitive to the need for a policy change in either direction. Accordingly, a symmetric directive would signal the Committee's readiness to respond promptly to developments that might threaten the economy's satisfactory performance.

At the conclusion of the Committee's discussion, all the members indicated their support of a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent, and all also favored a directive that did not include a presumption about the direction of a change, if any, in the stance of policy during the inter-

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meeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the members decided that a slightly higher or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that economic activity continued to grow rapidly during the closing months of 1997. Nonfarm payroll employment increased sharply further in December after posting very large gains in other recent months; the civilian unemployment rate, at 4.7 percent, remained near its low for the current economic expansion. Industrial production continued to advance at a brisk pace in the fourth quarter. Consumer spending rose appreciably in the quarter, and housing starts remained close to the highs of the current expansion. Business fixed investment weakened following exceptionally strong increases in the second and third quarters; nonfarm inventory accumulation appears to have picked up somewhat. The nominal deficit on U.S. trade in goods and services narrowed significantly on average in October and November from its level in the third quarter. Price inflation has remained subdued despite appreciably faster increases in worker compensation in recent months.

Most interest rates have declined on balance since the day before the Committee meeting on December 16, 1997. Share prices in U.S. equity markets have moved up somewhat over the period; equity markets in some other countries, notably in Asia, have remained volatile. In foreign exchange markets, the value of the dollar has risen over the intermeeting period relative to the currencies of several Asian developing countries, but it has registered only a small increase on average in relation to the currencies of major industrial nations.

M2 and M3 continued to grow at relatively rapid rates in December and apparently also in January. From the fourth quarter of 1996 to the fourth quarter of 1997, M2 expanded at a rate somewhat above the upper bound of its range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt expanded in 1997 at a pace somewhat below the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at this meeting established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a slightly higher federal funds rate or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Jordan, Kelley, Meyer, McTeer, Mses. Minehan, Phillips, and Rivlin. Votes against this action: None

It was agreed that the next meeting of the Committee would be held on Tuesday, March 31, 1998.

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The meeting adjourned at 10:50 a.m.

Donald L. Kohn
Secretary

Meeting Held on March 31, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, March 31, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Ms. Phillips
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Ms. Browne, Messrs. Cecchetti, Dewald, Hakkio, Lindsey, Promisel, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Mr. Slifman, Associate Director, Division of Research and Statistics, Board of Governors

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Assistant Director, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Rasdall, First Vice President, Federal Reserve Bank of Kansas City

Messrs. Goodfriend, Hunter, Kos, Lang, Rolnick, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Richmond, Chicago, New York, Philadelphia, Minneapolis, and Dallas respectively

Ms. Rosenbaum, Vice President, Federal Reserve Bank of Atlanta

Mr. Rudebusch, Research Officer, Federal Reserve Bank of San Francisco

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on February 3–4, 1998, were approved.

The Report of Examination of the System Open Market Account, conducted by the Board's Division of Reserve Bank Operations and Payment Systems as of the close of business on November 6, 1997, was accepted.

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The Manager of the System Open Market Account reported on developments in foreign exchange and international financial markets in the period since the previous meeting on February 3–4, 1998. There were no System open market transactions in foreign currencies during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period from February 4, 1998, through March 30, 1998. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that the economy continued to expand rapidly during the early months of 1998. Apparently, strong growth in private domestic spending for consumption, housing, and business equipment more than offset weakness in net exports and a slight moderation in inventory investment. Total employment continued to rise rapidly, but industrial production increased at a considerably slower pace. Despite indications of persisting pressures on employment costs associated with tight labor markets, price inflation abated further, primarily as a consequence of large declines in energy prices.

Nonfarm payroll employment rose sharply further in January and February. Growth in construction jobs was particularly strong, apparently reflecting in part the unseasonably warm weather across much of the country and the need to repair damage caused by ice storms and heavy rains. In addition, service industries continued to post very large employment gains. By contrast, manufacturing payrolls contracted slightly in February after a sizable increase in January. The civilian unemployment rate edged down to 4.6 percent in February, equaling its low for the current economic expansion.

Industrial production edged up on balance in January and February after having increased rapidly in the second half of 1997. Part of the deceleration stemmed from the depressing effect of unusually warm winter weather on the provision of heating services by utilities. The growth of manufacturing production also slowed considerably as a result of downward adjustments to assemblies of motor vehicles and, more generally, weakness in the output of business equipment. With investment in new manufacturing facilities still brisk and manufacturing output posting only a small advance in the January–February period, the factory operating rate eased a little.

Consumers stepped up their spending in the early months of the year; sentiment remained buoyant in the context of continued strong growth in disposable income and further gains in household wealth. Particularly large increases were recorded in expenditures on durable goods, apparel, and general merchandise. Housing demand also strengthened, with sales of existing homes reaching a record high in February and sales of new homes in January (latest data) almost equaling the previous record. Both housing starts and building permits remained on an upward trend.

Business fixed investment seemed to have rebounded from a small decline in the fourth quarter. Shipments of nondefense capital goods, notably of computing equipment whose prices continued to fall sharply, strengthened substantially in January and February. By contrast, expenditures on transportation equipment were sluggish. Despite further declines in vacancy rates and rising real estate prices, business spending on nonresidential construction also seemed

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to have been lackluster, with such activity not having changed much since last summer.

The pace of business inventory accumulation slowed sharply in January from the fourth-quarter rate. Some of the slowdown reflected a reduction in motor vehicle stocks; the remainder was largely associated with a drop in inventories of nondurable goods at the wholesale level. Inventory–sales ratios for most manufacturing and trade categories were within the ranges experienced over the past year.

The nominal deficit on U.S. trade in goods and services widened substantially in January from its average monthly level for the fourth quarter. The value of exports declined considerably, partly as a result of reduced exports to Asia, but the value of imports changed little. The decrease in exports was mainly in civilian aircraft and other capital goods. The available information indicated that the pace of economic expansion picked up in Europe after having slowed somewhat in the fourth quarter and was still strong on balance in Canada. Economic activity remained weak in Japan and decelerated sharply in Asian countries that had been the focus of financial turmoil.

Consumer prices were little changed on balance in January and February, as substantial declines in energy prices largely offset increases elsewhere. Excluding food and energy items, consumer price inflation picked up somewhat in the first two months of the year from the pace of the second half of 1997; on a year-over-year basis, however, the increase in consumer prices during the twelve months ended in February was slightly smaller than that in the year-earlier period. At the producer level, falling prices for finished energy goods in January and February pulled down the index of prices for all finished items; excluding food and energy, prices were unchanged on balance over the two months. Over the twelve months ended in February, producer price inflation was negligible. Tight labor markets appeared to be putting some upward pressure on labor compensation, but the pickup was limited. The change in average hourly earnings over the twelve months ended in February was only slightly larger than the increase over the year-earlier period.

With economic growth still solid and inflation subdued, the Committee at its meeting on February 3–4, 1998, had adopted a directive that called for maintaining conditions in reserve markets that would be consistent with an unchanged federal funds rate of about 5½ percent. The substantial uncertainties about the future strength of economic activity and inflation suggested that the next change in policy could be in either direction, and the Committee also had agreed that the directive should not contain a presumption about the direction of any change in the stance of policy during the intermeeting period. The reserve market conditions associated with this directive had been expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

Open market operations throughout the intermeeting period were directed toward maintaining reserve conditions consistent with the intended average for the federal funds rate of around 5½ percent, and the rate fluctuated in a narrow range around that level. By contrast, interest rates in other domestic financial markets generally rose somewhat on balance over the period in response to incoming information that suggested aggregate private demand remained robust. Despite the rise in rates and some erosion in the outlook for near-term corporate profits, share prices in

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U.S. equity markets moved up substantially further.

In foreign exchange markets, the dollar appreciated somewhat on balance over the intermeeting period in relation to the currencies of the other major industrial countries. Against a background of weakening growth in Japan and continued uncertainty about the prospects for fiscal stimulus in that country, the dollar rose considerably against the yen. The dollar changed little against the mark and other continental European currencies but declined against the Canadian dollar and the British pound. The dollar also depreciated significantly relative to the currencies of several emerging market economies in Asia, reflecting market assessments that progress had been made in reforming economic policies and financial and commercial practices in most of those countries.

The available information for February and part of March indicated that M2 and M3 expanded more rapidly than the Committee had anticipated at the time of its February meeting. On a quarterly average basis, growth of both monetary aggregates picked up somewhat in the first quarter from already robust rates in the fourth quarter. The increased demand for M2 was perhaps associated in part with the reduced attractiveness of longer-term fixed rate market assets, whose yields had declined significantly relative to the returns on liquid investment components of M2. In addition, households might have been trying to rebalance asset portfolios that had become more heavily weighted in equities as a result of the run-up in stock prices. The pickup in M3 growth reflected a surge in bank issuance of large time deposits to finance strong demands for loans by businesses and households. The expansion of total domestic nonfinancial debt also strengthened over recent months in response to heavy private demands for credit.

The staff forecast prepared for this meeting indicated that the expansion of economic activity would slow appreciably during the next few quarters and remain moderate in 1999. The staff analysis suggested that the surge in household net worth over the past several years would help to support sizable, though gradually diminishing, gains in consumer spending; favorable cash flow affordability would underpin housing demand at a relatively high level; and substantial increases in capital spending would persist until slower growth in business sales and weaker profits began to have a restraining effect in 1999. Reduced growth of foreign economic activity and the lagged effects of the considerable rise that had occurred in the foreign exchange value of the dollar were expected to exert substantial restraint on the demand for U.S. exports over the projection period and to increase the pressures on domestic producers that face import competition. An anticipated slowdown in the pace of inventory accumulation also would restrain domestic production as stocks were brought into balance with the expected lower trajectory for sales. Although pressures on production resources would abate to a degree as output growth slowed, inflation was expected to increase somewhat in response to persisting tightness in labor markets and a diminishing drag from non-oil import prices.

In the Committee's discussion of current and prospective developments, members commented on the persistence of unusually favorable economic conditions, characterized by strong growth and low inflation, but a number questioned how long these conditions might last without a policy adjustment.

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Domestic demand was exceeding expectations and was likely to continue to increase rapidly for some time, supported by accommodative conditions in key segments of financial markets. Developments in foreign trade were moderating demands on domestic resources; but with domestic spending strong, members were becoming more concerned that those developments might not exert enough restraint on aggregate demand to slow the expansion to a sustainable pace in line with the growth of the economy's potential. Despite tightening labor markets, inflation prospects remained quite favorable for a while as a number of factors—some temporary—helped to damp near-term pressures on prices. Nonetheless, in the absence of some slowing in the expansion, labor compensation probably would continue to accelerate and increasingly outpace productivity, adding to pressures on prices.

In their review of the outlook for spending in key sectors of the domestic economy, members saw little reason to anticipate substantial slowing in the growth of consumer or business expenditures in coming quarters, and they also expected housing activity to be maintained at a relatively high level. The recent further increases in equity prices from already high levels played an important role in the assessments of several members. The stock market's rise was viewed as somewhat puzzling, given indications of some slowing in the growth of profits and the potential for earnings disappointments as the expansion in spending moderated and profit margins narrowed in the context of more rapid labor cost increases. So long as a high degree of optimism in the stock market persisted, however, the elevated level of financial wealth and the low cost of capital should continue to boost spending. Consumer expenditures, especially for durable goods, had risen sharply thus far this year, and the factors that had fueled that expansion were still unusually positive. They included large increases in employment and personal incomes, the continuing uptrend in financial wealth relative to disposable income, and, in these circumstances, the persistence of a very high level of consumer confidence. Attractive financing conditions and favorable business confidence also were expected to support substantial further growth in business investment, especially in high tech equipment that was characterized by rapid product improvement and falling prices. Investment in nonresidential structures, notably in office and other commercial markets, seemed likely to strengthen somewhat in response to reduced vacancy rates and sizable increases in rents in many areas; indeed, several members again reported indications of speculative nonresidential construction in some parts of the country. Residential construction was expected to be maintained at a high level, though single-family starts might soften over the next few months after a surge that appeared to have been related to relatively favorable weather conditions during the winter. With mortgage rates at their recent reduced levels and incomes continuing to rise, the cash flow affordability of home ownership was exceptionally favorable.

Developments in two areas of expenditures were thought likely to exert some restraining effect on the overall expansion in economic activity over coming quarters. One was business inventory accumulation, which had exceeded the robust growth in final sales in 1997 and probably would moderate this year as business firms sought to restrain the buildup in their inventories to keep them in better alignment with the expected moderation of gains in sales.

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The second, foreign trade developments, also was likely to have a damping influence on the domestic economy. While the lagged effects of the dollar's appreciation and economic conditions in key U.S. trading partners around the world were important factors in this assessment, members focused in this discussion on the effects of weakness in several Asian economies. Conditions in Japan and in key emerging market economies in Asia were still quite fragile, adjustments on the real side of the economy were just beginning to be felt in some cases, and outcomes for economic growth and exchange rates were still very much in doubt. Nonetheless, some progress had been made in putting recovery programs together, and financial markets had seemed to stabilize in several countries. Anecdotal reports of adverse repercussions on individual U.S. firms from the Asian financial turmoil had increased somewhat since the Committee's previous meeting, but the direct overall impact on the U.S. economy was still limited. Indeed, developments in Asia also appeared to have had positive, albeit indirect, effects on domestic demand and prices in the near term by exerting some downward pressure on U.S. interest rates and world oil prices. Prices in the United States of a number of Asian goods and of domestic products competing with those goods had been lowered. Over time, conditions in key Asian economies were thought likely to have a more pronounced retarding effect on the U.S. economy. While the eventual dimensions of that effect remained uncertain, a number of members commented that, on the basis of developments to date, they might turn out to be less negative than had been expected earlier, or at least that some "worst case" outcomes seemed less likely.

With regard to the outlook for inflation, members observed that price inflation remained quite low—in fact, it was still declining by some measures—and there was little evidence of any potential acceleration in current price data or in anecdotal reports from around the country. Nonetheless, as they had at previous meetings, members expressed particular concern about the outlook for prices in the absence of appreciable slowing in the growth of aggregate demand, which appeared to be adding to pressures on labor resources. Anecdotal reports from across the nation continued to suggest exceptionally tight labor markets and growing indications of somewhat faster increases in labor compensation. To date, unit labor costs had been contained by large capital investments and other initiatives that had raised the productivity of labor. But additional improvements in productivity growth could not be counted on to offset further increases in the rate of growth of labor compensation, which were more likely to occur especially if labor markets were to tighten further. Moreover, the effects of a number of special factors that had tended to limit cost pressures and price inflation in recent years were not likely to persist; these included the declines in world oil prices, the subdued increases in the costs of health benefits, and the lagged effects of the appreciation of the dollar. To be sure, the factors that had produced the favorable inflation results of recent years were not all well understood, and consequently expectations of greater price pressures had to be tentative. On balance, though any upsurge in inflation seemed unlikely in the nearer term, the risk that inflation might move higher over the longer run seemed to have increased.

Despite perceptions of a greater risk of rising inflation over time, all but one of the members indicated in the Com-

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mittee's policy discussion that they preferred, or could accept, a proposal to maintain an unchanged policy stance that also included a shift from the current symmetrical directive to an asymmetrical directive tilted toward restraint. The members agreed that should the strength of the economic expansion and the firming of labor markets persist, policy tightening likely would be needed at some point to head off imbalances that over time would undermine the expansion in economic activity. Most saw little urgency to tighten policy at this meeting, however. The economy might well continue to accommodate relatively robust economic growth and a high level of resource use for an extended period without a rise in inflation. Some members noted that price increases would be held down for a while by the effects of the higher dollar, which had not worked their way fully through domestic prices. Moreover, inflation continued to fall by some measures and inflation expectations still seemed to be adjusting downward toward actual inflation; further declines in these expectations would restrain increases in compensation and prices. Members also noted that the ultimate extent of retarding effects from the financial turmoil in Asia was still uncertain, and several cited the possibility of a downward adjustment in the stock market, perhaps in response to disappointing growth in business profits, that could have an adverse impact on business and consumer confidence. In these circumstances, a preemptive policy move to head off rising inflation could prove premature or perhaps even unwarranted; indeed, in the view of some, a tightening move was not inevitable. Moreover, because a policy action was not currently anticipated, some commented that a tightening could produce an outsized and undesirable response in financial markets. On balance, in light of the uncertainties in the outlook and given that a variety of special factors would continue to contain inflation for a time, the Committee could await further developments bearing on the strength of inflationary pressures without incurring a significant risk that disruptive policy actions would be needed later in response to an upturn in inflation and inflation expectations.

One member indicated a strong preference for an immediate policy tightening move, largely on the grounds that under current conditions relatively rapid growth in money and credit was not consistent with continued progress toward reducing inflation. A number of other members also commented that the strength of the monetary aggregates, especially if it should persist, was suggesting ample liquidity and accommodative financial conditions. In addition, some cited ebullient equity markets and narrow risk spreads in credit markets as additional evidence that financial conditions were not restraining final demands very much. These were factors that they would weigh in their evaluation of the need for, and timing of, a policy tightening move.

The members agreed that they should be particularly sensitive to developments that might signal rising inflation pressures, and in that regard a shift to an asymmetric directive seemed desirable. Such a directive would be consistent with the Committee's judgment that the information that had become available since a symmetric directive was last adopted in February had altered the inflation risks enough to make some tightening a likely prospect in the not too distant future. In that regard several suggested that the need for some policy tightening could well materialize in the near future.

At the conclusion of the Committee's discussion, all but one member sup-

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ported a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent and that contained a bias toward the possible firming of reserve conditions and a higher federal funds rate. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with considerable moderation in the growth in M2 and M3 over the months ahead.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that economic activity continued to grow rapidly during the early months of 1998. Nonfarm payroll employment increased sharply further in January and February, and the civilian unemployment rate, at 4.6 percent in February, equaled its low for the current economic expansion. However, growth in manufacturing payroll employment was down over the first two months of the year, and factory output decelerated appreciably. Consumer spending has risen considerably further since year-end, and housing activity also has strengthened in recent months. Available indicators point to a sharp rebound in business fixed investment following a small decline in the fourth quarter. Fragmentary data on nonfarm inventories suggest a slower rate of accumulation early in the year. The nominal deficit on U.S. trade in goods and services widened substantially in January from its average monthly rate in the fourth quarter. Despite indications of persisting pressures on employment costs associated with tight labor markets, price inflation has abated further, primarily as a consequence of large declines in energy prices.

Interest rates generally have risen somewhat on balance over the intermeeting period. Share prices in U.S. equity markets have moved up substantially further over the period. In foreign exchange markets, the value of the dollar has increased somewhat over the period in relation to the currencies of other major industrial nations, but it has depreciated relative to the currencies of most emerging market economies in Asia.

Growth of M2 and M3 picked up somewhat in the first quarter from already robust rates in the fourth quarter. Expansion of total domestic nonfinancial debt also has strengthened over recent months.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in February established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a somewhat higher federal funds rate would or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with considerable moderation in the growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich,

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Hoenig, Kelley, Meyer, Mses. Minehan, Phillips, Mr. Poole, and Ms. Rivlin. Vote against this action: Mr. Jordan.

Mr. Jordan dissented because growth rates of various measures of money and credit in the second half of 1997 and the first quarter of this year were not consistent in his view with continued progress in reducing inflation. Recent price statistics understated the trend rates of inflation. The one-time effects of falling oil prices, lower food prices, and recent appreciation of the dollar on foreign exchange markets provided only a temporary reduction of inflation. While some reacceleration of reported rates of inflation was probably unavoidable, sustained rapid money growth would risk even higher inflation in future years. The durability of the economic expansion would be jeopardized by price and wage decisions reflecting expectations that the purchasing power of the dollar would decline at faster rates in the future. Once such expectations became imbedded in the economy, even stronger policy actions would be required in order to reestablish a downward trend of inflation.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 19, 1998.

The meeting adjourned at 1:05 p.m.

Donald L. Kohn
Secretary

Meeting Held on May 19, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 19, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Ms. Phillips
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Ms. Browne, Messrs. Cecchetti, Dewald, Hakkio, Lindsey, Simpson, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Ms. Fox, Deputy Congressional Liaison, Office of Board Members, Board of Governors

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

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Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Assistant Director, Division of Monetary Affairs, Board of Governors

Ms. Garrett, Economist, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Kumasaka, Research Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Eisenbeis, Goodfriend, Hunter, Lang, Rolnick, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Richmond, Chicago, Philadelphia, Minneapolis, and Dallas respectively

Messrs. Altig, Bentley, and Judd, Vice Presidents, Federal Reserve Banks of Cleveland, New York, and San Francisco respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 31, 1998, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange markets during the period March 31, 1998, through May 18, 1998. There were no System open market transactions in foreign currencies during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period March 31, 1998, through May 18, 1998. By unanimous vote, the Committee ratified these transactions.

The Manager informed the Committee of his intention to discuss with market participants proposed changes in the procedures for lending securities from the System Open Market Account. The changes would be intended to adapt the lending program to the evolving structure of the U.S. Treasury securities market. They are designed to make System securities lending more effective at helping to relieve occasional significant shortages of particular securities, which could cause disruptions to the market. In a brief discussion, Committee members sought clarification of some of the proposed details of the new program and how it would fit with the Federal Reserve's broader responsibilities. Action to amend paragraph 2 of the Authorization for Domestic Open Market Operations would be required at a later date when the details of the new program had been decided upon after discussions with market participants.

The Committee then turned to a discussion of the economic and financial outlook, and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the economy continued to expand rapidly in 1998. Strength in consumption, business outlays for durable equipment, and homebuilding boosted growth in domestic final demand to a very rapid pace in the first quarter, and there had been indi-

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cations of slower expansion since then. However, weakening net exports were exerting a considerable drag on economic growth. Moreover, the extraordinary pace of inventory investment thus far this year might foreshadow less robust expansion ahead. Payroll employment remained on a brisk uptrend, but industrial production decelerated sharply after having surged in the second half of last year. Despite indications of persisting pressures on employment costs associated with tight labor markets, consumer price inflation remained subdued, importantly reflecting large declines in energy prices.

Nonfarm payroll employment registered another large increase in April after a small decline in March; these data, along with the still-low level of initial claims for unemployment insurance in recent weeks, suggested that labor demand had remained robust thus far in 1998. Hiring in the trade, finance and real estate, and services industries was brisk in April; employment in construction retraced part of an apparently weather-related drop in March. The number of manufacturing jobs declined in April for a second consecutive month. The civilian unemployment rate fell sharply, to 4.3 percent in April, after having averaged around 4¾ percent since last November.

Industrial production rose somewhat over March and April after having weakened earlier in the year. Part of the slowdown this year, following rapid growth in the second half of last year, was attributable to weakness in utility output associated with unusually warm winter weather across much of the country. More importantly, though, manufacturing output had changed little on balance in recent months. In April, a pickup in the production of business equipment, particularly of information processing equipment, was largely offset by further declines in the output of construction supplies, basic metals, and nondurable materials. The production of consumer goods was unchanged. The factory operating rate eased further in April, reflecting the continuing brisk expansion in manufacturing facilities and slow growth in output.

Consumer spending had remained strong this year in the context of robust gains in income and household net worth and of very favorable consumer sentiment. Total retail sales rose appreciably in April, boosted by increases in purchases of automobiles and nondurable goods. Housing demand and residential construction activity also continued to increase at a rapid pace this year. Home sales were at very high levels, reflecting the continuing improvement in housing affordability as a result of declining mortgage rates. Although housing starts slipped in April, they remained at an elevated level.

Business fixed investment rebounded sharply in the first quarter from a small decline in the fourth quarter of 1997. A surge in expenditures on producers' durable equipment, notably on computers, communications equipment, and heavy trucks, more than offset continued weakness in outlays for nonresidential structures. While available indicators pointed to further substantial gains in equipment purchases over coming months, data on construction contracts offered little evidence of a pickup in nonresidential construction activity in the near term, even though vacancy rates were declining and office rents were rising.

Business inventories increased at a very rapid pace in the first quarter, but with sales strong, inventory–sales ratios remained within their ranges over the past year. In manufacturing, stock accumulation slowed in March after having increased fairly rapidly in January and

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February. At the wholesale level, inventories rose about in line with sales during the quarter, and in the retail sector inventories built up at a greatly accelerated pace in the first quarter.

The nominal deficit on U.S. trade in goods and services widened substantially in January and February from its average monthly rate in the fourth quarter. The value of exports declined considerably in the January–February period, with most of the drop attributable to reduced sales to Asian countries. The decrease in exports was concentrated in agricultural products, industrial supplies, and machinery. The value of imports rose slightly, largely reflecting higher amounts of imported automotive products and higher service payments. The available information suggested that economic growth in continental Europe strengthened in the first quarter, with strong domestic demand apparently offsetting the effects of Asian turmoil on foreign trade. Robust domestic demand also continued to buoy the Canadian economy. By contrast, economic activity in Japan contracted in the first quarter and decelerated sharply further in Asian countries that had experienced financial turmoil.

Consumer prices were unchanged in March and rose moderately in April. Energy prices were down slightly further in April after having declined markedly in previous months, and food prices increased a little; excluding food and energy, consumer price inflation picked up in April as prices of services accelerated and prices of tobacco surged higher. Over the course of recent months, core consumer inflation had accelerated to rates that were somewhat above those registered earlier. Even so, on a year-over-year basis, the increases in total and core consumer prices were substantially smaller over the twelve months ended in April than they had been in the year-earlier period; falling import prices apparently helped damp the goods component of the index. At the producer level, price inflation of finished goods other than food and energy picked up a bit in April, but it was considerably lower over the twelve months ended in April than over the year-earlier interval. Inflation at earlier stages of production also remained subdued. The rate of increase in hourly compensation of private industry workers slowed in the first quarter, reflecting smaller advances in both the wage and benefit components of the index; however, compensation costs accelerated appreciably on a year-over-year basis, primarily as a result of faster growth in wages and salaries.

At its meeting on March 31, 1998, the Committee adopted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate averaging around 5½ percent. However, in light of increased concerns that growth in aggregate demand might outpace the expansion of the economy's potential for some time, possibly generating inflationary imbalances in labor markets, the Committee decided that the directive should include a bias toward the possible firming of reserve conditions and a higher federal funds rate. The reserve conditions associated with this directive were expected to be consistent with considerable moderation in the growth in M2 and M3 over the months ahead.

Open market operations throughout the intermeeting period were directed toward maintaining reserve conditions consistent with the intended average of around 5½ percent for the federal funds rate. Though tax flows were heavy at times and reserves were drained from depository institutions as tax payments spilled into Treasury deposits at the Fed-

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eral Reserve Banks, the federal funds rate averaged a little below its intended level over the period. Most other market interest rates declined slightly on balance over the intermeeting period; incoming data suggested that labor markets remained tight and that the economy retained considerable upward momentum, but market participants evidently gave greater weight to information indicating that wage and price inflation was well contained in the first quarter. Share prices in U.S. equity markets rose further despite some reports of soft corporate earnings, and equity prices in most other industrial countries also reached new highs.

In foreign exchange markets, the trade-weighted value of the dollar in terms of major currencies changed little on balance over the period. The dollar declined considerably against the German mark and other continental European countries amid signs of strong growth in the German economy and further progress in resolving the outstanding issues associated with next year's launch of the euro; French and German interest rates also rose slightly over the period. The dollar appreciated somewhat against the yen; the announcement of a large fiscal stimulus package and Japan's intervention in support of the yen did not offset indications of further weakening in the Japanese economy and related declines in Japanese interest rates. Other Asian financial markets came under renewed pressure after a brief period of relative calm. The currencies of several key Asian emerging market economies depreciated considerably against the dollar; and in sharp contrast to the performance of equity markets in most industrial countries, prices in Asian equity markets declined substantially on balance over the period to near their lows of late 1997 or early 1998.

M2 and M3 expanded briskly further in April, but data for late April and early May showed M2 declining and M3 leveling out; much of the fluctuation in M2 during the April–May period appeared to be related to movements of funds associated with unusually heavy nonwithheld tax payments and a surge in mortgage refinancings to take advantage of lower long-term rates. On balance, the underlying growth of these aggregates seemed to be slowing from the pace of the first quarter. The moderation in M3 partly reflected a reduced need for non-M2 sources of funds at a time when bank credit expansion seemed to be slowing. Growth of total domestic nonfinancial debt apparently had slipped somewhat after picking up earlier in the year.

The staff forecast prepared for this meeting indicated that the expansion of economic activity would slow considerably during the next few quarters and remain moderate in 1999. Reduced growth of foreign economic activity and the lagged effects of the sizable rise that had occurred in the foreign exchange value of the dollar were expected to place substantial restraint on the demand for U.S. exports and to add to the pressures on domestic producers to hold down prices to meet import competition. An anticipated sharp slowdown in the pace of inventory accumulation also would damp domestic production as the growth of stocks was brought into balance with the expected more moderate trajectory of final sales. The staff analysis suggested that further strong gains in income, along with the surge in household net worth over the past several years, would support brisk, though gradually diminishing, gains in consumer spending. Housing demand, fostered by the favorable cash flow affordability of home ownership, was expected to remain at a generally high

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level, though the anticipated slowing in income growth over the projection period would damp residential construction activity somewhat. Substantial increases in capital spending would continue, but slower growth in business sales and profits would produce a gradual deceleration. While pressures on production resources were likely to abate to a degree as output growth slowed, inflation was expected to increase somewhat from its recent pace in response to rising compensation costs associated with persisting tightness in labor markets, a limited rebound in energy prices, and a diminishing drag on non-oil import prices.

In the Committee's discussion of current and prospective economic developments, members noted the exceptional strength in domestic final demand and viewed robust further expansion in such demand as highly likely. Final purchases were being supported by accommodative financial conditions, especially a rising equity market, by ebullient consumer sentiment, and by business spending on productivity-enhancing equipment. While there were limited indications of weakness in some sectors of the economy—such as manufacturing, energy, and agriculture in some areas—the members did not see conclusive evidence of appreciable moderation in the pace of the overall economic expansion. Nonetheless, they generally believed that substantial moderation in the expansion was a likely prospect in coming quarters, largely as a consequence of a marked slowing in inventory investment from the clearly unsustainable pace of the first quarter and, to a lesser extent, from some further weakness in net exports. The outlook for the latter was especially uncertain, and the weakness could be greater than previously anticipated owing to renewed turmoil in emerging Asian economies and pronounced weakness in Japan. Whether the moderation in U.S. economic growth would be sufficient to forestall cost increases arising from tight labor markets that in turn would add to pressures on prices was open to question. To date, developments in business costs had been relatively benign, owing to an important extent to somewhat faster productivity growth. This circumstance and a number of one-time influences holding down costs and prices had contained inflation at rates that were lower than those seen in several decades, and probably would continue to do so for a while. But the members generally were concerned that inflation might begin to rise over the intermediate term, especially if labor markets tightened further.

In their assessment of the factors underlying the persisting strength of aggregate final demand, members took particular note of the effect of accommodative financial conditions. The rapid growth in consumer spending was being bolstered by large gains in stock market wealth; and the strength in housing and other interest-sensitive consumer expenditures also reflected declines in nominal, and perhaps in real, intermediate- and long-term interest rates and the ample availability of loans. Likewise, the ready availability of equity and debt financing on favorable terms was a key factor in the continuing robust growth of business investment. Indeed, some members expressed concern that the widespread perceptions of reduced risk or complacency that had bolstered equity prices beyond levels that seemed justified by fundamentals were beginning to be felt in a variety of other markets as well, including commercial and residential properties, business ventures, and land. In the view of a number of members, rapid growth of the monetary aggregates, though it had slowed very recently, was a further indication that

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financial conditions were not restraining economic activity.

Despite the failure of domestic demand to moderate in line with their earlier expectations, the members were persuaded that appreciable slowing in the growth of economic activity was a likely prospect over the course of coming quarters even though its exact timing and extent were unknown. Key elements in this assessment were the outlook for inventories and net exports. The surge in inventory accumulation in the first quarter did not appear to have resulted in overall stock imbalances as evidenced by stock–sales ratios or anecdotal reports. Even so, growth in inventory investment at a pace sharply exceeding the sustainable growth of final sales was unlikely to continue for an extended period. Given the ample availability of industrial capacity and the related absence of pressures on lead or delivery times, business firms did not need to build precautionary stocks. Thus, inventory investment was likely to respond to the expected deceleration in final sales over coming quarters. Some members expressed reservations about the probable extent of the deceleration in the period ahead, especially in the context of their expectations of a still relatively robust uptrend in final sales.

Developments in Asia clearly were having adverse effects on a number of U.S. industries, but the overall effects on the U.S. economy appeared to have been limited thus far. Indeed, the direct effects of the Asian financial and economic problems on U.S. trade over time needed to be weighed against their indirect but positive effects in the near term in helping to hold down U.S. interest rates and in reducing the prices of oil and other imported commodities. However, members were concerned that, as evidenced by the most recent developments, conditions in Asian financial markets and economies were deteriorating further, with potentially adverse consequences for net U.S. exports. Of particular concern in this regard was the possibility of worsening economic conditions in Japan and the negative implications not only for U.S. trade with Japan but for worldwide trade and financial markets. Some members also commented that unsettled financial and economic conditions in East Asia could tend to exacerbate the economic problems of several important emerging economies in other parts of the world, including major Latin American trading partners of the United States. On balance, forecasts of a limited further drag on U.S. net exports from developments in Asia were subject to substantial uncertainty, with the risks tilted toward a greater effect on the U.S. economy than had been anticipated earlier. Moreover, the lingering effects of the dollar's appreciation last year against a broad array of currencies would continue to depress the nation's foreign trade position for some time.

The decline in the unemployment rate to its lowest level in nearly three decades underscored anecdotal reports of further tightening in labor markets in recent months and added to concerns about the outlook for inflation. Though the first-quarter data had not suggested as steep an increase as a number of observers had anticipated, labor compensation clearly was trending higher. But as suggested by the rise until recently in profit margins, businesses had been able to realize productivity gains that tended to offset the faster increases in compensation costs. Indeed, while the most recent data were difficult to read, once likely revisions were taken into account productivity improvements could well be on a steeper uptrend than had been estimated earlier. Even so, the members remained concerned that if

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pressures on labor resources continued to intensify, the associated increases in labor compensation would at some point significantly exceed the gains in productivity. The resulting pressures on prices might be muted, but probably only for a time, by the inability of many business firms in highly competitive markets to raise their prices or to raise them sufficiently to offset rising costs. Some members emphasized that a number of developments that had held down prices, including the dollar's sizable appreciation last year, the drop in world oil prices, and the downtrend in employee benefit cost increases, were unlikely to be repeated over the coming year and could even be reversed to a degree. Members acknowledged, however, that the nexus between labor market tightness, accelerating labor costs, and the effects on price inflation was very difficult to ascertain and analyses based on earlier patterns that pointed to rising inflation had proved consistently wrong in recent years.

In the Committee's discussion of monetary policy for the intermeeting period ahead, a majority of the members indicated that they preferred or could accept an unchanged policy. These members also expressed a preference for retaining the asymmetric instruction in the directive that the Committee had adopted at the previous meeting. In this view, the uncertainties in the outlook for economic expansion and inflation remained sufficiently great to warrant a continued wait-and-see policy stance. Considerations underlying this view included the possibility that financial and economic conditions in Asia might worsen further and exert a stronger retarding effect on the performance of the U.S. economy than presently seemed to be in train. A good deal of uncertainty also surrounded the potential extent to which developments in the domestic economy, notably the pace of inventory accumulation over coming months, might foster slower economic expansion and the related degree to which pressures in labor markets would be affected. Moreover, considerable questions remained about the relationship of labor market pressures to inflation. In these circumstances, it was possible that inflation would continue to be contained, though the risks clearly seemed to be tilted in the direction that action would become necessary at some point to keep inflation low.

While a delay in implementing a tighter policy that ultimately proved to be needed to curb rising inflation involved some risks, many of the members concurred in the view that the potential costs of postponing action for a limited time were small. By some measures, inflation had continued to drop in the first quarter, and the appreciation of the dollar, reduced commodity prices, and low—if not declining—inflation expectations would help to hold down nominal wage increases and price pressures for some time, even if, as a number of members suspected, the economy was now producing beyond its long-run potential. Forecasts of rising inflation had proved unreliable and needed to be viewed in light of the considerable uncertainties surrounding them. The members recognized, however, that the longer any needed action was delayed, the more important it would be to take prompt and perhaps vigorous action once the danger of rising inflation became clearer.

Another reason for not taking action at this meeting was the possibility that even a modest tightening action could have outsized effects on the already very sensitive financial markets in Asia. The resulting unsettlement could have substantial adverse repercussions on U.S. financial markets and, over time, on the

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U.S. economy. Many of the members emphasized, however, that market considerations could not be allowed to jeopardize the effective conduct of a U.S. monetary policy aimed at an optimal performance of the U.S. economy. Indeed, such a performance would best serve the interests of troubled financial markets and economies abroad.

A number of members indicated that the decision was a close call for them. In this regard, some emphasized that financial conditions were very accommodative in terms of the ample availability of financing to most borrowers on very attractive terms and increases in equity prices. Several expressed concern that the persistence of quite rapid monetary growth this year was symptomatic of a monetary policy that was not positioned to restrain ebullient domestic demand sufficiently, even if short-term real interest rates were quite high. Although some of these members could accept postponing action for the present to await further information on the balance of risks, two members, while acknowledging the uncertainties that surrounded the economic outlook, indicated a strong preference for tightening the stance of policy at this meeting. They believed that current policy was accommodating excessive strength in aggregate demand that very likely would be felt in higher inflation before long. Prompt tightening was needed to avert the necessity of stronger and potentially disruptive policy actions later to contain inflation.

All the members who intended to vote for an unchanged policy at this meeting supported the retention of a directive that was biased toward restraint. In their view, current developments did not call for any policy action, at least at this meeting, but because they felt the risks were tilted in the direction of rising inflation, a policy tightening move, possibly in the near future, was a likely though not an inevitable prospect.

At the conclusion of the Committee's discussion, all but two of the members supported a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent and that contained a bias toward the possible firming of reserve conditions and a higher federal funds rate. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with considerable moderation in the growth of M2 and M3 over the months ahead.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that economic activity has continued to grow rapidly in 1998. Nonfarm payroll employment registered another substantial increase in April after a slight decline in March, and the civilian unemployment rate fell to 4.3 percent in April. However, factory output has changed little on balance in recent months. Retail sales grew appreciably in April, and consumer spending as a whole has been very strong this year. Residential sales and construction also have strengthened this year. Business fixed investment rebounded sharply in the first quarter after having declined slightly in the fourth quarter, and available indicators point to continuing strength over coming months. Business

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inventories appear to have increased very rapidly in the first quarter. The nominal deficit on U.S. trade in goods and services widened substantially in January and February from its average monthly rate in the fourth quarter. Despite indications of persisting pressures on employment costs associated with tight labor markets, price inflation has remained subdued this year, primarily as a consequence of large declines in energy prices.

Most market interest rates have declined slightly on balance over the intermeeting period. Share prices in U.S. equity markets have moved up a little further. In foreign exchange markets, the trade-weighted value of the dollar in terms of major currencies has changed little on net over the period. However, the dollar has risen on balance against the currencies of key emerging market economies, particularly those in Asia. Equity markets in Asia have fallen substantially over the period to near their lows of late 1997, while those in Europe have risen to new highs.

M2 and M3 expanded briskly further in April, but data for late April and early May show M2 declining and M3 leveling out. The swing in these measures seemed to be related largely to movements of funds associated with tax payments. Expansion of total domestic nonfinancial debt appears to have moderated somewhat after a pickup earlier in the year.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in February established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic non-financial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a somewhat higher federal funds rate would or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with considerable moderation in the growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Mses. Minehan, Phillips, and Rivlin. Votes against this action: Messrs. Jordan and Poole.

Mr. Poole dissented because he believed that the sustained increase in money growth in recent quarters and associated accommodative conditions in the credit markets pointed to rising inflation. Although faster productivity growth suggested that trend output growth might be modestly higher than previously thought, the growth rate of aggregate demand over the past two years clearly had exceeded the economy's long-run growth potential. Without a reduction of aggregate demand growth, inflation would rise. In his view, the Federal Reserve should therefore take prompt action to reduce money growth to limit the rise in inflation and to avoid an increase in longer-term inflation expectations, which would tend to destabilize aggregate employment and financial markets.

Mr. Jordan also noted that the monetary and credit aggregates had accelerated further from already rapid growth rates in 1997. In his view, these high growth rates were fueling unsustainably rapid increases of real estate and other asset prices, and reports of "too much cash chasing too few deals" were becoming more frequent. Anticipated gains on both real and financial investments had risen relative to the cost of

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borrowed funds. In these circumstances, it was increasingly likely that the Committee would face a choice between smaller increases in interest rates sooner versus larger increases later. He added that maximum sustainable economic growth occurs when businesses and households act on the assumption that the dollar will maintain its value over time, and nothing he had heard from consumer groups, bankers, or other business people in his District led him to believe that decisions were being made in the expectation that the purchasing power of the dollar would be stable. Furthermore, expectations that market values of income-producing investments would continuously rise relative to underlying earning streams were not consistent with a stable purchasing power of money. He also believed that the view that real interest rates currently were high was not confirmed by observed behavior. Bankers told him that both consumers and businesses believed that credit was cheap and plentiful. These potentially inflationary conditions and imbalances in the economy were not conducive to sustained maximum growth.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, June 30–July 1, 1998.

The meeting adjourned at 1:35 p.m.

Donald L. Kohn
Secretary

Meeting Held on June 30–July 1, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, June 30, 1998, at 1:30 p.m. and continued on Wednesday, July 1, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Ms. Browne, Messrs. Dewald, Hakkio, Lindsey, Simpson, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

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Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Assistant Director, Division of Monetary Affairs, Board of Governors

Messrs. Small,[3] Reifschneider,[3] and Whitesell, Section Chiefs, Divisions of Monetary Affairs, Research and Statistics, and Monetary Affairs respectively, Board of Governors

Ms. Kusko,[4] Senior Economist, Division of Research and Statistics, Board of Governors

Mr. Elmendorf[4] and Ms. Garrett, Economists, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Beebe, Eisenbeis, Goodfriend, Hunter, Lang, Rosenblum, and Steindel, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, Chicago, Philadelphia, Dallas, and New York respectively

Ms. Perelmuter, Vice President, Federal Reserve Bank of New York

Mr. Bryan, Assistant Vice President, Federal Reserve Bank of Cleveland

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on May 19, 1998, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange markets and on System transactions in those markets during the period May 19, 1998, through June 30, 1998. By unanimous vote, the Committee ratified these transactions.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period May 19, 1998, through June 30, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook, the ranges for the growth of money and debt in 1998 and 1999, and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the expansion in economic activity had slowed considerably after a very rapid advance in the first quarter. Much of the slowdown reflected a substantial moderation in business inventory accumulation. Consumer spending, business investment, and residential homebuilding, though remaining robust, apparently also were decelerating somewhat after very strong

3. Attended portion of the meeting relating to the discussion of the Committee's consideration of its monetary and debt ranges for 1998 and 1999.

4. Attended portions of the meeting relating to the Committee's review of the economic outlook and consideration of its monetary and debt ranges for 1998 and 1999.

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gains in the first quarter; and the erosion in net exports continued to damp demand for domestically produced goods. Payroll employment persisted on a brisk uptrend, but industrial production seemed likely to record only modest further expansion in the second quarter. Labor markets remained tight, and there were indications of some further acceleration in employment costs. Recent data on consumer prices were a little less favorable than they had been earlier in the year.

Nonfarm payroll employment registered substantial increases in April and May despite further job losses in manufacturing. Construction payrolls declined in May, but they were up sharply on balance over the April–May period following substantial gains earlier in the year. Employment increases in service-producing industries, notably business services and retail and wholesale trade, continued to be robust. The civilian unemployment rate stayed at 4.3 percent in May, and initial claims for unemployment insurance remained low through mid-June, after taking into account the onset of layoffs associated with the strike at General Motors.

Industrial production picked up in April and May after having changed little in the first quarter, but the strike at General Motors likely depressed industrial production substantially in June. In manufacturing, the output of motor vehicles rose briskly on balance over April and May, and the production of computers and office equipment remained robust. Growth in the manufacture of materials slowed sharply, perhaps reflecting the effects of reduced exports to Asia. Output of utilities, which continued to fluctuate widely, changed little on balance over the April–May period. The rate of utilization of manufacturing capacity edged down in May to its lowest level in more than two years as capacity grew at a faster rate than output.

Total nominal retail sales posted large gains in April and May. Sales were strong at automotive dealers in response to a sharp increase in incentives offered by the Big Three automakers. Sales also rose briskly at building material and supply outlets and at general merchandise, apparel, and furniture and appliance stores. Although the growth in real outlays for services in April (latest data available) was held down by a small decline in purchases of energy services, the expansion of outlays for non-energy services remained brisk. Sales of homes were very strong in April and May, but housing starts and building permits declined slightly on a seasonally adjusted basis from their elevated first-quarter rates.

Available information suggested that the growth of business fixed investment slowed somewhat in the second quarter from a very strong pace earlier in the year. A deceleration in expenditures for producers' durable equipment, after the surge in purchases of computer and communications equipment in the first quarter, apparently more than offset a pickup in spending on nonresidential structures. The recent upturn in building activity was consistent with the continuing indications of declining vacancy rates and rising real estate prices, but available data on construction contracts did not point to further strength in nonresidential construction.

Business inventory investment slowed sharply in April from the extraordinarily rapid rate of accumulation in the first quarter. In manufacturing, stockbuilding picked up somewhat in April from the first-quarter pace, but with sales also rising, the stock–sales ratio remained at a very low level. Wholesale inventories declined sharply in April, primarily reflecting runoffs in

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stocks of motor vehicles; the inventory–sales ratio for the sector remained near the upper end of its range over the preceding twelve months. Retail inventory accumulation slowed somewhat in April, and the aggregate inventory–sales ratio stayed close to the lower end of its range over the past year.

The nominal deficit on U.S. trade in goods and services widened further in April, as the value of exports declined more than that of imports. Exports of aircraft and parts dropped sharply from the first-quarter level, and exports of industrial supplies decreased by lesser amounts. Most of the decline in imports was in capital goods and automotive products. Recent information suggested a mixed economic performance among the major foreign industrial countries. Economic activity in Japan contracted sharply in the first quarter after having declined slightly in the fourth quarter, and many other economies in Asia remained quite weak. The Asian crises held down exports of the major European countries, partly offsetting the influence of strong domestic demand.

Consumer prices advanced at a slightly faster rate in May as an upturn in energy prices and a large increase in food prices more than offset a slower rate of increase in the prices of nonfood, non-energy items. Core consumer prices accelerated during the three months ended in May, largely reflecting higher tobacco prices and shelter costs. Nonetheless, core consumer prices rose less over the twelve months ended in May than they had over the previous twelve months. At the producer level, prices of finished goods other than food and energy continued to rise at a subdued rate in May. For the twelve months ended in May, core producer prices rose by a small amount after having changed little in the year-earlier period. At the intermediate level, core producer prices edged down in May and were little changed on net over the twelve months ended in May. Average hourly earnings of production or nonsupervisory workers increased at a slightly faster rate on balance over April and May. Measured on a year-over-year basis, average hourly earnings accelerated further in the year ended in May. The largest gains were in business services and finance, insurance, and real estate, but marked acceleration also was evident in wholesale and retail trade. By contrast, gains in manufacturing had changed little over the past three years.

At its meeting on May 19, 1998, the Committee adopted a directive that called for maintaining conditions in reserve markets that would be consistent with the federal funds rate continuing to average around 5½ percent. In light of concerns that growth in aggregate demand might remain so strong relative to the expansion of the economy's potential that inflationary pressures would tend to be generated, the Committee chose to retain an asymmetric directive tilted toward a possible firming of reserve conditions and a higher federal funds rate. The reserve conditions associated with this directive were expected to be consistent with considerable moderation in the growth of M2 and M3 over the months ahead.

Open market operations were directed throughout the intermeeting period toward maintaining the existing degree of pressure on reserve positions, and the federal funds rate averaged close to the intended level of 5½ percent. Market participants interpreted the further turmoil in financial markets in Asia and emerging market economies elsewhere as damping the outlook for U.S. economic growth and improving the chances that inflation would remain low. While most short-term interest rates changed little on balance over the

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period, yields on longer-term Treasury securities, and to a lesser extent on private debt instruments, declined somewhat, at least partly reflecting a further flight to safety and quality from renewed turbulence in a number of foreign markets. Share prices in U.S. equity markets remained volatile, and changes in major indexes were mixed on balance over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar in terms of other major currencies continued to increase through the middle of June, but it then retraced much of that rise, ending the intermeeting period somewhat higher on balance. The recent fluctuations in the dollar's trade-weighted value were largely accounted for by movements in the Japanese yen, which reached an eight-year low against the dollar in the middle of June in response to growing market pessimism about the prospects for a prompt resolution of Japan's financial sector problems and for economic recovery in that country. The yen rebounded in mid-June in response to coordinated intervention by the Japanese and U.S. governments but soon renewed its downward drift, partly as a result of rising concerns that the Japanese government would not take prompt action to address weaknesses in the country's banking sector and in aggregate demand; the yen finished the period substantially lower on balance. The dollar changed little on net against the German mark and other continental European currencies; declines in long-term interest rates in those countries generally matched the drop in yields on comparable U.S. instruments. Against the backdrop of weakness in the yen, the currencies of key emerging market economies, particularly some of those in Asia, fell further against the dollar.

Growth of M2 and M3 slowed in the second quarter but remained fairly robust. Households accumulated unusually large deposit balances to make hefty nonwithheld tax payments in April, and these balances ran off in May as tax checks cleared; averaging through these gyrations, the expansion of the broad aggregates slowed on balance over April and May, and preliminary data suggested further slowing in June. The growth of M3 remained a little faster than that of M2, reflecting the further progress made by institution-only money market funds in attracting corporate cash-management business. For the year through June, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt appeared to have moderated somewhat after picking up earlier in the year; the moderation evidently reflected some slowing in the growth of business and household borrowing as well as paydowns of federal debt made possible by robust tax revenues.

The staff forecast prepared for this meeting indicated that economic activity would expand more slowly over the projection period than it had in recent years. Moderation in business inventory investment would damp domestic production as inventory accumulation was brought into better balance with the expected more moderate trajectory of final sales. In addition, reduced growth of foreign economic activity and the lagged effects of the sizable earlier rise in the foreign exchange value of the dollar were anticipated to place substantial restraint on the demand for U.S. exports and to lead to further substitution of imports for domestic products. The staff analysis suggested that the prospective gains in income coupled with the run-up that had occurred in household wealth would support further brisk, though gradually diminishing, increases in consumer spending. Housing demand

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was expected to remain at a generally high level in the context of the persisting favorable cash flow affordability of home ownership, though the slower income growth anticipated over the projection period would damp homebuilding somewhat. Growth in business fixed investment would gradually moderate from the vigorous pace of the first half of the year in response to smaller increases in business sales and profits. Pressures on labor resources were likely to diminish somewhat as the expansion of economic activity slowed, but underlying inflation was expected to pick up gradually as gains in compensation increasingly outpaced improvements in productivity.

In the Committee's discussion of current and prospective economic developments, the members generally agreed that the expansion in economic activity was likely to be relatively moderate over coming quarters, and that such growth would be consistent with some limited increase in inflation from the current unusually low level. The accumulation of business inventories, which until recently had added substantially to economic growth, was expected to continue at a much lower and more sustainable pace. Moreover, the effects on the U.S. trade balance of the appreciated value of the dollar and of economic weakness in several of the nation's trading partners probably would hold down increases in domestic output in coming quarters. Many of the members commented, however, that the already substantial risks surrounding the economic outlook had increased on both sides of their forecasts. On the downside, the greater risks focused on potential developments in Asia. Financial and economic conditions in Asia had deteriorated in recent months, and the members could not rule out the possible emergence of even greater financial turmoil and economic weakness in that part of the world that could spill over to other countries, including the United States. On the upside, in the absence of strongly retarding effects from developments in Asia, persistent strength in domestic final demand might well add to inflationary pressures. Indeed, there were signs of modestly rising inflation in some recent measures of prices, though the rate of inflation was still relatively subdued.

In keeping with the practice at meetings when the Committee sets its long-run ranges for the money and debt aggregates, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members provided individual projections of the growth in real and nominal GDP, the rate of unemployment, and the rate of inflation for the years 1998 and 1999. The forecasts of the rate of expansion in real GDP for 1998 as a whole had a central tendency of 3 to 3¼ percent, which implied some moderation over the second half from staff estimates at the time of this meeting of the average rate of growth in the first and second quarters; for 1999 the forecasts pointed to moderate growth and were centered on a range of 2 to 2½ percent. These projected rates of economic growth were accompanied by a very slight rise in the civilian rate of unemployment over the next eighteen months to still quite low rates centering on 4½ to 4¾ percent in the fourth quarter of 1999. With regard to the growth of nominal GDP, most of the forecasts were in ranges of 4½ to 5 percent for 1998 and 4¼ to 5 percent for 1999. Projections of the rate of inflation, as measured by the consumer price index, indicated a slightly faster rise over the second half of this year and in 1999, largely because of expectations that the plunge in energy prices earlier in the year would not be repeated. Specifically, the projections converged on

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CPI inflation rates of 1¾ to 2 percent for 1998 as a whole and 2 to 2½ per cent in 1999.

In their review of developments in different parts of the country, Reserve Bank presidents reported high levels of business activity across the nation, but several also indicated that there were signs of some slowing in the expansion of regional economic activity. With regard to the nation as a whole, members noted that rising levels of employment and incomes were continuing to foster solid growth in consumer spending, a development that was abetted by the sharp increases that had occurred in household wealth as a consequence of the extended uptrend in stock market prices and to a lesser extent the appreciation of home prices. However, some anecdotal and other evidence suggested that retail sales had moderated in recent weeks in at least some areas; the moderation appeared to be only partly associated with the work stoppage at General Motors. The apparent deceleration in retail sales could prove to be temporary, though some slowing in the growth of overall consumer spending over the forecast horizon, perhaps to a pace more in line with the growth of disposable income, was viewed as a reasonable expectation, especially with equity price gains of recent years unlikely to be repeated.

Business fixed investment remained on a strong uptrend, buoyed by several favorable factors. The latter included the ready availability of debt and equity financing on relatively attractive terms, and opportunities to invest in high-tech equipment at lower prices to enhance productivity and hold down labor costs in a period of very tight labor markets. While these factors were expected to support appreciable further expansion in business investment, growth in demand for capital goods was likely to diminish as a result of the projected slowing in the expansion of final sales and business profits and the absence of pressure on manufacturing capacity. With regard to the outlook for nonresidential construction, members reported that declining vacancy rates and rising prices and rents of office buildings and to some extent other commercial structures were fostering very high levels of construction activity in several areas. Moreover, there were indications that some construction projects were being delayed because of scarcities of labor or construction materials. A number of members commented that some of the construction was being undertaken on a speculative basis and that the strong pace of building activity pointed to overbuilding in some areas. On the residential side, construction activity also displayed considerable strength across much of the country. There were widespread anecdotal and other reports of high levels of home sales and few reports of faltering housing demand. Favorable factors undergirding current housing activity, including the robust growth in employment and incomes, high wealth-to-income ratios, and very attractive terms on home mortgages, seemed likely to continue to hold housing construction close to current elevated levels.

Based on very partial data, business inventory investment appeared to have moderated considerably in the second quarter from an unsustainable pace in the first quarter, and some further reductions in inventory accumulation could be expected over the balance of the year. Several members commented, however, that despite the outsized rate of stockbuilding early in the year, there were no broad indications of an inventory overhang, whether from the standpoint of inventory–sales ratios or anecdotal expressions of concern. Against this background, many of the members saw

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little reason to anticipate a further sizable drop in nonfarm inventory investment, though the performance of this sector of the economy was always subject to a high degree of uncertainty.

With regard to the external sector of the economy, the recent deterioration of conditions in Japan and several emerging economies in Asia and the related effects on other countries around the world were adding significantly to the uncertainties facing the U.S. economy. Members commented that it was too soon to judge the eventual extent and duration of the turmoil in Asia and its spillover to other nations, but several suggested that the consequences were likely to be more severe and longer lasting than they had anticipated earlier. Moreover, there seemed to be a very small but growing possibility of marked and spreading weakness that might have a more major effect on U.S. financial markets and the U.S. economy. One key to an improvement in the outlook for Asia was the adoption of appropriate policies by Japan, but very difficult political as well as economic problems clearly were involved for that nation and their resolution might well require an extended period of internal deliberations. From the standpoint of the United States, the Asian crisis and its repercussions around the world obviously were deepening the nation's trade deficit, but other effects such as those on U.S. interest rates and prices in world commodity markets, notably oil, were boosting domestic demand and tended to have a moderating near-term influence on inflation.

With regard to the outlook for prices and wages, members observed that some key measures of price inflation had displayed a modest uptilt recently. Though overall price inflation had remained subdued when viewed over a longer horizon, signs of a continuing acceleration, should they become evident, would be a matter of growing concern. Reflecting very tight labor markets, the rate of increase in labor compensation had been on an uptrend, but the rise in unit labor costs and overall unit product costs had been held down to a very modest pace by gains in productivity. At some point, however the advance in labor compensation would exceed likely improvements in productivity by an increasing margin unless the expansion in overall demand, and hence in labor demand, moderated significantly. Members cited greater, albeit still occasional, indications of heightened worker demands in labor negotiations that likely were encouraged in part by ample job opportunities. Any tendency for faster increases in labor costs to feed through to price inflation was likely to be reinforced for a time by the unwinding of a number of special factors that had tended to hold inflation down, including the decline in energy prices in recent quarters and the dollar's appreciation during 1997. Moreover, a rise in inflation would tend to erode currently favorable inflation expectations and lead workers to demand higher nominal compensation. Nonetheless, questions could be raised about how rapidly and to what extent the effects of tight labor markets would show through to higher labor compensation and overall producer costs and in turn how quickly the latter would induce significantly faster increases in prices. Very competitive domestic and international markets for a wide range of products along with reduced prices of oil, other commodities, and imports more generally could well keep inflation in check for some time. It was noted in this regard that members had tended in recent years to anticipate greater inflation than had materialized.

In keeping with the requirements of the Full Employment and Balanced

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Growth Act of 1978 (the Humphrey–Hawkins Act), the Committee at this meeting reviewed the ranges for growth of the monetary and debt aggregates that it had established in February for 1998 and also decided on tentative ranges for those aggregates in 1999. The current ranges for the period from the fourth quarter of 1997 to the fourth quarter of 1998 were unchanged from the ranges for other recent years and included expansion of 1 to 5 percent for M2 and 2 to 6 percent for M3. An unchanged range of 3 to 7 percent also was set in February for growth of total domestic nonfinancial debt in 1998.

All the members favored or could support the retention of the current ranges for this year and their extension on a provisional basis to 1999. They took note of a staff projection that indicated that, given the Committee's expectations for the performance of the economy and prices and assuming no major changes in interest rates, growth of M2 and M3 probably would exceed the current ranges in 1998 and decline to a little below the upper end of those ranges in 1999. Both M2 and M3 had grown unusually quickly relative to spending in the first half of the year. The staff analysis suggested that some of the forces that might have been responsible for this decline in velocity would abate, and the projections anticipated that the velocity of M2 would be roughly in line with historical experience before the early 1990s, as it had been, on balance, for several years.

In their discussion of the choice of ranges for growth of M2 and M3 in 1998 and 1999, the members agreed that those ranges should not reflect forecasts of money growth under anticipated economic and financial conditions, but instead should be viewed as anchors or benchmarks for money growth that would be associated with price stability and sustained economic growth, assuming behavior of velocity in line with historical experience. Reaffirming the current ranges for 1998 and extending them to 1999 would thus underscore the Committee's commitment to a policy of achieving price stability over time. In the view of a few members, the Committee should consider adopting ranges centered on its expectations for growth of the monetary aggregates in the future, but only if the members became more confident about the relationship between the growth of money and measures of aggregate economic performance and undertook to give more weight to the growth of the broad monetary aggregates in setting monetary policy. Some members noted that retention of the current monetary ranges oriented toward price stability did not preclude greater use of the aggregates in assessing overall financial conditions and the formulation of monetary policy. The Committee agreed that the current range for nonfinancial debt for 1998 should be left unchanged and that the same range should be extended to 1999. The current range readily encompassed the growth rate seen likely to be associated with the members' forecasts for economic activity and prices.

At the conclusion of this discussion, the Committee voted to reaffirm the ranges for growth of M2, M3, and total domestic nonfinancial debt that it had established in February for 1998 and to extend those ranges on a tentative basis to 1999. In keeping with its usual procedure under the Humphrey–Hawkins Act, the Committee would review its preliminary ranges for 1999 early next year. Accordingly, the Committee voted to incorporate the following statement regarding the 1998 and 1999 ranges in its domestic policy directive:

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The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at this meeting the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on tentative ranges for monetary growth, measured from the fourth quarter of 1998 to the fourth quarter of 1999, of 1 to 5 percent for M2 and 2 to 6 percent for M3. The Committee provisionally set the associated range for growth of total domestic nonfinancial debt at 3 to 7 percent for 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Jordan, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin. Votes against this action: None.

In the Committee's discussion of policy for the intermeeting period ahead, all but one of the members indicated that they could support an unchanged policy stance and retention of the current tilt toward possible tightening in the directive. Although recent developments had increased both the upside and the downside uncertainties in the economic outlook, most of the members felt that the risks continued to point on balance toward rising inflation. While the available evidence suggested that the economic expansion had in fact slowed considerably in the second quarter, largely because of reduced inventory accumulation against the backdrop of weakness in the foreign trade sector, the retarding effects of those factors were seen as likely to wane over coming quarters and there were only limited indications of any softening in domestic final demand. Moreover, the persistence of accommodative financial conditions, as evidenced by the ample availability of financing on favorable terms to business and household borrowers and by robust monetary growth, might well continue to support relatively strong domestic spending. As a consequence, many of the members expressed concern that the expansion in demand might continue at a fast enough pace to raise pressures on wages and prices over time. Nonetheless, the substantial uncertainties relating to prospective developments argued, as they had at recent meetings, in favor of a cautious "wait and see" policy stance.

Another important reason for deferring any policy action was that a tightening move would involve the risk of outsized reactions and consequent destabilizing effects on financial markets in the growing number of countries abroad that were experiencing severe financial difficulties. It was not possible to anticipate precisely what those effects might be, but the risks seemed to be particularly high at this time. To be sure, U.S. monetary policy had to be set ultimately on the basis of the needs of the U.S. economy, but recognition had to be given to the feedback of developments abroad on the domestic economy. Those repercussions could be quite severe in the event of further sizable economic and financial disturbances in some of the nation's important trading partners. Many members concluded that because there did not seem to be any urgency to tighten current policy for domestic reasons, given the likelihood that inflation would remain subdued for a while, important weight should be given to potential reactions abroad. A number of these members emphasized, however, that they continued to see a high probability that some tightening of monetary policy would be needed later to curb

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rising inflationary pressures. Accordingly, they believed that the Committee should take advantage of any early opportunity to tighten policy in order to improve the prospects of containing inflation and prolonging the economic expansion. One member was persuaded, however, that such a policy move should be implemented at this meeting in order to avert the need for a stronger and probably more disruptive policy adjustment that would be needed later to head off rising inflation.

Given that the balance of risks was seen as pointing to rising inflation over time, the members agreed that it was desirable to retain the tilt toward restraint in the directive. Such a tilt would continue to underscore the Committee's commitment to its long-run objective of price stability and its view of the likely direction of the next policy move.

At the conclusion of the Committee's discussion, all but one of the members accepted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent and that contained a bias toward the possible firming of reserve conditions and a higher federal funds rate. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate growth in M2 and M3 over the months ahead.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that the expansion in economic activity has slowed considerably after a very rapid advance in the first quarter. Nonfarm payroll employment registered another substantial increase in May, and the civilian unemployment rate was unchanged at 4.3 percent. Industrial output picked up in recent months after weakening early this year; however, a strike at General Motors likely depressed output substantially in June. Although retail sales posted large gains in April and May, overall consumer spending appears to have grown less rapidly in the second quarter than in the first. Residential sales have remained exceptionally strong, but housing starts and building permits slipped back in the spring, on a seasonally adjusted basis, from a sharply increased first-quarter level. Available indicators suggest that growth of business fixed investment also is slowing after a surge earlier in the year. Business inventory accumulation appears to have moderated in April from an extraordinarily rapid rate in the first quarter. The nominal deficit on U.S. trade in goods and services continued to widen in April. Developments in the food and energy sectors contributed to a slightly faster advance in consumer prices in May.

Most short-term interest rates have changed little since the meeting on May 19, but longer-term rates have declined somewhat. Share prices in U.S. equity markets remained volatile and changes in major indexes were mixed on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar rose sharply through mid-June in terms of other major currencies, declined more recently, but is up somewhat on net since the May meeting; the fluctuations in the average value of the dollar in terms of these major currencies were largely related to movements against the Japanese yen. The dollar has risen further against the currencies of key emerging market economies, particularly some of those in Asia.

Growth of M2 and M3 slowed in the second quarter, but remained fairly robust. For the year through June, both aggregates

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rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt appears to have moderated somewhat after a pickup earlier in the year.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at this meeting the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on tentative ranges for monetary growth, measured from the fourth quarter of 1998 to the fourth quarter of 1999, of 1 to 5 percent for M2 and 2 to 6 percent for M3. The Committee provisionally set the associated range for growth of total domestic nonfinancial debt at 3 to 7 percent for 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a somewhat higher federal funds rate would or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin. Votes against this action: Mr. Jordan.

Mr. Jordan dissented because he believed that the unsustainably rapid growth of domestic demand—fueled by the acceleration of money and credit growth in the past year—was reflected in the recent sharp increase in imports and rising trade deficits. As U.S. output growth slows significantly from the rapid pace of 1997 and early 1998, it will be essential that domestic demand also slow. The very welcome progress toward eliminating inflation in recent years has contributed to the outstanding performance of the economy. Allowing domestic demand to continue to exceed domestic production would run the risk that corrosive effects of rising inflation would undermine future growth prospects. Furthermore, the resultant trade and current account deficits would have to be matched by ever larger inflows of foreign capital. Modest monetary restraint at this time might prevent either the buildup of inflationary imbalances that would eventually necessitate future policy restraint or unsustainable capital flows. In either case an economic contraction might become unavoidable.

The meeting adjourned at 12:40 p.m.

Donald L. Kohn
Secretary

Meeting Held on August 18, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 18, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Poole
Ms. Rivlin

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Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Guynn and Parry, Presidents of the Federal Reserve Banks of Atlanta and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Cecchetti, Dewald, Hakkio, Lindsey, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Hooper and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Struckmeyer, Assistant Director, Division of Research and Statistics, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Ms. Strand and Mr. Varvel, First Vice Presidents, Federal Reserve Banks of Minneapolis and Richmond respectively

Messrs. Beebe, Goodfriend, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Richmond, and Dallas respectively

Messrs. Bolwell, King, Kopcke, Meyer, and Sullivan, Vice Presidents, Federal Reserve Banks of New York, Atlanta, Boston, Philadelphia, and Chicago respectively

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on June 30–July 1, 1998, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange markets during the period since the previous meeting. There were no open market operations in foreign currencies for the System's account during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period July 1, 1998, through August 17, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

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The information reviewed at this meeting suggested that domestic final demand continued to expand at a robust pace. However, increases in consumer spending and business investment seemed to be moderating somewhat after very large gains earlier in the year, and inventory investment had slowed markedly. Net exports remained weak as a result of the persisting turmoil in Asian economies. The strike at General Motors had damped overall economic activity temporarily, but total payroll employment continued to trend upward, and labor markets remained extremely tight. Despite the pressures on labor resources, trends in wages and prices had remained stable in recent months.

Nonfarm payroll employment expanded further in July even though manufacturing payrolls plunged in association with the General Motors strike; job growth remained strong in most nonmanufacturing sectors. Construction employment continued to increase at about the brisk pace recorded over the first half of the year, and hiring in retail trade surged. The expansion of jobs in the services industry slowed considerably in July, but this partly reflected a decline in temporary help jobs related to the GM strike. The civilian unemployment rate was unchanged in July at 4.5 percent.

Industrial production declined considerably in June and July. Abstracting from the effects of the GM strike, manufacturing output fell slightly over the June–July period after having recorded moderate gains on average in earlier months of the year; production of business equipment expanded briskly in June and July, while the output of consumer goods and materials weakened. The rate of utilization of manufacturing capacity was down appreciably in June and July, mostly reflecting the effects of the GM strike.

Total nominal retail sales fell in July after having risen at a rapid pace in the first half of the year. A sharp contraction in spending for motor vehicles, reflecting the termination at midyear of sales incentives offered by the Big Three automakers and shrinking inventories at GM dealers, more than accounted for the drop in July. Non-auto-related outlays continued on a robust upward trend, with gains evident in all major categories. Sales increases were particularly large at furniture and appliance stores and apparel outlets. In the housing sector, both demand and construction activity remained strong. Starts of single-family units edged down in May but rebounded in June. Sales of new homes were at an all-time high in June, and sales of existing homes were only a little below the record level reached in March of this year. With sales robust, the inventory of unsold new homes remained low.

Growth of business fixed investment slowed in the second quarter as the pace of business spending for durable equipment moderated considerably from the exceptionally strong rate of earlier in the year. Nonetheless, outlays for computer and communications equipment continued to expand rapidly in the second quarter, and purchases of other capital goods rose briskly. Available information suggested that growth in business spending on capital goods likely would slow further in the months ahead. In contrast to the strength in equipment spending, expenditures on nonresidential building declined further in the second quarter, and available indicators pointed to a mixed outlook for this sector in coming months.

Business inventory investment slowed sharply in the second quarter, owing in substantial measure to a runoff of motor vehicle inventories at the

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wholesale and retail levels. In manufacturing, stockbuilding slowed somewhat in the second quarter, and the stock–shipments ratio at the end of the quarter remained close to the low level that had prevailed over the past year. Wholesale inventories changed little on balance in the second quarter as a sizable decline in motor vehicle stocks offset a buildup of non-auto durable goods; in June, the aggregate inventory–sales ratio for this sector was at the upper end of its narrow range for the past year. At the retail level, a drop in inventories of motor vehicles in the second quarter more than offset a small increase in stocks at non-auto retailers, and the aggregate inventory–sales ratio in June was a little below the lower end of its range for the past year.

The nominal deficit on U.S. trade in goods and services widened substantially further in the second quarter; the value of exports of goods and services declined for a second straight quarter, while the value of imports continued to rise, though at a somewhat reduced pace. Much of the decline in exports in the second quarter was in capital goods, but there also were noticeable decreases in most other major trade categories. The increase in imports was concentrated in imported consumer goods, aircraft, and steel. Economic activity in most of the major foreign industrial countries continued to expand, though at a slower rate, in the second quarter. In Japan, however, economic activity appeared to have contracted sharply further in the second quarter. In most other Asian economies, currencies and equity prices were under downward pressure, and in Russia, asset values plummeted in often disorderly markets. Risk spreads on dollar-denominated debt widened substantially, not only in Russia but for Latin American issuers as well.

Price and wage inflation had remained relatively stable in recent months. Both the overall CPI and the CPI excluding food and energy items rose slightly on balance in June and July; a small rise in food prices offset a noticeable decline in energy prices over the two-month period. For the twelve months ended in July, the core CPI registered a slightly smaller increase than it had in the year-earlier period, partly reflecting lower prices for new motor vehicles. Producer prices of finished goods changed little on balance in June and July; a sizable drop in the prices of energy products over the June–July period more than offset a modest rise in core producer prices. For the year ended in July, core producer prices rose somewhat more than in the year-earlier period, reflecting larger increases in the prices of finished consumer goods. Hourly compensation of private industry workers rose in the second quarter at about the average rate for the previous two quarters. For the year ended in June, however, hourly compensation picked up significantly from the year-earlier period; the acceleration in compensation was evident in wages and salaries and in benefits.

At its meeting on June 30–July 1, 1998, the Committee adopted a directive that called for maintaining conditions in reserve markets that would be consistent with the federal funds rate continuing to average around 5½ percent. With the balance of risks still pointing to the possibility of rising inflation over time, the Committee chose to retain an asymmetric directive tilted toward a possible firming of reserve conditions and a higher federal funds rate. The reserve conditions associated with this directive were expected to be consistent with moderate growth in M2 and M3 over the months ahead.

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Open market operations were directed throughout the period since the meeting on June 30–July 1 toward maintaining the existing degree of pressure on reserve positions, and the federal funds rate averaged a little above the intended level of 5½ percent. Most other interest rates fell slightly on balance over the intermeeting period in response to market assessments that worsening conditions in Asia, Latin America, and Russia portended slower growth in U.S. output and inflation over an extended period ahead. Declines in Treasury yields also reflected a continuing flight toward safety and quality from the persisting turbulence in foreign markets. In an atmosphere of increasing concerns about the prospects for corporate earnings, share prices in U.S. equity markets remained volatile and major indexes declined appreciably on balance over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar rose somewhat further over the intermeeting period in relation to other major currencies. The dollar changed little against the continental European currencies, but it moved up strongly against the Japanese yen and, to a lesser extent, the Canadian dollar. The dollar's rise in terms of the yen reflected spreading pessimism regarding the Japanese government's ability to redress the problems of its troubled banking system and provide fiscal stimulus adequate to turn its economy around. The dollar's advance against the Canadian dollar occurred in the context of continuing weakness in global commodity prices that was weighing down that currency. The dollar also appreciated slightly in terms of an index of the currencies of the developing countries of Latin America and Asia that are important trading partners of the United States.

After having expanded briskly in the second quarter, M2 grew at a somewhat more moderate rate in July, and M3 changed little. The deceleration in M2 reflected reduced inflows to retail money market funds. The halt in the growth of M3 was associated with a sharp runoff of large time deposits and outflows from institution-only money market funds triggered by a temporary spike in interest rates on market instruments around quarter-end. For the year through July, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt appeared to have moderated somewhat in recent months after a pickup earlier in the year.

The staff forecast prepared for this meeting indicated that economic activity would expand through 1999 at a pace somewhat below the estimated growth of the economy's potential. Reduced growth of foreign economic activity and the lagged effects of the sizable earlier rise in the foreign exchange value of the dollar were anticipated to place substantial restraint on the demand for U.S. exports and to lead to further substitution of imports for domestic products. Moreover, additional moderation in business inventory investment would damp domestic production as inventory accumulation was brought into better balance with the forecast of a more moderate trajectory of final sales. The staff analysis suggested that the prospective gains in income coupled with the earlier run-up in household wealth would support further brisk, though gradually diminishing, gains in consumer spending. Housing demand was expected to remain relatively strong in the context of the persisting favorable cash flow affordability of home ownership, though the slower income growth anticipated over the projection period would damp homebuilding somewhat.

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Growth in business fixed investment would gradually moderate from the vigorous pace of the first half of the year in response to smaller increases in business sales and profits. Pressures on labor resources were likely to diminish somewhat as the expansion of economic activity slowed, but inflation was expected to pick up gradually as a result of an anticipated reversal of some of the decline in energy prices this year.

In the Committee's discussion of current and prospective economic conditions, members focused on the disparate forces that continued to shape trends in economic activity, notably the persistence of considerable strength in private domestic spending and the damping influences stemming from foreign economic developments. The latter seemed likely to be larger than previously anticipated as financial turmoil in some foreign economies had deepened and spread and currently showed few signs of stabilizing. Moreover, equity prices and risk spreads in U.S. financial markets were beginning to be adversely affected, potentially slowing domestic demand. The members generally anticipated somewhat more moderate growth than they had in their previous forecasts, with prospective expansion at a pace near or somewhat below the growth of the economy's potential. Nonetheless, they remained concerned about the potential for higher inflation, given the widespread tightness in labor markets and an upward tilt in the rise of labor compensation. For the present, however, inflation remained subdued, and it was likely to remain relatively low for some time in light of the weakness in commodity and other import prices and the tendency for low current inflation to hold down expected price increases.

Among the factors bearing on the outlook for domestic economic activity, the members viewed the external sector as a major source of uncertainty. The continued rapid decline in net exports during the first half of the year largely seemed to reflect the further financial unsettlement and a deeper contraction in Asian economies than had been anticipated earlier, and several members commented that they saw little evidence that financial and economic conditions in Asia were stabilizing. Indeed, such conditions appeared to be worsening further in some Asian nations, and other countries had been affected by the associated weakening in the demand for commodities and the more risk-averse attitudes of investors. Anecdotal reports at this meeting suggested that the impact on the domestic economy was being felt by manufacturing firms in several industries, although some firms also reported that declining exports to Asia were being offset at least in part by rising exports to other areas of the world. Looking ahead, the members agreed that the duration and extent of disruptions in Asian and other economies could not be anticipated with any degree of confidence; while net exports were not expected to decline as rapidly as they had in the first half of the year, even more serious disruptions in Asia could not be ruled out and would have important implications for the U.S. economy.

In their review of developments in key expenditure sectors of the domestic economy, members observed that over the first half of the year the strength in domestic final demand, notably in the consumer and business investment sectors, had more than offset the negative effects of developments in the foreign sector and other factors. In the consumer sector, the outlook for further sizable increases in spending was buttressed by unusually favorable underlying factors, including solid ongoing gains in employment and incomes and substantial further increases in household net worth

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this year. A pause in the robust gains in retail sales in early summer was accounted for in part by limited inventories of new motor vehicles associated with the now-settled GM strike. While a variety of factors pointed to sustained growth in consumer spending, a less ebullient stock market, should it persist, would foster more moderate expansion in consumer spending, perhaps at a pace more in line with the rise in consumer incomes, or at an even slower pace if consumer confidence were adversely affected by developments in financial markets.

Business fixed investment also seemed to be on a solid upward trajectory, though some slowing in the growth of business investment spending was anticipated in response to a projected deceleration in overall business output and weaker business profits. Members continued to cite anecdotal evidence of very strong construction activity in many parts of the country, including indications that building projects were being delayed because of shortages of labor and some construction materials. In other parts of the country, building activity remained at a high level but seemed to have moderated somewhat. Business spending for various types of high-tech equipment had surged to an undoubtedly unsustainable pace in the first half of the year. Against this background, several members referred to emerging signs of slightly more cautious attitudes among their business contacts, in many cases the result of concerns about developments in Asia. On balance, diminishing momentum in business investment appeared to be a likely prospect, but the ample availability of financing on favorable terms would continue to support this sector.

In the housing sector, construction activity remained at a high level in most parts of the nation and, as was the case for construction activity more generally, homebuilding continued to be restrained in a number of areas by limits on the availability of labor and other inputs. The housing market clearly was benefiting from strong gains in household incomes, high levels of household wealth, and very attractive financing costs. There were few indications of any moderation in this sector of the economy. Even so, some slowing was anticipated, at least after current construction backlogs were satisfied, in response to the projected slowing in employment growth and the high level of the housing stock.

Currently available data indicated that the pace of inventory accumulation had moderated substantially in the second quarter. Nonetheless, the rate of nonauto inventory investment in the spring still appeared to have exceeded a pace that was consistent with sustainable growth in sales. Anecdotal reports at this meeting pointed to a somewhat mixed picture with regard to desired inventory levels, including examples of both overstocking and shortages. Looking ahead and apart from short-run fluctuations, inventories were not expected to add to demand over coming quarters, at least after the restocking of motor vehicles by General Motors was completed.

In the Committee's discussion of the outlook for wages and prices, members commented that the rate of inflation in consumer prices was difficult to characterize with precision because alternative price indexes provided different measurement results; in particular, chain price indexes for consumption expenditures showed substantially less inflation than the CPI. Even so, it was clear on the basis of any measure that consumer prices and inflation more generally had remained remarkably subdued in the context of very tight labor markets and

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upward pressure on labor compensation. And whatever the explanation, it seemed that the economy had been less prone to rising inflation than it had been historically under similarly tight labor market conditions. The members acknowledged that a number of special factors were contributing to the relatively benign inflation climate. Those factors included the appreciation of the dollar; declines in many commodity prices, notably that of oil; ample industrial capacity; and evidently diminished inflation expectations. Moreover, substantial gains in productivity were muting the effects of rising labor compensation on unit costs, and vigorous competition in numerous markets was continuing to make it very difficult or impossible for business firms to raise their prices to cover rising costs or enhance profit margins. Against this backdrop, members remained persuaded that a significant rise in price inflation was not likely to occur in the nearer term.

Looking further ahead, however, the members generally agreed that rising price inflation remained an important threat. Significant additional tightening in labor markets would, of course, exacerbate that risk, but even at current levels these markets were tight and at some point labor costs could increase more rapidly, pressing on prices. Moreover, the effects of some of the factors holding down inflation seemed likely to wane, and possibly to reverse, over time. The latter included the effects of the dollar's appreciation on the prices of imports and competing domestic products, a possible upturn in energy prices and perhaps other commodity prices as foreign economies stabilized, and faster increases in the costs of worker benefits, notably those related to health care. The apparently greater willingness of labor unions to press for higher wages and other benefits in very tight labor markets might also intensify upward pressures on labor costs. On balance, while the risks of an overheating economy and rising price inflation might have faded to some degree, many of the members continued to emphasize that the Committee could not ignore those risks in its policy formulation.

In the Committee's discussion of policy for the intermeeting period ahead, all but one of the members agreed on the desirability of maintaining a steady policy stance. The overall performance of the economy remained highly satisfactory. While inflation risks were still a concern, given the high level of output and strong domestic demand, the uncertainties bearing on the economic outlook remained substantial, and indeed the risks on the downside seemed to have increased appreciably further. On balance, domestic economic and financial conditions had not changed sufficiently during the intermeeting period to warrant an adjustment to policy. With regard to the current uncertainties in the economic outlook, members emphasized that the extent and ultimate effects of the apparently spreading fragility in foreign financial markets and economies on U.S. financial and economic conditions were unknown. In these circumstances, nearly all the members believed that a cautious wait-and-see approach to policy seemed appropriate to allow the Committee time to assess the course of events and the interplay of the divergent forces bearing on the performance of the economy. In this regard it was noted that while domestic financial conditions remained generally accommodative, recent developments in foreign exchange and domestic financial markets had tended on balance to decrease some of the stimulative effects of financial conditions on aggregate demand in the United States by shifting demand overseas, increasing somewhat

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the cost of raising capital, and reducing the financial wealth of households. However, a few members expressed concern about the potentially inflationary implications of relatively rapid growth in key monetary aggregates over the past year, though such growth appeared to have moderated recently. And in the view of one of these members, the trend in monetary growth along with indications of rising speculative imbalances and excesses in various markets for financial and nonfinancial assets called for a prompt firming of monetary policy.

While overall economic conditions had not changed enough in recent weeks to warrant an adjustment in policy, a majority of the members agreed that the risks to the economic outlook were now more balanced and called for a shift from asymmetry to symmetry in the Committee's directive. Such a directive would better represent their view that the Committee's next policy move could be in either direction depending on developments abroad and their interaction with a domestic economy that had remained quite strong. Greater difficulties abroad and associated downward pressures on demand and prices had substantially diminished the chances of a strengthening of inflation pressures over coming months and quarters that would require a near-term tightening of policy. Other members continued to believe that the risks were still tilted to some degree toward rising inflation, though to a lesser extent than earlier. Labor market developments continued to suggest that the economy could well be producing beyond its sustainable potential and concrete signs that inflation pressures would abate had yet to emerge. Accordingly, they still preferred an asymmetrical directive but could accept symmetry in light of the prevailing uncertainties in the economic outlook and the expectation, shared by the other members, that policy would not need to be changed during the intermeeting period ahead.

At the conclusion of the Committee's discussion, all but one of the members were in favor of retaining a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent. Most also indicated that they could support a shift to a directive that did not include a presumption about the likely direction of any adjustments to policy during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that slightly greater or slightly lesser reserve restraint would be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate growth in M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that domestic final demand has continued to expand at a robust pace, but overall economic activity has been adversely affected by the strike at General Motors and developments in Asia. Nonfarm payroll employment continued to expand through July and the civilian unemployment rate was unchanged at 4.5 percent. Industrial production declined considerably in June and July; most of the drop over the two months reflected the GM strike. A decline in total retail sales in July was more than accounted for by a sharp contraction in spending for motor vehicles. Residential sales and construction have remained exceptionally strong

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in recent months. Available indicators point to continued growth in business capital spending, although apparently at a more moderate pace than earlier in the year. Business inventory accumulation slowed sharply in the spring. The nominal deficit on U.S. trade in goods and services widened substantially further in the second quarter. Trends in wages and prices have remained stable in recent months.

Most interest rates have fallen slightly on balance since the meeting on June 30–July 1. Share prices in U.S. equity markets have remained volatile and major indexes have declined appreciably on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar rose somewhat further over the intermeeting period in relation to other major currencies; in addition, it was up slightly in terms of an index of the currencies of the developing countries of Latin America and Asia that are important trading partners of the United States.

After robust growth in the second quarter, M2 decelerated somewhat and M3 was about unchanged in July. For the year through July, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt appears to have moderated somewhat in recent months after a pickup earlier in the year.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting on June 30–July 1 the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on a tentative basis to set the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a slightly higher federal funds rate or a slightly lower federal funds rate would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin. Vote against this action: Mr. Jordan.

Mr. Jordan dissented because he believed that the underlying strength of aggregate demand in the U.S. economy would remain fundamentally intact, despite economic problems abroad. The problems in Asia provide a channel for economic imbalances to develop. Exports from some U.S. manufacturing industries will decline due to softer foreign markets and import competition. At the same time, domestic demand for imports, housing, and consumer durables will increase due to favorable interest rate trends. Though U.S. production of goods and services might slow during the period ahead, it is not yet clear that total demand will diminish at a comparable pace. At the same time, ample credit provision encourages speculative lending and excessive consumption. Consequently, continued rapid growth in the money supply creates the risk that inflation will accelerate and economic imbalances will become protracted.

Telephone Conference

On September 21 the Committee held a telephone conference to discuss recent developments in domestic and interna-

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tional financial markets and their implications for the U.S. economy. The consultation was held as background for Chairman Greenspan's testimony on September 23 before the Senate Budget Committee.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 29, 1998.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary

Meeting Held on September 29, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 29, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Truman, Economist

Messrs. Cecchetti, Dewald, Hakkio, Lindsey, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors[5]

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Struckmeyer, Assistant Director, Division of Research and Statistics, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Spillenkothen and Parkinson,[6] Director, Division of Supervision and Regulation, and Associate Director, Division of Research and Statistics respectively, Board of Governors

5. Attended portion of the meeting relating to the Committee's disclosure policies.

6. Attended portion of meeting relating to developments stemming from the financial difficulties of a large hedge fund.

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Mr. Connolly, First Vice President, Federal Reserve Bank of Boston

Messrs. Eisenbeis, Goodfriend, Hunter, Kos, Lang, and Rolnick, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Richmond, Chicago, New York, Philadelphia, and Minneapolis respectively

Messrs. Judd and Rosengren, Vice Presidents, Federal Reserve Banks of San Francisco and Boston respectively

Ms. Yucel, Research Officer, Federal Reserve Bank of Dallas

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 18, 1998, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period August 18, 1998, through September 28, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook, and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that economic activity was expanding at a moderate rate. Growth of private domestic final demand had slowed from its pace in the first half of the year, though it was still relatively robust, and reduced spending on U.S. exports and rising import competition were exerting appreciable restraint on overall activity, as was a slowing in inventory investment. Reflecting the moderation in growth from the first half of the year, total payroll employment was trending up at a somewhat slower pace. Despite the pressures on labor resources associated with still-tight labor markets, trends in wages and prices remained stable.

Growth in nonfarm payroll employment slowed somewhat over the July–August period. The deceleration reflected further job losses in the manufacturing sector, notably in the apparel and electronic components industries on which the crisis in Asia was having a sizable adverse effect. Outside of manufacturing, employment increases remained strong in the service-producing industries, and even though anecdotal reports continued to indicate shortages of skilled workers, further sizable job gains were recorded in construction. The civilian unemployment rate stayed at 4.5 percent in August.

Industrial output rebounded in August as production at General Motors resumed following the settlement of the labor strike. Outside the motor vehicle sector, however, output had changed little on balance over recent months in association with the erosion in net exports stemming from the turmoil in Asia and its repercussions on a number of other U.S. trading partners; production of consumer goods edged down on balance in July and August, and the growth of output of business equipment slowed. The rise in industrial production

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in August boosted the rate of utilization of manufacturing capacity, but the factory operating rate remained somewhat below the level of late last year.

Total retail sales were held down in July and August by a sharp contraction in spending for motor vehicles, but non-auto sales continued to rise at a brisk pace. The gains were widespread, with increases in spending on furniture and appliances, apparel, and miscellaneous nondurables especially strong. Purchases of services also were up appreciably further in July and August after a rapid second-quarter rise. Sales and construction of residential buildings remained quite strong on balance, reflecting very favorable homebuying conditions. Housing starts slipped in August but were still above the high level of the first half of the year. Sales of existing homes dropped back in August from the record high registered in July, while sales of new homes were slightly higher in July (latest data) than in the first half of the year.

Available indicators pointed to more moderate growth in business fixed investment after the surge in capital spending during the first half of the year. Shipments of nondefense capital goods declined in July and August, retracing much of June's large increase, while sales of medium and heavy trucks continued to increase at a rapid pace. Nonresidential construction weakened in July, extending a pattern of sluggish building activity; construction of industrial structures remained in a downtrend, and office building activity changed little on balance over June and July.

Business inventory accumulation eased further in July after having slowed sharply in the second quarter, and inventory–sales ratios remained moderate. Stockbuilding in manufacturing was at a somewhat lower rate in July than in the second quarter, and the stock–shipments ratio for the sector stayed a little above the low level that had prevailed over the past year. At the wholesale level, a further decline in inventories reflected additional reductions in motor vehicles; the inventory–shipments ratio remained in the upper part of its narrow range for the past year. In the retail sector, a sharp drop in stocks at automotive dealerships more than offset a rise in stocks of other goods. The aggregate inventory–sales ratio for the retail sector was at a relatively low level.

The nominal deficit on U.S. trade in goods and services narrowed slightly in July from its second-quarter average, with the value of imports falling more than the value of exports. Much of the decline in imports and exports involved trade in automotive products with Canada and Mexico. Economic activity in the major foreign industrial countries other than Japan decelerated on average in the second quarter, with a deterioration in net exports partially offsetting continued strength in domestic final demand. In Japan, activity contracted for a third consecutive quarter; net exports made a large positive contribution as imports dropped sharply, but domestic demand, most notably business fixed investment, fell steeply.

Both the overall and the core CPI again rose moderately in August; a further increase in food prices was offset by a sizable decrease in energy prices. For the twelve months ended in August, core consumer prices rose slightly more than they had in the year-earlier period. At the producer level, prices of finished goods dropped appreciably in August, largely reflecting declines in the prices of finished foods and, notably, energy goods. Producer prices of finished goods other than food and energy moved slightly higher in the twelve months ended in August after having edged down in the year-earlier period. Pro-

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ducer prices at earlier stages of production were under strong downward pressure; prices of intermediate materials fell during the year ended in August by slightly more than they had risen in the year-earlier period, and prices of crude materials plunged further in the twelve months ended in August. Average hourly earnings of production or nonsupervisory workers continued to increase at a relatively moderate pace in the July–August period, and for the twelve months ended in August they rose slightly more than in the year-earlier period.

At its meeting on August 18, 1998, the Committee adopted a directive that called for maintaining conditions in reserve markets that would be consistent with the federal funds rate continuing to average around 5½ percent. However, in light of mounting financial strains abroad, their potential implications for the U.S. economy, and less accommodative conditions in domestic financial markets, the Committee concluded that the risks to the outlook were no longer tilted toward rising inflation but had become more balanced. Accordingly, the Committee adopted a directive that did not include a presumption about the likely direction of any adjustment to policy during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with moderate growth of M2 and M3 over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining the existing degree of pressure on reserve positions, and the federal funds rate remained close to its intended level of 5½ percent. In an atmosphere of greatly increased volatility in financial asset values worldwide and a reduced appetite for risk among many investors, interest rates on U.S. Treasury securities, and to a much smaller extent on investment-grade corporate debt, fell appreciably during the intermeeting period; in contrast, yields on the bonds of lower-rated firms increased sharply, and a number of large banks tightened terms and standards for making business loans to sizable firms. Credit conditions also tightened in Europe, Asia, and Latin America. Share prices in U.S. and foreign equity markets remained volatile during the intermeeting period, and major U.S. equity price indexes declined considerably further on balance.

In foreign exchange markets, the trade-weighted value of the dollar depreciated substantially over the intermeeting period in relation to other major currencies. A spreading perception that the United States was more vulnerable than either Europe or Japan to an economic downturn in Latin America, increasing expectations of monetary easing in the United States, and shifts into yen associated with the end of the fiscal half-year in Japan and the unwinding of some investment positions financed in yen were factors that weighed on the dollar. By contrast, the dollar appreciated slightly in terms of an index of currencies that includes the developing countries of Latin America and Asia that are important trading partners of the United States.

Growth of M2 and M3 picked up considerably in August and apparently strengthened further in September. The acceleration was the result of unusually large inflows to money market funds that in part reflected households' preference for relatively safe, liquid placements for funds shifted out of equities and lower-rated corporate debt. For the year through September, both aggregates recorded growth rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt had moderated somewhat in

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recent months after having picked up earlier in the year.

The staff forecast prepared for this meeting incorporated a considerably weaker assessment of underlying aggregate demand, owing to downward revisions to growth abroad and to the less accommodative conditions that were evolving in U.S. financial markets. The staff projected that the expansion of economic activity would slow for a time to a pace appreciably below the estimated growth of the economy's potential and then would pick up to a rate more in line with that potential. Damped expansion of foreign economic activity and the lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place considerable restraint on the demand for U.S. exports for a period ahead and to lead to further substitution of imports for domestic products. Domestic production also would be held back for a while by the efforts of firms to bring inventories into better balance with the anticipated moderation in the trajectory of final sales. In addition, private final demand would be restrained by tighter lending terms and conditions as well as the drop that had occurred in equity prices. Pressures on labor resources were likely to ease somewhat as the expansion of economic activity slowed, but inflation was projected to pick up gradually in association with a partial reversal of the decline in energy prices this year.

In the Committee's discussion of current and prospective economic conditions, members focused on developments that pointed to the potential for a significant weakening in the growth of spending. They recognized that there were at present few statistical indications that the economy was on a significantly slower growth track. Indeed, the available data suggested that consumer expenditures and business investment retained considerable strength. At the same time, however, investors' perceptions of risks and their aversion to taking on more risk had increased markedly in financial markets around the world. That change in sentiment was exacerbating financial and economic problems in a number of important trading partners of the United States. In addition, it was generating lower equity prices and tightening credit availability in U.S. financial markets. As a consequence, the downside risks to the domestic expansion appeared to have risen substantially in recent weeks. Though labor markets were expected to remain relatively tight for some time, the members saw little prospect that inflation would gather significant momentum in coming quarters. Declining commodity and other import prices would be restraining prices and inflation expectations for a while. Overall consumer prices might rise a little more rapidly next year as the effects of a number of favorable factors, such as falling energy prices, diminished or reversed, but underlying inflation was expected to stay quite subdued as inflation expectations remained damped and pressures in labor markets became less pronounced.

The intensification and further spread of turmoil in international financial markets, notably since the outbreak of a financial crisis in Russia in mid-August, had spilled over into U.S. financial markets. Strong demands for safety and liquidity had driven down yields on U.S. Treasury securities, but spreads of private rates over Treasury rates had gapped higher. Increases in risk spreads were especially large for lower-grade borrowers and on bonds below investment grade, whose rates had increased considerably since mid-August. In addition, many banks had tightened their credit standards and terms. Prices in U.S.

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equity markets, which had weakened appreciably before the crisis in Russia, had declined substantially further. These market developments strongly suggested, and anecdotal reports tended to confirm, the emergence of widespread perceptions of greater risks in a broad range of financial investment activities and of considerably greater reluctance to put capital at risk. The members did not believe that the tightness in credit markets and strong demand for safety and liquidity were likely to lead to a "credit crunch," though some members expressed the view that such an outcome could not be ruled out. At a time when business balance sheets already indicated a significant softening of cash flows owing to weaker profits, many business firms were experiencing increased difficulty and costs in their efforts to raise funds in debt or equity markets or to borrow from lending institutions; if these conditions were to persist, the sustainability of the current strength in business capital expenditures would come into question. The decline in stock market prices also appeared likely to damp the growth of consumer spending over time, with added implications for business capital expenditures.

Despite the emergence of decidedly less hospitable financial conditions, there were few indications in the data available to the Committee of any weakening as yet in consumer and business spending. Consumer expenditures, though temporarily held back by shortages of new motor vehicles stemming from the work stoppage at General Motors, had remained on a solid uptrend, with overall growth in recent months apparently slipping only a little from a remarkably rapid pace in the first half of the year. Strong growth in jobs and incomes along with substantial further increases in stock market prices through mid-July had fostered a high level of consumer confidence and spending. Members commented that the more recent weakness in the stock market and the related decline in household net worth had removed an important support for the growth of consumer spending, but they noted that recent surveys indicated only a slight deterioration in consumer sentiment and that the stimulus from earlier stock market gains probably would dissipate only gradually. Looking further ahead, consumer spending could be expected to expand at a pace that was more in line with the growth of household incomes than it had been in recent years.

Growth in business investment spending, while apparently moderating from an extraordinary pace during the first half of the year, likewise seemed to have been little affected to date by the tightening in credit conditions and the increased aversion to risktaking. Data on shipments of capital equipment continued to display a clear uptrend, and members reported very strong construction activity in many parts of the country. Declining relative prices and rapid technological advances were likely to generate appreciable further growth in spending for computer and office equipment over the projection horizon. Moreover, new orders for capital equipment did not suggest any general weakening, though such orders had declined dramatically in the steel industry under the weight of intense foreign competition. Even so, the members anticipated that the pronounced increase in investor and lender perceptions of risk would result in considerable moderation in the growth of overall business investment, especially in light of concurrent expectations of reduced gains in sales and profits and evidence of some diminution in both internal and external sources of financing. Reports from nearly every Federal Reserve District suggested that

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executives had become considerably more concerned about business prospects. In a number of cases they already had seen a substantial downturn in their exports or a surge in competing imports at prices they found difficult to match. In other cases they were anticipating such developments or were reacting to the general sense of unease and uncertainty evident in financial markets. Forthcoming data on capital spending, including new orders and contracts, were likely to point to a weaker uptrend in business fixed investment. How much weaker was a major uncertainty in the economic outlook and a key to determining the extent to which financial market turmoil was likely to affect the real economy.

Very favorable underlying factors, including a strong job market and declining mortgage rates, had helped to sustain homebuilding activity at an elevated level. The large further advance in stock market prices earlier in the year also appeared to have been a positive factor in the strong performance of the housing market. While anecdotal reports suggested that softening was confined to only a few areas, the delayed effects of the drop in stock market prices and forecasts of slower employment and income growth suggested some moderation in housing activity at some point. Even so, the continued affordability of new homes for many households was likely to sustain housing demand at a relatively high albeit diminished level, and homebuilding activity would be bolstered for a time as backlogs created by shortages of skilled construction workers in many areas were worked off.

Net exports, while subject to a great deal of uncertainty, were seen as likely to continue to restrain demand and production to a substantial extent over coming quarters. Members cited examples from across the country of business firms, notably in the manufacturing sector but also in energy, agriculture, forest products, and some other industries, that already were being adversely affected by weaker export markets and increased competition from lower-priced imports. Moreover, the intensification of turmoil in international financial markets since the Russian devaluation and debt moratorium had led to tighter financial conditions in key U.S. trading partners—especially in the Americas—a development that was likely to weaken growth in those markets and demand for U.S. products. Of potentially greater importance for the domestic economic outlook, however, was the spread of international financial unsettlement to U.S. financial markets and the attendant deterioration in business and investor confidence. It was clear that the contagious effects of international economic and financial turmoil had markedly increased the downside threat to the domestic expansion.

In their comments about the outlook for inflation, members referred to the persistence of very tight labor markets across the nation and to indications of escalating increases in labor compensation in a number of areas. At the same time, price inflation generally had remained subdued, with little evidence of acceleration. As had been true for an extended period, competitive pressures were widely reported to be preventing employers from passing through rising labor costs to consumer prices. Looking ahead, members cited a variety of factors bearing on the prospects for inflation that on the whole suggested that the risks of an inflationary uptrend had receded. Favorable factors in the outlook for prices included the lingering effects of the dollar's earlier appreciation, ample industrial capacity, generally declining commodity and other import prices, and an apparently more

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rapid trend of productivity gains. Over time, some slowing in economic growth and less intense pressures on labor resources would hold down increases in labor costs. Developments that might tend to offset these positive factors, at least in part, included a possible turnaround in energy prices after sizable declines over the past year and an upturn in the costs of worker benefits, notably for medical expenses. A few members also observed that the rapid growth of key monetary aggregates, including M2, over a period of several quarters was a worrisome element in the outlook for inflation, though the most recent surge in M2 probably was induced in large measure by a flight to quality and liquidity.

In their discussion of policy for the intermeeting period ahead, all the members endorsed a proposal calling for a slight easing in reserve markets to produce a decline of ¼ percentage point in the federal funds rate to an average of about 5¼ percent. In their view, such an action was desirable to cushion the likely adverse consequences on future domestic economic activity of the global financial turmoil that had weakened foreign economies and of the tighter conditions in financial markets in the United States that had resulted in part from that turmoil. At a time of abnormally high volatility and very substantial uncertainty, it was impossible to predict how financial conditions in the United States would evolve. In the view of many members, equity prices and risk spreads in U.S. financial markets previously had embodied an overly optimistic assessment of business prospects, and they saw some correction in these markets as a positive development. Moreover, they expected markets to become much more settled once the initial adjustments to new risk assessments had been made. On balance, however, credit conditions were likely to remain tighter and equity prices lower than earlier, and in the context of continued damped inflation, monetary policy had the room to adjust to these new circumstances. In any event, an easing policy action at this point could provide added insurance against the risk of a further worsening in financial conditions and a related curtailment in the availability of credit to many borrowers.

The members agreed that the decrease in the federal funds rate should be limited to 25 basis points. Several emphasized in this regard that although the risk of rising inflation might have receded, it was still present, especially in light of the persistence to date of very tight labor markets and relatively robust economic growth. In these circumstances, while an easing move was warranted to provide some insurance against undesirably tight domestic financial conditions, many members saw the need for a cautious policy action. A more sizable policy move at this point might convey an exaggerated impression of the Committee's current thinking regarding the extent of downside risks in the economy.

The members were divided over whether to retain the current symmetrical directive or to adopt an asymmetrical directive that would be tilted toward ease. A small majority favored moving to asymmetry on the grounds that it seemed more consistent with the increased downside risks to the economy that they believed would exist even after the contemplated policy action and that it would underscore the Committee's readiness to respond promptly to conditions that might threaten the sustainability of the expansion. Other members expressed a preference for a symmetric directive but indicated that they could accept a directive that was tilted toward ease. In their opinion, the uncer-

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tainties relating to the direction of the next policy move were sufficiently great on both sides to justify a neutral directive. Some commented that unanticipated developments were likely in any event to provide the principal basis for future policy actions. They suggested that the Committee would undoubtedly confer by telephone should such developments materialize during the intermeeting period, and the symmetry or asymmetry of the directive would have little bearing on whatever policy decision might be reached.

At the conclusion of the Committee's discussion, all the members supported a directive that called for conditions in reserve markets that would be consistent with a slight decrease in the federal funds rate to an average of about 5¼ percent. All the members also indicated that they could accept a change in the directive to include a bias toward easing. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a slightly higher federal funds rate might be acceptable or a somewhat lower federal funds rate would be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the growth of M2 and M3 over the months ahead.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that the economy has been growing at a moderate rate, paced by brisk, albeit slowing, increases in spending by businesses and households, while expansion in overall economic activity has continued to be restrained by developments abroad. Nonfarm payroll employment grew somewhat more slowly over July and August, mostly reflecting job losses in the manufacturing sector; the civilian unemployment rate was unchanged at 4.5 percent in August. Industrial production has changed little on balance over recent months. Total retail sales over July and August were held down by a sharp contraction in spending for motor vehicles. Residential sales and construction have remained quite strong in recent months. Available indicators point to continued growth in business capital spending, but at a more moderate pace than in the first half of the year. Business inventory accumulation slowed further in July. The nominal deficit on U.S. trade in goods and services narrowed slightly in July from its second-quarter average. Trends in wages and prices have remained stable in recent months.

Most interest rates have fallen appreciably since the meeting on August 18, though yields on the bonds of lower-rated firms have increased and a number of large banks have tightened terms and standards for making business loans. Broadly similar developments have occurred in major foreign markets. Share prices in U.S. and global equity markets have remained volatile and major indexes have declined considerably further on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar declined substantially over the intermeeting period in relation to other major currencies; it was up slightly in terms of an index of the currencies of the developing countries of Latin America and Asia that are important trading partners of the United States.

Growth of M2 and M3 strengthened considerably in August and appeared to have picked up further in September, partly reflecting shifts of funds by households out of investments in equities and lower-rated corporate debt. For the year through September, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt has moderated somewhat in recent months after a pickup earlier in the year.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sus-

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tainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting on June 30–July 1 the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on a tentative basis to set the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with decreasing the federal funds rate to an average of around 5¼ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a slightly higher federal funds rate might or a somewhat lower federal funds rate would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Jordan, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin. Votes against this action: None.

Release of Information about FOMC Meetings

At this meeting, the Committee reviewed its current practices relating to its policy announcements, meeting minutes, and directive wording. This discussion was part of an ongoing appraisal of the Committee's disclosure policies. The Committee took no action at this meeting but agreed that further review of some of these issues would be appropriate.

Financial Problems of a Large Hedge Fund

The Committee discussed the limited role of the Federal Reserve Bank of New York in facilitating a private-sector resolution of the severe financial problems encountered in the portfolio managed by Long-Term Capital Management L.P. The size and nature of the positions of this fund were such that their sudden liquidation in already unsettled financial markets could well have induced further financial dislocations around the world that could have impaired the economies of many nations, including that of the United States. Against this background, the Federal Reserve Bank of New York had brought together key interested parties with the aim of increasing the probability of an orderly private-sector solution to the hedge fund's difficulties.

It was agreed that the next meeting of the Committee would be held on Tuesday, November 17, 1998.

The meeting on September 29 adjourned at 2:40 p.m.

After the meeting, the following press release was issued:

The Federal Open Market Committee decided today to ease the stance of monetary policy slightly, expecting the federal funds rate to decline ¼ percentage point to around 5¼ percent.

The action was taken to cushion the effects on prospective economic growth in the United States of increasing weakness in foreign economies and of less accommodative financial conditions domestically. The recent changes in the global economy and adjustments in U.S. financial markets mean that a slightly lower federal funds rate should now

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be consistent with keeping inflation low and sustaining economic growth going forward.

The discount rate remains unchanged at 5 percent.

Conference Call

In a telephone conference held on October 15, 1998, the Committee members discussed recent economic and financial developments and their implications for monetary policy. Risk aversion in financial markets had increased further since the Committee's meeting in September, raising volatility and risk spreads even more, eroding market liquidity, and constraining borrowing and lending in a number of sectors of the financial markets. Although indications of any softening in the pace of the economic expansion across the country remained sparse, the widespread signs of deteriorating business confidence and evidence of less accommodative domestic financial conditions suggested that the downside risks to the expansion had continued to mount.

Against this background, a consensus emerged in favor of a ¼ percentage point reduction in the federal funds rate that would accompany a reduction in the discount rate that the Board of Governors was expected to approve at a meeting following this telephone conference. Some members were concerned that a policy move so soon after the late September action might be misread as indicative of a degree of concern about prospective developments in financial markets or the economic outlook that did not represent the Committee's thinking. However, the members generally concluded that the risk of adverse market reactions was worth taking and that the easing actions under consideration were more likely to help settle volatile financial markets and cushion the effects of more restrictive financial conditions on the ongoing expansion. At the conclusion of this discussion, the Chairman indicated that he would instruct the Federal Reserve Bank of New York to lower the intended federal funds rate by 25 basis points, consistent with the Committee's directive issued at the meeting on September 29, 1998.

Donald L. Kohn
Secretary

On October 15, 1998, the following press release was issued:

The Federal Reserve today announced the following set of policy actions:

- The Board of Governors approved a reduction in the discount rate by 25 basis points from 5 percent to 4¾ percent.
- The federal funds rate is expected to fall 25 basis points from around 5¼ percent to around 5 percent.

Growing caution by lenders and unsettled conditions in financial markets more generally are likely to be restraining aggregate demand in the future. Against this backdrop, further easing of the stance of monetary policy was judged to be warranted to sustain economic growth in the context of contained inflation.

In taking the discount rate action, the Board approved requests submitted by the Boards of Directors of the Federal Reserve Banks of New York, Philadelphia, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, and San Francisco. The discount rate is the interest rate that is charged depository institutions when they borrow from their district Federal Reserve Banks.

Meeting Held on November 17, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, November 17, 1998, at 9:00 a.m.

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Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Prell, Economist

Messrs. Cecchetti, Dewald, Lindsey, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Ms. Johnson, Director, Division of International Finance, Board of Governors

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Alexander and Hooper, Deputy Directors, Division of International Finance, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Whitesell, Assistant Director, Division of Monetary Affairs, Board of Governors

Ms. Garrett, Economist, Division of Monetary Affairs, Board of Governors

Mr. Kumasaka, Assistant Economist, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Moore, First Vice President, Federal Reserve Bank of San Francisco

Messrs. Beebe, Eisenbeis, Ms. Krieger, Messrs. Lang, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, New York, Philadelphia, and Dallas respectively

Messrs. Evans, Fuhrer, Hetzel, Miller, and Sellon, Vice Presidents, Federal Reserve Banks of Chicago, Boston, Richmond, Minneapolis, and Kansas City respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on September 29, 1998, were approved. The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions

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in government securities and federal agency obligations during the period September 29, 1998, through November 16, 1998. By unanimous vote, the Committee ratified these transactions.

The Manager informed the Committee that he planned to initiate outright purchases in the secondary market of inflation-indexed Treasury securities. In the past, the System had been acquiring holdings of such securities in Treasury auctions in exchange for maturing nominal obligations. In the Manager's opinion, secondary market transactions would provide a helpful addition to the current range of assets that the System normally purchased, especially in a period of little or no increase in Treasury debt. Some members expressed concern that sizable purchases of indexed securities by the central bank might impair the liquidity of the market and limit the usefulness of these obligations as indicators of inflationary expectations. It was noted, however, that relatively limited System purchases of such securities were contemplated so that the market was not likely to be significantly affected. Moreover, the System's participation could contribute to a more active and liquid secondary market.

In further discussion of the wording of the operating paragraph of its directive, the Committee at this meeting focused on proposals by members to simplify and clarify the sentence relating to the symmetry or asymmetry of the directive as it applied to possible future policy changes. Time constraints did not permit the Committee to complete its deliberations, and it agreed to continue its discussion at a later meeting.

The Committee then turned to the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York. Committee decisions to amend the Authorization for Domestic Open Market Operations and to renew certain swap line agreements also are summarized below.

The information reviewed at this meeting suggested some moderation in the expansion of economic activity from a brisk pace during the summer months. Although growth of economic activity in the third quarter apparently about matched the pace in the first half of the year, a large buildup of nonfarm inventories had accounted for a significant portion of the persisting strength of the expansion during the quarter. Growth in consumer spending had been well maintained during the summer months, and housing activity had remained at a high level. In other major sectors of the economy, business fixed investment had softened after having surged in the first half, and net exports had declined further, although at a reduced pace. Growth in employment had slowed appreciably on balance during the summer and early fall months, but tight conditions had persisted in most labor markets. Recent wage and price developments had been mixed.

Growth in nonfarm payroll employment slowed appreciably in September and October. The slowing partly reflected sizable job losses in manufacturing, which has been substantially affected since earlier in the year by rising foreign competition stemming from the crisis in Asia. Outside of manufacturing, increases in employment in the service-producing industries moderated somewhat over the two months, although gains in finance, insurance, and

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real estate were relatively robust. The civilian unemployment rate remained near 4½ percent during the two months.

Industrial output had declined slightly in recent months after having rebounded in August when production resumed at General Motors following settlement of the labor strike. Outside the motor vehicle sector, manufacturing output edged lower in recent months after having decelerated markedly earlier in the year. Weakness in the manufacturing and mining sectors was associated in large measure with the fallout from the turmoil in Asia, its repercussions on a number of U.S. trading partners, and the related softness in world oil markets. The downward trend in the utilization of capacity in manufacturing left the factory operating rate appreciably below its level of late last year.

Personal consumption expenditures rose considerably further during the third quarter, though at a much slower pace than that recorded earlier in the year. Retail sales were down slightly on balance during the quarter, reflecting a sharp drop in sales of motor vehicles associated with the work stoppage at General Motors. However, the settlement of that strike and the resumption of production led to an upturn in motor vehicle sales in August and a sizable advance in September. A large further gain in such sales contributed to a sharp rise in overall retail sales in October. Consumer confidence retreated further in October, but according to a major survey it turned up in early November, albeit to a level still somewhat below its peak earlier in the year.

Available indicators pointed to a pickup in business capital spending after a third-quarter lull, owing to some extent to a recovery from the General Motors strike. Business investment expenditures during the summer were held down in part by the strike-related decline in fleet sales of new motor vehicles. In addition, spending for other types of business equipment grew somewhat more slowly in the third quarter after having expanded at an extraordinary pace earlier in the year. Orders received by U.S. equipment makers continued to trend up through September. In contrast, nonresidential building activity apparently fell somewhat further in the third quarter. While the construction of lodging facilities surged and the construction of office space persisted at a high level, there was a decline in other commercial building, which includes retail stores and warehouses, industrial structures, and institutional buildings. The availability of financing for various types of construction appeared to lessen substantially in late summer, and financing costs rose for many borrowers.

In the residential sector, housing sales and starts remained quite strong, though below early summer highs. Housing activity showed signs of dropping off from peak levels during the latter part of the summer, but the decline in mortgage rates this fall produced an upturn in several indicators of demand for single-family housing, including a rebound in a survey index of homebuying conditions. Multifamily housing starts increased considerably in the third quarter, but since late summer the availability of financing for multifamily building projects has tended to diminish and interest costs to rise.

Business inventory accumulation was sizable in the third quarter, and stocks–sales ratios rose to uncomfortable levels in some industries that were being adversely affected by the nation's growing trade deficit. In manufacturing, however, stockbuilding slowed during the summer months and the stock–shipment ratio was unchanged at a level just above its average for the past year. At the wholesale level, a rapid increase dur-

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ing the third quarter lifted the inventory–sales ratio for this sector to its highest level since 1986; nearly half the rise was the result of a buildup of farm products that was related in part to an early harvest, but wholesalers of machinery, chemicals, and metals and minerals also apparently experienced undesired buildups of stocks. Retail inventories excluding motor vehicles accumulated at a slow pace during the summer, and the inventory–sales ratio for this category remained well within the narrow range of the past year.

The nominal deficit on U.S. trade in goods and services widened to some extent in July–August from its second-quarter average. The value of imports in the July–August period, though rising appreciably in August, was somewhat below the second-quarter average, with most of the decline involving automotive products and oil. The value of exports fell somewhat over the two months, largely reflecting declines in exports of automotive products and industrial supplies and reduced service transactions. Decreases in exports partly reflected weakness in foreign economies. In the third quarter, growth in economic activity slowed on average in the major industrial countries, other than Japan, from the average pace in the first half of the year and contracted for a fourth consecutive quarter in Japan. There were widespread indications in the industrial nations, particularly from surveys of business and consumer confidence, that some slowing was persisting into the fourth quarter. Elsewhere, the available evidence pointed to some improvement in economic trends in a number of Asian nations, but the economies of several sizable South American countries appeared to have weakened. Recent economic indicators for Mexico were mixed.

The performance of various measures of wages and prices was uneven in recent months. The most recently available employment cost index indicated that hourly compensation of private industry workers posted a sizable increase in the third quarter. However, gains in average hourly earnings moderated considerably in September and October. The increase in the employment cost index over the past year was appreciably larger than in the previous year, while the advance in average hourly earnings moderated somewhat.

Consumer energy prices rose appreciably in October, but they were still down sharply from a year earlier and on balance limited the increase of overall consumer prices over the past year. Core consumer prices moved up at a faster pace than overall consumer prices in recent months and over the past year, reflecting sizable increases in the prices of tobacco, used cars and trucks, and services. At the producer level, prices of finished goods edged up in recent months but were down on balance over the past year; excluding food and energy items, producer prices rose somewhat over the past year.

At its meeting on September 29, 1998, the Committee adopted a directive that called for implementing conditions in reserve markets that were consistent with a one-quarter percentage point decrease in the federal funds rate to an average of around 5¼ percent. The Committee also decided to adopt an asymmetric directive that was tilted toward ease to highlight its view that the risks to the economic expansion were mainly on the downside and to underscore its readiness to respond promptly to developments that threatened the sustainability of the expansion. The reserve conditions associated with this directive were expected to be consistent with

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some moderation in the growth of M2 and M3 over subsequent months.

Following the meeting, open market operations were directed initially toward implementing a slight easing in the degree of pressure on reserve positions. The federal funds rate, responding to quarter-end pressures and uncertainties created by shifting funding patterns in volatile financial markets, tended at first to average somewhat above the intended rate of 5¼ percent despite a relatively liberal provision of reserves by the System. Strains in financial markets continued to mount, with intermediaries and final investors much more cautious about risks and leverage and much more eager to hold very liquid assets. These developments in turn disrupted flows of funds in a number of financial markets. On October 15, the Committee discussed these developments and their implications for the domestic economy, and the members supported the Chairman's suggestion that, in keeping with the directive issued at the September 29 meeting, he instruct the Federal Reserve Bank of New York to reduce the intended federal funds rate by a further 25 basis points to around 5 percent. On the same day, the Board of Governors approved a reduction in the discount rate from 5 percent to 4¾ percent. These actions were taken in the light of growing indications of caution by lenders and unsettled conditions in financial markets more generally that were deemed likely to restrain aggregate demand in the future. Subsequently, trading in the federal funds market remained relatively volatile but the federal funds rate averaged close to its lower intended level. In financial markets more generally, strains gradually moderated after mid-October and sizable issuance of securities resumed in a number of key markets, but uncertainty remained high and relatively illiquid conditions persisted. In the stock market, share prices dropped in the weeks following the September meeting, but the market rallied strongly after mid-October and key market indexes posted sizable gains on balance over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar fell moderately over the period in relation to other major currencies. The largest decline occurred in relation to the Japanese yen and appeared to reflect efforts to reduce speculative exposure to that currency; changes in the value of the dollar against other major currencies were mixed, likely fostered by disparate interest rate and economic developments. The dollar also fell somewhat in terms of a broad index of currencies of other countries that are important trading partners of the United States, including the developing nations of Latin America and Asia.

M2 and M3 posted very large increases in September and October. The gains appeared to be induced to an important extent by increased demand for safe and liquid assets in a period of substantial turmoil in financial markets that led to shifts of funds by households out of investments in equities and lower-rated corporate debt. The advance in M2 during October probably also was boosted by the decline in its opportunity cost resulting from the effects of the System's easing actions on market interest rates and the unusual softness in Treasury bill rates during much of the month. The even faster increase in M3 in October also reflected both inflows to institution-only money market mutual funds that were stimulated by declines in short-term market rates and bank efforts to fund heavy demand for loans arising in part from the deflection of demand for funding from securities mar-

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kets. For the year through October, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic nonfinancial debt moderated slightly in recent months after having picked up earlier in the year.

The staff forecast prepared for this meeting continued to point to considerable slowing in the expansion of economic activity to a pace appreciably below the estimated growth of the economy's potential, but the expansion was expected to pick up later to a rate more in line with that potential. Subdued expansion of foreign economic activity and the lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place considerable, albeit diminishing, restraint on the demand for U.S. exports for some period ahead and to lead to further substitution of imports for domestic products. Domestic production would also be held back for a time by the efforts of firms to bring inventories into better balance with the anticipated moderation in the trajectory of final sales. In addition, private final demand would be restrained a bit by the tighter terms and conditions that were now imposed by many types of lenders and by the anticipated waning of positive wealth effects stemming from earlier increases in equity prices. Pressures on labor resources were likely to ease somewhat as the expansion of economic activity moderated, but inflation was projected to rise considerably over the year ahead in association with a partial reversal of the decline in energy prices this year.

In the Committee's discussion of current and prospective economic developments, members observed that indications of some moderation in the pace of the economic expansion were still quite limited, but they generally agreed that the economy appeared to be headed toward slower growth. Relatively tight profit margins and less ebullient growth in wealth were among the factors expected to be damping investment and consumption. In addition, even apart from the possibility of further financial contagion in Latin America, the weakness in foreign economies continued to be seen as a persistent source of restraint on demand in a number of domestic sectors, notably manufacturing, agriculture, and some extractive businesses. Although the financial markets had improved substantially in recent weeks, overall credit conditions were still relatively unsettled and a possible reintensification of difficulties in credit markets constituted an important downside risk to the expansion. The members recognized that not all the risks were in one direction, however. The economy had demonstrated remarkable resilience and strength over recent years, and in the view of some members the rapid growth of liquidity and bank credit suggested that financial conditions were not excessively tight. With regard to the outlook for inflation, members noted that while statistical and anecdotal information pointed to persistently tight labor markets in much of the nation, price inflation remained subdued. Indeed, even though the recent evidence relating to prices was somewhat mixed, several broad measures of prices suggested that inflation might be on a declining trend.

In the course of the Committee's discussion, the members gave considerable attention to recent financial developments and their implications for the economic outlook. Financial markets clearly had calmed markedly since the System's easing actions in mid-October, though they were still atypically volatile. Risk spreads had narrowed substantially and other measures of financial market performance also suggested that

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risk aversion and the related desire for liquidity had diminished appreciably. Markets for new issues had reopened for many borrowers, and stock market prices had posted large gains. Nonetheless, strains and weaknesses in financial markets had not disappeared—many risk spreads were still at unusually high levels—and the markets remained quite sensitive to unanticipated developments. Members also noted that the improvement in debt markets appeared to have come to a halt most recently and that renewed strains had emerged in some short-term debt markets, though the latter probably were related in large measure to concerns about year-end pressures in the money markets. Indeed, efforts by lenders and borrowers to position for year-end financial statements were likely to contribute considerably to keeping market conditions unsettled over coming weeks. Lending activity at banks had increased sharply in recent months as many borrowers found other sources of funds less receptive or unavailable and turned to backup lines for credit, but banks also had tightened their credit terms and standards for most new loans and lines of credit. As a result, financing generally had become less available and more expensive for higher-risk business borrowers. In light of these developments, members believed that the continuing fragility of financial markets and the increased scrutiny of the credit quality of borrowers, though the latter was in some respects a welcome development, posed a considerable downside risk to the expansion. The very recent behavior of equity prices was difficult to explain satisfactorily, and potential movements in those prices posed risks on both sides of the most likely forecast: A future substantial increase would bolster wealth and spending, but a sharp decline also could not be ruled out—especially if, as seemed quite possible, added increases in prices were not supported by robust increases in profits.

Foreign economic and financial developments were another important source of downside risk and uncertainty. The economic and financial turmoil in Asia had spread to numerous other nations around the world and to an extent to the United States. While economic weakness in many U.S. trading partners likely would continue to have adverse effects on net U.S. exports, the potential extent of such weakness was subject to considerable uncertainty as were the associated repercussions on financial markets. As they had at previous meetings, members referred to numerous anecdotal reports of heightened competition from foreign producers that was curbing the sales of many domestic manufacturers, notably in the steel industry, and in some other industries and agriculture. Moreover, the low level of world oil prices, which appeared to be importantly associated with diminished demand from Asian countries, was retarding production and reducing revenues in the U.S. energy and related industries. On the positive side, members commented that economic and financial conditions appeared to have stabilized or improved a bit in a number of Asian nations, though the recession in Japan showed little evidence of coming to an end, and the outlook for Brazil seemed a little more promising. However, economic and financial conditions in Brazil and a number of other countries remained very fragile. The recent depreciation of the dollar, while perhaps putting some upward pressure on prices, would damp the deterioration in net U.S. exports.

In their review of recent and prospective developments across the nation and in key sectors of the economy, members referred to scattered indications of

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some slowing in private domestic final demands. In the important consumer sector, however, evidence of weakening growth in expenditures was quite limited. The most recent anecdotal reports pointed to solid growth in most though not all regions of the country, and retail sales posted a strong advance in October. Moreover, consumer sentiment remained at a high level, albeit below its peak earlier in the year according to a recent survey. Members commented, however, that the more moderate growth in employment and incomes experienced recently likely would persist and should result in reduced gains in consumer expenditures next year, but they also noted that the extent of the deceleration was subject to considerable uncertainty. Some members referred to reports from contacts in the retailing industry who expressed some concern about the potential for weaker retail sales after the holiday season. A significant factor bearing on consumer spending would be the performance of the stock market. The impetus from the wealth effects of rapidly rising share prices would wane if such prices were to stabilize near current levels.

With regard to business fixed investment, anecdotal evidence was accumulating that many business firms, notably in manufacturing, were scaling back their planned capital outlays for the year ahead. Factors contributing to the prospective deceleration in business capital expenditures included a weaker trend in profits over the past several quarters, a related deterioration in business cash flows, and a large buildup in capacity over the course of recent years. Members also referred to indications of curtailed availability and more costly financing for some businesses, notably for relatively speculative construction projects. A number of members observed that the latter was a healthy development in that it would tend to hold down overbuilding in some areas. Overall, capital expenditures would undoubtedly recover from their slight decline during the summer months, but the outlook was for growth next year at a pace well below that experienced for an extended period before mid-1998. Housing construction was expected to remain at a high level, buttressed by attractive terms on new home mortgages, but housing activity appeared to have peaked or declined slightly in some regions.

The rapid buildup in inventories during the third quarter was not likely to continue, but the timing and extent of the expected moderation were largely unpredictable. It was noted in this regard that while inventories appeared to have risen to uncomfortable levels in some industries, there was no evidence of a general inventory overhang. Looking ahead, the projected slowing in the growth of final sales, including the effects of weak export markets, likely would reinforce business efforts to bring the growth of their inventories into better alignment with that of their sales, and such a development should contribute to the projected slowing in overall economic activity in coming quarters. It was unclear at this point to what extent year 2000 concerns might stimulate extra inventory investment prior to the end of 1999.

In their review of developments bearing on the outlook for inflation, members commented that labor markets remained exceptionally tight, though there was little evidence that they had tightened further in recent weeks. Employers were continuing to resist pressures to grant unusually large wage increases, and the persistence of vigorous competition, including that from Asian imports, was preventing most business firms from passing cost

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increases through to prices. Indeed, the declining trend in profits in recent quarters suggested that many firms were absorbing some of their rising labor costs to the extent that the latter were not offset by improvements in productivity. Looking ahead, slower growth in economic activity would tend to hold down pressures on wages and prices during 1999 and imports from Asian and other depressed economies would continue to generate intense competition in many markets; but labor markets remained tight, energy and commodity prices could well turn up after substantial declines, and the recent depreciation of the dollar would lessen pressures from foreign competition. A number of members expected that, on balance, inflation might be less favorable next year, though any deterioration in underlying trends should be relatively limited; others anticipated little change in and possibly some further ebbing of price inflation, extending the subdued behavior of a number of comprehensive measures of prices.

In the Committee's discussion of policy for the intermeeting period ahead, nearly all the members indicated that they could accept a proposal to reduce the federal funds rate by a further 25 basis points to an average of 4¾ percent. This policy decision was viewed as a close call by several members. While the growth of the economy was expected to slow appreciably over the year ahead, the expansion currently displayed only modest signs of moderating from what seemed to be an unsustainable pace. Moreover, many members saw some risk that an easing move at this point might trigger a strong further advance in stock market prices that would not be justified on the basis of likely future earnings and could therefore lead to a relatively sharp and disruptive market adjustment later. The members were more concerned, however, about the risks stemming from the still sensitive state of financial markets, and in that regard many believed that a prompt policy easing would help to ensure against a resurgence of severe financial strains. A further easing move would complete the policy adjustment to the changed economic and financial climate that had emerged since midsummer and would provide some insurance against any unexpectedly severe weakening of the expansion. Most members saw little risk that a modest easing would ignite inflationary pressures in the economy, given the subdued behavior of inflation and their outlook for economic activity. Moreover, the easing could readily be reversed if unexpected circumstances should call for such an action. In this view, the risks of inaction were greater in terms of the potential financial consequences and also could materialize much sooner than the risks of stimulating greater inflation through the slight easing that was contemplated.

Some members indicated that in light of continued robust economic growth, tight labor markets, and improving financial conditions they had a preference for awaiting further developments that might provide a stronger basis for an easing action. Some of these members expressed concern that easier reserve conditions would accommodate a step-up in monetary growth that was already quite rapid, with potentially inflationary consequences later. Nonetheless, all but one of these members could endorse the decision to ease, given the evident downside risks in the international situation, financial market uncertainty, the likelihood that inflation would still be quite low, and the possibility of reversing the action reasonably promptly should circumstances warrant.

Given its decision to ease policy, the Committee favored a change to symme-

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try from the asymmetry toward ease in its recent directives. A symmetrical directive was now felt to be appropriate in light of the Committee's expectation that further easing was not likely to be needed over the months ahead unless ongoing developments pointed to a more substantial decline in the growth of economic activity or further ebbing of inflation than was currently anticipated. The members recognized that the possible emergence of severe year-end pressures in the money market might require some temporary easing in reserve conditions, but such a development did not seem to have a high probability and could in any event be readily and properly accommodated regardless of the bias in the directive.

At the conclusion of the Committee's discussion, all except one member supported a directive that called for conditions in reserve markets that would be consistent with a slight decrease in the federal funds rate to an average of about 4¾ percent. These members also accepted a proposal to remove the bias toward easing that had been adopted at the previous meeting. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a slightly higher federal funds rate or a slightly lower federal funds rate would be acceptable during the the intermeeting period. A staff analysis prepared for this meeting suggested that the reserve conditions contemplated by the Committee were likely to be consistent with some moderation in the growth of M2 and M3 over the months ahead.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests some moderation in the expansion of economic activity from a brisk pace during the summer months. Growth in nonfarm payroll employment slowed appreciably in September and October; the civilian unemployment rate remained near 4½ percent. Industrial production has declined slightly in recent months. Business inventory accumulation was sizable in the third quarter, and stock–sales ratios rose to uncomfortable levels in some sectors strongly affected by the nation's trade deficit. The nominal deficit on U.S. trade in goods and services widened somewhat in July–August from its second-quarter average. Total retail sales rose sharply in October after increasing only moderately in August and September. Residential sales and building starts have remained quite strong, but below recent peaks. Available indicators point to a pickup in business capital spending after a lull in the third quarter, owing in part to a recovery from the summer strike in the motor vehicle industry. Trends in various measures of wages and prices have been mixed in recent months.

Most market interest rates have risen on balance since the meeting on September 29, though yields on the bonds of lower-rated firms have declined. The Board of Governors approved a reduction in the discount rate from 5 to 4¾ percent on October 15. Share prices in U.S. and global equity markets have remained volatile but have posted sizable gains on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar declined moderately over the period in relation to other major currencies; it also fell somewhat in terms of an index of the currencies of other countries that are important trading partners of the United States.

M2 and M3 have posted very large gains in recent months, reflecting the effects of recent System easing actions on market interest rates and shifts of funds by households out of investments in equities and lower-rated corporate debt. For the year through October, both aggregates rose at rates well above the Committee's ranges for the year. Expansion of total domestic non-

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financial debt has moderated slightly in recent months after a pickup earlier in the year.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting on June 30–July 1 the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on a tentative basis to set the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with decreasing the federal funds rate to an average of around 4¾ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a slightly higher federal funds rate or a slightly lower federal funds rate would be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin. Vote against this action: Mr. Jordan.

Mr. Jordan dissented because he believed that the two recent reductions in the federal funds rate were sufficient responses to the stresses in financial markets that had emerged suddenly in late August. An additional rate reduction risked fueling an unsustainably strong growth rate of domestic demand. He expressed concern that the excessively rapid rates of growth of the monetary and credit aggregates were inconsistent with continued low inflation. Moreover, any further monetary expansion in response to economic weakness abroad could ultimately have a disrupting influence on domestic prosperity if policy were forced to reverse course at a later date to defend the purchasing power of the dollar.

Renewal of Reciprocal Currency Arrangements with the Banks of Canada and Mexico

The Committee voted unanimously to reauthorize Federal Reserve participation in the North American Framework Agreement, established in 1994, and the associated bilateral reciprocal currency ("swap") arrangements with the Bank of Canada and the Bank of Mexico. These arrangements, which predated the North American Framework Agreement, were linked into a trilateral facility in connection with the establishment of the North American Financial Group in 1994 to facilitate consultation and cooperation among the three countries in the area of macroeconomic policy as an outgrowth of the increasing integration of those economies expected to result from the North American Free Trade Agreement.

Owing to the formation of the European Central Bank and in light of 15 years of disuse, the bilateral swap arrangements of the Federal Reserve with the Austrian National Bank, the National Bank of Belgium, the Bank of France, the German Federal Bank, the Bank of Italy, and the Netherlands Bank were jointly deemed no longer to be necessary in view of the well established present-day arrangements

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for international monetary cooperation. Accordingly, it was agreed by all the bilateral parties to allow them to lapse. Similarly, it was jointly agreed to allow the bilateral swap arrangements between the Federal Reserve and the National Bank of Denmark, the Bank of England, the Bank of Japan, the Bank of Norway, the Bank of Sweden, the Swiss National Bank, and the Bank for International Settlements to lapse in light of their disuse and present day arrangements for international monetary cooperation.

Authorization for Domestic Open Market Operations

On the recommendation of the Manager, the Committee voted unanimously to amend the authorization for domestic open market operations to extend the maximum maturity of System repurchase agreements from 15 calendar days to 60 calendar days. The purpose of the expanded authority was to enhance the flexibility of the Manager in meeting reserve-supplying objectives during periods of pronounced seasonal needs, notably those associated with the year-end. Subject to the Committee's approval, the Manager would initiate the System's use of extended-term repurchase agreements ahead of the coming year-end, and he anticipated that such use could prove to be especially advantageous in late 1999 to the extent that year 2000 concerns generated accentuated seasonal demand for currency. In addition, the availability of the extended funding could help to allay concerns in the federal funds market about the cost of financing during periods of peak seasonal pressures, with favorable effects on the market's functioning.

Accordingly, effective November 17, 1998, paragraphs 1(b) and 3 of the authorization for domestic open market operations were amended to read as follows:

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 60 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 60 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

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It was agreed that the next meeting of the Committee would be held on Tuesday, December 22, 1998.

The meeting adjourned at 1:25 p.m.

Normand Bernard
Deputy Secretary

After the meeting, the following press release was issued:

The Federal Reserve today announced the following set of policy actions:

- The Board of Governors approved a reduction in the discount rate by 25 basis points from 4¾ percent to 4½ percent.
- The federal funds rate is expected to fall 25 basis points from around 5 percent to around 4¾ percent.

Although conditions in financial markets have settled down materially since mid-October, unusual strains remain. With the 75 basis point decline in the federal funds rate since September, financial conditions can reasonably be expected to be consistent with fostering sustained economic expansion while keeping inflationary pressures subdued.

In taking the discount rate action, the Board approved requests submitted by the Boards of Directors of the Federal Reserve Banks of New York, Philadelphia, and Dallas. The discount rate is the interest rate that is charged depository institutions when they borrow from their district Federal Reserve Banks.

Meeting Held on December 22, 1998

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 22, 1998, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Jordan
Mr. Kelley
Mr. Meyer
Ms. Minehan
Mr. Poole
Ms. Rivlin

Messrs. Boehne, McTeer, Moskow, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Broaddus, Guynn, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Fox, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist

Ms. Browne, Messrs. Cecchetti, Hakkio, Lindsey, Simpson, Sniderman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Ms. Johnson, Director, Division of International Finance, Board of Governors

Messrs. Alexander and Hooper, Deputy Directors, Division of International Finance, Board of Governors

Messrs. Madigan and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Mr. Reinhart, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

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Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Ms. Pianalto, First Vice President, Federal Reserve Bank of Cleveland

Messrs. Beebe, Eisenbeis, Goodfriend, Hunter, Lang, and Rolnick, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Richmond, Chicago, Philadelphia, and Minneapolis respectively

Mr. Gavin and Ms. Perelmuter, Vice Presidents, Federal Reserve Banks of St. Louis and New York respectively

Mr. Duca, Assistant Vice President, Federal Reserve Bank of Dallas

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 17, 1998, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting, and thus no vote was required of the Committee.

By unanimous vote the Committee amended the Authorization for Foreign Currency Operations to add the euro to the list of foreign currencies in which the Federal Reserve Bank of New York is authorized to conduct open market operations. The Desk's holdings of German marks will automatically be converted to euros when that currency is introduced on January 1, 1999.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period November 17, 1998, through December 21, 1998. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the economy had continued to expand at a brisk pace in recent months. Domestic final demand had remained robust, and production and employment had recorded further solid gains. Trends in various measures of wages and prices had been mixed in recent months.

Nonfarm payroll employment rose strongly in November after having recorded reduced increases in September and October. Job gains were widespread in November; hiring in the services industries remained brisk, construction payrolls surged further, and retail employment rebounded after a lackluster rise in October. In sharp contrast to the general job picture, employment in manufacturing continued to drop. The civilian unemployment rate fell to 4.4 percent in November.

Total industrial production declined somewhat in November in association with a weather-related drop in utilities output and persisting weakness in mining activity. Manufacturing output was unchanged in November after a considerable increase in October. Production in high-tech industries recorded large gains over the October–November period, the output of construction supplies climbed rapidly, and consumer goods manufacture expanded briskly.

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However, production of motor vehicles and parts was unchanged on balance over the two months and materials output continued to decline, with the iron and steel industry registering particularly large decreases. The utilization of manufacturing capacity dropped over the October–November period to its lowest level in more than five years.

Strength in consumer spending persisted in October and November, with retail sales rising sharply in both months. Increases in sales of motor vehicles and other durable goods were particularly large, but expenditures for nondurable goods also recorded sizable advances. Supported by continuing gains in disposable income and the rebound in the stock market, consumer confidence remained at a relatively favorable level, though noticeably below the peak reached earlier in the year.

The residential housing sector continued to surge, as single-family housing starts registered another strong advance in November and sales of new homes remained at a very high level. Unseasonably favorable weather over much of the country evidently contributed to that performance. Nonetheless, the low level of mortgage rates and a record high in an index of consumer assessments of homebuying conditions in November suggested that strength in single-family housing might continue for a time. Multifamily housing starts in October and November were slightly above the average for earlier in the year, and permits for new projects had been rising recently.

Business fixed investment appeared to have rebounded from a small decrease in the third quarter that had been associated in part with a strike-related drop in business purchases of motor vehicles and persisting weakness in nonresidential construction. Shipments of office and computing equipment rose sharply in October after having declined for two months, and a sizable backlog of orders for communications equipment suggested that the downturn in shipments in October after a September surge would be shortlived. In addition, outlays for heavy trucks reached record levels and expenditures for aircraft were well maintained. In the nonresidential sector, building activity remained soft in October. Office construction picked up further in response to falling vacancy rates and rising rental costs, but other building activity continued sluggish, and available data on new contracts pointed to persisting weakness.

Business inventory accumulation slowed appreciably in October after a sizable rise in the third quarter. In manufacturing, however, the pace of stockbuilding picked up in October from a slow rate in the third quarter, and the stock–shipments ratio remained in the upper portion of its narrow range over the past year. In the wholesale sector, inventories declined somewhat in October following a large increase in the third quarter; much of the reduction was in farm products. The inventory–sales ratio for the wholesale sector was still at the top of its range over the past year. Retail inventory accumulation in October was near the modest pace of the third quarter, and the inventory–sales ratio was slightly below its range over the preceding twelve months.

The nominal deficit on U.S. trade in goods and services in October was little changed from its September level but was slightly smaller than its average for the third quarter. The value of exports was up considerably in October from its third-quarter average; the largest gains were in machinery, agricultural products, and industrial supplies. The value of imports also rose in October. The rise in imports was spread across all major trade categories, with the largest

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increases being in capital goods and oil. The limited information available for the fourth quarter suggested that the Japanese economy remained mired in recession and that the pace of economic growth in most of the other major industrial countries was slowing. Activity in most of the Asian developing economies remained depressed, though there were signs that activity in some was nearing a trough and that growth in China and Taiwan had picked up somewhat. In contrast, economic conditions in most Latin American economies had worsened considerably in recent months.

Consumer price inflation remained subdued in November, with both the overall index and the index excluding food and energy items rising at the same relatively low rates as in October. For the twelve months ended in November, the increase in core consumer prices was a little larger than in the previous twelve-month period, reflecting slightly bigger advances in the prices of both commodities and services. A similar pattern was evident in producer prices of finished goods other than food and energy; core producer prices continued to rise at a low rate in November, and the increase in these prices in the twelve months ended in November was somewhat larger than in the previous twelve-month period. In contrast, prices for crude and intermediate materials continued their downward trend in both the October–November period and the twelve months ended in November. Growth in average hourly earnings of production or nonsupervisory workers had slowed over recent months to a modest rate in October and November. While the deceleration in hourly earnings was relatively widespread across industries, and most pronounced in manufacturing, wages continued to accelerate in the services industries and in finance, insurance, and real estate.

At its meeting on November 17, 1998, the Committee adopted a directive that called for implementing conditions in reserve markets that were consistent with a one-quarter percentage point decrease in the federal funds rate to an average of around 4¾ percent. The Committee also decided that moving to a symmetric directive would be appropriate, given that further easing likely would not be needed over the months ahead unless unexpected developments were to point toward a more substantial weakening in the growth of economic activity or to less inflation than was currently anticipated. The reserve conditions associated with this directive were expected to be consistent with some moderation in the growth of M2 and M3 over the months ahead.

Open market operations immediately after the meeting were directed toward implementing the desired slight easing in the degree of pressure on reserve positions, and through the remainder of the intermeeting period the Manager sought to maintain that easier stance. The federal funds rate remained very close to its intended lower level on average, and most other short-term market rates registered small mixed changes. Longer-term Treasury rates declined somewhat in response to a weaker outlook for foreign economic activity and the potential damping effect of lower commodity prices on inflation. Share prices in U.S. equity markets remained volatile but posted substantial increases on balance over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar fell slightly over the intermeeting period in relation to other major currencies and also in terms of an index of the currencies of other countries that are important trading partners of the United States. Concerns about the vulnerability of U.S. markets to financial difficulties in

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Brazil and uncertainty generated by the impeachment proceedings were said to weigh on the dollar at times. The dollar's larger decline against the Japanese yen than against the German mark and other European currencies may have stemmed from a disparity in interest rate movements in those countries; long-term interest rates rose in Japan, partly in anticipation of heightened financing requirements associated with further fiscal stimulus, while European interest rates fell in response to cuts in official interest rates and weaker-than-expected economic data. Financial conditions affecting emerging market economies continued to improve for a time after the Committee eased monetary policy at its November 17 meeting, but that trend was subsequently reversed after Brazil's legislature decided to reject a key fiscal reform measure.

M2 and M3 had continued to expand rapidly in recent months, although incoming data indicated that growth was slowing somewhat in December. The continued strength of M2 in November reflected the reduction in its opportunity cost as a result of recent easings of monetary policy, greater growth of liquid deposits in association with heavy mortgage refinancing activity, and brisk demand for U.S. currency both at home and abroad. M3 growth was bolstered by further large flows into institution-only money market funds and additional RP financing in association with hefty acquisitions of securities by banks. For the year through November, both aggregates rose at rates well above the Committee's annual ranges. Total domestic nonfinancial debt had expanded in recent months at a pace somewhat above the middle of its range. Continued paydowns of debt by the federal government were more than offset by appreciable growth of private demands for credit to finance strong spending on durable goods, housing, and business investment, as well as merger and acquisition activity.

The staff forecast prepared for this meeting pointed to considerable slowing in the expansion of economic activity in the year ahead to a pace somewhat below the estimated growth of the economy's potential. However, the expansion was expected to pick up later to a rate more in line with that potential. Subdued expansion of foreign economic activity and the lagged effects of the earlier rise in the foreign exchange value of the dollar were expected to place continuing, albeit diminishing, restraint on the demand for U.S. exports for some period ahead and to lead to further substitution of imports for domestic products. In addition, growth in private final demand would be restrained to some extent by the tighter terms and conditions that were now being imposed by many types of lenders, by the anticipated waning of positive wealth effects stemming from earlier large increases in equity prices, and by the buildup of stocks of consumer durables, housing units, and business capital goods. Pressures on labor resources were likely to ease slightly as the expansion of economic activity moderated, but inflation was projected to rise noticeably over the year ahead, largely in association with a partial reversal of the decline in energy prices this year.

In the Committee's discussion of current and prospective economic conditions, members commented that moderate growth at a pace close to the economy's potential remained a reasonable expectation for the year ahead. The members recognized, however, that such a projection was subject to an unusually wide range of uncertainty in both directions. On the upside, they emphasized the marked resilience and persisting strength of private domestic demand,

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which had kept the economy expanding at a faster pace than most had anticipated. In addition, members commented that domestic financial conditions, including the rebound in stock market prices, currently were supportive of further expansion in aggregate demand, and in that regard several noted the continued rapid growth of the broad monetary aggregates. Still, domestic financial markets remained unusually sensitive and subject to relatively pronounced adjustments to unanticipated developments that could have substantial effects on confidence and economic activity. The external sector continued to represent a major source of downside risk; the economies of several industrial countries seemed to be weakening and the outlook for several key emerging market economies remained in doubt, with a further loss of confidence and contagion from the latter a continuing threat. With regard to the outlook for inflation, members reported that labor markets were extraordinarily tight across the nation, but they saw only limited evidence of accelerating wage increases and little or no evidence of rising inflation in broad measures of prices. Several commented, however, that the risks of inflation appeared to be tilted to the upside, given the continuing strength of the domestic expansion and accommodative financial conditions.

In their review of developments in various parts of the country and major industries, members referred to widespread evidence of high levels and strong growth of overall domestic production and demand, but also to the continued retarding effects of the foreign trade sector on agriculture and manufacturing and extractive industries. Growth in consumer spending was expected to moderate over coming quarters from a very robust pace. Factors contributing to this assessment included expectations of somewhat slower growth in employment and incomes and the prospect that increases in financial wealth would moderate or even end at some point. Members also referred to the possibility that the very low saving rate would tend to limit increases in consumer spending, but they noted that high levels of consumer confidence and wealth along with low interest rates should help to sustain at least moderate growth in coming quarters.

Forecasts of business investment spending pointed to appreciable deceleration in the year ahead after very rapid increases in recent years. Among the factors cited in support of a slowing uptrend were the anticipated slower growth in overall demand and the large cumulative buildup of business capital that had resulted in comparatively subdued pressures on capacity. Forecasts of reduced growth in business expenditures tended to be supported by anecdotal reports that many business firms were planning to trim their capital outlays during the year ahead. Perhaps the slower growth in corporate earnings, which had been evident since earlier in the year, and reduced cash flows were beginning to exert some restraint on business capital spending. Some members observed, however, that there was little evidence thus far of any deceleration in business equipment expenditures and that the persistence of tight labor markets should continue to encourage relatively rapid growth in labor-saving business capital.

Housing activity had displayed a great deal of strength in recent months according to both anecdotal and statistical reports at this meeting. Comparatively warm weather had extended the building season in several areas, while rising incomes and low interest rates had continued to stimulate housing demand. Some retrenchment in housing activity

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from currently high levels seemed likely over coming quarters, given the recent large additions to the stock of housing units and some anticipated deceleration in the growth of jobs and incomes.

Members viewed the foreign sector as likely to exert a smaller negative effect on domestic growth in the year ahead. This view was based on the expectation of some stabilization or improvement in foreign financial markets and economies. In addition, the foreign exchange value of the dollar had been declining in recent months, and the effects of its earlier appreciation on the trade balance would be waning. However, they recognized that net exports could turn out to be substantially more negative than the modal forecast, given the persistence of very fragile financial and economic conditions in several large emerging economies, continued weakness in the Japanese economy, and questions about the prospective strength of economic activity in other industrial nations. As recent experience had demonstrated, a crisis in one or a group of important financial markets and economies could spread rapidly around the world.

The outlook for inflation remained favorable, though some members referred to a number of upside risks going forward. For now, however, there were few signs of rising price inflation despite widespread indications of very tight labor markets, including reports of further tightening in some areas. Indeed, the most recent wage and price data were encouraging. Increases in core measures of prices were limited, and sizable declines in oil and commodity prices should help to moderate inflation going forward, in part by holding down inflation expectations. Looking beyond the nearer term, current forecasts suggested that moderating growth in overall economic activity would tend to limit pressures on resources and foster relatively subdued price inflation in the context of robust productivity growth and ample industrial capacity. Members who viewed the risks as tilted mainly to the upside commented that the effects of the anticipated reversal of a number of factors—including the declines in oil and commodity prices and restrained increases in health care costs—that had tended to hold down overall inflation might turn out to be more pronounced than was currently forecast. Moreover, underlying cost and price pressures might emerge more rapidly under such circumstances, especially if overall demand continued to outpace the growth of potential. Some members also referred to the potential inflationary effects over time of the continuation of quite rapid monetary growth. On balance, however, the members generally believed that prospective trends in overall economic activity and the persistence of strong competitive pressures in most markets, including the effects of foreign competition, were likely in the context of now firmly embedded expectations of low inflation to moderate any tendency for price inflation to accelerate over the year ahead.

In the Committee's discussion of policy for the intermeeting period, all the members agreed on the desirability of maintaining an unchanged policy stance. The System's policy easing actions since late September had helped to stabilize a dangerously eroding financial situation, and current financial conditions as well as underlying economic trends suggested that needed policy adjustments had been completed. For now at least, monetary policy appeared to be consistent with the Committee's objectives of fostering sustained low inflation and high employment. Accordingly, the Committee had entered a period where vigilance was called for but where the

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direction and timing of the next policy move were uncertain.

As already noted, Committee members saw risks on both sides of their forecasts. Persistently strong demand and increasingly supportive conditions in debt and equity markets suggested the possibility of rising inflation pressures. But greater disturbances abroad, especially if they were to be transmitted to domestic financial markets, could exert considerable restraint on the domestic economy. Fortunately, with low inflation, if not price stability, increasingly embedded in expectations, the Committee would have time to react to potential inflationary pressures. In the event of downward shocks to the expansion, prompt action to ease policy would be needed, but such shocks could not be anticipated at this point. Against this background, all the members indicated that they were in favor of retaining the symmetry in the existing directive.

Before its vote on policy at this meeting, the Committee discussed the wording of the operating paragraph of the directive, building on progress made toward a consensus at previous meetings. Attention focused in part on proposed new wording to describe the possibility of intermeeting actions. There were minor differences about specific wording, but no strongly held opinions, and all the members agreed that the new wording preferred by a majority of the members represented an improvement over the traditional language in that it would communicate more clearly and succinctly the substance of the Committee's policy decisions. The Committee also discussed deleting the last sentence in the operating paragraph relating to the outlook for the growth of money; another paragraph in the directive would continue to report the long-run ranges for such growth that the Federal Reserve Act requires the Committee to establish. With regard to the proposed deletion, some felt it was desirable for the central bank to retain a reference to money in the operating paragraph; more members supported the deletion on the ground that, as had been explained to the Congress, money growth had not had any special significance for some time in the formulation of monetary policy owing to often unexplained and unexpected changes in velocity. The rewording of the sentence on symmetry and the deletion of the sentence on money were not intended to imply any change in policy or the Committee's approach to policy or its decisionmaking.

At the conclusion of the Committee's discussion, all the members supported a reworded directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 4¾ percent and did not contain any bias with respect to the direction of possible adjustments to policy during the intermeeting period.

The Committee then voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that the economy has continued to expand at a brisk pace in recent months. Growth in nonfarm payroll employment was strong in November, after more moderate gains in September and October, and the civilian unemployment rate fell to 4.4 percent. Total industrial production declined somewhat in November, but manufacturing output was stable and up considerably from the third-quarter pace. Business inventory accumulation slowed appreciably in October after a sizable rise in the third quarter. The nominal deficit on U.S. trade in goods and services narrowed slightly in October from its third-quarter average. Total retail sales rose sharply in October and November, and

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housing starts were strong as well. Available indicators point to a considerable pickup in business capital spending after a lull in the third quarter. Trends in various measures of wages and prices have been mixed in recent months.

Most short-term interest rates have changed little on balance since the meeting on November 17, but longer-term rates have declined somewhat. Share prices in equity markets have remained volatile and have posted sizable gains on balance over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar has declined slightly over the period in relation to other major currencies and in terms of an index of the currencies of other countries that are important trading partners of the United States.

M2 and M3 have posted very large increases in recent months. For the year through November, both aggregates rose at rates well above the Committee's annual ranges. Total domestic nonfinancial debt has expanded in recent months at a pace somewhat above the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at its meeting on June 30–July 1 the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1999, the Committee agreed on a tentative basis to set the same ranges for growth of the monetary aggregates and debt, measured from the fourth quarter of 1998 to the fourth quarter of 1999. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

To promote the Committee's long-run objectives of price stability and sustainable economic growth, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 4¾ percent. In view of the evidence currently available, the Committee believes that prospective developments are equally likely to warrant an increase or a decrease in the federal funds rate operating objective during the intermeeting period.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Hoenig, Jordan, Kelley, Meyer, Ms. Minehan, Mr. Poole, and Ms. Rivlin. Votes against this action: None.

Disclosure Policy

The members also discussed various issues relating to the timing and manner of releasing information about the Committee's policy decisions. A range of views was expressed, as at earlier meetings, on the desirability of releasing a statement routinely not only after those meetings at which there was a change in the stance of policy but also after meetings where the Committee altered its view of the direction of possible policy actions during the intermeeting period. Members who favored more announcements believed that such disclosure, by providing more information on the Committee's views of the risks in the economic outlook, generally would allow financial market prices to reflect more accurately the likely future stance of monetary policy. However, other members were concerned that such announcements often would provoke market reactions. As a consequence, the Committee would become less willing to change the symmetry in the directive, and a policy of immediate release might therefore have adverse repercussions on the Committee's decisionmaking. Nonetheless, the members decided to implement the previously stated policy of releasing, on an infrequent basis, an announcement immediately after certain FOMC meetings when the stance of monetary policy remained unchanged. Specifically, the Committee would do so

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on those occasions when it wanted to communicate to the public a major shift in its views about the balance of risks or the likely direction of future policy. Such announcements would not be made after every change in the symmetry of the directive but only when it seemed important for the public to be aware of an important shift in the members' views. On the basis of experience with such announcements, the Committee would evaluate later whether further changes in its approach to disclosures would be desirable.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, February 2–3, 1999.

The meeting adjourned at 12:55 p.m.

Donald L. Kohn
Secretary

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Consumer and Community Affairs

In 1998 the Board's activities in consumer and community affairs centered on reviewing applications for the acquisition of banking organizations, on improving disclosures to consumers about mortgage transactions, and on fair lending issues, including the material enhancement of the Board's enforcement capabilities.

As consolidation of the banking industry continued during 1998, the Board received applications for several exceptionally large mergers and acquisitions, and held public meetings on five of them. After extensive analysis, the Board approved all the applications, finding in each instance that approval was consistent with the convenience and needs of the communities to be served.

In July the Board and the Department of Housing and Urban Development (HUD) issued a report to the Congress suggesting legislative reforms to the Truth in Lending Act (which is administered by the Board) and the Real Estate Settlement Procedures Act (which is administered by HUD). The two agencies had earlier considered whether the disclosures required under these laws could be simplified and streamlined, either by regulatory or statutory amendment. After determining that regulatory change alone would not achieve the improvements called for by the Congress in 1996 legislation, the Board and HUD made recommendations on four key questions as a starting point for congressional consideration of statutory reform.

In the fair lending area, the Board's enforcement capabilities were materially enhanced with the adoption of new interagency examination procedures, developed over the past two years by an interagency team. The Board referred one discrimination case involving a state member bank to the Department of Justice.

Acting on behalf of the Federal Financial Institutions Examination Council (FFIEC) and HUD, the Board prepared Home Mortgage Disclosure Act (HMDA) statements for individual lenders and aggregate reports for metropolitan areas. The statements reflected data reported in 1998 for the preceding year. These data indicated that denial rates continued to show disparities among racial and ethnic groups; the number of loans to black and Hispanic applicants increased in 1997 as in previous years, but the increases were modest compared with the average annual increase during the five years from 1993 through 1997.[1]

These matters are discussed below, along with other Board activities in the areas of consumer and community affairs.

Applications

While most applications to the Board for approval of an acquisition are processed by a Reserve Bank under authority delegated by the Board, the Board itself considers applications for acquisitions that are exceptionally large or that raise substantive issues. As required by the Bank Holding Company Act (BHCA), the Board's consideration of

1. The period 1993–97 is used for analysis of trends in HMDA data because HMDA coverage was expanded in 1993 to include a significantly larger group of independent mortgage companies.

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such applications in 1998 takes account of specific factors, including the competitive effects of the acquisitions, the parties' financial and managerial resources, and the convenience and needs of the communities to be served, including the Community Reinvestment Act (CRA) performance records of the insured depository institutions involved. In addition to soliciting written comment from the public on these applications, in 1998 the Board held public meetings on five applications to give interested persons an opportunity to present oral testimony. After extensive analysis, the Board approved all the applications, finding in each case that approval was consistent with the factors prescribed by the BHCA, including the convenience and needs of the communities to be served.

- In April the Board approved the application by First Union Corporation, Charlotte, North Carolina, to acquire CoreStates Financial Corporation, Philadelphia, Pennsylvania.
- In August the Board approved the application by NationsBank Corporation, Charlotte, North Carolina, to acquire BankAmerica Corporation, San Francisco, California, a merger resulting in the nation's largest depository institution.
- In September the Board approved the application by Travelers Group, Inc., New York, New York, to acquire Citicorp, New York, New York. The resulting company, Citigroup, became the largest commercial banking organization in the world, offering not only banking but also securities and insurance services.
- Also in September the Board approved the application by Banc One Corporation, Columbus, Ohio, to acquire First Chicago NBD Corporation, Chicago, Illinois. This acquisition created the largest banking organization in the Midwest and the fifth largest in the nation.
- In October the Board approved the application by Norwest Corporation, Minneapolis, Minnesota, to acquire Wells Fargo and Company, San Francisco, California.
- Also in October the Board approved the application by SunTrust Banks, Inc., Atlanta, Georgia, to acquire Crestar Financial Corporation, Richmond, Virginia.

These applications generated significant public interest. While they were supported by many commenters, adverse comment generally focused on anticipated job losses, branch closures, decreased lending, or other economic effects in the areas served by the organization being acquired. Commenters also criticized the CRA records of depository institutions involved in the acquisitions. Responding to such comment, some organizations pledged specific sums for future lending, investment, and services.

In each of these applications, the Board found the CRA records of the organizations involved to be consistent with approval. In the cases involving anticipated branch closures, the Board required that the merged organizations report, for a two-year period, all branch closures and consolidations resulting from the mergers.

In addition to these "megamergers," the Federal Reserve System acted on nineteen bank and bank holding company applications during 1998 that involved protests by members of the public concerning insured depository institutions' performance under the CRA and three applications that involved depository institutions' adverse CRA performance records. One other application involved both a CRA protest and an

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adverse CRA performance record. The Federal Reserve reviewed another twenty-five applications involving fair lending and other issues related to compliance with consumer protection laws.[2]

TILA and RESPA Reform

In July the Board and HUD submitted a report to the Congress concerning legislative changes to the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA) as these statutes apply to home-secured loans. The report responded to a congressional mandate for the Board and HUD to simplify and improve the disclosures required by the two laws and to create a single format for complying with them.

The agencies' report followed an eighteen-month study indicating that consumers primarily wanted disclosures about mortgage costs to be given earlier, so that they could comparison shop before applying for a loan from a particular lender. Consumers also wanted the cost disclosures to be as accurate as possible, so that they would not face unexpected charges at loan closing, when they no longer have the flexibility to seek other financing. Consumer advocates believed that the benchmark figure for comparison shopping—the annual percentage rate (APR)—should be retained and made more inclusive, and that any rate and other cost information provided at the time of application should be firm, subject to only limited conditions. They also believed that abusive lending practices should be addressed as part of any reform effort.

Many creditors asserted that the regulatory framework could be simplified by eliminating many of the disclosures, including the APR and finance charge items. They suggested that disclosures should focus instead on the interest rate, points, monthly payments, and settlement costs. To address concerns about the accuracy of settlement cost disclosures, some creditors favored a system of guaranteed costs in exchange for protection from RESPA's anti-kickback provisions. Other creditors and settlement service providers expressed concern that under such a plan they would be unable to compete with larger creditors and service providers.

The report to the Congress discussed ways to provide consumers with more meaningful and more timely cost information about home-secured transactions and at the same time ease compliance burdens on creditors. It contained recommendations addressing four key questions:

- Should the finance charge and APR disclosures be eliminated, or modified and retained? The Board and HUD recommended that the finance charge and APR concepts be retained and that the definition of the finance charge be expanded to include all costs the consumer is required to pay to obtain the loan, with limited exceptions. The agencies also recommended changes in the disclosures—such as including the contract interest rate, so that consumers can better understand the distinction between that rate and the APR.
- Should creditors be required to give firmer quotes for closing costs disclosed under RESPA? The Board and HUD recommended that creditors be required to give consumers more-reliable closing cost information, to promote shopping and competition.

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2. In addition, three applications were withdrawn in 1998—one involving an adverse CRA performance record and two involving issues with respect to compliance with consumer protection laws.

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Currently, creditors provide a good faith estimate of closing costs, but there are no standards for accuracy. The agencies recommended that creditors be given a choice of either guaranteeing the settlement costs (with the possibility of relief from RESPA's anti-kickback provisions) or providing a good faith estimate that is accurate within a specified tolerance.

- Should the timing rules for providing cost disclosures to consumers be changed (and should creditors be required to provide disclosures before imposing substantial fees)? The Board and HUD recommended that consumers be given cost disclosures for any home-secured loan as early as possible in the shopping process. The Board recommended that the initial disclosures be provided not later than three days after application. In addition, the Board and HUD recommended that, three days before closing, creditors be required to redisclose significant changes in the APR or other material disclosures and to provide an accurate copy of the required HUD settlement statement. For home-secured transactions not involving a home purchase, the Board recommended that, three days before closing, consumers also receive a notice of a pre-closing right to a refund of fees paid that in most instances would substitute for the existing right to rescind the transaction and receive a refund.
- Should additional substantive consumer protections be added to the statutes to address abusive lending practices? The Board and HUD recommended the adoption of substantive protections that target abusive lending practices without unduly interfering with the flow of credit, creating unnecessary creditor burden, or narrowing consumers' options in legitimate transactions. The agencies specifically recommended extending restrictions on balloon payments for loans subject to the Home Ownership and Equity Protection Act (HOEPA); prohibiting the advance collection of lump-sum credit-insurance premiums for HOEPA loans; and requiring certain minimum standards for the notice of home foreclosures that creditors must provide.[3]

The Board and HUD presented their recommendations in hearings before subcommittees of the House Committee on Banking and Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs. The agencies suggested that the Congress use the recommendations as a starting point for considering legislative changes.

Regulatory Matters

The Board has responsibility for implementing federal laws concerning consumer financial services and fair lending. In 1998, significant regulatory developments in these areas included the following:

- Mandatory compliance with comprehensive new rules under Regulation M (Consumer Leasing) became effective January 1, 1998.
- In March the Board published an advance notice of proposed rulemaking, announcing a comprehensive review of Regulation B (Equal Credit Opportunity). The notice solicited comment on several specific issues, including lenders' pre-application marketing practices and whether the

3. Enacted in 1994, HOEPA amended the TILA to require additional disclosures and provide for substantive restrictions on nonpurchase-money home loans that involve rates or fees above a certain amount.

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current prohibition on creditors' collecting race and similar information about applicants for nonmortgage credit products should be removed.

- In March the Board published an advance notice of proposed rulemaking, launching a comprehensive review of Regulation C (Home Mortgage Disclosure). The review will identify ways in which the Board could revise the regulation to clarify and simplify the regulatory language, respond to technological and other developments, reduce undue regulatory burden on the industry, eliminate obsolete provisions, and improve the quality and usefulness of the data collected under the regulation. The Board solicited comment on several specific issues, such as whether to require creditors to collect and report data on pre-approvals and whether to modify the current reporting categories applicable to refinancings and home improvement loans.
- In March the Board issued a proposal to permit the electronic delivery of disclosures for Regulations B, M, Z (Truth in Lending), and DD (Truth in Savings). The proposal would allow financial institutions, creditors, and others—with the consumer's consent—to provide electronically the information required by these regulations. This information could include such items as initial disclosures of terms and conditions of accounts, loans, and leases; periodic statements of account activity; and notices about error resolution. The proposal corresponds in approach to an interim rule, also published in March, amending Regulation E (Electronic Fund Transfers). The Board received more than 200 public comments on the proposal and the interim rule. Commenters generally supported modifying the regulations to permit the electronic delivery of disclosures but expressed concerns about how the rules would apply in particular circumstances.
- In September the Board published revisions to Regulation E reducing the time periods for investigations of claimed errors involving consumers' use of debit cards at point-of-sale and in foreign-initiated transactions. The revised rule requires a financial institution to provisionally credit an account within ten business days—rather than twenty, as the regulation permitted formerly—if the institution has not resolved the error claim within that time. To address commenters' concerns about the amount of time necessary to complete an investigation, the revised rule leaves in place a provision that gives institutions up to ninety calendar days to complete the investigation. At the same time, the Board adopted a rule that increases the time period for investigating errors claimed within thirty days after a consumer has opened an account; this rule was issued to address fraudulent claims of error on new accounts. Under the rule, an institution has up to twenty business days—rather than the ten formerly permitted—to resolve an alleged error before it must provisionally credit funds. It also has up to ninety calendar days to complete the investigation, rather than forty-five days.

In addition, the Board took the following regulatory actions:

- Adopted amendments to the model forms in Regulation B related to consumer rights under the Fair Credit Reporting Act
- Published technical amendments to Regulation M that clarify the rules for disclosing scheduled lease payments

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and the disclosure requirements for advertisements

- Updated the official staff commentary to Regulation Z to give guidance on disclosures for open-end credit plans that offer deferred payment features or that permit creditors to increase rates when consumers make late payments or exceed established credit limits, and to address the treatment of annuity costs in reverse mortgage transactions and transaction fees imposed on checking accounts with overdraft protection
- Adopted amendments to Regulation DD to implement minor changes to the Truth in Savings Act contained in the Economic Growth and Regulatory Paperwork Reduction Act of 1996
- Made final an interim rule (adopted in 1995) on the disclosure of the annual percentage yield for certain certificates of deposit that have maturities greater than one year and that do not compound interest.

Also, in March the Board reported to the Congress on the ways in which it assists small entities regarding compliance with Board regulations. The report was required under the Small Business Regulatory Enforcement Fairness Act of 1996. The Board reported that, in accordance with the Federal Deposit Insurance Act, it ordinarily will reduce civil penalties against small entities from the amount that would be assessed against larger entities, or may waive them altogether. But the Board will not reduce or waive these penalties when aggravating factors exist. Guidance to small entities is available from the Federal Reserve through conferences or training for bankers; review of submitted forms and other documents; educational advisory visits to banks; brochures, compliance guides, and newsletters; and telephone responses to calls and letters.

HMDA Data and Lending Patterns

The Home Mortgage Disclosure Act requires mortgage lenders covered by the act to collect and make public certain data about their home purchase, home improvement, and refinancing loan transactions. Depository institutions generally are covered if they were located in metropolitan areas and met the asset threshold at the end of the preceding year. For 1997, the asset threshold for depository institutions was $28 million. Mortgage companies are covered if they were located in or made loans in metropolitan areas and had assets of more than $10 million (when combined with the assets of any parent company) at the end of the preceding year; and they are covered, regardless of asset size, if they originated 100 or more home purchase loans in the preceding year.

In 1998, 6,886 depository institutions and affiliated mortgage companies and 1,039 independent mortgage companies reported HMDA data for calendar year 1997 to their supervisory agencies. These lenders submitted information about the geographic location of the properties related to their loans and applications, the disposition of loan applications, and, in most cases, the race or national origin, income, and sex of applicants and borrowers. The Federal Financial Institutions Examination Council processed the data and produced disclosure statements on behalf of HUD and the FFIEC's member agencies.[4]

4. The member agencies of the FFIEC are the Board, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

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The FFIEC prepared individual disclosure statements for each lender that reported data—one statement for each metropolitan area in which the lender had offices and reported loan activity. In July, each institution made its disclosure statement public; in August, reports containing aggregate data for all lenders in a given metropolitan area were made available at central depositories in the nation's approximately 330 metropolitan areas. These data were used not only by the FFIEC member agencies, the reporting institutions, and the public, but also by HUD in its oversight of Fannie Mae and Freddie Mac and by HUD and the Department of Justice as one component of fair lending reviews. The data also assisted HUD, the Department of Justice, and state and local agencies in responding to allegations of lending discrimination and in targeting lenders for further inquiry.[5]

The data reported in 1998 for the prior year included 16.4 million reported loans and applications, an increase of about 11 percent over 1996, due primarily to increased refinancing activity. The number of home purchase loans extended in 1997 compared with 1996 increased 12 percent for Asians, 4 percent for blacks and Hispanics, and 2 percent for whites, while decreasing 1 percent for Native Americans. Over the five years from 1993 through 1997, the number of home purchase loans extended increased 62 percent for blacks, 58 percent for Hispanics, 29 percent for Asians, 25 percent for Native Americans, and 16 percent for whites.

The number of home purchase loans extended to applicants in all income categories increased in 1997 compared with the preceding year. The number of such loans extended to lower-income applicants increased 6 percent, and the number extended to upper-income applicants increased 5 percent. Over the five years from 1993 to 1997, the number of home purchase loans extended to lower-income and upper-income applicants increased 38 percent and 27 percent respectively.

In 1997, 34 percent of Hispanic applicants and 26 percent of black applicants for home purchase loans sought government-backed mortgages; the comparable figures for white applicants, Asian applicants, and Native American applicants were 15 percent, 12 percent, and 11 percent, respectively. Twenty-seven percent of lower-income applicants for home purchase loans applied for government-backed loans in 1997, compared with 11 percent of upper-income applicants.

Denial rates for conventional (non-government-backed) home purchase loans in 1997 were 53 percent for black applicants, 52 percent for Native American applicants, 38 percent for Hispanic applicants, 26 percent for white applicants, and 13 percent for Asian applicants. Except for Asian applicants, each of these rates exceeded the comparable rate for 1996.

Overall, the denial rate for conventional loans was 29 percent in 1997. This rate has increased in each of the past several years, reflecting, in part, the increasing share of applications for conventional loans filed by lower-income applicants.

In recent years, a growing share of the applications reported under HMDA has been filed with lenders that specialize in manufactured housing and subprime lending. In 1997, these lenders

5. On behalf of the nation's eight active private mortgage insurance (PMI) companies, the FFIEC also compiles information on applications for PMI similar to the information on home mortgage lending collected under HMDA. Lenders typically require PMI for conventional mortgages that involve small downpayments.

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Federal Reserve Bank of St. Louis

denied 56 percent of all applications for conventional home purchase loans they received, compared with 12 percent for other lenders.

Fair Lending

The Board's fair lending activity during 1998 focused on enhanced enforcement capabilities, referrals to the Department of Justice, and consumer education.

Examination Procedures

During 1998 the Board adopted new procedures for fair lending examinations. The new procedures' principal analytical technique calls for examining the files of denied applications, identifying the minority applicant with the least deficient credit record for a given denial reason, and comparing that applicant's record against nonminority applicants whose credit records were more deficient, relative to the same denial reason, and yet were approved for credit. Variations of this technique will be employed in examining for potential discrimination in pricing, commercial lending, and credit-scored products and for redlining analysis. The new procedures were field-tested during 1998 in several Federal Reserve Districts and will be in effect for all compliance examinations begun after January 1, 1999. To prepare examiners for the new procedures, the Board over the past year developed and implemented two training programs for fair lending.

The Board also made important enhancements to the statistical regression program used to aid examiners in assessing fair lending compliance among large-volume mortgage lenders. For example, a methodology for analyzing discrimination in loan pricing was added to the program's existing methodology for the analysis of apparent discriminatory disparities in application denials. In addition, efforts continued in 1998 to achieve closer matching of minority and nonminority applicants for comparative analysis through adjustments to the type and number of factors (or variables) used in the regression. Finally, significant work was done on developing a regression methodology for use in examining groups of loan transactions that included too few denied applications to permit use of the existing regression format. This latter effort addressed a recurring limitation on the use of regression analysis.

Referrals to the Department of Justice

Under the 1991 amendments to the Equal Credit Opportunity Act, the Board refers to the Department of Justice violations that it believes may constitute a "pattern or practice" of discrimination. Potential referral cases identified during Federal Reserve compliance examinations are sent to the Board for review and a determination as to whether there is "reason to believe" that a pattern or practice warranting referral has occurred. Of the sixteen cases reviewed by the Board in 1998, three involved complicated fact patterns regarding the acceptance or denial of loan applications and eight raised issues of potentially discriminatory pricing identified through review of bank policies and analysis of loan files. One case was referred to the Department of Justice in 1998; it involved the failure of a credit card issuer to consider child support payments as income. Four cases were still under investigation at year-end.

Consumer Education

In 1998 an interagency Fair Lending Task Force prepared a booklet on mort-

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Federal Reserve Bank of St. Louis

gage loan pricing, *Looking for the Best Mortgage—Shop, Compare, Negotiate.* The booklet tells prospective loan applicants how mortgage loans are priced, how to obtain and compare price information from different lenders, and how to negotiate the best price. It focuses on such pricing practices as "overages," which have been the subject of recent regulatory agency fair lending investigations. It also advises consumers about the applicability of the fair lending laws to the loan-pricing practices of mortgage lenders.

Community Development

Through its community affairs program, the Federal Reserve conducts ongoing outreach, informational, and educational activities to help financial institutions and the public understand and address financial services issues affecting low- and moderate-income persons and communities. In 1998 the Board and the Reserve Banks began a Systemwide strategic planning process to re-examine their mission in regard to community affairs and to develop strategies for responding better to emerging financial services issues.

Throughout 1998, educational and technical assistance activities focused increasingly on small business and economic development in low- and moderate-income and rural communities. For example,

- The Federal Reserve Bank of Cleveland began the implementation phase of its "Access to Capital Initiative," a joint effort with the Small Business Administration and the Greater Cleveland Growth Association's Council of Smaller Enterprises. The initiative was designed to help expand small business access to technical assistance on financing and business development. Recommendations and action plans were developed at a meeting of more than 175 bankers, small business finance intermediaries, venture capitalists, accountants, attorneys, public officials, and business owners.
- The Chicago Reserve Bank began planning its "Small Business Credit Access Initiative." This initiative seeks to identify and address barriers to equity and debt capital for small enterprises in the Chicago metropolitan area, especially businesses located in predominantly minority and low- and moderate-income communities.
- The Richmond Reserve Bank, in conjunction with the National Association of Women Business Owners, conducted a series of six conferences on "Access to Capital: Start to Finish," which focused on the financing needs of and resources for women-owned businesses.
- The Boston Reserve Bank sponsored a conference, "Making It in the Mainstream," that reviewed partnerships between minority business enterprises and major corporations as a strategy for inner-city business development and job creation.

Several educational programs focused on financial and technical assistance to help very small and start-up businesses. For example,

- The Minneapolis Reserve Bank sponsored a conference on small business development.
- The Atlanta Reserve Bank conducted a workshop on issues affecting microenterprise lending, and the Boston Reserve Bank developed a training curriculum on lending and the provision of technical assistance for organizations that offer services to microentrepreneurs.

Rural community development was the focus of several educational programs and publications. For example,

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Federal Reserve Bank of St. Louis

- The Kansas City Reserve Bank's community affairs and economic research departments worked together to sponsor a conference, "Equity for Rural America: From Main Street to Wall Street," to explore how rural communities can gain access to equity capital markets to strengthen local economies.
- The St. Louis Reserve Bank produced the *Community Development Resource Guide: A Rainbow of Opportunity in the Delta*, a resource focusing on organizations and financial resources available in the lower Mississippi Delta region. The Bank also conducted community development workshops that highlighted many of the successful initiatives that are helping to revitalize that region.

Several Reserve Banks' educational programs explored techniques for helping low-income persons move into mainstream employment and the financial services markets. For example, the Richmond Reserve Bank, together with Virginia Commonwealth University, sponsored a symposium on the "Delivery of Financial Services in a Post–Welfare Reform Society." Participants discussed means of serving individuals who do not have transaction accounts with depository institutions; the effects that trends toward electronic benefits transfer and other electronic banking trends will have on low- and moderate-income households; and techniques for helping low-income persons build financial assets.

Three Reserve Banks continued their long-term efforts to facilitate community and economic development on Indian reservations:

- The San Francisco Reserve Bank joined with the Affiliated Tribes of Northwest Indians to conduct four workshops on "Sovereign Lending" for bankers and tribal leaders, to help facilitate lending by financial institutions in Indian Country.
- The Minneapolis Reserve Bank co-sponsored, with the Federal Deposit Insurance Corporation (FDIC), two roundtables for Montana bankers on lending in Indian Country, with an emphasis on small business financing and economic development; and continued to work on community development issues at the Pine Ridge Reservation. The Reserve Bank also continued to develop a personal finance course to be offered at the Fond du Lac Tribal Community College.
- The Kansas City Reserve Bank drafted a case study focusing on community development issues encountered by Native Americans for use in educational programs in Indian Country.

Other educational programs focused on community development and reinvestment tools and techniques. For example,

- The Philadelphia Reserve Bank convened a workshop for Philadelphia-area nonprofit community development organizations and local bankers to share information on potential projects and financing opportunities.
- The Dallas Reserve Bank sponsored a workshop on "Asset-Based Community Development: Mobilizing an Entire Community," which focused on ways to strengthen community-led development of affordable housing and small business initiatives in the Dallas–Ft. Worth area.
- The San Francisco Reserve Bank, in cooperation with the University of California at Berkeley and the Institute of Urban and Regional Development, conducted the National Community Development Lending

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Federal Reserve Bank of St. Louis

School—a weeklong training program for lenders engaged in financing affordable housing, small businesses, commercial development, and community facilities in the community development context.

Overall during 1998, Reserve Banks sponsored or cosponsored 280 conferences, seminars, and informational meetings on community and economic development, reinvestment, and fair lending topics. More than 12,900 bankers, examiners, and participants from small businesses and community and consumer groups attended. Board and Reserve Bank community affairs staff also made presentations at conferences, seminars, and meetings sponsored by banking, governmental, business, and community organizations.

The Board and Reserve Banks provided in-depth technical assistance to bankers and community organizations on a variety of housing, community, and economic development issues. For example, the Atlanta Reserve Bank assisted bankers in their efforts to create bank and bank holding company community development corporations, and provided guidance on the financial structure of housing projects qualifying for federal low-income housing tax credits.

Also during 1998, Board and Reserve Bank community affairs staff conducted more than 1,600 outreach meetings with financial institutions, community development organizations, small businesses, public-sector agencies, academic institutions and foundations, and consumer and community groups to discuss community credit needs and issues related to the provision of financial services. In conjunction with these outreach efforts, several Reserve Banks developed or updated community profiles that identify key community and economic development needs and describe resource organizations in selected communities. These profiles are made available to banks and to community and business organizations, and often help stimulate collaborative approaches to community reinvestment.

The Reserve Banks issued a variety of publications and other resources to provide bankers and community development organizations with information about community development issues and opportunities. For example,

- The Richmond Reserve Bank published two *MarketWise Reports*. One focused on development opportunities associated with the redevelopment of environmentally damaged areas (called "brownfields"); the other summarized survey data on the credit needs of small businesses and provided information on financial resources and technical assistance available to small firms.
- The Chicago Reserve Bank produced a videotape, *To Their Credit: Women-Owned Businesses*, designed to heighten awareness among lenders about barriers affecting the loan application process for women-owned businesses and to encourage and facilitate small business lending affiliations.
- The New York Reserve Bank published a *Directory of Small Business Assistance Resources for Northern New Jersey*.

The Reserve Banks published a total of twelve community affairs newsletters dealing with various aspects of community and economic development, reinvestment, and fair lending topics. The average combined circulation of these newsletters in 1998 was more than 67,000 bankers, small-business owners, housing, community and economic development officials, and community-

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Federal Reserve Bank of St. Louis

based development and consumer groups.

Community affairs staff members in 1998 continued to support the Federal Reserve's supervisory responsibilities. For example,

- They joined in reviewing proposals for community development initiatives from banks and bank holding companies, and assisted examiners by providing community contact and other information useful in CRA examinations.
- At several Reserve Banks, they assisted in conducting analyses of HMDA and CRA small business lending data.
- They held meetings with national organizations representing property insurers and appraisers to discuss issues and recommendations emerging from Mortgage Credit Partnership Projects, two-year efforts coordinated by six Reserve Banks to help identify and address barriers to equal access to credit in the homebuying process in selected cities.
- At the New York, Philadelphia, Chicago, Minneapolis, and San Francisco Reserve Banks, they arranged public meetings associated with Board consideration of applications for mergers involving major bank holding companies.

Board and Reserve Bank staff continued to provide support to members of the Board and Reserve Bank presidents on community development and financial services issues affecting low- and moderate-income households and communities. Their efforts included support for the Conference of Presidents' Subcommittee on Community Affairs; assistance with speeches and presentations by Board members before conferences and meetings of community, consumer, and civil rights groups; help in connection with tours by Board members of low- and moderate-income neighborhoods and community development projects; and support for a Board member who serves as Chairman of the Board of Directors of the Neighborhood Reinvestment Corporation.

Economic Effects of the Electronic Fund Transfer Act

As required by statute, the Board monitors the effects of the Electronic Fund Transfer Act (EFTA) on the compliance costs and consumer benefits related to electronic fund transfer (EFT) services. In 1998 the economic effects of the EFTA likely continued to increase because of the continued growth of EFT services.

The Board approved two amendments to Regulation E involving the resolution of billing errors claimed by consumers. (See "Regulatory Matters.") Neither amendment is expected to have a negative economic effect. There were no changes to the EFTA in 1998.

Results of consumer surveys (most recently in 1996) indicate that during this decade the proportion of U.S. households using EFT services has grown at an annual rate of about 2 percent. About 85 percent of households have one or more EFT features on their accounts at financial institutions. Automated teller machines (ATMs) remain the most widely used EFT service. Over the past year, the number of ATM transactions increased about 2 percent, from 910 million a month in 1997 to 930 million a month in 1998. Over the same period the number of installed ATMs rose 13 percent, to 187,000. Direct deposit is another widely used EFT service: More than half of all households in the United States have funds deposited directly into their accounts. Use of the service is particularly widespread in the public sector,

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Federal Reserve Bank of St. Louis

accounting for more than half of social security payments and two-thirds of federal salary and retirement payments. Taking into account both public and private payments, the proportion of households receiving direct deposits has grown about 5 percent a year in this decade. About one-third of U.S. households have debit cards, which consumers use at merchant terminals to debit their transaction accounts. Such point-of-sale (POS) systems still account for a fairly small share of electronic transactions, but their use continued to grow rapidly in 1998. Over the past year, the number of POS transactions rose 25 percent, from about 120 million a month in 1997 to 150 million a month, and the number of POS terminals rose 31 percent, to 1.7 million.

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

Compliance

During 1998, the Board's compliance activities included examinations, examiner training, and participation in the compliance activities of the Federal Financial Institutions Examination Council, including activities promoting increased uniformity in Community Reinvestment Act examinations.

Compliance Examinations

Since 1977 the Federal Reserve has maintained a compliance examination program to ensure that state member banks and foreign banking organizations subject to Federal Reserve examination comply with federal laws protecting consumers in the provision of financial services. During the 1998 reporting period (July 1, 1997, through June 30, 1998), the Federal Reserve conducted 546 examinations for compliance with consumer protection laws: 416 of state member banks and 130 of foreign banking organizations.[6]

Examiner Training

Examiner training in consumer protection laws, fair lending laws, and the CRA is an important aspect of the Federal Reserve's compliance program. New Reserve Bank examiners attend a two-week basic compliance course; and examiners with six to twelve months of field experience attend a two-week advanced course, a two-week course in examination techniques for fair lending, and a one-week course in CRA examination techniques. During the 1998 reporting period, the Federal Reserve conducted two basic compliance courses with a total of thirty-four participants, two advanced compliance courses with a total of forty-one participants, two courses in fair lending examination techniques with a total of twenty-eight participants, and three courses in CRA examination techniques with a total of sixty-one participants.

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

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Federal Reserve Bank of St. Louis

Participation in FFIEC Activities

The FFIEC is charged with developing uniform examination principles, standards, and report forms. In 1998, the member agencies of the FFIEC jointly revised examination procedures to reflect changes in consumer protection laws and regulations, including the Real Estate Settlement Procedures Act and the Electronic Fund Transfer Act. In addition, the FFIEC revised its policy guide, *Administrative Enforcement of the Truth in Lending Act—Restitution*, for the first time since 1980.

During 1998 the Board also participated in the FFIEC's efforts to promote consistency among the agencies in reporting CRA ratings information to the public—in particular, in developing a page on the Internet for CRA ratings (http://www.ffiec.gov/cracf/crarating/main.cfm).

The FFIEC worked during 1998 to foster consistency in the application of large-bank CRA examination procedures, which became fully effective on July 1, 1997. As part of this effort, the Board, the FDIC, the OCC, and the OTS reviewed performance evaluations for institutions examined under the lending, investment, and service tests; they also conducted eight joint examinations. The agencies found that examiners are generally conducting examinations in accordance with interagency CRA examination procedures for large retail institutions and the interagency questions and answers; some minor differences were noted among the performance evaluations reviewed and among the examiners participating in the joint examinations. In October, the agencies held an interagency examiner forum to discuss the results of the performance evaluation review and the joint examinations, as well as to develop recommendations for refining examiner guidance for large institutions. Interpretive guidance on issues identified through these efforts will be issued in 1999.

Community Reinvestment Act

The Federal Reserve assesses the Community Reinvestment Act performance of state member banks during regular compliance examinations and takes their CRA ratings (as well as other factors) into account when acting on applications from state member banks and from bank holding companies for mergers, acquisitions, and certain other actions.

The Federal Reserve has a three-faceted program for fostering better bank performance under the CRA:

- Examining institutions to assess compliance with the CRA
- Disseminating information on community development techniques to bankers and the public through community affairs offices at the Reserve Banks
- Performing CRA analyses in connection with applications from banks and bank holding companies.

During the 1998 reporting period (July 1, 1997, through June 30, 1998), the Federal Reserve conducted 410 CRA examinations. Of the banks examined, 96 were rated "outstanding" in meeting community credit needs, 308 were rated "satisfactory," 5 were rated "needs to improve," and 1 was rated as being in "substantial noncompliance."

Agency Reports on Compliance with Consumer Regulations

The Board is required to report annually on compliance with Regulation B, which implements the Equal Credit Opportunity Act (ECOA); Regulation E, which implements the Electronic Fund Transfer Act (EFTA); Regulation M,

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Federal Reserve Bank of St. Louis

which implements the Consumer Leasing Act (CLA); Regulation Z, which implements the Truth in Lending Act (TILA); Regulation CC, which implements the Expedited Funds Availability Act (EFAA); Regulation DD, which implements the Truth in Savings Act (TISA); and Regulation AA, which targets unfair and deceptive practices. The Board assembles data on compliance from the Reserve Banks and also collects compliance data from the FFIEC agencies and other federal supervisory agencies.[7]

Summarized below are the reported compliance data for the period July 1, 1997, through June 30, 1998 (referred to below as the 1998 reporting period, or sometimes simply as 1998). The overall level of compliance in 1998 was similar to the overall level in 1997, but, as in past years, the level of compliance varied considerably from regulation to regulation.

Regulation B (Equal Credit Opportunity)

The FFIEC agencies reported that 79 percent of the institutions examined during the 1998 reporting period were in compliance with Regulation B, compared with 80 percent for the 1997 reporting period. Of the institutions not in compliance, 69 percent had one to five violations. The most frequent violations involved the failure to take one or more of the following actions:

- Provide a written notice of credit denial or other adverse action containing a statement of the action taken, the name and address of the creditor, a Regulation B notice, and the name and address of the federal agency that enforces compliance
- Collect information for monitoring purposes about the race or national origin, sex, marital status, and age of applicants seeking credit primarily for the purchase or refinancing of a principal residence
- Notify the credit applicant of the action taken within the time frames specified in Regulation B
- Give a statement of reasons for credit denial or other adverse action that is specific and indicates the principal reasons for the credit denial or other adverse action
- Take a written credit application for the purchase or refinancing of a principal residence
- Refrain from requesting the race, color, religion, national origin, or sex of an applicant in transactions not covered by the monitoring requirements.

The Office of Thrift Supervision (OTS) issued two formal enforcement actions that contained provisions relating to Regulation B.

The Federal Trade Commission (FTC) filed a complaint in a federal district court charging a mortgage lender in the Washington, D.C., area with violations of the ECOA, including, among others, failing to take written applications for mortgage loans, failing to collect monitoring information on mortgage loan applicants, and providing inadequate notices of adverse action to loan applicants. The FTC is seeking civil money penalties and injunctive relief.

The FTC also participated in credit-related seminars organized by the Congressional Black Caucus and released a new publication, *Bound for Good Credit*, designed to educate consumers

7. The agencies use different methods to compile compliance data. Accordingly, the data—which are presented here in terms of percentages of financial institutions supervised or examined—support only general conclusions.

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Federal Reserve Bank of St. Louis

on credit-related issues. In addition, the FTC is continuing its work with other government agencies and with creditor and consumer organizations to increase awareness of and compliance with the ECOA.

The other agencies that enforce the ECOA—the Farm Credit Administration (FCA), the Department of Transportation (DOT), the Securities and Exchange Commission (SEC), the Small Business Administration, and the Grain Inspection, Packers and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise. The FCA's examination and enforcement activities revealed certain violations of the ECOA, most of them due to creditors' failure to collect information for monitoring purposes and to comply with rules regarding adverse action notices; however, no formal actions were initiated. The SEC reported that no violations of the ECOA were detected in examinations of registered broker–dealers conducted by self-regulatory organizations, the SEC's principal method of reviewing for compliance.

Regulation E (Electronic Fund Transfers)

The FFIEC agencies reported that approximately 96 percent of the institutions examined during the 1998 reporting period were in compliance with Regulation E, compared with 94 percent for the 1997 reporting period. Financial institutions most frequently failed to comply with the following requirements:

- Investigate an alleged error promptly after receiving a notice of error, determine whether an error was actually made, and transmit the results of the investigation and determination to the consumer within ten business days
- Provide customers with a periodic statement of all required information at least quarterly, or monthly if EFT activity occurred.

The OTS issued two formal enforcement actions that contained provisions relating to Regulation E during the 1998 reporting period. The FTC issued final decisions and orders with three Internet service providers settling charges that these companies violated the EFTA; specifically, the companies' "free trial" offers for on-line service resulted in unexpected charges for many consumers because the providers failed to make clear that consumers had an affirmative obligation to cancel before the trial period ended. The SEC reported that no violations of Regulation E were detected in examinations of registered broker–dealers conducted by self-regulatory organizations.

Regulation M (Consumer Leasing)

The FFIEC agencies reported substantial compliance with Regulation M for the 1998 reporting period. As in 1997, more than 99 percent of the institutions examined were in compliance. The few violations involved failures to adhere to specific disclosure requirements.

In 1998 the FTC issued final decisions and orders in thirteen administrative cases concerning alleged deceptive lease or credit advertising, specifically, failure to clearly and conspicuously disclose and make available advertised lease and credit terms, in violation of the CLA or the TILA. Final decisions and orders issued by the FTC in 1998 settled charges against two

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Federal Reserve Bank of St. Louis

major automobile manufacturers, and five dealerships and their chief executive officers in the St. Louis area, for violations of the CLA and the TILA involving misrepresentation and hiding or failing to disclose adequately the terms of advertised automobile lease deals.

The FCA reported that it identified no violations of the CLA during its examinations in 1998.

Regulation Z (Truth in Lending)

The FFIEC agencies reported that 74 percent of the institutions examined during the 1998 reporting period were in compliance with Regulation Z, compared with 75 percent in 1997. The Board and the OTS reported increases in compliance, the OCC and the FDIC reported decreases, and the NCUA reported an unchanged level of compliance. The FFIEC agencies indicated that of the institutions not in compliance, 62 percent had one to five violations, the same as in 1997.

The violations of Regulation Z most often observed were failures to comply with the following requirements:

- Accurately disclose the finance charge, payment schedule, annual percentage rate, security interest in collateral, and amount financed
- Accurately itemize the amount financed upon request
- Provide disclosures within three business days of application for RESPA-related residential mortgage applications
- Redisclose the annual percentage rate when a change occurred before consummation or settlement
- Withhold loan funds until the end of the rescission period.

The OTS issued two formal enforcement actions that contained provisions relating to Regulation Z. A total of 205 institutions supervised by the Board, the FDIC, or the OTS were required, under the Interagency Enforcement Policy on Regulation Z, to refund $2.3 million to consumers in 1998 because of improper disclosures.

The FTC filed a complaint in federal district court charging a mortgage lender in the Washington, D.C., area, and its owner, with violating the TILA in connection with alleged deceptive and unfair practices in home mortgage lending. The FTC also issued final decisions and orders in thirteen administrative cases concerning alleged deceptive lease or credit advertising that involved the failure to clearly and conspicuously disclose and make available advertised lease and credit terms, in violation of the CLA or the TILA.

During 1998 the FTC also issued three publications informing consumers about home equity loans and reverse mortgages. In addition, the FTC issued a news release to customers of two airlines to assist them in exercising their rights under the Fair Credit Billing Act provisions of the TILA.

The Department of Transportation (DOT) continued during 1998 to prosecute an ongoing formal enforcement proceeding instituted in 1993 against a travel agency and a charter operator. The complaint in this proceeding alleged that the two organizations had violated Regulation Z by routinely failing to send credit statements for refund requests to credit card issuers within seven days of receiving fully documented credit refund requests from customers. A motion filed by the DOT before an administrative law judge for summary judgment was denied. The DOT is currently in negotiations to settle this litigation.

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Federal Reserve Bank of St. Louis

Regulation CC (Expedited Funds Availability)

The FFIEC agencies reported that 89 percent of institutions examined during the 1998 reporting period were in compliance with Regulation CC, compared with 87 percent in the 1997 reporting period. Of the institutions not in compliance, 65 percent had one to five violations. Institutions most frequently failed to comply with the following requirements:

- Follow special procedures for large-dollar deposits
- For deposits not subject to next-day availability, provide immediate availability of amounts up to $100
- Make funds from certain checks, both local and nonlocal, available for withdrawal within the times prescribed by the regulation
- Provide exception notices about funds availability, including all required information.

The OTS in 1998 issued two formal enforcement actions that contained provisions relating to Regulation CC.

Regulation DD (Truth in Savings)

The FFIEC agencies reported that 88 percent of institutions examined during the 1998 reporting period were in full compliance with Regulation DD. Institutions most frequently failed to comply with the following requirements:

- Provide appropriate maturity notices for certificates of deposit maturing in more than one year
- State required additional information in advertisements containing the annual percentage yield.

Regulation AA (Unfair or Deceptive Acts or Practices)

The three bank regulators with responsibility for enforcing Regulation AA's Credit Practices Rule—the Federal Reserve, the OCC, and the FDIC—reported that 99 percent of the institutions examined during the 1998 reporting period were in compliance. The most frequent violation was failure to provide a clear, conspicuous disclosure regarding a cosigner's liability for a debt. No formal enforcement actions for violations of the regulation were issued during the period.

Consumer Complaints

The Federal Reserve investigates complaints against state member banks and forwards to the appropriate enforcement agencies complaints that involve other creditors and businesses (see table). The Federal Reserve also monitors and analyzes complaints about unregulated practices.

Complaints against State Member Banks

In 1998 the Federal Reserve received 3,889 complaints: 3,108 by mail, 760 by telephone, 14 electronically, and 7 in person. Fewer than half of the complaints (1,643) were against state member banks; of these, almost two-thirds involved unregulated practices. Of the complaints against state member banks, about 71 percent concerned lending: 3 percent alleged discrimination on a prohibited basis, and 68 percent addressed a variety of other practices, such as the denial of credit on a basis not prohibited by law (for example, credit history or length of residence)

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Federal Reserve Bank of St. Louis

or the release or use of credit information. Another 20 percent involved disputes about interest on deposits and general deposit account practices; the remaining 9 percent concerned disputes about electronic fund transfers, trust services, or other miscellaneous practices (see table).

In 1998 the Federal Reserve also received 2,114 inquiries about consumer credit and banking policies and practices. In responding to these inquiries, the Board and the Reserve Banks gave specific explanations of laws, regulations, and banking practices and provided relevant printed materials on consumer issues.

Unregulated Practices

Under section 18(f) of the Federal Trade Commission Act, the Board in 1998 continued to monitor complaints about banking practices that are not subject to existing regulations and to focus on those complaints alleging practices that may be unfair or deceptive. Of the 2,381 complaints received about unregulated practices, the five most numerous categories related to credit cards: penalty charges on accounts (154); miscellaneous problems involving credit cards (148); customer service problems (138); interest rates and terms (125); and debt collection tactics (79). The specific complaints within these categories concerned such matters as creditors' failure to close accounts as requested; penalty charges, including over-limit fees; increased interest rates on accounts; and changed credit terms on pre-approved accounts. Each of these five complaint categories accounted for a small portion (4 percent or less) of all consumer complaints received by the Federal Reserve.

Complaint Referrals to and by HUD

In 1998, in accordance with a memorandum of understanding between the agencies, the Board referred to HUD five complaints about state member banks that alleged violations of the Fair Hous-

Consumer Complaints against State Member Banks and Other Institutions Received by the Federal Reserve System in 1998

Subject	State member banks	Other institutions[1]	Total
Regulation B (Equal Credit Opportunity)	59	39	98
Regulation E (Electronic Fund Transfers)	20	53	73
Regulation M (Consumer Leasing)	7	19	26
Regulation Q (Payment of Interest)	1	1	2
Regulation Z (Truth in Lending)	270	393	663
Regulation BB (Community Reinvestment)	0	4	4
Regulation CC (Expedited Funds Availability)	23	51	74
Regulation DD (Truth in Savings)	40	55	95
Fair Credit Reporting Act	102	301	403
Fair Debt Collection Practices Act	9	24	33
Fair Housing Act	0	1	1
Flood insurance	1	5	6
Regulations G, T, U, and X	0	0	0
Real Estate Settlement Procedures Act	2	28	30
Unregulated practices	1,109	1,272	2,381
Total	**1,643**	**2,246**	**3,889**

1. Complaints against these institutions were referred to the appropriate enforcement agencies.

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ing Act. Investigations of these complaints (and of three others pending at year-end 1997) revealed no evidence of unlawful discrimination.

Also in accordance with the memorandum of understanding, during 1998 HUD referred two complaints involving state member banks to the Federal Reserve. By year-end the Federal Reserve had completed its investigation of one of the two complaints; the investigation revealed no evidence of unlawful discrimination.

Complaint Program Activities

During 1998 the Board's consumer complaints staff completed work on the Complaint Analysis Evaluation System and Reports (CAESAR) system, a personal computer–based system that will consolidate and replace mainframe-based analysis tools. The Board uses CAESAR, scheduled to be implemented in January 1999, to monitor the status and resolution of consumer complaints and inquiries received by the Federal Reserve. Along with other management tools, CAESAR produces reports that allow staff to analyze, by type of allegation, the discrimination complaints received by the Federal Reserve; to automatically generate response letters to individual complaints; and to analyze data to determine patterns and trends.

During 1998 individual staff members from the Reserve Banks continued to work at the Board for several weeks at a time to gain familiarity with complaint operations in Washington. Fourteen participants from eleven Reserve Banks participated in the program.

Consumer Policies

Through its consumer policies program, the Board explores ways to protect consumers in the area of retail financial

Consumer Complaints Received by the Federal Reserve System, by Type and Function, 1998

Complaint	Complaints against state member banks					
	Total		Not investigated		Investigated	
					Bank legally correct	
	Number	Percent	Unable to obtain sufficient information	Explanation of law provided to consumer	No reimbursement or other accommodation	Goodwill reimbursement or other accommodation
Loans						
Discrimination alleged						
Real estate loans	9	1	0	0	6	0
Credit cards	26	1	0	5	6	2
Other loans	24	1	1	0	12	0
Discrimination not alleged						
Real estate loans	92	6	2	14	35	9
Credit cards	880	54	7	135	217	319
Other loans	135	8	0	30	55	14
Deposits	326	20	5	36	128	55
Electronic fund transfers	20	1	2	1	8	1
Trust services	14	1	1	6	3	2
Other	117	7	13	21	44	18
Total	**1,643**	**100**	**31**	**248**	**514**	**420**

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services other than by regulation, and conducts research that bears directly on policymaking. During 1998 much of this work related to leasing. The Board researched and analyzed consumers' understanding of lease terms and conditions, and helped disseminate consumer information on the consumer leasing disclosure requirements that took effect in January 1998. More than 650,000 copies of the Board's publication *Keys to Vehicle Leasing—A Consumer Guide* have been distributed through trade associations and conferences, auto shows, and the media; and the Board's web site on consumer leasing has had almost 175,000 visits.

During 1998 the Board also participated on an interagency team working to educate consumers about basic financial services. The team has developed a package of materials, entitled *Helping People in Your Community Understand Basic Financial Services*, that community educators can use in promoting direct deposit among recipients of federal benefits. In connection with this effort, the Board used data from its Survey of Consumer Finances to develop a profile of households that do not have transaction accounts with depository institutions.

For its work during 1998 on reform of the Truth in Lending Act and the Real Estate Settlement Procedures Act, the Board studied the credit shopping behavior of consumers. Using data from the Board's 1995 Survey of Consumer Finances and from the Survey Research Center's monthly surveys of consumers, staff members analyzed consumers' mortgage-shopping behavior and their understanding of mortgage terms and conditions; results were shared with other agencies and the public through meetings, conferences, and journal articles. Staff members also gathered qualitative information from consumer focus

Consumer Complaints Received—Continued

Complaints against state member banks						Referred to other agencies	Total complaints
Investigated					Pending, December 31		
Customer error	Bank error	Factual or contractual dispute—resolvable only by courts	Possible bank violation—bank took corrective action	Matter in litigation			
0	0	1	0	0	2	14	23
0	2	1	0	0	10	11	37
0	0	1	1	0	9	14	38
0	16	3	0	3	10	303	395
11	123	11	3	2	52	747	1,627
0	20	1	1	3	11	361	496
2	55	9	2	11	23	462	788
1	6	1	0	0	0	53	73
0	1	0	0	0	1	6	20
0	11	2	0	2	6	275	392
14	**234**	**30**	**7**	**21**	**124**	**2,246**	**3,889**

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groups in Baltimore and northern Virginia; alternative disclosure formats for the annual percentage rate and contract interest rates, the good faith estimate given under the Real Estate Settlement Procedures Act, and the disclosures of guaranteed settlement costs were tested.

Consumer Advisory Council

The Consumer Advisory Council convened in March, June, and October to advise the Board on matters concerning laws that the Board administers and other issues related to consumer financial services. The council's thirty members come from consumer and community organizations, the financial services industry, academic institutions, and state government agencies. Council meetings are open to the public.

The implementation of the Community Reinvestment Act was addressed at each of the three meetings. In March the council focused on perceived problems with uniformity among the supervisory agencies in evaluating the CRA performance of their respective institutions under the revised CRA regulations. In recognition of these issues, the agencies were taking steps to help assess the uniformity of their approaches. At all three meetings the council discussed the challenges faced by institutions and examiners in delineating an institution's CRA assessment area. This issue is significant for numerous banks, such as national institutions that have only one branch or main office, consumer lenders that have loan production offices but no deposit-gathering branches, and Internet banks that have no branch or main office. Council members voiced concerns that de-emphasizing geography might adversely affect low- and moderate-income persons and those in rural areas who do not have access to electronic distribution systems. Other CRA issues discussed by the council included how the lending test accounts for loans originated and purchased, bank performance under the investment and service tests, and use of the strategic plan option by financial institutions.

In March the council discussed legislative recommendations being developed to simplify, consolidate, and streamline regulations implementing the Truth in Lending Act and the Real Estate Settlement Procedures Act. (See "TILA and RESPA Reform.") The discussion focused on the timing and feasibility of providing firm mortgage loan cost estimates that would enable consumers to make meaningful cost comparisons when they shopped for loans. The accuracy of early disclosures was a particular concern. Some members believe that the existing good faith estimate, provided within three days of a mortgage loan application, gives reasonable certainty about closing costs. Others expressed interest in reform proposals in which the lender might guarantee both the interest rate and closing costs. In June the council reviewed remedies that protect consumers when the timing or content of the disclosures is improper or defective. Concerns that twenty-four states do not require the sending of a notice of foreclosure to a debtor who is in default, and that only nineteen states give the homeowner a statutory right to cure a default, led the council to consider whether there should be a federally required notice and a right-to-cure.

Also in June the council discussed the collection of data on the race and sex of applicants for consumer loans other than mortgages. Regulation B currently prohibits such collection. The council focused on whether lenders should be required, or allowed, to collect such data. Some members favored, and others opposed, mandatory data col-

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lection. Some preferred letting lenders collect the data voluntarily. It was suggested that either mandatory or voluntary collection could provide useful data in marketing and fair lending, could help lenders create targeted marketing programs, and could facilitate referrals for special credit programs. Council members' concerns about the data collection included cost burdens, problems in identifying an applicant's characteristics when the applicant does not volunteer the information, and difficulties in characterizing the characteristics when a firm applying for a small-business loan has multiple owners. The council also discussed the benefits and disadvantages of requiring that pre-approvals or prequalifications for home mortgage loans be reported in the HMDA data. Currently, a preliminary evaluation of a potential applicant's creditworthiness is not reported.

The council also addressed issues concerning the substitution of electronic delivery of consumer disclosures for traditional paper copies. The Board's interim rule governing electronic fund transfer, issued in March 1998, permits depository institutions to deliver certain disclosures electronically if the consumer agrees. (See "Regulatory Matters.") Council members provided a variety of comments on electronic delivery of federal disclosures. For example, some believed that consumers should have a right to paper copies of certain disclosures upon request. Some were concerned about creditors providing certain notices electronically, such as the TILA right of rescission. Others were concerned about ensuring that consumers make informed decisions about receiving disclosures electronically.

At its October meeting the council considered how the use of credit scoring systems was affecting consumer and small business lending. Members noted that credit scoring provides many benefits, including significant efficiencies that reduce lender costs while helping to minimize subjectivity in loan decisions; but credit scoring has also raised a number of issues. Council members noted that credit scoring can have fair lending implications. For example, some members suggested that unequal access to credit by minorities could bias or distort the data used in a scoring model.

In October, the council also discussed barriers to lending and reinvestment efforts by financial institutions on Indian reservations. Council members noted that Indian Country is perceived to be among the most underserved credit and banking service markets in the nation. One critical restraint to economic and community development on Indian reservations is that each tribe is a sovereign nation with its own commercial laws that affect creditors' rights.

Testimony and Legislative Recommendations

In June the Board testified before the House Committee on Commerce on developments in electronic commerce generally, and electronic payments specifically. The testimony noted that new payment products, such as stored-value cards and electronic cash for use on the Internet, are designed to substitute for existing payment methods such as cash, checks, and credit and debit cards; thus, to gain acceptance, they will likely need to offer consumers and businesses significantly improved features in terms of cost and convenience. Although anticipating that the effect of the emerging electronic payment methods on the Board's core responsibilities will be minimal in the near term, the Board cautioned that technological change and the growth of electronic commerce

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could raise complex policy issues that may require careful monitoring.

In July the Board testified before the House and Senate Banking Committees on ways to improve the disclosures required for home mortgage loans under the TILA and to unify them with the disclosures required under RESPA. The Board's testimony discussed the joint report issued by the Board and the Department of Housing and Urban Development, which provided a framework for simplifying and streamlining the information given to consumers in the mortgage lending process. (See "TILA and RESPA Reform.")

Recommendations of Other Agencies

Each year the Board asks for recommendations from the other federal supervisory agencies for amending the consumer financial services laws or the implementing regulations.

The OCC believes that despite legislative and regulatory efforts to reduce compliance burden, the rules and disclosure requirements under the consumer financial services laws remain complex for consumers and costly for creditors. Accordingly, the OCC suggests that the Congress consider alternatives to provide more meaningful disclosures to consumers that are less burdensome to depository institutions. In addition, the OCC recommends that the Congress consider modifications to the referral requirements in the ECOA. The OCC suggests, for example, limiting mandatory referrals to specific prohibited bases, authorizing the Department of Justice to relieve an agency from mandatory referral requirements, or authorizing agency waiver of referral if detected violations stem from self-assessments.

The FTC supports the Board's current review of Regulation B and would support any similar effort to update and clarify Regulation Z. The FDIC supports amending Regulations B, M, Z, and DD to allow for the electronic delivery of certain disclosures. The FDIC also expresses concern about the predatory marketing practices of some subprime credit-card lenders, and in this regard supports the development of regulatory or legislative changes to Regulation Z or Regulation AA that would enable the agencies to supervise current trade practices more effectively.

Year 2000 Initiatives

During 1998 the Board made a major effort to ensure that the hardware and software systems it uses in connection with consumer and community affairs matters are Year 2000 compliant. Among other things, it revised certain systems and converted them from a mainframe environment to a personal-computer environment. Certification of compliance is scheduled for March 1999. ▪

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Litigation

During 1998, the Board of Governors was a party in eighteen lawsuits or appeals filed that year and was a party in fifteen other cases pending from previous years, for a total of thirty-three cases. In 1997, the Board had been a party in a total of thirty-eight cases. Four of the eighteen lawsuits or appeals filed in 1998 raised questions under the Bank Holding Company Act. As of December 31, 1998, fourteen cases were pending.

Judicial Review of Board Orders under the Bank Holding Company Act

Independent Bankers Association of America v. Board of Governors, No. 98–1482 (D.C. Circuit, filed October 21, 1998), is a petition for review of a Board order dated September 23, 1998, conditionally approving the applications of Travelers Group, Inc., New York, New York, to become a bank holding company by acquiring Citicorp, New York, New York, and its bank and nonbank subsidiaries (84 *Federal Reserve Bulletin* 985). Another case challenging the same order, *Cunningham v. Board of Governors*, No. 98–1459 (D.C. Circuit, filed September 30, 1998), was dismissed by the court on December 4, 1998.

In *Attorneys Against American Apartheid v. Board of Governors*, No. 98–1483 (D.C. Circuit, filed October 21, 1998), petitioners seek review of a Board order dated August 17, 1998, approving the application by NationsBank Corporation, Charlotte, North Carolina, to merge with BankAmerica Corporation, San Francisco, California (84 *Federal Reserve Bulletin* 858).

In *Inner City Press/Community on the Move v. Board of Governors*, No. 97–1514 (U.S. Supreme Court, petition for *certiorari* filed March 12, 1998), petitioners sought review of the dismissal by the U.S. Court of Appeals for the District of Columbia Circuit (130 F.3d 1088) of their petition for review of a Board order dated May 14, 1997, approving the application of Banc One Corporation, Inc., Columbus, Ohio, to merge with First USA, Inc., Dallas, Texas (83 *Federal Reserve Bulletin* 602). On June 22, 1998, the Supreme Court denied review (118 S. Ct. 2341).

Greeff v. Board of Governors, No. 97–1976 (4th Circuit, filed June 17, 1997), was a petition for review of a Board order dated May 19, 1997, approving the application of Allied Irish Banks, plc, Dublin, Ireland, and First Maryland Bancorp, Baltimore, Maryland, to acquire Dauphin Deposit Corporation, Harrisburg, Pennsylvania, and thereby acquire Dauphin's banking and nonbanking subsidiaries (83 *Federal Reserve Bulletin* 607). On August 14, 1998, the court denied the petition.

In *The New Mexico Alliance v. Board of Governors*, No. 96–9552 (10th Circuit, filed December 24, 1996), petitioners sought review of a Board order dated December 16, 1996, approving the acquisition by NationsBank Corporation and NB Holdings Corporation, both of Charlotte, North Carolina, of Boatmen's Bancshares, Inc., St. Louis, Missouri (83 *Federal Reserve Bulletin* 148). On January 21, 1998, the court transferred the case to the U.S. Court of Appeals for the District of Columbia Circuit

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(No. 98-1049), and on May 27, 1998, that court granted the Board's motion to dismiss the petition.

Litigation under the Financial Institutions Supervisory Act

In *Pharaon v. Board of Governors*, No. 98–103 (U.S. Supreme Court, petition for *certiorari* filed July 15, 1998), petitioner sought review of a decision by the U.S. Court of Appeals for the District of Columbia Circuit (135 F.3d 148) denying a petition for review of a Board order dated January 31, 1997, imposing civil money penalties and an order of prohibition against Ghaith R. Pharaon for violations of the Bank Holding Company Act (83 *Federal Reserve Bulletin* 347). On October 19, 1998, the Supreme Court denied review (119 S. Ct. 371).

In *Board of Governors v. Carrasco*, No. 98–3474 (S.D. New York, filed May 15, 1998), the Board seeks to freeze the assets of an individual pending the administrative adjudication of an action by the Board requiring restitution by the individual. On May 26, 1998, the district court granted the Board's request for a preliminary injunction.

In *Board of Governors v. Pharaon*, Nos. 98–6101 and 98–6121 (2d Circuit, filed May 4 and May 22, 1998), both parties appeal an order of the U.S. District Court for the Southern District of New York (No. 91–6250, March 18, 1998) granting in part and denying in part the Board's motion for partial summary judgment in an action to freeze assets of an individual pending adjudication of a civil money penalty assessment by the Board.

In *Banking Consultants of America v. Board of Governors*, No. 98–5354 (6th Circuit, filed March 10, 1998), plaintiffs appeal an order of the U.S. District Court for the Western District of Tennessee (No. 97–2791, January 23, 1998) dismissing their action to enjoin an investigation by the Board, the Office of the Comptroller of the Currency, and the Department of Labor.

Leuthe v. Office of Financial Institution Adjudication, No. 97–1826 (3d Circuit, filed October 7, 1997), was an appeal of a district court dismissal (977 F. Supp. 537 (E.D. Pa. 1997)) of an action against the Board and other federal banking agencies challenging the constitutionality of the Office of Financial Institution Adjudication. On June 8, 1998, the court of appeals affirmed the district court's dismissal.

Towe v. Board of Governors, No. 97–71143 (9th Circuit, filed September 15, 1997), is a petition for review of a Board order dated August 18, 1997 (83 *Federal Reserve Bulletin* 849), prohibiting Edward Towe and Thomas E. Towe from further participation in the banking industry.

In *Vickery v. Board of Governors*, No. 97–1344 (D.C. Circuit, filed May 9, 1997), petitioner sought review of a Board order dated April 14, 1997, prohibiting Charles R. Vickery, Jr., from further participation in the banking industry (83 *Federal Reserve Bulletin* 535). On March 3, 1998, the court of appeals denied the petition, and on May 4, 1998, it denied petitioner's petition for rehearing and suggestion for rehearing *in banc* (159 F.3d 638).

Other Actions

In *Fraternal Order of Police v. Board of Governors*, No. 98–3116 (D. District of Columbia, filed December 22, 1998), plaintiff seeks a declaratory judgment regarding the Board's labor practices.

Inner City Press/Community on the Move v. Board of Governors, No. 98–4608 (2d Circuit, filed December 3, 1998), is an appeal of an order of the

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U.S. District Court for the Southern District of New York (No. 98–4608, September 30, 1998) granting the Board's motion for summary judgment on plaintiff's Freedom of Information Act complaint.

Goldman v. Department of the Treasury, No. 98–9451 (11th Circuit, filed November 10, 1998), is an appeal from an order of the U.S. District Court for the Northern District of Georgia (No. 1–97–CV–3798, November 2, 1998) dismissing an action challenging Federal Reserve notes as lawful money.

In *Wasserman v. Board of Governors*, No. 98–CIV–6017 (S.D. New York, filed August 24, 1998), plaintiff alleged that the Board wrongfully failed to investigate the activities of a bank. The plaintiff voluntarily withdrew his complaint on October 14, 1998, following the filing of the Board's motion to dismiss.

Clarkson v. Greenspan, No. 98–5349 (D.C. Circuit, filed July 29, 1998), is an appeal of a district court order granting the Board's motion for summary judgment on plaintiff's Freedom of Information Act complaint.

In *Research Triangle Institute v. Board of Governors*, No. 97–1759 (U.S. Supreme Court, petition for *certiorari* filed April 28, 1998), petitioners sought review of a decision by the U.S. Court of Appeals for the Fourth Circuit (132 F.3d 985) affirming the dismissal of a contract action against the Board. On October 5, 1998, the Supreme Court denied review (119 S. Ct. 44).

Fenili v. Davidson, No. C–98–01568CW (N.D. California, filed April 17, 1998), is a case claiming tort and constitutional violations arising out of the return of a check.

Wilkins v. Warren, No. 98–1320 (4th Circuit, filed March 5, 1998), was an appeal of an order of the U.S. District Court for the Eastern District of Virginia dismissing plaintiff's complaint arising out of a dispute with a bank. On June 10, 1998, the court of appeals affirmed the district court dismissal.

Jones v. Board of Governors, No. 98–30138 (5th Circuit, filed February 9, 1998), was an appeal of a decision by the U.S. District Court for the Western District of Louisiana dismissing plaintiff's complaint alleging violations of the Fair Housing Act. On November 19, 1998, the court of appeals dismissed the action.

Logan v. Greenspan, No. 98–0049 (D. District of Columbia, filed January 9, 1998), is an employment discrimination action.

Kerr v. Department of the Treasury, No. CV–S–97–01877–DWH (D. Nevada, filed December 22, 1997), is a challenge to income taxation and Federal Reserve notes.

Allen v. Indiana Western Mortgage Corp., No. 97–7744 RJK (C.D. California, filed November 12, 1997), was a customer dispute with a bank. On March 25, 1998, the court dismissed the action.

Patrick v. United States, No. 97–75564 (E.D. Michigan, filed November 7, 1997), and *Patrick v. United States*, No. 97–75017 (E.D. Michigan, filed September 30, 1997), were actions for damages arising out of tax disputes. On August 20, 1998, both cases were dismissed.

Artis v. Greenspan, No. 97–5235 (D.C. Circuit, filed September 19, 1997), was an appeal of a district court order dismissing a class complaint alleging race discrimination in employment. The court of appeals affirmed the dismissal on October 20, 1998 (158 F.3d 1301). A related employment discrimination case, *Artis v. Greenspan*, No. 97–5234 (D.C. Circuit, filed September 19, 1997), was an appeal of the dismissal of an individual discrimination claim. On

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January 29, 1998, the court of appeals granted the Board's motion for summary affirmance of the district court's dismissal.

In *In re Subpoena Duces Tecum Served on the Board of Governors*, No. 97–5229 (D.C. Circuit, filed September 12, 1997), the plaintiff appealed a district court order denying his motion to compel production of pre-decisional supervisory documents and testimony sought in connection with an action by Bank of New England Corporation's trustee in bankruptcy against the Federal Deposit Insurance Corporation. On June 26, 1998, the court of appeals reversed the district court's order, 145 F.3d 1422, and on October 6, 1998, the court amended its opinion following the Board's petition for rehearing (156 F.3d 1279).

Bettersworth v. Board of Governors, No. 97–CA–624 (W.D. Texas, filed August 21, 1997), is a complaint under the Privacy Act.

Maunsell v. Greenspan, No. 97–6131 (2d Circuit, filed May 22, 1997), was an appeal of district court dismissal of an action for compensatory and punitive damages for alleged violations of civil rights by a federal savings bank. On May 12, 1998, the court dismissed the appeal.

American Bankers Insurance Group, Inc. v. Board of Governors, No. 96–CV–2383–EGS (D. District of Columbia, filed October 16, 1996), was an action seeking declaratory and injunctive relief invalidating a new regulation issued by the Board under the Truth in Lending Act relating to treatment of fees for debt cancellation agreements (12 C.F.R. section 226.4(d)(3)). On April 21, 1998, the district court granted the Board's motion for summary judgment (3 F. Supp. 237). ▪

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Legislation Enacted

Among the legislation enacted during 1998, the Consumer Reporting Employment Clarification Act, the Credit Union Membership Access Act, the Examination Parity and Year 2000 Readiness for Financial Institutions Act, the Federal Employees Health Care Protection Act, the Homeowners Protection Act, the Money Laundering and Financial Crimes Strategy Act, and the U.S. Holocaust Assets Commission Act directly affect the Federal Reserve System or the institutions it regulates.

Consumer Reporting Employment Clarification Act

The Consumer Reporting Employment Clarification Act amends the Fair Credit Reporting Act by removing the seven-year limitation on the reporting of criminal convictions by consumer reporting agencies. This change should help insured depository institutions comply with the prohibition on employing individuals convicted of criminal offenses involving dishonesty or a breach of trust.

In addition, the act expands an exemption, created in the Intelligence Authorization Act for Fiscal Year 1998, from certain Fair Credit Reporting Act disclosure provisions when a U.S. government agency or department has obtained, or seeks to obtain, a consumer report for use in a national security investigation, such as a review of a consumer's security clearance. For the agency or department to qualify for the exemption, the head of the agency or department must make a written finding that the consumer report is relevant to its national security investigation; that the investigation is within its jurisdiction; and that there is reason to believe that compliance with the disclosure requirements will (1) endanger the life or physical safety of any person, (2) result in flight from prosecution, (3) result in the destruction of, or tampering with, evidence relevant to the investigation, (4) result in the intimidation of a potential witness relevant to the investigation; (5) result in the compromise of classified information, or (6) otherwise seriously jeopardize or unduly delay the investigation or another official proceeding.

Credit Union Membership Access Act

The Credit Union Membership Access Act, among other things, reverses the Supreme Court's recent decision in *National Credit Union Administration v. First National Bank & Trust Co.*,[1] which held that the same common bond of occupation must unite all members of an occupationally defined federal credit union.[2] The act permits the formation of credit unions on the basis of more than one common bond, and thus increases the potential customer base of credit unions. The act also requires the Secretary of the Treasury to conduct a study of the difference between credit unions and other federally insured financial institutions. It requires the National Credit Union Administration Board (NCUA Board) to periodically assess the potential liquidity needs of credit unions and the options available to

1. 118 S.Ct. 927 (1998).
2. Id. at 939.

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credit unions to meet those needs, and to make available to Federal Reserve Banks information relevant to making advances to such credit unions, including the NCUA Board's reports of examination. Finally, the act requires the federal banking agencies to submit a report, one year from the date of enactment of the act, detailing their progress in carrying out section 303(a) of the Riegle Community Development and Regulatory Improvement Act of 1994.

Examination Parity and Year 2000 Readiness for Financial Institutions Act

The Examination Parity and Year 2000 Readiness for Financial Institutions Act requires that each federal banking agency offer to the depository institutions it regulates seminars on the implications of the Year 2000 computer problem. It also requires that each federal banking agency make available to the depository institutions it regulates model approaches to common Year 2000 computer concerns, such as project management, vendor contracts, testing regimes, and business continuity planning.

The act also authorizes the Office of Thrift Supervision to examine service companies that provide services to, or are owned by, savings associations to the same extent savings associations are currently examined. The act allows such examinations to be conducted by any federal banking agency that supervises any other owner of part of the service company or subsidiary. It also authorizes the National Credit Union Administration to examine credit union organizations to the same extent insured credit unions are currently examined and allows such examinations to be conducted by any federal banking agency that supervises any other person who maintains an ownership interest in a credit union organization.

Federal Employees Health Care Protection Act

Among other things, the Federal Employees Health Care Protection Act permits certain Board employees, who were previously ineligible, to participate in the Federal Employees Health Benefits Program (FEHBP). This change will enable certain employees who retired from the Board before becoming eligible to participate in FEHBP the opportunity to participate in FEHBP during their retirement.

Homeowners Protection Act

The Homeowners Protection Act limits a creditor's right to require private mortgage insurance once a consumer's equity in his or her home reaches a certain level. The act grants consumers the right to request cancellation of the private mortgage insurance on their residence once their loan balance reaches 80 percent of the property's original value. The accumulated equity in the home is calculated on the basis of either amortization schedules or actual payments. Before terminating private mortgage insurance a lender may ensure that the value of the home has not declined, that the individual has a good payment history, and that the equity in the home is unencumbered. The act also requires lenders to cancel private mortgage insurance automatically when the loan balance reaches 78 percent of the property's original value but also contains exceptions for high-risk loans. A consumer's right to cancel private mortgage insurance must be disclosed at loan consummation and annually thereafter. Once the insurance is canceled, the mortgage servicer must return any

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unearned premiums to the consumer. Finally, the act imposes civil liability on servicers, lenders, and insurers who violate the act and requires federal banking agencies to enforce the act.

Money Laundering and Financial Crimes Strategy Act

The Money Laundering and Financial Crimes Strategy Act requires the Secretary of the Treasury and the Attorney General to develop a national strategy for combating money laundering and related financial crimes. In general, the aims of the national strategy are to develop research-based goals, objectives, and priorities for reducing and preventing money laundering and related financial crimes in the United States. The act requires that the Secretary of the Treasury, in developing the national strategy, consult with the Board of Governors, among other parties. In addition, the act requires that the national strategy identify areas where money laundering and related financial crimes are extensive or present a substantial risk, so that a comprehensive approach to combating such crime in those areas can be developed.

U.S. Holocaust Assets Commission Act

The U.S. Holocaust Assets Commission Act establishes the Presidential Advisory Commission on Holocaust Assets in the United States to conduct a thorough study of, and develop a historical record of, the collection and disposition of certain types of assets that came into the possession or control of the federal government, including the Board of Governors or any Federal Reserve Bank, after January 30, 1933. ■

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Banking Supervision and Regulation

The overall condition of the U.S. banking system remained strong during 1998, though problems in certain emerging markets and the ensuing volatility in world financial markets posed challenges for larger, internationally active banks. For most banking organizations, profitability and asset quality remained robust, supported by the U.S. economic expansion. In contrast, several internationally active organizations reported reduced profitability and asset quality related to their foreign lending, trading, and investment-banking activities. Nevertheless, given the unusual severity of market volatility, the larger global firms showed remarkable resilience and, like the rest of the industry, generally maintained historically high capital ratios and adequate loss reserves.

Over the course of the year, industry consolidation continued as large and small banking firms sought to tap potential synergies and efficiencies. At the same time, competition to meet the rising demand for credit from businesses and consumers continued to intensify and to place pressure on loan terms and conditions. However, market volatility in the second half of the year caused many firms to reevaluate their practices, leading to a firming in the pricing and conditions for certain loan categories to reflect greater economic uncertainty.

As an important part of its supervisory role, the Federal Reserve has promoted the strengthening of bank risk-management systems, including the use of stress-testing. The recent turmoil in international financial markets has helped to underscore the need for improvement and has led many organizations to evaluate the underlying assumptions and adequacy of their risk-management systems. More work will need to be done in this critical area for bank safety and soundness.

Recent events have also underscored the importance of capital for the safety and soundness of individual institutions and the stability of financial systems both here and abroad. Over the past decade, the international risk-based capital standards established in 1988 through the Basle Capital Accord have served the U.S. and international banking systems well. To preserve the usefulness of the standards, the Federal Reserve and other international supervisors are evaluating ways of modernizing the standards to better address changes in rapidly evolving financial markets, products, and institutions.

Toward that end, and as part of its overall supervisory efforts, the Federal Reserve has intensified its evaluation of the techniques that banks are using to monitor and quantify their risk exposures and to allocate capital. In particular, the Federal Reserve has dedicated resources to studying bank practices for establishing internal risk grades for loans and other exposures, bank statistical modeling techniques for quantifying credit risk, and evolving methods for quantifying operational risk. Work is also under way to understand the range of practices banks are employing to internally allocate capital among business lines and to establish their own target capitalization on a firm-wide basis.

These hands-on evaluations of bank risk-measurement and capital-allocation practices not only have improved our understanding of individual institution

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safety and soundness, but have provided valuable comparative insights on the state of industry practices. These lessons are being shared with supervisors internationally and may serve as an important foundation in efforts to revise the capital standards that are now being considered by the Basle Committee on Banking Supervision.

In response to the increasing scope and complexity of banking activities, the Federal Reserve has not only intensified its focus on internal risk-management practices but has also placed greater emphasis on planning and examiner training, to ensure that supervisory efforts are targeted toward areas posing the highest risk to financial institutions. Work is also under way to provide staff with technology that facilitates more-continuous supervisory oversight and enables better coordination across Reserve Banks.

As part of its efforts to promote sound practices and to improve the quality and consistency of supervision, the Federal Reserve in 1998 undertook reviews of certain banking practices at several large institutions of similar size and characteristics. These coordinated supervisory reviews provided valuable comparative information on how well banking organizations are managing risk. For example, a detailed review of commercial lending standards at several of the largest banking organizations resulted in additional guidance to examiners and the industry. This review quantified trends in lending standards, described sound practices, and noted areas needing increased supervisory attention.

Along with these ongoing efforts to improve supervisory oversight and banking practices, the Federal Reserve has continued its extensive program for ensuring that institutions recognize their obligations to be ready for the century date change. During 1998, the Federal Reserve reviewed every bank subject to its supervisory oversight for Year 2000 readiness. In addition, working with regulators both here and abroad, the Federal Reserve issued numerous public statements and held, as well as cosponsored, several conferences to provide guidance to the industry. Work in this area will continue throughout 1999.

Another significant area of supervisory attention during 1998 stemmed from the escalation of problems in certain Asian countries and the rapid spread of difficulties across other markets subsequent to the Russian bond default. In response to these problems, the Federal Reserve built on its strong relationships with domestic and international regulatory bodies to gain a better understanding of the extent of U.S. financial institutions' exposures to internationally active organizations and to formulate appropriate remedial actions. Efforts focused on both the foreign operations of U.S. banks in troubled economies and the U.S. operations of banks based in those countries.

These and other efforts detailed in this chapter form the basis by which the bank supervision function supports the Federal Reserve's mission of promoting financial stability, containing systemic risk, and providing a safe and sound banking system.

Scope of Responsibilities for Banking Supervision and Regulation

The Federal Reserve is the federal supervisor and regulator of all U.S. bank holding companies and of state-chartered commercial banks that are members of the Federal Reserve System. In overseeing these organizations, the Federal Reserve primarily seeks to promote their safe and sound operation and their compliance with laws and

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Federal Reserve Bank of St. Louis

regulations, including the Bank Secrecy Act and regulations on consumer and community affairs.[1] The Federal Reserve also examines the specialized activities of these institutions, such as information technology, fiduciary activities, capital markets activities, and government securities dealing and brokering.

In addition, the Federal Reserve has responsibility for the supervision of all Edge Act and agreement corporations; the international operations of state member banks and U.S. bank holding companies; and the operations of foreign banking companies in the United States.[2]

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

Supervision for Safety and Soundness

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

Examinations and Inspections

The Federal Reserve conducts *examinations* of state member banks, branches and agencies of foreign banks, Edge Act corporations, and agreement corporations. Because many aspects of the reviews at bank holding companies and their nonbank subsidiaries differ from bank examinations, the Federal Reserve conducts *inspections* of holding companies and their subsidiaries. Preexamination planning and on-site review of operations are integral parts of ensuring the safety and soundness of financial institutions. Regardless of whether it is an examination or an inspection, the review entails (1) an assessment of the quality of the processes in place to identify, measure, monitor, and control risk exposures; (2) an appraisal of the quality of the institution's assets; (3) an evaluation of management, including an assessment of internal policies, procedures, controls, and operations; (4) an assessment of the key financial factors of capital, earnings, liquidity, and sensitivity to market risk; and (5) a review for compliance with applicable laws and regulations.

1. The Board's Division of Consumer and Community Affairs is responsible for coordinating the Federal Reserve's supervisory activities with regard to the compliance of banking organizations with these laws and regulations. To carry out this responsibility, the Federal Reserve specifically trains a number of its bank examiners to evaluate institutions with regard to such compliance. The chapter of this REPORT covering consumer and community affairs describes these regulatory responsibilities. Compliance with other statutes and regulations, which is treated in this chapter, is the responsibility of the Board's Division of Banking Supervision and Regulation and the Reserve Banks, whose examiners also check for safety and soundness. Several regulatory organizations enforce compliance with the Board's securities credit regulations, which are administered by the Board's Legal Division.

2. Edge Act corporations are chartered by the Federal Reserve, and agreement corporations are chartered by the states, to provide all segments of the U.S. economy with a means of financing international trade, especially exports.

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Federal Reserve Bank of St. Louis

State Member Banks

At the end of 1998, 994 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented about 11.4 percent of all insured U.S. commercial banks and held about 24.2 percent of all insured commercial bank assets in the United States.

The guidelines for Federal Reserve examinations of state member banks are fully consistent with section 10 of the Federal Deposit Insurance Act, as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and by the Riegle Community Development and Regulatory Improvement Act of 1994. For most of these banks, a full-scope, on-site examination is required at least once during each twelve-month period; certain well-capitalized and well-managed institutions with assets of less than $250 million may be examined every eighteen months.

During 1998, the Federal Reserve Banks conducted 540 examinations of state member banks (some of them jointly with the state agencies), and state banking departments conducted 293 independent examinations of state member banks.

Bank Holding Companies

At year-end 1998, the number of U.S. bank holding companies totaled 5,979. These organizations controlled 6,829 insured commercial banks and held approximately 95.4 percent of all insured commercial bank assets.

Federal Reserve guidelines call for annual inspections of large bank holding companies and smaller companies that have significant nonbank assets. In judging the financial condition of subsidiary banks, Federal Reserve examiners consult the examination reports of the federal and state banking authorities that have primary responsibility for the supervision of these banks, thereby minimizing duplication of effort and reducing the burden on banking organizations. In 1998, Federal Reserve examiners conducted 1,057 bank holding company inspections, 76 of which were conducted off site, and state examiners conducted 76 independent inspections. These inspections were conducted at 917 bank holding companies.

Certain small, noncomplex bank holding companies—those that have less than $1 billion in consolidated assets, do not have debt outstanding to the public, and do not engage in significant nonbank activities—are subject to a special supervisory program that became effective in 1997. The program permits a more flexible approach to supervising those entities in a risk-focused environment and is designed to improve the overall effectiveness and efficiency of the Federal Reserve's bank supervisory efforts. Each such holding company is subject to off-site review once during each supervisory cycle, which corresponds to the mandated examination cycle for the company's lead bank. In 1998, the Federal Reserve conducted 2,662 reviews of these companies.

Enforcement Actions, Civil Money Penalties, and Suspicious Activity Reporting

In 1998, the Federal Reserve Banks recommended, and members of the Board's staff initiated and worked on, 103 enforcement cases involving 186 separate actions, such as cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalties. Of these, 35 cases involving 53 actions were completed by year-end.

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Federal Reserve Bank of St. Louis

One of the final actions taken by the Board of Governors with regard to the illegal activities of the Bank of Credit and Commerce International (BCCI) was an agreement with Clark Clifford and Robert Altman to settle the Board's allegations that Messrs. Clifford and Altman had engaged in violations of laws and regulations with regard to BCCI's fraudulent activities. In settlement of the Board's charges, Messrs. Clifford and Altman paid penalties of approximately $5 million.

In other significant matters, the Board of Governors assessed civil money penalties totaling more than $500,000. The Board also issued two formal enforcement actions against institutions that exhibited less than satisfactory progress in addressing Year 2000 deficiencies.

All final enforcement orders issued by the Board of Governors and all written agreements executed by the Federal Reserve Banks in 1998 are available to the public and can be accessed from the Board's public web site.

In addition to formal enforcement actions, the Federal Reserve Banks in 1998 completed fifty-eight informal enforcement actions, such as memorandums of understanding and resolutions from boards of directors.

Specialized Examinations

The Federal Reserve conducts specialized examinations of banking organizations in the areas of information technology, fiduciary activities, transfer agent activities, government and municipal securities dealing, and securities underwriting and dealing through so-called section 20 subsidiaries of bank holding companies. As part of the technology review, examiners in 1998 also conducted targeted reviews of preparedness for the century date change. The Federal Reserve also conducts specialized examinations of certain persons, other than banks, brokers, or dealers, who extend securities credit subject to the Board's margin regulations.

Information Technology

The Federal Reserve examines the information technology activities of state member banks, U.S. branches and agencies of foreign banks, Edge Act and agreement corporations, and independent data centers that provide electronic data processing services to these institutions. These examinations are conducted in recognition of the importance of information technology to the financial industry and help to ensure that banking organizations conduct their operations in a safe and sound manner. During 1998, the Federal Reserve conducted 278 examinations that focused on information technology and electronic data processing systems. The Federal Reserve was also the lead agency on two examinations of large, multiregional data processing servicers examined in cooperation with the other federal banking agencies.

Year 2000 Compliance

The Year 2000 supervision program is divided into three phases and assesses the progress of three types of entities in preparing for the century date change: financial institutions, service providers, and software vendors. (The program is described more fully later in the discussion of the Federal Financial Institutions Examination Council.) Phase 1, which ended June 30, 1998, included the review of 1,569 financial institutions and 49 service providers and software vendors. Phase 2 began July 1, 1998, and will run through March 1999. By year-end 1998, reviews of 837 financial institutions and 28 service providers and

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Federal Reserve Bank of St. Louis

software vendors had been conducted as part of phase 2. Phase 3 is currently being developed and is to run from April 1999 until early 2000.

Fiduciary Activities

The Federal Reserve has supervisory responsibility for institutions that together hold more than $11.5 trillion of assets in various fiduciary capacities. This group of institutions comprises 319 state-chartered member banks and trust companies, 71 nonmember trust companies that are subsidiaries of bank holding companies, and 18 entities that are either branches or agencies of foreign banking organizations or Edge corporation subsidiaries of domestic banking institutions.

During on-site examination of an institution's fiduciary activities, examiners evaluate the institution's management and operations, including its asset and account management, risk management, and audit and control procedures, and review its compliance with laws, regulations, general fiduciary principles, and potential conflicts of interest. In 1998, Federal Reserve examiners conducted 219 on-site trust examinations.

Transfer Agents and Securities-Clearing Agencies

The Federal Reserve conducts specialized examinations of those state member banks and bank holding companies that serve as registered transfer agents. Among other things, transfer agents countersign and monitor the issuance of securities, register the transfer of securities, and exchange or convert securities. On-site examinations focus on the effectiveness of transfer agent operations and compliance with relevant securities regulations. During 1998, Federal Reserve examiners conducted examinations at 53 of the 143 state member banks and bank holding companies that were registered as transfer agents.

In addition, during 1998, the Federal Reserve examined two state member limited-purpose trust companies that acted as national securities depositories to ensure the safety and soundness of their operations and their compliance with applicable laws and regulations. These institutions, which were registered as clearing agencies with the Securities and Exchange Commission, held dematerialized and immobilized securities in custody on behalf of participants and their customers and facilitated the settlement of securities transactions through electronic book entry accounting. During 1998, one of the institutions, the Participants Trust Company, which provided depository and settlement services for mortgage-backed securities, became a division of the other, the Depository Trust Company, which is the national securities depository for most corporate and municipal securities

Government and Municipal Securities Dealers and Brokers

The Federal Reserve is responsible for examining the government securities dealer and broker activities of state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with Department of the Treasury regulations. Thirty-six state member banks and nine state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 1998, the Federal Reserve conducted fourteen examinations of broker–dealer activities in government securities at these institutions.

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Federal Reserve Bank of St. Louis

Under the Securities Act Amendments of 1975, the Federal Reserve is also responsible for the supervision of state member banks and bank holding companies that act as municipal securities dealers. The Federal Reserve supervises thirty-six banks that act as municipal securities dealers. In 1998, thirteen of these institutions were examined.

Securities Subsidiaries of Bank Holding Companies

All subsidiaries of bank holding companies established pursuant to section 20 of the Banking Act of 1933 are required to conduct business subject to uniform operating standards, consistent with safe and sound operations. To ensure that section 20 firms will not be engaged principally in underwriting and dealing in securities, the Board limits revenues derived from such activities to less than 25 percent of the total revenues of the section 20 subsidiary.

As the structure of the financial services industry has continued to evolve, a trend toward acquisition of independent securities firms by banking organizations has emerged. As a result, significant Federal Reserve resources have been devoted to monitoring and supervising such mergers and acquisitions to ensure that banking organizations develop and maintain the necessary risk management and corporate oversight to avoid any negative effect on the banking organization and its banking operations.

At year-end 1998, forty-six bank holding companies and foreign banking organizations owned a total of fifty-three section 20 subsidiaries authorized to underwrite and deal in ineligible securities; largely because of mergers and acquisitions, six of these institutions owned more than one section 20 subsidiary. Of the forty-six, thirty-five were permitted to underwrite any debt or equity security, two were permitted to underwrite any debt security, and nine were permitted to underwrite only the limited types of debt securities first approved by the Board in 1987. The Federal Reserve follows specialized inspection procedures to review the operations of these securities subsidiaries; it conducted twenty-three such inspections in 1998.

Securities Credit Regulation

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

At the end of 1998, 829 lenders other than banks, brokers, or dealers were registered with the Federal Reserve; of these, 584 were under the Federal Reserve's supervision. The Federal Reserve regularly inspects 270 of these lenders either biennially or triennially, according to the type of credit they extend; during 1998, Federal Reserve examiners inspected 143 of them for compliance with Regulation U. The remaining 314 lenders were exempt from periodic on-site inspections by the Federal Reserve but were monitored through the filing of periodic regulatory reports.

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Federal Reserve Bank of St. Louis

International Activities

Foreign Office Operations of U.S. Banking Organizations

The Federal Reserve examines the international operations of state member banks, Edge Act corporations, and bank holding companies, principally at the U.S. head offices of these organizations, where the ultimate responsibility for their foreign offices lies. In 1998, the Federal Reserve conducted examinations of nine foreign branches of state member banks and eighty-two foreign subsidiaries of Edge Act corporations and bank holding companies. All of the examinations abroad were conducted with the cooperation of the supervisory authorities of the countries in which they took place; when appropriate, the examinations were coordinated with the Office of the Comptroller of the Currency. Also, examiners made twenty-three visits to the overseas offices of U.S. banks to obtain financial and operating information and, in some instances, to evaluate their compliance with corrective measures or to test-check their adherence to safe and sound banking practices.

Foreign Branches of Member Banks

At the end of 1998, eighty-three member banks were operating 881 branches in foreign countries and overseas areas of the United States; fifty-three national banks were operating 693 of these branches, and thirty state member banks were operating the remaining 188 branches. In addition, twenty-two nonmember banks were operating 47 branches in foreign countries and overseas areas of the United States.

Edge Act and Agreement Corporations

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

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

At year-end 1998, there were eighty-five Edge Act and agreement corporations with thirty-three branches. During the year, the Federal Reserve examined all of these corporations.

U.S. Activities of Foreign Banks

The Federal Reserve has broad authority to supervise and regulate the U.S. activities of foreign banks that engage in banking and related activities in the United States through branches, agencies, representative offices, commercial lending companies, Edge Act corporations, commercial banks, and certain nonbank companies. Foreign banks continue to be significant participants in the U.S. banking system. As of year-end 1998, 246 foreign banks from 58 countries operated 421 state-licensed branches and agencies (of which 20 were insured by the Federal Deposit Insurance Corporation) as well as 62

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Federal Reserve Bank of St. Louis

branches licensed by the Office of the Comptroller of the Currency (of which 6 had FDIC insurance). These foreign banks also directly owned 15 Edge Act corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 65 U.S. commercial banks. Altogether, these U.S. offices of foreign banks at the end of 1998 controlled approximately 20 percent of U.S. banking assets. These foreign banks also operated 216 representative offices; an additional 87 foreign banks operated in the United States solely through a representative office.

The Federal Reserve has acted to ensure that all state-licensed and federally licensed branches and agencies are examined on site at least once during each twelve-month or eighteen-month period, either by the Federal Reserve or by a state or other federal regulator. On-site examinations of state- and federally licensed branches and agencies are usually conducted at least once during a twelve-month period, but the period may be extended to eighteen months if the branch or agency meets certain criteria. The Federal Reserve conducted or participated with state and federal regulatory authorities in 431 examinations during 1998.

Joint Program for Supervising the U.S. Operations of Foreign Banking Organizations

In 1995 the Federal Reserve, in cooperation with the other federal and state banking supervisory agencies, formally adopted a joint program for supervising the U.S. operations of foreign banking organizations (FBOs). The program has two major parts. One part focuses on the examination process for those FBOs that have multiple U.S. operations and is intended to improve coordination among the various U.S. supervisory agencies. The other part is a review of the financial and operational profile of each FBO to assess its general ability to support its U.S. operations and to determine what risks, if any, the FBO poses through its U.S. operations. Together, these two processes provide critical information to the U.S. supervisors in a logical, uniform, and timely manner. During 1998, the Federal Reserve continued to implement program goals through coordination with other supervisory agencies and the development of financial and risk assessments of foreign banking organizations and their U.S. operations.

Technical Assistance

In 1998, the Federal Reserve System continued to provide staff for technical assistance missions covering bank supervisory matters to an increasing number of central banks and supervisory authorities around the world. Technical assistance takes a wide variety of forms, ranging from official visits by foreign supervisors to the Board and Reserve Banks for the purpose of learning about U.S. supervisory practices and procedures to secondments of Federal Reserve System staff to overseas supervisory authorities for the purpose of advising on strengthening the bank supervisory process in a foreign country. In 1998, technical assistance was concentrated primarily in Latin America, the Far East, and former Soviet bloc countries. During the year, the Federal Reserve offered supervision training courses in Washington, D.C., and on site in a number of foreign jurisdictions exclusively for staff of foreign supervisory authorities. System staff also took part in technical assistance and training missions led by the International Monetary Fund, the World Bank, the Inter-American Development Bank, and the Basle Committee on Banking Supervision.

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Federal Reserve Bank of St. Louis

Risk-Focused Supervision

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

In 1998, the Federal Reserve continued to revise its supervisory process to improve the effectiveness of its examinations and inspections as well as to address changes in the banking industry. As of October 1, 1998, pre-membership examinations of state nonmember banks, national banks, and savings associations seeking to convert to state membership status are no longer required if the bank or savings association seeking membership meets the criteria for "eligible bank" as set forth in the Board's Regulation H.

During the year, two of the Federal Reserve's risk-focused supervision programs for banks—one for large, complex banking organizations and the other for community banks—were reviewed for effectiveness and the need for further enhancements. Both programs rely on gaining an understanding of the institution, performing risk assessments, developing a supervisory plan, and tailoring examination procedures to the institution's risk profile.

Risk-Focused Supervision of Community Banks

Implementation of the risk-focused supervision program for community banks was reviewed at each of the twelve Reserve Banks. The primary objective was to identify best practices, procedures, and processes as well as those that might require improvement or further clarification. The reviews emphasized that certain elements are key to the risk-focused supervision process, including adequate planning time, completion of a pre-examination visit, preparation of a detailed scope-of-examination memorandum, thorough documentation of the work done, and preparation of an examination report tailored to the scope of the examination. The findings from the reviews are expected to be distributed to the Reserve Banks in early 1999.

Risk-Focused Supervision of Large, Complex Banking Organizations

In an effort to build on the Federal Reserve's Framework for Risk-Focused Supervision of Large, Complex Financial Institutions, a group of Reserve Bank and Board senior supervisory staff in 1998 codified best practices across the System for supervising the largest, most complex of these financial institutions. The key features of the program for implementing risk-focused supervision at these large, complex banking organizations (LCBOs) are (1) identifying those LCBOs that, based on their shared risk characteristics, present the highest level of supervisory risk to the Federal Reserve System; (2) maintaining continual supervision of these LCBOs to keep current the Federal Reserve's assessment of each organization's condition; (3) instituting a defined, stable supervisory team for each LCBO composed of Reserve Bank staff who have skills appropriate for the organization's unique risk profile, led by a Reserve Bank central point of contact who has responsibility for only one LCBO, and supported by specialists skilled in evaluating the risks of highly complex LCBO business activi-

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Federal Reserve Bank of St. Louis

ties and functions; and (4) promoting information-sharing on a Systemwide and interagency basis through an automated system.

Technology Initiatives for the Risk-Focused Supervision Program

To assist in the supervision of large U.S. banking organizations and the U.S. branches and agencies of foreign banking organizations, the Federal Reserve in 1998 introduced the Large Bank Desktop and expanded the FBO Desktop. These automated systems are vehicles for sharing information used in the supervision of these organizations throughout the Federal Reserve System and with other federal and state banking supervisors.

Additionally, development of the Banking Organization National Desktop (BOND) has begun, with the aim of providing the high degree of information-sharing and ongoing collaboration necessary to support the risk-focused supervision of the largest, most complex banking organizations. BOND will expand on the capabilities of the Large Bank and FBO Desktops to provide immediate, user-friendly access to a full range of internal and third-party information and to risk-assessment and other decision-support tools. It will also serve to foster collaboration among Federal Reserve staff and other bank supervisors. BOND is expected to facilitate the analysis of trends for like organizations and to improve the Federal Reserve's ability to identify and manage the risks posed by these banking organizations.

Risk-Focused Supervision of Small Shell Bank Holding Companies

During 1998, the Board implemented surveillance screens for small shell bank holding companies that identify trends that may adversely affect individual companies. These screens support the risk-focused supervision program for small shell bank holding companies, which tailors supervisory activities to an assessment of each company's reported condition and activities and the condition of its subsidiary banks. Under the program, Reserve Banks are expected to perform a risk assessment of each small shell bank holding company at least once during each supervisory cycle, which depends on the examination frequency for the holding company's lead bank. If a preliminary assessment identifies no unusual supervisory issues or concerns, no special follow-up with the company is necessary. However, if it supports the assignment of a supervisory rating (that is, a BOPEC rating) of 3 or worse or a management rating of less than satisfactory, a full-scope, on-site inspection is expected to be performed. New companies will still be subject to a full-scope, on-site inspection within the first twelve to eighteen months of operation.

Surveillance and Risk Assessment

The Federal Reserve monitors the financial condition and performance of individual banking organizations and of the banking system as a whole to identify areas of supervisory concern. This is accomplished, in part, through the use of automated screening systems. Surveillance screens address a number of aspects of banking performance, including capitalization, growth, loan quality, loan concentrations, liquidity, and capital markets activities. Information from these screens assists in allocating examination resources to deteriorating institutions and is also used in planning examinations. The systems used to monitor bank performance include two econo-

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Federal Reserve Bank of St. Louis

metric models that use quarterly Call Report data to estimate examination ratings for all banks and to identify banks having the potential to become critically undercapitalized over the subsequent two years.

During 1998, the Federal Reserve also initiated efforts to refine reports used in monitoring the international activities of domestic and foreign banking organizations. These efforts included expanding stock price monitoring efforts for global institutions and enhancing reports on the foreign exposure of U.S. banking institutions.

In addition, the Federal Reserve broadened the supervisory staff's electronic access to data on U.S. branches and agencies of foreign banking organizations through enhancements to the Performance Report Information and Surveillance Monitoring application (PRISM). PRISM is a PC-based application that supports financial analysis by facilitating access to supervisory and structure data housed in the National Information Center (NIC) and by electronically distributing surveillance and monitoring results.

To assist supervisory staff in evaluating individual bank holding companies, the Federal Reserve produces and distributes the quarterly Bank Holding Company Performance Report (BHCPR). This report includes detailed information on current and historic bank holding company conditions and performance. During the year, the Federal Reserve implemented a web version of the BHCPR to make nonconfidential versions of the report more accessible to the public.

The Federal Reserve actively works with the other federal banking agencies to enhance surveillance tools through its representation on the Federal Financial Institutions Examination Council Task Force on Surveillance Systems.

Supervisory Policy

The supervisory policy function develops guidance for examiners and financial institutions as well as regulations for financial institutions under the supervision of the Federal Reserve. Supervisory function staff members also participate in international supervisory forums and provide significant support for the work of the FFIEC. The following discussion summarizes the work of this function.

Trading and Capital Markets Activities

In 1998, the Board's Division of Banking Supervision and Regulation issued a significantly revised and expanded version of its *Trading and Capital Markets Activities Manual,* which provides examiners with guidance for reviewing capital markets and trading activities at financial institutions of all types and sizes. The revised guidance takes a functional approach to activities, as opposed to a legal-entity focus. The manual includes new chapters on basic treasury functions and other capital markets activities, capital adequacy, and settlement risk and contains thirty-five new profiles of capital markets products. Chapters on market risk, pre-settlement risk, legal risk, financial performance, accounting and regulatory reporting, and ethics have been revised and updated to reflect new regulatory guidance and best practices.

The manual codifies current procedures used in reviewing capital markets and trading activities. It discusses the risks involved in various activities, risk-management and risk-measurement techniques, appropriate internal controls, and examination objectives and procedures. The manual is updated

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periodically as products and activities evolve.

Capital Adequacy Guidelines

During 1998, the Federal Reserve, together with the other federal banking agencies, issued two final rules that amended their capital standards. One rule permits institutions to include up to 45 percent of unrealized gains on certain equity securities in tier 2 capital. The other raises the tier 1 capital limitation for mortgage-servicing assets from 50 percent to 100 percent of tier 1 capital.

Market Risk/Specific Risk

During 1998 the Federal Reserve, together with the FDIC and the OCC, worked to develop a final rule to amend their respective risk-based capital standards for market risk applicable to certain institutions having significant trading activities. The rule would finalize an interim rule issued by the agencies in December 1997. The interim rule permits institutions to use qualifying internal models to determine their capital requirements in relation to specific risk (an element of market risk) without comparing the requirements generated by their internal models with the so-called standardized specific-risk capital requirement. The final rule being developed, which is similar in substance to the interim rule, is expected to be finalized in early 1999.

Servicing Assets

On August 10, 1998, the federal banking agencies issued a final rule amending their risk-based and tier 1 leverage capital guidelines for banks, bank holding companies, and thrift institutions to address the accounting treatment of servicing assets on both mortgage assets and financial assets other than mortgages. The final rule reflects changes in accounting standards for servicing assets made in Statement of Financial Accounting Standard (FAS) No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. FAS 125 extends the accounting treatment for mortgage servicing to servicing on all financial assets. The final rule raises the capital limitations on the sum of all servicing assets (mortgage and nonmortgage) and purchased credit card relationships (PCCRs) from 50 percent of tier 1 capital to 100 percent of tier 1 capital. It also subjects nonmortgage servicing assets and PCCRs to a further sublimit of 50 percent of tier 1 capital.

Unrealized Gains on Certain Equity Securities

On September 1, 1998, the federal banking agencies issued a joint final rule that amended the risk-based capital rules and allows banking organizations to include up to 45 percent of their net unrealized holding gains on certain available-for-sale equity securities in tier 2 capital. The rule became effective on October 1, 1998. The full amount of net unrealized gains on available-for-sale securities is included as a component of equity capital under U.S. generally accepted accounting principles (GAAP), but until the adoption of this interagency rule such gains had not been included in regulatory capital. The agencies' capital rules, consistent with GAAP, continue to require banking organizations to deduct the amount of net unrealized losses on their available-for-sale equity securities from tier 1 capital. To be consistent with a restriction in the Basle Accord, the agencies have limited the inclusion of net unrealized gains on

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Federal Reserve Bank of St. Louis

equity securities in tier 2 capital to no more than 45 percent of such net unrealized gains.

Leverage Capital Ratios

On June 4, 1998, the Federal Reserve issued a final rule that amended its leverage standard for bank holding companies. Under the rule, bank holding companies that either are rated a composite 1 under the BOPEC rating system or have implemented the Board's risk-based capital market risk measure are subject to a minimum 3 percent leverage ratio. All other bank holding companies are subject to a minimum 4 percent leverage ratio.

Accounting for Derivative Instruments and Hedging Activities (FAS 133)

On December 29, 1998, the federal banking agencies issued a joint release that describes the appropriate interim regulatory capital treatment of derivatives for those banking organizations choosing to early-adopt Statement of Financial Accounting Standard (FAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. Banking organizations are not required to adopt FAS 133 until fiscal years beginning after June 15, 1999. The new accounting standard requires that all derivatives be recorded on the balance sheet as assets or liabilities at fair value. It also requires that a specific portion of cash flow hedges be reflected as a separate component of equity. Moreover, it significantly alters the accounting for derivatives used for hedging purposes and for financial instruments having specific types of embedded derivatives.

The interagency guidance states that until the agencies determine otherwise, the separate component of equity capital resulting from cash flow hedges should not be included in regulatory capital. The guidance further notes that the existing risk-based capital treatment for derivatives affects a banking organization's risk-based and tier 1 capital leverage ratios. The changes in the fair value of derivatives may indirectly affect retained earnings, thus affecting tier 1 capital. In addition, the on-balance-sheet recorded amount of derivatives may affect the total assets reported by banking organizations, thus directly affecting the leverage ratio.

Development of International Guidance on Supervisory Policies

As a member of the Basle Committee on Banking Supervision (Basle Supervisors Committee) and the Joint Forum on Financial Conglomerates (Joint Forum), the Federal Reserve has a key role in developing supervisory guidance on a wide range of international supervisory policies. The Federal Reserve's goal is to work toward the adoption and implementation of sound supervisory policies for banking institutions and to ensure the stability of the international banking system. During 1998, the Federal Reserve actively played a central role in developing a number of supervisory policy papers, reports, and recommendations that were issued, or are in the process of being issued, by the Basle Supervisors Committee and the Joint Forum, including the following:

- The Basle Committee undertook in the latter part of 1998 a major effort to revisit the various parts of the Basle Accord to ensure the continued vigor of this international capital framework. The Committee is considering this issue in light of changes in financial institutions and their activities in the financial markets, as well as

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the development of advanced risk management approaches, since the Accord's adoption in 1988.

- The Basle Committee undertook to study banking institutions' interaction with highly leveraged institutions (HLIs) such as hedge funds, particularly in light of the near-collapse of Long-Term Capital Management. A major part of this work was to assess the quality of banking institutions' risk-management practices related to HLIs and appropriate supervisory responses to address any weaknesses identified.
- The Basle Committee issued in October 1998 an interpretation of the Accord for capital adequacy regarding the capital instruments eligible for inclusion in tier 1 capital. The interpretation set forth the essential characteristics that capital instruments must have to warrant their inclusion in tier 1 capital under the Accord.
- The Basle Committee published in September 1998 the results of its survey of major banking institutions in member countries on their approaches to measuring, monitoring, and controlling operational risks arising from their financial activities.
- The Basle Committee conducted a survey on cross-border supervision focusing on two principal issues: access by home country supervisors to information on the activities of home country banking institutions in other countries, and the ability of supervisors to conduct cross-border inspections.
- In 1998, the Basle Committee extensively developed a consultative paper setting forth essential principles for the measurement and management of credit risk.
- The Joint Forum, with international participation by supervisors of the banking, securities, and insurance industries, continued its work toward improving supervisors' cooperation and coordination in an effort to ensure the sound oversight of international financial conglomerates crossing national and traditional industry lines.

Recourse

During 1998, the Federal Reserve, together with the OCC, FDIC, and OTS (Office of Thrift Supervision), continued to work on revisions to the rules regarding risk-based capital standards to address the regulatory capital treatment of recourse obligations and direct credit substitutes that expose banks, bank holding companies, and thrift institutions to credit risk. The proposed revisions would use credit ratings to match the risk-based capital assessment more closely to an institution's relative risk of loss in certain asset securitizations.

Technical Modifications

The federal banking agencies continued in 1998 to work to amend their capital adequacy guidelines to eliminate differences among the agencies. At year-end 1998, several technical modifications were still outstanding. These addressed the risk-based capital treatment of (1) construction loans for presold one- to four-family residential properties, (2) second liens on one- to four-family residential properties, and (3) investments in mutual funds and to simplify the agencies' leverage capital rules for banks and thrifts. The first proposal would permit a 50 percent risk weight for construction loans on all presold one- to four-family residential properties. The second proposal would treat first and second liens issued by the same institution (where there are no intervening liens) as a single extension of credit for purposes of determining loan-to-

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value percentages as well as risk weighting. These two proposed amendments would not change current Federal Reserve treatment of these assets for capital purposes. For investments in mutual funds, the proposed amendments would give institutions the option of assigning mutual fund investments on a pro rata basis among the risk categories according to the investment limits in the mutual fund prospectus. With regard to the tier 1 leverage ratio, the proposed amendment on mutual funds would permit certain institutions with the highest supervisory rating to have a 3 percent minimum leverage ratio; all other banks and thrift institutions would be required to have a minimum leverage ratio of 4 percent. The agencies are working to finalize these proposed amendments in early 1999.

Interagency Statement on the Allowances for Loan Losses

In November, the Federal Reserve, the Securities and Exchange Commission, and the other federal banking agencies issued a joint interagency statement on allowances for the loan losses of depository institutions. The statement reiterates the agencies' position that allowances for loan losses should be established and maintained in a manner that is consistent with generally accepted accounting principles and with the banking agencies' December 1993 interagency policy statement on the allowance for loan losses. The joint statement emphasizes the importance of prudent, conservative, but not excessive loan-loss allowances that fall within an acceptable range of estimated losses. The statement also states that the agencies will continue to fulfill their responsibility to ensure that allowances for loan losses are appropriately determined and that earnings are not improperly managed, consistent with the objectives of safety and soundness and investor protection.

Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure

The Board and the other federal banking agencies in December 1998 issued a joint policy statement regarding intercompany tax allocations for banking organizations and savings associations that file an income tax return as a member of a consolidated group. The statement provides guidance to institutions regarding the allocation and payment of taxes among a bank holding company and its depository institution subsidiaries, and related internal policies. In general, the guidance is consistent with the Federal Reserve's pre-existing policies on income taxes, but it has been updated to reflect current tax terminology and to ensure a uniform interagency approach. Consistent with long-standing policy, the statement adheres to the general principle that intercorporate tax settlements between an institution and its parent company should be conducted in a manner that is no less favorable to the institution than if it were a separate taxpayer.

International Guidance on Internal Control, Accounting, and Disclosures

As a member of the Basle Committee on Banking Supervision (Basle Supervisors Committee), the Federal Reserve has a key role in the development of supervisory guidance on best accounting and best reporting practices among banking organizations. The objectives of this guidance are to promote greater transparency in financial statements, to encourage sound risk management, and

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to improve disclosures of qualitative and quantitative information on bank risk exposures and risk-management policies and practices. During 1998, the Federal Reserve contributed to several papers and reports on internal controls, accounting, and disclosure that were issued by the Basle Supervisors Committee:

- "Framework for Supervisory Information about Derivatives and Trading Activities" (September) discusses the types of information supervisory authorities should obtain for their evaluations of the derivatives activities of banks and securities firms. The paper builds on the supervisory information framework that was jointly published in May 1995 by the Basle Supervisors Committee and the Technical Committee of the International Organization of Securities Commissions (IOSCO) and addresses more comprehensively the market risk exposures arising from trading in both cash and derivatives instruments.
- "Enhancing Bank Transparency: Public Disclosure and Supervisory Information That Promote Safety and Soundness in Banking Systems" (September) discusses the role of information in effective market discipline and banking supervision. It provides general guidance to banking supervisors and regulators on ways to formulate and improve regulatory frameworks for public disclosure and supervisory reporting; it also provides general guidance to the banking industry on core disclosures that should be provided to the public.
- "Framework for Internal Control Systems in Banking Organizations" (September) outlines a comprehensive framework for the supervisory evaluation of banks' internal controls, including management's responsibility for maintaining the system of internal control, the role of the board of directors in establishing a corporate culture that emphasizes the importance of internal controls, and the monitoring activities and communication systems that are necessary to correct deficiencies. It also includes principles to guide supervisory authorities when evaluating banks' internal control systems.
- "Sound Practices for Loan Accounting, Credit Risk Disclosure and Related Matters" (October) provides guidance to banks, banking supervisors, and those who set accounting standards on the recognition and measurement of loans, the establishment of allowances for loan losses, credit risk disclosure, and related matters.
- "Trading and Derivatives Disclosures of Banks and Securities Firms: Results of the Survey of 1997 Disclosures" (November) is the fourth annual joint report of the Basle Supervisors Committee and IOSCO on the public disclosure of trading and derivatives activities of banks and securities firms worldwide. The report provides an overview and analysis of the disclosures about trading and derivatives activities presented in the 1997 annual reports of a sample of the largest internationally active banks and securities firms in the G-10 countries, and notes improvements since 1993.

In addition, a Federal Reserve official is a participating observer at meetings of the Financial Accounting Standards Board's (FASB) Financial Instruments Task Force. The task force was created to help the FASB answer questions related to its accounting and disclosure standards for financial instruments. This Federal Reserve official is also a participating observer at the board and steering committee meetings of the

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International Accounting Standards Committee (IASC) as a designee of the Basle Committee's Task Force on Accounting Issues. The IASC's objectives are to formulate and publish, in the public interest, accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance; and to work generally for the improvement and harmonization of regulations, accounting standards, and procedures relating to the presentation of financial statements.

Real Estate Appraisal Regulation

In November 1998, the Board adopted a final rule amending its real estate appraisal regulation for bank holding companies and their nonbank subsidiaries. The final rule permits a bank holding company, or its nonbank subsidiary, having the authority to underwrite or deal in mortgage-backed securities, to do so without demonstrating that the loans underlying the securities are supported by appraisals that at origination met the Board's appraisal regulation. The amendment addresses concerns raised by bank holding companies regarding the inability of their nonbank subsidiaries to actively participate in the commercial mortgage-backed securities market because of the earlier requirements.

Examination-Frequency Guidelines

In August 1998, the Federal Reserve and the other federal banking agencies issued an interim rule revising their examination-frequency guidelines to address provisions in the Riegle Community Development and Regulatory Improvement Act of 1994 and the Economic Growth and Regulatory Paperwork Reduction Act of 1996. As a result of the revision, certain U.S. branches and agencies of foreign banking organizations may qualify for an eighteen-month examination cycle rather than a twelve-month cycle.

To qualify for consideration for less-frequent examination, a U.S. branch or agency must have total assets of $250 million or less, must have received a composite supervisory rating of 1 or 2 at its most recent examination, and must not be subject to a formal enforcement action. In addition, the U.S. branch or agency must have satisfied the requirements that either (1) the foreign bank's most recently reported capital adequacy position consists of, or is equivalent to, tier 1 and total risk-based capital ratios of at least 6 percent and 10 percent respectively, on a consolidated basis; or (2) the office has maintained, on a daily basis over the past three quarters, eligible assets (determined consistent with applicable federal and state law) in an amount not less than 108 percent of the preceding quarter's average third-party liabilities and sufficient liquidity is currently available to meet its obligations to third parties. Finally, the foreign bank must not have experienced a change in control during the preceding twelve months.

Guidance on Credit Risk Management

During 1998, the Federal Reserve issued guidance regarding the internal rating systems banks use to support their sophisticated credit risk management systems. The guidance underlines the need for supervisors and examiners, both in their on-site examinations and inspections and in their other contacts with banking organizations, to emphasize the importance of developing and implementing effective internal credit-rating systems and the critical role

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such systems should play in the credit risk management process at sound large institutions. The study on which this guidance is based is available in the November 1998 *Federal Reserve Bulletin* and on the Federal Reserve's public web site.

Also in 1998, the Federal Reserve undertook an extensive study of lending terms and standards. This study, involving several hundred loans from across the country and many of the Federal Reserve's most experienced examiners, compared loans made in late 1995 with loans made in late 1997. The study concluded that intense competition for loan customers had led to a significant easing of pricing and of some non-price terms but that, on balance, the overall quality of loans being made had not changed significantly over the period, largely because of favorable economic conditions.

Risk Assessment of an Institution's Information Technology

In April 1998, the Federal Reserve issued guidance on assessing information technology in the risk-focused frameworks for the supervision of community banks and large, complex banking organizations. The guidance highlights the critical dependence of the financial services industry on information technology, reinforces the concept that the risk-focused supervisory process must address the risks associated with the use of information technology, and provides a basic framework and a common vocabulary for evaluating the effectiveness of processes used to manage the risks associated with information technology.

Bank Holding Company Reports

As the federal supervisor and regulator of all U.S. bank holding companies, the Federal Reserve requires periodic regulatory reports from these organizations. These reports provide essential information to assist the Federal Reserve in the formulation of regulations and supervisory policies. The reports are also used by the Federal Reserve to respond to requests from the Congress and the public for information on bank holding companies and their nonbank subsidiaries. The FR Y-9 series of reports (FR Y-9C, FR Y-9LP, and FR Y-9SP) provides standardized financial statements for the consolidated bank holding company and its parent. The Federal Reserve uses these reports to detect emerging financial problems, to review performance and conduct pre-inspection analysis, to monitor and evaluate risk profiles and capital adequacy, to evaluate proposals for bank holding company mergers and acquisitions, and to analyze a bank holding company's overall financial condition to ensure safe and sound operations. The FR Y-11 series of reports aids the Federal Reserve in determining the condition of bank holding companies that are engaged in nonbanking activities and in monitoring the volume, nature, and condition of their nonbanking subsidiaries.

During 1998, revisions that reduce reporting burden were made to the FR Y-9C; the revisions generally conform with revisions to the FFIEC 031 Call Report, including the elimination of several detailed items on investment securities and trading portfolios and the addition of items to monitor compliance with risk-based capital standards for market risk exposures and for low-level recourse transactions.[3] Revisions to the

3. Revisions to the Call Reports are discussed later in this section in connection with the work of Federal Reserve staff under the auspices of the Federal Financial Institutions Examination Council (FFIEC).

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FR Y-9LP and FR Y-9SP during 1998 were minor and consisted mainly of the addition of items to collect information about nonbank subsidiaries of bank holding companies. There were no substantive revisions to the FR Y-11 series of reports during the year.

In December 1998, the Federal Reserve announced proposed revisions to the FR Y-9 and FR Y-11 series of reports effective with the March 1999 reporting date. Most of the proposed revisions pertain to the FR Y-9C and attempt to minimize reporting burden by generally paralleling proposed revisions to the FFIEC 031 Call Report. The proposed revisions to the FR Y-9C include the elimination of detailed items for high-risk mortgage securities; implementation of the disclosure requirements of Statement of Financial Accounting Standard (FAS) No. 133, Accounting for Derivative Instruments and Hedging Activities, for cash flow hedges; and implementation of items for monitoring risk-based capital. The proposed revisions to the other FR Y-9 reports and to the FR Y-11 series of reports consist primarily of implementation of the FAS 133 disclosure requirements for cash flow hedges. The addition of a section for "Notes to the Financial Statements" has also been proposed for the FR Y-11 series.

Federal Financial Institutions Examination Council

Year 2000 Supervision Program

The Federal Reserve has worked closely with the other federal banking agencies to address the banking industry's readiness for the Year 2000. Under the auspices of the Federal Financial Institutions Examination Council, the Federal Reserve and the other member agencies continued in 1998 to assess the readiness of financial institutions, service providers, and software vendors to ensure that Year 2000-related computer problems and major service disruptions to customers and the banking system do not occur. The review program is divided into three phases and emphasizes five components of preparedness. Phase 1 (June 1997 through June 1998) focused on evaluating an institution's ability to understand the myriad issues related to Year 2000 (the Awareness and Assessment components) and its progress in identifying necessary changes to its computer programs to ensure their correct operation during the century date change and beyond. During phase 2 (July 1998 through March 1999), examiners are assessing institutions' progress toward making, and then testing, the necessary changes to their computer programs and systems (the Renovation and Validation components). Phase 3 (beginning in April 1999 and continuing into 2000) will concentrate on assessing the adequacy of the final stages of testing and contingency planning efforts (the Implementation component).

As part of their efforts, the agencies in 1998 issued a series of guidance statements on important aspects of Year 2000, including

- Guidance Concerning Institution Due Diligence in Connection with Service Provider and Software Vendor Year 2000 Readiness (March 17)
- Guidance Concerning the Year 2000 Impact on Customers (March 17)
- Guidance Concerning Testing for Year 2000 Readiness (April 10)
- Guidance on Year 2000 Customer Awareness Programs (May 13)
- Guidance Concerning Contingency Planning in Connection with Year 2000 Readiness (May 13)

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- Questions and Answers Concerning FFIEC Year 2000 Policy (August 31)
- Guidance Concerning Fiduciary Services and Year 2000 Readiness (September 2)
- Interagency Guidelines Establishing Year 2000 Standards for Safety and Soundness (October 15)
- Questions and Answers Concerning Year 2000 Contingency Planning (December 11).

To help institutions understand the Year 2000 guidance statements and review process, the agencies conducted hundreds of banker and community outreach programs throughout the country. The programs focused on supervisory expectations and served to convey a consistent message.

Finally, the member agencies of the FFIEC participated in the President's Council on Year 2000 Conversion, which is coordinating the federal government's efforts to address the Year 2000 problem. The council is made up of representatives of more than thirty major federal executive and regulatory agencies. Some agencies serve as sector coordinators to promote action on the Year 2000 problem within their policy areas. The Federal Reserve Board is the coordinator for the working group on the finance sector, which comprises representatives of twenty-one organizations involved in the financial services industry. This broad-based group has been instrumental in furthering the goals of the agencies and is making every effort to ensure that financial institutions are prepared for the century date change.

Policy Statement on Investment Securities and End-User Derivatives Activities

On April 23, 1998, the FFIEC issued a Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities (referred to as the 1998 Policy Statement). The policy statement, which was adopted by the Federal Reserve, provides guidance on sound practices for managing the risks involved in investment and end-user activities. It rescinded the constraints on investments in "high risk" mortgage derivatives products contained in the 1992 FFIEC Supervisory Policy Statement on Securities Activities.

The guidance in the 1998 Policy Statement reflects the agencies' move to a more risk-focused approach to supervision. This approach considers the appropriateness of an instrument held for investment or end-user purposes in light of a several factors, including management's ability to measure and manage the risks of the institution's holdings and the effect of those holdings on aggregate portfolio risk. The statement reflects a supervisory focus on evaluating and controlling risks on an investment-portfolio or an institution-wide basis.

Uniform Rating System for Information Technology

On December 18, 1998, the FFIEC Task Force on Supervision revised the Uniform Interagency Rating System for Data Processing Operations, commonly referred to as the Information Systems rating system. The revised system, whose formal name was changed to the Uniform Rating System for Information Technology (URSIT), reflects changes in the data-processing-services industry and in supervisory policies and procedures since the rating system was first adopted in 1978. In the new system, the numerical ratings have been revised to conform to the language and tone of the ratings definitions used in the Uniform Financial Institutions Rating System, commonly referred to as the CAMELS

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rating system. Also, the component rating descriptions have been reformatted and clarified, and the quality of risk-management processes is emphasized in the descriptions of the rating components. In addition, two new component categories—Development and Acquisition, and Support and Delivery—have replaced two former categories (Systems Development and Programming, and Operations). Finally, the new system explicitly identifies the types of risk that are considered in assigning component ratings.

Uniform Interagency Trust Rating System

On October 13, 1998, the FFIEC adopted revisions to update the Uniform Interagency Trust Rating System (UITRS), which became effective for examinations beginning on or after January 1, 1999. The UITRS is a supervisory rating system, originally adopted in 1978, used to promote consistency among the federal banking agencies in evaluating the fiduciary activities of institutions under their supervisory jurisdiction. The Federal Reserve issued implementing guidelines for the revised UITRS for Federal Reserve examiners in December 1998.

The major revisions to the UITRS included (1) modifying the definitions of the ratings to better align the UITRS rating definitions with the language and tone of the CAMELS and BOPEC ratings, (2) combining the Account Administration and Conflict of Interest rating components into a new Compliance component, (3) requiring a rating of Earnings only for those institutions that are required to file schedule E of the FFIEC 001 report (those with trust assets of more than $100 million), and (4) placing greater emphasis on risk-management processes.

Revisions to Call Reports

The FFIEC implemented changes to the bank Reports of Condition and Income (Call Reports), effective with the March 1998 report, to improve the banking agencies' ability to monitor compliance with certain regulations and to eliminate items that were considered unnecessary for safety and soundness or for other public policy purposes. The changes enable the agencies to more readily monitor compliance with the risk-based capital standards for market risk exposures and low-level recourse transactions and also reduce the burden of reporting certain information on deposits, investment securities, and trading portfolios. The FFIEC also revised the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002), effective with the March 1998 report, to maintain consistency with the bank Call Reports.

In October, the Federal Reserve and the other federal banking agencies proposed a small number of revisions to the bank Call Reports to facilitate bank supervision. The revisions would, effective with the March 1999 report, add items to conform with changes in GAAP, specifically the disclosure requirements of Statement of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities. The revisions would also eliminate several detailed items on bank investment portfolios and certain agricultural loan information.

In November, the Federal Reserve and the other federal banking agencies announced the discontinuation of the Monthly Consolidated Foreign Currency Report of Banks in the United States (FFIEC 035), effective with the December 1998 report. The agencies determined that the foreign exchange activities reported in the FFIEC 035 could

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be monitored through other supervisory means. Some of the information once collected through the report will be collected by the Department of the Treasury.

Supervisory Information Technology

The Supervisory Information Technology (SIT) function was established within the Board's Division of Banking Supervision and Regulation to facilitate management of the diverse information technology (IT) requirements of the Federal Reserve's supervision function. Its goals are to ensure that

- IT initiatives support a broad range of supervisory activities without duplication or overlap
- The underlying IT architecture fully supports those initiatives
- The supervision function's use of technology takes advantage of the systems and expertise available more broadly within the Federal Reserve System.

The SIT function works through assigned staff at the Board of Governors and at selected Reserve Banks and through a committee structure that ensures that key staff members actively participate in identifying requirements and setting priorities for IT initiatives.

Large Bank Supervision

During 1998, significant progress was made in developing a new information system to support the supervision of large, complex banking organizations. The system, scheduled for implementation in September 1999, will provide collaboration, messaging, and document-management capabilities.

Community Bank Supervision

For the past three years, the Federal Reserve has worked closely with the FDIC, the Conference of State Bank Supervisors, and several state banking authorities to automate the examination process for community banks. The agencies now have a set of automated examination tools that support a common supervisory approach. The FDIC and several states began using the first version of one of these tools in the fourth quarter 1998. The Federal Reserve will begin implementing this same tool in the second quarter of 1999.

Document Management

The Federal Reserve is developing a document repository using a commercial document-management software system. The repository, which will be part of the Federal Reserve's National Information Center (NIC), will initially contain all examination-related documents that result from the large, complex banking organization supervision program. Examination documents from the community bank supervision program will immediately follow. Other supervisory documents will be added to the repository as requirements are defined.

National Information Center

During the past year, the Federal Reserve further expanded the capabilities of the NIC. In January, the National Examination Data (NED) system was fully implemented. NED uses state-of-the-art client/server technology to provide on-line access to NIC banking structure, financial, and examination data. NIC is accessible by supervision staff across the Federal Reserve System over the System's intranet. Since

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November, NIC has been accessible by state banking authorities and the other federal regulators that use the NED system over an extranet developed by the Federal Reserve.

In March, the first version of a new banking structure updating system was implemented as part of NIC. When the second version is complete, NIC will have a new automation architecture that provides for state-of-the-art client/server and web technologies such that NIC can be accessed easily and can be modified quickly to respond to changing demands in the financial services industry.

Finally, the capabilities of the NIC public web site have been expanded. The site (http://www.ffiec.gov/nic/) contains all NIC banking structure and financial data and, since November 1998, all bank holding company performance ratios.

Staff Training

The Supervisory Education Program trains staff members having supervisory or regulatory responsibilities at the Reserve Banks, at the Board of Governors, and at state banking departments. Students from supervisory counterparts in foreign countries attend the training sessions on a space-available basis. The program provides training at the basic,

Number of Sessions of Training Programs for Banking Supervision and Regulation, 1998

Program	Total	Regional
Schools or seminars conducted by the Federal Reserve		
Core schools		
Introduction to examinations[1]	5	3
Banking and supervision elements	3	2
Financial institution analysis	9	6
Bank management	5	3
Effective writing for banking supervision staff[2]	12	12
Report writing	3	3
Management skills	10	9
Conducting meetings with management	16	16
Other schools		
Loan analysis	6	5
Real estate lending seminar	4	1
Specialized lending seminar	4	4
Senior forum for current banking and regulatory issues	3	3
Banking applications	1	...
Bank holding company inspections	5	4
Basic entry-level trust	1	...
Advanced trust	1	...
Consumer compliance examinations I	2	...
Consumer compliance examinations II	2	1
CRA examination techniques	3	1
Fair lending	5	1
Foreign banking organizations	3	2
Information systems and emerging technology risk management	18	18
Information systems continuing education	3	...
Intermediate information systems examination	1	...
Capital markets seminars	24	18
Section 20 securities seminar	2	...
Internal controls	6	5
Seminar for senior supervisors of foreign central banks[3]	1	...
Other agencies conducting courses[4]		
Federal Financial Institutions Examination Council	43	4
Office of the Comptroller of the Currency	2	...

NOTE. ... Not applicable.

1. Replaced by Banking and Supervision Elements in September.

2. Replaced by Report Writing in August.

3. Conducted jointly with the World Bank.

4. Open to Federal Reserve employees.

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intermediate, and advanced levels for the four disciplines of bank supervision: bank examinations, bank holding company inspections, surveillance and monitoring, and applications analysis. Classes are conducted in Washington, D.C., or at regional locations and may be held jointly with other regulators of financial institutions. The program is designed to increase the student's knowledge of the total supervisory and regulatory process and thereby provide a higher degree of cross-training among staff members.

The Federal Reserve System also participates in training offered by the Federal Financial Institutions Examination Council and by certain other regulatory agencies. The System's involvement includes developing and implementing basic and advanced training in various emerging issues as well as in such specialized areas as trust activities, international banking, information technology, municipal securities dealer activities, capital markets, payment systems risk, white collar crime, and real estate lending. In addition, the System co-hosts the World Bank Seminar for students from developing countries.

During 1998, the Federal Reserve conducted a variety of schools and seminars, and staff members participated in several courses offered by or cosponsored with other agencies, as shown in the accompanying table. In 1998, the Federal Reserve trained 3,502 students in System schools, 822 in schools sponsored by the FFIEC, and 75 in other schools, for a total of 4,399, including 322 representatives from foreign central banks. The number of student days of training was 36,790, which was comparable to the amount of training provided in recent years.

The Federal Reserve System also gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program 789 state examiners were trained: 504 in Federal Reserve courses, 277 in FFIEC programs, and 8 in other courses.

Every staff member seeking an examiner's commission is required to pass proficiency examinations, which include a core content area and a specialty area of the student's choice—safety and soundness, consumer affairs, trust, or information technology. In 1998, 96 students took the examination (see table).

The System continued in 1998 to make revisions initiated in 1997 to the training program that leads to the commissioning of assistant examiners. The project was undertaken to give assistant examiners a greater understanding of risk-focused examination concepts, the components of sound internal controls, the importance of management information systems, the concept of risk as it

Status of Students Registered for the Core Proficiency Examination, 1998

Student status	Core	Specialty area			
		Safety and soundness	Consumer	Trust	Information technology
In queue, year-end 1997	23	13	9	0	1
Test taken, 1998	96	63	34	3	2
Passed	83	53	28	2	2
Failed	13	10	6	1	0
In queue, year-end 1998	33	22	10	1	0

NOTE. Students choose a test in one specialty area to accompany the core examination.

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applies to banking, and the key supervisory issues related to integrated supervision. The changes will be implemented over 1999.

Regulation of the U.S. Banking Structure

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

Bank Holding Company Act

Under the Bank Holding Company Act, a company must obtain the Federal Reserve's approval before forming a bank holding company by acquiring control of one or more banks in the United States. Once formed, a bank holding company must receive the Federal Reserve's approval before acquiring additional banks or nonbanking companies. The act permits well-run bank holding companies that satisfy specific criteria to commence certain nonbanking activities on a de novo basis without prior Board approval and establishes an expedited prior notice procedure for other activities and for small acquisitions.

In reviewing an application or notice filed by a bank holding company for prior Board approval, the Federal Reserve considers several factors, including the financial and managerial resources of the applicant, the future prospects of both the applicant and the company to be acquired, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, and the applicant's ability to make available to the Board information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor.

In 1998, the Federal Reserve approved 310 proposals by foreign or domestic companies to become bank holding companies; approved 177 proposals by existing bank holding companies to merge with other bank holding companies; approved 319 proposals by existing bank holding companies to acquire or retain banks; approved 490 requests by existing bank holding companies to acquire nonbank firms engaged in activities closely related to banking; and approved 201 other bank holding company applications or notices. Data on these and all other decisions are shown in the accompanying table.

Bank Merger Act

The Bank Merger Act requires that all proposed mergers of insured depository institutions be acted on by the appropriate federal banking agency. If the institution surviving the merger is a state member bank, the Federal Reserve has primary jurisdiction. Before acting on a proposed merger, the Federal Reserve considers factors relating to the financial and managerial resources of the applicant, the future prospects of the existing and combined institutions, the convenience and needs of the community to

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be served, and the competitive effects of the proposal. It also considers the views of certain other agencies regarding the competitive factors involved in the transaction. During 1998, the Federal Reserve approved 162 merger applications. As required by law, each merger is described in this REPORT (in table 15 of the "Statistical Tables" section).

When the FDIC, the OCC, or the OTS has jurisdiction over a proposed merger, the Federal Reserve is asked to comment on the competitive factors to ensure comparable enforcement of the antitrust provisions of the Bank Merger Act. The Federal Reserve and those agencies have adopted standard terminology for assessing competitive factors in merger cases to ensure consistency in administering the act. The Federal Reserve submitted 844 reports on competitive factors to the other federal banking agencies in 1998.

Change in Bank Control Act

The Change in Bank Control Act requires that persons seeking control of a U.S. bank or bank holding company obtain approval from the appropriate federal banking agency before completing the transaction. Under the act, the Federal Reserve is responsible for reviewing changes in control of state member banks and of bank holding companies. In doing so, the Federal Reserve reviews the financial position, competence, experience, and integrity of the acquiring person; considers the effect on the financial condition of the bank or bank holding company to be acquired; determines the effect on competition in any relevant market; assesses the completeness of information submitted by the acquiring person; and considers whether the proposal would have an adverse effect on the federal deposit

Decisions by the Federal Reserve, Domestic and International Applications, 1998

Proposal	Direct action by the Board of Governors			Action under authority delegated by the Board of Governors					Total
				Director of the Division of Banking Supervision and Regulation		Office of the Secretary	Federal Reserve Banks		
	Approved	Denied	Permitted	Approved	Denied	Approved	Approved	Permitted	
Formation of bank holding company	13	0	0	0	0	5	210	82	310
Merger of bank holding company	16	0	0	0	0	23	91	47	177
Acquisition or retention of bank	32	0	0	0	0	29	182	76	319
Acquisition of nonbank	3	0	132	0	0	62	2	291	490
Merger of bank	15	0	0	0	0	14	133	0	162
Change in control	2	0	0	0	0	0	0	165	167
Establishment of a branch, agency, or representative office by a foreign bank	22	0	1	0	0	0	0	1	24
Other	239	0	34	28	0	387	1,177	148	2,013
Total	**342**	**0**	**167**	**28**	**0**	**520**	**1,795**	**810**	**3,662**

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insurance funds. For certain proposals, the notice process may involve conducting name checks with other agencies of the U.S. government.

The appropriate federal banking agencies are required to publish notice of each proposed change in control and to invite public comment, particularly from persons located in the markets served by the institution to be acquired. In 1998, the Federal Reserve acted on 167 proposed changes in control of state member banks and bank holding companies.

International Banking Act

The International Banking Act, as amended by the Foreign Bank Supervision Enhancement Act of 1991, requires Federal Reserve approval for the establishment of branches, agencies, commercial lending company subsidiaries, and representative offices by foreign banks in the United States. In reviewing proposals, the Board generally considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. It may also take into account whether the home country supervisor has consented to the establishment of the U.S. office; the financial condition and resources of the foreign bank and its existing U.S. operations; the managerial resources of the foreign bank; whether the home country supervisor shares information regarding the operations of the foreign bank with other supervisory authorities; whether the foreign bank has provided adequate assurances that information concerning its operations and activities will be made available to the Board, if deemed necessary to determine and enforce compliance with applicable law; and the record of the foreign bank with respect to compliance with U.S. law. The Board may also consider the needs of the community, the foreign bank's history of operation, and its relative size in its home country.

In 1998, the Federal Reserve approved applications by nine foreign banks from seven foreign countries to establish branches, agencies, and representative offices in the United States.

Public Notice of Federal Reserve Decisions

Most decisions by the Federal Reserve that involve a bank holding company, a bank merger, a change in control, or the establishment of a new U.S. banking presence by a foreign bank is effected by an order or an announcement. Orders state the decision, the essential facts of the application or notice, and the basis for the decision; announcements state only the decision. All orders and announcements are made public immediately, as are all applications and notices that have been received by the Federal Reserve but not yet acted on. Each of these matters is subsequently reported in the Board's weekly H.2 statistical release (Actions of the Board, Its Staff, and the Federal Reserve Banks; Applications and Reports Received) and in the monthly *Federal Reserve Bulletin*. The related H.2A release (Notice of Formations and Mergers of, and Acquisitions by, Bank Holding Companies; Change in Bank Control) contains the ending comment periods for each pending application and notice. In 1998, the Board's public web site was enhanced to include not only the H.2 and the H.2A, but also other information relevant to the applications process.

Timely Processing of Applications

The Federal Reserve maintains target dates and procedures for the processing

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of applications. The setting of target dates promotes efficiency at the Board and the Reserve Banks and reduces the burden on applicants. The time allowed for final action ranges from twelve to sixty days, depending on the type of application or notice. In 1998, 93 percent of decisions met these deadlines.

Delegation of Applications

Historically, the Board of Governors has delegated certain regulatory functions—including the authority to approve, but not to deny, certain types of applications—to the Reserve Banks, to the Director of the Division of Banking Supervision and Regulation, and to the Secretary of the Board. In 1998, 86 percent of the applications processed were acted on under delegated authority.

Banking and Nonbanking Proposals

Consolidation among some of the largest U.S. banking organizations continued in 1998. The Federal Reserve approved five proposals for which public meetings were held in cities throughout the United States; as in earlier cases, the proposals generated many comments, particularly with respect to Community Reinvestment Act, fair lending, and competitive issues. The Federal Reserve also approved various proposals involving mutual bank holding companies. In 1998, the Federal Reserve continued to act on proposals involving section 20 companies. The proposals involved expansion on a de novo as well as acquisition basis. Early in the year, the Board also streamlined the restrictions applicable to bank holding companies that seek to act as a commodity pool operator or otherwise to act as a general partner of an investment fund.

Overseas Investments by U.S. Banking Organizations

U.S. banking organizations, with the authorization of the Federal Reserve, may engage in a broad range of activities overseas. Most foreign investments may be made under general consent procedures that involve only after-the-fact notification to the Board; significant investments must be reviewed by the Board in advance. In 1998, the Board approved thirty-eight proposals (excluding those related to recent large domestic mergers) by U.S. banking organizations to make significant investments overseas.

The Federal Reserve also has authority to act on proposals involving Edge Act and agreement corporations, which are established by banking organizations to provide a means of engaging in international business. In 1998, the Board approved two proposals by member banks to increase their investment in their Edge corporation subsidiaries to more than 10 percent but less than 20 percent of the member bank's capital and surplus. The Board also approved four applications for the establishment of new agreement corporations.

Applications by Member Banks

State member banks must obtain Board approval to establish domestic branches, and all member banks (including national banks) must obtain Board approval to establish foreign branches. In considering proposals for domestic branches, the Board reviews the scope of the functions and the character of the business to be conducted. In reviewing proposals for foreign branches, the Board considers, among other things, the condition of the bank and the bank's experience in international business. Once a member bank has received

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authority to open a branch in a particular foreign country, the member bank may open additional branches in that country without prior Board approval. In 1998, the Federal Reserve acted on new and merger-related branch proposals related to 1,473 domestic branches and granted prior approval for the establishment of 13 foreign branches (excluding those related to recent large domestic mergers).

Stock Repurchases by Bank Holding Companies

A bank holding company may purchase its own shares from its shareholders. When the company borrows money to buy the shares, the transaction increases its debt and decreases its equity. Relatively larger purchases may undermine the financial condition of a bank holding company and its bank subsidiaries. The Federal Reserve may object to stock repurchases by bank holding companies that fail to meet certain standards, including the Board's capital guidelines. In 1998, the Federal Reserve reviewed twenty-nine proposed stock repurchases by bank holding companies, all of which were approved under delegated authority by either a Reserve Bank or the Secretary of the Board.

Recent Regulatory Changes

In July 1998, the Board approved various amendments to Regulation H, which implements the Federal Reserve Act, portions of the Federal Deposit Insurance Act, and related statutes. The amendments were designed to reduce regulatory burden and to simplify and update the regulation. As part of the final regulation, the Board adopted new expedited procedures for membership and branch applications, modified various criteria related to membership in the Federal Reserve System, and provided further guidance to member banks regarding permissible investments in securities. The Board also adopted new definitions for various terms used in the regulation, including those related to capital stock and surplus and to a branch.

Enforcement of Other Laws and Regulations

Financial Disclosure by State Member Banks

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including financial reports and proxy statements. By statute, the Board's financial disclosure rules must be substantially similar to those of the Securities and Exchange Commission. At the end of 1998, twenty-five state member banks, most of them small or medium sized, were registered with the Board under the Securities Exchange Act.

Securities Credit

Under the Securities Exchange Act of 1934, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. The Board's Regulation T limits the amount of credit that may be provided by securities brokers and dealers. The Board's Regulation U, which had limited the amount of credit that may be provided by commercial banks, was amended effective April 1998 to also cover lenders other than banks, brokers, or dealers. Lenders other than banks, brokers, or dealers were formerly subject to Regulation G, which was eliminated in April 1998. The Board's

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Federal Reserve Bank of St. Louis

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

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

Regulation T limits the amount of credit that brokers and dealers may extend when the credit is used to purchase or carry publicly held debt or equity securities. Regulation U limits the amount of credit that lenders other than brokers and dealers may extend when the credit is used to purchase or carry publicly held equity securities if the loan is secured by those or other publicly held equity securities.

Since 1968, the Federal Reserve has monitored the market activity of all stocks traded over-the-counter (OTC) in the United States to determine which of them are subject to the Board's margin regulations. Also since that time, the Board has periodically published the resulting "List of Marginable OTC Stocks." In 1997, the Board amended its margin regulations to eliminate the OTC list by the end of 1998 and instead to rely on the listing standards of the Nasdaq Stock Market. The Board published the last OTC list in November 1998. It also published OTC lists in February, May, and August 1998.

Since 1990, the Board has published a list of foreign stocks that are eligible for margin treatment at broker–dealers on the same basis as domestic margin securities. In 1998, the foreign list was revised in February, May, August, and November.

Bank Secrecy Act/Anti-Money Laundering

The regulation (31 CFR Part 103) implementing the Currency and Foreign Transactions Reporting Act, also known as the Bank Secrecy Act, requires banks and other types of financial institutions to file certain reports and to maintain certain records. The requirements include the reporting of information concerning persons involved in large currency transactions as well as suspicious activity related to a possible violation of federal law. Records that must be maintained include those kept in the ordinary course of business as well as the identity of persons who purchase monetary instruments with currency and those who send or receive funds transfers in substantive amounts. The act is regarded as a primary tool in the fight against money laundering; in part it creates a paper trail that helps law enforcement agencies and regulators identify and trace the proceeds of illegal activity.

Pursuant to Regulation H, section 208.63, each banking organization supervised by the Federal Reserve must also develop a program for compliance with the Bank Secrecy Act. The program, which must be in writing and formally approved by the institution's board of directors, must (1) establish a system of internal controls to ensure compliance with the act, (2) provide for independent compliance testing, (3) identify individual(s) responsible for coordinating and monitoring day-to-day compliance, and (4) provide training

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for appropriate personnel. Through its examination process, training, and other off-site measures, the Federal Reserve monitors compliance with the Bank Secrecy Act and Regulation H by the banking organizations under its supervision.

In 1998, the Federal Reserve continued to provide expertise and guidance to the Bank Secrecy Act Advisory Group, a committee established at the Department of the Treasury by congressional mandate to seek measures to reduce unnecessary burdens created by the act's requirements and to increase the utility of data collected under the act to regulators and law enforcement agencies. In October, in consultation with and assistance from the Federal Reserve, the Treasury Department issued final rules revising exemption procedures to reduce significantly the number of Currency Transaction Reports filed. The Federal Reserve also led an interagency group that revised the Suspicious Activity Report to make it more useful to law enforcement as well as Year 2000 compliant. The new form is scheduled for use in the spring of 1999.

The Federal Reserve in December issued a proposed rule regarding Know Your Customer programs. The proposal was issued along with nearly identical proposals by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

Through the Special Investigations Section of the Division of Banking Supervision and Regulation, the Federal Reserve in 1998 assisted in the investigation of money laundering activities, including Operation Casablanca, which involved a number of foreign banking organizations. The section also provided anti-money-laundering training to designated staff members at each Reserve Bank, to the domestic banking sector through trade association conferences and seminars, and to representatives of law enforcement agencies.

Internationally, the section assisted the State Department by providing anti-money-laundering training and technical assistance to countries in Asia, eastern Europe and the newly independent states, South and Central America, and the Caribbean. Board staff also participated extensively in numerous multilateral international anti-money-laundering initiatives including the G-7, the Financial Action Task Force, and the Asia Pacific Working Group on Money Laundering.

Loans to Executive Officers

Under section 22(g) of the Federal Reserve Act, a state member bank must include in its quarterly Call Report

Loans by State Member Banks to their Executive Officers, 1997 and 1998

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
1997			
October 1–December 31	695	38,279,000	4.8–20.0
1998			
January 1–March 31	750	42,592,000	3.0–19.5
April 1–June 30	750	37,183,000	3.0–18.0
July 1–September 30	657	34,564,000	2.0–19.5

SOURCE. Call Reports.

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information on all extensions of credit by the bank to its executive officers since the date of the preceding report. The accompanying table summarizes this information.

Federal Reserve Membership

At the end of 1998, 3,401 banks were members of the Federal Reserve System. At that time, member banks were operating 46,112 branches and additional offices and accounted for 39 percent of all commercial banks in the United States and for 74 percent of all commercial banking offices.

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Regulatory Simplification

In 1978 the Board of Governors established a program of regulatory review to help minimize the burden of regulation on banking organizations. The objectives of the program are to ensure that all regulations, existing and proposed, represent the best course of action; to afford interested parties the opportunity to participate in the design of regulations and to comment on them; and to ensure that regulations are written in simple, clear language. Staff members regularly review Federal Reserve regulations for their adherence to these objectives and their consistency with the Regulatory Flexibility Act, which also requires that consideration be given to the economic consequences of regulation on small business. In its review process, the Board also follows the mandates of section 303 of the Riegle Community Development and Regulatory Improvement Act.

In 1998 the Board, as part of this review process, revised Regulation H and Regulation I and eliminated Regulation P by incorporating its provisions into the revised Regulation H. It also modified Regulation D to reduce regulatory burden and initiated formal reviews of two other major regulations, Regulations B and C.

Comprehensive Revisions Adopted

Regulations H and P
Membership in the Federal Reserve System, and Bank Protection Act

The Board proposed in 1997 to amend subpart A of Regulation H, which concerns the general provisions for membership in the Federal Reserve System, and the associated interpretations in subpart E; it also proposed to incorporate Regulation P into Regulation H. In June 1998, on the basis of public comments, the Board adopted a revised proposal, effective October 1998. In general, the amendments as adopted reorganized, clarified, and reduced the burden of compliance with subpart A. They did away with obsolete procedures and other unnecessary provisions, reflect the requirements of the Community Reinvestment Act in applications to establish branches, and provide expedited procedures in connection with certain membership and branch applications. In adopting the amendments the Board also eliminated a number of interpretations that had been included in Regulation H.

Former Regulation P implemented the requirements of the Bank Protection Act of 1968. Although the amendments that subsumed Regulation P into the revised subpart A of Regulation H did not substantively amend the terms of Regulation P, the move has simplified compliance for state member banks by consolidating the requirements into one regulation.

Regulation I
Issue and Cancellation of Federal Reserve Bank Capital Stock

In June 1998 the Board adopted amendments to Regulation I that had been proposed in March 1997. The amendments, which took effect in October 1998, simplified, modernized, and condensed the regulation and reflect the replacement of share certificates by a

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book-entry system. They also codified interpretations previously issued by the Board of Governors and by staff members. Finally, the amendments eliminated references to specific forms, many of which were obsolete.

Other Revisions Adopted

Regulation D
Reserve Requirements of Depository Institutions

In March 1998 the Board adopted amendments to Regulation D that had been proposed in November 1997. The revisions, which took effect in the summer, improved the Board's ability to estimate the need for reserves on a timely basis and at the same time reduced regulatory burden on certain depository institutions. They moved institutions that report deposits weekly from a system of contemporaneous reserve maintenance to a system under which reserves are maintained on a lagged basis. The reserve maintenance period for weekly reporters now begins thirty days after the beginning of a reserve computation period; it formerly began two days after the beginning of a computation period. The longer time between computation and maintenance of reserves is expected to facilitate compliance by weekly reporting institutions.

Comprehensive Revisions Proposed

Regulation B
Equal Credit Opportunity

In March 1998 the Board issued an advance notice of proposed rulemaking as the first step in its review of Regulation B, which implements the provisions of the Equal Credit Opportunity Act. The act makes it unlawful for creditors to discriminate against an applicant for credit in any aspect of a credit transaction on the basis of race, color, religion, national origin, sex, marital status, age, or other specified bases. The review will determine whether Regulation B needs to be revised to address technological and other developments; will identify parts of the regulation that could be revised to achieve a better balance between consumer protections and industry burden; and will eliminate obsolete provisions. To gather information needed to accomplish these objectives, the notice requested comment on several specific issues, including pre-application marketing practices, inquiry versus application, voluntary data collection on specific characteristics of applicants, the definition of creditor, documentation for business credit, and business credit exemptions.

Regulation C
Home Mortgage Disclosure

In March 1998 the Board issued an advance notice of proposed rulemaking as the first step in its review of Regulation C, which implements the Home Mortgage Disclosure Act. The review will identify ways in which the regulation can be revised to reduce regulatory burden and to respond to technological and other developments. The advance notice solicited comment on such specific issues as reporting pre-approvals, reporting refinancings and home improvement loans, geocoding purchased loans, reporting temporary financing, reporting mobile home transactions as a separate category, and reporting additional characteristics of mortgage loan transactions. ■

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Federal Reserve Banks

A major activity of the Federal Reserve Banks again in 1998 was preparation for the century date change. Efforts in that area as well as other activities affecting the Reserve Banks are described in this chapter.

Century Date Change

The Federal Reserve Banks in 1998 made considerable progress toward ensuring that they continue to provide reliable service to the nation's banking system and financial markets at the turn of the century. By year-end 1998, the Reserve Banks had completed nearly all changes to applications critical to their mission, such as Fedwire funds transfer, Fedwire securities transfer, and FedACH; system testing; and user acceptance testing. The Federal Reserve also took steps to meet a possible increase in the demand for currency as the year 2000 nears.

In 1998, the Reserve Banks supported extensive year 2000 testing by depository institutions. Testing facilities were made available beginning in midyear, and more than 5,000 depository institutions had tested with the Federal Reserve by year-end. The Federal Reserve will continue to offer year 2000 testing through 1999.

Also during the year, the Reserve Banks introduced programs focusing on year 2000 contingency planning, planning for responding to customer disruptions, and event management. In addition, the Federal Reserve implemented a change-management policy that will provide a stable operations environment at the millennium.

The Federal Reserve in 1998 continued to educate the public on plans for addressing the year 2000 problem and continued to advise depository institutions of the Federal Reserve's plans and schedules. The Reserve Banks participated in numerous domestic and international forums to help foster awareness of year 2000 issues and to share experiences, ideas, and best practices. In December, the Federal Reserve sponsored an interactive teleconference with depository institution customers to discuss the Federal Reserve's contingency planning for the year 2000. The Federal Reserve also provided extensive information concerning its year 2000 activities to government oversight organizations, including the U.S. General Accounting Office, the House and Senate Banking Committees, and the Office of Management and Budget.

In anticipation that individuals may hold extra cash during the century rollover as a precaution, the Federal Reserve in 1998 made plans to have ample supplies of currency available in late 1999 to meet potential demand. The Federal Reserve will increase the value of currency either in circulation or in Federal Reserve vaults about 15 percent over current levels, resulting in a cushion of about $200 billion. In addition, the Reserve Banks have encouraged depository institutions to develop contingency plans to meet a possible increase in cash demand.

Developments in Federal Reserve Priced Services

The Monetary Control Act of 1980 requires that the Federal Reserve set fees for providing "priced services" to depository institutions that, over the long run, recover all the direct and indi-

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rect costs of providing the services as well as the imputed costs, such as the income taxes that would have been paid and the return on equity that would have been earned had the services been provided by a private firm. The imputed costs and imputed profit are collectively referred to as the private sector adjustment factor (PSAF).[1] Over the past ten years, the Federal Reserve Banks have recovered 100.7 percent of their priced services costs, including the PSAF.

Overall, the price index for Federal Reserve services declined approximately 3.7 percent from 1997.[2] Revenue from priced services was $816.0 million, other income related to priced services was $23.7 million, and costs related to priced services were $697.5 million, including the PSAF. Income before income taxes was $142.3 million; priced services recovered 103.7 percent of total costs. In 1997, revenue from priced services was $97.3 million more than costs related to priced services, including the PSAF, and priced services recovered 101.5 percent of total costs.[3]

Check Collection

In 1998, total Reserve Bank operating expenses and imputed costs for commercial check services were $577.3 million, compared with $581.2 million in 1997. Revenue from check operations totaled $632.6 million, and other income amounted to $19.1 million, resulting in income before income taxes of $74.5 million. The Reserve Banks handled 16.6 billion checks, an increase of 3.9 percent over 1997 (see table). The volume of fine-sort check deposits, which are presorted by the depositing bank according to paying bank, decreased 3.6 percent in 1998, compared with an increase of 0.7 percent in 1997. The volume of checks deposited that required processing by Reserve Banks rose 5.3 percent; in 1998, the Banks processed 85.6 percent of the checks they presented, and they received the remaining 14.4 percent in fine-sort deposits.

Overall, the fees charged by the Reserve Banks for paper and electronic check products rose approximately 2.5 percent compared with 1997. Fees for paper products rose about 3.4 percent, while fees for electronic products (primarily payor bank information and electronic check presentment) declined approximately 6.2 percent.

The use of electronic check products provided by the Reserve Banks has continued to grow rapidly. During 1998, the Banks electronically presented 2.8 billion checks, or about 16.9 percent of all checks presented to paying banks, an increase of 24.7 percent over 1997. The use of electronic check information products declined 2.1 percent. Reserve

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

2. Based on a chained Fisher Ideal price index not adjusted for quality changes.

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

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Banks provided data to paying banks electronically for 25.4 percent of checks presented. Thirty-seven offices, at least one office in every Federal Reserve District, now offer products involving the capture and storage of digital check images. In 1998, images were captured of approximately 3.9 percent of the checks presented by the Reserve Banks.

In 1998, the Reserve Banks adopted a strategy to standardize check-processing environments across Banks and thereby lower the operating costs of providing check processing and provide greater consistency in products and service levels. The Banks plan to establish standard hardware platforms and to develop software systems that can be used on either of the System's check-processing platforms, to consolidate processor management, and to develop common Reserve Bank check-processing applications. The Reserve Banks' Retail Payments Office, which directs check and automated clearinghouse (ACH) services and the Interdistrict Transportation System for the Banks, will manage this long-term initiative. During the year, this office relocated to the Federal Reserve Bank of Atlanta from the Federal Reserve Bank of Boston.

In March, the Board requested comment on the effect of its same-day settlement rule on the interbank check-collection market, on the check-collection process, and, more broadly, on the payments system. The Board also requested comment on the benefits and drawbacks of reducing legal disparities, such as the later presentment time available to the Reserve Banks, between Federal Reserve Banks and private collecting banks in the presentment and settlement of checks. On the basis of an analysis of the comments received, the Board concluded that the costs associated with further reducing legal disparities would outweigh any payments system efficiency gains and, in December, decided not to propose any specific regulatory changes with respect to the remaining legal differences between the Reserve Banks and private collecting banks.

Fedwire Funds Transfer and Multilateral Settlement

Reserve Bank operating expenses and imputed costs for Fedwire funds transfer and multilateral settlement services totaled $72.7 million in 1998, compared

Activity in Federal Reserve Priced Services, 1998, 1997, and 1996

Thousands of items

Service	1998	1997	1996	Percentage change	
				1997 to 1998	1996 to 1997
Commercial checks	16,573,463	15,949,152	15,486,833	3.9	3.0
Funds transfers	100,609	91,800	84,871	9.6	8.2
Securities transfers	5,115	4,136	4,125	23.7	.3
Commercial ACH	2,965,739	2,602,892	2,372,108	13.9	9.7
Noncash collection	755	887	1,069	−14.8	−17.1
Cash transportation	18	27[1]	36	−32.6	−25.2[1]

NOTE. Components may not yield percentages shown because of rounding. Activity in *commercial checks* is the total number of commercial checks collected, including processed and fine-sort items; in *funds transfers* and *securities transfers*, the number of transactions originated on line and off line; in *commercial ACH*, the total number of commercial items processed; in *noncash collection*, the number of items on which fees are assessed; in *cash transportation*, the number of registered mail shipments and FRB-arranged armored carrier stops.

1. Restatements resulting from a change in definition or to correct a previously reported error.

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with $79.9 million in 1997. Revenue from these operations totaled $92.2 million, and other income amounted to $2.3 million, resulting in income before income taxes of nearly $21.8 million.

Fedwire Funds Transfer

The number of Fedwire funds transfers originated by depository institutions increased 9.6 percent in 1998, to 100.6 million. The increase in volume was due largely to sustained strong economic growth.

Fees charged for Fedwire funds transfers were lowered 11.1 .percent in January 1998, from $0.45 to $0.40 per basic transfer. The reduction reflects efficiencies resulting from the processing of funds transfers in a centralized environment.

In December 1997, the Fedwire funds transfer service began opening at 12:30 a.m. eastern time instead of 8:30 a.m., thereby expanding the service day to eighteen hours from the previous ten hours. On average, the funds transfer service processed 3.4 percent of its daily transfer volume and about 0.5 percent of daily value before 8:30 a.m.; approximately eighty Fedwire participants originated funds transfers in the early morning. The level of participation and transfer activity before 8:30 a.m. remained relatively constant throughout 1998.

Depository institutions that do not have an electronic connection to the Fedwire funds transfer system can originate transfers via "off-line" telephone instructions. The volume of off-line Fedwire funds transfers has been declining substantially in recent years. Because of the decline and the small percentage of transfers that are originated off line (0.04 percent), the Federal Reserve in 1998 began consolidating its Fedwire off-line services at the Federal Reserve Banks of Boston and Kansas City. Seven Reserve Banks consolidated their off-line activity during the year, and the remaining three are scheduled to consolidate their activity by March 1, 1999. Consolidation will allow the Reserve Banks to streamline service and ensure uniform service nationwide.

In response to a request by correspondent banks expressing difficulty managing their reserve positions because they were receiving respondent transfers late in the day, the Board in June requested comment on a proposal to segment the last half-hour of the Fedwire funds transfer operating day into two settlement periods. Transfers to or from respondent banks would have been prohibited during the last fifteen minutes of the Fedwire operating day. Support for the proposal was mixed. In December, the Board concluded that the benefits of a segmented settlement period did not warrant the change, and it decided not to adopt a segmented settlement period. Rather, the Board believes that correspondents can mitigate reserve-management difficulties on their own by imposing internal cutoff times for sending and receiving respondent transfers.

Multilateral Settlement

The Federal Reserve provides settlement services to approximately 130 local and national private-sector clearing and settlement arrangements. In 1998, the Reserve Banks processed about 373,000 settlement entries for these arrangements.

The Reserve Banks offer two types of settlement services. In the "settlement sheet" service, the settlement agent for a clearinghouse provides a settlement sheet to a Reserve Bank. The Reserve Bank posts net debit and credit entries

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to the accounts of the settling participants. The entries are provisional until the banking day after settlement. In the Fedwire-based settlement service, the clearinghouse uses a zero-balance settlement account to receive and send Fedwire funds transfers to settle participants' obligations. Fedwire funds transfers are final and irrevocable when processed.

During 1998, the Reserve Banks prepared to offer an enhanced settlement service that allows settlement agents to submit settlement files electronically to a Reserve Bank through a Fedline terminal or a computer interface connection. The enhanced settlement service, to be introduced in the first quarter of 1999, will improve operational efficiency. It will also reduce settlement risk to participants by granting settlement finality on the settlement day and enable Reserve Banks to manage and limit risk by incorporating risk controls that are as robust as those used currently in the Fedwire funds transfer service. The Reserve Banks will continue to offer the current settlement sheet and Fedwire-based settlement services. The settlement sheet service, however, will be phased out by year-end 2001. The Fedwire-based service will be available indefinitely.

Fedwire Book-Entry Securities

Reserve Bank operating expenses and imputed costs for the Fedwire book-entry securities service totaled $13.0 million in 1998, compared with $15.5 million in 1997. Revenue from these operations totaled $18.3 million, and other income amounted to $0.4 million, resulting in income before income taxes of $5.7 million.

The Reserve Banks processed 5.1 million transfers of government agency securities on the Fedwire book-entry securities transfer system during the year, a 23.7 percent increase from the 1997 level. The increase may be attributable to securities movements associated with mergers and with more mortgage refinancing than in 1997, creating activity in the mortgage-backed securities market. Fees charged for Fedwire book-entry securities transfers did not change in 1998.[4]

In February 1998, the New York Reserve Bank converted its Fedwire securities transfer application to the Federal Reserve's centralized application, the National Book-Entry System (NBES), joining the eleven Reserve Banks that had converted in 1996 and 1997. The NBES has generated several benefits for the Fedwire book-entry securities service, including (1) an expanded account structure designed to accommodate the different needs of Federal Reserve customers and U.S. government agencies, (2) modular, centralized application software designed to facilitate a more rapid response to changing industry needs, (3) improved, standardized contingency and disaster recovery capabilities, and (4) processing efficiencies such as uniform operating hours in all Districts. Full implementation of NBES has created scale econo-

4. The revenues, expenses, and volumes reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and international institutions such as the World Bank. The Fedwire book-entry securities service also provides custody, transfer, and settlement services for U.S. Treasury securities. The Reserve Banks act as fiscal agents of the United States when they provide transfer and safekeeping of U.S. Treasury securities, and the Treasury Department assesses fees on depository institutions for some of these services. For more details, see the section "Marketable Treasury Securities."

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Federal Reserve Bank of St. Louis

mies that have lowered per-item data processing costs.

The volume of off-line Fedwire securities transfers, in which institutions that do not have an electronic connection to the Fedwire book-entry securities transfer system originate transfers through telephone instructions, has been declining substantially over the past few years. As a result of the decline and the small percentage of transfers originated off line (0.56 percent), the Federal Reserve began in 1998 consolidating its Fedwire off-line services at the Federal Reserve Banks of Boston and Kansas City. The consolidation will bring to securities transfers the same benefits it offers for funds transfers.

After requesting and receiving public comment on the issue, the Board decided in April not to implement an earlier opening time for the Fedwire book-entry securities service, mainly because of the anticipated cost and technical hurdles identified by industry participants and because of concerns expressed by the Department of the Treasury. Over time, the industry may eliminate some of these difficulties by, for example, implementing real-time and straight-through processing or improving contingency arrangements. The Federal Reserve plans to monitor developments in these areas and in the securities transfer market; if market demand for expanded hours arises, it will reconsider the issue of expanded operating hours for the Fedwire book-entry securities service.

Automated Clearinghouse

Reserve Bank operating expenses and imputed costs for commercial ACH services totaled $44.9 million in 1998, compared with $52.3 million in 1997. Revenue from ACH operations totaled $66.7 million, and other income amounted to $1.7 million, resulting in income before income taxes of $23.5 million. The Reserve Banks processed 3.0 billion commercial ACH transactions during the year, an increase of 13.9 percent over 1997 volume. Several fees were reduced early in the year: The fees for items originated in small and large files, for items received, and for addenda originated and received were reduced one to two mill, or 14 percent to 33 percent, depending on the product.

The Reserve Banks introduced several improvements to the ACH service in 1998. In the fall, they began providing FedEDI, electronic data interchange software that enables ACH customers to translate information accompanying ACH payments. The software supports both the U.S. Treasury's initiative to make most of its payments electronically and National Automated Clearing House Association rules. In November, the Reserve Banks began to test a commercial cross-border ACH service to facilitate greater exchange of electronic payments between the United States and Canada. During the year, Reserve Banks also worked with the U.S. Treasury, the National Automated Clearing House Association, and local ACH associations to promote direct deposit and electronic payments.

In December, the Board requested comment on the benefits and drawbacks of providing settlement finality on the morning of the settlement day for ACH credit transactions processed by the Reserve Banks. Settlement day finality would be conditioned on enhanced risk-control measures commensurate with those used in other services that have similar finality characteristics.

Noncash Collection

Reserve Bank operating expenses and imputed costs for noncash collection services totaled $2.1 million in 1998,

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compared with $3.2 million in 1997. Revenue from noncash operations totaled $3.5 million, and other income amounted to $0.1 million, resulting in income before income taxes of $1.5 million. The Reserve Banks processed 755,000 noncash collection items (coupons and bonds), a decrease of 14.8 percent from 1997 levels.

All noncash processing is centralized at the Jacksonville Branch of the Atlanta Reserve Bank.

Cash Services

Because providing high-quality currency and coin is a basic responsibility of the Federal Reserve, the Reserve Banks charge fees only for special cash services and nonstandard access.[5] Priced special cash services represent a very small portion (approximately 0.5 percent) of the cost of overall cash services provided by the Reserve Banks to depository institutions. Special cash services include wrapped coin, nonstandard packaging of currency and coin orders and deposits, and registered mail shipments of currency and coin.

The Cleveland District and the Helena Branch of the Minneapolis Reserve Bank provide wrapped coin as a priced service. The Chicago District provides currency in nonstandard packages, and the Helena Branch provides coin in nonstandard packages. In addition, five Districts provide cash transportation by registered mail. Reserve Bank operating expenses and imputed costs for special cash services totaled $2.4 million in 1998, compared with $4.5 million in 1997. Revenue from cash operations totaled $2.6 million, and other income amounted to $0.1 million, resulting in income before income taxes of $0.2 million.

Float

Federal Reserve float increased in 1998 to a daily average of $323.6 million, from a daily average of $282.0 million in 1997. The Federal Reserve recovers the cost of float associated with priced services as part of the fees for those services.

Developments in Currency and Coin

The Federal Reserve continued in 1998 to work closely with the Treasury to deter the counterfeiting of U.S. currency. The Series 1996 currency design program continued with the introduction of the new $20 note in September. The Series 1996 $50 note, introduced in October 1997, continued to gain acceptance and accounted for 49 percent of the $50 notes in circulation by the end of 1998. The Series 1996 $100 note, introduced in March 1996, accounted for 66 percent of $100 notes in circulation. Work on the Series 1996 $10 and $5 notes continued; distribution is scheduled for 2000.

The Federal Reserve's cost of new currency in 1998 was $409 million. The Treasury's Bureau of Engraving and Printing produced 9.8 billion notes during the year; 47 percent of the notes produced were of the Series 1996 design $100, $50, and $20 notes, 40 percent were $1 notes, and the remaining 13 percent were $5 and $10 notes.

The Federal Reserve supplies currency and coin to approximately 9,700 depository institutions throughout the United States; these institutions supply currency and coin to other depository institutions and the public. The value of currency and coin in circula-

5. Nonstandard access is not treated as a priced service; instead, fees for nonstandard access are treated as a recovery of expenses. See the discussion under "Developments in Currency and Coin" below.

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Federal Reserve Bank of St. Louis

tion increased 7 percent in 1998 and exceeded $517 billion at year-end. During the year, the Federal Reserve received more than 26.6 billion Federal Reserve notes in deposits from depository institutions and sent more than 27.5 billion Federal Reserve notes to depository institutions. Reserve Bank operating expenses for processing and storing currency and coin, including priced cash services, totaled $293 million for the year.

In March, the Board revised its uniform cash access policy to clarify the base level of free currency access to all depository institutions in an interstate banking environment. The policy became effective on May 4. The Board clarified that each depository institution may designate up to ten endpoints to receive free currency access from each Reserve Bank office but that an endpoint may not receive free cash access from more than one Reserve Bank office.[6] Depository institutions that meet minimum volume thresholds are eligible for more frequent free access; fees are charged for additional access beyond the free service level. The income from fees charged for additional access is treated as a recovery of expense rather than as priced service revenue. To date, the policy has resulted in larger deposits and larger orders of currency; Systemwide, the overall volume of currency has remained relatively stable.

Also in 1998, the Board approved the Federal Reserve Bank of San Francisco's proposal to establish a currency operations center in Phoenix, Arizona. Arizona depository institutions currently receive currency services from the Los Angeles Branch. The operations center will eliminate the need to transport currency over the long distance between Los Angeles and Phoenix and will improve cash services and access for all Arizona depository institutions.

6. A designated endpoint may be a branch, a head office, a money room, or an armored carrier used by the depository institution to provide cash.

Developments in Fiscal Agency and Government Depository Services

The Federal Reserve Act provides that when required by the Secretary of the Treasury, Reserve Banks will act as fiscal agents and depositories of the United States. As fiscal agents, Reserve Banks provide the Department of the Treasury with services related to the federal debt. For example, the Reserve Banks issue, transfer, reissue, exchange, and redeem marketable Treasury securities and savings bonds; they also process secondary market transfers initiated by depository institutions. As depositories, Reserve Banks collect and disburse funds on behalf of the federal government. They also provide fiscal agency services on behalf of several domestic and international government agencies.

The total cost of providing fiscal agency and depository services to the Treasury in 1998 amounted to $250.9 million, compared with $255.4 million in 1997 (table). The cost of providing services to other government agencies was $46.6 million, compared with $48.6 million in 1997.

The Federal Reserve controls collateral pledged to secure credit it extends to depository institutions and, in its role as fiscal agent for the U.S. Treasury, to secure Treasury tax and loan deposits held by depository institutions. In September, the Reserve Banks implemented mark-to-market pricing for book-entry collateral. If reliable and active markets exist for the assets, collateral valuation is generally based on market values; if market information is insufficient, valuation takes into account risk factors such

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Federal Reserve Bank of St. Louis

as credit quality, payment streams, interest rate risk, and unanticipated credit or liquidity events. At the time mark-to-market pricing was implemented, the Federal Reserve was using a risk-based matrix to determine the value of nonpriced collateral. Market pricing was applied to definitive (paper) instruments in 1995.

The Reserve Banks continued in 1998 to implement a policy, adopted in late 1996, to clarify the Reserve Banks' unique statutory relationship with the Treasury and other federal government entities. The policy, among other things, establishes uniform and consistent practices for accounting, reporting, and billing for the full costs of providing fiscal agency and depository services to the U.S. government. To capture these costs, the Reserve Banks developed the Government Entity Accounting and Reporting System, which collects cost information from each District and issues quarterly bills to the appropriate government entity. In 1998, total reimbursable expenses for fiscal agency and depository services to the Treasury and other government agencies were $297.5 million, a decrease of $6.5 million from 1997. Reimbursement has been received or is expected for most of the expenses billed.

Fiscal Agency Services

The Reserve Banks handle marketable Treasury securities and savings bonds

Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 1998, 1997, and 1996

Thousands of dollars

Agency and service	1998	1997	1996
DEPARTMENT OF THE TREASURY			
Bureau of the Public Debt			
Savings bonds	71,401.8	70,340.4	78,765.8
Treasury Direct	35,859.1	35,440.4	26,788.8
Commercial book entry	17,880.4	26,809.4	27,099.0
Marketable Treasury issues	15,530.5	14,855.4	22,349.9
Definitive securities and Treasury coupons	3,734.2	3,618.9	3,498.5
Other services	83.7	...	...
Total	144,489.7	151,064.5	158,502.0
Financial Management Service			
Treasury tax and loan and Treasury general account	35,428.2	35,265.9	38,828.2
Government check processing	34,096.4	26,548.0	22,604.1
Automated clearinghouse	11,716.0	14,477.3	20,557.0
Government agency check deposits	2,731.0	2,795.3	3,366.1
Fedwire funds transfers	186.3	422.0	455.3
Other services	16,045.2	20,994.2	17,346.3
Total	100,203.1	100,502.7	103,157.1
Other Treasury			
Total	6,237.6	3,840.0	3,554.6
Total, Treasury	250,930.4	255,407.2	265,213.6
OTHER FEDERAL AGENCIES			
Department of Agriculture			
Food coupons	24,452.4	25,495.7	25,287.6
United States Postal Service			
Postal money orders	5,275.3	6,108.7	5,722.9
Miscellaneous agencies			
Other services	16,850.6	17,042.1	18,788.8
Total, other agencies	46,578.3	48,646.5	49,799.3
Total reimbursable expenses	**297,508.7**	**304,053.7**	**315,012.9**

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Federal Reserve Bank of St. Louis

and monitor the collateral pledged by depository institutions to the federal government.

Marketable Treasury Securities

Reserve Bank 1998 operating expenses for activities related to marketable Treasury securities (Treasury Direct, commercial book entry, Treasury auctions issues, and definitive securities and coupons) amounted to $73.0 million, a 9.5 percent decrease from 1997. The Reserve Banks processed more than 316,000 commercial tenders for government securities in Treasury auctions, a 23.2 percent decline from the 1997 volume level. Commercial tenders are processed at the New York, Chicago, and San Francisco Reserve Banks using an application known as the Treasury Automated Auction Processing System.

The Reserve Banks operate two book-entry securities systems for Treasury securities: the Fedwire book-entry securities system, which provides custody and transfer services, and Treasury Direct, which provides custody services only.[7] Almost all book-entry Treasury securities, 97.5 percent of the total par value outstanding at year-end 1998, were maintained on Fedwire; the remainder were maintained on Treasury Direct. The Reserve Banks in 1998 processed 8.9 million Fedwire transfers of Treasury securities, a 1.9 percent increase from the 1997 level. They also processed 26.7 million interest and principal payments for Treasury and government agency securities, an increase of 11.4 percent over 1997.

Treasury Direct, operated by the Philadelphia Reserve Bank, is a system of book-entry securities accounts for institutions and individuals planning to hold their Treasury securities to maturity. The Treasury Direct system holds more than 1.9 million accounts. During 1998, the Reserve Banks processed more than 309,000 tenders for Treasury Direct customers seeking to purchase Treasury securities at Treasury auctions and handled 1.1 million reinvestment requests; the volume of tenders was 28.6 percent lower than in 1997, and the volume of reinvestment requests was 37.7 percent lower. The Philadelphia Reserve Bank issued 6.6 million payments for discounts, interest, and redemption proceeds; the Treasury Direct facility was also used to originate 2.8 million payments for savings bonds and almost 46,000 interest payments for definitive Treasury issues.

As a service to Treasury Direct investors, the Chicago Reserve Bank, through the Sell Direct program, sells investors' Treasury securities on the secondary market for a fee. In 1998, Sell Direct's first full year of operation, the Bank sold more than 16,000 securities worth $510.6 million and collected more than $550,000 in fees on behalf of the Treasury.

In 1998, the Treasury started accepting tenders over the Internet and by telephone for Treasury Direct investors who pay for their Treasury securities by ACH debits to their bank accounts. Investors can also reinvest their maturing Treasury securities and request a statement of their accounts electronically. Late in the year, the Reserve Banks began to work with Treasury to identify other electronic alternatives for serving Treasury Direct investors and to reduce the number of Reserve Bank sites providing Treasury Direct customer service.

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7. The Fedwire book-entry securities mechanism is also used for safekeeping and transfer of securities issued by federal government agencies, government-sponsored enterprises, and international institutions. For more details, see the section "Fedwire Book-Entry Securities" earlier in this chapter.

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Federal Reserve Bank of St. Louis

Savings Bonds

Reserve Bank operating expenses for savings bond activities amounted to $71.4 million in 1998, an increase of 1.6 percent over 1997 expenses. The Reserve Banks printed and mailed 45.2 million savings bonds on behalf of the Treasury's Bureau of the Public Debt, a 12.1 percent decline from 1997. They processed 7.1 million original-issue transactions. They also processed approximately 604,000 redemption, reissue, and exchange transactions, a 10.4 percent decrease from 1997. In addition, the Reserve Banks responded to 1.7 million service calls from owners of savings bonds, approximately the same number as in 1997. Savings bond operations are conducted at five Reserve Bank offices: Buffalo, Pittsburgh, Richmond, Minneapolis, and Kansas City. All five offices process savings bond transactions, but only the Pittsburgh and Kansas City offices print and mail savings bonds.

The Reserve Banks made changes to both their automated applications and their processing procedures for the Treasury's new inflation-indexed Series I savings bond, which was introduced on September 1. The earnings rate for the Series I bond is the sum of the fixed rate set at the time the bond is purchased plus an inflation rate based on an annualized rate of inflation. Series EE and HH savings bonds are still available.

The Reserve Banks, working with the Treasury, also completed a long-range automation study in 1998 and agreed to adopt a distributed-processing automation platform for savings bonds in the future to replace several current mainframe applications. The Pittsburgh Branch of the Cleveland Reserve Bank completed a successful pilot project to use digital scanning software to convert applications submitted on paper by banks across the country into an electronic medium. After minimal operator intervention, the resulting electronic file can be used. The other four savings bond processing sites expect to install similar systems in 1999.

The Richmond Reserve Bank, on behalf of the Treasury, introduced the EasySaver plan, which permits individuals who do not have access to a payroll deduction plan to make recurring savings bond purchases. Current over-the-counter purchasers, employees of small businesses, and retirees are expected to benefit.

Other Initiatives

The St. Louis Reserve Bank fully implemented Cash Track in 1998. By consolidating information about receipts and payments processed on behalf of the Treasury, Cash Track makes it easier for the Treasury to forecast its cash needs.

Depository Services

The Reserve Banks maintain the Treasury's funds account, accept deposits of federal taxes and fees, pay checks drawn on the Treasury's account, and make electronic payments on behalf of the Treasury.

Federal Tax Payments

Reserve Bank operating expenses related to federal tax payment activities in 1998 totaled $35.4 million. The Banks processed approximately 231,000 paper and 5.0 million electronic advices of credit from depository institutions handling tax payments for businesses and individuals. Advices of credit are notices from depository institutions to the Federal Reserve and the Treasury summarizing taxes collected on a given day. The volume of paper advices

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of credit declined 30.8 percent from 1997 to 1998, and the volume of tax payments submitted electronically decreased 12.3 percent. The Reserve Banks also received a small number of tax payments directly.

Depository institutions that receive tax payments may place the funds in a Treasury tax and loan (TT&L) account or remit the funds to a Reserve Bank. The Minneapolis Reserve Bank operates an automated system through which businesses pay taxes that are due on the same day the tax liability is determined. These electronic tax payments, a part of the Treasury's Electronic Federal Tax Payment System, are invested in depository institutions' TT&L balances via the Federal Reserve's TT&L mechanism. In 1998, this electronic tax application processed approximately 106,000 tax payments from 6.3 million taxpayers totaling $151.1 billion. Most Electronic Federal Tax Payment System payments are made via ACH to accounts maintained by two commercial banks as Treasury's financial agents.

The St. Louis Reserve Bank, acting on behalf of the Treasury, began planning to truncate paper tax coupons collected by all Reserve Banks when the new Treasury Investment Program is implemented in mid-2000. The Treasury Investment Program, designed to replace the twelve existing TT&L software applications with a single application and database, will process only electronic tax payments, which now constitute most business tax payments. A separate application, called Patax (paper tax system), will automate the handling of paper tax payments.

Payments Processed for the Treasury

Reserve Bank operating expenses related to government payment operations (check processing, ACH, agency deposits, and funds transfers) amounted to $48.7 million in 1998. The Treasury continued to encourage electronic payments: The number of ACH transactions processed for the Treasury totaled 753 million, an increase of 11.2 percent over 1997.[8] Most government payments made via the ACH are social security, pension, and salary payments; some are payments to vendors. All recurring Treasury Direct payments and many definitive securities interest payments are made via the ACH.

The Treasury also continues to reduce the number of payments it makes by check. The Reserve Banks processed 321 million paper government checks in 1998, a decrease of 14.9 percent from 1997. The Reserve Banks also issued more than 785,000 million fiscal agency checks, a decrease of 24.9 percent. Fiscal agency checks were used primarily to pay semiannual interest on registered, definitive Treasury notes and bonds and on Series H and HH savings bonds, but they were also used to pay the principal of matured securities and coupons and to make discount payments to first-time purchasers of government securities through Treasury Direct.

In 1998, the Reserve Banks completed implementation of a check imaging system that captures and stores digital images of U.S. government checks for the Treasury's Financial Management Service. Imaging all government checks improves processing efficiency for the U.S. Treasury while lowering its operating costs.

Services Provided to Other Entities

When required to do so by the Secretary of the Treasury or when required or

8. ACH nonvalue transactions processed for the Treasury amounted to an additional 17.7 million items, an increase of 105.5 percent over 1997.

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permitted to do so by federal statute, the Reserve Banks provide fiscal agency and depository services to other domestic and international agencies. Depending on the authority under which the services are provided, the Reserve Banks may (1) maintain book-entry accounts of government agency securities and handle their transfer,[9] (2) provide custody for the stock of unissued, definitive securities, (3) maintain and update balances of outstanding book-entry and definitive securities for issuers, (4) perform other securities-servicing activities, (5) maintain funds accounts for some government agencies, and (6) provide various payments services.

One such service is the provision of food coupon services for the U.S. Department of Agriculture. Reserve Bank operating expenses for food coupon services in 1998 totaled $24.5 million, 4.1 percent less than in 1997. The Reserve Banks redeemed 1.8 billion food coupons, a decrease of 35.4 percent from 1997. As a result of the Department of Agriculture's program to provide benefits electronically, the volume of paper food coupons redeemed by the Reserve Banks is expected to continue to decline.

As fiscal agents of the United States, the Reserve Banks also process all postal money orders deposited by banks for collection, 213 million in 1998, a 4.4 percent increase over 1997. Much of this work is centralized at the Federal Reserve Bank of St. Louis. In 1998, the St. Louis Reserve Bank worked with the U.S. Postal Service to design an image capture service for postal money orders. This service, which is similar to that provided for Treasury checks, is scheduled to be implemented in 2000; digital files of paid money orders will facilitate the Postal Service's accounting, reconcilement, and claims processes.

Information Technology

In 1998, the Federal Reserve established a Systemwide information technology governance and management structure that spans the full range of central bank and financial services functions performed by the Reserve Banks and the Board of Governors. An oversight committee was formed to establish the strategic direction for information technology Systemwide. The position of Director of Federal Reserve Information Technology was also established.

Federal Reserve Information Technology is composed of two operating units, Federal Reserve Automation Services and Information Technology Planning and Standards. The former supports the Federal Reserve's mainframe computing and national network services. The latter is a new unit that develops information technology plans and standards for the System and assists with information technology decisions.

Reserve Banks have made significant progress in using the World Wide Web as a new service-delivery channel. Web technology provides new opportunities to improve depository institutions' access to electronic services. The web is well suited for programs that allow customers to submit forms-based information to the Federal Reserve or to retrieve information stored on a Federal Reserve database. Several trials were conducted in 1998 to test customer acceptance of this new service-delivery channel and the security and network components that allow customers secure access to web-based services. Among the services

9. The Federal Reserve tracks the transfer and account maintenance of agency securities as a priced service to depository institutions; the expenses of providing these services are not charged to the agencies.

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tested were cash and savings bond ordering, on-line submission of statistical reports, and check image retrieval.

The Reserve Banks have completed an extensive analysis of the encryption techniques they use to ensure the security of payments information and other information electronically transmitted daily between Reserve Banks and financial institutions nationwide. As a consequence, they have adopted Triple DES as the System's encryption standard. Triple DES, an advanced application of the Data Encryption Standard (DES), is a complex scrambling technique. The new standard is designed to bring even greater protection to data that are transmitted electronically among Reserve Banks and between the Federal Reserve and financial institutions. The Federal Reserve began installing Triple DES on its internal network in 1998 and will complete installation in 1999. Depository institutions will begin receiving Triple DES in 1999.

Financial Examinations of Federal Reserve Banks

Section 21 of the Federal Reserve Act requires the Board of Governors to order an examination of each Federal Reserve Bank at least once a year; the Board assigns this responsibility to its Division of Reserve Bank Operations and Payment Systems. The division engages a public accounting firm to perform an annual audit of the combined financial statements of the Reserve Banks. (See the following section, "Federal Reserve Banks Combined Financial Statements.") The public accounting firm also audits the annual financial statements of each of the twelve Banks. In 1998, the Reserve Banks endorsed the Systemwide implementation of the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) for internal controls over financial reporting, including the safeguarding of assets. Within this framework, each Reserve Bank provides an assertion letter to its board of directors annually confirming adherence to these standards, and a public accounting firm certifies management's assertion and issues an attestation report to the Bank's board of directors and to the Board of Governors.

In 1998, the division's attentions at the twelve Banks focused on rendering an opinion on each District's internal control system using a format consistent with the integrated COSO framework. The scope of these examinations included comprehensive reviews of each Bank's internal control system in terms of the five COSO control components: control environment, risk assessment, control activities, information and communication, and monitoring.

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

Income and Expenses

The accompanying table summarizes the income, expenses, and distributions of net earnings of the Federal Reserve Banks for 1997 and 1998.

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Federal Reserve Bank of St. Louis

Income in 1998 was $28,149 million, compared with $26,917 million in 1997. Revenue from priced services was $816 million. Total expenses were $2,011 million ($1,487 million in operating expenses, $346 million in earnings credits granted to depository institutions, and $178 million in assessments for expenditures by the Board of Governors). The cost of new currency was $409 million. Unreimbursed expenses for services provided to the Treasury and other government entities amounted to $8 million.[10]

The profit and loss account showed a net gain of $1,914 million. The gain was due primarily to realized and unrealized profits on assets denominated in foreign currencies that were revalued to reflect current exchange rates. Statutory dividends paid to member banks totaled $343 million, $43 million more than in 1997; the increase reflects an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Reserve Banks.

10. The Reserve Banks bill the Treasury and other government entities for the cost of certain services, and the portions of the bills that are not paid are reported as unreimbursed expenses.

Payments to the Treasury in the form of interest on Federal Reserve notes totaled $26,561 million in 1998, up from $20,659 million in 1997; the payments equal net income after the deduction of dividends paid and of the amount necessary to bring the surplus of the Reserve Banks to the level of capital paid in.

In the "Statistical Tables" section of this REPORT, table 5 details the income and expenses of each Federal Reserve Bank for 1998, and table 6 shows a condensed statement for each Bank for 1914–98. A detailed account of the assessments and expenditures of the Board of Governors appears in the section "Board of Governors Financial Statements."

Holdings of Securities and Loans

The Reserve Banks' average daily holdings of securities and loans during 1998 amounted to $447,095 million, an

Income, Expenses, and Distribution of Net Earnings of Federal Reserve Banks, 1998 and 1997

Millions of dollars

Item	1998	1997
Current income	28,149	26,917
Current expenses	1,833	1,976
Operating expenses[1]	1,487	1,618
Earnings credits granted	346	359
Current net income	26,316	24,941
Net additions to (deductions from, –) current net income	1,914	−2,577
Cost of unreimbursed services to Treasury	8	35
Assessments by the Board of Governors	587	539
For expenditures of Board	178	174
For cost of currency	409	364
Net income before payments to Treasury	27,636	21,790
Dividends paid	343	300
Transferred to surplus	732	832
Payments to Treasury	26,561	20,659

NOTE. In this and the following table, components may not sum to totals because of rounding.

1. Includes a net periodic credit for pension costs of $288 million in 1998 and $200 million in 1997.

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Securities and Loans of Federal Reserve Banks, 1996–98

Millions of dollars, except as noted

Item and year	Total	U.S. government securities[1]	Loans[2]
Average daily holdings[3]			
1996	390,268	390,063	206
1997	417,805	417,529	277
1998	447,095	446,933	161
Earnings			
1996	23,895	23,884	11
1997	25,714	25,699	15
1998	26,851	26,842	9
Average interest rate (percent)			
1996	6.12	6.12	5.27
1997	6.15	6.16	5.27
1998	6.01	6.01	5.44

1. Includes federal agency obligations.
2. Does not include indebtedness assumed by the Federal Deposit Insurance Corporation.
3. Based on holdings at opening of business.

increase of $29,289 million over 1997 (see table). Holdings of U.S. government securities increased $29,404 million, and holdings of loans decreased $116 million.

The average rate of interest earned on Reserve Banks' holdings of government securities declined to 6.01 percent, from 6.16 percent in 1997, and the average rate of interest earned on loans rose to 5.44 percent from 5.27 percent.

Volume of Operations

Table 8 in the "Statistical Tables" section shows the volume of operations in the principal departments of the Federal Reserve Banks for the years 1994 through 1998.

Federal Reserve Bank Premises

The expansion and renovation of the Cleveland Reserve Bank's headquarters building was completed in 1998. Also, the design of the Atlanta Reserve Bank's new Birmingham Branch building was completed and construction was begun. The Atlanta Bank sold the existing Branch building but will continue to lease it until the new facility is completed. Design of the Bank's new headquarters building continued.

Multiyear renovation programs continued for the New York Reserve Bank's headquarters building and for buildings for the Kansas City Bank's Oklahoma City Branch and the San Francisco Bank's Seattle, Portland, and Salt Lake City Branches. Also, the multiyear leasehold improvements program was begun for the New York Reserve Bank's new leased office space in New York City. ■

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Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 1998 and 1997

Millions of dollars

Item	1998		1997[1]	
Short-term assets (Note 1)				
Imputed reserve requirements on clearing balances	725.3		658.0	
Investment in marketable securities	6,527.7		5,922.0	
Receivables	76.8		72.8	
Materials and supplies	4.4		2.8	
Prepaid expenses	20.4		9.0	
Items in process of collection	4,272.5		4,505.8	
Total short-term assets		11,626.9		11,170.3
Long-term assets (Note 2)				
Premises	398.6		389.2	
Furniture and equipment	127.6		137.4	
Leases and leasehold improvements	26.8		31.8	
Prepaid pension costs	437.3		350.2	
Total long-term assets		990.4		908.5
Total assets		**12,617.3**		**12,078.9**
Short-term liabilities				
Clearing balances and balances arising from early credit of uncollected items	8,011.8		7,289.0	
Deferred-availability items	3,513.7		3,796.9	
Short-term debt	101.5		84.5	
Total short-term liabilities		11,626.9		11,170.3
Long-term liabilities				
Obligations under capital leases	.0		.7	
Long-term debt	193.6		188.8	
Postretirement/postemployment benefits obligation	217.4		205.0	
Total long-term liabilities		411.0		394.5
Total liabilities		**12,037.9**		**11,564.8**
Equity		579.4		514.0
Total liabilities and equity (Note 3)		**12,617.3**		**12,078.9**

NOTE. Components may not sum to totals because of rounding.

The priced services financial statements consist of these tables and the accompanying notes.

1. Some of these data have been revised.

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Pro Forma Income Statement for Federal Reserve Priced Services, 1998 and 1997

Millions of dollars

Item	1998		1997	
Revenue from services provided to depository institutions (Note 4)		816.0		789.1
Operating expenses (Note 5)		654.1		672.6
Income from operations		161.9		116.4
Imputed costs (Note 6)				
Interest on float	16.2		14.6	
Interest on debt	17.0		17.5	
Sales taxes	8.7		9.8	
FDIC insurance	1.4	43.4	6.9	48.9
Income from operations after imputed costs		118.5		67.6
Other income and expenses (Note 7)				
Investment income	352.0		367.7	
Earnings credits	−328.2	23.7	−338.0	29.7
Income before income taxes		142.3		97.3
Imputed income taxes (Note 8)		45.7		31.2
Net income (Note 9)		**96.6**		**66.1**
MEMO: Targeted return on equity (Note 10)		66.8		54.3

NOTE. Components may not sum to totals because of rounding.

The priced services financial statements consist of these tables and the accompanying notes.

Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 1998

Millions of dollars

Item	Total	Commercial check collection	Funds transfer and net settlement	Book-entry securities	Commercial ACH	Noncash collection	Cash services
Revenue from operations	816.0	632.6	92.2	18.3	66.7	3.5	2.6
Operating expenses (Note 5)	654.1	540.0	69.5	12.4	42.8	1.9	2.4
Income from operations	161.9	92.6	22.7	5.9	23.9	1.6	.2
Imputed costs (Note 6)	43.4	37.3	3.2	.6	2.1	.2	.0
Income from operations after imputed costs	118.5	55.3	19.5	5.3	21.8	1.4	.1
Other income and expenses, net (Note 7)	23.7	19.1	2.3	.4	1.7	.1	.1
Income before income taxes	142.3	74.5	21.8	5.7	23.5	1.5	.2

NOTE. Components may not sum to totals because of rounding.

The priced services financial statements consist of these tables and the accompanying notes.

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FEDERAL RESERVE BANKS

NOTES TO FINANCIAL STATEMENTS FOR PRICED SERVICES

(1) SHORT-TERM ASSETS

The imputed reserve requirement on clearing balances held at Reserve Banks by depository institutions reflects a treatment comparable to that of compensating balances held at correspondent banks by respondent institutions. The reserve requirement imposed on respondent balances must be held as vault cash or as non-earning balances maintained at a Reserve Bank; thus, a portion of priced services clearing balances held with the Federal Reserve is shown as required reserves on the asset side of the balance sheet. The remainder of clearing balances is assumed to be invested in three-month Treasury bills, shown as investment in marketable securities.

Receivables are (1) amounts due the Reserve Banks for priced services and (2) the share of suspense-account and difference-account balances related to priced services.

Materials and supplies are the inventory value of short-term assets.

Prepaid expenses include salary advances and travel advances for priced-service personnel.

Items in process of collection is gross Federal Reserve cash items in process of collection (CIPC) stated on a basis comparable to that of a commercial bank. It reflects adjustments for intra-System items that would otherwise be double-counted on a consolidated Federal Reserve balance sheet; adjustments for items associated with non-priced items, such as those collected for government agencies; and adjustments for items associated with providing fixed availability or credit before items are received and processed. Among the costs to be recovered under the Monetary Control Act is the cost of float, or net CIPC during the period (the difference between gross CIPC and deferred-availability items, which is the portion of gross CIPC that involves a financing cost), valued at the federal funds rate.

(2) LONG-TERM ASSETS

Consists of long-term assets used solely in priced services, the priced-services portion of long-term assets shared with nonpriced services, and an estimate of the assets of the Board of Governors used in the development of priced services. Effective Jan. 1, 1987, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). Accordingly, the Reserve Banks recognized credits to expenses of $87.1 million in 1998 and $62.8 million in 1997 and corresponding increases in this asset account.

(3) LIABILITIES AND EQUITY

Under the matched-book capital structure for assets that are not "self-financing," short-term assets are financed with short-term debt. Long-term assets are financed with long-term debt and equity in a proportion equal to the ratio of long-term debt to equity for the fifty largest bank holding companies, which are used in the model for the private-sector adjustment factor (PSAF). The PSAF consists of the taxes that would have been paid and the return on capital that would have been provided had priced services been furnished by a private-sector firm. Other short-term liabilities include clearing balances maintained at Reserve Banks and deposit balances arising from float. Other long-term liabilities consist of accrued postemployment and postretirement benefits costs and obligations on capital leases.

(4) REVENUE

Revenue represents charges to depository institutions for priced services and is realized from each institution through one of two methods: direct charges to an institution's account or charges against its accumulated earnings credits.

(5) OPERATING EXPENSES

Operating expenses consist of the direct, indirect, and other general administrative expenses of the Reserve Banks for priced services plus the expenses for staff members of the Board of Governors working directly on the development of priced services. The expenses for Board staff members were $2.8 million in 1998 and $2.9 million in 1997. The credit to expenses under SFAS 87 (see note 2) is reflected in operating expenses.

The income statement by service reflects revenue, operating expenses, and imputed costs except for income taxes. Certain corporate overhead costs not closely related to any particular priced service are allocated to priced services in total based on an expense–ratio method, but are allocated among priced services based on management decision. Corporate overhead was allocated among the priced services during 1998 and 1997 as follows:

	1998	1997
Check	27.1	30.7
ACH	.0	.0
Funds transfer	19.6	12.3
Book entry	.0	.0
Noncash collection	.1	.0
Special cash services	.1	.3
Total	**46.9**	**43.3**

Total operating expense on the income statement by service does not equal the sum of operating expenses for each service because of the effect of SFAS 87. Although the portion of the SFAS 87 credit related to the current year is allocated to individual services, the amortization of the initial effect of implementation is reflected only at the System level.

(6) IMPUTED COSTS

Imputed costs consist of interest on float, interest on debt, sales taxes, and the FDIC assessment. Interest on float is derived from the value of float to be recovered, either explicitly or through per-item fees, during the period. Float costs include costs for checks, book-entry securities, noncash collection, ACH, and funds transfers.

Interest is imputed on the debt assumed necessary to finance priced-service assets. The sales taxes and FDIC assessment that the Federal Reserve would have paid had it been a private-sector firm are among the components of the PSAF (see note 3).

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Float costs are based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses less shipping expenses for each service to the total expenses for all services less the total shipping expenses for all services.

The following list shows the daily average recovery of float by the Reserve Banks for 1998 in millions of dollars:

Total float	632.7
Unrecovered float	18.3
Float subject to recovery	614.4
Sources of recovery of float	
Income on clearing balances	61.3
As-of adjustments	309.1
Direct charges	137.2
Per-item fees	106.8

Unrecovered float includes float generated by services to government agencies and by other central bank services. Float recovered through income on clearing balances is the result of the increase in investable clearing balances; the increase is produced by a deduction for float for cash items in process of collection, which reduces imputed reserve requirements. The income on clearing balances reduces the float to be recovered through other means. As-of adjustments and direct charges are midweek closing float and interterritory check float, which may be recovered from depositing institutions through adjustments to the institution's reserve or clearing balance or by valuing the float at the federal funds rate and billing the institution directly. Float recovered through per-item fees is valued at the federal funds rate and has been added to the cost base subject to recovery in 1998.

(7) Other Income and Expenses

Consists of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances represents the average coupon-equivalent yield on three-month Treasury bills applied to the *total* clearing balance maintained, adjusted for the effect of reserve requirements on clearing balances. Expenses for earnings credits granted to depository institutions on their clearing balances are derived by applying the average federal funds rate to the *required* portion of the clearing balances, adjusted for the net effect of reserve requirements on clearing balances.

Because clearing balances relate directly to the Federal Reserve's offering of priced services, the income and cost associated with these balances are allocated to each service based on each service's ratio of income to total income.

(8) Income Taxes

Imputed income taxes are calculated at the effective tax rate derived from the PSAF model (see note 3). Taxes have not been allocated by service because they relate to the organization as a whole.

(9) Adjustments to Net Income for Price Setting

In setting fees, certain costs are excluded in accordance with the System's overage and shortfalls policy and its automation consolidation policy. Accordingly, to compare the financial results reported in this table with the projections used to set prices, adjust net income as follows (amounts shown are net of tax):

	1998	1997
Net income	96.6	66.1
Amortization of the initial effect of implementing SFAS 87	−10.2	−10.2
Deferred costs of automation consolidation	−14.5	−8.5
Adjusted net income	71.9	47.4

(10) Return on Equity

The after-tax rate of return on equity that the Federal Reserve would have earned had it been a private business firm, as derived from the PSAF model (see note 3). This amount is adjusted to reflect the recovery of $14.5 million of automation consolidation costs for 1998 and $8.5 million for 1997. The Reserve Banks plan to recover these amounts, along with a finance charge, by the end of the year 1999. After-tax return on equity has not been allocated by service because it relates to the organization as a whole.

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Federal Reserve Banks Combined Financial Statements

The combined financial statements of the Federal Reserve Banks were audited by PricewaterhouseCoopers LLP, independent accountants, for the years ended December 31, 1998 and 1997.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Governors of The Federal Reserve System
and the Board of Directors of each of The Federal Reserve Banks:

We have audited the accompanying combined statements of condition of The Federal Reserve Banks (the "Reserve Banks") as of December 31, 1998 and 1997, and the related combined statements of income and changes in capital for the years then ended. These financial statements are the responsibility of the Reserve Banks' management. Our responsibility is to express an opinion on the financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of the Reserve Banks as of December 31, 1998 and 1997, and combined results of their operations for the years then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

Washington, D.C.
March 12, 1999

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THE FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CONDITION
December 31, 1998 and 1997

(in millions)

ASSETS	1998	1997
Gold certificates	$ 11,046	$ 11,047
Special drawing rights certificates	9,200	9,200
Coin	358	460
Items in process of collection	6,933	7,800
Loans to depository institutions	17	2,035
U.S. government and federal agency securities, net	488,911	458,555
Investments denominated in foreign currencies	19,768	17,046
Accrued interest receivable	4,680	4,386
Bank premises and equipment, net	1,787	1,781
Other assets	1,942	1,612
Total assets	$544,642	$513,922

LIABILITIES AND CAPITAL	1998	1997
LIABILITIES		
Federal Reserve notes outstanding, net	$491,657	$457,469
Deposits		
Depository institutions	26,306	30,838
U.S. Treasury, general account	6,086	5,444
Other deposits	413	681
Deferred credit items	5,924	7,239
Surplus transfer due U.S. Treasury	1,373	653
Accrued benefit cost	780	747
Other liabilities	199	198
Total liabilities	532,738	503,269
CAPITAL		
Capital paid-in	5,952	5,433
Surplus	5,952	5,220
Total capital	11,904	10,653
Total liabilities and capital	$544,642	$513,922

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

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THE FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF INCOME
for the years ended December 31, 1998 and 1997

(in millions)

	1998	1997
Interest income		
Interest on U.S. government securities	$26,842	$25,699
Interest on foreign currencies	435	375
Interest on loans to depository institutions	9	15
Total interest income	27,286	26,089
Other operating income (loss)		
Income from services	816	789
Reimbursable services to government agencies	299	224
Foreign currency gains (losses), net	1,870	(2,593)
Government securities gains, net	44	13
Other income	72	61
Total other operating income (loss)	3,101	(1,506)
Operating expenses		
Salaries and other benefits	1,358	1,300
Occupancy expense	181	184
Equipment expense	244	261
Cost of unreimbursed Treasury services	8	35
Assessments by Board of Governors	587	539
Other expenses	374	474
Total operating expenses	2,752	2,793
Net income prior to distribution	$27,635	$21,790
Distribution of net income		
Dividends paid to member banks	$ 343	$ 300
Transferred to surplus	732	831
Payments to U.S. Treasury as interest on Federal Reserve notes	8,774	...
Payments to U.S. Treasury as required by statute	17,786	20,659
Total distribution	$27,635	$21,790

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

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THE FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CHANGES IN CAPITAL
for the years ended December 31, 1998 and 1997

(in millions)

	Capital paid-in	Surplus	Total capital
Balance at January 1, 1997 (92 million shares)	$4,602	$4,496	$9,098
Net income transferred to surplus	...	831	831
Statutory surplus transfer to the U.S. Treasury	...	(107)	(107)
Net change in capital stock issued (17 million shares)	831	...	831
Balance at December 31, 1997 (109 million shares)	$5,433	$5,220	$10,653
Net income transferred to surplus	...	732	732
Net change in capital stock issued (10 million shares)	519	...	519
Balance at December 31, 1998 (119 million shares)	$5,952	$5,952	$11,904

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

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS

(1) ORGANIZATION AND BASIS OF PRESENTATION

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

Although the Reserve Banks are chartered as independent organizations overseen by the Board of Governors, the Reserve Banks work jointly to carry out their statutory responsibilities. The majority of the assets, liabilities, and income of the Reserve Banks is derived from central bank activities and responsibilities with regard to monetary policy and currency. For this reason, the accompanying combined set of financial statements for the twelve independent Reserve Banks is prepared, adjusted to eliminate interdistrict accounts and transactions.

Structure

The Reserve Banks serve twelve Federal Reserve Districts nationwide. In accordance with the Federal Reserve Act, supervision and control of each Reserve Bank is exercised by a Board of Directors. Banks that are members of the System include all national banks and any state-chartered bank that applies and is approved for membership in the System.

Board of Directors

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

(2) OPERATIONS AND SERVICES

The System performs a variety of services and operations. Functions include formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearinghouse operations, and check processing; distribution of coin and currency; fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies, state member banks, and U.S. offices of foreign banking organizations; and administering other regulations of the Board of Governors. The Board of Governors' operating costs are funded through assessments on the Reserve Banks.

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NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of U.S. government and federal agency securities, matched sale–purchase transactions, the purchase of securities under agreements to resell, and the lending of U.S. government securities. Additionally, the FRBNY is authorized by the FOMC to hold balances of and to execute spot and forward foreign exchange and securities contracts in fourteen foreign currencies, maintain reciprocal currency arrangements (F/X swaps) with various central banks, and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund (ESF) through the Reserve Banks.

(3) SIGNIFICANT ACCOUNTING POLICIES

Accounting principles for entities with the unique powers and responsibilities of the nation's central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared to the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* (*Financial Accounting Manual*), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the *Financial Accounting Manual*.

The financial statements have been prepared in accordance with the *Financial Accounting Manual*. Differences exist between the accounting principles and practices of the System and generally accepted accounting principles (GAAP). The primary differences are the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP, and the accounting for matched sale–purchase transactions as separate sales and purchases, rather than secured borrowings with pledged collateral, as is required by GAAP. In addition, the Board of Governors and the Reserve Banks have elected not to include a Statement of Cash Flows or a Statement of Comprehensive Income. The Statement of Cash Flows has not been included as the liquidity and cash position of the Reserve Banks are not of primary concern to users of these financial statements. The Statement of Comprehensive Income, which comprises net income plus or minus certain adjustments, such as the fair value adjustments for securities, has not been included because as stated above the securities are reported at amortized cost and there are no other adjustments in the determination of Comprehensive Income applicable to the Reserve Banks. Other information regarding the Reserve Banks' activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. Therefore, a Statement of Cash Flows or a Statement of Comprehensive Income would not provide any additional useful information. There are no other significant differences between the policies outlined in the *Financial Accounting Manual* and GAAP.

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

(A) *Gold Certificates*

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time, and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged, and the Reserve Banks' gold certificate account is lowered. The value of gold for purposes of backing the gold certificates is set by law at $42^{2}/_{9}$ a fine troy ounce.

(B) *Special Drawing Rights Certificates*

Special drawing rights (SDRs) are issued by the International Monetary Fund (Fund) to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for U.S. participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate account is increased. The Reserve Banks are required to purchase SDRs, at the direction of the U.S. Treasury, for the purpose of financing SDR certificate acquisitions or for financing exchange stabilization operations.

(C) *Loans to Depository Institutions*

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If any loans were deemed to be uncollectible, an appropriate reserve would be established. Interest is recorded on the accrual basis and is charged at the applicable discount rate established at least every fourteen days by the boards of directors of the Reserve Banks, subject to review by the Board of

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Governors. However, Reserve Banks retain the option to impose a surcharge above the basic rate in certain circumstances.

(D) *U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies*

The FOMC has designated the FRBNY to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account (SOMA). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or other needs specified by the FOMC in carrying out the System's central bank responsibilities.

Purchases of securities under agreements to resell and matched sale–purchase transactions are accounted for as separate sale and purchase transactions. Purchases under agreements to resell are transactions in which the FRBNY purchases a security and sells it back at the rate specified at the commencement of the transaction. Matched sale–purchase transactions are transactions in which the FRBNY sells a security and buys it back at the rate specified at the commencement of the transaction.

Reserve Banks are authorized by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires the lending Reserve Bank to take possession of the collateral in amounts in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by the lending Reserve Bank on a daily basis, with additional collateral obtained as necessary. The securities loaned continue to be accounted for in the SOMA.

Foreign exchange contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed upon period of time (up to twelve months), at an agreed upon interest rate. These arrangements give the FOMC temporary access to foreign currencies that it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank, and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The Bank will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

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

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts that contain varying degrees of off-balance-sheet market risk because they represent contractual commitments involving future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

While the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio from time to time involve transactions that can result in gains or losses when holdings are sold prior to maturity. However, decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, earnings and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government and federal agency securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income is accrued on a straight-line basis and is reported as "Interest on U.S. government securities" or "Interest on foreign currencies," as appropriate. Income earned on securities lending transactions is reported as a component of "Other income." Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Gains and losses on the sales of U.S. government and federal agency securities are reported as "Government securities gains, net." Foreign currency denominated assets are revalued monthly at current market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency gains (losses), net." Foreign currencies held through F/X swaps, when initiated by the counter party, and warehousing arrangements are revalued monthly, with the unrealized gain or loss reported as a component of "Other assets" or "Other liabilities," as appropriate.

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NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

(E) *Bank Premises and Equipment*

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from 2 to 50 years. New assets, major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts. Maintenance, repairs, and minor replacements are charged to operations in the year incurred.

(F) *Federal Reserve Notes*

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank. In accordance with the Federal Reserve Act, gold certificates, special drawing rights certificates, U.S. government and agency securities, loans allowed under section 13, and investments denominated in foreign currencies are pledged as collateral for net Federal Reserve notes outstanding. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, whose collateral value is equal to the par value of the securities tendered. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides that certain assets of the Reserve Banks are jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the U.S. government.

The "Federal Reserve notes outstanding, net" account represents Federal Reserve notes reduced by cash held in the vaults of the Reserve Banks of $120,030 million and $92,131 million at December 31, 1998 and 1997, respectively.

At December 31, 1998 and 1997, all gold certificates, all special drawing rights certificates, and domestic securities with par values of $471,411 million and $437,222 million, respectively, were pledged as collateral. At December 31, 1998 and 1997, no loans or investments denominated in foreign currencies were pledged as collateral.

(G) *Capital Paid-In*

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6% of the capital and surplus of the member bank. As a member bank's capital and surplus changes, its holdings of the Reserve Bank's stock must be adjusted. Member banks are those state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of $100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6% on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

(H) *Surplus*

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. Payments made after September 30, 1998, represent payment of interest on Federal Reserve notes outstanding.

The Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66, Section 3002) codified the existing Board surplus policies as statutory surplus transfers, rather than as payments of interest on Federal Reserve notes, for federal government fiscal years 1998 and 1997 (which began on October 1, 1997 and 1996, respectively). In addition, the legislation directed the Reserve Banks to transfer to the U.S. Treasury additional surplus funds of $107 million and $106 million during fiscal years 1998 and 1997 respectively. These transfers were made on October 1, 1997 and 1996, respectively. Reserve Banks were not permitted to replenish surplus for these amounts during this time. The 1997 transfer is reported on the Statement of Changes in Capital as "Statutory surplus transfer to the U.S. Treasury."

In the event of losses, payments to the U.S. Treasury are suspended until such losses are recovered through subsequent earnings. Weekly payments to the U.S. Treasury vary significantly.

(I) *Cost of Unreimbursed Treasury Services*

Reserve Banks are required by the Federal Reserve Act to serve as fiscal agents and depositories of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services. The costs of providing fiscal agency and depository services to the Treasury Department that have been billed but will not be paid are reported as the "Cost of unreimbursed Treasury services."

(J) *Taxes*

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

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Notes to the Combined Financial Statements of the Federal Reserve Banks—Continued

(4) U.S. Government and Federal Agency Securities

Securities bought outright and held under agreements to resell are held in the SOMA at the FRBNY.

Total securities held in the SOMA at December 31, 1998 and 1997, that were bought outright were as follows (in millions):

	1998	1997
Par value		
Federal agency	$ 337	$ 685
U.S. government		
Bills	194,772	197,123
Notes	187,895	174,206
Bonds	69,474	59,407
Total par value	452,478	431.421
Unamortized premiums	7,387	6,197
Unaccreted discounts	(3,198)	(3,617)
Total	$456,667	$434,001

The maturities of U.S. government and federal agency securities bought outright, which were held in the SOMA at December 31, 1998, were as follows (in millions):

Maturities of securities held	Par value: U.S. government securities	Par value: Federal agency obligations	Total
Within 15 days	$ 1,158	$ . . .	$ 1,158
16 days to 90 days	99,127	27	99,154
91 days to 1 year	143,635	75	143,710
Over 1 year to 5 years	107,730	61	107,791
Over 5 years to 10 years	44,822	174	44,996
Over 10 years	55,669	. . .	55,669
Total	$452,141	$337	$452,478

Total securities held under agreements to resell at December 31 1998 and 1997, respectively were as follows (in millions):

	1998	1997
Par value		
Federal agency	$10,702	$ 2,652
U.S. government	19,674	21,188
Total par value	30,376	23,840
Unamortized premiums	2,133	996
Unaccreted discounts	(265)	(282)
Total	$32,244	$24,554

The resell date for securities purchased under agreements to resell does not exceed fifteen days after the purchase date.

At December 31, 1998 and 1997, matched sale–purchase transactions involving U.S. government securities with par values of $20,927 million and $17,027 million, respectively, were outstanding. Matched sale–purchase transactions are generally overnight arrangements.

At December 31, 1998 and 1997, U.S. government securities with par values of $325 million and $887 million, respectively, were loaned.

(5) Investments Denominated in Foreign Currencies

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

Total investments denominated in foreign currencies, valued at current exchange rates at December 31, were as follows (in millions):

	1998	1997
German marks		
Foreign currency deposits	$10,451	$ 8,271
Government debt instruments, including agreements to resell	2,373	3,215
Japanese yen		
Foreign currency deposits	666	575
Government debt instruments, including agreements to resell	6,196	4,902
Accrued interest	97	86
Total	$19,783	$17,049

In addition to the balances reported above, $15 million and $3 million in unearned interest collected on certain foreign currency holdings were also reported as "Investments denominated in foreign currencies" at December 31, 1998 and 1997, respectively.

The maturities of investments denominated in foreign currencies at December 31, 1998, were as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies	
Within 1 year	$18,826
Over 1 year to 5 years	496
Over 5 years to 10 years	461
Total	$19,783

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NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

At December 31, 1998 and 1997, there were no open foreign exchange contracts or outstanding F/X swaps.

At December 31, 1998, the warehousing facility was $5,000 million, with nothing outstanding.

(6) BANK PREMISES AND EQUIPMENT

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

	1998	1997
Bank premises and equipment		
Land	$ 191	$ 194
Buildings	1,177	1,100
Building machinery and equipment	271	255
Construction in progress	41	61
Furniture and equipment	1,244	1,258
	2,924	2,868
Accumulated depreciation	(1,137)	(1,087)
Bank premises and equipment, net	$1,787	$1,781

Depreciation expense was $184 million and $194 million for the years ended December 31, 1998 and 1997, respectively.

Bank premises and equipment at December 31 include the following amounts for leases that have been capitalized (in millions):

	1998	1997
Bank premises and equipment	$89	$95
Accumulated depreciation	(78)	(81)
Capitalized leases, net	$11	$14

Certain of the Reserve Banks lease unused space to outside tenants. Those leases have terms ranging from 1 to 16 years. Rental income from such leases totaled $17 million for each of the years ended December 31, 1998 and 1997. Future minimum lease payments under agreements in existence at December 31, 1998, were (in millions):

1999	$14
2000	14
2001	12
2002	11
2003	8
Thereafter	23
Total	$82

(7) COMMITMENTS AND CONTINGENCIES

At December 31, 1998, the Reserve Banks were obligated under noncancelable leases for premises and equipment with terms ranging from 1 year to approximately 25 years. These leases provide for increased rentals based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance, and maintenance when included in rent), net of sublease rentals, was $64 million and $69 million for the years ended December 31, 1998 and 1997, respectively. Certain of the Reserve Banks' leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with terms of one year or more, at December 31, 1998, were (in millions):

	Operating
1999	$ 14
2000	11
2001	9
2002	6
2003	6
Thereafter	$119
Total	$165

At December 31, 1998, the Reserve Banks had contractual commitments through the year 2007 totaling $243 million for the maintenance of currency processing machines, none of which has been recognized. One Reserve Bank contracts for maintenance for these machines on behalf of the System and allocates the costs, annually, to each other Reserve Bank.

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

(8) RETIREMENT AND THRIFT PLANS

Retirement Plans

The Reserve Banks currently offer two defined benefit retirement plans to their employees, based on length of service and level of compensation. Substantially all of the Reserve Banks' employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan) and the Benefit Equalization Retirement Plans offered by each individual Reserve Bank (BEPs).

The System Plan is a multi-employer plan with contributions fully funded by participating employers. No separate accounting is maintained of assets contributed by the participating employers. FRBNY acts as the sponsor of this plan. The prepaid pension cost includes amounts related to the participation of employees of the twelve Reserve Banks, the Board of Governors, and the Plan Administrative Office in the plan.

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NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

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

	1998	1997
Estimated actuarial present value of projected benefit obligation at January 1	$2,476	$2,270
Service cost—benefits earned during the period	79	71
Interest cost of projected benefit obligation	169	160
Actuarial loss	140	80
Contributions by plan participants	4	4
Benefits paid	(125)	(117)
Special termination benefits	...	4
Plan amendments	31	4
Estimated actuarial present value of projected benefit obligation at December 31	$2,774	$2,476

During 1997, a special retirement program was offered by one of the employers to employees who were eligible to retire in 1998.

Following is a reconciliation showing the beginning and ending balance of the System Plan assets, the funded status, and the prepaid pension benefit cost (in millions):

	1998	1997
Estimated fair value of plan assets at January 1	$5,031	$4,157
Actual return on plan assets	888	904
Contributions by employer	...	83
Contributions by plan participants	4	4
Benefits paid	(125)	(117)
Estimated fair value of plan assets at December 31	$5,798	$5,031
Funded status	$3,024	$2,555
Unrecognized initial net transition (obligation)	(136)	(181)
Unrecognized prior service cost	152	135
Unrecognized net actuarial (gain)	(1,549)	(1,307)
Prepaid pension benefit cost	1,491	1,202

Prepaid pension benefit cost is reported as a component of "Other assets."

The weighted-average assumptions used in developing the pension benefit obligation for the System Plan are as follows:

	1998	1997
Discount rate	6.25%	7.00%
Expected long-term rate of return on plan assets	9.00%	9.00%
Rate of compensation increase	4.25%	5.00%

The components of net periodic pension benefit credit for the System Plan as of December 31 are shown below (in millions):

	1998	1997
Service cost—benefits earned during the period	$ 79	$ 71
Interest cost on projected benefit obligation	169	160
Amortization of initial net transition obligation	(45)	(46)
Amortization of prior service cost	15	13
Recognized net (gain)	(59)	(34)
Expected return on plan assets	(448)	(369)
Cost of special termination benefits	...	4
Net periodic pension benefit (credit)	$(289)	$(201)

Net periodic pension benefit (credit) is reported as a component of "Other expense."

The Reserve Banks' projected benefit obligation and net pension costs for the BEP at December 31, 1998 and 1997, and for the years then ended, are not material.

Thrift Plan

Employees of the Reserve Banks may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Reserve Banks' Thrift Plan contributions totaled $43 million and $41 million for the years ended December 31, 1998 and 1997, respectively, and are reported as a component of "Salaries and other benefits."

(9) POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits Other Than Pensions

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

The Reserve Banks fund benefits payable under the medical and life insurance plans as due and, accordingly, have no plan assets. Net postretirement benefit cost is actuarially determined, using a January 1 measurement date.

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NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

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

	1998	1997
Accumulated postretirement benefit obligation at January 1	$588	$582
Service cost—benefits earned during the period	15	15
Interest cost of accumulated benefit obligation	39	39
Actuarial loss (gain)	41	(14)
Contributions by plan participants	3	3
Benefits paid	(24)	(22)
Plan amendments, acquisitions, foreign currency exchange rate changes, business combinations, diverstitures, curtailments, settlements, special termination benefits	(17)	(15)
Accumulated postretirement benefit obligation at December 31	$645	$588

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

	1998	1997
Fair value of plan assets at January 1	$ . . .	$ . . .
Actual return on plan assets	. . .	. . .
Contributions by the employer	21	19
Contributions by plan participants	3	3
Benefits paid	(24)	(22)
Fair value of plan assets at December 31	$ . . .	$ . . .
Unfunded postretirement benefit obligation	$645	$588
Unrecognized initial net transition asset (obligation)	. . .	(1)
Unrecognized prior service cost	100	92
Unrecognized net actuarial (loss)	(50)	(7)
Accrued postretirement benefit cost	$695	$672

Accrued postretirement benefit cost is reported as a component of "Accrued benefit cost."

The weighted-average assumption used in developing the postretirement benefit obligation as of December 31 is as follows:

	1998	1997
Discount rate	6.25%	7.00%

For measurement purposes, an 8.5% annual rate of increase in the cost of covered health care benefits was assumed for 1999. Ultimately, the health care cost trend rate is expected to decrease gradually to 4.75% by 2006, and remain at that level thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A 1 percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 1998 (in millions):

	1 Percentage Point Increase	1 Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit cost	$ 10	$ (10)
Effect on accumulated postretirement benefit obligation	106	(107)

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

	1998	1997
Service cost—benefits earned during the period	$15	$16
Interest cost of accumulated benefit obligation	39	40
Amortization of prior service cost	(8)	(6)
Recognized net actuarial loss	. . .	. . .
Net periodic postretirement benefit cost	$46	$50

Net periodic postretirement benefit cost is reported as a component of "Salaries and other benefits."

Postemployment Benefits

The Reserve Banks offer benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, disability benefits, and those workers' compensation expenses self-insured by individual Reserve Banks. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Reserve Banks at December 31, 1998 and 1997, were $84 million and $76 million, respectively. This cost is included as a component of "Accrued benefit cost." Net periodic postemployment benefit costs included in 1998 and 1997 operating expenses were $19 million and $17 million, respectively.

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Board of Governors Financial Statements

The financial statements of the Board for 1998 were audited by Deloitte & Touche LLP, independent auditors.

Deloitte & Touche LLP

INDEPENDENT AUDITORS' REPORT

To the Board of Governors of the
Federal Reserve System

We have audited the accompanying balance sheet of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 1998, and the related statements of revenues and expenses and fund balance, and of cash flows for the year then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Board for the year ended December 31, 1997, were audited by other auditors whose report, dated March 16, 1998, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 1998 financial statements referred to above present fairly, in all material respects, the financial position of the Board as of December 31, 1998, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 20, 1999, on our tests of the Board's compliance with certain provisions of laws, regulations, contracts, and grants and our consideration of the Board's internal control over financial reporting.

Deloitte & Touche LLP

April 20, 1999
Washington, DC

Deloitte Touche Tohmatsu

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEETS

	As of December 31, 1998	As of December 31, 1997
ASSETS		
CURRENT ASSETS		
Cash	$20,111,430	$ 23,364,834
Accounts receivable	910,282	1,071,278
Transfers receivable—surplus Federal Reserve Bank earnings (Note 1)	0	652,913,560
Prepaid expenses and other assets	1,215,277	992,096
Total current assets	22,236,989	678,341,768
PROPERTY, BUILDINGS, AND EQUIPMENT, NET (Note 5)	58,438,555	64,220,105
Total assets	$80,675,544	$742,561,873
LIABILITIES AND FUND BALANCE		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	$ 8,231,187	$ 9,797,829
Accrued payroll and related taxes	7,745,624	7,609,781
Transfers payable—surplus Federal Reserve Bank earnings (Note 1)	0	652,913,560
Accrued annual leave	7,493,533	7,477,187
Capital lease payable (current portion)	135,205	98,772
Unearned revenues and other liabilities	2,034,129	2,016,190
Total current liabilities	25,639,678	679,913,319
CAPITAL LEASE PAYABLE (non-current portion)	406,773	516,228
ACCUMULATED RETIREMENT BENEFIT OBLIGATION (Note 2)	773,177	740,497
ACCUMULATED POSTRETIREMENT BENEFIT OBLIGATION (Note 3)	20,721,869	20,193,034
ACCUMULATED POSTEMPLOYMENT BENEFIT OBLIGATION (Note 4)	2,183,602	1,769,646
Total liabilities	49,725,099	703,132,724
FUND BALANCE	30,950,445	39,429,149
Total liabilities and fund balance	$80,675,544	$742,561,873

See notes to financial statements.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF REVENUES AND EXPENSES AND FUND BALANCE

	For the years ended December 31, 1998	1997
BOARD OPERATING REVENUES		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures	$ 178,008,900	$ 174,406,600
Other revenues (Note 6)	8,345,087	9,460,475
Total operating revenues	186,353,987	183,867,075
BOARD OPERATING EXPENSES		
Salaries	110,455,527	108,870,919
Retirement and insurance contributions	18,684,301	19,835,377
Contractual services and professional fees	17,913,599	10,735,745
Depreciation and net losses on disposals	13,013,690	9,306,428
Postage and supplies	6,843,836	4,261,161
Travel	5,170,630	4,680,031
Utilities	4,798,940	4,172,795
Software	4,344,064	4,130,603
Equipment and facilities rental	4,257,297	4,291,093
Repairs and maintenance	3,280,615	2,895,097
Printing and binding	2,138,315	2,707,738
Other expenses (Note 6)	3,931,877	3,665,738
Total operating expenses	194,832,691	179,552,725
BOARD OPERATING REVENUES OVER (UNDER) EXPENSES	(8,478,704)	4,314,350
ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES		
Assessments levied on Federal Reserve Banks for currency costs	408,544,472	363,738,623
Expenses for currency printing, issuance, retirement, and shipping	408,544,472	363,738,623
CURRENCY ASSESSMENTS OVER (UNDER) EXPENSES	0	0
TOTAL REVENUE OVER (UNDER) EXPENSES	(8,478,704)	4,314,350
FUND BALANCE, Beginning of year	39,429,149	35,114,799
TRANSFERS TO THE U.S. TREASURY		
Transfers and accrued transfers from surplus Federal Reserve Bank earnings (Note 1)	18,438,855,572	20,765,972,296
Transfers and accrued transfers to the U.S. Treasury (Note 1)	(18,438,855,572)	(20,765,972,296)
FUND BALANCE, End of year	$ 30,950,445	$ 39,429,149

See notes to financial statements.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF CASH FLOWS

	For the years ended December 31,	
	1998	1997
CASH FLOWS FROM OPERATING ACTIVITIES		
Board operating revenues over (under) expenses	$ (8,478,704)	$ 4,314,350
Adjustments to reconcile operating revenue over (under) expenses to net cash provided by operating activities:		
Depreciation and net losses on disposals	13,013,690	9,306,428
(Increase) decrease in accounts receivable, prepaid expenses and other assets	(62,185)	2,745,993
(Increase) decrease in transfers receivable—surplus Federal Reserve Bank earnings	652,913,560	6,949,042
Increase (decrease) in accounts payable and accrued liabilities	(1,566,642)	(637,716)
Increase (decrease) in payroll payable and related taxes	135,843	805,103
Increase (decrease) in transfers payable—surplus Federal Reserve Bank earnings	(652,913,560)	(6,949,042)
Increase (decrease) in accrued annual leave	16,346	510,860
Increase (decrease) in capital lease payable	(73,022)	0
Increase (decrease) in unearned revenues and other liabilities	17,939	(247,148)
Increase (decrease) in accumulated retirement benefits	32,680	274,441
Increase (decrease) in accumulated postretirement benefits	528,835	2,021,312
Increase (decrease) in accumulated postemployment benefits	413,956	360,303
Net cash provided by operating activities	3,978,736	19,453,926
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from disposals of furniture and equipment	16,400	18,301
Capital expenditures	(7,248,540)	(11,819,651)
Net cash used in investing activities	(7,232,140)	(11,801,350)
NET INCREASE (DECREASE) IN CASH	(3,253,404)	7,652,576
CASH BALANCE, Beginning of year	23,364,834	15,712,258
CASH BALANCE, End of year	$ 20,111,430	$23,364,834
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Capital lease obligations incurred	$ 0	$ 615,000

See notes to financial statements.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOTES TO FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 1998 AND 1997

(1) SIGNIFICANT ACCOUNTING POLICIES

Board Operating Revenues and Expenses—Assessments made on the Federal Reserve Banks for Board operating expenses and capital expenditures are calculated based on expected cash needs. These assessments, other operating revenues, and operating expenses are recorded on the accrual basis of accounting.

Issuance and Redemption of Federal Reserve Notes—The Board incurs expenses and assesses the Federal Reserve Banks for the costs of printing, issuing, shipping, and retiring Federal Reserve Notes. These assessments and expenses are separately reported in the statements of revenues and expenses because they are not Board operating transactions.

Property, Buildings and Equipment—The Board's property, buildings and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 4 to 10 years for furniture and equipment and from 10 to 50 years for building equipment and structures. Upon the sale or other disposition of a depreciable asset, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is recognized.

Federal Reserve Bank Surplus Earnings—The Omnibus Budget Reconciliation Act of 1993 required that surplus Federal Reserve Bank earnings be transferred from the Banks to the Board and then to the U.S. Treasury for the period October 1, 1996, to September 30, 1998. Prior to October 1, 1996 and after September 30, 1998, the Federal Reserve Banks made their transfers directly to the Treasury. The Board accounted for these transfers when earned and due, which may result in transfers receivable and payable as of the balance sheet date.

Estimates—The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications—Certain 1997 amounts have been reclassified to conform with the 1998 presentation.

(2) RETIREMENT BENEFITS

Substantially all of the Board's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). The System Plan is a multiemployer plan which covers employees of the Federal Reserve Banks, the Board, and the Plan Administrative Office. Employees of the Board who entered on duty prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who entered on duty after 1983 are covered by a non-contributory defined benefits program under the System Plan. Contributions to the System Plan are actuarially determined and funded by participating employers at amounts prescribed by the System Plan's administrator. Based on actuarial calculations, it was determined that employer funding contributions were not required for the years 1998 and 1997, and the Board was not assessed a contribution for these years. Excess Plan assets will continue to fund future years' contributions. The Board is not accountable for the assets of this plan.

A relatively small number of Board employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). The Board matches employee contributions to these plans. These defined benefits plans are administered by the Office of Personnel Management. The Board's contributions to these plans totaled $233,000 and $196,000 in 1998 and 1997, respectively. The Board has no liability for future payments to retirees under these programs, and it is not accountable for the assets of the plans.

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan. Under the Thrift Plan, members may contribute up to a fixed percentage of their salary. Board contributions are based upon a fixed percentage of each member's basis contribution and were $4,794,000 and $4,772,000 in 1998 and 1997, respectively.

Effective January 1, 1996, Board employees covered under the System Plan are also covered under a Benefits Equalization Plan (BEP). Benefits paid under the BEP are limited to those benefits that cannot be paid from the System Plan because of limitations imposed by Sections 401(a)(17), 415(b), and 415(e) of the Internal Revenue Code of 1986. Pension costs attributed to the BEP reduce the pension costs of the System Plan. Activity for 1998 and 1997 is summarized in the following table:

	1998	1997
Change in benefit obligation		
Benefit obligation at beginning of year	$528,000	$1,118,000
Service cost	65,000	133,000
Interest cost	21,000	81,000
Plan participants' contributions	0	0
Plan amendments	0	(820,000)
Actuarial (gain)/loss	320,000	16,000
Benefits paid	(36,000)	0
Benefit obligation at end of year	$898,000	$ 528,000

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	1998	1997
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	36,000	0
Plan participants' contributions	0	0
Benefits paid	(36,000)	0
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
Funded status	($ 898,000)	($ 528,000)
Unrecognized net actuarial (gain)/ loss	(609,177)	(476,497)
Unrecognized prior service cost	(424,000)	(996,000)
Unrecognized net transistion obligation	1,158,000	1,260,000
Prepaid/(accrued) postretirement benefit cost	($ 773,177)	($ 740,497)
Weighted-average assumptions as of December 31		
Discount rate	6.25%	7.00%
Rate of compensation increase	4.25%	5.00%
Components of net periodic expense for year		
Service cost	$ 65,000	$ 133,000
Interest cost	21,000	81,000
Expected return on plan assets	0	0
Amortization of net liability	103,000	103,000
Amortization of prior service cost	(73,000)	(14,000)
Recognized net actuarial gain	(48,000)	(29,000)
Special termination benefit	0	0
Total net periodic expense	$ 68,000	$ 274,000

(3) Postretirement Benefits

The Board provides certain defined benefit health and life insurance for its active employees and retirees. Activity for 1998 and 1997 is summarized in the following table:

	1998	1997
Change in benefit obligation		
Benefit obligation at beginning of year	$22,973,898	$21,329,126
Service cost	133,733	154,474
Interest cost	1,397,922	1,474,782
Plan participants' contributions	195,272	187,788
Plan amendments	0	1,161,618
Actuarial (gain)/loss	(549,800)	(251,176)
Benefits paid	(1,204,713)	(1,082,714)
Benefit obligation at end of year	$22,946,312	$22,973,898
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	1,009,441	894,926
Plan participants' contributions	195,272	187,788
Benefits paid	(1,204,713)	(1,082,714)
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
Funded status	($22,946,312)	($22,973,898)
Unrecognized net actuarial (gain)/loss	2,224,443	2,780,864
Unrecognized prior service cost	0	0
Unrecognized net transition obligation	0	0
Prepaid/(accrued) postretirement benefit cost	($20,721,869)	($20,193,034)
Components of net periodic expense for year		
Service cost	$ 133,733	$ 154,474
Interest cost	1,397,922	1,474,782
Amortization of prior service cost	0	0
Amortization of (gains)/losses	6,621	1,286,982
Total net periodic expense	$ 1,538,276	$ 2,916,238

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	1998	1997
Effect of a one-percentage point increase in health care cost trend rate on:		
Year-end benefit obligation	$ 2,382,383	$ 1,777,007
Total of service and interest cost components	97,751	172,488
Effect of a one-percentage point decrease in health care cost trend rate on:		
Year-end benefit obligation	$(1,885,077)	$(2,536,859)
Total of service and interest cost components	(156,553)	(152,179)

The liability and costs for the postretirement benefit plan were determined using discount rates of 6.25 percent as of December 31, 1998 and 7.00 percent as of December 31, 1997. Unrecognized losses of $2,224,443 and $2,780,864 as of December 31, 1998 and 1997, respectively, result from changes in the discount rate used to measure the liabilities. Under Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, the Board may have to record some of these unrecognized losses in operations in future years. The assumed health care cost trend rate for measuring the increase in costs from 1998 to 1999 was 8.50 percent. These rates were assumed to gradually decline to an ultimate rate of 4.75 percent in the year 2006 for the purpose of calculating the December 31, 1998 accumulated postretirement benefit obligation. The assumed salary trend rate for measuring the increase in postretirement benefits related to life insurance was an average of 5 percent.

The above accumulated postretirement benefit obligation is related to the Board sponsored health benefits and life insurance programs. During 1997, a special retirement program was offered to employees who were eligible to retire by May 31, 1998. This resulted in a curtailment loss of $1,174,489 for 1997, comprised of $1,044,096 for 62 employees covered by the Board sponsored health benefits plan, and $130,393 for 78 employees covered by the Board sponsored life insurance plan. The Board has no liability for future payments to employees who continue coverage under the federally sponsored programs upon retiring. Contributions for active employees participating in federally sponsored programs totaled $3,839,000 and $3,667,000 in 1998 and 1997, respectively.

The medical component of the benefit obligation at end of year 1998 was $18,538,000. Pursuant to the Federal Employees Health Care Act of 1998, on January 11, 1999, the Board paid the Office of Personnel Management $16,100,000 to compensate the Employee Health Benefits Fund for the costs of providing future health care benefits. Coverage for Board employees and retirees enrolled in the Federal Reserve System Health Plan terminated involuntarily on December 31, 1998.

(4) Postemployment Benefit Plan

The Board provides certain postemployment benefits to eligible employees after employment but before retirement. Effective January 1, 1994, the Board adopted Statement of Financial Accounting Standards No. 112, Employers' Accounting for Postemployment Benefits, which requires that employers providing postemployment benefits to their employees accrue the cost of such benefits. Prior to January 1994, postemployment benefit expenses were recognized on a pay-as-you-go basis. The postemployment benefit expense was $614,000 and $516,000 for 1998 and 1997, respectively.

(5) Property, Buildings and Equipment

The following is a summary of the components of the Board's fixed assets, at cost, net of accumulated depreciation.

	As of December 31,	
	1998	1997
Land and improvements	$ 1,301,314	$ 1,301,314
Buildings	43,162,040	65,611,228
Furniture and equipment	46,133,411	63,486,071
	90,596,765	130,398,613
Less accumulated depreciation	(32,158,210)	(66,178,508)
Total property, buildings and equipment	$ 58,438,555	$ 64,220,105

Furniture and equipment and accumulated depreciation as of December 31, 1998 includes $615,000, and $102,500, respectively, for capitalized leases, which were acquired during 1997.

During 1998 the Board increased the threshold for capitalization of furniture and equipment from $1,000 to $5,000 per item. The Board expensed the undepreciated value of previously capitalized furniture and equipment not meeting the new capitalization threshold. The Board also simplified the method of capitalizing major building modifications, eliminating the previously used depreciation recovery method of reporting. For 1998, these changes increased depreciation expense $4,033,000, decreased cost by $44,112,000, and decreased accumulated depreciation by $40,079,000.

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(6) Other Revenues and Other Expenses

The following are summaries of the components of Other Revenues and Other Expenses.

	For the years ended December 31,	
	1998	1997
Other Revenues		
Data processing revenue	$4,332,513	$5,184,075
National Information Center	2,052,273	2,156,191
Subscription revenue	1,248,121	1,394,394
Reimbursable services to other agencies	147,491	399,426
Miscellaneous	564,689	326,389
Total Other Revenues	$8,345,087	$9,460,475
Other Expenses		
Tuition, registration, and membership fees	$1,428,717	$1,118,683
Cafeteria operations, net	756,548	794,019
Subsidies and contributions	666,843	653,207
Miscellaneous	1,079,769	1,099,829
Total Other Expenses	$3,931,877	$3,665,738

(7) Commitments

The Board has entered into several operating leases to secure office, training, and warehouse space for periods ranging from one to ten years. Minimum future commitments under those leases having an initial or remaining noncancelable lease term in excess of one year at December 31, 1998, are as follows:

1999	$ 4,148,000
2000	4,851,000
2001	4,846,000
2002	4,820,000
after 2002	15,757,000
	$34,422,000

Rental expenses under the operating leases were $3,873,000 and $3,960,000 in 1998 and 1997, respectively.

(8) Federal Financial Institutions Examination Council

The Board is one of the five member agencies of the Federal Financial Institutions Examination Council (the "Council"). During 1998 and 1997, the Board paid $249,000 and $228,000, respectively, in assessments for operating expenses of the Council. These amounts are included in other expenses for 1998 and 1997. During 1998 and 1997, the Board paid $159,000 and $158,000, respectively, for office space subleased from the Council. ■

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Statistical Tables

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1. Statement of Condition of Each Federal Reserve Bank, December 31, 1998 and 1997

Million of dollars

Item	Total 1998	Total 1997	Boston 1998	Boston 1997
Assets				
Gold certificate account	11,046	11,047	582	624
Special drawing rights certificate account	9,200	9,200	530	530
Coin	358	460	23	23
Loans				
To depository institutions	17	2,035	0	21
Other	0	0	0	0
Acceptances bought outright and held under repurchase agreements	0	0	0	0
Federal agency obligations				
Bought outright	338	685	18	42
Held under repurchase agreements	10,702	2,652	0	0
U.S. Treasury securities				
Bought outright[1]	452,141	430,736	24,625	26,259
Held under repurchase agreements	19,674	21,188	0	0
Total loans and securities	482,872	457,295	24,643	26,322
Items in process of collection	7,582	8,378	539	441
Bank premises	1,301	1,272	94	94
Other assets				
Denominated in foreign currencies[2]	19,769	17,046	958	637
All other[3]	16,628	13,722	683	697
Interdistrict Settlement Account	0	0	1,172	−3,621
Total assets	**548,756**	**518,420**	**29,225**	**25,746**
Liabilities				
Federal Reserve notes	491,657	457,469	26,417	22,984
Deposits				
Depository institutions	26,306	30,838	1,568	1,544
U.S. Treasury, general account	6,086	5,444	0	0
Foreign, official accounts	167	457	7	5
Other[4]	1,619	897	68	2
Total deposits	34,179	37,636	1,643	1,551
Deferred credit items	6,574	7,817	392	412
Other liabilities and accrued dividends[5]	4,442	4,845	238	283
Total liabilities	**536,852**	**507,767**	**28,690**	**25,231**
Capital Accounts				
Capital paid in	5,952	5,433	267	262
Surplus	5,952	5,220	267	254
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	**548,756**	**518,420**	**29,225**	**25,746**
Federal Reserve Note Statement				
Federal Reserve notes outstanding (issued to Bank)	611,688	549,600	30,296	27,943
Less: Held by Federal Reserve Bank	120,030	92,131	3,879	4,959
Federal Reserve notes, net	**491,657**	**457,469**	**26,417**	**22,984**
Collateral for Federal Reserve notes				
Gold certificate account	11,046	11,047	...	...
Special drawing rights certificate account	9,200	9,200	...	...
Other eligible assets	0	0	...	...
U.S. Treasury and federal agency securities	471,412	437,222	...	...
Total collateral	**491,657**	**457,469**	...	...

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1—Continued

New York		Philadelphia		Cleveland		Richmond	
1998	1997	1998	1997	1998	1997	1998	1997
4,206	3,934	323	350	643	669	807	965
3,202	3,202	282	282	574	574	792	792
15	20	23	53	16	27	53	64
0	1,465	0	16	0	0	0	0
0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0
125	221	10	23	22	47	27	65
10,702	2,652	0	0	0	0	0	0
167,582	139,322	13,145	14,400	29,386	29,794	35,617	40,983
19,674	21,188	0	0	0	0	0	0
198,083	164,848	13,155	14,438	29,408	29,842	35,644	41,048
745	1,026	266	222	527	352	624	474
158	156	50	51	158	132	125	126
4,002	3,885	1,034	1,014	1,271	1,083	3,066	1,177
8,465	5,941	475	384	815	764	1,083	1,157
–5,656	16,310	2,181	–162	–4,170	–1,888	4,985	–8,468
213,219	**199,322**	**17,790**	**16,632**	**29,242**	**31,556**	**47,179**	**37,336**
194,182	179,316	16,456	13,970	26,164	28,441	41,577	32,459
7,533	9,257	433	1,720	1,574	1,815	1,898	2,062
6,086	5,444	0	0	0	0	0	0
53	346	8	9	9	9	22	10
484	360	147	11	89	54	188	77
14,156	15,406	588	1,740	1,672	1,879	2,109	2,149
809	794	242	184	334	235	676	650
1,654	1,643	151	181	275	316	342	427
210,802	**197,159**	**17,437**	**16,075**	**28,445**	**30,871**	**44,704**	**35,684**
1,208	1,108	177	284	399	349	1,238	833
1,208	1,055	177	273	399	335	1,238	818
0	0	0	0	0	0	0	0
213,219	**199,322**	**17,790**	**16,632**	**29,242**	**31,556**	**47,179**	**37,336**
239,794	209,843	18,434	16,784	29,535	31,706	50,920	39,172
45,611	30,527	1,978	2,815	3,370	3,265	9,343	6,713
194,182	**179,316**	**16,456**	**13,970**	**26,164**	**28,441**	**41,577**	**32,459**
...	...	...	...	...	...	...	...
			...	...	...		...
...	...	...	...	...	...	...	...
	...	...	...	...	...	...	...

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1. Statement of Condition of Each Federal Reserve Bank, December 31, 1998 and 1997—Continued

Millions of dollars

Item	Atlanta		Chicago	
	1998	1997	1998	1997
ASSETS				
Gold certificate account	717	723	998	1,069
Special drawing rights certificate account	602	602	900	900
Coin	44	45	35	52
Loans				
To depository institutions	4	163	3	13
Other	0	0	0	0
Acceptances bought outright and held under repurchase agreements	0	0	0	0
Federal agency obligations				
Bought outright	21	46	32	73
Held under repurchase agreements	0	0	0	0
U.S. Treasury securities				
Bought outright[1]	27,504	28,743	43,406	45,944
Held under repurchase agreements	0	0	0	0
Total loans and securities	27,529	28,952	43,442	46,031
Items in process of collection	1,050	1,287	794	773
Bank premises	82	78	107	108
Other assets				
Denominated in foreign currencies[2]	1,295	1,574	1,911	1,989
All other[3]	807	764	1,185	1,222
Interdistrict Settlement Account	4,780	793	1,838	-5,705
Total assets	**36,906**	**34,818**	**51,210**	**46,438**
LIABILITIES				
Federal Reserve notes	33,103	30,390	44,608	40,531
Deposits				
Depository institutions	1,769	2,081	4,282	3,570
U.S. Treasury, general account	0	0	0	0
Foreign, official accounts	9	13	14	17
Other[4]	81	99	121	125
Total deposits	1,860	2,193	4,416	3,712
Deferred credit items	821	1,210	609	679
Other liabilities and accrued dividends[5]	285	328	410	487
Total liabilities	**36,069**	**34,121**	**50,044**	**45,409**
CAPITAL ACCOUNTS				
Capital paid in	418	359	583	527
Surplus	418	338	583	502
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	**36,906**	**34,818**	**51,210**	**46,438**
FEDERAL RESERVE NOTE STATEMENT				
Federal Reserve notes outstanding (issued to Bank)	44,429	38,413	54,114	47,119
Less: Held by Federal Reserve Bank	11,326	8,023	9,506	6,589
Federal Reserve notes, net	**33,103**	**30,390**	**44,608**	**40,531**

NOTE. Differences may exist between amounts reported in these statistical tables and amounts reported in the audited Federal Reserve Bank financial statements because of intercompany eliminations, reclassifications, and rounding required for presentation of the audited data based on generally accepted accounting principles (GAAP).

Components may not sum to totals because of rounding.

1. Includes securities loaned—fully guaranteed by U.S. Treasury securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale–purchase transactions.

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1—Continued

St. Louis		Minneapolis		Kansas City		Dallas		San Francisco	
1998	1997	1998	1997	1998	1997	1998	1997	1998	1997
358	401	128	147	289	286	530	459	1,465	1,420
340	340	123	123	247	247	367	367	1,241	1,241
19	15	16	20	24	36	40	37	52	68
7	4	0	5	2	13	0	0	1	335
0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0
12	27	4	10	9	20	15	25	42	86
0	0	0	0	0	0	0	0	0	0
15,889	17,156	4,967	5,999	12,543	12,299	20,558	15,643	56,919	54,194
0	0	0	0	0	0	0	0	0	0
15,908	17,186	4,971	6,014	12,554	12,332	20,574	15,668	56,962	54,615
516	93	510	701	496	440	392	359	1,123	2,210
31	31	130	132	54	55	149	150	162	159
462	424	710	395	456	647	1,029	951	3,574	3,270
444	439	169	191	362	331	583	420	1,558	1,411
−1,841	−534	1,381	−1,205	1,324	880	1,679	5,259	−7,673	−1,658
16,235	**18,396**	**8,139**	**6,517**	**15,806**	**15,253**	**25,343**	**23,670**	**58,463**	**62,737**
14,701	16,422	6,136	4,792	14,256	13,541	23,072	20,007	50,984	54,617
692	1,244	1,039	629	652	761	1,166	2,479	3,700	3,677
0	0	0	0	0	0	0	0	0	0
3	4	5	3	3	5	7	8	26	28
32	29	33	5	50	63	105	13	222	59
727	1,276	1,077	637	706	830	1,278	2,501	3,948	3,763
398	252	442	610	414	473	334	424	1,102	1,893
168	197	79	96	149	164	205	184	486	539
15,994	**18,147**	**7,734**	**6,135**	**15,525**	**15,007**	**24,889**	**23,116**	**56,520**	**60,812**
121	127	202	194	140	127	227	283	972	980
121	122	202	189	140	119	227	271	972	945
0	0	0	0	0	0	0	0	0	0
16,235	**18,396**	**8,139**	**6,517**	**15,806**	**15,253**	**25,343**	**23,670**	**58,463**	**62,737**
17,290	18,568	7,690	6,480	17,214	15,339	33,678	26,054	68,294	72,179
2,589	2,145	1,554	1,689	2,958	1,798	10,606	6,047	17,310	17,562
14,701	**16,422**	**6,136**	**4,792**	**14,256**	**13,541**	**23,072**	**20,007**	**50,984**	**54,617**

2. Valued monthly at market exchange rates.

3. The Federal Reserve System total includes depository institution overdrafts of $11 million for 1998 and $33 million for 1997.

4. Includes international organization deposits of $104 million for 1998 and $100 million for 1997. These deposits are held solely by the Federal Reserve Bank of New York.

5. Includes exchange-translation account reflecting the monthly revaluation at market exchange rates of foreign-exchange commitments.

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2. Federal Reserve Open Market Transactions, 1998

Millions of dollars

Type of security and transaction	Jan.	Feb.	Mar.	Apr.
U.S. TREASURY SECURITIES				
Outright transactions (excluding matched transactions)				
Treasury bills				
Gross purchases	0	0	0	3,550
Gross sales	0	0	0	0
Exchanges	41,371	35,495	34,025	46,802
New bills	41,371	35,495	34,025	46,802
Redemptions	2,000	0	0	0
Others within 1 year				
Gross purchases	0	0	1,501	1,369
Gross sales	0	0	0	0
Maturity shift	3,447	6,098	1,964	4,369
Exchanges	−400	−6,128	−5,736	−2,601
Redemptions	478	0	0	286
0 to 5 years				
Gross purchases	0	0	2,262	2,993
Gross sales	0	0	0	0
Maturity shift	−3,447	−3,213	−1,964	−4,369
Exchanges	0	3,383	5,736	2,201
5 to 10 years				
Gross purchases	0	0	283	495
Gross sales	0	0	0	0
Maturity shift	0	−2,884	0	0
Exchanges	400	1,420	0	0
More than 10 years				
Gross purchases	0	0	743	0
Gross sales	0	0	0	0
Maturity shift	0	0	0	0
Exchanges	0	1,325	0	400
All maturities				
Gross purchases	0	0	4,789	8,407
Gross sales	0	0	0	0
Redemptions	2,478	0	0	286
Matched transactions				
Gross purchases	332,581	326,813	364,307	354,756
Gross sales	332,795	326,235	364,537	354,741
Repurchase agreements				
Gross purchases	45,544	33,428	40,211	59,548
Gross sales	65,932	30,583	37,010	50,663
Net change in U.S. Treasury securities	−23,079	3,423	7,760	17,021
FEDERAL AGENCY OBLIGATIONS				
Outright transactions				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Redemptions	0	10	50	74
Repurchase agreements				
Gross purchases	12,488	9,615	17,685	13,547
Gross sales	13,872	8,776	18,342	13,042
Net change in agency obligations	−1,384	829	−707	431
Total net change in System Open Market Account	**−24,463**	**4,252**	**7,053**	**17,452**

NOTE. Sales, redemptions, and negative figures reduce holdings of the System Open Market Account; all other figures increase such holdings. Components may not sum to totals because of rounding.

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Federal Reserve Bank of St. Louis

2—Continued

May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
0	0	0	0	0	0	0	0	3,550
0	0	0	0	0	0	0	0	0
35,190	32,830	40,312	34,607	33,140	40,712	34,957	41,393	450,835
35,190	32,830	40,312	34,607	33,140	40,712	34,957	41,393	450,835
0	0	0	0	0	0	0	0	2,000
0	0	0	986	1,038	741	662	0	6,297
0	0	0	0	0	0	0	0	0
6,951	1,520	2,638	6,367	2,301	2,423	5,444	2,539	46,062
−4,990	−5,084	−2,242	−8,964	−2,242	−400	−8,093	−2,555	−49,434
0	0	1,311	0	0	602	0	0	2,676
0	0	0	535	3,989	725	2,397	0	12,901
0	0	0	0	0	0	0	0	0
−6,620	−1,520	−2,638	−2,168	−2,301	−2,423	−4,574	−2,539	−37,777
2,270	5,084	1,842	5,828	2,242	0	6,013	2,555	37,154
0	0	0	303	351	0	862	0	2,294
0	0	0	0	0	0	0	0	0
−331	0	0	−3,411	0	0	718	0	−5,908
2,720	0	0	1,364	0	400	1,135	0	7,439
0	0	0	1,769	0	1,674	698	0	4,884
0	0	0	0	0	0	0	0	0
0	0	0	−789	0	0	−1,589	0	−2,377
0	0	400	1,772	0	0	945	0	4,842
0	0	0	3,593	5,377	3,140	4,619	0	29,926
0	0	0	0	0	0	0	0	0
0	0	1,311	0	0	602	0	0	4,676
367,934	369,358	373,285	346,245	380,594	402,581	358,438	418,538	4,399,330
368,281	370,569	371,142	348,318	382,063	400,995	359,256	420,397	4,395,430
7,722	57,098	52,116	39,078	63,924	40,823	23,884	49,296	512,671
20,456	41,414	63,531	38,402	59,731	48,672	19,200	38,592	514,186
−13,081	14,473	−10,584	2,196	8,101	−3,725	8,484	8,845	19,835
0	0	0	0	0	0	0	0	0
0	0	0	25	0	0	0	0	25
0	25	0	50	48	15	20	30	322
1,575	14,548	11,236	33,431	18,486	51,471	51,419	48,815	284,316
3,300	12,913	12,341	30,625	19,953	50,032	48,785	44,285	276,266
−1,725	1,610	−1,105	2,731	−1,515	1,424	2,614	4,500	7,703
−14,806	**16,083**	**−11,689**	**4,927**	**6,586**	**−2,301**	**11,098**	**13,345**	**27,538**

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3. Federal Reserve Bank Holdings of U.S. Treasury and Federal Agency Securities, December 31, 1996–98

Millions of dollars

Description	December 31			Change	
	1998	1997	1996	1997 to 1998	1996 to 1997
U.S. TREASURY SECURITIES					
Held outright[1]	**473,068**	**447,762**	**405,613**	**25,306**	**42,149**
By remaining maturity					
Bills					
1–90 days	106,996	112,892	106,063	–5,896	6,829
91 days to 1 year	108,703	101,257	99,289	7,446	1,968
Notes and bonds					
1 year or less	49,149	49,370	29,045	–221	20,325
More than 1 year through 5 years	107,730	95,028	95,608	12,702	–580
More than 5 years through 10 years	44,822	40,907	33,782	3,915	7,125
More than 10 years	55,668	48,308	41,826	7,360	6,482
By type					
Bills	215,699	214,149	205,353	1,550	8,796
Notes	187,895	174,206	150,922	13,689	23,284
Bonds	69,474	59,407	49,339	10,067	10,068
Repurchase agreements	**19,674**	**21,188**	**19,971**	**–1,514**	**1,217**
MSPs, foreign accounts	**20,927**	**17,027**	**14,706**	**3,900**	**2,321**
MSPs, in the market	**0**	**0**	**0**	**0**	**0**
FEDERAL AGENCY SECURITIES					
Held outright[1]	**338**	**685**	**2,225**	**–347**	**–1,540**
By remaining maturity					
1 year or less	102	252	1,223	–150	–971
More than 1 year through 5 years	61	153	520	–92	–367
More than 5 years through 10 years	175	255	457	–80	–202
More than 10 years	0	25	25	–25	0
By issuer					
Federal Farm Credit Banks	10	10	912	0	–902
Federal Home Loan Banks	38	57	115	–19	–58
Federal Land Banks	0	0	17	0	–17
Federal National Mortgage Association	290	618	1,181	–328	–563
Repurchase agreements	**10,702**	**2,652**	**1,612**	**8,050**	**1,040**

NOTE. Components may not sum to totals because of rounding.

1. Excludes the effects of temporary transactions—repurchase agreements and matched sale–purchase agreements (MSPs).

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Federal Reserve Bank of St. Louis

4. Number and Annual Salaries of Officers and Employees of Federal Reserve Banks, December 31, 1998

Federal Reserve Bank (including Branches)	President	Other officers		Employees			Total	
	Salary (dollars)	Number	Salaries (dollars)	Number: Full-time	Number: Part-time	Salaries (dollars)	Number	Salaries (dollars)
Boston	201,600	59	6,679,597	1,046	171	49,865,200	1,277	56,746,397
New York	258,200	253	35,301,965	3,488	84	171,825,348	3,826	207,385,513
Philadelphia	228,100	56	6,358,100	1,126	40	45,329,834	1,223	51,916,034
Cleveland	204,500	47	5,134,890	1,305	52	47,212,600	1,405	52,551,990
Richmond	202,600	82	8,369,500	1,904	163	71,145,099	2,150	79,717,199
Atlanta	217,250	87	9,254,500	2,398	53	84,187,224	2,539	93,658,974
Chicago	228,000	88	9,891,080	1,964	70	84,920,403	2,123	95,039,483
St. Louis	193,000	61	5,923,800	1,084	74	39,963,224	1,220	46,080,024
Minneapolis	214,600	45	4,885,650	1,098	113	42,213,508	1,257	47,313,758
Kansas City	201,100	59	5,994,201	1,418	64	52,839,496	1,542	59,034,796
Dallas	202,000	57	5,946,500	1,371	61	53,640,685	1,490	59,789,185
San Francisco	282,500	106	12,616,000	2,360	83	106,728,026	2,550	119,626,526
Federal Reserve Information Technology	0	24	2,939,300	533	11	31,478,133	568	34,417,433
Total	**2,633,450**	**1,024**	**119,295,083**	**21,095**	**1,039**	**881,348,779**	**23,170**	**1,003,277,312**

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Federal Reserve Bank of St. Louis

5. Income and Expenses of Federal Reserve Banks, 1998

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
CURRENT INCOME					
Loans	8,783	340	1,194	64	194
U.S. Treasury and federal agency securities	26,842,437	1,492,766	9,802,637	803,569	1,754,431
Foreign currencies	435,220	20,795	88,982	22,934	27,946
Priced services	816,019	72,813	99,723	40,176	52,393
Other	47,019	636	33,890	1,713	552
Total	**28,149,477**	**1,587,349**	**10,026,426**	**868,456**	**1,835,516**
CURRENT EXPENSES					
Salaries and other personnel expenses	1,078,887	60,362	224,927	54,448	55,381
Retirement and other benefits	279,229	16,931	63,264	13,668	15,257
Net periodic pension costs[1]	−288,444	−1	−288,604	18	1
Fees	45,784	7,265	8,306	904	1,951
Travel	46,492	2,027	6,818	2,167	2,670
Software expenses	61,175	3,825	7,885	1,794	2,242
Postage and other shipping costs	78,791	35,423	5,686	1,289	2,191
Communications	9,933	365	2,077	348	611
Materials and supplies	55,515	2,467	11,184	3,256	2,790
Building expenses					
Taxes on real estate	28,188	4,169	4,160	1,520	2,236
Property depreciation	61,900	4,020	10,873	2,763	5,145
Utilities	29,196	2,354	6,123	2,456	2,000
Rent	33,964	668	11,079	294	2,048
Other	27,920	649	7,379	1,283	1,458
Equipment					
Purchases	9,036	520	1,848	709	327
Rentals	31,632	221	2,131	282	204
Depreciation	122,176	6,152	20,087	5,418	5,121
Repairs and maintenance	81,318	4,526	11,188	3,639	4,477
Earnings-credit costs	346,410	19,944	59,114	20,410	27,616
Other	66,022	4,042	14,630	1,907	3,455
Shared costs, net[2]	0	498	22,508	12,647	13,968
Recoveries	−71,086	−10,006	−8,200	−3,508	−1,831
Expenses capitalized[3]	−2,067	−210	0	−210	−340
Total	**2,131,971**	**166,214**	**204,463**	**127,499**	**148,977**
Reimbursements	−298,536	−16,887	−57,990	−24,389	−29,354
Net expenses	1,833,436	149,327	146,473	103,111	119,623

For notes see end of table.

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Federal Reserve Bank of St. Louis

5—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
428	526	1,263	931	1,983	904	77	878
2,211,659	1,657,072	2,625,338	966,913	313,396	741,531	1,136,404	3,336,721
65,353	29,142	42,536	10,190	15,310	10,406	22,736	78,891
65,133	108,025	94,588	41,060	46,698	55,028	56,270	84,114
1,160	1,305	2,141	353	659	178	540	3,890
2,343,733	**1,796,069**	**2,765,866**	**1,019,448**	**378,045**	**808,047**	**1,216,028**	**3,504,494**
124,593	101,233	101,491	51,121	50,359	63,348	63,839	127,785
32,169	25,950	27,108	14,286	12,542	13,420	17,602	27,031
26	31	37	18	1	32	0	−3
13,346	2,210	2,778	1,298	1,503	1,303	744	4,177
5,522	4,755	4,876	2,304	2,685	3,185	3,092	6,391
25,669	4,038	3,366	2,197	1,850	1,606	2,348	4,355
3,451	8,449	4,561	2,457	2,997	4,100	2,472	5,714
1,008	1,030	1,000	569	425	873	795	834
7,228	6,452	5,223	3,050	1,966	3,270	3,594	5,034
2,243	1,445	3,237	239	4,594	596	1,861	1,888
5,878	3,810	5,952	3,161	3,942	3,889	5,289	7,178
2,367	1,646	2,559	1,388	1,881	1,333	1,902	3,187
10,617	5,956	1,427	542	55	347	341	589
2,971	2,042	5,130	1,084	1,036	787	1,942	2,160
1,295	1,071	675	366	509	468	554	694
26,554	556	843	199	204	132	88	219
38,611	10,379	8,591	3,883	3,872	4,833	5,456	9,773
17,316	9,912	8,403	2,808	2,753	2,680	3,749	9,867
40,138	27,131	49,766	16,247	5,384	12,787	27,123	40,751
5,994	6,783	6,714	4,522	2,575	4,213	4,186	7,002
−146,782	13,334	22,207	11,669	9,501	18,080	14,130	8,241
−17,892	−6,905	−5,198	−1,287	−775	−1,061	−4,705	−9,719
−119	−532	−283	−121	0	−138	−60	−53
202,204	**230,776**	**260,461**	**121,999**	**109,860**	**140,082**	**156,340**	**263,096**
−31,227	−17,651	−22,142	−16,809	−20,223	−22,479	−10,533	−28,852
170,976	213,124	238,319	105,190	89,637	117,603	145,807	234,244

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Federal Reserve Bank of St. Louis

5. Income and Expenses of Federal Reserve Banks, 1998—Continued

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
PROFIT AND LOSS					
Current net income	26,316,041	1,438,022	9,879,953	765,345	1,715,893
Additions to and deductions from (–) current net income[4]					
Profits on sales of U.S. Treasury and federal agency securities	44,483	2,376	16,828	1,262	2,861
Profits on foreign exchange transactions	1,870,499	90,538	379,801	97,809	120,180
Other additions	197	13	15	0	14
Total additions	1,915,179	92,927	396,644	99,072	123,055
Other deductions	–729	–2	–44	–4	–2
Total deductions	–729	–2	–44	–4	–2
Net addition to or deduction from (–) current net income	1,914,450	92,926	396,600	99,068	123,053
Cost of unreimbursed Treasury services	8,412	235	714	3,457	751
Assessments by Board					
Board expenditures[5]	178,009	8,500	36,010	9,033	11,539
Cost of currency	408,544	20,526	160,139	12,476	25,399
Net income before payment to U.S. Treasury	27,635,525	1,501,687	10,079,690	839,448	1,801,257
Dividends paid	343,014	15,149	69,493	15,759	22,930
Payments to U.S. Treasury (interest on Federal Reserve notes)	8,774,994	451,882	3,097,657	385,606	546,945
Statutory transfer	17,785,942	1,020,803	6,759,420	534,413	1,168,239
Transferred to surplus	731,575	13,853	153,120	–96,330	63,142
Surplus, January 1	5,220,449	253,558	1,055,274	272,832	335,400
Surplus, December 31	5,952,024	267,411	1,208,394	176,503	398,543

NOTE. Also see note at the end of table 1.

Components may not sum to totals because of rounding.

1. Reflects the effect of Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). The System Retirement Plan for employees is recorded on behalf of the System on the books of the Federal Reserve Bank of New York, resulting in a reduction in expenses of $288,733 thousand. The Retirement Benefits Equalization Plan is recorded by each Federal Reserve Bank.

2. Includes distribution of costs for projects performed by one Reserve Bank for the benefit of one or more other Reserve Banks.

3. Includes expenses for labor and materials temporarily capitalized and charged to activities when the products are consumed.

4. Includes reimbursement from the U.S. Treasury for uncut sheets of Federal Reserve notes, gains and losses on the sale of Reserve Bank buildings, counterfeit currency that is not charged back to the depositing institution, and stale Reserve Bank checks that are written off.

5. For additional details, see the preceding chapter, "Board of Governors Financial Statements."

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Federal Reserve Bank of St. Louis

5—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
2,172,757	1,582,944	2,527,546	914,258	288,409	690,443	1,070,220	3,270,250
3,386	2,663	4,193	1,529	467	1,228	2,089	5,600
289,920	122,419	180,698	43,635	67,141	43,154	97,321	337,883
6	111	17	2	2	2	12	2
293,311	125,193	184,909	45,167	67,610	44,384	99,421	343,485
−329	−312	−11	−1	−8	−2	−9	−5
−329	−312	−11	−1	−8	−2	−9	−5
292,982	124,881	184,898	45,166	67,602	44,382	99,412	343,480
371	272	644	240	430	430	348	521
28,718	12,284	17,009	4,050	6,265	4,118	8,743	31,741
28,987	27,140	36,196	14,666	4,279	12,093	17,867	48,776
2,407,662	1,668,129	2,658,596	940,467	345,036	718,185	1,142,674	3,532,692
61,327	25,083	32,311	7,113	11,690	8,180	15,045	58,933
732,859	557,712	770,200	266,492	127,980	209,182	440,684	1,187,796
1,193,996	1,005,562	1,775,122	667,799	191,663	479,235	730,552	2,259,136
419,480	79,772	80,963	−936	13,704	21,588	−43,607	26,826
818,065	338,496	502,046	121,628	188,649	118,837	270,877	944,786
1,237,545	418,268	583,009	120,692	202,353	140,425	227,270	971,612

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6. Income and Expenses of Federal Reserve Banks, 1914–98

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (–)[1]	Assessments by Board of Governors	
				Board expenditures	Costs of currency
All Banks					
1914–15	2,173	2,018	6	302	. . .
1916	5,218	2,082	–193	192	. . .
1917	16,128	4,922	–1,387	238	
1918	67,584	10,577	–3,909	383	
1919	102,381	18,745	–4,673	595	
1920	181,297	27,549	–3,744	710	
1921	122,866	33,722	–6,315	741	
1922	50,499	28,837	–4,442	723	. . .
1923	50,709	29,062	–8,233	703	. . .
1924	38,340	27,768	–6,191	663	. . .
1925	41,801	26,819	–4,823	709	. . .
1926	47,600	24,914	–3,638	722	1,714
1927	43,024	24,894	–2,457	779	1,845
1928	64,053	25,401	–5,026	698	806
1929	70,955	25,810	–4,862	782	3,099
1930	36,424	25,358	–93	810	2,176
1931	29,701	24,843	311	719	1,479
1932	50,019	24,457	–1,413	729	1,106
1933	49,487	25,918	–12,307	800	2,505
1934	48,903	26,844	–4,430	1,372	1,026
1935	42,752	28,695	–1,737	1,406	1,477
1936	37,901	26,016	486	1,680	2,178
1937	41,233	25,295	–1,631	1,748	1,757
1938	36,261	25,557	2,232	1,725	1,630
1939	38,501	25,669	2,390	1,621	1,356
1940	43,538	25,951	11,488	1,704	1,511
1941	41,380	28,536	721	1,840	2,588
1942	52,663	32,051	–1,568	1,746	4,826
1943	69,306	35,794	23,768	2,416	5,336
1944	104,392	39,659	3,222	2,296	7,220
1945	142,210	41,666	–830	2,341	4,710
1946	150,385	50,493	–626	2,260	4,482
1947	158,656	58,191	1,973	2,640	4,562
1948	304,161	64,280	–34,318	3,244	5,186
1949	316,537	67,931	–12,122	3,243	6,304
1950	275,839	69,822	36,294	3,434	7,316
1951	394,656	83,793	–2,128	4,095	7,581
1952	456,060	92,051	1,584	4,122	8,521
1953	513,037	98,493	–1,059	4,100	10,922
1954	438,486	99,068	–134	4,175	6,490
1955	412,488	101,159	–265	4,194	4,707
1956	595,649	110,240	–23	5,340	5,603
1957	763,348	117,932	–7,141	7,508	6,374
1958	742,068	125,831	124	5,917	5,973
1959	886,226	131,848	98,247	6,471	6,384
1960	1,103,385	139,894	13,875	6,534	7,455
1961	941,648	148,254	3,482	6,265	6,756
1962	1,048,508	161,451	–56	6,655	8,030
1963	1,151,120	169,638	615	7,573	10,063
1964	1,343,747	171,511	726	8,655	17,230
1965	1,559,484	172,111	1,022	8,576	23,603
1966	1,908,500	178,212	996	9,022	20,167
1967	2,190,404	190,561	2,094	10,770	18,790
1968	2,764,446	207,678	8,520	14,198	20,474
1969	3,373,361	237,828	–558	15,020	22,126

For notes see end of table.

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Federal Reserve Bank of St. Louis

6—Continued

Dividends paid	Payments to U.S. Treasury		Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Statutory transfers [2]	Interest on Federal Reserve notes		
217	. . .			. . .
1,743	. . .			. . .
6,804	1,134			1,134
5,541	. . .			48,334
5,012	2,704			70,652
5,654	60,725			82,916
6,120	59,974			15,993
6,307	10,851			−660
6,553	3,613			2,546
6,682	114			−3,078
6,916	59			2,474
7,329	818			8,464
7,755	250			5,044
8,458	2,585			21,079
9,584	4,283			22,536
10,269	17			−2,298
10,030	. . .		. . .	−7,058
9,282	2,011		. . .	11,021
8,874	. . .		. . .	−917
8,782	. . .		−60	6,510
8,505	298		28	607
7,830	227		103	353
7,941	177		67	2,616
8,019	120		−419	1,862
8,110	25		−426	4,534
8,215	82		−54	17,617
8,430	141		−4	571
8,669	198		50	3,554
8,911	245		135	40,327
9,500	327	. . .	201	48,410
10,183	248	. . .	262	81,970
10,962	67	. . .	28	81,467
11,523	36	75,284	87	8,366
11,920	. . .	166,690	. . .	18,523
12,329	. . .	193,146	. . .	21,462
13,083		196,629		21,849
13,865		254,874		28,321
14,682		291,935		46,334
15,558		342,568		40,337
16,442		276,289		35,888
17,712		251,741		32,710
18,905		401,556		53,983
20,081		542,708		61,604
21,197		524,059		59,215
22,722		910,650		−93,601
23,948		896,816		42,613
25,570		687,393		70,892
27,412		799,366		45,538
28,912		879,685		55,864
30,782		1,582,119		−465,823
32,352		1,296,810		27,054
33,696	. . .	1,649,455		18,944
35,027	. . .	1,907,498	. . .	29,851
36,959	. . .	2,463,629	. . .	30,027
39,237	. . .	3,019,161	. . .	39,432

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6. Income and Expenses of Federal Reserve Banks, 1914–98—Continued

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (–)[1]	Assessments by Board of Governors	
				Board expenditures	Costs of currency
1970	3,877,218	276,572	11,442	21,228	23,574
1971	3,723,370	319,608	94,266	32,634	24,943
1972	3,792,335	347,917	–49,616	35,234	31,455
1973	5,016,769	416,879	–80,653	44,412	33,826
1974	6,280,091	476,235	–78,487	41,117	30,190
1975	6,257,937	514,359	–202,370	33,577	37,130
1976	6,623,220	558,129	7,311	41,828	48,819
1977	6,891,317	568,851	–177,033	47,366	55,008
1978	8,455,309	592,558	–633,123	53,322	60,059
1979	10,310,148	625,168	–151,148	50,530	68,391
1980	12,802,319	718,033	–115,386	62,231	73,124
1981	15,508,350	814,190	–372,879	63,163	82,924
1982	16,517,385	926,034	–68,833	61,813	98,441
1983	16,068,362	1,023,678	–400,366	71,551	152,135
1984	18,068,821	1,102,444	–412,943	82,116	162,606
1985	18,131,983	1,127,744	1,301,624	77,378	173,739
1986	17,464,528	1,156,868	1,975,893	97,338	180,780
1987	17,633,012	1,146,911	1,796,594	81,870	170,675
1988	19,526,431	1,205,960	–516,910	84,411	164,245
1989	22,249,276	1,332,161	1,254,613	89,580	175,044
1990	23,476,604	1,349,726	2,099,328	103,752	193,007
1991	22,553,002	1,429,322	405,729	109,631	261,316
1992	20,235,028	1,474,531	–987,788	128,955	295,401
1993	18,914,251	1,657,800	–230,268	140,466	355,947
1994	20,910,742	1,795,328	2,363,862	146,866	368,187
1995	25,395,148	1,818,416	857,788	161,348	370,203
1996	25,164,303	1,947,861	–1,676,716	162,642	402,517
1997	26,917,213	1,976,453	–2,611,570	174,407	364,454
1998	28,149,477	1,833,436	1,906,037	178,009	408,544
Total, 1914–98	**472,475,528**	**34,356,870**	**5,380,239**	**2,666,670**	**5,162,131**
Aggregate for each Bank, 1914–98					
Boston	25,604,983	2,332,427	183,423	100,564	301,485
New York	153,427,418	5,762,555[4]	1,618,119	693,451	1,646,661
Philadelphia	17,926,175	1,900,552	145,024	125,529	202,825
Cleveland	30,605,204	2,158,855	257,294	184,591	323,451
Richmond	37,775,079	2,967,643	460,800	181,158	447,371
Atlanta	22,293,573	3,235,234	425,035	220,996	292,682
Chicago	61,543,695	4,425,609	618,611	341,841	631,717
St. Louis	16,446,361	1,754,512	96,759	73,483	196,905
Minneapolis	8,566,866	1,610,709	159,858	76,790	88,164
Kansas City	18,405,744	2,195,732	152,159	104,346	203,156
Dallas	23,590,890	2,198,163	462,059	175,284	248,651
San Francisco	56,289,540	3,814,878	801,098	388,637	579,063
Total	**472,475,528**	**34,356,870**	**5,380,239**	**2,666,670**	**5,162,131**

NOTE. Also see note at the end of table 1.

Components may not sum to totals because of rounding.

1. For 1987 and subsequent years, includes the cost of services provided to the Treasury by Federal Reserve Banks for which reimbursement was not received.

2. Represents transfers made as a franchise tax from 1917 to 1932; transfers made under section 13b of the Federal Reserve Act from 1935 to 1947; and transfers made under section 7 of the Federal Reserve Act for 1996 and 1997.

3. The $6,293,697 thousand transferred to surplus was reduced by direct charges of $500 thousand for charge-off on Bank premises (1927), $139,300 thousand for contributions to capital of the Federal Deposit Insurance Corporation (1934), $4 thousand net upon elimination of section 13b surplus (1958), and $106,000 thousand (1996) and $107,000 thousand (1997) transferred to the Treasury as statutorily required; and was increased by transfer of $11,131 thousand from reserves for contingencies (1955), leaving a balance of $5,952,024 thousand on December 31, 1998.

4. This amount is reduced $1,406,215 thousand, which is related to the System Retirement Plan. See note 1, table 5.

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Federal Reserve Bank of St. Louis

6—Continued

Dividends paid	Payments to U.S. Treasury		Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Statutory transfers [2]	Interest on Federal Reserve notes		
41,137	...	3,493,571	...	32,580
43,488	...	3,356,560	...	40,403
46,184	...	3,231,268	...	50,661
49,140	...	4,340,680	...	51,178
52,580	...	5,549,999	...	51,483
54,610	...	5,382,064	...	33,828
57,351	...	5,870,463	...	53,940
60,182	...	5,937,148	...	45,728
63,280	...	7,005,779	...	47,268
67,194	...	9,278,576	...	69,141
70,355	...	11,706,370	...	56,821
74,574	...	14,023,723	...	76,897
79,352	...	15,204,591	...	78,320
85,152	...	14,228,816	...	106,663
92,620	...	16,054,095	...	161,996
103,029	...	17,796,464	...	155,253
109,588	...	17,803,895	...	91,954
117,499	...	17,738,880	...	173,771
125,616	...	17,364,319	...	64,971
129,885	...	21,646,417	...	130,802
140,758	...	23,608,398	...	180,292
152,553	...	20,777,552	...	228,356
171,763	...	16,774,477	...	402,114
195,422	...	15,986,765	...	347,583
212,090	...	20,470,011	...	282,122
230,527	...	23,389,367	...	283,075
255,884	5,517,716	14,565,624	...	635,343
299,652	20,658,972	0	...	831,705
343,014	17,785,942	8,774,994	...	731,575
4,291,580	**44,113,958**	**380,970,865**	**−4**	**6,293,697** [3]
172,293	2,579,504	20,015,922	135	286,075
1,128,823	17,307,161	127,208,985	−433	1,298,335
213,390	1,312,118	14,114,228	291	202,268
309,754	2,827,043	24,633,319	−10	425,493
306,314	3,083,928	29,990,927	−72	1,258,610
338,495	2,713,230	15,474,153	5	443,813
539,295	4,593,811	51,006,564	12	623,458
118,834	1,833,837	12,434,486	−27	131,089
121,758	416,227	6,201,659	65	211,353
163,589	1,249,703	14,488,701	−9	152,685
266,691	1,510,802	19,409,194	55	244,109
612,345	4,686,594	45,992,727	−17	1,016,409
4,291,580	**44,113,958**	**380,970,865**	**−4**	**6,293,697** [3]

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Federal Reserve Bank of St. Louis

7. Acquisition Costs and Net Book Value of Premises of Federal Reserve Banks and Branches, December 31, 1998

Thousands of dollars

Federal Reserve Bank or Branch	Acquisition costs				Net book value	Other real estate[3]
	Land	Buildings (including vaults)[1]	Building machinery and equipment	Total[2]		
BOSTON	22,074	97,334	10,438	129,846	93,799	...
NEW YORK	20,330	140,862	45,813	207,006	152,603	
Buffalo	888	4,809	3,227	8,924	5,511	
PHILADELPHIA	2,380	62,023	8,616	73,018	50,475	
CLEVELAND	3,067	115,936	24,143	143,146	128,378	
Cincinnati	2,247	17,051	8,376	27,673	13,186	
Pittsburgh	1,658	12,975	7,267	21,900	16,460	
RICHMOND	6,268	63,810	22,966	93,043	71,144	
Baltimore	6,478	27,101	4,569	38,148	26,154	...
Charlotte	3,130	27,541	4,750	35,421	28,079	...
ATLANTA[4]	17,689	14,801	0	32,490	32,487	5,857
Birmingham[4]	4,852	0	0	4,852	4,852	...
Jacksonville	1,730	17,226	2,945	21,901	16,892	48
Miami	3,823	14,756	2,728	21,308	14,837	...
Nashville	629	3,090	2,651	6,370	3,508	...
New Orleans	3,497	7,297	2,961	13,756	9,533	...
CHICAGO	5,030	119,789	14,090	138,909	98,330	...
Detroit	798	6,094	3,635	10,527	8,213	...
ST. LOUIS	700	19,727	6,158	26,585	16,829	...
Little Rock	1,148	3,956	1,263	6,367	4,931	...
Louisville	700	3,740	1,586	6,026	4,385	.
Memphis	1,136	4,513	2,755	8,403	5,160	.
MINNEAPOLIS	11,093	99,451	13,300	123,843	120,135	.
Helena	1,955	9,335	788	12,078	10,358	.
KANSAS CITY	2,048	18,344	8,355	28,748	17,112	.
Denver	3,188	7,590	3,506	14,285	9,399	.
Oklahoma City	646	11,238	3,475	15,359	11,916	.
Omaha	6,535	11,000	1,401	18,936	15,147	.
DALLAS	28,986	104,243	18,859	152,088	132,867	.
El Paso	262	3,150	908	4,320	3,325	.
Houston	2,205	4,703	1,755	8,664	6,352	.
San Antonio	482	5,340	2,686	8,509	6,122	.
SAN FRANCISCO	15,600	73,396	18,441	107,437	75,604	.
Los Angeles	3,892	52,854	9,508	66,254	49,905	.
Portland	2,799	11,447	2,144	16,390	14,351	...
Salt Lake City	495	8,842	2,283	11,620	9,359	...
Seattle	325	12,935	2,909	16,169	13,014	...
Total	**190,764**	**1,218,300**	**271,257**	**1,680,321**	**1,300,712**	**5,905**

NOTE. Also see note at the end of table 1.

Components may not sum to totals because of rounding.

1. Includes expenditures for construction at some offices, pending allocation to appropriate accounts.

2. Excludes charge-offs of $17,699 thousand before 1952.

3. Covers acquisitions for banking-house purposes and Bank premises formerly occupied and being held pending sale.

4. The Atlanta and Birmingham offices sold their buildings and building machinery and equipment in 1997 and 1998 respectively. These offices are leasing back their buildings pending completion of their new facilities.

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8. Operations in Principal Departments of Federal Reserve Banks, 1995–98

Operation	1998	1997	1996	1995
Millions of pieces (except as noted)				
Loans (thousands)	4	7	6	6
Currency received and counted	26,341	24,510	23,436	22,594
Currency verified and destroyed	7,251	7,769	8,686	8,911
Coin received and counted	8,454	9,603	8,654	7,578
Checks handled				
U.S. government checks	321	378	436	460
Postal money orders	213	204	206	203
All other	16,573	15,949	15,487	15,465
Government securities transfers	14	13	13	13
Transfer of funds	98	90	83	76
Automated clearinghouse transactions[1]				
Commercial	2,966	2,603	2,372	2,046
Government	753	677	625	599
Food stamps redeemed	1,843	2,854	3,637	3,954
Millions of dollars				
Loans	20,431	39,863	25,350	22,854
Currency received and counted	409,166	399,080	375,399	345,318
Currency verified and destroyed	94,858	123,359	148,394	113,828
Coin received and counted	1,001	1,212	1,175	1,112
Checks handled				
U.S. government checks	343,670	401,989	462,647	490,299
Postal money orders	28,469	26,464	25,831	24,835
All other	13,076,097	12,169,087	11,584,276	11,567,820
Government securities transfers	197,781,609	174,949,330	160,637,460	149,764,431
Transfer of funds	328,748,912	288,419,808	249,140,021	222,954,083
Automated clearinghouse transactions[1]				
Commercial	10,338,376	9,128,779	8,287,711	7,817,323
Government	1,988,335	1,581,552	1,250,472	1,117,452
Food stamps redeemed	9,278	15,054	18,669	20,862

1. Beginning in 1997, the reported ACH volumes no longer include non-value items.

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Federal Reserve Bank of St. Louis

9. Federal Reserve Bank Interest Rates on Loans to Depository Institutions, December 31, 1998

Reserve Bank	Adjustment credit[1]	Seasonal credit[2]	Extended credit[3]	
			First thirty days of borrowing	After thirty days of borrowing
All Federal Reserve Banks	4.50	4.85	4.50	5.35

1. Adjustment credit is available on a short-term basis to help depository institutions meet temporary needs for funds that cannot be met through reasonable alternative sources. Adjustment credit is usually provided at the basic discount rate, but under certain circumstances a special rate or rates above the basic discount rate may be applied. See section 201.3(a) of Regulation A.

2. Seasonal credit is available to help smaller depository institutions meet regular, seasonal needs for funds that cannot be met through special industry lenders and that arise from a combination of expected patterns of movement in their deposits and loans. The discount rate on seasonal credit takes into account rates on market sources of funds and ordinarily is reestablished on the first business day of each two-week reserve maintenance period; however, it is never lower than the discount rate applicable to adjustment credit. See section 201.3(b) of Regulation A.

3. Extended credit is available to depository institutions, if similar assistance is not reasonably available from other sources, when exceptional circumstances or practices involve only a particular institution or when an institution is experiencing difficulties adjusting to changing market conditions over a longer period of time. See section 201.3(c) of Regulation A.

Extended-credit loans outstanding more than thirty days will be charged a flexible rate somewhat above rates on market sources of funds; the rate will always be at least 50 basis points above the discount rate applicable to adjustment credit. The flexible rate is reestablished on the first business day of each two-week reserve maintenance period. At the discretion of the Federal Reserve Bank, the flexible rate may be charged on extended-credit loans that are outstanding less than thirty days.

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Federal Reserve Bank of St. Louis

10. Reserve Requirements of Depository Institutions, December 31, 1998

Type of deposit	Requirements	
	Percentage of deposits	Effective date
Net transaction accounts[1]		
$0 million–$46.5 million[2]	3	12-31-98
More than $46.5 million[3]	10	12-31-98
Nonpersonal time deposits[4]	0	12-27-90
Eurocurrency liabilities[5]	0	12-27-90

NOTE. Required reserves must be held in the form of deposits with Federal Reserve Banks or vault cash. Nonmember institutions may maintain reserve balances with a Federal Reserve Bank indirectly, on a pass-through basis, with certain approved institutions. For previous reserve requirements, see earlier editions of the *Annual Report* or the *Federal Reserve Bulletin*. Under the Monetary Control Act of 1980, depository institutions include commercial banks, savings banks, savings and loan associations, credit unions, agencies and branches of foreign banks, and Edge Act corporations.

1. Transaction accounts include all deposits against which the account holder is permitted to make withdrawals by negotiable or transferable instruments, payment orders of withdrawal, or telephone or preauthorized transfers for the purpose of making payments to third persons or others. However, accounts subject to the rules that permit no more than six preauthorized, automatic, or other transfers per month (of which no more than three may be by check, draft, debit card, or similar order payable directly to third parties) are savings deposits, not transaction accounts.

2. The Monetary Control Act of 1980 requires that the amount of transaction accounts against which the 3 percent reserve requirement applies be modified annually by 80 percent of the percentage change in transaction accounts held by all depository institutions, determined as of June 30 each year. Effective with the reserve maintenance period beginning December 31, 1998, for depository institutions that report weekly, and with the reserve maintenance period beginning January 14, 1999, for institutions that report quarterly, the amount was decreased from $47.8 million to $46.5 million.

Under the Garn–St Germain Depository Institutions Act of 1982, the Board adjusts the amount of reservable liabilities subject to a zero percent reserve requirement each year for the succeeding calendar year by 80 percent of the percentage increase in the total reservable liabilities of all depository institutions, measured on an annual basis as of June 30. No corresponding adjustment is made in the event of a decrease. The exemption applies only to accounts that would be subject to a 3 percent reserve requirement. Effective with the reserve maintenance period beginning December 31, 1998, for depository institutions that report weekly, and with the reserve maintenance period beginning January 14, 1999, for institutions that report quarterly, the exemption was raised from $4.7 million to $4.9 million.

3. The reserve requirement was reduced from 12 percent to 10 percent on April 2, 1992, for institutions that report weekly, and on April 16, 1992, for institutions that report quarterly.

4. For institutions that report weekly, the reserve requirement on nonpersonal time deposits with an original maturity of less than 1½ years was reduced from 3 percent to 1½ percent for the maintenance period that began December 13, 1990, and to zero for the maintenance period that began December 27, 1990. For institutions that report quarterly, the reserve requirement on nonpersonal time deposits with an original maturity of less than 1½ years was reduced from 3 percent to zero on January 17, 1991.

The reserve requirement on nonpersonal time deposits with an original maturity of 1½ years or more has been zero since October 6, 1983.

5. The reserve requirement on Euroccurency liabilities was reduced from 3 percent to zero in the same manner and on the same dates as the reserve requirement on nonpersonal time deposits with an original maturity of less than 1½ years (see note 4).

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Federal Reserve Bank of St. Louis

11. Initial Margin Requirements under Regulations T, U, and X

Percent of market value

Effective date	Margin stocks	Convertible bonds	Short sales, T only[1]
1934, Oct. 1	25–45	...	...
1936, Feb. 1	25–55	...	...
Apr. 1	55	...	...
1937, Nov. 1	40	...	50
1945, Feb. 5	50	...	50
July 5	75	...	75
1946, Jan. 21	100	...	100
1947, Feb. 21	75	...	75
1949, Mar. 3	50	...	50
1951, Jan. 17	75	...	75
1953, Feb. 20	50	...	50
1955, Jan. 4	60	...	60
Apr. 23	70	...	70
1958, Jan. 16	50	...	50
Aug. 5	70	...	70
Oct. 16	90	...	90
1960, July 28	70	...	70
1962, July 10	50	...	50
1963, Nov. 6	70	...	70
1968, Mar. 11	70	50	70
June 8	80	60	80
1970, May 6	65	50	65
1971, Dec. 6	55	50	55
1972, Nov. 24	65	50	65
1974, Jan. 3	50	50	50

NOTE. These regulations, adopted by the Board of Governors pursuant to the Securities Exchange Act of 1934, limit the amount of credit to purchase and carry "margin securities" (as defined in the regulations) when such value is collateralized by securities. Margin requirements on securities are the difference between the market value (100 percent) and the maximum loan value of collateral as prescribed by the Board. Regulation T was adopted effective October 15, 1934; Regulation U, effective May 1, 1936; and Regulation X, effective November 1, 1971. The former Regulation G, which was adopted effective March 11, 1968, was merged with Regulation U, effective April 1, 1998.

1. From October 1, 1934, to October 31, 1937, the requirement was the margin "customarily required" by the brokers and dealers.

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Federal Reserve Bank of St. Louis

12. Principal Assets and Liabilities and Number of Insured Commercial Banks in the United States, by Class of Bank, June 30, 1998 and 1997

Millions of dollars, except as noted

Item	Total	Member banks			Nonmember banks
		Total	National	State	
	1998				
ASSETS					
Loans and investments	3,677,921	2,866,969	2,191,905	675,064	810,952
Gross loans	2,786,358	2,198,799	1,720,822	477,977	587,559
Net loans	2,783,353	2,197,144	1,719,461	477,683	586,209
Investments	891,563	668,169	471,082	197,087	223,394
U.S. Treasury and federal agency securities	301,443	198,241	127,365	70,876	103,202
Other	590,120	469,928	343,717	126,211	120,192
Cash assets, total	245,823	203,132	155,703	47,429	42,690
LIABILITIES					
Deposits, total	2,938,465	2,249,939	1,696,040	553,899	688,526
Interbank	55,983	48,489	38,068	10,421	7,495
Other transaction	696,333	535,492	406,520	128,972	160,840
Other nontransaction	2,345,038	1,765,139	1,327,342	437,797	579,898
Equity capital	444,112	353,257	262,072	91,185	90,855
Number of banks	8,922	3,510	2,529	981	5,412
	1997 r				
ASSETS					
Loans and investments	3,412,025	2,616,827	1,974,291	642,536	795,198
Gross loans	2,593,006	2,018,356	1,567,616	450,740	574,649
Net loans	2,589,248	2,016,200	1,565,849	450,351	573,047
Investments	819,019	598,471	406,675	191,796	220,548
U.S. Treasury and federal agency securities	298,643	190,188	130,351	59,837	108,454
Other	520,376	408,282	276,323	131,959	112,094
Cash assets, total	242,378	200,602	148,165	52,437	41,776
LIABILITIES					
Deposits, total	2,768,356	2,094,624	1,573,407	521,217	673,733
Interbank	49,495	42,444	31,928	10,516	7,051
Other transaction	720,995	554,323	415,051	139,272	166,672
Other nontransaction	2,163,744	1,600,169	1,204,777	395,392	563,575
Equity capital	402,012	315,364	231,741	83,623	86,648
Number of banks	9,257	3,630	2,644	986	5,627

NOTE. Components may not sum to totals because of rounding.

r. Data have been revised.

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13. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items—Year-End 1918–98, and Month-End 1998

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding								Gold stock[6]	Special drawing rights certificate account	Treasury currency outstanding[7]
	U.S. Treasury and federal agency securities			Loans	Float[3]	All other[4]	Other Federal Reserve assets[5]	Total			
	Total	Bought outright[1]	Held under repurchase agreement[2]								
1918	239	239	0	1,766	199	294	0	2,498	2,873	...	1,795
1919	300	300	0	2,215	201	575	0	3,292	2,707	...	1,707
1920	287	287	0	2,687	119	262	0	3,355	2,639	...	1,709
1921	234	234	0	1,144	40	146	0	1,563	3,373	...	1,842
1922	436	436	0	618	78	273	0	1,405	3,642	...	1,958
1923	134	80	54	723	27	355	0	1,238	3,957	...	2,009
1924	540	536	4	320	52	390	0	1,302	4,212	...	2,025
1925	375	367	8	643	63	378	0	1,459	4,112	...	1,977
1926	315	312	3	637	45	384	0	1,381	4,205	...	1,991
1927	617	560	57	582	63	393	0	1,655	4,092	...	2,006
1928	228	197	31	1,056	24	500	0	1,809	3,854	...	2,012
1929	511	488	23	632	34	405	0	1,583	3,997	...	2,022
1930	739	686	43	251	21	372	0	1,373	4,306	...	2,027
1931	817	775	42	638	20	378	0	1,853	4,173	...	2,035
1932	1,855	1,851	4	235	14	41	0	2,145	4,226	...	2,204
1933	2,437	2,435	2	98	15	137	0	2,688	4,036	...	2,303
1934	2,430	2,430	0	7	5	21	0	2,463	8,238	...	2,511
1935	2,431	2,430	1	5	12	38	0	2,486	10,125	...	2,476
1936	2,430	2,430	0	3	39	28	0	2,500	11,258	...	2,532
1937	2,564	2,564	0	10	19	19	0	2,612	12,760	...	2,637
1938	2,564	2,564	0	4	17	16	0	2,601	14,512	...	2,798
1939	2,484	2,484	0	7	91	11	0	2,593	17,644	...	2,963
1940	2,184	2,184	0	3	80	8	0	2,274	21,995	...	3,087
1941	2,254	2,254	0	3	94	10	0	2,361	22,737	...	3,247
1942	6,189	6,189	0	6	471	14	0	6,679	22,726	...	3,648
1943	11,543	11,543	0	5	681	10	0	12,239	21,938	...	4,094
1944	18,846	18,846	0	80	815	4	0	19,745	20,619	...	4,131
1945	24,252	24,252	0	249	578	2	0	15,091	20,065	...	4,339
1946	23,350	23,350	0	163	580	1	0	24,093	20,529	...	4,562
1947	22,559	22,559	0	85	535	1	0	23,181	22,754	...	4,562
1948	23,333	23,333	0	223	541	1	0	24,097	24,244	...	4,589
1949	18,885	18,885[1]	0	78	534	2	0	19,499	24,427	...	4,598
1950	20,778	20,725	53	67	1,368	3	0	22,216	22,706	...	4,636
1951	23,801	23,605	196	19	1,184	5	0	25,009	22,695	...	4,709
1952	24,697	24,034	663	156	967	4	0	25,825	23,187	...	4,812
1953	25,916	25,318	598	28	935	2	0	26,880	22,030	...	4,894
1954	24,932	24,888	44	143	808	1	0	25,885	21,713	...	4,985
1955	24,785	24,391	394	108	1,585	29	0	26,507	21,690	...	5,008
1956	24,915	24,610	305	50	1,665	70	0	26,699	21,949	...	5,066
1957	24,238	23,719	519	55	1,424	66	0	25,784	22,781	...	5,146
1958	26,347	26,252	95	64	1,296	49	0	27,755	20,534	...	5,234
1959	26,648	26,607	41	458	1,590	75	0	28,771	19,456	...	5,311

For notes see end of table.

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Federal Reserve Bank of St. Louis

13—Continued

Factors absorbing reserve funds											
Currency in circulation	Treasury cash holdings[8]	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve accounts[5]	Required clearing balances	Other Federal Reserve liabilities and capital[5]	Member bank reserves[9]			
		Treasury	Foreign	Other				With Federal Reserve Banks	Currency and coin[10]	Required[11]	Excess[11]
4,951	288	51	96	25	118	0	0	1,636	0	1,585	51
5,091	385	51	73	28	208	0	0	1,890	0	1,822	68
5,325	218	57	5	18	298	0	0	1,781	0	0	0
4,403	214	96	12	15	285	0	0	1,753	0	1,654	99
4,530	225	11	3	26	276	0	0	1,934	0	0	0
4,757	213	38	4	19	275	0	0	1,898	0	1,884	14
4,760	211	51	19	20	258	0	0	2,220	0	2,161	59
4,817	203	16	8	21	272	0	0	2,212	0	2,256	−44
4,808	201	17	46	19	293	0	0	2,194	0	2.250	−56
4,716	208	18	5	21	301	0	0	2,487	0	2,424	63
4,686	202	23	6	21	348	0	0	2,389	0	2,430	−41
4,578	216	29	6	24	393	0	0	2,355	0	2,428	−73
4,603	211	19	6	22	375	0	0	2,471	0	2,375	96
5,360	222	54	79	31	354	0	0	1,961	0	1,994	−33
5,388	272	8	19	24	355	0	0	2,509	0	1,933	576
5,519	284	3	4	128	360	0	0	2,729	0	1,870	859
5,536	3,029	121	20	169	241	0	0	4,096	0	2,282	1,814
5,882	2,566	544	29	226	253	0	0	5,587	0	2,743	2,844
6,543	2,376	244	99	160	261	0	0	6,606	0	4,622	1,984
6,550	3,619	142	172	235	263	0	0	7,027	0	5,815	1,212
6,856	2,706	923	199	242	260	0	0	8,724	0	5,519	3,205
7,598	2,409	634	397	256	251	0	0	11,653	0	6,444	5,209
8,732	2,213	368	1,133	599	284	0	0	4,026	0	7,411	6,615
11,160	2,215	867	774	586	291	0	0	12,450	0	9,365	3,085
15,410	2,193	799	793	485	256	0	0	13,117	0	11,129	1,988
20,499	2,303	579	1,360	356	339	0	0	12,886	0	11,650	1,236
25,307	2,375	440	1,204	394	402	0	0	14,373	0	12,748	1,625
28,515	2,287	977	862	446	495	0	0	15,915	0	14,457	1,458
28,952	2,272	393	508	314	607	0	0	16,139	0	15,577	562
28,868	1,336	870	392	569	563	0	0	17,899	0	16,400	1,499
28,224	1,325	1,123	642	547	590	0	0	20,479	0	19,277	1,202
27,600	1,312	821	767	750	106	0	0	16,568	0	15,550	1,018
27,741	1,293	668	895	565	714	0	0	17,681	0	16,509	1,172
29,206	1,270	247	526	363	746	0	0	20,056	0	19,667	389
30,433	1,270	389	550	455	777	0	0	19,950	0	20,520	−570
30,781	761	346	423	493	839	0	0	20,160	0	19,397	763
30,509	796	563	490	441	907	0	0	18,876	0	18,618	258
31,158	767	394	402	554	925	0	0	19,005	0	18,903	102
31,790	775	441	322	426	901	0	0	19,059	0	19,089	−30
31,834	761	481	356	246	998	0	0	19,034	0	19,091	−57
32,193	683	358	272	391	1,122	0	0	18,504	0	18,574	−70
32,591	391	504	345	694	841	0	0	18,174	310	18,619	−135

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13. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items—Year-End 1918–98 and Month-End 1998—Continued

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding								Gold stock[6]	Special drawing rights certificate account	Treasury currency outstanding[7]
	U.S. Treasury and federal agency securities			Loans	Float[3]	All other[4]	Other Federal Reserve assets[5]	Total			
	Total	Bought outright[1]	Held under repurchase agreement[2]								
1960	27,384	26,984	400	33	1,847	74	0	29,338	17,767	...	5,398
1961	28,881	30,478	159	130	2,300	51	0	31,362	16,889	...	5,585
1962	30,820	28,722	342	38	2,903	110	0	33,871	15,978	...	5,567
1963	33,593	33,582	11	63	2,600	162	0	36,418	15,513	...	5,578
1964	37,044	36,506	538	186	2,606	94	0	39,930	15,388	...	5,405
1965	40,768	40,478	290	137	2,248	187	0	43,340	13,733	...	5,575
1966	44,316	43,655	661	173	2,495	193	0	47,177	13,159	...	6,317
1967	49,150	48,980	170	141	2,576	164	0	52,031	11,982	...	6,784
1968	52,937	52,937	0	186	3,443	58	0	56,624	10,367	...	6,795
1969	57,154	7,154[5]	0	183	3,440	64	2,743	64,584	10,367	...	6,852
1970	62,142	62,142	0	335	4,261	57	1,123	67,918	10,732	400	7,147
1971	70,804	69,481	1,323	39	4,343	261	1,068	76,515	10,132	400	7,710
1972	71,230	71,119	111	1,981	3,974	106	1,260	78,551	10,410	400	8,313
1973	80,495	80,395	100	1,258	3,099	68	1,152	86,072	11,567	400	8,716
1974	85,714	84,760	954	299	2,001	999	3,195	92,208	11,652	400	9,253
1975	94,124	92,789	1,335	211	3,688	1,126	3,312	102,461	11,599	500	10,218
1976	104,093	100,062	4,031	25	2,601	991	3,182	110,892	11,598	1,200	10,810
1977	111,274	108,922	2,352	265	3,810	954	2,442	118,745	11,718	1,250	11,331
1978	118,591	117,374	1,217	1,174	6,432	587	4,543	131,327	11,671	1,300	11,831
1979	126,167	124,507	1,660	1,454	6,767	704	5,613	140,705	11,172	1,800	13,083
1980	130,592	128,038	2,554	1,809	4,467	776	8,739	146,383	11,160	2,518	13,427
1981	140,348	136,863	3,485	1,601	1,762	195	9,230	153,136	11,151	3,318	13,687
1982	148,837	144,544	4,293	717	2,735	1,480	9,890	63,659	11,148	4,618	13,786
1983	160,795	159,203	1,592	918	1,605	418	8,728	172,464	11,121	4,618	15,732
1984	169,627	167,612	2,015	3,577	833	0	12,347	186,384	11,096	4,618	16,418
1985	191,248	186,025	5,223	3,060	988	0	15,302	210,598	11,090	4,718	17,075
1986	221,459	205,454	16,005	1,565	1,261	0	17,475	241,760	11,084	5,018	17,567
1987	231,420	226,459	4,961	3,815	811	0	15,837	251,883	11,078	5,018	18,177
1988	247,489	240,628	6,861	2,170	1,286	0	18,803	269,748	11,060	5,018	18,799
1989	235,417	233,300	2,117	481	1,093	0	39,631	276,622	11,059	8,518	19,628
1990	259,785[r]	241,431[r]	18,354	190	2,566	0	39,880	302,421	11,058	10,018	20,404
1991	288,429	272,531	15,898	218	1,026	0	34,524	324,197	11,059	10,018	21,017
1992	308,517[r]	300,423[r]	8,094	675	3,350	0	30,278	342,820	11,056	8,018	21,452
1993	349,866[r]	336,654[r]	13,212	94	963	0	33,394	384,317[r]	11,053	8,018	22,101
1994	378,746	368,156	10,590	223	740	0	33,441	413,150	11,051	8,018	23,001[r]
1995	394,693	380,831	13,862	135[r]	231	0	33,483	428,543	11,050	10,168	24,011[r]
1996	414,715	393,132	21,583	85	5,297	0	32,222	452,319	11,048	9,718	24,981[r]
1997	455,260	431,420	23,840	2,035	561	0	32,044	489,901	11,047	9,200	25,606[r]
1998	482,854	452,478	30,376	17	1,009	0	37,692	521,573	11,046	9,200	26,281

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13—Continued

Factors absorbing reserve funds												
Currency in circulation	Treasury cash holdings[8]	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve accounts[5]	Required clearing balances	Other Federal Reserve liabilities and capital[5]	Member bank reserves[9]			
		Treasury	Foreign	Other				With Federal Reserve Banks	Currency and coin[10]	Required[11]	Excess[11,12]
32,869	377	485	217	533	941	0	0	17,081	2,544	18,988	637
33,918	422	465	279	320	1,044	0	0	17,387	2,544	18,988	96
35,338	380	597	247	393	1,007	0	0	17,454	3,262	20,071	645
37,692	361	880	171	291	1,065	0	0	17,049	4,099	20,677	471
39,619	612	820	229	321	1,036	0	0	18,086	4,151	21,663	574
42,056	760	668	150	355	211	0	0	18,447	4,163	22,848	−238
44,663	1,176	416	174	588	−147	0	0	19,779	4,310	24,321	−232
47,226	1,344	1,123	135	563	−773	0	0	21,092	4,631	25,905	−182
50,961	695	703	216	747	−1,353	0	0	21,818	4,921	27,439	−700
53,950	596	1,312	134	807	0	0	1,919	22,085	5,187	28,173	−901
57,903	431	1,156	148	1,233	0	0	1,986	24,150	5,423	30,033	−460
61,068	460	2,020	294	999	0	0	2,131	27,788	5,743	32,496	1,035
66,516	345	1,855	325	840	0	0	2,143	25,647	6,216	32,044	98[12]
72,497	317	2,542	251	1,419[13]	0	0	2,669	27,060	6,781	35,268	−1,360
79,743	185	2,113	418	1,275[13]	0	0	2,935	25,843	7,370	37,011	−3,798
86,547	483	7,285	353	1,090	0	0	2,968	26,052	8,036	35,197	−1,103[14]
93,717	460	10,393	352	1,357	0	0	3,063	25,158	8,628	35,461	−1,535
103,811	392	7,114	379	1,187	0	0	3,292	26,870	9,421	37,615	−1,265
114,645	240	4,196	368	1,256	0	0	4,275	31,152	10,538	42,694	−893
125,600	494	4,075	429	1,412	0	0	4,957	29,792	11,429	44,217	−2,835
136,829	441	3,062	411	617	0	0	4,671	27,456	13,654	40,558	675
144,774	443	4,301	505	781	0	117	5,261	25,111	15,576	42,145	−1,442
154,908	429	5,033	328	1,033	0	436	4,990	26,053	16,666	41,391	1,328
171,935	479	3,661	191	851	0	1,013	5,392	20,413	17,821	39,179	−945
183,796	513	5,316	253	867	0	1,126	5,952	20,693			
197,488	550	9,351	480	1,041	0	1,490	5,940	27,141			
211,995	447	7,588	287	917	0	1,812	6,088	46,295			
230,205	454	5,313	244	1,027	0	1,687	7,129	40,097			
247,649	395	8,656	347	548	0	1,605	7,683	37,742			
260,456	450	6,217	589	1,298	0	1,618	8,486	36,713			
286,965	561	8,960	369	242	0	1,962[r]	8,147	36,696[r]	n.a.	n.a.	n.a.
307,759	636	17,697	968	1,706	0	3,949[r]	8,113	25,464[r]			
334,706	508	7,492	206	372	0	5,898[r]	7,984	26,181			
365,277[r]	377	14,809	386	397	0	6,332	9,292	28,619[r]			
403,851[r]	335	7,161	250	876	0	4,197[r]	11,959	26,592[r]			
424,253[r]	270	5,979	386	932	0	5,167[r]	12,342	24,444[r]			
450,663[r]	249	7,742	167	892	0	6,601	13,829	17,923[r]			
482,390[r]	225	5,444	457	900	0	6,667	15,500	24,171			
517,496	85	6,086	167	1,605	0	6,788	16,354	19,518			

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13. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items—Year-End 1918–98, and Month-End 1998—Continued

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding								Gold stock[6]	Special drawing rights certificate account	Treasury currency outstanding[7]
	U.S. Treasury and federal agency securities			Loans	Float[3]	All other[4]	Other Federal Reserve assets[5]	Total			
	Total	Bought outright[1]	Held under repurchase agreement[2]								
1998											
Jan.	430,796	428,728	2,068	24	736	0	31,986	463,541	11,046	9,200	25,659
Feb.	435,046	429,294	5,752	13	−164	0	30,804	465,699	11,050	9,200	25,716
Mar.	442,102	433,806	8,296	29	1,431	0	31,921	475,483	11,049	9,200	25,728
Apr.	459,559	441,873	17,686	86	−503	0	33,833	492,976	11,048	9,200	25,790
May	444,757	441,530	3,227	136	234	0	30,638	475,765	11,049	9,200	25,794
June	460,845	440,299	20,546	963	1,741	0	33,783	497,331	11,047	9,200	25,851
July	449,163	441,137	8,026	241	−139	0	32,950	482,215	11,046	9,200	25,917
Aug.	454,093	442,585	11,508	293	497	0	32,565	487,448	11,046	9,200	25,984
Sept.	460,683	446,449	14,234	1,055	−257	0	35,623	497,104	11,044	9,200	26,057
Oct.	458,391	450,567	7,824	69	−310	0	36,842	494,992	11,041	9,200	26,155
Nov.	469,500	454,358	15,142	17	436	0	34,693	504,646	11,041	9,200	26,211
Dec.	482,854	452,478	30,376	17	1,009	0	37,692	521,573	11,046	9,200	26,281

NOTE. For a description of figures and discussion of their significance, see *Banking and Monetary Statistics, 1941–1970* (Board of Governors of the Federal Reserve System, 1976), pp. 507–23. Components may not sum to totals because of rounding.

... Not applicable.

r. Revised.

n.a. Not available.

1. Beginning in 1969, includes securities loaned—fully guaranteed by U.S. government securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale–purchase transactions.

2. Beginning December 1, 1966, includes federal agency obligations held under repurchase agreements and beginning September 29, 1971, includes federal agency issues bought outright.

3. Beginning in 1960, figures reflect a minor change in concept; see *Federal Reserve Bulletin*, vol. 47 (February 1961), p. 164.

4. Principally acceptances and, until August 21, 1959, industrial loans, authority for which expired on that date.

5. For the period before April 16, 1969, includes the total of Federal Reserve capital paid in, surplus, other capital accounts, and other liabilities and accrued dividends, less the sum of bank premises and other assets, and is reported as "Other Federal Reserve accounts"; thereafter, "Other Federal Reserve assets" and "Other Federal Reserve liabilities and capital" are shown separately.

6. Before January 30, 1934, includes gold held in Federal Reserve Banks and in circulation.

7. Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are fractional and dollar coins. For details see "Currency and Coin in Circulation," *Treasury Bulletin*.

8. Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

9. Beginning in November 1979, includes reserves of member banks, Edge Act corporations, and U.S. agencies and branches of foreign banks. Beginning on November 13, 1980, includes reserves of all depository institutions.

Beginning in 1984, data on "Currency and coin" and "Required" and "Excess" reserves changed from daily to biweekly basis.

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Federal Reserve Bank of St. Louis

13—Continued

Factors absorbing reserve funds

Currency in circulation	Treasury cash holdings[8]	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve accounts[5]	Required clearing balances	Other Federal Reserve liabilities and capital[5]	Member bank reserves[9]			
		Treasury	Foreign	Other				With Federal Reserve Banks	Currency and coin[10]	Required[11]	Excess[11,12]
468,321	220	5,552	215	343	0	6,731	15,969	12,095	n.a.	n.a.	n.a.
472,013	241	5,037	243	349	0	6,722	16,256	10,803	n.a.	n.a.	n.a.
475,031	265	5,490	167	354	0	6,610	15,708	17,835	n.a.	n.a.	n.a.
476,739	275	28,014	162	360	0	6,481	16,894	10,089	n.a.	n.a.	n.a.
480,726	226	5,693	156	309	0	6,421	16,743	11,533	n.a.	n.a.	n.a.
483,865	204	18,140	201	296	0	6,572	17,073	17,079	n.a.	n.a.	n.a.
486,095	141	4,648	161	264	0	6,745	16,830	13,494	n.a.	n.a.	n.a.
488,645	94	6,704	162	332	0	6,695	17,420	13,626	n.a.	n.a.	n.a.
494,306	92	4,952	347	349	0	6,690	17,654	19,016	n.a.	n.a.	n.a.
497,493	87	4,440	154	381	0	6,681	18,241	13,912	n.a.	n.a.	n.a.
507,159	99	5,219	211	337	0	6,547	16,579	14,946	n.a.	n.a.	n.a.
517,496	85	6,086	167	1,605	0	6,788	16,354	19,518	n.a.	n.a.	n.a.

10. Between December 1, 1959, and November 23, 1960, part was allowed as reserves; thereafter all was allowed.

11. Estimated through 1958. Before 1929, data were available only on call dates (in 1920 and 1922 the call date was December 29). Beginning on September 12, 1968, the amount is based on close-of-business figures for the reserve period two weeks before the report date.

12. Beginning with week ending November 15, 1972, includes $450 million of reserve deficiencies on which Federal Reserve Banks are allowed to waive penalties for a transition period in connection with bank adaptation to Regulation J as amended, effective November 9, 1972. Allowable deficiencies are as follows (beginning with first statement week of quarter, in millions): 1973—Q1, $279; Q2, $172; Q3, $112; Q4, $84; 1974—Q1, $67; Q2, $58. The transition period ended with the second quarter of 1974.

13. For the period before July 1973, includes certain deposits of domestic nonmember banks and foreign-owned banking institutions held with member banks and redeposited in full with Federal Reserve Banks in connection with voluntary participation by nonmember institutions in the Federal Reserve System program of credit restraint.

As of December 12, 1974, the amount of voluntary nonmember bank and foreign-agency and branch deposits at Federal Reserve Banks that are associated with marginal reserves are no longer reported. However, two amounts are reported: (1) deposits voluntarily held as reserves by agencies and branches of foreign banks operating in the United States and (2) Eurodollar liabilities.

14. Adjusted to include waivers of penalties for reserve deficiencies, in accordance with change in Board policy effective November 19, 1975.

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Federal Reserve Bank of St. Louis

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1998—Continued

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-4-98)
The applicant has assets of $1.3 billion; the target has assets of $60 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Texas State Bank, McAllen, Texas *to merge with* **Brownsville National Bank, Brownsville, Texas**

SUMMARY REPORT BY THE ATTORNEY GENERAL (1-23-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-4-98)
The applicant has assets of $1.3 billion; the target has assets of $97 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Texas State Bank, McAllen, Texas *to merge with* **Texas Bank & Trust, Brownsville, Texas**

SUMMARY REPORT BY THE ATTORNEY GENERAL (1-23-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-4-98)
The applicant has assets of $1.3 billion; the target has assets of $45 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Farmers Trust Bank, Lebanon, Pennsylvania *to merge with* **Lebanon Valley National Bank, Lebanon, Pennsylvania**

SUMMARY REPORT BY THE ATTORNEY GENERAL (1-23-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-6-98)
The applicant has assets of $181 million; the target has assets of $642 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

WestStar Bank, Inc., Bartlesville, Oklahoma *to merge with* **Victory Bank of Nowata, Nowata, Oklahoma**

SUMMARY REPORT BY THE ATTORNEY GENERAL (1-23-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-18-98)
The applicant has assets of $475 million; the target has assets of $25 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Triangle Bank, Raleigh, North Carolina *to merge with* **Guaranty State Bank, Durham, North Carolina**

SUMMARY REPORT BY THE ATTORNEY GENERAL (2-24-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-23-98)
The applicant has assets of $1.2 billion; the target has assets of $104 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Centura Bank, Rocky Mount, North Carolina *to merge with* **Pee Dee State Bank, Timmonsville, South Carolina**

SUMMARY REPORT BY THE ATTORNEY GENERAL (2-6-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-24-98)
The applicant has assets of $6.8 billion; the target has assets of $134 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

First Farmers Bank & Trust Company, Converse, Indiana *to acquire assets and liabilities of* **1 branch of National City Bank, Indianapolis, Indiana**

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Federal Reserve Bank of St. Louis

15—Continued

SUMMARY REPORT BY THE ATTORNEY GENERAL (2-24-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-26-98)
The applicant has assets of $159 million; the target has assets of $14 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Isabella Bank and Trust, Mt. Pleasant, Michigan *to acquire assets and liabilities of* **3 branches of Old Kent Bank, Ferris, Michigan**

SUMMARY REPORT BY THE ATTORNEY GENERAL (3-6-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-27-98)
The applicant has assets of $317 million; the targets have assets of $55 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Community First Bank and Trust Company, Celina, Ohio *to merge with* **The Union State Bank, Payne, Ohio**

SUMMARY REPORT BY THE ATTORNEY GENERAL (3-6-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (3-4-98)
The applicant has assets of $586 million; the target has assets of $62 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

F&M Bank–Richmond, Richmond, Virginia *to merge with* **Peoples Bank of Virginia, Chesterfield, Virginia**

SUMMARY REPORT BY THE ATTORNEY GENERAL (3-6-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (3-11-98)
The applicant has assets of $174 million; the target has assets of $80 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Valley Independent Bank, El Centro, California *to acquire assets and liabilities of* **1 branch of Palm Desert National Bank, Palm Desert, California**

SUMMARY REPORT BY THE ATTORNEY GENERAL (2-24-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (3-12-98)
The applicant has assets of $447 million; the target has assets of $12 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Peoples Bank and Trust Company, Selma, Alabama *to merge with* **Merchants & Planters Bank, Montevalle, Alabama**

SUMMARY REPORT BY THE ATTORNEY GENERAL (4-2-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (3-24-98)
The applicant has assets of $361 million; the target has assets of $66 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Richwood Banking Company, Richwood, Ohio *to acquire assets and liabilities of* **1 branch of National City Bank of Columbus, Columbus, Ohio**

SUMMARY REPORT BY THE ATTORNEY GENERAL (4-2-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (3-25-98)
The applicant has assets of $85 million; the target has assets of $13 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

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Federal Reserve Bank of St. Louis

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1998—Continued

Shore Bank–Detroit, Detroit, Michigan *to merge with* **OmniBank, River Rouge, Michigan**

Summary Report by the Attorney General (4-2-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (4-9-98)
The applicant has assets of $54 million; the target has assets of $42 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama *to acquire assets and liabilities of* **1 branch of Premier Bank, Atlanta, Georgia**

Summary Report by the Attorney General (4-17-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (4-15-98)
The applicant has assets of $7 billion; the target has assets of $9 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Bank of Commerce, San Diego, California *to merge with* **Rancho Vista National Bank, Vista, California**

Summary Report by the Attorney General (4-17-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (4-17-98)
The applicant has assets of $558 million; the target has assets of $125 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

F&M Bank–Northern Virginia, Fairfax, Virginia *to merge with* **The Bank of Alexandria, Alexandria, Virginia**

Summary Report by the Attorney General (4-17-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (4-21-98)
The applicant has assets of $530 million; the target has assets of $76 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Interchange State Bank, Saddle Brook, New Jersey *to merge with* **The Jersey Bank for Savings, Montvale, New Jersey**

Summary Report by the Attorney General (4-17-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (4-21-98)
The applicant has assets of $548 million; the target has assets of $77 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

The Fifth Third Bank, Cincinnati, Ohio *to merge with* **Century Savings Bank, Upper Arlington, Ohio**

Summary Report by the Attorney General (4-2-98)

Basis for Approval by the Federal Reserve (4-23-98)
The applicant has assets of $9 billion; the target has assets of $250 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

FCNB Bank, Frederick, Maryland *to acquire assets and liabilities of* **3 branches of Farmers Bank of Maryland, Annapolis, Maryland, and 4 branches of First Virginia Bank–Maryland, Upper Marlboro, Maryland**

Summary Report by the Attorney General (4-17-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (4-27-98)
The applicant has assets of $907 million; the targets have assets of $44 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and

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Federal Reserve Bank of St. Louis

15—Continued

needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama *to merge with* **Commercial Bank of Nevada, Las Vegas, Nevada**

Summary Report by the Attorney General (5-7-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (5-12-98)
The applicant has assets of $7 billion; the target has assets of $120 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Atlantic Bank, Ocean City, Maryland *to acquire assets and liabilities of* **5 branches of Bank of Maryland, Towson, Maryland**

Summary Report by the Attorney General (5-7-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (5-13-98)
The applicant has assets of $145 million; the targets have assets of $87 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Johnson Bank, Racine, Wisconsin *to merge with* **Bank of Fort Atkinson, Atkinson, Wisconsin**

Summary Report by the Attorney General (5-7-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (5-14-98)
The applicant has assets of $800 million; the target has assets of $38 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Farmers State Bank, Mankato, Kansas *to acquire assets and liabilities of* **1 branch of The Security National Bank, Manhattan, Kansas**

Summary Report by the Attorney General (6-24-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (5-15-98)
The applicant has assets of $54 million; the target has assets of $4 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Republic Security Bank, West Palm Beach, Florida *to merge with* **UniFirst Federal Savings Bank, Hollywood, Florida**

Summary Report by the Attorney General (6-24-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (5-21-98)
The applicant has assets of $1 billion; the target has assets of $141 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Bank of Colorado, Fort Lupton, Colorado *to merge with* **First Security Bank, Craig, Colorado**

Summary Report by the Attorney General (5-14-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (5-27-98)
The applicant has assets of $325 million; the target has assets of $41 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

The Bank of Belton, Belton, South Carolina *to acquire assets and liabilities of* **2 branches of Carolina First Bank, Greenville, South Carolina**

Summary Report by the Attorney General (6-24-98)
The proposed transaction would not be significantly adverse to competition.

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Federal Reserve Bank of St. Louis

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1998—Continued

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (5-29-98)
The applicant has assets of $20 million; the targets have assets of $40 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Centura Bank, Rocky Mount, North Carolina *to merge with* **NBC Bank of Knoxville, Knoxville, Tennessee**

SUMMARY REPORT BY THE ATTORNEY GENERAL (6-23-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-5-98)
The applicant has assets of $7 billion; the target has assets of $17 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama *to merge with* **Commercial National Bank, Daytona Beach, Florida**

SUMMARY REPORT BY THE ATTORNEY GENERAL (6-23-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-10-98)
The applicant has assets of $7 billion; the target has assets of $83 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

WestStar Bank, Vail, Colorado *to merge with* **Glenwood Independent Bank, Glenwood Springs, Colorado**

SUMMARY REPORT BY THE ATTORNEY GENERAL (6-23-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-10-98)
The applicant has assets of $249 million; the target has assets of $29 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Peninsula Trust Bank, Gloucester, Virginia *to acquire assets and liabilities of* **1 branch of First Virginia Bank–Commonwealth, Grafton, Virginia**

SUMMARY REPORT BY THE ATTORNEY GENERAL (6-23-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-11-98)
The applicant has assets of $174 million; the target has assets of $4 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Exchange Bank, Luckey, Ohio *to merge with* **Towne Bank, Perrysburg, Ohio**

SUMMARY REPORT BY THE ATTORNEY GENERAL (6-23-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-18-98)
The applicant has assets of $2 billion; the target has assets of $306 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Huron Community Bank, East Tawas, Michigan *to merge with* **2 branches of First America Bank, N.A., Kalamazoo, Michigan**

SUMMARY REPORT BY THE ATTORNEY GENERAL (6-23-98)

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-22-98)
The applicant has assets of $95 million; the targets have assets of $35 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Triangle Bank, Raleigh, North Carolina *to merge with* **United Federal Savings Bank, Rocky Mount, North Carolina**

SUMMARY REPORT BY THE ATTORNEY GENERAL (6-23-98)

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Federal Reserve Bank of St. Louis

15—Continued

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-24-98)
The applicant has assets of $2 billion; the target has assets of $306 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Compass Bank, Houston, Texas *to merge with* **Hill Country Bank, Austin, Texas**

SUMMARY REPORT BY THE ATTORNEY GENERAL (6-23-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-26-98)
The applicant has assets of $6 billion; the target has assets of $112 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Bank of Cushing & Trust Company, Cushing, Oklahoma *to acquire assets and liabilities of* **1 branch of BancFirst–Oklahoma City, Cushing, Oklahoma**

SUMMARY REPORT BY THE ATTORNEY GENERAL (6-23-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-29-98)
The applicant has assets of $61 million; the target has assets of $10 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Exchange Bank & Trust Company, Perry, Oklahoma *to acquire assets and liabilities of* **1 branch of BancFirst, Oklahoma City, Oklahoma**

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-24-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-8-98)
The applicant has assets of $85 million; the target has assets of $9 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

The Bank of Marion, Marion, Virginia *to acquire assets and liabilities of* **3 branches of First-Citizens Bank & Trust Company, Raleigh, North Carolina**

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-13-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-14-98)
The applicant has assets of $181 million; the targets have assets of $56 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Citizens Bank, Flint, Michigan *to acquire assets and liabilities of* **1 branch of First of America Bank, N.A., Kalamazoo, Michigan**

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-13-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-16-98)
The applicant has assets of $4 billion; the target has assets of $6 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Hanmi Bank, Los Angeles, California *to merge with* **First Global Bank, FSB, Los Angeles, California**

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-13-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-28-98)
The applicant has assets of $500 million; the targets have assets of $78 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

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Federal Reserve Bank of St. Louis

15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1998—Continued

Republic Security Bank, West Palm Beach, Florida *to merge with* **First Bank of Florida, West Palm Beach, Florida**

SUMMARY REPORT BY THE ATTORNEY GENERAL (8-11-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-29-98)
The applicant has assets of $1 billion; the targets have assets of $2 billion. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

BancFirst, Oklahoma City, Oklahoma *to merge with* **Exchange National Bank and Trust Company, Ardmore, Oklahoma**

SUMMARY REPORT BY THE ATTORNEY GENERAL (8-11-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-30-98)
The applicant has assets of $2 billion; the target has assets of $196 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

BancFirst, Oklahoma City, Oklahoma *to merge with* **Amquest Bank, N.A., Lawton, Oklahoma**

SUMMARY REPORT BY THE ATTORNEY GENERAL (8-11-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-30-98)
The applicant has assets of $2 billion; the target has assets of $369 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Old Kent Bank, Grand Rapids, Michigan *to merge with* **First National Bank of Evergreen, Evergreen Park, Illinois**

SUMMARY REPORT BY THE ATTORNEY GENERAL (8-11-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-30-98)
The applicant has assets of $14 billion; the target has assets of $2 billion. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

WestStar Bank, Bartlesville, Oklahoma *to acquire assets and liabilities of* **1 branch of Superior Federal Bank, F.S.B.—Nowata, Nowata, Oklahoma**

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-24-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (8-3-98)
The applicant has assets of $515 million; the target has assets of $6 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama *to merge with* **Prime Bank of Central Florida, Titusville, Florida**

SUMMARY REPORT BY THE ATTORNEY GENERAL (8-11-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (8-4-98)
The applicant has assets of $8 billion; the target has assets of $70 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

The Peoples Bank and Trust Company, Selma, Alabama *to merge with* **The Bank of Tallassee, Tallassee, Alabama**

SUMMARY REPORT BY THE ATTORNEY GENERAL (8-11-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (8-5-98)
The applicant has assets of $437 million; the target has assets of $92 million. The parties do not operate in the same market. The banking factors

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Federal Reserve Bank of St. Louis

15—Continued

and considerations relating to the convenience and needs of the community are consistent with approval.

Bank of Casa Grande Valley, Casa Grande, Arizona *to acquire assets and liabilities of* **1 branch of National Bank of Arizona, Eloy, Arizona**

Summary Report by the Attorney General (8-11-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (8-6-98)
The applicant has assets of $44 million; the target has assets of $8 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama *to merge with* **First Macon Bank and Trust Company, Macon, Georgia**

Summary Report by the Attorney General (8-11-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (8-12-98)
The applicant has assets of $8 billion; the target has assets of $195 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

First Community Bank, Glasgow, Montana *to merge with* **Cheyenne Western Bank, Ashland, Montana**

Summary Report by the Attorney General (8-11-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (8-14-98)
The applicant has assets of $106 million; the target has assets of $11 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama *to merge with* **FirstBank, Dallas, Texas**

Summary Report by the Attorney General (8-20-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (8-20-98)
The applicant has assets of $9 billion; the target has assets of $173 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Fifth Third Bank of Southern Ohio, Hillsboro, Ohio *to acquire assets and liabilities of* **4 offices of Bank One, N.A., Columbus, Ohio**

Summary Report by the Attorney General (8-20-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (8-27-98)
The applicant has assets of $527 million; the targets have assets of $25 billion. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Fifth Third Bank of Southern Ohio, Hillsboro, Ohio *to acquire assets and liabilities of* **3 branches of Bank One, N.A., Columbus, Ohio**

Summary Report by the Attorney General (8-20-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (8-27-98)
The applicant has assets of $527 million; the targets have assets of $171 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Killbuck Savings Bank, Killbuck, Ohio *to merge with* **The Commercial and Savings Bank, Danville, Ohio**

Summary Report by the Attorney General (8-20-98)

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15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1998—Continued

The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (8-27-98)
The applicant has assets of $187 million; the target has assets of $16 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Centura Bank, Rocky Mount, North Carolina *to merge with* **Clyde Savings Bank, Franklin, North Carolina**

Summary Report by the Attorney General (9-17-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (9-15-98)
The applicant has assets of $7.4 billion; the target has assets of $9 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

FCNB Bank, Frederick, Maryland *to merge with* **Capital Bank, National Association, Rockville, Maryland**

Summary Report by the Attorney General (9-17-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (9-15-98)
The applicant has assets of $1,009 million; the target has assets of $167 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Laurel Bank, Johnstown, Pennsylvania *to merge with* **The Peoples National Bank of Rural Valley, Rural Valley, Pennsylvania**

Summary Report by the Attorney General (9-17-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (9-22-98)
The applicant has assets of $2 billion; the target has assets of $37 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama *to merge with* **InterWest Bank, Reno, Nevada**

Summary Report by the Attorney General (9-17-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (9-29-98)
The applicant has assets of $9 billion; the target has assets of $123 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Bank of Bentonville, Bentonville, Arkansas *to merge with* **State Bank of Noel, Noel, Missouri**

Summary Report by the Attorney General (9-30-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (10-9-98)
The applicant has assets of $544 million; the target has assets of $11 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama *to merge with* **Texas Bank and Trust, Dallas, Texas**

Summary Report by the Attorney General (9-30-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (10-15-98)
The applicant has assets of $9 billion; the target has assets of $103 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Capital City Bank, Tallahassee, Florida *to acquire assets and liabilities of* **8 Florida branches of First Union National Bank, Charlotte, North Carolina**

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15—Continued

SUMMARY REPORT BY THE ATTORNEY GENERAL (9-30-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (10-20-98)
The applicant has assets of $1 billion; the targets have assets of $221 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Farmers State Bank of West Concord, West Concord, Minnesota *to acquire assets and liabilities of* **1 office of Eagle Valley Bank, N.A., St. Croix Falls, Wisconsin**

SUMMARY REPORT BY THE ATTORNEY GENERAL (9-30-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (10-21-98)
The applicant has assets of $21 million; the target has assets of $5 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Republic Security Bank, West Palm Beach, Florida *to merge with* **Newberry Bank, Newberry, Florida**

SUMMARY REPORT BY THE ATTORNEY GENERAL (9-30-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (10-21-98)
The applicant has assets of $1 billion; the target has assets of $36 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Republic Security Bank, West Palm Beach, Florida *to acquire assets and liabilities of* **2 branches of Household Bank, F.S.B., Wood Dale, Illinois**

SUMMARY REPORT BY THE ATTORNEY GENERAL (10-9-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (10-28-98)
The applicant has assets of $1 billion; the targets have assets of $19 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Winfield Banking Company, Winfield, Missouri *to acquire assets and liabilities of* **3 branches of Allegiant Bank, St. Louis, Missouri**

SUMMARY REPORT BY THE ATTORNEY GENERAL (10-27-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (10-28-98)
The applicant has assets of $29 million; the targets have assets of $41 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Republic Security Bank, West Palm Beach, Florida *to merge with* **Northside Bank of Tampa, Tampa, Florida**

SUMMARY REPORT BY THE ATTORNEY GENERAL (10-27-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (11-9-98)
The applicant has assets of $1 billion; the target has assets of $69 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Southwest Georgia Bank, Moultrie, Georgia *to merge with* **1 branch of Farmers and Merchants Bank, Monticello, Florida**

SUMMARY REPORT BY THE ATTORNEY GENERAL (10-27-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (11-9-98)
The applicant has assets of $217 million; the target has assets of $5 million. The parties do not operate in the same market. The banking factors and con-

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15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1998—Continued

siderations relating to the convenience and needs of the community are consistent with approval.

Centura Bank, Rocky Mount, North Carolina *to merge with* **Scotland Savings Bank, SSB, Laurinburg, North Carolina**

Summary Report by the Attorney General (10-27-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (11-5-98)
The applicant has assets of $7.4 billion; the target has assets of $61 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Banco Popular North America, New York, New York *to merge with* **First State Bank of Southern California, Santa Fe Springs, California**

Summary Report by the Attorney General (9-30-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (11-16-98)
The applicant has assets of $4 billion; the target has assets of $188 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Banco Popular North America, New York, New York *to merge with* **Bronson-Gore Bank, Prospect Heights, Illinois**

Summary Report by the Attorney General (9-30-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (11-16-98)
The applicant has assets of $4 billion; the target has assets of $79 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Banco Popular North America, New York, New York *to merge with* **Irving Bank, Chicago, Illinois**

Summary Report by the Attorney General (9-30-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (11-16-98)
The applicant has assets of $4 billion; the target has assets of $53 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Salin Bank and Trust Company, Indianapolis, Indiana *to acquire assets and liabilities of* **4 branches of Bank One, Indiana, N.A., Indianapolis, Indiana**

Summary Report by the Attorney General (12-9-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (12-7-98)
The applicant has assets of $459 million; the target has assets of $8 billion. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Valley Independent Bank, El Centro, California *to acquire assets and liabilities of* **1 branch of Fremont Investment and Loan, Anaheim, California**

Summary Report by the Attorney General (12-8-98)
The proposed transaction would not be significantly adverse to competition.

Basis for Approval by the Federal Reserve (12-8-98)
The applicant has assets of $491 million; the target has assets of $106 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Marine Midland Bank, Buffalo, New York *to merge with* **First Commercial Bank of Philadelphia, Philadelphia, Pennsylvania**

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15—Continued

SUMMARY REPORT BY THE ATTORNEY GENERAL (11-25-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-9-98)
The applicant has assets of $33.2 billion; the target has assets of $89 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

The Fifth Third Bank of Southern Ohio, Hillsboro, Ohio *to merge with* **Bank of Ashland, Ashland, Kentucky**

SUMMARY REPORT BY THE ATTORNEY GENERAL (12-8-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-10-98)
The applicant has assets of $577 million; the target has assets of $164 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Chickasha Bank & Trust Company, Chickasha, Oklahoma *to merge with* **Cement Bank, Cement, Oklahoma**

SUMMARY REPORT BY THE ATTORNEY GENERAL (11-5-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-14-98)
The applicant has assets of $65 million; the target has assets of $9 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

US Bank, Johnstown, Pennsylvania *to acquire assets and liabilities of* **2 branches of First Western Bank, N.A., New Castle, Pennsylvania**

SUMMARY REPORT BY THE ATTORNEY GENERAL (12-15-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-24-98)
The applicant has assets of $1.3 billion; the targets have assets of $50 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Southern California Bank, Newport Beach, California *to merge with* **Pacific National Bank, Newport Beach, California**

SUMMARY REPORT BY THE ATTORNEY GENERAL (12-16-98)
The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-30-98)
The applicant has assets of $880 million; the targets have assets of $271 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Table 15 continued on next page.

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15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1998—Continued

Mergers Approved Involving Wholly Owned Subsidiaries of the Same Bank Holding Company

The following transactions involve banks that are subsidiaries of the same bank holding company. In each case, the Summary Report by the Attorney General indicates that the transaction would not have a significantly adverse effect on competition because the proposed merger is essentially a corporate reorganization. The Federal Reserve determined that the competitive effects of the proposed transaction, the financial and managerial resources and prospects of the banks concerned, and the convenience and needs of the community to be served were consistent with approval.

Institution [1]	Assets (millions of dollars)	Date of approval
Farmers Bank of Maryland, Annapolis, Maryland	852	1-13-98
Merger		
The Caroline County Bank, Greensboro, Maryland	29	
Capital One Bank, Glen Allen, Virginia	5,400	1-22-98
Merger		
Capital One, F.S.B., Falls Church, Virginia	444	
Farmers State Bank, Victor, Montana	113	1-23-99
Merger		
Farmers State Bank, F.S.B., Stevensville, Montana	5	
Shore Bank, Onley, Virginia	111	2-9-98
Merger		
Shore Savings Bank, F.S.B., Onley, Virginia		
F&M Bank–Blakeley, Inc., Ranson, West Virginia	114	2-25-98
Merger		
F&M Bank–Keyser, Inc., Keyser, West Virginia	97	
F&M Bank–Martinsburg, Martinsburg, West Virginia	100	
M&I Marshall & Ilsley Bank, Milwaukee, Wisconsin	8,081	2-25-98
Merger		
M&I Bank South, Janesville, Wisconsin	14	
M&I Bank of Burlington, Burlington, Wisconsin	14	
M&I Bank of Racine, Racine, Wisconsin	286	2-25-98
Merger		
Advantage Bank, FSB (1 branch), Kenosha, Wisconsin	7	
Wesbanco Bank, Wheeling, West Virginia	869	3-2-98
Merger		
Bank of Paden City, Paden City, West Virginia	34	
Bank of McMechen, McMechen, West Virginia	31	
First Banking Center–Burlington, Burlington, Wisconsin	280	3-20-98
Merger		
First Banking Center–Albany, Albany, Wisconsin	25	

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15—Continued

Institution[1]	Assets (millions of dollars)	Date of approval
The Fifth Third Bank of Kentucky, Inc., Louisville, Kentucky	2,100	4-9-98
Merger		
The Fifth Third Bank of Kentucky, Inc. (2 branches), Louisville, Kentucky	23	
The Fifth Third Bank of Central Kentucky, Inc., Paris, Kentucky	81	4-9-98
Merger		
The Fifth Third Bank of Kentucky, Inc. (2 branches), Louisville Kentucky	23	
The Fifth Third Bank of Central Kentucky, Inc., Clarksville, Indiana	81	4-9-98
Merger		
The Fifth Third Bank of Kentucky, Inc. (2 branches), Louisville, Kentucky	23	
American Bank of Montana, Bozeman, Montana	161	4-10-98
Merger		
American Bank–Whitefish, Whitefish, Montana	10	
Fifth Third Bank, Cincinnati, Ohio	9,400	4-23-98
Merger		
Fifth Third Bank of Western Ohio, Dayton, Ohio	1,900	
Fifth Third Bank of Cincinnati, Cincinnati, Ohio	9,400	4-23-98
Merger		
Century Savings Bank, Columbus, Ohio	250	
Fifth Third Bank of Columbus, Columbus, Ohio	1,600	4-23-98
Merger		
Fifth Third Bank of Cincinnati, Cincinnati, Ohio	17	
Ohio State Savings Bank, Columbus, Ohio	2,100	
Fifth Third Bank of Western Ohio, Dayton, Ohio	1,991	4-23-98
Merger		
Citizens Federal Savings Bank, FSB, Dayton, Ohio	3,277	
Mercantile Bank, Overland Park, Kansas	4,000	4-29-98
Merger		
Mercantile Bank of Northern Missouri, Macon, Missouri	1	
Mercantile Bank of St. Joseph, St. Joseph, Missouri	348	
Western Bank of Cody, Cody, Wyoming	55	5-26-98
Merger		
First National Bank, Worland, Wyoming	90	
Bank of Colorado, Ft. Lupton, Colorado	325	5-27-98
Merger		
First Security Bank, Craig, Colorado	41	

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15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1998—Continued

Institution [1]	Assets (millions of dollars)	Date of approval
Alpha Community Bank, Washburn, Illinois	29	5-28-98
Merger		
Citizens National Bank of Toluca, Toluca, Illinois	40	
Minonk State Bank, Minonk, Illinois	49	
RCB Bank, Claremore, Oklahoma	376	6-2-98
Merger		
Bank of Inola, Broken Arrow, Oklahoma	31	
Wesbanco Bank Wheeling, Wheeling, West Virginia	877	6-3-98
Merger		
Wesbanco Bank Barnesville, Barnesville, Ohio	159	
Hanover Bank, Mechanicsville, Virginia	142	7-2-98
Merger		
Regency Bank, Richmond, Virginia	82	
First Community Bank, Forest, Virginia	165	
Citizens Banking Company, Salineville, Ohio	1,300	7-3-98
Merger		
First National Bank of Chester, Chester, West Virginia	33	
BancFirst, Oklahoma City, Oklahoma	1,500	7-9-98
Merger		
The Security Bank & Trust Company, Lawton, Oklahoma	94	
M&I Bank of Shawano, Shawano, Wisconsin	199	7-10-98
Merger		
M&I Bank S.S.B.–Sheboygan, Clintonville, Wisconsin	24	
Peoples First Bank, Hennessey, Oklahoma	326	7-23-98
Merger		
Home State Bank, Hobart, Oklahoma	42	
Mercantile Bank of Western Iowa, Des Moines, Iowa	1,123	8-4-98
Merger		
Mercantile Bank of Eastern Iowa, Waterloo, Iowa	1,521	
One Valley Bank of Summersville, Inc., Summersville, West Virginia	120	8-5-98
Merger		
One Valley Bank of Oak Hill, Inc., Oak Hill, West Virginia	149	
One Valley Bank of Ronceverte, N.A., Ronceverte, West Virginia	141	
Johnson Bank, Racine, Wisconsin	800	8-20-98
Merger		
Johnson Bank, N.A., Janesville, Wisconsin	164	
Lindell Bank & Trust Company, St. Louis, Missouri	137	8-24-98
Merger		
Duchesne Bank, St. Peters, Missouri	108	

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15—Continued

Institution[1]	Assets (millions of dollars)	Date of approval
Compass Bank, Birmingham, Alabama	9	8-28-98
Merger		
Compass Bank, Houston, Texas	6	
The Eaton Bank, Eaton Colorado	184	9-16-98
Merger		
Fort Collins Branch of Farmers Bank, Eaton, Colorado	22	
Mercantile Bank Midwest, Des Moines, Iowa	1,253	10-2-98
Merger		
First National Bank of Iowa, Iowa City, Iowa	556	
The Rock Island Bank, N.A., Bettendorf, Iowa	511	
BancFirst, Oklahoma City, Oklahoma	2,100	10-7-98
Merger		
Kingfisher Bank & Trust Company, Kingfisher, Oklahoma	80	
People First Bank, Hennessey, Oklahoma	359	10-8-98
Merger		
City Bank, Weatherford, Oklahoma	59	
Comerica Bank, Detroit, Michigan	28,000	10-19-98
Merger		
Comerica Bank & Trust, F.S.B., Boca Raton, Florida	110	
Security Bank, Ralls, Texas	27	10-26-98
Merger		
First State Bank, Petersburg, Texas	15	
The Citizens Banking Company, Salineville, Ohio	1,000	10-27-98
Merger		
Century National Bank and Trust Company, Rochester, Pennsylvania	448	
Peoples Bank and Trust Company of Lincoln County, Troy, Missouri	142	10-28-98
Merger		
Winfield Banking Company, Winfield, Missouri	29	
Banco Popular de Puerto Rico, Hato Rey, Puerto Rico	17,000	11-16-98
Merger		
Banco Popular, New York, New York	4,000	
Banco Popular, New York, New York	4,000	11-16-98
Merger		
Banco Popular, F.S.B., Newark, New Jersey	2,000	
Banco Popular–Illinois, Chicago, Illinois	1,000	
Banco Popular, N.A. (California), City of Commerce, California	167	
Banco Popular, N.A. (Florida), Sanford, Florida	122	

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15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1998—Continued

Institution[1]	Assets (millions of dollars)	Date of approval
The Ohio Bank, Findlay, Ohio	600	11-19-98
Merger		
AmeriFirst Bank, N.A., Xenia, Ohio	231	
American Community Bank, N.A., Lima, Ohio	374	
Pinnacle Bank, St. Joseph, Michigan	2,027	11-25-98
Merger		
The Citizens National Bank of Evansville, Evansville, Indiana	2,491	
Citizens Bank of Western Indiana, Terre Haute, Indiana	439	
Citizens Bank of Central Indiana, Greenwood, Indiana	669	
Citizens Bank of Southern Indiana, Tell City, Indiana	305	
Citizens Bank of Kentucky, Madinsonville, Kentucky	790	
Citizens Bank of Illinois, N.A., Mount Vernon, Illinois	710	
Bank of Colorado, Fort Lupton, Colorado	327	12-2-98
Merger		
Bank of Colorado–Front Range, Windsor, Colorado	48	

1. Each proposed transaction was to be effected under the charter of the first-named bank. The entries are in chronological order of approval. Some transactions include the acquisition of certain assets and liabilities of the affiliated bank.

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15—Continued

Mergers Approved Involving a Non-Operating Institution with an Existing Bank

The following transactions have no significant effect on competition; they merely facilitate the acquisition of the voting shares of a bank (or banks) by a holding company. In such cases, the summary report by the Attorney General indicates that the transaction will merely combine an existing bank with a non-operating institution; in consequence, and without regard to the acquisition of the surviving bank by the holding company, the merger would have no effect on competition. The Federal Reserve determined that the proposal would, in itself, have no adverse competitive effects and that the financial factors and considerations relating to the convenience and needs of the community were consistent with approval.

Institution [1]	Assets (millions of dollars)	Date of approval
Marshall & Ilsley Bank, Milwaukee, Wisconsin	8,081	2-25-98
Merger		
Advantage Wisconsin Interim Bank, FSB, Kenosha, Wisconsin	363	
M&I Bank of Burlington, Burlington, Wisconsin	205	2-25-98
Merger		
Advantage Burlington Interim Bank, FSB, Kenosha, Wisconsin	27	
Canadian State Bank, Yukon, Oklahoma	21	5-29-98
Merger		
New Canadian State Bank, Oklahoma City, Oklahoma	...	
Commercial Bank, Delphos, Ohio	187	7-2-98
Merger		
Delphos Interim Bank, Delphos, Ohio	...	
First Sentinel Bank, Richlands, Virginia	42	7-15-98
Merger		
Sentinel Interim Bank, Richlands, Virginia	...	
The Bank of Monroe, Union, West Virginia	46	9-9-98
Merger		
Monroe Interim Bank, Union, West Virginia	...	
Virginia Heartland Bank, Fredericksburg, Virginia	103	9-22-98
Merger		
Virginia Heartland Interim Bank, Fredericksburg, Virginia	...	
First Valley Bank, Seeley Lake, Montana	13	11-4-98
Merger		
New First Valley Bank, Seeley Lake, Montana	...	
The Pleasants County Bank, St. Marys, West Virginia	43	11-5-98
Merger		
Pleasants County Interim Bank, St. Marys, West Virginia	...	
Banco Popular North America, New York, New York	4,000	11-16-98
Merger		
Popular Transition Bank, Hato Rey, Puerto Rico	...	

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15. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1998—Continued

Institution[1]	Assets (millions of dollars)	Date of approval
Farmers & Merchants Bank, Hannibal, Missouri	91	11-25-98
Merger		
F&M Interim Bank, Hannibal, Missouri	...	
Poteau State Bank, Poteau, Oklahoma	92	12-2-98
Merger		
Spiro Interim Bank, Spiro, Oklahoma	...	

1. Each proposed transaction was to be effected under the charter of the first-named bank. The entries are in chronological order of approval. Some transactions include the acquisition of certain assets and liabilities of the affiliated bank.

. . . Not applicable; the bank is newly organized and not in operation.

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Board of Governors of the Federal Reserve System

December 31, 1998

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Term expires January 31,

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J. Virgil Mattingly, Jr., *General Counsel*
Scott G. Alvarez, *Associate General Counsel*
Richard M. Ashton, *Associate General Counsel*
Oliver Ireland, *Associate General Counsel*
Kathleen M. O'Day, *Associate General Counsel*
Katherine H. Wheatley, *Assistant General Counsel*

OFFICE OF THE SECRETARY

Jennifer J. Johnson, *Secretary*
Robert deV. Frierson, *Associate Secretary*
Barbara R. Lowrey, *Associate Secretary and Ombudsman*

DIVISION OF INTERNATIONAL FINANCE

Karen H. Johnson, *Director*
Lewis S. Alexander, *Deputy Director*
Peter Hooper III, *Deputy Director*
Dale W. Henderson, *Associate Director*
David H. Howard, *Senior Adviser*
Donald B. Adams, *Assistant Director*
Thomas A. Connors, *Assistant Director*

DIVISION OF MONETARY AFFAIRS

Donald L. Kohn, *Director*
David E. Lindsey, *Deputy Director*
Brian F. Madigan, *Associate Director*
Richard D. Porter, *Deputy Associate Director*
Vincent R. Reinhart, *Deputy Associate Director*
William C. Whitesell, *Assistant Director*
Normand R.V. Bernard, *Special Assistant to the Board*

1. The designations as Chairman and Vice Chair expire on June 20, 2000, and June 24, 2000, respectively, unless the service of these members of the Board shall have terminated sooner.

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Board of Governors—Continued

DIVISION OF RESEARCH AND STATISTICS

Michael J. Prell, *Director*
Edward C. Ettin, *Deputy Director*
David J. Stockton, *Deputy Director*
William R. Jones, *Associate Director*
Myron L. Kwast, *Associate Director*
Patrick M. Parkinson, *Associate Director*
Thomas D. Simpson, *Associate Director*
Lawrence Slifman, *Associate Director*
Martha S. Scanlon, *Deputy Associate Director*
David S. Jones, *Assistant Director*
Stephen D. Oliner, *Assistant Director*
Stephen A. Rhoades, *Assistant Director*
Janice Shack-Marquez, *Assistant Director*
Charles S. Struckmeyer, *Assistant Director*
Alice Patricia White, *Assistant Director*
Joyce K. Zickler, *Assistant Director*
Glenn B. Canner, *Senior Adviser*
John J. Mingo, *Senior Adviser*

DIVISION OF BANKING SUPERVISION AND REGULATION

Richard Spillenkothen, *Director*
Stephen C. Schemering, *Deputy Director*
Herbert A. Biern, *Associate Director*
Roger T. Cole, *Associate Director*
William A. Ryback, *Associate Director*
Gerald A. Edwards, Jr., *Deputy Associate Director*
Stephen M. Hoffman, Jr., *Deputy Associate Director*
James V. Houpt, Jr., *Deputy Associate Director*
Jack P. Jennings, *Deputy Associate Director*
Michael G. Martinson, *Deputy Associate Director*
Sidney M. Sussan, *Deputy Associate Director*
Molly S. Wassom, *Deputy Associate Director*
Howard A. Amer, *Assistant Director*
Norah M. Barger, *Assistant Director*
Betsy Cross Jacowski, *Assistant Director*
Richard A. Small, *Assistant Director*
William C. Schneider, Jr., *Project Director, National Information Center*

DIVISION OF CONSUMER AND COMMUNITY AFFAIRS

Dolores S. Smith, *Director*
Glenn E. Loney, *Deputy Director*
Sandra F. Braunstein, *Assistant Director*
Maureen P. English, *Assistant Director*
Adrienne D. Hurt, *Assistant Director*
Irene Shawn McNulty, *Assistant Director*

DIVISION OF FEDERAL RESERVE BANK OPERATIONS AND PAYMENT SYSTEMS

Clyde H. Farnsworth, Jr., *Director*
David L. Robinson, *Deputy Director (Finance and Control)*
Louise L. Roseman, *Associate Director*
Paul W. Bettge, *Assistant Director*
Jack Dennis, Jr., *Assistant Director*
Earl G. Hamilton, *Assistant Director*
Joseph H. Hayes, Jr., *Assistant Director*
Jeffrey C. Marquardt, *Assistant Director*
Marsha W. Reidhill, *Assistant Director*

OFFICE OF STAFF DIRECTOR FOR MANAGEMENT

S. David Frost, *Staff Director*
John R. Weis, *Adviser*

MANAGEMENT DIVISION

S. David Frost, *Director*
Stephen J. Clark, *Associate Director, Finance Function*
Darrell R. Pauley, *Associate Director, Human Resources Function*
Sheila Clark, *Equal Employment Opportunity Programs Director*

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Board of Governors—Continued

DIVISION OF INFORMATION RESOURCES MANAGEMENT
Stephen R. Malphrus, *Director*
Richard C. Stevens, *Deputy Director*
Marianne M. Emerson, *Assistant Director*
Maureen Hannan, *Assistant Director*
Po Kyung Kim, *Assistant Director*
Raymond H. Massey, *Assistant Director*
Edward T. Mulrenin, *Assistant Director*
Day W. Radebaugh, Jr., *Assistant Director*
Elizabeth B. Riggs, *Assistant Director*

DIVISION OF SUPPORT SERVICES
Robert E. Frazier, *Director*
George M. Lopez, *Assistant Director*
David L. Williams, *Assistant Director*

OFFICE OF THE INSPECTOR GENERAL
Barry R. Snyder, *Inspector General*
Donald L. Robinson, *Assistant Inspector General*

Federal Open Market Committee

December 31, 1998

Members

ALAN GREENSPAN, *Chairman*, Board of Governors
WILLIAM J. MCDONOUGH, *Vice Chairman*, President, Federal Reserve Bank of New York
ROGER W. FERGUSON, JR., Board of Governors
EDWARD M. GRAMLICH, Board of Governors
THOMAS M. HOENIG, President, Federal Reserve Bank of Kansas City
JERRY L. JORDAN, President, Federal Reserve Bank of Cleveland
EDWARD W. KELLY, JR., Board of Governors
LAURENCE H. MEYER, Board of Governors
CATHY E. MINEHAN, President, Federal Reserve Bank of Boston
WILLIAM POOLE, President, Federal Reserve Bank of St. Louis
ALICE M. RIVLIN, Board of Governors

Alternate Members

EDWARD G. BOEHNE, President, Federal Reserve Bank of Minneapolis
ROBERT D. MCTEER, JR., President, Federal Reserve Bank of Dallas
MICHAEL H. MOSKOW, President, Federal Reserve Bank of Chicago
GARY H. STERN, President, Federal Reserve Bank of Philadelphia

Officers

DONALD L. KOHN, *Secretary and Economist*
NORMAND R.V. BERNARD, *Deputy Secretary*
LYNN S. FOX, *Assistant Secretary*
GARY P. GILLUM, *Assistant Secretary*
J. VIRGIL MATTINGLY, JR., *General Counsel*
THOMAS C. BAXTER, JR., *Deputy General Counsel*
MICHAEL J. PRELL, *Economist*
LYNN E. BROWNE, *Associate Economist*

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Board of Governors of the Federal Reserve System

Errata: In the list of alternate members of the Federal Open Market Committee (p. 368), the affiliations of two Federal Reserve Bank presidents are incorrect. The correct information is as follows:

EDWARD G. BOEHNE, President, Federal Reserve Bank of Philadelphia
GARY H. STERN, President, Federal Reserve Bank of Minneapolis

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Federal Open Market Committee—Continued

STEPHEN G. CECCHETTI, *Associate Economist*
WILLIAM G. DEWALD, *Associate Economist*
CRAIG S. HAKKIO, *Associate Economist*
DAVID E. LINDSEY, *Associate Economist*
THOMAS D. SIMPSON, *Associate Economist*
MARK S. SNIDERMAN, *Associate Economist*
DAVID J. STOCKTON, *Associate Economist*

PETER R. FISHER, *Manager, System Open Market Account*

During 1998 the Federal Open Market Committee held eight regularly scheduled meetings (see Minutes of Federal Open Market Committee Meetings in this REPORT.)

Federal Advisory Council

December 31, 1998

Members

District 1—WILLIAM M. CROZIER, JR., *Chairman of the Board*, Bank of Boston Corporation, Boston, Massachusetts

District 2—DOUGLAS A. WARNER III, *Chairman, President, and Chief Executive Officer*, J.P. Morgan & Co., Incorporated, New York, New York

District 3—WALTER E. DALLER, JR., *Chairman, President, and Chief Executive Officer*, Harleysville National Bank and Trust Company, Harleysville, Pennsylvania

District 4—ROBERT W. GILLESPIE, *Chairman and Chief Executive Officer*, KeyCorp, Cleveland, Ohio

District 5—KENNETH D. LEWIS, *President, Consumer and Commercial Banking*, Bank of America, Charlotte, North Carolina

District 6—STEPHEN A. HANSEL, *President and Chief Executive Officer*, Hibernia National Bank, New Orleans, Louisiana

District 7—NORMAN R. BOBINS, *President and Chief Executive Officer*, LaSalle National Bank and LaSalle National Corporation, Chicago, Illinois

District 8—THOMAS H. JACOBSEN, *Chairman, President, and Chief Executive Officer*, Mercantile Bancorporation, Inc., St. Louis, Missouri

District 9—RICHARD A. ZONA, *Vice Chairman*, U.S. Bancorp, Minneapolis, Minnesota

District 10—C.Q. CHANDLER, *Chairman and Chief Executive Officer*, INTRUST Financial Corporation, Wichita, Kansas

District 11—CHARLES T. DOYLE, *Chairman and Chief Executive Officer*, Texas First Bank – Texas City, Texas City, Texas

District 12—VACANCY

Officers

THOMAS H. JACOBSEN, *President*
CHARLES T. DOYLE, *Vice President*
JAMES E. ANNABLE, *Co–Secretary*
WILLIAM J. KORSVIK, *Co–Secretary*

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Federal Advisory Council—Continued

Directors

WILLIAM M. CROZIER, JR.

WALTER E. DALLER, JR.

The Federal Advisory Council met on February 5–6, April 30–May 1, September 10–11, and November 5–6, 1998. The Board of Governors met with the council on February 6, May 1, September 11, and November 6, 1998. The council, which is composed of one representative of the banking industry from each of the twelve Federal Reserve Districts, is required by law to meet in Washington at least four times each year and is authorized by the Federal Reserve Act to consult with, and advise, the Board on all matters within the jurisdiction of the Board.

Consumer Advisory Council

December 31, 1998

Members

RICHARD S. AMADOR, *President and Chief Executive Officer,* CHARO Community Development Corporation, Los Angeles, California

WALTER J. BOYER, *President,* United Central Bank, Garland, Texas

WAYNE-KENT A. BRADSHAW, *President and Chief Executive Officer,* Family Savings Bank, FSB, Los Angeles, California

JEREMY D. EISLER, *Director of Litigation,* South Mississippi Legal Services Corp., Biloxi, Mississippi

ROBERT F. ELLIOTT, *Vice Chairman,* Household International, Prospect Heights, Illinois

HERIBERTO FLORES, *President and Chief Executive Officer,* Brightwood Development Corporation, Springfield, Massachusetts

DWIGHT GOLANN, *Professor of Law,* Suffolk University Law School, Boston, Massachusetts

MARVA H. HARRIS, *Senior Vice President and Manager for Community Development,* PNC Bank Corporation, Pittsburgh, Pennsylvania

KARLA S. IRVINE, *Executive Director,* Housing Opportunities Made Equal of Greater Cincinnati, Inc., Cincinnati, Ohio

FRANCINE C. JUSTA, *Executive Director,* Neighborhood Housing Services of New York, New York, New York

JANET C. KOEHLER, *Vice President,* Electronic Commerce Citibank, Jacksonville, Florida

GWENN S. KYZER, *Vice President,* Target Marketing Service, Experian, Inc., Allen, Texas

JOHN C. LAMB, *Senior Staff Counsel,* Department of Consumer Affairs, Sacramento, California

ERROL T. LOUIS, *Consultant,* Brooklyn, New York

MARTHA W. MILLER, *President,* Choice Federal Credit Union, Greensboro, North Carolina

DANIEL W. MORTON, *Vice President and Senior Counsel,* The Huntington National Bank, Columbus, Ohio

CHARLOTTE NEWTON, *Consumer Adviser,* 9213 Beachway Lane, Springfield, Virginia

CAROL J. PARRY, *Executive Vice President,* Chase Manhattan Bank, New York, New York

PHILIP PRICE, JR., *Executive Director,* The Philadelphia Plan, Philadelphia, Pennsylvania

DAVID L. RAMP, *Attorney,* Legal Aid Society of Minneapolis, Minneapolis, Minnesota

MARILYN ROSS, *Executive Director,* Holy Name Housing Corporation, Omaha, Nebraska

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Consumer Advisory Council—Continued

MARGOT F. SAUNDERS, *Managing Attorney,* National Consumer Law Center, Washington, D.C.

ROBERT G. SCHWEMM, *Ashland Professor of Law,* University of Kentucky, Lexington, Kentucky

DAVID J. SHIRK, *Senior Vice President,* Frontier Investment Company, Eugene, Oregon

GAIL M. SMALL, *Executive Director,* Native Action, Lame Deer, Montana

GREGORY D. SQUIRES, *Professor,* University of Wisconsin-Milwaukee, Milwaukee, Wisconsin

GEORGE P. SURGEON, *Chief Financial Officer and Executive Vice President,* Shorebank Corporation, Chicago, Illinois

THEODORE J. WYSOCKI, JR., *Executive Director,* CANDO, Chicago, Illinois

Officers

WILLIAM N. LUND, *Chair*
Director, Office of Consumer Credit
Regulation, State of Maine
Augusta, Maine

YVONNE S. SPARKS, *Vice Chair*
Vice President, NationsBank
Community Investments Group
St. Louis, Missouri

The Consumer Advisory Council met with members of the Board of Governors on March 19, June 25, and October 22, 1998. The council is composed of academics, state and local government officials, representatives of the financial industry, and representatives of consumer and community interests. It was established pursuant to the 1976 amendments to the Equal Credit Opportunity Act to advise the Board on consumer financial services.

Thrift Institutions Advisory Council

December 31, 1998

Members

GAROLD R. BASE, *President and Chief Executive Officer,* Community Credit Union, Plano, Texas

DAVID A. BOCHNOWSKI, *Chairman, President, and Chief Executive Officer,* Peoples Bank, SB, Munster, Indiana

DAVID E.A. CARSON, *Chairman, President, and Chief Executive Officer,* Peoples Bank, Bridgeport, Connecticut

RICHARD P. COUGHLIN, *President and Chief Executive Officer,* Stoneham Co-operative Bank, Stoneham, Massachusetts

WILLIAM A. FITZGERALD, *Chairman and Chief Executive Officer,* Commercial Federal Bank, Omaha, Nebraska

STEPHEN D. HAILER, *President and Chief Executive Officer,* North Akron Savings Bank, Akron, Ohio

F. WELLER MEYER, *President and Chief Executive Officer,* Acacia Federal Savings Bank, Falls Church, Virginia

EDWARD J. MOLNAR, *President and Chief Executive Officer,* Harleysville Savings Bank, Harleysville, Pennsylvania

GUY C. PINKERTON, *Chairman, President, and Chief Executive Officer,* Washington Federal Savings and Loan Association, Seattle, Washington

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Thrift Institutions Advisory Council—Continued

CHARLES R. RINEHART, *Former Chairman and Chief Executive Officer*, Home Savings of America, FSB, Irwindale, California

TERRY R. WEST, *President and Chief Executive Officer*, Jax Navy Federal Credit Union, Jacksonville, Florida

FREDERICK WILLETTS III, *President and Chief Executive Officer*, Cooperative Bank for Savings, Inc., SSB, Wilmington, North Carolina

Officers

CHARLES R. RINEHART, *President*

WILLIAM A. FITZGERALD, *Vice President*

The members of the Thrift Institutions Advisory Council met with the Board of Governors on March 6, July 24, and December 4, 1998. The council, which is composed of representatives from credit unions, savings and loan associations, and savings banks, consults with, and advises, the Board on issues pertaining to the thrift industry and on various other matters within the Board's jurisdiction.

Officers of Federal Reserve Banks and Branches

December 31, 1998

BANK or Branch	Chairman[1] Deputy Chairman	President First Vice President	Vice President in charge of Branch
BOSTON[2]	William C. Brainard William O. Taylor	Cathy E. Minehan Paul M. Connolly	
NEW YORK[2]	John C. Whitehead Peter G. Peterson	William J. McDonough Vacant	
Buffalo	Bal Dixit		Carl W. Turnipseed[3]
PHILADELPHIA	Joan Carter Charisse R. Lillie	Edward G. Boehne William H. Stone, Jr.	
CLEVELAND[2]	G. Watts Humphrey, Jr. David H. Hoag	Jerry L. Jordan Sandra Pianalto	
Cincinnati	George C. Juilfs		Charles A. Cerino[3]
Pittsburgh	John T. Ryan III		Robert B. Schaub
RICHMOND[2]	Claudine B. Malone Robert L. Strickland	J. Alfred Broaddus, Jr. Walter A. Varvel	
Baltimore	Daniel R. Baker		William J. Tignanelli[3]
Charlotte	Dennis D. Lowery		Dan M. Bechter[3]

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Officers of Federal Reserve Banks and Branches—Continued

BANK or Branch	Chairman[1] / Deputy Chairman	President / First Vice President	Vice President in charge of Branch
ATLANTA	David R. Jones	Jack Guynn	James M. McKee
	John F. Wieland	Patrick K. Barron	
Birmingham	Patricia B. Compton		Fred R. Herr[3]
Jacksonville	Judy Jones		James D. Hawkins[3]
Miami	R. Kirk Landon		James T. Curry III
Nashville	Frances F. Marcom		Melvyn K. Purcell
New Orleans	Lucimarian Roberts		Robert J. Musso
CHICAGO[2]	Lester H. McKeever, Jr.	Michael H. Moskow	
	Arthur C. Martinez	William C. Conrad	
Detroit	Florine Mark		David R. Allardice[3]
ST. LOUIS	John F. McDonnell	William Poole	
	Susan S. Elliott	W. Legrande Rives	
Little Rock	Betta M. Carney		Robert A. Hopkins
Louisville	Roger Reynolds		Thomas A. Boone
Memphis	Carol G. Crawley		Martha L. Perine
MINNEAPOLIS	David A. Koch	Gary H. Stern	
	James J. Howard	Colleen K. Strand	
Helena	William P. Underriner		Samuel H. Gane
KANSAS CITY	Jo Marie Dancik	Thomas M. Hoenig	
	Terrence P. Dunn	Richard K. Rasdall	
Denver	Peter I. Wold		Carl M. Gambs[3]
Oklahoma City	Barry L. Eller		Kelly J. Dubbert
Omaha	Arthur L. Shoener		Steven D. Evans
DALLAS	Roger R. Hemminghaus	Robert D. McTeer, Jr.	
	James A. Martin	Helen E. Holcomb	
El Paso	Patricia Z. Holland-Branch		Sammie C. Clay
Houston	Edward O. Gaylord		Robert Smith III[3]
San Antonio	H. B. Zachry, Jr.		James L. Stull[3]
SAN FRANCISCO	Gary G. Michael	Robert T. Parry	
	Cynthia A. Parker	John F. Moore	
Los Angeles	Anne L. Evans		Mark L. Mullinix[3]
Portland	Carol A. Whipple		Raymond H. Laurence[3]
Salt Lake City	Richard E. Davis		Andrea P. Wolcott
Seattle	Richard R. Sonstelie		Gordon R.G. Werkema[4]

NOTE. A current list of these officers appears each month in the *Federal Reserve Bulletin*.

1. The Chairman of a Federal Reserve Bank serves, by statute, as Federal Reserve Agent.

2. Additional offices of these Banks are located at Windsor Locks, Connecticut; Utica at Oriskany, New York; East Rutherford, New Jersey; Columbus, Ohio; Charleston, West Virginia; Columbia, South Carolina; Indianapolis, Indiana; Milwaukee, Wisconsin; Des Moines, Iowa; and Peoria, Illinois.

3. Senior Vice President.

4. Executive Vice President.

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Conference of Chairmen

The chairmen of the Federal Reserve Banks are organized into the Conference of Chairmen, which meets to consider matters of common interest and to consult with, and advise, the Board of Governors. Such meetings, attended also by the deputy chairmen, were held in Washington on May 27 and 28, and on November 19 and 20, 1998.

The members of the Executive Committee of the Conference of Chairmen during 1998 were John F. McDonnell, chair; G. Watts Humphrey, Jr., vice chair; and Jo Marie Dancik, member.

On November 20, 1998, the conference elected its Executive Committee for 1999; it named G. Watts Humphrey, Jr., as chair, Jo Marie Dancik as vice chair, and Claudine B. Malone as the third member.

Conference of Presidents

The presidents of the Federal Reserve Banks are organized into the Conference of Presidents, which meets periodically to consider matters of common interest and to consult with, and advise, the Board of Governors.

Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City, served as chair of the conference in 1998, and Jerry L. Jordan, President of the Federal Reserve Bank of Cleveland, served as its vice chair. Esther L. George, of the Federal Reserve Bank of Kansas City, served as its secretary, and Stephen J. Ong, of the Federal Reserve Bank of Cleveland, served as its assistant secretary.

On November 3, 1998, the conference elected Jerry L. Jordan as its chair for 1999–2000, and J. Alfred Broaddus, Jr., of the Federal Reserve Bank of Richmond, as its vice chair.

Conference of First Vice Presidents

The Conference of First Vice Presidents of the Federal Reserve Banks was organized in 1969 to meet periodically for the consideration of operations and other matters.

Colleen K. Strand, First Vice President of the Federal Reserve Bank of Minneapolis, served as chair of the conference in 1998, and Richard K. Rasdall, Jr., First Vice President of the Federal Reserve Bank of Kansas City, served as its vice chair. Niel D. Willardson, of the Federal Reserve Bank of Minneapolis served as its secretary, and Leesa M. Guyton, of the Federal Reserve Bank of Kansas City, served as its assistant secretary.

Directors

The following list of directors of Federal Reserve Banks and Branches shows for each director the class of directorship, the director's principal organizational affiliation, and the date the director's term expires. Each Federal Reserve Bank has a nine-member board: three Class A and three Class B directors, who are elected by the stockholding member banks, and three Class C directors, who are appointed by the Board of Governors of the Federal Reserve System.

Class A directors represent the stockholding member banks in each Federal Reserve District. Class B and Class C directors represent the public and are chosen with due, but not exclusive, consideration to the interests of agriculture, commerce, industry, services, labor, and consumers; they may not be officers, directors, or employees of any bank or bank holding company. In addition, Class C directors may not be stockholders of any bank or bank holding company.

For the election of Class A and Class B directors, the Board of Governors classifies the member banks of each Federal Reserve District into three groups. Each group, which comprises banks with similar capitalization, elects one Class A director and one Class B director. Annually, the Board of Governors designates one of the Class C directors as chair of the board and Federal Reserve Agent of each District Bank, and it designates another Class C director as deputy chair.

Federal Reserve Branches have either five or seven directors, a majority of whom are appointed by the parent Federal Reserve Bank; the others are appointed by the Board

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of Governors. One of the directors appointed by the Board is designated annually as chair of the board of that Branch in a manner prescribed by the parent Federal Reserve Bank.

For the name of the chair and deputy chair of the board of directors of each Reserve Bank and of the chair of each Branch, see the preceding table, "Officers of Federal Reserve Banks and Branches."

Directors of Federal Reserve Banks and Branches

		Term expires Dec. 31
DISTRICT 1—BOSTON		
Class A		
Marshall N. Carter	Chairman and Chief Executive Officer, State Street Bank and Trust Company, Boston, Massachusetts	1998
G. Kenneth Perine	President and Chief Executive Officer, National Bank of Middlebury, Middlebury, Vermont	1999
Edwin N. Clift	President and Chief Executive Officer, Merrill Merchants Bank, Bangor, Maine	2000
Class B		
Robert R. Glauber	Adjunct Lecturer, John F. Kennedy School of Government, Harvard University, Cambridge, Massachusetts	1998
Stephen L. Brown	Chairman and Chief Executive Officer, John Hancock Mutual Life Insurance Company, Boston, Massachusetts	1999
Edward Dugger III	President and Chief Executive Officer, UNC Ventures, Inc., Boston, Massachusetts	2000
Class C		
William C. Brainard	Professor of Economics, Yale University, New Haven, Connecticut	1998
William O. Taylor	Chairman Emeritus, The Boston Globe, Boston, Massachusetts	1999
James J. Norton	President, Graphic Communications International Union, Washington, D.C.	2000
DISTRICT 2—NEW YORK		
Class A		
Robert G. Wilmers	Chairman and Chief Executive Officer, Manufacturers and Traders Trust Company, Buffalo, New York	1998
George W. Hamlin IV	President and Chief Executive Officer, The Canandaigua National Bank and Trust Company, Canandaigua, New York	1999
Walter V. Shipley	Chairman and Chief Executive Officer, The Chase Manhattan Corporation, New York, New York	2000

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		Term expires Dec. 31

DISTRICT 2, NEW YORK—Continued

Class B

Ronay Menschel	President, Phipps Houses, New York, New York	1998
Ann M. Fudge	Executive Vice President, Kraft Foods, Inc., and President, Coffee & Cereals Division, Tarrytown, New York	1999
Eugene R. McGrath	Chairman, President, and Chief Executive Officer, Consolidated Edison Company of New York, Inc., New York, New York	2000

Class C

Peter G. Peterson	Chairman, The Blackstone Group, New York, New York	1998
John C. Whitehead	Former Chairman, Goldman, Sachs & Co., Inc., New York, New York	1999
Vacancy		2000

BUFFALO BRANCH

Appointed by the Federal Reserve Bank

Kathleen R. Whelehan	Executive Vice President, Consumer Finance Division, Marine Midland Bank, Buffalo, New York	1998
Louise Woerner	Chairman and Chief Executive Officer, HCR, Rochester, New York	1999
William E. Swan	President and Chief Executive Officer, Lockport Savings Bank, Lockport, New York	2000
Mark W. Adams	Owner and Operator, Adams Poultry Farm, Naples, New York	2000

Appointed by the Board of Governors

Bal Dixit	President and Chief Executive Officer, Newtex Industries, Inc., Victor, New York	1998
Patrick P. Lee	Chairman and Chief Executive Officer, International Motion Control, Inc., Orchard Park, New York	1999
Louis J. Thomas	Director, District 4, United Steelworkers of America, Cheektowaga, New York	2000

DISTRICT 3—PHILADELPHIA

Class A

Albert B. Murry	President and Chief Executive Officer, Lebanon Valley National Bank, Lebanon, Pennsylvania	1998
David B. Lee	President and Chief Executive Officer, Omega Bank, N.A., State College, Pennsylvania	1999

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		Term expires Dec. 31
DISTRICT 3, *Class A*—Continued		
Harry Elwell III	President and Chief Executive Officer, First National Bank of Absecon, Absecon, New Jersey	2000
Class B		
Howard E. Cosgrove	Chairman and Chief Executive Officer, Conectiv (Delmarva Power and Light Company), Wilmington, Delaware	1998
J. Richard Jones	President and Chief Executive Officer, Jackson–Cross Company, Philadelphia, Pennsylvania	1999
Robert D. Burris	President and Chief Executive Officer, Burris Foods, Inc., Milford, Delaware	2000
Class C		
Charisse R. Lillie	Partner, Ballard Spahr Andrews & Ingersoll, Philadelphia, Pennsylvania	1998
Joan Carter	President and Chief Operating Officer, UM Holdings Ltd., Haddonfield, New Jersey	1999
Glenn A. Schaeffer	President, Pennsylvania Building and Construction Trades Council, Harrisburg, Pennsylvania	2000
DISTRICT 4—CLEVELAND		
Class A		
David A. Daberko	Chairman and Chief Executive Officer, National City Corporation, Cleveland, Ohio	1998
Tiney M. McComb	Chairman and President, Heartland BancCorp, Gahanna, Ohio	1999
David S. Dahlmann	President and Chief Executive Officer, Southwest National Corporation, Greensburg, Pennsylvania	2000
Class B		
I.N. Rendall Harper, Jr.	President and Chief Executive Officer, American Micrographics Company, Inc., Monroeville, Pennsylvania	1998
David L. Nichols	Former Chairman and Chief Executive Officer, Mercantile Stores Inc., Fairfield, Ohio	1999
Cheryl L. Krueger–Horn	President and Chief Executive Officer, Cheryl & Co., Westerville, Ohio	2000

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Federal Reserve Bank of St. Louis

		Term expires Dec. 31

DISTRICT 4, CLEVELAND—Continued

Class C

David H. Hoag	Chairman, The LTV Corporation, Cleveland, Ohio	1998
Robert Y. Farrington	Executive Secretary–Treasurer, Emeritus, Ohio State Building and Construction Trades Council, Columbus, Ohio	1999
G. Watts Humphrey, Jr.	President, GWH Holdings, Inc., Pittsburgh, Pennsylvania	2000

CINCINNATI BRANCH

Appointed by the Federal Reserve Bank

Jean R. Hale	President and Chief Executive Officer, Community Trust Bank, N.A., Pikeville, Kentucky	1998
Judith G. Clabes	President and Chief Executive Officer, Scripps Howard Foundation, Cincinnati, Ohio	1999
Phillip R. Cox	President and Chief Executive Officer, Cox Financial Corporation, Cincinnati, Ohio	1999
Stephen P. Wilson	President and Chief Executive Officer, Lebanon Citizens National Bank, Lebanon, Ohio	2000

Appointed by the Board of Governors

Thomas Revely III	President and Chief Executive Officer, Cincinnati Bell Supply Co., Cincinnati, Ohio	1998
George C. Juilfs	President and Chief Executive Officer, SENCORP, Newport, Kentucky	1999
Wayne Shumate	Chairman and Chief Executive Officer, Kentucky Textiles, Inc., Paris, Kentucky	2000

PITTSBURGH BRANCH

Appointed by the Federal Reserve Bank

Edward V. Randall, Jr.	Chairman, PNC Bank Foundation, Pittsburgh, Pennsylvania	1998
Georgia Berner	President, Berner International Corp., New Castle, Pennsylvania	1999
Peter N. Stephans	Chairman and Chief Executive Officer, Trigon Incorporated, McMurray, Pennsylvania	1999
Thomas J. O'Shane	Chairman and Chief Executive Officer, First Western Bancorp, Inc., New Castle, Pennsylvania	2000

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Term expires Dec. 31

DISTRICT 4, PITTSBURGH BRANCH—Continued

Appointed by the Board of Governors

Gretchen R. Haggerty	Vice President–Accounting and Finance, U.S. Steel Group, USX Corporation, Pittsburgh, Pennsylvania	1998
Charles E. Bunch	Senior Vice President, Strategic Planning and Corporate Services, PPG Industries, Inc., Pittsburgh, Pennsylvania	1999
John T. Ryan III	Chairman and Chief Executive Officer, Mine Safety Appliances Company, Pittsburgh, Pennsylvania	2000

DISTRICT 5—RICHMOND

Class A

George A. Didden III	Chairman and Chief Executive Officer, The National Capital Bank of Washington, Washington, D.C.	1998
J. Walter McDowell	President–North Carolina Banking, Wachovia Bank, N.A., Winston–Salem, North Carolina	1999
Elizabeth A. Duke	President and Chief Executive Officer, Bank of Tidewater, Virginia Beach, Virginia	2000

Class B

Craig A. Ruppert	President and Owner, The Ruppert Companies, Laytonsville, Maryland	1998
Wesley S. Williams, Jr.	Partner, Covington & Burling, Washington, D.C.	1999
James E. Haden	President and Chief Executive Officer, Martha Jefferson Hospital, Charlottesville, Virginia	2000

Class C

Robert L. Strickland	Retired Chairman, Lowe's Companies, Inc., Winston–Salem, North Carolina	1998
Jeremiah J. Sheehan	Chairman and Chief Executive Officer, Reynolds Metals Company, Richmond, Virginia	1999
Claudine B. Malone	President, Financial & Management Consulting, Inc., McLean, Virginia	2000

BALTIMORE BRANCH

Appointed by the Federal Reserve Bank

Jeremiah E. Casey	Chairman, First Maryland Bancorp, Baltimore, Maryland	1998
Morton I. Rapoport	President and Chief Executive Officer, University of Maryland Medical System, Baltimore, Maryland	1999

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Federal Reserve Bank of St. Louis

Term expires Dec. 31

DISTRICT 5, BALTIMORE BRANCH

Appointed by the Federal Reserve Bank—Continued

Name	Position	Term expires Dec. 31
William L. Jews	President and Chief Executive Officer, Blue Cross Blue Shield of Maryland, Owings Mills, Maryland	2000
Virginia W. Smith	President and Chief Executive Officer, Union National Bank, Westminster, Maryland	2000

Appointed by the Board of Governors

Name	Position	Term expires Dec. 31
Daniel R. Baker	President and Chief Executive Officer, Tate Access Floors, Inc., Jessup, Maryland	1998
George L. Russell, Jr.	Partner, Piper & Marbury L.L.P., Baltimore, Maryland	1999
Betty Bednarczyk	International Secretary–Treasurer, Service Employees International Union, AFL-CIO, CLC, Washington, D.C.	2000

CHARLOTTE BRANCH

Appointed by the Federal Reserve Bank

Name	Position	Term expires Dec. 31
William H. Nock	President and Chief Executive Officer, Sumter National Bank, Sumter, South Carolina	1998
Laura M. Fleming	President and Chief Executive Officer, Founders Federal Credit Union, Lancaster, South Carolina	1999
Elleveen T. Poston	President, Quality Transport, Inc., Lake City, South Carolina	2000
Cecil W. Sewell, Jr.	Chairman and Chief Executive Officer, Centura Banks, Inc., Rocky Mount, North Carolina	2000

Appointed by the Board of Governors

Name	Position	Term expires Dec. 31
James O. Roberson	President and Chief Executive Officer, Research Triangle Foundation of North Carolina, Research Triangle Park, North Carolina	1998
Dennis D. Lowery	Chief Executive Officer and Chairman, Continental Chemicals, Charlotte, North Carolina	1999
Joan H. Zimmerman	President, Southern Shows, Inc., Charlotte, North Carolina	2000

DISTRICT 6—ATLANTA

Class A

Name	Position	Term expires Dec. 31
Waymon L. Hickman	Chairman and Chief Executive Officer, First Farmers and Merchants National Bank, Columbia, Tennessee	1998

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Federal Reserve Bank of St. Louis

		Term expires Dec. 31
DISTRICT 6, *Class A*—Continued		
Howard L. McMillan, Jr.	Chairman, Jackson Advisory Board, Deposit Guaranty National Bank, Jackson, Mississippi	1999
D. Paul Jones, Jr.	Chairman and Chief Executive Officer, Compass Bancshares, Inc., Birmingham, Alabama	2000
Class B		
Suzanne E. Boas	President, Consumer Credit Counseling Service of Greater Atlanta, Atlanta, Georgia	1998
Juanita P. Baranco	Executive Vice President, Baranco Automotive Group of Metro Atlanta, Morrow, Georgia	1999
Maria Camila Leiva	Executive Vice President, Miami Free Zone Corporation, Miami, Florida	2000
Class C		
David R. Jones	Chairman, AGL Resources Inc., Atlanta, Georgia	1998
John F. Wieland	Chairman and Chief Executive Officer, John Wieland Homes and Neighborhoods, Inc., Atlanta, Georgia	1999
Paula Lovell	President, Lovell Communications, Inc., Nashville, Tennessee	2000

BIRMINGHAM BRANCH

Appointed by the Federal Reserve Bank		
J. Stephen Nelson	Chairman and Chief Executive Officer, First National Bank of Brewton, Brewton, Alabama	1998
W. Charles Mayer III	Senior Executive Vice President, AmSouth Bancorporation, and President, Alabama Banking Group, AmSouth Bank, Birmingham, Alabama	1999
Roland Pugh	Chairman, Roland Pugh Construction, Inc., Northport, Alabama	2000
Hundley Batts, Sr.	Managing Agent, Hundley Batts & Associates Ins. Agency, Huntsville, Alabama	2000
Appointed by the Board of Governors		
Patricia B. Compton	President, Patco, Inc., Georgiana, Alabama	1998
V. Larkin Martin	Managing Partner, Martin Farm, Courtland, Alabama	1999
D. Bruce Carr	Labor-Relations Liaison, Laborers' District Council of Alabama, Gadsden, Alabama	2000

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Term expires Dec. 31

DISTRICT 6, ATLANTA—Continued

JACKSONVILLE BRANCH

Appointed by the Federal Reserve Bank

Royce B. Walden	President, Walden Enterprises, Inc., Orlando, Florida	1998
William G. Smith, Jr.	President, Capital City Bank Group, Tallahassee, Florida	1999
Terry R. West	President and Chief Executive Officer, Jax Navy Federal Credit Union, Jacksonville, Florida	2000
Michael W. Poole	Principal, Poole Carbone Capital Partners, Inc., Winter Park, Florida	2000

Appointed by the Board of Governors

Judy Jones	President, J. R. Jones and Associates, Tallahassee, Florida	1998
Marsha G. Rydberg	Partner, Foley & Lardner, Tampa, Florida	1999
William E. Flaherty	Chairman, Blue Cross and Blue Shield of Florida, Inc., Jacksonville, Florida	2000

MIAMI BRANCH

Appointed by the Federal Reserve Bank

E. Anthony Newton	Past President and Chief Executive Officer, Island National Bank and Trust Company, West Palm Beach, Florida	1998
D. Keith Cobb	Former Vice Chairman and Chief Executive Officer, Alamo Rent A Car, Inc., Ft. Lauderdale, Florida	1999
James W. Moore	President, Gulf Utility Company, Fort Myers, Florida	1999
Carlos A. Migoya	President, Dade/Monroe Counties, First Union National Bank of Florida, Miami, Florida	2000

Appointed by the Board of Governors

R. Kirk Landon	Chairman, American Bankers Insurance Group, Miami, Florida	1998
Mark T. Sodders	President, Lakeview Farms, Inc., Pahokee, Florida	1999
Kaaren Johnson–Street	Vice President, Minority Business Development and Urban Initiatives, Enterprise Florida, Inc., Coral Gables, Florida	2000

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Federal Reserve Bank of St. Louis

		Term expires Dec. 31
DISTRICT 6, NASHVILLE BRANCH		
Appointed by the Federal Reserve Bank		
Dale W. Polley	President, First American National Bank, Nashville, Tennessee	1998
Leonard A. Walker, Jr.	Chairman, President, and Chief Executive Officer, First National Bank and Trust Company, Athens, Tennessee	1999
James E. Dalton, Jr.	President and Chief Executive Officer, Quorum Health Group, Inc., Brentwood, Tennessee	2000
John E. Seward, Jr.	President and Chief Executive Officer, Paty Lumber Co., Inc., Piney Flats, Tennessee	2000
Appointed by the Board of Governors		
Frances F. Marcum	Chairman and Chief Executive Officer, Micro Craft, Inc., Tullahoma, Tennessee	1998
Michael E. Bennett	UAW Manufacturing Advisor, UAW Local 1853, Saturn Corporation, Spring Hill, Tennessee	1999
N. Whitney Johns	Chairman and Chief Executive Officer, Whitney Johns & Company, Nashville, Tennessee	2000
NEW ORLEANS BRANCH		
Appointed by the Federal Reserve Bank		
Howell N. Gage	Chairman and Chief Executive Officer, Merchants Bank, Vicksburg, Mississippi	1998
Howard C. Gaines	President, Military Division, First USA Partners, New Orleans, Louisiana	1999
Teri G. Fontenot	President and Chief Executive Officer, Woman's Health Foundation/Woman's Hospital, Baton Rouge, Louisiana	2000
David Guidry	President and Chief Executive Officer, Guico Machine Works, Inc., Harvey, Louisiana	2000
Appointed by the Board of Governors		
Lucimarian Roberts	Community Advocate, Biloxi, Mississippi	1998
Glenn Pumpelly	President and Chief Executive Officer, Pumpelly Oil Inc., Sulphur, Louisiana	1999
Jackie Ducote	President, Public Affairs Research Council of Louisiana, Baton Rouge, Louisiana	2000

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Federal Reserve Bank of St. Louis

Term expires Dec. 31

DISTRICT 7—CHICAGO

Class A

Arnold C. Schultz	Chairman and Chief Executive Officer, Grundy National Bank, Grundy Center, Iowa	1998
Verne G. Istock	Chairman, Bank One Corporation, Chicago, Illinois	1999
Robert R. Yohanan	Managing Director and Chief Executive Officer, First Bank & Trust of Evanston, Evanston, Illinois	2000

Class B

Donald J. Schneider	President, Schneider National, Inc., Green Bay, Wisconsin	1998
Migdalia Rivera	Former Executive Director, Latino Institute, Chicago, Illinois	1999
Jack B. Evans	President, The Hall–Perrine Foundation, Cedar Rapids, Iowa	2000

Class C

Arthur C. Martinez	Chairman and Chief Executive Officer, Sears, Roebuck and Co., Hoffman Estates, Illinois	1998
Robert J. Darnall	President and Chief Executive Officer, Ispat North America, Inc., Chicago, Illinois	1999
Lester H. McKeever, Jr.	Managing Partner, Washington, Pittman & McKeever, Chicago, Illinois	2000

DETROIT BRANCH

Appointed by the Federal Reserve Bank

Richard M. Bell	President and Chief Executive Officer, The First National Bank of Three Rivers, Three Rivers, Michigan	1998
Denise Ilitch	Vice Chairwoman, Little Caesars Enterprises, and President,, Olympia Development, Inc., Detroit, Michigan	1999
Irma B. Elder	President, Troy Motors, Inc., Troy, Michigan	1999
David J. Wagner	Chairman, President, and Chief Executive Officer, Old Kent Financial Corporation, Grand Rapids, Michigan	2000

Appointed by the Board of Governors

Stephen R. Polk	Chairman and Chief Executive Officer, R.L. Polk & Co., Southfield, Michigan	1998
Florine Mark	President and Chief Executive Officer, The WW Group, Inc., Farmington Hills, Michigan	1999
Timothy D. Leuliette	President and Chief Operating Officer, Penske Corporation, Detroit, Michigan	2000

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Federal Reserve Bank of St. Louis

		Term expires Dec. 31
DISTRICT 8—ST. LOUIS		
Class A		
Douglas M. Lester	President and Chief Executive Officer, Sea Change Corporation, Bowling Green, Kentucky	1998
W.D. Glover	Chairman and Chief Executive Officer, First National Bank of Eastern Arkansas, Forrest City, Arkansas	1999
Michael A. Alexander	Chairman and President, The First National Bank of Mount Vernon, Mount Vernon, Illinois	2000
Class B		
Richard E. Bell	President and Chief Executive Officer, Riceland Foods, Inc., Stuttgart, Arkansas	1998
Joseph E. Gliessner, Jr.	Executive Director, New Directions Housing Corp., Louisville, Kentucky	1999
Robert L. Johnson	Chairman and Chief Executive Officer, Johnson Bryce, Inc., Memphis, Tennessee	2000
Class C		
John F. McDonnell	Former Chairman, McDonnell Douglas Corporation, St. Louis, Missouri	1998
Veo Peoples, Jr.	Partner, Haverstock, Garrett and Roberts, St. Louis, Missouri	1999
Susan S. Elliott	Chairman and Chief Executive Officer, Systems Service Enterprises, Inc., St. Louis, Missouri	2000
LITTLE ROCK BRANCH		
Appointed by the Federal Reserve Bank		
Mark A. Shelton III	President, M. A. Shelton Farming Company, Hot Springs, Arkansas	1998
Mark Simmons	Chairman, Simmons Foods, Inc., Siloam Springs, Arkansas	1999
Ross M. Whipple	Chairman and Chief Executive Officer, Horizon Bancorp, Inc., Arkadelphia, Arkansas	1999
Lunsford W. Bridges	President and Chief Executive Officer, Metropolitan National Bank, Little Rock, Arkansas	2000
Appointed by the Board of Governors		
Betta M. Carney	Chairman and Chief Executive Officer, World Wide Travel Service Inc., Little Rock, Arkansas	1998
Janet M. Jones	President, The Janet Jones Company, Little Rock, Arkansas	1999
Diana T. Hueter	President and Chief Executive Officer, St. Vincent Health Systems, Little Rock, Arkansas	2000

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Federal Reserve Bank of St. Louis

		Term expires Dec. 31

DISTRICT 8, LOUISVILLE BRANCH

Appointed by the Federal Reserve Bank

Name	Position	Term expires Dec. 31
Orson Oliver	President, Mid-America Bank of Louisville & Trust Co., Louisville, Kentucky	1998
Larry E. Dunigan	Chairman and Chief Executive Officer, Holiday Management Corp., Evansville, Indiana	1999
Ronald R. Cyrus	Former Executive Secretary–Treasurer, Kentucky State AFL-CIO, Frankfort, Kentucky	1999
Frank J. Nichols	Chairman, President, and Chief Executive Officer, Community Financial Services, Inc., Benton, Kentucky	2000

Appointed by the Board of Governors

Name	Position	Term expires Dec. 31
Roger Reynolds	President and Chief Executive Officer, The Reynolds Group, Inc., Louisville, Kentucky	1998
Vacancy		1999
Debbie Scoppechio	Chairman and Chief Executive Officer, Creative Alliance, Inc., Louisville, Kentucky	2000

MEMPHIS BRANCH

Appointed by the Federal Reserve Bank

Name	Position	Term expires Dec. 31
Anthony M. Rampley	President and Chief Executive Officer, Arkansas Glass Container Corporation, Jonesboro, Arkansas	1998
Katie S. Winchester	President and Chief Executive Officer, First Citizens National Bank, Dyersburg, Tennessee	1999
John C. Kelley, Jr.	President, Memphis Banking Group, First Tennessee Bank, Memphis, Tennessee	1999
E. C. Neelly III	Chief Executive Officer, First American National Bank, Iuka, Mississippi	2000

Appointed by the Board of Governors

Name	Position	Term expires Dec. 31
John V. Myers	President, Better Business Bureau, Memphis, Tennessee	1998
Mike P. Sturdivant, Jr.	Partner, Due West Plantation, Glendora, Mississippi	1999
Carol G. Crawley	Vice President & Regional Manager, Mid-America Apartment Communities, Inc., Memphis, Tennessee	2000

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Federal Reserve Bank of St. Louis

DISTRICT 9—MINNEAPOLIS

		Term expires Dec. 31
Class A		
Dale J. Emmel	President, First National Bank of Sauk Centre, Sauk Centre, Minnesota	1998
Lynn M. Hoghaug	President, Ramsey National Bank and Trust Co., Devils Lake, North Dakota	1999
Bruce Parker	President, Norwest Bank Montana, Billings, Montana	2000
Class B		
Dennis W. Johnson	President, TMI Systems Design Corporation, Dickinson, North Dakota	1998
Rob L. Wheeler	Vice President, Wheeler Mfg. Co., Inc., Lemmon, South Dakota	1999
Kathryn L. Ogren	Owner, Bitterroot Motors, Missoula, Montana	2000
Class C		
James J. Howard	Chairman, President, and Chief Executive Officer, Northern States Power Company, Minneapolis, Minnesota	1998
David A. Koch	Chairman, Graco, Inc., Plymouth, Minnesota	1999
Ronald N. Zwieg	President, United Food & Commercial Workers, Local 653, Plymouth, Minnesota	2000

HELENA BRANCH

Appointed by the Federal Reserve Bank		
Sandra M. Stash, P.E.	Vice President, Environmental Services, ARCO Environmental Remediation L.L.C., Anaconda, Montana	1998
Richard E. Hart	President, Mountain West Bank, Great Falls, Montana	1999
Emil W. Erhardt	Chairman and President, Citizens State Bank, Hamilton, Montana	2000
Appointed by the Board of Governors		
Thomas O. Markle	President and Chief Executive Officer, Markle's Inc., Glasgow, Montana	1999
William P. Underriner	General Manager, Selover Buick Inc., Billings, Montana	2000

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		Term expires Dec. 31

DISTRICT 10—KANSAS CITY

Class A

William L. McQuillan	President and Chief Executive Officer, City National Bank, Greeley, Nebraska	1998
Dennis E. Barrett	President, FirstBank Holding Company of Colorado, Lakewood, Colorado	1999
Bruce A. Schriefer	President, Bankers' Bank of Kansas, N.A., Wichita, Kansas	2000

Class B

Frank A. Potenziani	M & T Trust, Albuquerque, New Mexico	1998
Charles W. Nichols	Managing Partner, Davison & Sons Cattle Company, Arnett, Oklahoma	1999
Hans Helmerich	President and Chief Executive Officer, Helmerich & Payne, Inc., Tulsa, Oklahoma	2000

Class C

Jo Marie Dancik	Area Managing Partner, Ernst & Young LLP, Minneapolis, Minnesota	1998
Colleen D. Hernandez	Executive Director, Kansas City Neighborhood Alliance, Kansas City, Missouri	1999
Terrence P. Dunn	President and Chief Executive Officer, J. E. Dunn Construction Company, Kansas City, Missouri	2000

DENVER BRANCH

Appointed by the Federal Reserve Bank

Albert C. Yates	President, Colorado State University, Ft. Collins, Colorado	1998
C.G. Mammel	President and Chief Executive Officer, The Bank of Cherry Creek, N.A., Denver, Colorado	1999
Robert M. Murphy	President, Sandia Properties Ltd., Co., Albuquerque, New Mexico	2000
John W. Hay III	President, Rock Springs National Bank, Rock Springs, Wyoming	2000

Appointed by the Board of Governors

Peter I. Wold	Partner, Wold Oil & Gas Company, Casper, Wyoming	1998
Teresa N. McBride	Chief Executive Officer, McBride and Associates, Inc., Albuquerque, New Mexico	1999
Kathryn A. Paul	Division President, Kaiser Permanente, Denver, Colorado	2000

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		Term expires Dec. 31

DISTRICT 10, OKLAHOMA CITY BRANCH

Appointed by the Federal Reserve Bank

Name	Position	Term expires Dec. 31
Betty Bryant Shaull	President-Elect and Director, Bank of Cushing and Trust Company, Cushing, Oklahoma	1998
Dennis M. Mitchell	Vice Chairman, Citizens Bank & Trust Co., Ardmore, Oklahoma	1998
William H. Braum	President, Braum Ice Cream Co., Oklahoma City, Oklahoma	1999
Michael S. Samis	President and Chief Executive Officer, Macklanburg-Duncan Co., Oklahoma City, Oklahoma	2000

Appointed by the Board of Governors

Name	Position	Term expires Dec. 31
Barry L. Eller	Senior Vice President and General Manager, MerCruiser, Stillwater, Oklahoma	1998
Larry W. Brummett	Chairman, President, and Chief Executive Officer, ONEOK, Inc., Tulsa, Oklahoma	1999
Patricia B. Fennell	Executive Director, Latino Community Development Agency, Oklahoma City, Oklahoma	2000

OMAHA BRANCH

Appointed by the Federal Reserve Bank

Name	Position	Term expires Dec. 31
Robert L. Peterson	Chairman and Chief Executive Officer, IBP, Inc., Dakota City, Nebraska	1998
Bruce R. Lauritzen	Chairman and President, First National Bank of Omaha, Omaha, Nebraska	1999
Frank L. Hayes	President, Hayes & Associates, L.L.C., Omaha, Nebraska	2000
H.H. Kosman	Chairman, President, and Chief Executive Officer, Platte Valley National Bank, Scottsbluff, Nebraska	2000

Appointed by the Board of Governors

Name	Position	Term expires Dec. 31
Gladys Styles Johnston	Chancellor, University of Nebraska at Kearney, Kearney, Nebraska	1998
Bob L. Gottsch	Vice President, Gottsch Feeding Corporation, Hastings, Nebraska	1999
Arthur L. Shoener	Shoener Consulting LLC, Omaha, Nebraska	2000

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Term expires Dec. 31

DISTRICT 11—DALLAS

Class A

Dudley K. Montgomery	President and Chief Executive Officer, The Security State Bank of Pecos, Pecos, Texas	1998
Gayle M. Earls	President and Chief Executive Officer, Texas Independent Bank, Dallas, Texas	1999
Kirk A. McLaughlin	President and Chief Executive Officer, Security Bank, Ralls, Texas	2000

Class B

Julie S. England	Vice President, Semiconductor Group, Texas Instruments, Dallas, Texas	1998
Dan Angel	President, Stephen F. Austin State University, Nacogdoches, Texas	1999
Robert C. McNair	Chairman and Chief Executive Officer, Cogen Technologies Energy Group, Houston, Texas	2000

Class C

Roger R. Hemminghaus	Chairman and Chief Executive Officer, Ultramar Diamond Shamrock Corp., San Antonio, Texas	1998
James A. Martin	General Vice President, International Association of Bridge, Structural, Ornamental and Reinforcing Iron Workers, Austin, Texas	1999
Ray L. Hunt	Chairman, President, and Chief Executive Officer, Hunt Consolidated, Inc., Dallas, Texas	2000

EL PASO BRANCH

Appointed by the Federal Reserve Bank

Lester L. Parker	President and Chief Operating Officer, Bank of the West, El Paso, Texas	1998
James D. Renfrow	President and Chief Executive Officer, The Carlsbad National Bank, Carlsbad, New Mexico	1999
Melissa W. O'Rourke	President, Charlotte's Inc., El Paso, Texas	1999
Cecil E. Nix	Business Manager, IBEW Local 460, Midland, Texas	2000

Appointed by the Board of Governors

Beauregard Brite White	Rancher, J. E. White, Jr. & Sons, Marfa, Texas	1998
Patricia Z. Holland-Branch	President and Chief Executive Officer, HB/PZH Commercial Environments, Inc., El Paso, Texas	1999
Gail S. Darling	Chief Executive Officer, Gail Darling, Inc., El Paso, Texas	2000

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Term expires Dec. 31

DISTRICT 11, HOUSTON BRANCH

Appointed by the Federal Reserve Bank

J. Michael Solar	Principal Attorney, Solar & Fernandes L.L.P., Houston, Texas	1998
Judith B. Craven	Houston, Texas	1999
Ray B. Nesbitt	President, Exxon Chemical Company, Houston, Texas	1999
Alan R. Buckwalter III	Chairman and Chief Executive Officer, Chase Bank of Texas, N.A. Houston, Texas	2000

Appointed by the Board of Governors

Edward O. Gaylord	Chairman, EOTT Energy Corp., and General Partner, EOTT Energy Partners L.P., Houston, Texas	1998
Peggy Pearce Caskey	Chief Executive Officer, Laboratories for Genetic Services, Inc., Houston, Texas	1999
Malcolm Gillis	President, Rice University, Houston, Texas	2000

SAN ANTONIO BRANCH

Appointed by the Federal Reserve Bank

Richard W. Evans, Jr.	Chairman and Chief Executive Officer, Frost National Bank, San Antonio, Texas	1998
Juliet V. Garcia	President, The University of Texas at Brownsville, Brownsville, Texas	1999
Douglas G. Macdonald	President, South Texas National Bank, Laredo, Texas	1999
Arthur Emerson	Vice President and General Manager, KVDA-TV 60 Telemundo, San Antonio, Texas	2000

Appointed by the Board of Governors

Carol L. Thompson	President, The Thompson Group, Austin, Texas	1998
Patty P. Mueller	Vice President/Finance, Mueller Energetics Corp., Corpus Christi, Texas	1999
H.B. Zachry, Jr.	Chairman and Chief Executive Officer, H. B. Zachry Company, San Antonio, Texas	2000

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		Term expires Dec. 31
DISTRICT 12—SAN FRANCISCO		
Class A		
Warren K.K. Luke	Vice Chairman, President, and Chief Executive Officer, Hawaii National Bank, Honolulu, Hawaii	1998
E. Lynn Caswell	Chairman and Chief Executive Officer, Pacific Community Banking Group, Laguna Hills, California	1999
John V. Rindlaub	Group Executive Vice President, Bank of America Northwest Group, Seattle, Washington	2000
Class B		
Stanley T. Skinner	Chairman and Chief Executive Officer (Retired), Pacific Gas and Electric Co., San Francisco, California	1998
Robert S. Attiyeh	Senior Vice President and Chief Financial Officer, Amgen, Inc., Thousand Oaks, California	1999
Krestine Corbin	President and Chief Executive Officer, Sierra Machinery, Inc., Sparks, Nevada	2000
Class C		
Cynthia A. Parker	Executive Director, Anchorage Neighborhood Housing Services, Inc., Anchorage, Alaska	1998
Gary G. Michael	Chairman and Chief Executive Officer, Albertson's, Inc., Boise, Idaho	1999
Nelson C. Rising	President and Chief Executive Officer, Catellus Development Corporation, San Francisco, California	2000
LOS ANGELES BRANCH		
Appointed by the Federal Reserve Bank		
Stephen G. Carpenter	Director, California United Bank, Encino, California	1998
John H. Gleason	Senior Vice President, Del Webb Corporation, Phoenix, Arizona	1999
Liam E. McGee	Group Executive Vice President, Bank of America, Los Angeles, California	2000
Linda Griego	Managing General Partner, Engine Co. No. 28, Los Angeles, California	2000
Appointed by the Board of Governors		
Anne L. Evans	Chairman, Evans Hotels, San Diego, California	1998
Lori R. Gay	President, Los Angeles Neighborhood Housing, Los Angeles, California	1999
Lonnie Kane	President, Karen Kane, Inc., Los Angeles, California	2000

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Federal Reserve Bank of St. Louis

		Term expires Dec. 31

DISTRICT 12, PORTLAND BRANCH

Appointed by the Federal Reserve Bank

Name	Position	Term expires Dec. 31
Gary T. Duim	Vice Chairman, U. S. Bancorp, Portland, Oregon	1998
Phyllis A. Bell	President, Oregon Coast Aquarium, Newport, Oregon	1999
Martin Brantley	President and General Manager, KPTV-12, Oregon Television, Inc., Portland, Oregon	1999
Thomas C. Young	President, Chairman, and Chief Executive Officer, Northwest National Bank, Vancouver, Washington	2000

Appointed by the Board of Governors

Name	Position	Term expires Dec. 31
Carol A. Whipple	Proprietor, Rocking C Ranch, Elkton, Oregon	1998
Nancy Wilgenbusch	President, Marylhurst College, Marylhurst, Oregon	1999
Patrick Borunda	Executive Director, ONABEN—A Native American Business Network, Portland, Oregon	2000

SALT LAKE CITY BRANCH

Appointed by the Federal Reserve Bank

Name	Position	Term expires Dec. 31
Roy C. Nelson	President, Bank of Utah, Ogden, Utah	1998
J. Pat McMurray	President, First Security Bank, N.A., Boise, Idaho	1999
Maria Garciaz	Executive Director, Salt Lake Neighborhood Housing Services, Salt Lake City, Utah	1999
R.D. Cash	Chairman, President, and Chief Executive Officer, Questar Corporation, Salt Lake City, Utah	2000

Appointed by the Board of Governors

Name	Position	Term expires Dec. 31
Richard E. Davis	President and Chief Executive Officer, Salt Lake Convention & Visitors Bureau, Salt Lake City, Utah	1998
Nancy S. Mortensen	Vice President–Marketing Services, ZCMI, Salt Lake City, Utah	1999
Barbara L. Wilson	Regional Vice President, U.S. West, Boise, Idaho	2000

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		Term expires Dec. 31
DISTRICT 12, SEATTLE BRANCH		
Appointed by the Federal Reserve Bank		
Constance Leigh Proctor	Partner, Alston Courtnage Proctor & Bassetti, LLP, Seattle, Washington	1998
Tomio Moriguchi	Chairman and Chief Executive Officer, Uwajimaya, Inc., Seattle, Washington	1999
James C. Hawkanson	Managing Director and Chief Executive Officer, The Commerce Bank of Washington, N.A., Seattle, Washington	1999
Betsy Lawer	Vice Chair and Chief Operating Officer, First National Bank of Anchorage, Anchorage, Alaska	2000
Appointed by the Board of Governors		
Helen M. Rockey	President and Chief Executive Officer, Brooks Sports, Inc., Bothell, Washington	1998
Boyd E. Givan	Senior Vice President and Chief Financial Officer, The Boeing Company, Seattle, Washington	1999
Richard R. Sonstelie	Chairman, Puget Sound Energy, Inc., Bellevue, Washington	2000

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Maps of the Federal Reserve System

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The Federal Reserve System

LEGEND

Both pages

■ Federal Reserve Bank city

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Facing page

• Federal Reserve Branch city

— Branch boundary

NOTE

The Federal Reserve officially identifies Districts by number and by Reserve Bank city (shown on both pages) and by letter (shown on the facing page).

In the 12th District, the Seattle Branch serves Alaska, and the San Francisco Bank serves Hawaii.

The System serves commonwealths and territories as follows: The New York Bank serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands; the San Francisco Bank serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands. The maps show the boundaries within the System as of year-end 1998.

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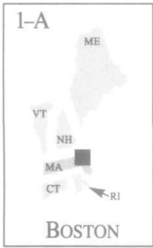

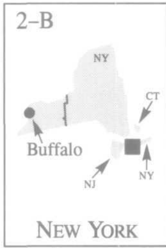

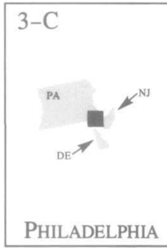

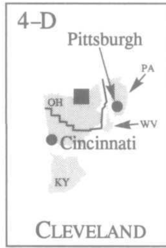

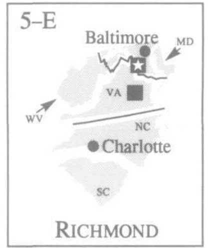

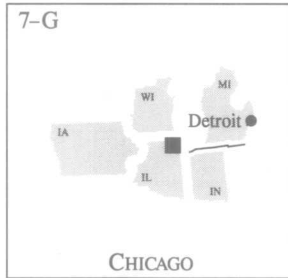

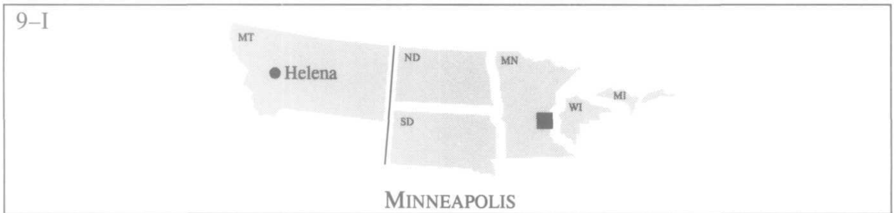

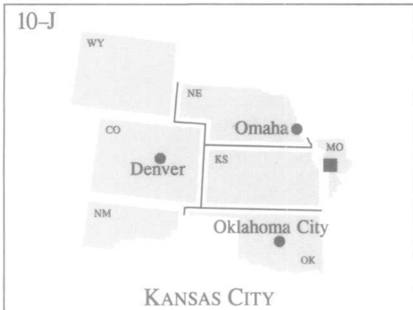

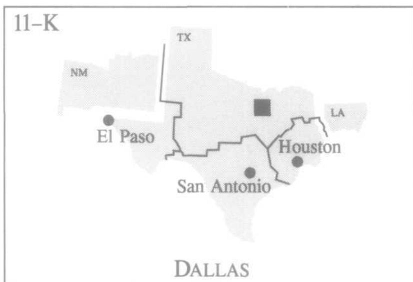

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Index

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Federal Reserve Bank of St. Louis

Index

Access to Capital Initiative, project, 215
Access to Capital: Start to Finish, conference, 215
Administrative Enforcement of the Truth in Lending Act—Restitution, FFIEC policy guide, 220
Agreement corporations, 243, 246, 267
Agriculture, U.S. Department of, 287
Altman, Robert, 243
Annual percentage rate, early disclosure, 209
Annual percentage yield, 212
Asset-Based Community Development: Mobilizing an Entire Community, workshop, 216
Assets and liabilities
  Banks, insured commercial, by class, 337
  Federal Reserve Banks, 316–9
Automated clearinghouse services, 280
Automated teller machines, 218
Availability of Funds and Collection of Checks (*See* Regulations: CC)

Balance sheet, Board of Governors, 308
Balance sheet, Federal Reserve priced services, 291
Banc One Corporation, 208
Bank examiners, training, 219
Bank holding companies
  Applications, 207, 264, 266
  Examinations and inspections, 241–6,
  Income tax allocation, 107, 254
  Leverage capital ratios, 252
  Reports to the Federal Reserve, 257
  Securities subsidiaries, 245
  Stock repurchases by, 268
Bank Holding Companies and Change in Bank Control (*See* Regulations: Y)
Bank Holding Company Act, 231, 264
Bank Merger Act, 264
Bank mergers, consolidations, and acquisitions, list, 345–64
Bank of Canada, reciprocal currency arrangement, 195
Bank of Credit and Commerce International (BCCI), 243
Bank of Mexico, reciprocal currency arrangement, 195
Bank Secrecy Act, 269
BankAmerica Corporation, 208
Banking organizations, overseas investments, 267
Banking structure, U.S., regulation of, 264–8
Basle Committee on Banking Supervision
  Federal Reserve guidance and recommendations to, 252, 254
  Reports
    Enhancing Bank Transparency: Public Disclosure and Supervisory Information that Promote Safety and Soundness in Banking Systems, 255
    Framework for Internal Control Systems in Banking Organizations, 255
    Framework for Supervisory Information about Derivatives and Trading Activities, 255
    Sound Practices for Loan Accounting, Credit Risk Disclosure and Related Matters, 255
    Trading and Derivatives Disclosures of Banks and Securities Firms: Results of the Survey of 1997 Disclosures, 255
Board of Governors (*See also* Federal Reserve System)
  Bank mergers, consolidations, and acquisitions, list, 345–64
  Consumer Advisory Council, 228
  Financial statements, 307–14
  Members and officers, list, 366–8
  Policy actions, 99–111
  Testimony and recommendations to the Congress, 229
Book-entry securities, Federal Reserve Banks, 279, 284
Bound for Good Credit, 221
Business spending, investment, and finance, 12–4, 48–50, 74–7

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

CAESAR (*See* Complaint Analysis Evaluation System and Reports)
Call Reports, revisions to, 260
Capital, changes in, Federal Reserve Banks, 310
Capital accounts, Federal Reserve Banks, 316–9, 332
Capital markets activities, supervision of, 250
Capital standards, 251–3
Cash access policy, 107, 282
Cash flows, Board of Governors, 310
Cash services, Federal Reserve Banks, 281
Cash Track, 285
Century date change (*See* Year 2000)
Change in Bank Control Act, 265
Check collection, Federal Reserve Banks, 276
Citicorp, 208
Civil money penalties, Federal Reserve System, 242
Clifford, Clark, 243
Collection of Checks and Other Items by Federal Reserve Banks (*See* Regulations: J)
Commercial banks, number of, 337, 344
Community Development Resource Guide: A Rainbow of Opportunity in the Delta, 216
Community Reinvestment Act, compliance records and examinations, 208, 219–20, 228
Complaint Analysis Evaluation System and Reports, 226
Comptroller of the Currency, Office of the, 230
Consumer Advisory Council, 228, 370
Consumer and community affairs, 207–30
Consumer complaints, 224–6
Consumer Leasing (*See* Regulations: M)
Consumer policies program, 226
Consumer Reporting Employment Clarification Act, 235
CoreStates Financial Corporation, 208
Credit and depository intermediation, 28, 57–61, 84
Credit risk management, Federal Reserve guidance, 256
Credit Union Membership Access Act, 235
Crestar Financial Corporation, 208
Currency and coin, 281

Data Encryption Standard (DES), 288
Debt, U.S. economy, 28, 57, 84
Delivery of Financial Services in a Post-Welfare Reform Society, symposium, 216
Depository institutions, 254, 264, 285, 338–43
Deposits
  Federal Reserve Banks, 316–9, 338–43
  Insured commercial banks, 337
Derivatives activities, 252, 259
Directors, Federal Reserve Banks and Branches, list, 374–94
Directory of Small Business Assistance Resources for Northern New Jersey, 217
Discount rates (*See also* Interest rates), 7, 109–11, 184, 197
Dividends, Federal Reserve Banks, 324–7

Earnings
  Board of Governors, 309
  Federal Reserve Banks, 288, 297, 324–7
  Federal Reserve priced services, 275, 283, 288, 291–4, 324–7
Economic projections, 1998–99, 41–5, 68–71
Economies, foreign, 32–7, 61–5, 89–92
Economy, U.S.
  Business sector, 10–14, 48–50, 74–7
  Capital flows, 18, 53
  Debt, U.S., 28, 57, 84
  Foreign exchange operations, 37
  Government sector, 14–7, 50–2, 77–9
  Household sector, 9–12, 45–8, 72–4
  Interest rates, 23–6, 60, 87
  Labor market, 19, 53–5, 80–2
  Monetary aggregates, 28–32, 58–60, 85–7
  Monetary policy, 3–7, 39–41, 65–8
  Prices, 20–2, 55–7, 82–4
  Trade and the current account, 17–9, 52, 79
Edge Act corporations, 243, 246, 267
Electronic Fund Transfer Act, economic effects of, 218
Electronic funds transfer (*See also* Regulations: E), 218, 278, 280, 284
Encryption, Federal Reserve data, 288
Enforcement actions, Federal Reserve System, 242

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Equal Credit Opportunity (*See* Regulations: B)
Equal Credit Opportunity Act, 214
Equity for Rural America: From Main Street to Wall Street, conference, 216
Equity prices, 26–8, 60, 88
Examination Parity and Year 2000 Readiness for Financial Institutions Act, 236
Examinations and inspections
  Bank holding companies, 242
  Compliance with consumer protection laws, 219
  Examination-frequency guidelines, 256
  Fair lending, 214
  Federal Reserve Banks, 288
  International banking activities, 246–7
  Specialized
    Fiduciary activities, 244
    Government and municipal securities dealers and brokers, 244
    Information technology activities, 243
    International activities, 246–7
    Securities credit regulation, 245
    Securities subsidiaries of bank holding companies, 245
    Securities-clearing agencies, 244
    Transfer agents, 244
    Year 2000 compliance, 243
  State member banks, 242
  Supervision process, effectiveness, 248–61

Fair lending examinations, 214
Federal Advisory Council, 369
Federal agency securities
  Federal Reserve Banks, 316–9, 322, 338–43
  Federal Reserve open market transactions, 320
Federal Deposit Insurance Corporation, 230
Federal Employees Health Care Protection Act, 236
Federal Financial Institutions Examination Council, 220–1, 258–61
Federal funds rate, 6, 7, 31, 183–4, 197
Federal Open Market Committee
  Authorizations, 113, 115, 121–2, 196
  Directives and instructions, 115, 117, 124
  Disclosure policy, 205
Federal Open Market Committee—Continued
  Meetings, minutes of, 118, 135, 143, 153, 164, 174, 184, 197
  Members and officers, list, 368
  Monetary policy actions, 183–4, 197
Federal Reserve Automation Services, 287
Federal Reserve Banks
  Assessments by Board of Governors, 324–7
  Audits of, 288
  Branches
    Directors list, 374–94
    Officers list, 372
    Premises, 332
    Vice presidents in charge, 372
  Community development, 215–8
  Condition statements, 296, 316–9
  Conferences of chairmen, presidents, and first vice presidents, 374
  Deposits, 316–9
  Directors, list, 374–94
  Discount rate, 184, 197, 334
  District Banks
    Atlanta, 215, 217, 290
    Boston, 215
    Chicago, 215, 217–8, 284
    Cleveland, 215, 290
    Dallas, 216
    Kansas City, 216, 285, 290
    Minneapolis, 215–6, 218, 285, 286
    New York, 217–8, 290
    Philadelphia, 216, 218, 284
    Richmond, 215–7, 285
    San Francisco, 216, 218, 282, 290
    St. Louis, 216, 285, 286
  Dividends paid, 324–7
  Earnings and expenses, 288, 297, 324–7, 328–31
  Examinations of, 288
  Financial statements, combined, 288, 295–305
  Holdings of loans and securities, 289, 316–9, 322, 324–7, 338–43
  Officers, list, 372
  Officers and employees, number and salaries, 323–4
  Operations, volume, 333
  Payments to the U.S. Treasury, 329, 331
  Premises, 290, 291, 296, 301, 303, 316–9, 332
  Priced services, 275–81, 291–4, 324–7

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Federal Reserve Banks—Continued
Salaries of officers and employees, 323–4
Securities and loan holdings, 289
Services
Automated clearinghouse, 280
Book-entry securities, 279
Cash, 281
Check collection, 276
Depository, 282, 285, 287
Fedwire funds transfer, 278
Fiscal agency, 282–3, 287
Float associated with, 281
Food coupon, 287, 333
Multilateral settlement, 278
Noncash collection, 280
Postal money order, 287
Federal Reserve Information Technology, director position established, 287
Federal Reserve notes, 281, 329, 338–44
Federal Reserve System (*See also* Board of Governors)
Applications and proposals, 264–8
Basle Supervisors Committee, recommendations to, 252, 254
Decisions, public notice of, 266
Enforcement actions and civil money penalties, 242
Examinations and inspections, 241, 256
Federal Reserve Information Technology, director position established, 287
Maps, 396–7
Membership, 101, 271
Staff training, 262–4
Supervision and regulation responsibilities, 240–50
Technical assistance, 247
Federal tax payments, 285
Federal Trade Commission, 221, 230
Fedwire
Book-entry securities transfer, 279, 284
Funds transfer, 277
Securities transfer service, 107
Settlement period, 108
FFIEC (*See* Federal Financial Institutions Examination Council)
Fiduciary activities, supervision of, 244
Financial statements
Board of Governors, 307–14
Federal Reserve Banks, combined, 295–305
Federal Reserve priced services, 291–4
First Chicago NBD Corporation, 208
First Union Corporation, 208
Fiscal agency services, Federal Reserve Banks, 282–3
Float, Federal Reserve, 281
Food coupon services, 287, 333
Foreign
Banking organizations, 244–50, 256, 266
Currencies, Federal Reserve income on, 324–7
Trade, 52, 79
Foreign exchange operations, 37

Gold certificate accounts of Reserve Banks and gold stock, 338–43, 316–9
Government and municipal securities dealers and brokers, examination, 244
Government depository services, Federal Reserve Banks, 282
Government Entity Accounting and Reporting System, 283
Government Performance and Results Act of 1993, 95–7
Government sector, 14–7, 50–2, 77–9

Hedging activities, 252–3
Hedge fund, Long-Term Capital Management, L.P., 24, 183, 253
Helping People in Your Community Understand Basic Financial Services, 227
Home Mortgage Disclosure (*See* Regulations: C)
Home Mortgage Disclosure Act, data on loan transactions, 212
Homeowners Protection Act, 236
Household sector, 9–12, 45–8, 72–4
Housing and Urban Development, Department of, complaint referrals, 225

Income and expenses
Board of Governors, 309
Federal Reserve Banks, 288, 297, 324–7
Federal Reserve priced services, 275, 283, 288, 291–4, 324–7
Information technology
FFIEC uniform rating system for, 259
Risk assessment, guidance, 257
Supervision Information Technology (SIT), 261

Digitized for FRASER
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Federal Reserve Bank of St. Louis

Information technology—Continued
Supervision of, by Federal Reserve Banks, 243
Information Technology Planning and Standards, 287
Insured commercial banks, assets and liabilities, 337
Intercompany tax allocation agreements, policy statement, 107
Interest rates (*See also* Discount rates *and* Federal funds rate), 23–6, 60, 87, 334
International Banking Act, 266
International banking activities, supervision and operations of (*See also* Regulations: K), 246–7
International Banking Operations (*See* Regulatons: K)
International Organization of Securities Commissions, 255
Investments
Commercial banks, 337
Federal Reserve Banks, 316–9
Securities, policy statement, 259
Issue and Cancellation of Federal Reserve Bank Capital Stock (*See* Regulations: I)

Joint Forum on Financial Conglomorates, 252–3
Justice, U.S. Department of, referrals to, 214

Keys to Vehicle Leasing—A Consumer Guide, 227

Labor market, 19, 53–5, 80–2
Leverage capital ratios, 252
Litigation involving the Board of Governors
Allen, 233
Allied Irish Banks, plc, 231
American Bankers Insurance Group, Inc., 234
Artis, 233
Attorneys against American Apartheid, 231
Banc One Corporation, Inc., 231
Bank of New England, 234
BankAmerica Corporation, 231
Banking Consultants of America, 232
Bettersworth, 234
Boatmen's Bancshares, Inc., 231
Litigation involving the Board of Governors—Continued
Carrasco, 232
Citicorp, 231
Clarkson, 233
Cunningham, 231
Dauphin Deposit Corporation, 231
Fenili, 233
First Maryland Bancorp, 231
First USA, Inc., 231
Fraternal Order of Police, 232
Goldman, 233
Greeff, 231
Independent Bankers Association of America, 231
Inner City Press/Community on the Move, 231–2
Jones, 233
Kerr, 233
Leuthe, 232
Logan, 233
Maunsell, 234
NationsBank Corporation, 231
NB Holdings Corporation, 231
New Mexico Alliance, 231
Patrick, 233
Pharaon, Ghaith R., 232
Research Triangle Institute, 233
Towe, Edward, 232
Towe, Thomas E., 232
Travelers Group, Inc., 231
Vickery, Charles R., Jr., 232
Wasserman, 233
Wilkins, 233
Loan loss reserves, 108, 254
Loans
Federal Reserve Banks
Holdings and income, 316–9, 324–7, 333, 338–43
Interest rates for depository institutions, 334
Insured commercial banks, loans by, 337
Long-Term Capital Management L.P., hedge fund, 24, 183, 253
Looking for the Best Mortgage—Shop, Compare, Negotiate, 215

Making It in the Mainstream, conference, 215
Maps, Federal Reserve System, 396–7
Margin requirements, 336
Margin stocks, 269, 336

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

MarketWise Reports, 217
Member banks (*See also* State member banks)
  Assets and liabilities, 337
  Number of, 337, 344
Membership of State Banking Institutions in the Federal Reserve System (*See also* Regulations: H), 101
Mergers, consolidations, and acquisitions, list, 345–64
Microenterprises, 215
Monetary aggregates, 28–32, 58–60, 85–7
Monetary policy, 3–7, 39–41, 65–8
Monetary policy reports to the Congress
  February 24, 1999, 39–65
  July 21, 1998, 65–92
Money and debt growth, 44, 58–60, 70
Money laundering, 237, 269
Money Laundering and Financial Crimes Strategy Act, 237
Mortgage costs, disclosure of, 209
Mortgage Credit Partnership Projects, 218
Mortgage lending data, 212
Multilateral settlement services, Federal Reserve Banks, 278

National Book-Entry System, 279
National Community Development Lending School, 216
National Examination Data system, 261
National Information Center, 261
NationsBank Corporation, 208
Native American community development, 216, 229
Noncash collection services, Federal Reserve Banks, 280
Nonmember banks, 337, 344
Norwest Corporation, 208

Patax (paper tax processing system), 286
Payments system risk, 107
Policy statements and other actions, 107
Postal money order services, 287
Premises, Federal Reserve Banks, 290, 291, 296, 301, 303, 316–9, 332
Priced services, Federal Reserve Banks, 275–8, 283, 288, 291–4, 324–7
Prices, 20–2, 55–7, 82–4
Privately Operated Multilateral Settlement Systems, policy statement, 107
Profit and loss, Federal Reserve Banks, 324–7
Publications (*See also* Videotape)
  Bound for Good Credit, 221
  Community Development Resource Guide: A Rainbow of Opportunity in the Delta, 216
  Directory of Small Business Assistance Resources for Northern New Jersey, 217
  Helping People in Your Community Understand Basic Financial Services, 227
  Keys to Vehicle Leasing—A Consumer Guide, 227
  Looking for the Best Mortgage—Shop, Compare, Negotiate, 215
  MarketWise Reports, 217
  Trading and Capital Markets Activities Manual, 250

Real estate appraisal, regulation, 256
Real Estate Settlement Procedures Act, 209–10
Reciprocal currency arrangements, 195
Regulations
  B, Equal Credit Opportunity, 99, 210–11, 221, 228, 274
  C, Home Mortgage Disclosure, 99, 211, 274
  D, Reserve Requirements of Depository Institutions, 99, 274, 335
  E, Electronic Fund Transfers, 101, 211, 218, 222
  H, Membership of State Banking Institutions in the Federal Reserve System, 268–9, 271, 273
  I, Issue and Cancellation of Federal Reserve Bank Capital Stock, 103, 273
  J, Collection of Checks and Other Items by Federal Reserve Banks, 103
  K, International Banking Operations, 104
  M, Consumer Leasing, 104, 210–11, 222
  P, Minimum Security Devices and Procedures for Federal Reserve Banks and State Member Banks, 102, 273
  T, Credit by Brokers and Dealers, 268, 336
  U, Credit by Banks for the Purpose of Purchasing or Carrying Margin Stocks, 268, 336

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Regulations—Continued
X, Borrowers of Securities Credit, 268, 336
Y, Bank Holding Companies and Change in Bank Control, 102, 104
Z, Truth in Lending, 105, 211–2, 223, 228
AA, Unfair or Deceptive Acts or Practices, 224
CC, Availability of Funds and Collection of Checks, 103, 224
DD, Truth in Savings, 106, 211–2, 224
Compliance with, 220–5
Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks, revision, 260
Reports, bank holding companies to the Federal Reserve, 257
Reports of Condition and Income (*See* Call Reports)
Reserve requirements of depository institutions (*See also* Regulations: D), 335
Reserves of depository institutions, 338–43
RESPA (*See* Real Estate Settlement Procedures Act)
Revenue and income
Board of Governors, 309
Federal Reserve Banks, 288, 297, 324–7
Federal Reserve priced services, 283, 288, 291–4, 324–7
Risk-based capital standards, 251
Rules Regarding Delegation of Authority, 106
Rural community development, 215–6

Salaries, Federal Reserve Bank staff, 323
Savings bonds, 285
Securities (*See also* Treasury securities)
Book-entry, 284
Credit for purchasing or carrying, 268, 336
Dealers and brokers, supervision of, 244
Equity, accounting procedures, 251
Holdings by Federal Reserve Banks, 289
Securities credit, regulation of, 268
Securities subsidiaries of bank holding companies, supervision of, 245
Securities-clearing agencies, supervision of, 244
Sell Direct, securities program, 284
Servicing assets, accounting procedure, 251
Settlement services, 108, 278
Small Business Credit Access Initiative, project, 215
Small business development, conference, 215
Small businesses, 212, 215
Sovereign Lending, workshops, 216
Special drawing rights certificates, 316–9, 338–43
State member banks
Applications by, 267
Community Reinvestment Act, compliance examinations, 219–20
Complaints against, 224
Examinations and inspections, 242, 243–7
Financial disclosure by, 268
Loans to executive officers, 270
Number, 337, 344
Stock repurchases, bank holding companies, 268
SunTrust Banks, Inc., 208
Supervision and regulation, Federal Reserve System, responsibilities, 240–50
Supervisory Education Program, 262
Supervisory Information Technology (SIT), 261
Systemwide information technology, 287

Tax allocation, bank holding companies, 254
Technical assistance to foreign and international entities, Federal Reserve System, 247
Testimony and recommendations, Board of Governors, 229
Thrift Institutions Advisory Council, 371
Thrift Supervision, Office of, 221
TILA (*See* Truth in Lending Act)
To Their Credit: Women-Owned Businesses, videotape, 217
Trading, supervision of, 250
Training, 219, 262–4
Transfer agents, supervision of, 244
Transfers of funds (*See also* Regulations: E), 325–7, 333
Travelers Group, Inc., 208
Treasury Direct, 284
Treasury Investment Program, 286
Treasury securities
Bank holdings, by class of bank, 337–43

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Treasury securities—Continued
Federal Reserve Banks
Holdings, 316–9, 322, 324–7
Income, 324–7
Marketable, 284
Open market transactions, 320
Repurchase agreements, 316–9, 320, 322, 338–43
Treasury, U.S. Department of the, 282, 286, 329, 331
Triple DES, encryption standard, 288
Truth in Lending (*See* Regulations: Z)
Truth in Lending Act, 209, 228
Truth in Savings (*See* Regulations: DD)
Twenty dollar note, introduction of, 281

U.S. Holocaust Assets Commission Act, 237
Unfair or Deceptive Acts or Practices (*See* Regulations: AA)
Uniform cash access policy, 107
Uniform Interagency Trust Rating System, 260
Unregulated banking practices, 225

Videotape, *To Their Credit: Women-Owned Businesses,* 217

Wells Fargo and Company, 208

Year 2000
Board of Governors, 230
Federal Reserve Banks, 275
FFIEC supervision program, 243, 258
Nonpreparation, enforcement actions, 243

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Federal Reserve Bank of St. Louis