91st Annual Report 2004

Board of Governors of the Federal Reserve System

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Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., April 2005

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 ninety-first annual report of the Board of Governors of the Federal Reserve System.

This report covers operations of the Board during calendar year 2004.

Sincerely,

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Monetary Policy and Economic Developments

Monetary Policy and the Economic Outlook

The year 2004 was marked by continued expansion in economic activity and appreciable gains in employment. With fiscal policy stimulative, monetary policy accommodative, and financial conditions favorable, household spending remained buoyant and businesses increased investment in capital equipment and inventories, despite the restraint imposed by sizable increases in oil prices. Labor market conditions improved significantly, albeit at an uneven pace, and productivity rose notably further. Consumer price inflation moved higher with the surge in energy prices, but core consumer price inflation (that is, excluding food and energy) remained well contained, and measures of expected inflation over longer horizons held steady or edged lower.

Although economic activity had increased substantially in 2003, the expansion nevertheless appeared somewhat tentative as 2004 opened, in large measure because businesses still seemed to be reluctant to boost hiring. Over the course of the spring, however, it became clearer that the expansion was solidifying. Businesses added appreciably to their payrolls, boosted investment in equipment and software, and started restocking inventories. While household spending growth softened somewhat, residential construction expanded rapidly. Rising energy prices boosted overall consumer price inflation, and core inflation moved up as well. In response to positive economic news and higher inflation during this period, market participants came to anticipate that monetary policy tightening would begin sooner than they had expected, and interest rates increased considerably. With the economic expansion more firmly established and slack in labor and product markets somewhat diminished, the Federal Open Market Committee (FOMC) at its June meeting began to reduce the substantial degree of monetary accommodation that was in place.

The gradual removal of monetary policy stimulus continued in the second half of the year as the economy expanded at a healthy clip on balance. Around midyear, some measures of growth in activity softened, partly because of the drain on income and the rise in business costs created by higher oil prices. The expansion of consumer spending slowed in the spring, and the pace of hiring and gains in industrial production dropped back notably during the summer. Equity prices and longer-term interest rates moved lower over this period as well. In the event, the slowdown in household spending growth proved short lived. Both hiring and increases in factory output stepped up again in the autumn, and these gains were extended early this year. With profits healthy and financial conditions still supportive, capital spending increased at a brisk pace throughout the year. Over the final quarter of 2004, short-term interest rates rose further as monetary policy was firmed at each FOMC meeting, but long-term interest rates were largely unchanged. Equity prices rose appreciably in the fourth

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NOTE. The discussion here and in the next section ("Economic and Financial Developments in 2004 and Early 2005") consists of the text, tables, and selected charts from the Monetary Policy Report submitted to the Congress on February 16, 2005, pursuant to section 2B of the Federal Reserve Act.

quarter, and the dollar depreciated against most other major currencies. The FOMC increased the target federal funds rate 25 basis points again at its meeting this month, bringing the cumulative tightening over the past year to 1½ percentage points.

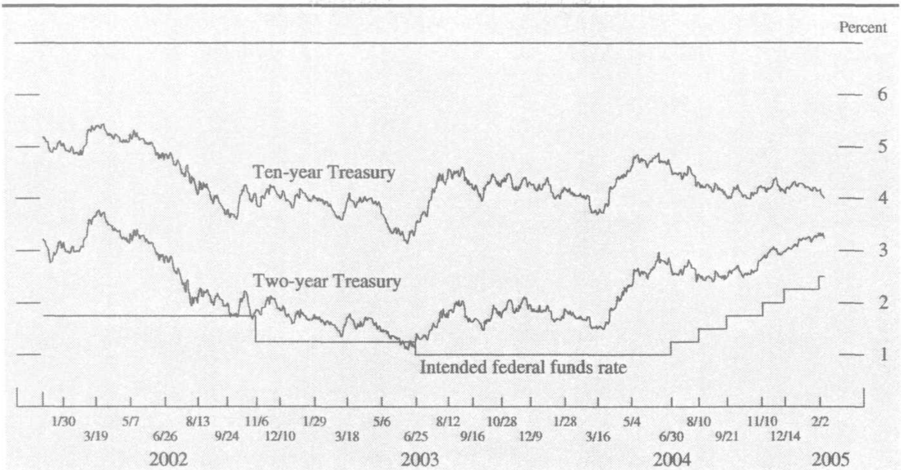
The fundamental factors underlying the continued strength of the economy last year should carry forward into 2005 and 2006, promoting both healthy expansion of activity and low inflation. Monetary policy is still accommodative, and financial conditions more generally continue to be advantageous for households and firms. Profits have been rising briskly, and corporate borrowing costs are low. Household net worth has increased with the continued sharp rise in the value of real estate assets as well as gains in equity prices, and this will likely help support consumer demand in the future. Absent a significant increase in oil prices from current levels, the drag from last year's run-up should wane this year. The lagged effects of the decline in the exchange value of the dollar since the autumn and sustained foreign economic growth are likely to boost the demand for U.S. exports. The prospects for the expansion of aggregate supply also appear to be quite favorable. Gains in structural labor productivity should continue, although not necessarily at the pace of recent years. Economic growth will likely be sufficient to generate notable increases in employment, although any reversal of the decline in labor force participation observed since 2001 would tend to hold up the unemployment rate. Core consumer price inflation has remained low since the larger increases posted in the early months of 2004, and long-term inflation expectations have been similarly well contained. With some slack likely remaining in labor and product markets at present and with the indirect effects of higher oil and import prices diminishing, the prospects for inflation staying low are good. A favorable economic outcome is, of course, not assured, but at the most recent FOMC meeting the Committee again assessed the risks to both output and inflation as balanced. The Committee also reaffirmed that it is prepared to respond to events as necessary in its pursuit of price stability.

Monetary Policy, Financial Markets, and the Economy in 2004 and Early 2005

In early 2004, against the backdrop of stimulative fiscal and monetary policy, continued rapid growth in productivity, and supportive financial market conditions, business outlays appeared to be firming significantly and household spending remained strong. The FOMC became more confident that the economic expansion was likely gaining traction and that the risk of significant further disinflation had been greatly reduced. In these circumstances, it recognized that a highly accommodative stance for monetary policy could not be maintained indefinitely. Nonetheless, the Committee was concerned about the persistently slow pace of hiring and viewed underlying inflation pressures as likely to remain subdued. Accordingly, the Committee left its target for the federal funds rate unchanged at 1 percent at its January and March meetings. However, beginning in January, it modified the language of its policy statement to gain greater flexibility to tighten policy should circumstances warrant by indicating that monetary policy accommodation would eventually have to be removed. At the same time, the Committee suggested that it could be patient in undertaking such actions.

By the time of the May and June FOMC meetings, incoming economic

Selected Interest Rates



NOTE. The data are daily and extend through February 9, 2005. Treasury rates are constant-maturity yields based on the most actively traded securities. The dates on the horizontal axis are those of FOMC meetings.
SOURCE. Department of the Treasury and the Federal Reserve.

data pointed to a broader and more firmly established expansion, with continued strength in housing markets and business fixed investment. Also, the employment reports for March, April, and May had indicated strong and widespread gains in private nonfarm payrolls, and previous reports for January and February were revised upward significantly. Overall consumer price inflation in the first quarter was faster than it had been a year earlier, and core inflation also increased, in part because of the indirect effects of higher energy prices. The Committee maintained its target for the federal funds rate at 1 percent in May, but on the basis of the evolving outlook for economic activity and prices, it revised its assessment of risks to indicate that the upside and downside risks for inflation had moved into balance. The Committee also stated that monetary policy accommodation could "be removed at a pace that is likely to be measured" to communicate its belief, given its economic outlook, that policy would probably soon need to move toward a more neutral stance, though probably not at a rapid pace. The Committee retained this language at the June meeting while raising its target for the federal funds rate from 1 percent to 1¼ percent and noting that it would "respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

The information that the Committee had received by the time of its August meeting indicated that economic growth had softened somewhat earlier in the summer. Although the housing market had remained strong and business outlays had continued to be healthy, consumer spending growth had slowed significantly, and industrial production had begun to level off. Also, the June and July labor market reports revealed that employment growth had slowed considerably. At the same time, core consumer price inflation had moderated in May and June even though sizable increases in food and energy prices continued.

However, the Committee believed that the softness in economic activity was caused importantly by higher prices of imported oil and would prove short lived. With financial conditions remaining stimulative, the economy appeared poised to grow at a pace sufficient to trim slack in resource utilization. In that regard, given the unusually low level of the federal funds rate, especially relative to the level of inflation, policymakers noted that significant cumulative policy tightening would likely be needed to meet the Federal Reserve's long-run objectives of price stability and sustainable economic growth. The Committee's decision at the meeting to raise its target for the federal funds rate 25 basis points, to 1½ percent, and to maintain its assessment of balanced risks with respect to sustainable growth and price stability was largely anticipated by financial markets. However, market participants revised up their expectations for the path of the federal funds rate, reportedly because the announcement conveyed a somewhat more optimistic outlook for the economy than many had anticipated.

By the time of the September FOMC meeting, available information suggested that the economy had regained momentum. Real consumer spending bounced back sharply in July after a weak second quarter, and incoming data on industrial production indicated a modest strengthening. Housing activity had increased further, and business outlays had picked up significantly in the second quarter. In addition, the labor market showed signs of improvement in August, as the unemployment rate edged down and nonfarm payrolls grew moderately. Core consumer price inflation slowed in June and July, and a decline in energy prices from record levels pushed down readings on headline inflation. Although the Committee acknowledged that higher oil prices had damped the pace of economic activity around midyear, it nonetheless saw the expansion as still on solid footing. Consequently, the Committee agreed to increase its target for the federal funds rate another 25 basis points, to 1¾ percent; to reiterate its view that the risks to price stability and to sustainable growth were balanced; and to repeat its indication that the removal of policy accommodation would likely proceed at a "measured" pace. The reaction in financial markets to the policy rate decision and the accompanying statement was muted.

The information in hand at the time of the November FOMC meeting generally suggested that the economy had continued to expand at a moderate rate despite the restraint that higher oil prices imparted to real incomes and consumer confidence. Consumer and business spending stayed firm, and the housing market remained buoyant. However, industrial production was about unchanged, and the news on job growth was uneven—lackluster increases in nonfarm payrolls in September were followed by robust expansion in October. Inflation measures were moderate, although up somewhat from one year earlier. On balance, the Committee saw the economy as growing at a pace that would reduce margins of slack in the utilization of resources. The Committee also judged that inflationary pressures would likely be well contained if monetary policy accommodation were gradually withdrawn. The Committee's decision to raise its target for the federal funds rate from 1¾ percent to 2 percent with minimal change in the language in the accompanying statement was largely anticipated by financial markets and elicited little reaction.

At its December meeting, the Committee viewed available information as continuing to indicate that the pace of the economic expansion was sufficient to further reduce the underutilization of resources, despite elevated oil prices. Consumer spending remained solid, investment spending was strong, and manufacturing production showed modest growth. Also, employment gains in October and November were consistent with gradual improvement in the labor market. Meanwhile, core inflation, while above the unusually low rates of late 2003, remained subdued. Accordingly, the Committee voted to raise its target for the federal funds rate 25 basis points, to 2¼ percent, and to retain the previous statement that the removal of policy accommodation would likely be "measured." Investors had largely anticipated the policy rate decision, but a few market participants had reportedly speculated that the Committee would signal increased concern about inflationary pressures. In the absence of any such signal, implied rates on near-dated futures contracts and longer-term Treasury yields declined a few basis points after the release of the December statement.

Also at its December meeting, the Committee considered an accelerated release of the minutes of FOMC meetings. The Committee's practice had been to publish the minutes for each meeting on the Thursday after the next scheduled meeting. The Committee believed that, because the minutes contain a more nuanced explanation of policy decisions than the statement released immediately after each meeting, publishing them on a timelier basis would help market participants interpret economic developments and thereby better anticipate the course of interest rates. Earlier release would also provide a context for the public remarks of individual FOMC members. It was also recognized, however, that financial markets might misinterpret the minutes at times and that earlier release might adversely affect the Committee's discussions and, perhaps, the minutes themselves. After weighing these considerations, the Committee voted unanimously to publish the FOMC minutes three weeks after the day of the policy decision.

The information that the Committee reviewed at its February 2005 meeting indicated that the economy had continued to expand at a steady pace. The labor market showed signs of further improvement, and consumer spending and the housing market remained robust. Industrial production accelerated, particularly at the end of 2004, and growth of business fixed investment was solid in the fourth quarter. Core inflation stayed moderate, and measures of inflation expectations remained well anchored. Given the solid economic expansion and limited price pressures, the Committee voted to continue its removal of policy accommodation by raising its target for the federal funds rate from 2¼ percent to 2½ percent and to essentially repeat the language of the December statement. Futures market quotes indicated that investors had already priced in a 25 basis point increase in the target federal funds rate at the meeting, and market participants reportedly expected no substantive changes to the accompanying statement. Accordingly, the reaction in financial markets to the announcement was minimal.

Economic Projections for 2005 and 2006

Federal Reserve policymakers expect the economy to expand moderately and inflation to remain low in 2005 and 2006.[1] The central tendency of the fore-

1. As a further step to enhance monetary policy communications, Federal Reserve policymakers

Economic Projections for 2005 and 2006
Percent

Indicator	Memo: 2004 actual	Federal Reserve Governors and Reserve Bank presidents			
		2005		2006	
		Range	Central tendency	Range	Central tendency
Change, fourth quarter to fourth quarter[1]					
Nominal GDP	6.2	5–6	5½–5¾	5–5¾	5–5½
Real GDP	3.7	3½–4	3¾–4	3¼–3¾	3½
PCE price index excluding food and energy	1.6	1½–2	1½–1¾	1½–2	1½–1¾
Average level, fourth quarter					
Civilian unemployment rate	5.4	5–5½	5¼	5–5¼	5–5¼

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

casts of real GDP growth made by the members of the Board of Governors and the Federal Reserve Bank presidents is 3¾ percent to 4 percent over the four quarters of 2005. The civilian unemployment rate is expected to average about 5¼ percent in the fourth quarter of 2005. For 2006, the policymakers project real GDP to increase about 3½ percent, and they expect the unemployment rate to edge down to between 5 percent and 5¼ percent. With regard to inflation, FOMC participants project that the chain-type price index for personal consumption expenditures excluding food and energy (core PCE) will increase between 1½ percent and 1¾ percent both this year and next—about the same as the 1.6 percent increase posted over 2004. ■

will now provide economic projections for two years, rather than one, in the February Monetary Policy Report.

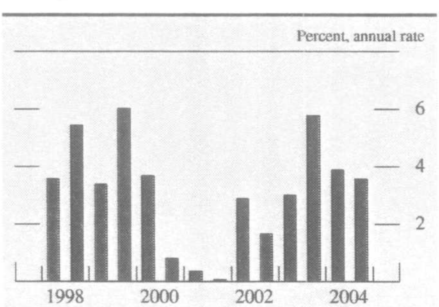
Economic and Financial Developments in 2004 and Early 2005

The economy proved to be sufficiently resilient to maintain solid growth and moderate core inflation in 2004 even as higher oil prices drained consumers' purchasing power and boosted firms' costs. Real GDP rose 3¾ percent last year after having increased 4½ percent in 2003. Activity was supported by continued robust advances in household spending. In addition, capital spending by businesses increased notably. Labor market conditions improved significantly, though at an uneven pace over the course of the year. Private payrolls, which turned up in late 2003, rose 170,000 per month last year, on average, and the unemployment rate declined below 5½ percent by year-end and to 5¼ percent in January 2005—the lowest rates since 2001.

Consumer price inflation was driven higher last year by the sharp rise in energy prices. Although core consumer price inflation moved up somewhat from unusually low levels recorded in 2003, it remained well contained. Price increases were restrained by continuing, though diminishing, slack in labor and product markets, which tended to offset the effects of higher energy and commodity prices, as well as the weaker dollar, on firms' overall costs. In addition, solid productivity gains implied that unit labor costs rose only modestly, even if up from the declines in the preceding two years. The decline in crude oil prices, on balance, since October points to some easing of cost pressures on firms from that source in the period ahead.

Several forces likely contributed to last year's impressive economic performance in the face of the sizable adverse oil shock. The growth of real output continued to be undergirded by gains in structural labor productivity. Moreover, fiscal policy remained stimulative last year through the combination of the lagged effect of earlier cuts in personal

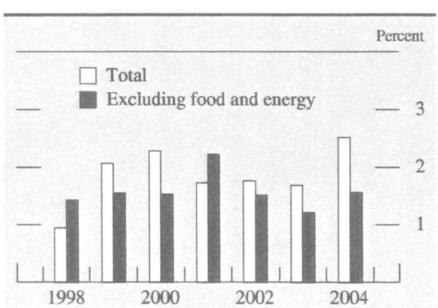
Change in Real GDP



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

SOURCE. Department of Commerce, Bureau of Economic Analysis.

Change in PCE Chain-Type Price Index



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

SOURCE. Department of Commerce, Bureau of Economic Analysis.

tax rates, the rise in defense spending, and perhaps also the partial-expensing tax incentives for business investment. Monetary policy was highly accommodative in the early part of the year and remained accommodative, though progressively less so throughout the year, and credit remained readily available at favorable terms. Consumer demand was also boosted by the strong increases in asset values during the past two years.

Financial conditions remained stimulative last year even as market participants revised up their expectations for the near-term path of monetary policy. Interest rates on longer-term Treasury securities remained low, risk spreads on corporate bonds narrowed, and commercial banks eased terms and standards on business loans. In this environment, household debt again increased briskly. The borrowing needs of nonfinancial businesses were damped by their strong cash flows. Equity values rose, especially toward the end of the year. At the same time, the exchange value of the dollar declined, on net, over the year as market participants apparently focused on the financing implications of the large and growing U.S. current account deficit.

The Household Sector

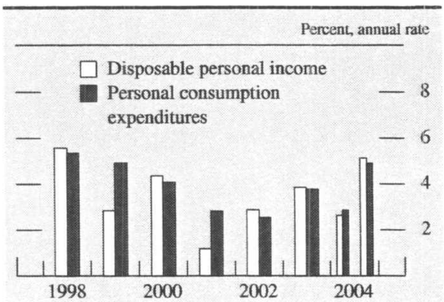
Consumer Spending

Consumer spending grew substantially last year. Personal consumption expenditures (PCE) advanced nearly 4 percent in real terms, about the same as the increase in 2003. Sales of new motor vehicles remained brisk, on average, at 16¾ million units. Excluding motor vehicles, consumer spending on most categories of durable and nondurable goods rose rapidly, as gains in real expenditures for food and clothing both exceeded 5 percent; however, spending on computing equipment increased less in 2004 than in preceding years, and consumers responded to the high cost of gasoline and heating fuel by cutting back on real spending for these items. Real outlays for services also increased rapidly last year, and medical services posted especially large gains.

Real disposable personal income (DPI) rose nearly 4 percent last year, but this figure is exaggerated by Microsoft's $32 billion special dividend payment in December (the bulk of which is estimated to have accrued to U.S. households). If this one-time event is excluded from the calculation, real DPI rose only 2¾ percent in 2004, well below the increase posted in 2003. Faster job growth helped to support increases in households' incomes last year in nominal terms, and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), which brought lower personal tax rates forward into 2003, led to larger refunds and smaller final payments in the spring of 2004. However, real income gains were held down, as higher oil prices siphoned off household purchasing power.

With the growth of real consumption spending outpacing that of real income through most of last year, the personal

Change in Real Income and Consumption



SOURCE. Department of Commerce, Bureau of Economic Analysis.

saving rate moved lower, from 1½ percent, on average, in 2003 to only ½ percent in the third quarter of last year. (The fourth-quarter surge in income associated with the Microsoft dividend payments pushed the saving rate back up to 1¼ percent, but this increase will likely be reversed early this year as dividend income falls back. Because the company's share price declined in step with the dividend payouts, the dividends had no effect on shareholders' overall financial resources and so probably had little effect on consumption.)

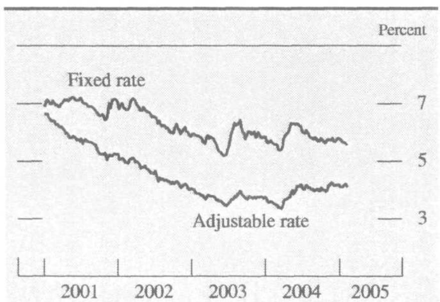
Low interest rates were one factor that helped to support consumption growth—especially for durable goods—despite comparatively slow gains in real income. Higher household wealth was also an important force that propelled consumer spending last year. According to the Federal Reserve's flow of funds accounts, the ratio of household net worth to disposable income rose sharply in 2003, as corporate equity values rebounded and home prices continued to rise. Moreover, although equity values were little changed, on net, through much of 2004 before rising notably in the final quarter, home prices continued to rise throughout the year, and the wealth-to-income ratio moved up further; by the third quarter (the most recent period for which the complete wealth data are available), the ratio had reversed nearly half its decline since the stock market peak in 2000. Because wealth feeds through into household spending over a period of several quarters, the wealth increases in both 2003 and 2004 were important in supporting consumer spending last year. The rise in house prices, together with continued low interest rates, also led consumers to extract additional equity from their homes, in particular through home equity loans. Such actions provided many households with a readily available and relatively low-cost source of funds for financing consumption.

Consumer confidence, which had improved in 2003, remained at generally favorable levels last year, according to surveys by both the Michigan Survey Research Center (SRC) and the Conference Board. Confidence tended to dip at times during the year when energy prices were moving up most rapidly, but it recovered soon after those episodes.

Residential Investment

Residential investment remained robust last year. Real expenditures increased 5¾ percent in 2004—the third straight year of strong gains. Demand for housing was influenced by the same factors that affected household spending more generally, but it was especially supported by nominal mortgage interest rates that have remained near their lowest levels since the late 1960s. Rates on thirty-year fixed-rate mortgages fluctuated between about 5½ percent and 6¼ percent over the past two years; they edged up to the high end of that range during the spring but dropped back to under 6 percent by the end of summer and now stand below 5¾ percent.

Mortgage Rates



NOTE. The data, which are weekly and extend through February 9, 2005, are contract rates on thirty-year mortgages.

SOURCE. Federal Home Loan Mortgage Corporation.

In the single-family sector, housing starts amounted to 1.6 million units last year, a rate faster than the already rapid pace of 1.5 million units started in 2003. In the multifamily sector, starts totaled a solid 350,000 units last year, a figure in line with that of the preceding several years. Sales of both new and existing single-family homes hit new highs last year, and home prices moved up sharply. The repeat-transactions price index for existing homes (limited to purchase transactions only), which is published by the Office of Federal Housing Enterprise Oversight, climbed more than 10 percent over the four quarters ending in the third quarter of last year (the latest quarter for which data are available) and is up a cumulative 65 percent since 1997, when it started to rise notably more rapidly than overall inflation. These price increases have also outstripped by a wide margin the increases in household incomes and rents. Another nationwide price index, the Census Bureau's constant-quality price index for new homes, rose only 6¾ percent last year. Because this index does not adjust for the location of new homes within metropolitan areas, and because new homes constitute only a small fraction of the overall housing stock, this index is probably a less reliable indicator of overall home values than is the repeat-transactions index.

Household Finance

Household debt is estimated to have increased about 9¾ percent in 2004, a touch less than in the previous year. Mortgage debt again paced this advance. The brisk expansion of mortgages reflected continued strong activity in housing markets and rising house prices. However, the growth rate of mortgage debt did not quite match that registered in 2003. Refinancing activity fell off sharply last year, as the pool of outstanding mortgages with interest rates above current market rates shrank considerably. Mortgages with adjustable interest rates, including hybrids that feature both fixed and adjustable interest rate components, were increasingly popular in 2004. Consumer credit continued to expand at a moderate pace by historical standards, restrained in part by the substitution of other forms of debt, such as home equity loans. Higher interest rates on some consumer loans and credit cards in the second half of 2004 may have also damped the growth of consumer credit.

Relatively low interest rates and further gains in disposable personal income limited pressures on household balance sheets in 2004. Measures of aggregate household financial obligations and debt service, which capture pre-committed expenditures relative to disposable income, were little changed last year, on balance, though they remained high by historical standards. Nevertheless, measures of household credit quality either held steady or improved during the course of the year. The latest available data indicate that delinquency rates on credit card loans, consumer loans, and residential mortgages at commercial banks declined, while those on auto loans at captive finance companies were about unchanged at a low level. Household bankruptcy filings ran below the elevated levels of 2003, although they stayed generally above the rates posted in earlier years.

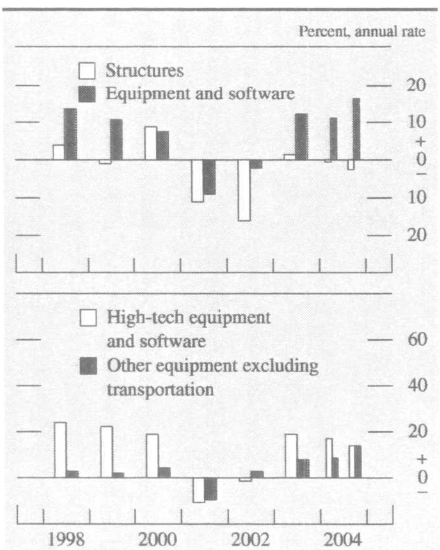
The Business Sector

Fixed Investment

Business fixed investment rose robustly for a second consecutive year in 2004. Real spending on equipment and software (E&S) increased 13½ percent, about as much as in 2003, as firms' final sales continued to increase, profits and cash flow rose further, and many businesses reported a need to replace or upgrade existing equipment and software. Although many firms had little need to seek outside financing given their flush cash situation, those that did generally found financial markets to be receptive—interest rates remained low, and other terms and conditions stayed relatively favorable. The partial-expensing tax incentives, which covered new equipment and software installed by the end of 2004, boosted profits and cash flow and may have also stimulated some investment spending.

Increases in E&S spending were fairly widespread across categories of capital goods. Spending on high-technology equipment increased 15½ percent last year after having risen 19 percent in 2003; these gains followed two years of declines. Although the pattern of spending was uneven over the four quarters of 2004, for the year as a whole, business outlays for computing equipment rose 25 percent in real terms, while spending on software and communications equipment posted increases of 13 percent and 10 percent respectively. Outside of the high-tech sector, business spending on aircraft moved lower for the third consecutive year, as airlines continued to struggle with a highly competitive market environment and high fuel prices. In contrast, business outlays on motor vehicles rose substantially last year, with the demand for trucks exceptionally strong. Investment in equipment other than high-tech and transportation goods—a category that includes industrial machinery and a wide range of other types of equipment—moved up 11 percent last year, the most in more than ten years.

Change in Real Business Fixed Investment



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

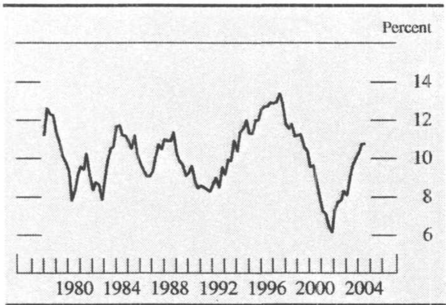
SOURCE. Department of Commerce, Bureau of Economic Analysis.

In contrast to the rebound in equipment spending, real outlays in the nonresidential construction sector were about unchanged for a second year in 2004 and have yet to recover from their sharp downturn during 2001 and 2002. In the office sector, where construction increased rapidly in the late 1990s, spending has remained especially weak; vacancy rates for these properties, although down a touch over the past year, are still quite elevated. Construction of industrial buildings has also remained low as a result of high vacancy rates. In contrast, demand for new retail and wholesale properties has been firmer, reportedly a reflection of the steady increases in consumer spending, and outlays for these types of buildings moved higher last year. In addition, investment in the drilling and mining sector rose last year in response to high prices for natural gas.

Inventory Investment

Businesses added appreciably to inventories last year for the first time since running down their holdings sharply in 2001. As economic activity strengthened during 2002 and 2003, many businesses chose to operate with inventories that were increasingly lean relative to sales. In 2004, when stocks had become quite spare—even after taking into account the ongoing improvements in inventory management that have allowed firms to economize on stockholding—and businesses had apparently grown more confident in the durability of the recovery, businesses accumulated $45 billion of inventories (in real terms), according to preliminary data. The step-up in the pace of stockbuilding contributed about ¼ percentage point to GDP growth last year.

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



NOTE. The data are quarterly and extend through 2004:Q3. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.

SOURCE. Department of Commerce, Bureau of Economic Analysis.

Corporate Profits and Business Finance

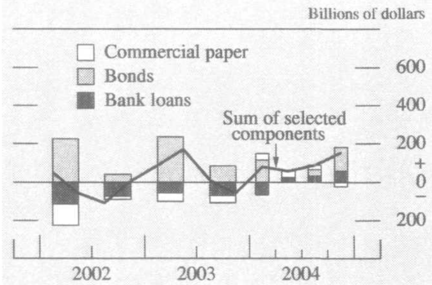
Strong growth of corporate profits again allowed many firms to finance capital spending with internal funds last year. As a result, nonfinancial business debt rose at only a moderate pace. Net equity issuance dropped further into negative territory in 2004, and on balance nonfinancial corporations are estimated to have raised no net funds in credit and equity markets. However, short-term business debt, including commercial paper and commercial and industrial (C&I) loans, expanded last year after three years of contraction, and commercial mortgage debt continued to increase rapidly. The credit quality of businesses remained strong.

Corporate profits held up well in 2004 after surging in the previous year. The ratio of before-tax profits of nonfinancial corporations to that sector's gross value added increased for a second consecutive year. In the fourth quarter of 2004, operating earnings per share for S&P 500 firms were nearly 20 percent above their level four quarters earlier. Analysts' earnings forecasts began to moderate somewhat in the second half of 2004 after several months of strong upward revisions.

In equity markets, net issuance of shares by nonfinancial firms turned more negative in 2004. Although initial public offerings rebounded from the sluggish pace of the past two years, ample profits and sizable cash holdings helped boost share retirements from mergers and repurchases.

Net corporate bond issuance was sluggish in 2004, as firms evidently relied heavily on their considerable profits to fund investment in fixed capital and inventories. The timing of gross bond issuance was influenced by interest rate movements during the year, as firms took advantage of occasional dips in longer-term yields to issue bonds. Firms reportedly used a large portion of the proceeds to pay down existing debt, although some companies used the funds raised in the bond market to

Selected Components of Net Business Financing



NOTE. Seasonally adjusted annual rate for nonfinancial corporate business. The data for the sum of selected components are quarterly. The data for 2004:Q4 are estimated.

SOURCE. Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

repurchase equity shares or to finance mergers.

Short-term business borrowing revived in 2004 after a prolonged contraction. Commercial paper outstanding turned up in the first half of the year, although it flattened out over the second half. Business loans at banks rebounded over the course of last year. According to results from the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, commercial banks eased terms and standards on business loans during the course of 2004 in response to the improved economic outlook and to increased competition from other banks and nonbank lenders. Survey responses also indicated an increase in demand for C&I loans that reflected firms' need to fund rising accounts receivable, inventories, capital expenditures, and merger activity. Concerns over loan quality seemed to diminish further in 2004, as spreads on leveraged deals in the syndicated loan market edged down from already low levels.

Corporate credit quality remained solid in 2004 amid strong earnings, low interest rates, and a further buildup of already substantial cash positions on firms' balance sheets. The delinquency rate on C&I loans declined further, and the twelve-month trailing default rate on corporate bonds fell to historically low levels before edging up late in the year. Net upgrades of bonds by Moody's Investors Service for both investment- and speculative-grade nonfinancial firms increased last year.

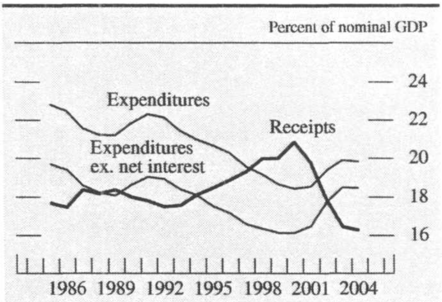
The stock of commercial mortgage debt outstanding grew at a rapid pace in 2004. Some firms reportedly continued to find mortgages an attractive source of long-term funding. The expansion of commercial mortgage credit helped propel issuance of commercial-mortgage-backed securities (CMBS) to near-record levels. Delinquency rates on commercial mortgages on the books of banks and insurance companies remained low throughout the year, and those on loans backing mortgage securities fell. Considerable gains in commercial real estate prices increased owners' equity and largely kept pace with the sizable increase in mortgage debt obligations. Yield spreads of CMBS over comparable Treasury securities remained moderate.

The Government Sector

Federal Government

The federal budget position deteriorated slightly further in 2004, as spending increases and further tax reductions offset the effects of stronger economic growth on revenues. The unified budget deficit widened from $378 billion in fiscal 2003 to $412 billion in fiscal 2004. As a share of GDP, the federal unified deficit stood close to 3½ percent in both years. Receipts increased 5½ percent in fiscal 2004 after two years of declines. Corporate receipts surged more than 40 percent, or $58 billion, reflecting

Federal Receipts and Expenditures



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

SOURCE. Office of Management and Budget.

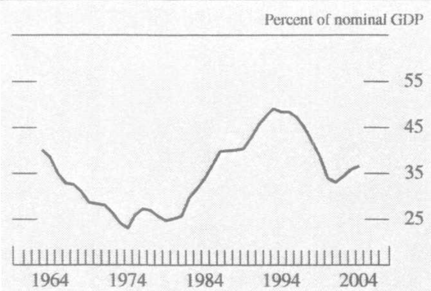
the improvement in corporate profits; individual tax receipts—restrained by JGTRRA, which pulled forward reductions of personal tax rates that had been scheduled for the second half of the decade—rose only about 2 percent. Overall federal receipts increased less rapidly than nominal GDP, and the ratio of receipts to GDP edged down to 16¼ percent, the lowest level in more than forty years.

Meanwhile, nominal federal outlays increased about 6 percent in fiscal 2004. Spending for national defense increased especially sharply, but spending also increased notably for Medicare and Medicaid. Debt service costs, which fell sharply from 1997 through 2003 as a result of reduced debt and declining interest rates, edged higher last year. Federal government purchases of goods and services—the part of spending that is counted in GDP—rose about 4 percent in real terms in 2004 after larger increases in the preceding two years. (Government spending on items such as interest payments and transfers is excluded from GDP because these items do not constitute a direct purchase of final production.)

Regarding legislative initiatives, two new tax bills were enacted in the fall of 2004. First, the Working Families Tax Relief Act extended through 2010 a variety of personal tax reductions that had previously been set to expire earlier. Second, the American Jobs Creation Act replaced the exclusion of extraterritorial income (which the World Trade Organization had declared an illegal export subsidy) with numerous other tax reductions for domestic manufacturers and U.S. multinationals. The first bill is expected to have a ten-year budget cost of around $150 billion, while the second bill was scored as being revenue neutral. As for federal spending in fiscal 2005, the regular appropriations bills provided for sizable increases in spending on defense and homeland security and for modest increases in nondefense discretionary expenditures. In addition, emergency legislation passed in the autumn provided disaster aid for victims of hurricanes and for ranchers and farmers affected by drought conditions.

The recent sizable deficits in the unified budget mean that the federal government, which had been contributing to the pool of national saving from 1997 through 2000, has been drawing on that pool since 2001. Net federal saving—essentially the unified budget balance adjusted to the accounting practices of the national income and product accounts (NIPA)—dropped from positive 2 percent of GDP in 2000 to a level below negative 3 percent of GDP in 2003 and 2004. Personal saving moved lower over this period as well, while business net saving rose with the rebound in corporate profits. In all, net national saving edged up in 2004 but remained near its postwar lows. Because net national saving has fallen increasingly short of net domestic investment over the past several years, the inflow of foreign funds needed to finance that investment has risen. The growing inflow of foreign capital is mirrored in

Federal Government Debt Held by the Public



NOTE. Through 2003, the data for debt are year-end figures, and the corresponding value for GDP is for Q4 at an annual rate; the final observation is for 2004:Q3. Excludes securities held as investments of federal government accounts.

the widening of the nation's current account deficit. Over time, the low national saving rate could eventually slow the rise in living standards either by increasing the burden of servicing U.S. foreign debt or by impinging on domestic capital formation.

The growth rate of Treasury debt moderated slightly last year after increasing substantially in 2003. Nonetheless, federal debt held by the public as a percentage of GDP continued to edge higher over the course of 2004 and currently stands at about 36½ percent. To help finance substantial budget deficits, the Treasury issued a considerable volume of bills as well as two-, three-, five-, and ten-year nominal notes. In addition, the Treasury expanded its borrowing program in 2004 by adding semiannual auctions of twenty-year inflation-protected bonds and five-year inflation-protected notes.

Various indicators suggested a continued strong appetite for Treasury securities among foreign investors last year. Indirect bidding at Treasury auctions, which includes bidding by the Federal Reserve Bank of New York on behalf of foreign official institutions, remained robust, and Treasury securities held in custody at the Federal Reserve Bank of New York on behalf of such institutions increased just over $200 billion in 2004. Also, data from the Treasury International Capital System showed a substantial increase in holdings of Treasury securities by foreign official and private investors, particularly those in Japan. The proportion of Treasury securities held by foreign investors is estimated to have risen to a record 43½ percent by the third quarter of 2004.

Treasury debt reached its statutory ceiling late last year. To cope with the constraint, the Treasury temporarily resorted to accounting devices, suspended issuance of state and local government series securities, and postponed a four-week bill auction. In mid-November, Congress raised the debt ceiling from $7.4 trillion to $8.1 trillion, and the Treasury subsequently resumed normal financing operations.

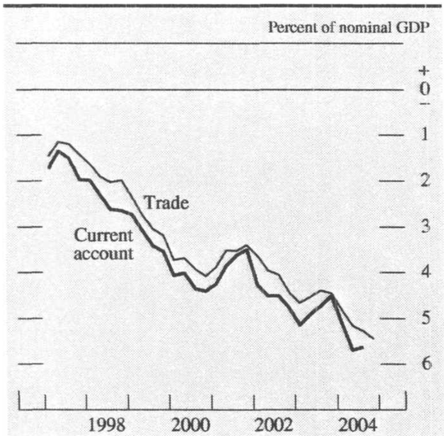
State and Local Governments

Pressures on the budgets of state and local governments have eased as economic activity has strengthened. Tax receipts have been spurred by the increases in household income, consumer spending, and property values. As a result, many states seem to be on track to meet balanced budget requirements in the current fiscal year (which ends June 30 for all but a few states) without using as much borrowing or other extraordinary measures as in recent years. Nevertheless, a number of states still must deal with lingering fiscal problems, particularly depleted reserve funds, the expiration of temporary tax hikes, and rising Medicaid costs. In addition, several states still face serious structural imbalances in their budgets.

Real expenditures by state and local governments as measured in the NIPAs remained about flat for a second year in 2004. Real spending on current operations rose less than 1 percent last year, while real investment spending declined. However, even as they were holding the line on spending increases, states and localities were able to resume net hiring in 2004 after having left employment about unchanged in 2003.

Net issuance of debt by state and local governments edged down from the rapid pace set in 2003, as improved budget positions permitted some contraction in short-term debt. Advance refunding offerings were again strong during the year, as states and municipalities took advantage of low long-term interest rates and moderate credit spreads. Credit quality of tax-exempt borrowers improved in 2004. Rating upgrades of tax-exempt bonds outpaced downgrades, especially later in the year.

U.S. Trade and Current Account Balances



NOTE. The data are quarterly. The trade data extend through 2004:Q4, and the current account data extend through 2004:Q3.

SOURCE. Department of Commerce.

The External Sector

After narrowing in 2003, the U.S. current account deficit widened again last year and was $660 billion (annual rate), or 5.6 percent of GDP, in both the second and third quarters. Much of this widening reflected a considerable increase in the deficit on goods and services trade, as a marked rise in imports more than offset solid increases in exports. The trade deficit expanded from $500 billion during the fourth quarter of 2003 to more than $650 billion, on average, during the second half of 2004.

International Trade

Real exports of goods and services rose an estimated 5½ percent in 2004 despite a deceleration in the fourth quarter. In the first half, exports were supported by the lagged effect of the fall in the dollar's value in 2003. Strong expansion of foreign economic activity also helped boost exports in the first half, but that stimulus diminished in the second half of the year when foreign growth slowed. For the year as a whole, exports of industrial supplies and capital goods posted solid growth. Exports to Canada, Mexico, and western Europe rose smartly in 2004, whereas exports to Japan were relatively weak. Real exports of services increased about 3½ percent through 2004 as a whole.

After increasing at an annual rate of almost 6 percent in the first half of 2004, prices of exported goods moved up at just a 2½ percent rate in the second half. This deceleration was due in large part to a reversal of the run-up in the prices of agricultural products that had occurred in late 2003 and early 2004. Better harvests last year returned prices of agricultural products to levels near those that had prevailed before the spike.

Solid growth in income in the United States spurred growth of real imports of 9½ percent in 2004. The increase primarily reflected higher imports of goods that occurred despite a notable rise in their prices. Real oil imports expanded almost 10 percent in 2004. Imports of capital equipment increased throughout the year, but imports of consumer goods suffered a period of weakness through the middle of the year before rebounding in the fourth quarter. Imports of services moved up only 1¾ percent in 2004.

Prices of imported non-oil goods increased at an annual rate of just over 4 percent in the first half of 2004, but the pace slowed to 2 percent in the second half. This step-down largely reflected a deceleration in the prices of industrial supplies, driven by a leveling off of nonfuel commodity prices at the elevated levels reached in March. Declines in the prices of foods offset continued price increases for metals.

The spot price of West Texas intermediate (WTI) crude oil moved up during most of 2004 and surged temporarily to a record high of $55 per barrel in October. Since then, it has fluctuated somewhat below that peak but still at levels well above $33 per barrel, the price at which it started 2004. Oil prices were driven up by intensified concerns that oil supply would not keep pace with surprisingly strong global demand. Oil consumption in China grew nearly 15 percent in 2004, pushing that economy past Japan as the world's second-largest consumer. As oil prices rose, OPEC increased its oil production, diminishing the cartel's estimated spare capacity to historically low levels. Increased OPEC production damped particularly the rise in prices of heavier, more sulfurous grades of crude oil but had less effect on prices of lighter grades like WTI. Supply disruptions also played a role in the run-up of oil prices. In October, Hurricane Ivan extensively damaged oil and gas production facilities in the Gulf of Mexico, boosting the price of WTI relative to other grades of crude oil. Sabotage of production and distribution facilities in Iraq hindered oil exports from that country, which remain below pre-war levels. In Nigeria, ethnic violence and community protests shut down some production. Russian oil output, however, continued despite the breakup of Yukos, formerly Russia's largest oil company. Late in the year, oil prices declined from their October highs, as production recovered in the Gulf of Mexico and OPEC added new capacity. The price of the far-dated NYMEX oil futures contract (currently for delivery in December 2011) rose about $10 per barrel during 2004, possibly reflecting expectations of greater oil demand in Asian emerging-market economies. The far-dated futures contract averaged about $38 per barrel in January 2005, while the spot price of WTI averaged about $48 per barrel.

The Financial Account

In 2004, the U.S. current account deficit was financed once again largely by foreign purchases of U.S. bonds. Foreign official inflows picked up further last year and were especially strong in the first quarter, reflecting sizable bond purchases by Asian central banks. Private foreign purchases of U.S. bonds rebounded in 2004 from a slight decline in 2003, with especially large purchases coming late in the fourth quarter. In contrast, foreign demand for U.S. equities weakened further in 2004, although this also picked up late in the year. Net purchases of foreign securities by U.S. investors remained strong in 2004, with most of the strength coming in the second half of the year.

U.S. direct investment abroad continued at a strong pace, as reinvested earnings remained sizable. Direct investment into the United States rebounded in the first three quarters of 2004 from its anemic pace in 2003; global mergers and acquisitions revived, and reinvested earnings picked up. Overall, net direct investment outflows continued over the first three quarters of 2004 but at a lower pace than in 2003.

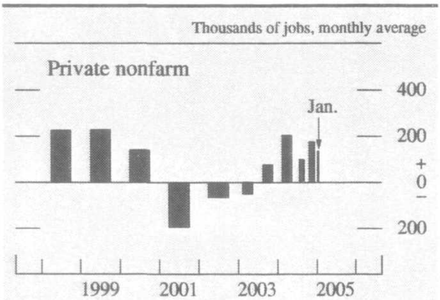
Net inflows of portfolio capital exceeded net outflows of direct investment and represented the financial counterpart to the U.S. current account deficit. These net financial inflows imply a further decline in the U.S. net international investment position, which began 2004 at a reported level of negative $2.4 trillion (22 percent of GDP).

The Labor Market

Employment and Unemployment

The labor market improved notably in 2004. Private payrolls, which began to post sustained increases in late 2003, rose an average of 170,000 per month last year. Progress was not steady over the course of the year, however. Employment growth stepped up sharply in the spring to a pace of almost 300,000 per month in March, April, and May; net hiring then dropped back to subpar rates of about 100,000 per month in June through September. In the four months since then, increases in private payrolls have averaged 165,000 per month.

Net Change in Payroll Employment



SOURCE. Department of Labor, Bureau of Labor Statistics.

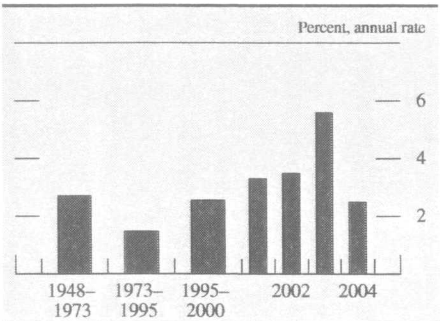
The improved pace of hiring was widespread, as all major industry groups contributed to faster employment growth relative to that of the latter part of 2003. The largest gains were in professional and business services and health services. The construction sector also posted substantial gains. In the manufacturing sector—where employment had declined almost continuously since early 2000—payrolls increased in the spring when overall employment was rising sharply but were about unchanged, on net, over the second half of the year. Employment gains in retail trade and in food services were also brisk over the first half of the year but tapered off in the second half. Meanwhile, state and local governments added substantially to their payrolls last year, especially for education, but civilian employment in the federal government edged lower.

The unemployment rate fell from near 6 percent in late 2003 to less than 5½ percent by late last year; joblessness fell further in January 2005, to 5¼ percent. The decline in the unemployment rate over the past year reflected both the pickup in hiring and a labor force participation rate that remained surprisingly low. From 2001 through 2003, the participation rate declined by more than would have been predicted on the basis of past relationships with indicators of labor demand, and in 2004, when the pace of hiring increased, the participation rate leveled off but failed to rise. These considerations suggest that there may be a persistent component to the recent softness in participation. However, participation had been quite strong through 2000, when the labor market was extremely tight, and the fact that participation turned down at the same time that labor demand weakened suggests that at least some of the recent low participation is cyclical. To the extent that some of this low participation proves to be transitory, the resumption of more-rapid labor force growth will limit the speed at which employment gains further push down the unemployment rate.

Productivity and Labor Costs

Labor productivity rose solidly again last year. Output per hour in the nonfarm business sector increased an estimated 2½ percent over the year. This increase was somewhat below the outsized 4 percent average pace of increase from 2001 through 2003. Those earlier huge productivity gains were not associated with especially large accumulations of new capital equipment, as had been the case during the late 1990s; instead, to a large degree, the gains seem to have been related to more effective use of capital equipment that had been acquired earlier and to one-time organizational innovations induced by firms' earlier reluctance to commit to increased hiring. Still, last year's 2½ percent increase in productivity was impressive by long-run standards: It was in line with the pace of the late 1990s and well above rates that had prevailed during the preceding two decades.

Change in Output per Hour



NOTE. Nonfarm business sector.
SOURCE. Department of Labor, Bureau of Labor Statistics.

Increases in hourly labor compensation remained moderate last year. As measured by the employment cost index (ECI), which is based on a quarterly survey from the Bureau of Labor Statistics, hourly compensation in private nonfarm businesses increased 3¾ percent in 2004, a bit less than in 2003. An alternative measure is compensation per hour in the nonfarm business sector as derived from compensation data in the NIPAs. This measure of hourly compensation rose 3½ percent last year, an increase similar to that in the ECI but substantially less than the 5½ percent rise in 2003.

As has been the case for several years, the cost of employee benefits rose considerably more than did wages and salaries last year. The benefits component of the ECI increased nearly 7 percent, while the wages and salaries component posted a much more moderate 3 percent increase. The rise in hourly wages and salaries was about the same as increases in the preceding two years; although probably boosted by last year's higher rate of price inflation, wages were likely held down by the continued, though diminishing, labor market slack and also by employers' attempts to offset continued large increases in benefits costs. Health insurance costs continued to rise rapidly. As measured by the ECI, employers' costs of health insurance, which account for about 6 percent of overall compensation costs, rose 7 percent last year after having increased more than 10 percent per year in 2002 and 2003.

Prices

Overall consumer prices rose notably more in 2004 than they did in 2003, and the sharp increase in energy prices accounted for much of the step-up. The chain-type price index for personal consumption expenditures (PCE) rose 2½ percent last year, compared with an increase of 1¾ percent in 2003. The increase in PCE prices excluding food and energy was considerably smaller—only 1½ percent, up a little more than ¼ percentage point from the increase in 2003. Inflation as measured by the market-based component of core PCE prices—which excludes a collection of erratic prices that are unobservable from market transactions and which the Bureau of Economic Analysis began to publish early last year—was in line with overall core PCE inflation last year. The core consumer price index (CPI) rose about 2 percent last year after having increased 1¼ percent in 2003. (The CPI differs from PCE prices in a number of respects, but one factor that boosted CPI inflation relative to PCE inflation last year was a difference in the way the two indexes measure the prices of medical services, especially physicians' services, which rose much more rapidly in the CPI than in the PCE index.) The rise in core consumer prices was largest in the early months of 2004: Core PCE prices increased at an annual rate of nearly 2 percent over the first half of the year and then decelerated to a 1¼ percent rate of increase in the second half.

The price index for GDP was less affected by last year's rise in energy prices than was the PCE measure; much of the energy price increase was attributable to the higher prices of imported oil, which are excluded from GDP because they are not part of domestic production. GDP prices increased 2½ percent last year, ¾ percentage point faster than in 2003. In addition to the rise in PCE prices (excluding the influence of imported oil), GDP prices were affected by a sizable increase in construction prices for residential and nonresidential structures.

Alternative Measures of Price Change

Percent

Price measure	2002	2003	2004
Chain-type			
Gross domestic product	1.6	1.7	2.4
Gross domestic purchases	1.8	1.8	2.9
Personal consumption expenditures	1.8	1.7	2.5
Excluding food and energy	1.5	1.2	1.6
Market-based PCE excluding food and energy	1.4	1.0	1.6
Fixed-weight			
Consumer price index	2.2	1.9	3.4
Excluding food and energy	2.0	1.2	2.1

NOTE. Changes are based on quarterly averages of seasonally adjusted data.

SOURCE. For chain-type measures, Department of Commerce, Bureau of Economic Analysis; for fixed-weight measures, Department of Labor, Bureau of Labor Statistics.

The jump in consumer energy prices in 2004 was driven by the run-up in crude oil prices. The prices of both gasoline and fuel oil increased approximately 30 percent over the year, and higher oil costs accounted for the bulk of the increase. Prices of natural gas, which can often substitute for fuel oil in the industrial sector, rose notably as well last year despite the restraining influence of ample inventories. Electricity prices, which tend to reflect fuel costs with a lag, also moved higher through most of the year but dropped back some near year-end.

Consumer food prices rose around 3 percent for a second consecutive year in 2004. Exports of beef dropped sharply last year when most of the largest importing countries placed restrictions on U.S. beef after a case of mad cow disease was discovered. Nevertheless, domestic demand was sufficiently strong to support consumer meat prices last year. Fruit and vegetable prices trended sideways through most of the year but then rose sharply in the fall because of crop damage associated with the series of hurricanes that hit the Southeast in August and September. In addition, prices for food away from home, which are driven more by labor costs than by raw food prices, increased more rapidly last year than in 2003.

Core consumer prices were influenced by a variety of forces last year. Price increases were likely restrained by continuing slack in labor markets and in some product markets, but businesses faced considerable pressure from several sources of increased costs. First, the indirect effects of the large jump in energy prices fed through to businesses throughout the economy and were especially important for firms in energy-intensive industries, such as those that produce plastics and fertilizers. Second, prices were up sharply for a number of other industrial commodities, including lumber and a variety of metals. These price increases reflected strengthening economic activity abroad as well as in the United States. Although these non-oil commodities represent a small part of businesses' overall costs, some businesses likely felt the pinch of sustained price increases in these areas. Third, the declining exchange value of the dollar boosted import prices, including those of many inputs to production. Finally, the deceleration in labor productivity boosted unit labor costs after two years of declines; nevertheless, last year's 1 percent rise in unit labor costs was quite modest.

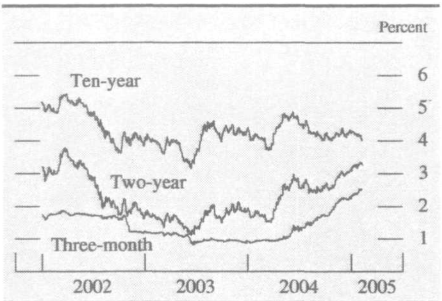
Taken together, these influences left their clearest mark on the prices of goods rather than services. Core goods prices were about unchanged, on average, last year, but this period of stability followed a period of unusually large declines in 2003. In particular, the prices of new motor vehicles leveled off after falling notably in 2003, and the prices of used vehicles reversed some of their sharp 2003 declines. Prices of non-energy PCE services rose about 2 percent in 2004—a smaller increase than in 2003.

Last year's rise in inflation showed through to short-term measures of expected inflation, but longer-term measures remained stable. According to the Michigan SRC, households' median expectations for inflation over the next year moved up considerably in the spring as inflation was rising, but then they eased back and ended the year near 3 percent—up from around 2½ percent in late 2003. In contrast, the median expectation for inflation over the next five to ten years held about steady near 2¾ percent throughout this period. Inflation compensation as measured by spreads between yields on nominal Treasury securities and inflation-indexed securities—another indicator of expected inflation, albeit one that is also influenced by perceptions of inflation risk and perhaps also by the development of the market for inflation-indexed debt—showed a similar pattern. Inflation compensation over the next five years moved up about ½ percentage point during 2004, to 2½ percent, while compensation at the five- to ten-year horizon edged lower, on net, over the year.

U.S. Financial Markets

Domestic financial conditions were supportive of economic growth in 2004. Interest rates on longer-term Treasury securities remained low, corporate risk spreads fell, and stock prices, on balance, registered gains. These developments occurred even as market participants revised up their expectations for the path of the federal funds rate. At the beginning of 2004, futures market quotes implied that investors expected a 1¾ percent target for the federal funds

Interest Rates on Selected Treasury Securities



NOTE. The data are daily and extend through February 9, 2005.

SOURCE. Department of the Treasury.

rate at year-end, 50 basis points below the target actually established at the FOMC meeting in December 2004. Consistent with the revision in policy expectations, yields on two-year Treasury notes increased about 1¼ percentage points in 2004. Yields on longer-dated Treasury securities, however, ended the year essentially unchanged. Despite the run-up in oil prices, equity prices registered solid gains in 2004 after rising sharply the year before. Risk spreads on investment-grade corporate debt declined a touch, and those on speculative-grade debt fell more noticeably. Moreover, banks appreciably eased terms and standards for lending to businesses.

Interest Rates

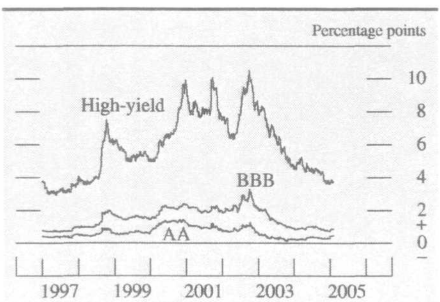
Most market interest rates rose, on balance, over the first half of 2004, particularly at shorter maturities. The FOMC's decision at its January meeting to shift from a statement that monetary policy could remain accommodative for "a considerable period" to an indication that it could be "patient" in removing policy accommodation prompted a rise in market interest rates. In early February and March, yields fell substantially in response to employment reports that indicated tepid job growth. Prices of federal funds and Eurodollar futures contracts implied that investors placed only small odds on an increase in the target funds rate before late 2004 and that they envisioned only moderate monetary policy tightening thereafter. Longer-term interest rates and the expected path for the federal funds rate were considerably marked up later in the spring in response to data suggesting a pickup in aggregate demand and hiring, readings on core inflation that came in above expectations, and rising oil prices. In the statement released after its May meeting, the Committee indicated that policy accommodation was likely to be removed at a "measured" pace. At its June meeting, the Committee raised the target for the federal funds rate from 1 percent to 1¼ percent, but it continued to assess the risks to sustainable growth and to price stability as balanced and reiterated the "measured pace" language. Interest rates across the term structure declined somewhat immediately after the announcement, reportedly because some market participants had expected the FOMC to mention upside risks to growth or inflation in its statement.

Chairman Greenspan's congressional testimony in July on monetary policy, which suggested that recent softness in consumer spending would likely prove short lived, sparked a jump in yields on Treasury securities. However, interest rates subsequently moved lower, on balance, as incoming data pointed to weaker spending and employment than investors had expected as well as to more-subdued core inflation. Apart from the August employment report, which seemed to hint that the economy was emerging from its "soft patch," incoming economic news remained somewhat lackluster through the end of the third quarter. However, investors reportedly viewed FOMC statements and comments by FOMC officials as more sanguine on near-term prospects for the economy than they had expected. In particular, the release of the minutes from the August FOMC meeting, which referenced the probable need for "significant cumulative tightening," prompted investors to mark up their expectations for the near-term path of monetary policy.

Short-term Treasury yields rose a bit further over the fall in association with actual and expected policy tightening, but long-term Treasury yields were little changed on net. Investors' expectations for the path of monetary policy firmed a bit more in the fourth quarter in response to higher-than-anticipated inflation and remarks from Federal Reserve officials that were reportedly interpreted as suggesting that an imminent pause in the tightening cycle was unlikely.

As the economic expansion gathered momentum and measures of corporate credit quality improved, investors' perception of risk seemed to diminish, and

Spreads of Corporate Bond Yields over Comparable Off-the-Run Treasury Yields



NOTE. The data are daily and extend through February 9, 2005. The high-yield index is compared with the five-year Treasury yield, and the BBB and AA indexes are compared with the ten-year Treasury yield.

SOURCE. Merrill Lynch AA and BBB indexes and Merrill Lynch Master II high-yield index.

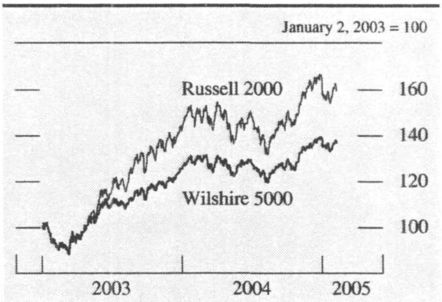
their willingness to bear risk apparently increased. Risk spreads on investment-grade corporate debt over comparable Treasuries ended the year slightly below their levels at the end of 2003. Spreads of speculative-grade yields declined further after narrowing sharply during 2003.

In early 2005, market participants boosted their expectations for the path of the federal funds rate, partly in response to the publication of the minutes of the December FOMC meeting, which investors reportedly interpreted as pointing to greater concerns about inflation than had been expected. Short- and intermediate-term Treasury yields rose along with expectations for the path of monetary policy, but longer-term yields edged lower. Yields on investment- and speculative-grade corporate bonds largely moved with those on comparable Treasury securities, and hence risk spreads remained at low levels.

Equity Markets

After surging as much as 30 percent in 2003, broad stock market indexes climbed modestly over the first half of 2004. The boost to equity prices from robust earnings reports and analysts' upward revisions for future profits during this period was offset in part by rising interest rates in the second quarter, worries about geopolitical developments, and sharply higher oil prices. Stock prices dipped early in the second half in response to softer economic data, further concerns about energy prices, and guidance from corporations that pointed to a less optimistic trajectory for earnings than investors had reportedly been expecting. However, as oil prices pulled back toward the end of 2004 and news on the economy improved, stock prices rebounded to post solid gains

Stock Price Indexes



NOTE. The data are daily and extend through February 9, 2005.

for the year. The increases were led by stocks with comparatively small market capitalizations; the Russell 2000 index climbed 17 percent in 2004 to a record high. The S&P 500 and the technology-laden Nasdaq advanced about 9 percent and 8½ percent respectively. To date in 2005, equity prices have edged lower, on balance, as investors have responded to a rebound in oil prices, lackluster earnings reports, cautious guidance for future profits, and indications of continued monetary policy tightening.

Expected volatility implied by options prices for both the Nasdaq 100 and the S&P 500 declined further in 2004 from already low levels. The difference between the earnings–price ratio and the real ten-year Treasury yield—a crude measure of the premium investors require for holding equity shares—changed little, on balance, remaining close to its average value over the past two decades but above its level during the late 1990s.

Debt, Bank Credit, and M2

The aggregate debt of domestic nonfinancial sectors is estimated to have increased about 7¾ percent in 2004, somewhat faster than nominal income but a bit slower than the pace set the year before. Household and federal debt expanded rapidly. Borrowing by nonfinancial businesses was moderate, although it picked up in the fourth quarter.

Commercial bank credit rose about 9 percent in 2004, a larger advance than in the previous year. Expansion of mortgage and home equity loans on banks' books remained strong, as activity in the housing market stayed robust while mortgage originations shifted somewhat toward adjustable-rate products. After several years of runoffs, business loans began to grow in the second quarter of the year. According to survey evidence, commercial banks eased terms and standards on business loans as the economic outlook improved and competition from other banks and nonbank lenders intensified. Also, banks reported a pickup in demand for business loans that was said to be driven by customers' needs to fund rising accounts receivable, inventories, capital expenditures, and mergers. After adjusting for certain reclassifications of securities as loans, the growth of consumer loans on banks' books remained sluggish. Despite reports of increased competition among banks and nonbank intermediaries, bank profits were again strong in 2004. Banks experienced further improvements in asset quality and, as a result, reduced their provisions for loan losses.

M2 grew at a pace roughly in line with that of nominal GDP during the first half of 2004. A resurgence of mortgage refinancing spurred by the first-quarter decline in mortgage rates likely boosted liquid deposit growth, as proceeds from refinancing were temporarily held in deposit accounts pending disbursement to the holders of mortgage-backed securities. M2 growth slowed in the second half of the year in response to a drop in mortgage refinancing activity and the increased opportunity cost of holding M2 assets, as returns available on market instruments rose more than those on M2 components. For example, yields on retail money market mutual funds moved up more slowly than did short-term market interest rates, and assets of money funds accordingly continued to shrink. Small time deposits, which had contracted over the previous three years, resumed expansion in the second half of the year, as their yields began to rise in association with the increase in other market rates. Currency grew at its slowest rate since 2000, apparently reflecting sluggish demand by both domestic and foreign holders. On balance, M2 growth from the fourth quarter of 2003 to the fourth quarter of 2004 was about 5¼ percent. The velocity of M2 rose 1 percent, on net, roughly in line with the historical relationships among money, income, and opportunity cost.

International Developments

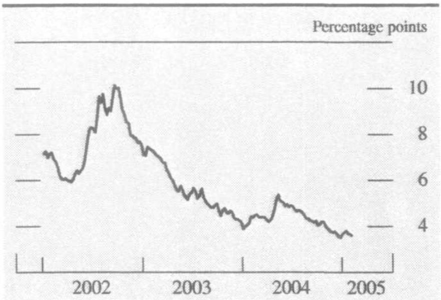
Foreign economic activity expanded in 2004 at a faster pace than in the preceding three years. The pickup in growth was widespread—global manufacturing and trade rebounded across industrial and emerging economies, in part because of strong demand from the United States and China. In the second half of the year, trade and foreign GDP growth slowed, partly as a result of higher oil prices and the appreciation of some foreign currencies against the dollar. The run-up in oil prices and other commodity prices contributed to higher, though still moderate, inflation across industrial and emerging economies.

Monetary policy in many foreign economies tightened over the course of 2004. Citing high rates of capacity utilization and mounting inflationary pressures, the Bank of England raised its target interest rate 100 basis points but has been on hold since August amid signs that housing prices and consumer spending are cooling. After cutting official interest rates earlier in the year, the Bank of Canada raised rates in the fall in response to diminishing slack in the economy. The Bank of Mexico tightened policy throughout the year to resist rising inflation, and Chinese authorities made monetary policy more restrictive to rein in soaring investment demand. In the euro area and Japan, central banks kept policy interest rates unchanged in 2004.

Foreign equity price indexes recorded moderate net gains last year after larger increases in 2003. Equity markets started the year strong, but prices declined in the spring as interest rates rose. The run-up in oil prices between July and October appeared to weigh on foreign equity prices, but the subsequent decline in oil prices helped support a rise in equity prices late in the year. Foreign long-term interest rates declined, on net, during 2004. Rates rose in the second quarter as new data (including reports from the United States) that showed faster growth and higher inflation led market participants to expect more-aggressive monetary tightening. However, foreign long-term interest rates slipped after midyear, when foreign growth slowed and foreign currencies appreciated against the dollar. Over the first half of the year, spreads on internationally issued sovereign debt of emerging-market economies over U.S. Treasuries moved up somewhat from low levels, but spreads more than reversed those increases in the second half.

The path of the exchange rate was uneven over the course of 2004. The dollar rose slightly in the first half of the year on perceptions that monetary policy would tighten more quickly in the United States than abroad. Beginning in

Spread on Internationally Issued Sovereign Debt of Emerging-Market Economies

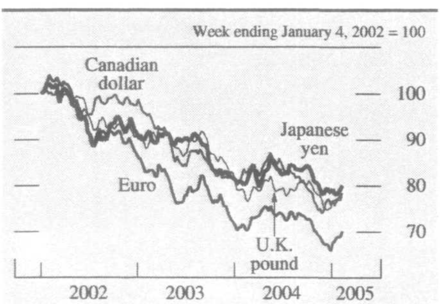


NOTE. The data are weekly averages. The last observation is the average of trading days through February 9, 2005. The series shown is the spread of the yield of certain dollar-denominated sovereign debt instruments of emerging-market economies over U.S. Treasury securities; over the period shown, the index encompassed nineteen countries.

SOURCE. J.P. Morgan Emerging Market Bond Index Plus (EMBI+).

September, however, the dollar resumed the depreciation that had started in 2002, as market participants focused on the financing implications of the large and growing U.S. current account deficit. In 2004, the dollar depreciated about 7 percent, on net, against the euro, the U.K. pound, and the Canadian dollar. The dollar declined 4 percent, on net, against the Japanese yen and 13 percent against the Korean won, but some other Asian central banks, most notably the People's Bank of China, kept their currencies stable against the dollar. So far in 2005, the dollar has rebounded, with market commentary focusing on the positive differential between U.S. economic growth and that in Europe and Japan.

U.S. Dollar Exchange Rate against Selected Major Currencies



NOTE. The data are weekly and are in foreign currency units per dollar. The last observation for each series is the average of trading days through February 9, 2005.

SOURCE. Bloomberg L.P.

Industrial Economies

After increasing strongly in the first quarter, Japanese GDP growth stagnated in the remainder of 2004. Growth in exports and business investment slowed over the year, and government investment contracted. However, corporate profits and balance sheets improved, and labor market conditions also brightened, with the job-offers-to-applicants ratio rising to a twelve-year high. Consumer prices continued to decline in 2004, though only slightly. In contrast, higher commodity prices helped push twelve-month wholesale price inflation up to 2 percent late in the year, its highest rate since 1990. The yield on the ten-year bellwether government bond rose from its June 2003 record low of about ½ percent to nearly 2 percent in midyear before retreating to about 1½ percent recently. After making substantial sales of yen for dollars in the first quarter, Japanese authorities ceased intervention in mid-March and remained on the sidelines even as the yen appreciated significantly against the dollar in the fall.

Economic conditions in the euro area firmed during the first half of 2004 but weakened in the second half. Private consumption and investment spending continued to rise, but export growth slowed after midyear. German GDP growth slowed to a crawl in the second half, as German consumer spending remained anemic, held down by a weak labor market and low consumer confidence. In contrast, French GDP growth was strong in the fourth quarter. The euro-area unemployment rate has been near 9 percent since rising to that level in early 2003. Inflation for the euro area remained just above the European Central Bank's medium-term goal of less than, but close to, 2 percent.

With the exception of a slowdown in the third quarter, economic expansion in the United Kingdom stayed strong during 2004, largely because of the brisk growth of consumption and government spending. Labor markets remained tight in 2004; the unemployment rate ticked down to its lowest level in almost three decades, and labor earnings posted solid gains. Consumer price inflation over the twelve months ending in December was 1½ percent, below the central bank's official target rate of 2 percent. Housing price rises slowed sharply from rapid rates and were muted during the second half of 2004. Household net mortgage borrowing declined to a level 20 percent below its 2003 peak.

The Canadian economy expanded at a healthy pace throughout 2004. Sizable gains in consumption and investment boosted output throughout the year. Export growth, supported by demand from the United States, was strong in the first half of the year but stagnated in the second half as U.S. manufacturing growth slowed and the Canadian dollar's appreciation hurt Canadian trade. The unemployment rate declined moderately over the year, and employment posted strong gains. Consumer price inflation has settled at about 2 percent, the midpoint of the Bank of Canada's inflation target range, whereas inflation excluding food, energy, and indirect taxes declined to around 1½ percent by year-end.

Emerging-Market Economies

Growth of real GDP in China remained very robust in 2004, supported by strong domestic demand and exports. The Chinese government took steps early in the year to slow investment spending, curbing investment approvals and lending. Investment growth slowed significantly but remained rapid. At the same time, indicators of personal consumption spending strengthened, and Chinese exports and imports continued to soar in 2004. Consumer price inflation peaked at a twelve-month change of more than 5 percent in July but has fallen since then to less than 3 percent, as food prices have moderated. Inflation excluding food is only about 1 percent.

Supported by exports to China, economic growth in other Asian emerging-market economies was generally strong in 2004. Economic expansion in Korea remained heavily dependent on external demand because high levels of consumer debt continued to weigh on consumption spending. Inflation across emerging Asia, though still moderate, was pushed up by higher energy prices and strong aggregate demand.

The Mexican economy grew rapidly in the first half of the year in response to strong demand from the United States. In the third quarter, Mexican GDP growth slowed somewhat, as manufacturing exports stagnated, but domestic demand remained buoyant. Increases in energy and food prices pushed up twelve-month consumer price inflation to more than 5 percent, above the Bank of Mexico's target range of 2 percent to 4 percent. Monetary policy tightened throughout the year, and inflation began to fall near year-end. Oil revenues boosted the Mexican public-sector fiscal surplus and allowed Mexican government spending to provide stimulus while still meeting fiscal targets.

In Brazil, economic activity continued to expand robustly in 2004. Domestic demand was supported by the monetary loosening that occurred in the second half of 2003 and early 2004. Export growth was boosted by demand for commodities and the recovery in Argentina. Brazilian asset prices declined through May on expectations that higher global interest rates would make it more difficult for the Brazilian government to finance its debt, but stock prices have moved up sharply since May, and the currency has appreciated. Concerns over inflation pressures have prompted the central bank to tighten monetary policy since September.

In Argentina, the economic recovery picked up steam last year, as exports were supported by strong demand for commodities. The country continues, however, to grapple with difficult structural problems. After more than three years in default, the government launched a debt swap in January with the goal of restructuring more than $80 billion in defaulted bonds. ■

Monetary Policy Report of July 2004

Monetary Policy and the Economic Outlook

The economic expansion in the United States became increasingly well established in the first half of 2004, but the pace of inflation picked up from its very low rate in 2003. At the time of the February *Monetary Policy Report to the Congress*, considerable evidence was already in hand indicating that the U.S. economy had made the transition from a period of subpar growth to one of more-vigorous expansion. Nevertheless, job creation remained limited, and gains in investment, although sizable, still seemed restrained by a lingering caution on the part of some businesses. In the event, businesses stepped up their hiring in the spring, and capital spending seems to have continued apace.

Over the first half of this year, energy prices soared; moreover, inflation in core consumer prices—as measured by the price index for personal consumption expenditures excluding the direct effects of movements in food and energy prices—increased from an exceptionally low rate of 1 percent over the four quarters of 2003 to an annual rate of a little more than 2 percent. To some extent, the upturn in core inflation reflected the indirect effects of higher energy prices, but other forces also played a role. Strengthening aggregate demand both at home and abroad induced a surge in the prices of many primary commodities and industrial materials. In addition, the decline in the foreign exchange value of the dollar in 2003 put upward pressure on the prices of imported goods and services. With strong demand in the United States and increased utilization of the productive capacity of the economy, firms were better able to pass on the higher costs of imports, raise the prices of domestically produced items that compete with imports, and in many cases boost their profit margins. Likely in response to the faster rate of price increases experienced this year, surveys suggest that near-term inflation expectations have moved up somewhat; still, expectations for price inflation over the longer term have remained in their recent range.

Monetary policy was very accommodative at the start of 2004 as the Federal Open Market Committee (FOMC) sought to provide continuing support to an economic expansion that had yet to produce a sustained improvement in the labor market and to ensure that the previous year's threat of an unwelcome disinflation would continue to recede. Although real GDP had accelerated sharply in the second half of 2003, the incoming data through the time of the March meeting suggested that employment was growing only slowly, as employers were relying on increased production efficiencies to satisfy considerable gains in aggregate demand. Surging oil prices were boosting overall inflation, while core inflation—though no longer declining—was still low. With subsequent labor market reports suggesting that hiring was on a stronger track, growth in output continuing at a solid pace, and core consumer price

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NOTE. The discussion in this section consists of the text and tables from the Monetary Policy Report submitted to the Congress on July 20, 2004; the charts from this report (as well as earlier reports) are available on the Board's web site, at www.federalreserve.gov/boarddocs/hh.

inflation possibly running higher, the FOMC announced in May that it saw the risks to the goal of price stability as having moved into balance. Even so, the Committee stated that it believed that the monetary policy accommodation then in place could be "removed at a pace that is likely to be measured." Indeed, at its June meeting, the FOMC decided that sufficient evidence was in hand to begin moving the federal funds rate back toward a more neutral setting and raised the federal funds rate ¼ percentage point to 1¼ percent, a decision that was widely anticipated by market participants.

Although some of the recent data have been on the soft side, the available information on the outlook for the U.S. economy is, on balance, positive. Households are enjoying a generally improving job market, rising real incomes, and greater wealth, all of which are providing them with the confidence and wherewithal to spend. In the business sector, capital spending apparently is continuing to increase briskly, bolstered by expectations of strong sales as well as by booming profits and supportive financial conditions; investment should also continue to be buoyed by firms' adoption of productivity-enhancing technologies. Moreover, inventories appear to be lean relative to sales even after taking account of the substantial improvements firms have made in managing their stocks, suggesting that stockbuilding may provide some impetus to production in the near term. The brightening outlook for economic activity abroad suggests that demand for U.S. exports should grow and provide a further lift to domestic production.

The prospects also seem favorable for inflation to remain contained in the period ahead. For one reason, some of the forces that contributed to the upturn in core inflation in the first half of 2004 are likely to prove transitory. In particular, the upward impetus from the rise in energy and commodity prices is likely to lessen in coming quarters. For another reason, the evidence suggests that the productive capacity of the economy is still not being fully used and that the attendant slack is probably exerting some downward pressure on inflation. If—as seems likely—the economy approaches full utilization of its productive capacity only gradually, that downward pressure should persist for a time. Moreover, productivity remains on a solid uptrend and should continue to restrain costs. To date, the gains in productivity have helped to boost profit margins. As firms compete to take advantage of profit opportunities, they may eventually be forced to absorb a portion of any increases in labor and other costs that occur. But history suggests that the absorption of costs has limits. Indeed, unit labor costs have turned up of late, as productivity growth has slowed below the rate of increase in hourly compensation. If increases in those costs were to develop any upward momentum, the well-behaved nature of inflation in recent years could be jeopardized.

Monetary Policy, Financial Markets, and the Economy over the First Half of 2004

At the beginning of 2004, the FOMC was growing more confident that the economic expansion was likely to be self-sustaining, particularly in light of the significant firming of business outlays and the continued strength in household spending. Moreover, stimulative fiscal and monetary policies, in conjunction with receptive financial markets, appeared likely to provide substantial support to economic activity and to ward off any further disinflation. However, the Committee remained concerned about the persistent weakness in the labor market. At its January meeting, the FOMC left the target for the federal funds rate at 1 percent. The Committee generally felt that the apparent slack in labor and product markets and continued strong productivity growth were likely to keep the underlying trend in inflation subdued, but it nevertheless was cognizant that a highly accommodative stance for monetary policy could not be maintained indefinitely. Given these considerations, the Committee modified the language of its policy statement to gain greater flexibility to firm policy should circumstances warrant. The Committee achieved this added flexibility by removing its assessment that monetary policy would be accommodative for "a considerable period" and instead saying that the Committee could be "patient" in removing its policy accommodation.

At the time of the March FOMC meeting, the Committee believed that conditions were mostly in place for further solid economic growth. Industrial production had picked up broadly, and consumer and business spending continued to expand briskly. However, the employment reports for January and February still painted a picture of subdued hiring. With financial markets quite accommodative, the Committee recognized that maintaining the current stance of policy could fuel inflation pressures and perhaps encourage excessive risk-taking by financial market participants. The Committee concluded that the low level of core consumer price inflation and continued evidence of weak hiring argued for the retention of both its 1 percent target for the federal funds rate and the wording in its statement that the Committee could be "patient" with respect to changes in monetary policy.

At the May FOMC meeting, members noted a distinct improvement in the economic outlook. The labor market figures reported for March had proved to be strong, and the reports for the two previous months had been revised upward significantly. Consumer price inflation in the first quarter of the year was faster than it had been in the previous quarter. Although much of this rise was due to escalating energy costs, core inflation also stepped up, and survey-based measures of near-term inflation expectations had edged higher. In response to the indications of rising aggregate demand and a strengthening job market, yields on Treasury securities had risen appreciably. Accordingly, the Committee was of the view that the expansion would be vigorous and believed that the odds of any further disinflation had been substantially reduced. On the basis of the evolving outlook for economic activity and prices, the Committee revised its assessment of risks to indicate that the upside and downside risks for inflation had moved into balance. To underscore its belief that policy would probably soon need to move toward a more neutral stance while emphasizing that this process was not expected to be rapid, the Committee stated its judgment that monetary policy accommodation "can be removed at a pace that is likely to be measured."

At the time of the June FOMC meeting, incoming information tended to confirm that the economy was expanding at a solid pace but also indicated that inflation was higher than had been anticipated. Quotes on near-term money market futures and options suggested that market participants were nearly certain of an increase of 25 basis points in the target for the federal funds rate at that meeting and had priced in a cumulative increase of about 2¼ percentage points in the federal funds rate over the next year. The Committee agreed that the current substantial degree of policy accommodation was no longer warranted and decided to increase its target for the federal funds rate 25 basis points. The Committee noted that it considered the risks to both sustainable economic growth and stable prices to be roughly balanced and maintained its appraisal that policy accommodation "can be removed at a pace that is likely to be measured" but also emphasized that it will "respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

Economic Projections for 2004 and 2005

In conjunction with the FOMC meeting at the end of June, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, were asked to provide economic projections for 2004 and 2005. The central tendency of the FOMC participants' forecasts for the increase in real GDP is 4½ percent to 4¾ percent over the four quarters of 2004 and 3½ percent to 4 percent in 2005. The civilian unemployment rate is expected to lie between 5¼ percent and 5½ percent in the fourth quarter of 2004 and to decline to between 5 percent and 5¼ percent by the fourth quarter of 2005.

Starting with this report, the Federal Reserve will provide projections for the price index for personal consumption expenditures excluding food and energy (core PCE), which the Committee believes is better as an indicator of underlying inflation trends than is the overall PCE price measure previously featured. Core PCE inflation appears to have run a little above an annual rate of 2 percent in the first half of 2004; for 2004 as a whole, most FOMC participants expect it to lie between 1¾ percent and 2 percent. For 2005, the central tendency of the projections for core PCE inflation is 1½ percent to 2 percent.

Economic Projections for 2004 and 2005

Percent

Indicator	Federal Reserve Governors and Reserve Bank presidents	
	Range	Central tendency
	2004	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	6–7	6¼–6¾
Real GDP	4–4¾	4½–4¾
PCE price index excluding food and energy	1½–2	1¾–2
Average level, fourth quarter		
Civilian unemployment rate	5¼–5½	5¼–5½
	2005	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4¾–6½	5¼–6
Real GDP	3½–4	3½–4
PCE price index excluding food and energy	1½–2½	1½–2
Average level, fourth quarter		
Civilian unemployment rate	5–5½	5–5¼

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

Economic and Financial Developments in 2004

After having surged in the second half of 2003, economic activity continued to expand at a solid pace in the first half of 2004. In the labor market, payroll employment started to increase last fall after a long string of declines and picked up further during the first half of this year. Headline inflation has been boosted significantly by the jump in energy prices this year, but core inflation has also moved up from the exceptionally low levels of late 2003.

The Household Sector

Consumer Spending

Consumer spending, which had gathered a good bit of steam in the second half of 2003, continued to move higher in the first half of 2004. The growth in spending was spurred by substantial gains in income. In addition, household wealth has risen sharply over the past year, and consumer surveys indicate that individuals are generally upbeat in their assessments of the economy's prospects and of their own situations.

Personal consumption expenditures rose at an annual rate of 3¾ percent in real terms in the first quarter. Spending on light motor vehicles, which had been supported in late 2003 by aggressive price and financing incentives, slipped somewhat in early 2004. But outlays for goods other than motor vehicles, which had risen 6½ percent in real terms in 2003, posted another huge increase in the first quarter; spending on services also perked up after having advanced only modestly in 2003. The available data point to a much smaller increase in consumer spending in the second quarter; the deceleration mainly reflects a sharp slowing in the growth of outlays on goods other than motor vehicles.

Real disposable personal income (DPI)—that is, after-tax income adjusted for inflation—rose at an annual rate of nearly 4 percent between the fourth quarter of 2003 and May 2004, a gain about in line with its rate of growth last year. To be sure, the rise in energy prices cut into the growth of real income in the first half of the year. However, aggregate wages and salaries, boosted by increases in both employment and earnings, rose appreciably in nominal terms. In addition, last year's tax legislation, which had already reduced withholding rates in mid-2003, added further to households' cash flow by increasing refunds and lowering final settlements this spring.

Household wealth increased only about in line with nominal DPI in the first quarter of 2004, and the wealth-to-income ratio was likely little changed in the second quarter as well. Nonetheless, the increase in wealth over the past year has been considerable—and probably large enough to more or less offset any lingering restraint on spending growth from the earlier declines in stock prices. Thus, with wealth approximately a neutral influence on the growth of spending of late, the personal saving rate has held fairly steady. In fact, the average saving rate over the first five months of the year—at 2¼ percent of DPI—was very close to the annual figures for 2002 and 2003.

Residential Investment

Activity in the housing sector remained torrid in the first half of 2004. Although starts in the single-family sector faltered a bit early in the year, in part because of unusually adverse weather, they subsequently snapped back and reached an annual rate of more than 1.6 million units in April and May—8½ percent greater than the already rapid pace for 2003 as a whole. Sales of new and existing homes have also been exceptionally strong, and they hit record highs in May. In general, housing activity has been supported by the favorable developments regarding jobs and income and, especially early in the year, by low mortgage rates. Rates on thirty-year fixed-rate mortgages, which had dipped to 5½ percent in March, rose markedly in the spring; they have edged down in recent weeks and now stand at 6 percent, a level still quite low by historical standards.

Home prices have continued to rise rapidly. For example, the national repeat-sales price index from the Office of Federal Housing Enterprise Oversight—which partially adjusts for shifts in the quality of homes sold—rose 7¾ percent over the year ending in the first quarter (the latest available data), a rate similar to the average annual gain since late 2000. By this measure—and many others—house price increases have outstripped gains in incomes as well as in rents in recent years.

Starts in the multifamily sector averaged an annual rate of 360,000 units over the first five months of the year, a pace slightly faster than that of the past several years. Low interest rates have apparently helped maintain the profitability of apartment construction, given that other fundamental determinants of activity in the sector have been weak: In particular, rents have remained soft, and in the first quarter, vacancy rates for multifamily rental properties reached a new high.

Household Finance

Household debt rose at an annual rate of about 10¾ percent in the first quarter of 2004. The especially rapid growth of mortgage debt was driven by the strong pace of activity in the housing market and the renewed wave of mortgage refinancing. However, the second-quarter rise in interest rates appears to have slowed the rate of refinancing and, consequently, the amount of equity being extracted from the value of homes through such transactions. Consumer credit—which constitutes the bulk of household debt aside from mortgage borrowing—expanded at an annual rate of about 6 percent over the first quarter of the year and at roughly a 4 percent pace in April and May. The growth of consumer credit likely has continued to be restrained by the substitution toward mortgage debt as a means to finance household expenditures.

Low interest rates, in concert with strong growth in disposable personal income, have helped to keep financial obligations manageable for most households. In the first quarter of the year, the debt service ratio and the financial obligations ratio for the household sector in the aggregate, both of which gauge precommitted expenditures relative to disposable income, continued to edge down from their peaks in 2001. Other indicators also suggest that the financial wellbeing of households has stabilized and may be improving. Delinquencies on credit card and auto loans generally declined in the first three months of the year, and bankruptcy rates, while still high, stepped down in the first quarter from their recent peak.

Rapid increases in home prices have continued to buoy household net worth this year. In contrast, stock prices are about unchanged. Although news on earnings and economic activity has generally been favorable, rising oil prices and interest rates and, perhaps, heightened geopolitical concerns have weighed on investor sentiment. Nevertheless, inflows into equity mutual funds have been even stronger thus far in 2004 than they were last year.

The Business Sector

Fixed Investment

For the most part, businesses appear to be shaking off the extraordinary reluctance to undertake new investment projects that was evident in 2002 and 2003. Indeed, although outlays on nonresidential construction have not yet turned up decisively, real spending on equipment and software (E&S) has been advancing briskly. The broadly based growth in E&S spending has been driven by increasingly favorable fundamentals: positive expectations for sales, high levels of corporate profits and cash flow, a desire to replace or upgrade aging equipment after a period of weak investment spending, and the continued low cost of capital.

Real E&S spending rose at an annual rate of more than 15 percent in the second half of last year, and it posted another sizable increase in the first quarter of 2004 despite flat business purchases of motor vehicles and a dip in deliveries of aircraft. Excluding transportation equipment, real spending on E&S rose at an annual rate of 13½ percent in the first quarter. In the high-tech category, real purchases of computers and software remained on the solid uptrend that has been evident for the past couple of years, and real outlays on communications equipment increased further, reaching a level about 20 percent above the low in the fourth quarter of 2002. Spending for equipment other than high-tech and transportation, which accounts for about 40 percent of E&S (measured in nominal terms), also rose markedly in the first quarter. Such spending tends to be particularly sensitive to the prospects for aggregate demand. In addition, it may be receiving a lift from the partial-expensing tax provision, which is especially valuable for equipment with relatively long service lives for tax purposes; that provision is slated to expire at the end of 2004.

Equipment spending appears to have posted another solid increase in the second quarter. Outlays on transportation equipment seem to have rebounded, and the incoming data on high-tech equipment point to robust real expenditures. Some indicators for spending on other nontransportation equipment have been a bit soft recently. But the May level of shipments for this broad category was still above that of the first quarter, and backlogs of unfilled orders, which have risen impressively over the past year, continued to build.

Real nonresidential construction has remained about unchanged, on net, since the steep decline in 2001 and 2002. Construction of office buildings is still running at roughly half the pace of 2000, although vacancy rates have stabilized—albeit at very high levels—and the decline in rents has slowed. Factory construction also remains sluggish. Construction of retail and wholesale facilities, in contrast, has held up fairly well, a performance consistent with the strength in consumer spending. Outlays on buildings for health care and education also have been reasonably well sustained.

Inventory Investment

Inventory investment has generally remained subdued even as final sales have strengthened. Although real nonfarm inventory investment picked up to an annual rate of $30 billion in the first quarter, the accumulation occurred almost entirely in the motor vehicle sector, in which sagging sales and a high level of production early in the year created a noticeable bulge in dealer stocks, especially of light trucks. In the second quarter, the automakers reduced assemblies; but with sales running only a little above their first-quarter pace on average, inventories of motor vehicles remained elevated. Outside the motor vehicle industry, nonfarm inventories increased at a meager $6 billion annual rate in real terms in the first quarter, and the available data point to only a moderate step-up in real stockbuilding, on balance, in April and May. In general, non-auto inventories appear lean relative to sales, even after factoring in the downward trend in inventory–sales ratios that has accompanied the ongoing improvements in supply-chain and logistics management.

Corporate Profits and Business Finance

Continuing the gains of last year, profits of the business sector to date have remained strong. In the first quarter of 2004, earnings per share for S&P 500 firms were about 26 percent higher than their level four quarters earlier, and before-tax profits of nonfinancial corporations as a share of GDP from that sector edged up following a steep increase in 2003. A jump in profits in the petroleum and gas industries owing to higher oil prices was responsible for much of the rise in earnings. However, firms across many industries, with the notable exception of telecommunication services, registered solid gains in earnings. In response to this pattern of higher profits, analysts have been steadily marking up their forecasts for earnings in subsequent quarters.

Net equity issuance has remained negative this year. Seasoned offerings have been scarce, the pace of initial public offerings has only inched up, and share retirements have continued to be strong. Corporations have continued to repurchase shares at a rapid rate to manage their cash positions, even as they have increased dividend payments.

Firms relied heavily on their elevated profits and substantial cash holdings to finance their investment in inventories and fixed capital in the first half of 2004. As a result, the growth of nonfinancial business debt remained modest. Much of the proceeds from bond issuance was used to pay down higher-cost debt, and the timing of the issuance of investment-grade bonds in particular was influenced by movements in interest rates; issuance spiked in March in the wake of the drop in yields but subsided in April as rates rebounded. Short-term debt financing showed signs of turning around after contracting over the previous three years. Commercial paper outstanding expanded in the first two quarters of 2004. Business loans at banks have fallen on balance so far this year but at a much slower pace than in 2003. The Federal Reserve's Senior Loan Officer Opinion Survey conducted in April 2004 indicated that demand for business loans had begun to expand and that commercial banks had again eased both standards and terms on these loans over the previous three months.

Strong profits, low interest rates, and continued deleveraging helped improve the credit quality of nonfinancial firms over the first half of the year. In the second quarter, the delinquency rate on business loans dropped for the sixth consecutive quarter; the continued decline has reversed a large part of the preceding run-up. Early in the year the twelve-month trailing default rate on outstanding bonds fell into the relatively low range observed over much of the 1990s, and in June it registered another decline. Moreover, in the first part of the year, the pace of upgrades of bond ratings by Moody's Investors Service rose while the pace of downgrades fell.

Borrowing against commercial real estate assets continued at a rapid pace during the first half of this year. Anecdotal reports suggest that some firms were using mortgages on commercial property to lock in low-cost, long-term funding. Despite the persistently high vacancy rates for most types of commercial property, the loans backed by these assets have continued to perform well. Delinquency rates on commercial mortgages held by banks and insurance companies remained very low in the first quarter. A drop in delinquencies on commercial-mortgage-backed securities (CMBS) in recent months has partially reversed last year's rise, and the narrow risk spreads on CMBS suggest that investors have limited concerns about loan quality.

The Government Sector

Federal Government

The deficit in the federal unified budget has continued to widen. Over the twelve months ending in June, the unified budget recorded a deficit of $431 billion, $120 billion more than during the comparable period last year and equal to nearly 4 percent of nominal GDP. In large part, the rise in the deficit is attributable to further rapid increases in spending on defense and other programs and the loss of revenues resulting from the tax legislation enacted in recent years. In addition, interest costs, which fell sharply between fiscal 1997 and fiscal 2003 as a result of budget surpluses and declining interest rates, have leveled off and thus are no longer a significant factor helping to restrain the deficit. The primary deficit, which excludes net interest, totaled $276 billion over the twelve months ending in June, also approximately $120 billion more than over the year ending in June 2003.

Over the twelve months ending in June, nominal federal spending was nearly 7 percent higher than during the same period a year earlier and stood at about 20 percent of nominal GDP—virtually the same as in fiscal 2003 but 1½ percentage points above the recent low in fiscal 2000. Spurred by the war in Iraq, defense spending ramped up another 14 percent; outlays for nondefense discretionary programs, which include homeland security, moved up further as well. Spending on the major health programs rose at a rapid clip, in part because the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) temporarily increased grants to the states under the Medicaid program and boosted payments to some Medicare providers. In addition, as noted, net interest payments, which had plummeted between 1997 and 2003, flattened out. Real federal expenditures for consumption and gross investment—the part of government spending that is a component of real GDP—rose at an annual rate of 8½ percent in the first calendar quarter of 2004; that increase reflected a surge in real defense spending, which now stands more than 30 percent above the levels that prevailed, on average, from 1997 to 2000.

Federal receipts in the twelve months ending in June were 1½ percent higher than during the comparable period of the previous year after having fallen markedly between fiscal 2000 and fiscal 2003. Receipts received a substantial boost over the past year from a strong gain in corporate taxes, which were lifted by robust profits. Social insurance taxes, which tend to move in line with wages and salaries, also increased. But individual income taxes were below last year's level: Although taxable incomes rose moderately, collections were reduced by the lower withholding rates in place since mid-2003 and by the effects of JGTRRA on refunds and final settlements this spring.

The deterioration in the unified budget since 2000 has been mirrored in a sharp downswing in federal saving—essentially, the unified surplus or deficit adjusted to conform to the accounting practices followed in the national income and product accounts (NIPA). Gross federal saving fell from a high of nearly 3 percent of nominal GDP in 2000 to negative 3 percent of GDP in the first quarter of 2004; measured net of estimated depreciation, federal saving fell from 2 percent of GDP to negative 4 percent of GDP over this period. In the past couple of years, the rise in business saving from the rebound in profits and reductions in corporate taxes has cushioned to some extent the effect of growing budget deficits on national saving. In fact, because of the dramatic increase in business saving in recent quarters, national saving has recovered some from the extreme lows of early 2003. Even so, as of the first quarter of 2004, national saving (measured net of estimated depreciation) was still equal to just about 2½ percent of GDP, compared with a recent high of 6½ percent in 1998. If not reversed over the longer haul, such low levels of national saving could eventually impinge on private capital formation and thus slow the rise of living standards.

Reflecting the need to finance the sizable federal budget deficit, federal debt held by the public expanded at an annual rate of 11¾ percent in the first half of the year. The ratio of this debt to nominal GDP now exceeds 36 percent. The Treasury tilted its issuance toward longer-term and inflation-indexed securities somewhat, and announced semiannual issuance of a twenty-year inflation-protected bond beginning in July and a five-year inflation-protected note beginning in October.

State and Local Governments

States and localities have started to see some improvement in their budget positions after having gone through several difficult years. Strong growth in household income and consumer spending has boosted revenues in recent quarters, as have the additional federal grants authorized under JGTRRA. And although rising medical costs and security needs have continued to put upward pressure on spending, state and local governments have generally held the line on hiring and have kept other outlays in check. The restraint on spending, in combination with a drawdown of reserve funds and some increases in taxes, has helped states and localities satisfy their balanced-budget requirements. In fact, between the third quarter of 2003 and the first quarter of 2004, NIPA net saving (excluding social insurance funds) for this sector averaged $21 billion at an annual rate (¼ percent of nominal GDP), compared with negative $7 billion in 2002 and negative $31 billion in the first half of 2003. (Net saving is roughly similar to the surplus or deficit in an operating budget.) Although a few states are still struggling with strained fiscal situations, most have entered fiscal 2005 (which started on July 1 in all but four states) with expectations of respectable growth in revenues and with budgets in place that allow for some increases in spending on high-priority services and some rebuilding of reserve funds.

Real consumption and investment spending by state and local governments was essentially flat in the first quarter of 2004; available indicators point to a moderate increase in the second quarter. Outlays for consumption items, which were little changed in 2003, appear to have remained subdued throughout the first half of the year. Investment expenditures also were about unchanged in the first quarter, but they turned up sharply in the spring, mainly because of a jump in spending on highways.

Significant demand for infrastructure spending and favorable interest rates led to robust issuance of state and local government debt to finance capital expenditures and to advance refund higher-cost debt. Nevertheless, over the first half of the year, net issuance edged down from its rapid pace in 2003 to about a 6 percent annual rate. The deceleration reflected a decline in short-term borrowing as improvements in the fiscal positions of state and local governments lessened the need for temporary funding of budget shortfalls.

The credit quality of municipal borrowers has stabilized after two years of deterioration; for the year to date, upgrades and downgrades of credit ratings have been roughly equal. In a marked change from last year's sentiment, rating agencies have begun to express guarded optimism about the credit quality of states because of improvements in state revenue flows and restraint on spending.

The External Sector

In the first quarter of 2004, the U.S. current account deficit expanded to an annual rate of $580 billion, or about 5 percent of GDP. As in the past, the widening was driven primarily by a larger deficit in trade of goods and services. The surplus on net investment income declined in the first quarter but remained well above its average value in the previous year. The deficit on net unilateral transfers rose because of a concentration of disbursements of government grants in the first quarter.

International Trade

The U.S. trade deficit in goods and services registered $548 billion at an annual rate in the first quarter, about $46 billion larger than in the fourth quarter of 2003. On average, data for April and May suggest that the trade deficit continued to widen in the second quarter.

Real exports of goods and services increased at an annual rate of 7½ percent in the first quarter of 2004, well off the blistering 20 percent pace of the fourth quarter but still above the average for 2003. Solid gains in exports since mid-2003 arose in part from the strong economic performance of many of our major trading partners. In addition, the net decline in the exchange value of the dollar since 2002 continued to make U.S. goods and services more competitive abroad. Increases in exports of U.S. goods were widespread across our major trading partners, with the exception of Japan, and were concentrated in real exports of capital goods, industrial supplies, and consumer goods. Real exports of agricultural products fell sharply, hurt by foreign bans on U.S. beef products following reports of mad cow disease in a U.S. herd. Exports of services rose moderately.

Prices of total exports rose at an annual rate of 5¾ percent in the first quarter, boosted by another jump in agricultural prices along with substantial increases in the prices of other primary commodities and industrial supplies. Prices of U.S. agricultural exports have been pushed up by very strong global demand, particularly from China. For specific products, such as cotton and soybeans, lower production in some countries also contributed to price run-ups. More recently, prices of soybeans and other agricultural products have eased in the face of a slowing in the growth of demand from China and the anticipation of larger harvests. Even so, available data point to continued strong increases in export prices in the second quarter.

Supported by solid U.S. economic growth, real imports of goods and services rose at an annual rate of 10½ percent in the first quarter. This increase was below the fourth-quarter pace but still roughly double the rate of increase for 2003 as a whole. Real imports of goods were boosted by a sharp increase in oil imports. Gains in imports of non-oil goods were also sizable and widespread across categories. Imports of services grew slightly in the first quarter.

The spot price of West Texas intermediate (WTI) crude oil surged above $40 per barrel in May and has since fluctuated close to that level. The run-up in the price since the beginning of the year has been driven by surprisingly strong global demand for oil. Supply issues have been important as well. These were mainly continued violence in Iraq, including the sabotage of oil facilities, attacks on foreigners in Saudi Arabia, ongoing unrest in Nigeria, political turmoil in Venezuela, and tax payment difficulties at a major Russian oil company. The recent increase in OPEC production (mainly by Saudi Arabia) has eased the upward pressure on prices a bit, but they have remained elevated.

Prices of imported non-oil goods rose at an annual rate of 5½ percent in the first quarter after minimal increases in the second half of 2003. Prices for imported consumer goods rose at an annual rate of 2¾ percent after being flat in 2003. Skyrocketing global commodity prices last year and early this year boosted prices of imported industrial supplies (especially metals) and of foods, feed, and beverages. The jump in commodity prices reflected strong demand, the net depreciation of the dollar over the past two years, and the limited expansion in supply of many commodities since the 2001 trough in commodity prices. Available data suggest a modest stepdown in the rate of increase of import prices in the second quarter; the move in part reflects a flattening of consumer goods prices.

The Financial Account

The U.S. current account deficit has continued to be financed largely by foreign flows into U.S. bonds. Foreign official inflows, already sizable in 2003, rose sharply in the first quarter of 2004 and then moderated somewhat. Similarly, private foreign purchases of U.S. bonds, which were significant in 2003, increased sharply in the first quarter and also appear to have moderated in the second quarter. In contrast, foreign demand for U.S. equities was weak in 2003 and has remained so in 2004. Purchases of foreign equities by private U.S. investors appear to be strengthening, but U.S. investors still show no appetite for foreign bonds.

Direct investment into the United States in the first quarter continued to be restrained by the slowdown of global mergers and acquisitions since 2002. In contrast, U.S. direct investment abroad was strong in 2003 and in the first quarter of 2004, as the effect of fewer mergers and acquisitions was offset by sizable reinvested earnings.

The Labor Market

Employment and Unemployment

The demand for labor turned up in late 2003 after an extended period of weakness, and it has gathered additional steam this year. After averaging about 60,000 per month in the fourth quarter of 2003, gains in private nonfarm payroll employment rose to an average of about 200,000 per month in the first half of 2004. The job gains were especially large in March, April, and May but ebbed somewhat in June. The civilian unemployment rate, which had fallen from a recent peak of 6.3 percent in June 2003 to 5.7 percent in December 2003, was little changed over the first half of the year. In June, it stood at 5.6 percent.

The increases in payrolls over the first half of 2004 were widespread. Especially notable was the turnaround in the manufacturing sector, in which employment bottomed out in January and then rose a cumulative 65,000 jobs through June. The rise in manufacturing jobs was concentrated in the durable goods industries—in particular, those making fabricated metals and other construction-related products, computers and electronic equipment, and machinery. After a long string of declines, employment at producers of nondurable goods was little changed, on net, over the first half. Job gains in virtually all other major sectors have been greater this year than last. In particular, hiring in retail trade, which had been lackluster in 2003, turned up appreciably, and construction employment increased further. The professional and business services sector also posted a sizable rise, in part because the rebound in manufacturing activity lifted hiring at temporary-help firms. A clear indication of the breadth of the employment increases is provided by the six-month diffusion index compiled by the Bureau of Labor Statistics (BLS). The index is equal to the percentage of industries that increased employment over the most recent six months plus one-half the percentage with unchanged employment; in June, the index moved up to its highest level since April 2000.

Productivity and Labor Costs

Gains in labor productivity have slowed somewhat in recent quarters after the spectacular increases of mid-2003. Still, according to the currently published data, output per hour in the nonfarm business sector rose a remarkable 5½ percent over the year ending in the first quarter. Over the past three years, increases in productivity have averaged more than 4 percent per year, compared with average increases of about 2½ percent per year in the second half of the 1990s. During that earlier period, an expansion of the capital stock was an important source of productivity growth. However, in the more recent period, when the business environment—at least until the past few quarters—was characterized by sluggish demand, lean capital budgets, and an extraordinary reluctance of firms to add to payrolls, businesses appear to have raised their productivity mainly through changes in organizational structures and better use of the capital already in place. With hiring having picked up of late, measured productivity growth may slow in coming quarters; but if recent experience is any guide, businesses will continue to focus on achieving structural improvements in the efficiency of their operations. The upswing in investment spending now under way also bodes well for sustained favorable productivity performance in the period ahead.

The rapid productivity growth in recent years has helped to bolster increases in hourly compensation in the face of the soft labor market and the low consumer price inflation in 2003. As a result, increases in the employment cost index (ECI) measure of hourly compensation, which is based on a survey of private nonfarm businesses conducted quarterly by the BLS, have held fairly steady of late. In fact, the rise in the ECI over the twelve months ending in March—at a shade less than 4 percent—was virtually the same as the increases over the preceding two years. Benefit costs, which rose 7 percent over the year ending in March, have continued to be the fastest rising portion of hourly compensation; health insurance costs have remained on a steep uptrend, and employers have boosted their contributions to defined-benefit retirement plans to make up for earlier stock market losses. The rising benefit costs have likely exerted some downward pressure on wages, which rose just 2½ percent over the twelve months ending in March; the twelve-month change in the wage component of the ECI, which was close to 4 percent in 2000 and 2001, has been in the range of 2½ percent to 3 percent since late 2002.

The change in compensation per hour in the nonfarm business (NFB) sector—an alternative measure of hourly compensation based on data constructed for the NIPA—has swung widely in recent years. Fluctuations in the value of stock option exercises, which are excluded from the ECI but included in the NFB measure, likely account for some of the differential movements in the two series. The four-quarter change in the NFB measure bottomed out at a bit less than 2 percent in 2002, when the value of exercised options was dropping; it has moved up steadily since that time and, in the first quarter, stood at 4½ percent—a rate not much different from the increase in the ECI. With productivity growth slowing to a pace below that of NFB hourly compensation, unit labor costs rose in both the fourth and first quarters after having trended down over the preceding two years.

Prices

Inflation moved higher in the first half of 2004. After rising just 1½ percent over the four quarters of 2003, the price index for personal consumption expenditures (PCE) increased at an annual rate of 3½ percent between the fourth quarter of 2003 and May 2004. In that period, energy prices soared, and increases in core consumer prices picked up to an annual rate of 2¼ percent—more than 1 percentage point faster than the increase in 2003. Data for the consumer price index (CPI) are available through June and show some moderation in the core component of the series. Over the first half of the year, the core CPI rose at an annual rate of 2½ percent, compared with an increase of 1¼ percent over the four quarters of 2003.

Reflecting the surge in crude oil prices, PCE energy prices rose at an annual rate of more than 25 percent in the first quarter; they apparently posted another outsized increase in the second quarter. Gasoline prices increased rapidly through May as crude oil costs rose and as price markups were boosted by strong demand and lean inventories; although gasoline prices have fallen on balance since late May, they are currently nearly 30 percent above their level at the end of last year. As for natural gas, which can often substitute for fuel oil in the industrial sector, spot prices were elevated at the start of the year, fell somewhat in February and March, and trended up over the spring. The higher spot prices for natural gas this spring pushed up prices paid by consumers through June. PCE electricity prices appear to have risen at an annual rate of 3 percent over the first half of the year, a pace similar to that in 2003.

Although volatile from month to month, consumer food prices rose moderately on balance over the first half of 2004 after having moved up in late 2003. Robust global demand is imparting upward impetus to food prices, but U.S. producers are in the process of boosting supply, which should help restrain increases in retail food prices in coming quarters.

The step-up in core PCE inflation this year has been especially pronounced in a few categories. In particular, prices of motor vehicles have firmed after a noticeable decrease in 2003. In addition, increases in shelter costs, which were surprisingly low in 2003, are now running more in line with earlier trends. Core inflation has also been lifted this year by substantial increases, on balance, in a number of categories for which prices cannot be derived from market transactions and thus must be imputed by the Bureau of Economic Analysis—for example, prices of financial services provided by banks without explicit charge. These non-market-based prices, which were about flat in 2003, are difficult to estimate, and the imputed figures tend to be volatile.

A number of factors have contributed to the run-up in core inflation this year. Higher oil prices have doubtless raised the cost of producing other goods and services. So have the steep increases in prices of non-oil commodities such as copper and lumber, which came about as economic activity strengthened worldwide and as industrial capacity utilization both here and abroad tightened. Likewise, the decline in the dollar has boosted non-oil import prices and thus the costs of inputs for many domestic producers. The weaker dollar has also likely lessened the pressure on firms facing foreign competition to hold the line on prices—a consideration that is probably contributing to the widespread perception that firms' pricing power has increased lately. Moreover, unit labor costs have edged up recently after having declined noticeably in 2002 and 2003.

From a cyclical perspective, the sharp upturn in commodity prices is not surprising, given the pickup in the growth of industrial production. In fact, such large increases in commodity prices are typical as economic activity accelerates and capacity utilization rises—especially for products for which the supply is relatively fixed in the short run. Some portion of these increases usually proves transitory. More important, cyclical swings in commodity prices tend to have only a minor effect on overall inflation, both because they account for a small share of total costs and because changes in commodity prices tend to be partly absorbed in firms' profit margins, at least for a time.

The faster rate of inflation this year underscores the difficulty of gauging price pressures. Nevertheless, on the whole, the evidence suggests that slack remains in labor and product markets, which should be exerting some downward pressure on inflation. The unemployment rate—at 5½ percent currently—is not significantly lower than it was through much of 2002 and 2003, when core inflation was trending down. And despite the run-up this year, capacity utilization in the manufacturing sector is still below its longer-run average. In addition, the strong upward trend in productivity is continuing to help keep the rise in labor costs muted, and profit margins are sufficiently wide to give firms scope to absorb cost increases for a while without putting undue upward pressure on prices.

The upturn in actual inflation has been echoed in some measures of inflation expectations. For example, according to the Michigan Survey Research Center, the median expectation for inflation over the coming year has averaged slightly more than 3 percent since early spring after hovering in the area of 2¼ percent to 2¾ percent in 2003 and early 2004. The median expectation for inflation over the next five to ten years has been running a bit below 3 percent in recent months, a reading similar to the figures for 2002 and 2003. According to the Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia, expectations of inflation over the next ten years held steady in June at 2½ percent. Inflation compensation over the next five years as mea-

Alternative Measures of Price Change
Percent

Price measure	2002 to 2003	2003 to 2004
Chain-type (Q1 to Q1)		
Gross domestic product	1.7	1.8
Gross domestic purchases	2.3	1.7
Personal consumption expenditures	2.4	1.6
Excluding food and energy	1.6	1.3
Fixed-weight (Q2 to Q2)		
Consumer price index	2.2	2.8
Excluding food and energy	1.5	1.8

NOTE. Changes are based on quarterly averages of seasonally adjusted data.

sured by the spread between the yield on nominal Treasury securities and their indexed counterparts rose noticeably during the first half of 2004. To be sure, inflation compensation is also influenced by perceptions of inflation risk and the secular increase in demand for inflation-indexed debt, but the rise in near-term inflation compensation likely reflects, at least in part, higher inflation expectations. Similar to the survey-based measures of longer-run inflation expectations, inflation compensation for the period five years to ten years ahead was little changed on net over the first half of the year.

Broader NIPA price measures are available only through the first quarter, and the four-quarter changes in these series do not show the rise in inflation indicated by the monthly data discussed above. In particular, the rate of increase in the price index for GDP over the year ending in the first quarter was just 1¾ percent, the same as over the preceding year. The four-quarter change in the price index for gross domestic purchases—which is defined as the prices paid for purchases of domestic and imported consumption, investment, and government goods and services—dropped from 2¼ percent to 1¾ percent over the same period; the deceleration reflects mainly the effects of energy prices, which rose even more rapidly over the year ending in the first quarter of 2003 than they did over the most recent year.

U.S. Financial Markets

As 2004 opened, financial market conditions were quite accommodative, with low corporate bond yields, narrow risk spreads, and relatively easy terms and standards on bank lending. Although equity prices changed little, and interest rates rose on balance in response to positive economic news and expectations of a tightening of monetary policy, financial conditions in the first half of the year remained supportive of economic growth. Business borrowing nevertheless remained tentative, while increases in the debt of the federal government and of households were sizable.

Interest Rates

From the end of 2003 through the end of March, yields on nominal Treasury coupon securities fell, on net, about 30 to 45 basis points. Although interest rates rose immediately after the FOMC's January meeting in response to the Committee's decision to remove its statement that monetary policy could remain accommodative for "a considerable period," the increase proved to be short lived. Weak employment reports released in early February and early March prompted yields to fall amid doubts about the strength of the economic expansion. Federal funds futures contracts at the end of March appeared to indicate that market participants placed small odds on a tightening of monetary policy before late 2004, and contracts also seemed to price in only a gradual increase in the federal funds rate during 2005.

Interest rates backed up in the second quarter as data releases increasingly suggested that the economic expansion would remain vigorous. Yields on the two-year and ten-year nominal Treasury notes ended the first half of the year 90 and 36 basis points higher, respectively, than at the end of 2003, as markets adjusted to the greater likelihood of an earlier onset and more rapid pace of monetary policy tightening. The surprisingly strong employment reports published in April and May, higher-than-expected readings on core inflation, and surging oil prices all spurred increases in Treasury yields. After the release of the employment report in May, federal funds futures contracts priced in a hike in the target federal funds rate at the June FOMC meeting and a more rapid tightening of monetary policy than had been anticipated. With the evolving outlook for monetary policy, the volatility of short-term interest rates implied by option prices jumped in the first half of the year after staying in a relatively low range in 2003. Near-term interest rates declined a bit after the Committee's decision at its June meeting to raise the intended federal funds rate 25 basis points; the Committee's reaffirmation that policy accommodation likely could be removed at a "measured" pace apparently reassured investors that a steep rise in the federal funds rate probably was not in train.

Yields on investment-grade corporate debt moved roughly in line with those on comparable nominal Treasury securities over the first half of the year, producing little net change in risk spreads from their level at the end of last year. Spreads on speculative-grade debt over Treasury debt declined a bit further after having narrowed sharply during 2003 as the economic expansion was seen as gathering steam.

Equity Markets

Over the first half of 2004, equity prices were subject to the strong crosscurrents of robust earnings reports, rising interest rates, fluctuating fears about geopolitical developments, and sharply higher oil prices. On balance, broad equity price indexes at the end of June had edged about 2½ percent to 3¼ percent above year-end levels after having surged 25–30 percent over the course of 2003. Over the first half, analysts raised their estimates of profits for coming quarters; the upward revision outstripped the more modest increase in equity prices and boosted the ratio of expected year-ahead earnings to stock prices. With real interest rates higher, however, the difference between the earnings–price ratio and the real ten-year Treasury yield—a crude measure of the equity risk premium—changed little to remain close to its average value over the past two decades and above its level during the late 1990s.

Debt and Financial Intermediation

Aggregate debt of the domestic nonfinancial sectors expanded at an annual rate of about 8½ percent in the first quarter of 2004, a gain similar to last year's increase. Debt growth in the business sector has remained subdued so far this year, as ample internal funding has limited the need for external finance. In contrast, household debt has continued to expand rapidly, spurred by an elevated pace of home purchases and cash-outs from mortgage refinancing. The large federal budget deficit led to another sharp increase in Treasury debt in the first half of this year. Municipal borrowing moderated somewhat, on balance, in the first half of the year, as the improving fiscal condition of state and local governments reduced the need for short-term borrowing to cover budget gaps.

The growth of credit on the books of depository institutions picked up to an annual rate of 14 percent in the first quarter of 2004. Financing secured by residential real estate—including home mortgages, home equity loans, and mortgage-backed securities—drove the expansion. In contrast, business loans continued to run off, falling at an annual rate of about 5 percent in the first half of the year after a 10 percent drop in 2003. The deceleration was consistent with some signs that demand for business loans was beginning to recover as well as with an easing of standards and terms on these loans.

The M2 Monetary Aggregates

In the first half of 2004, short-term interest rates were stable and M2 grew at an annual rate of 6½ percent—a pace that was roughly in line with estimates of nominal GDP—after contracting at a record rate in the fourth quarter of 2003. Liquid deposits—the largest component of M2—had been depressed late last year by the ebbing of last summer's mortgage refinancing boom. Mortgage refinancings tend to boost M2 as the proceeds are temporarily placed in non-interest-bearing deposit accounts pending disbursement of funds to the holders of mortgage-backed securities. When refinancings slowed last year, the decline in such escrow accounts held down the growth of liquid deposits. In the first half of this year, M2 probably received a boost from the new round of mortgage refinancings that followed the first-quarter decline in mortgage interest rates. The strength in liquid deposits was partly offset, however, by continued weakness in money market mutual funds and small time deposits. Given the recent very low yields on these two components of M2, households likely viewed them as less attractive savings vehicles than other assets.

International Developments

Foreign economic activity expanded in the first half of this year at a pace only slightly below the rapid increase in the second half of 2003. Global trade has been boosted by strong demand, especially from the United States and China. The run-up in oil and commodity prices has contributed to rising, though still moderate, inflation across the industrial and developing countries.

By the end of the first half of this year, monetary policy in most major foreign economies had either tightened or assumed a less accommodative tone. Citing high rates of capacity utilization and mounting inflationary pressures, the Bank of England has raised its target rate 100 basis points since early November. Mexico and China also have tightened policy. Elsewhere, including the euro area, Canada, and Japan, central banks most recently have kept policy unchanged after easing previously. In general, official statements are expressing increasing concern over the inflationary risks associated with stronger economic activity and higher world energy and commodity prices.

In foreign financial markets, equity price performance has been more mixed so far in 2004 than during the second half of 2003; sharply rising interest rates over the past few months have weighed on equity valuations, damping the effects of an improved earnings outlook. Since year-end, stock prices in Europe and Canada have changed little, on balance. In contrast, rapidly improving economic conditions in Japan have helped boost Japanese equity prices about 10 percent. Other Asian stock price indexes have fallen, on average, in part because of concerns about the possibility of an acute slowdown in China. Mexican stocks have been bolstered by strong earnings growth of leading Mexican communications firms and, more generally, by the strengthening U.S. expansion. Foreign long-term interest rates rose rapidly in the second quarter as new data (including from the United States) showing faster growth and higher inflation led market participants to expect more-aggressive monetary tightening. Over the first half of the year, the spread on internationally issued sovereign debt of emerging-market economies over U.S. Treasuries moved up somewhat from its very low level.

After depreciating over the previous two years, the value of the dollar rose slightly, on balance, in the first half of 2004. The firming of the dollar has been attributed to perceptions by market participants that near-term monetary tightening in the United States would be faster than such tightening abroad.

Industrial Economies

A broadly based recovery appears to have been established in Japan over the first half of 2004. Real GDP rose at an annual rate of more than 6 percent in the first quarter after an even greater increase in the fourth quarter. Aided by demand from China, growth of Japanese real exports remained robust. Personal consumption and business investment also firmed. More-recent indicators show that domestic strength continued in the spring with large gains in household expenditures and improved labor market conditions. Deflation continued to wane in Japan. Consumer price deflation over the first half of the year was slight, and wholesale prices increased. In financial markets, the stronger economy boosted equity markets and helped drive up the yield on the ten-year bellwether government bond to more than 1¾ percent from its June 2003 record low of about ½ percent. After making substantial sales of yen for dollars in the first quarter, Japanese authorities ceased intervention in mid-March. Even so, the yen depreciated early in the second quarter before appreciating to around ¥109 per dollar.

Economic conditions in the euro area firmed over the first half of 2004, but performance varied across countries, and the region as a whole continues to lag the global upturn. Real GDP in the euro area increased at an annual rate of 2¼ percent in the first quarter; output in France, Spain, and several smaller member countries rose relatively briskly, while growth in Germany and Italy was less robust. In the first quarter, domestic demand firmed noticeably, except in Germany, where growth was due entirely to a spike in exports. German consumer spending remains anemic, held down by a weak labor market and low consumer confidence. Euro-area indicators for the second quarter initially were upbeat, but more-recent data have been mixed. Labor markets have yet to benefit from the recovery, and the average unemployment rate in the region edged up to 9 percent in the spring. Inflation for the euro area over the twelve months ending in June was near 2½ percent, a rate above the European Central Bank's medium-term goal of less than, but close to, 2 percent. Excluding energy, food, alcohol, and tobacco, prices rose slightly less than 2 percent over the same period.

Economic expansion in the United Kingdom continued unabated over the first half of 2004. Labor markets tightened further; the unemployment rate edged down to its lowest level in almost three decades, and labor earnings posted solid gains. Despite the strong economy, consumer price inflation over the twelve months ending in June was 1½ percent, remaining below the central bank's official target rate of 2 percent. Conditions in the U.K. housing market, however, remained red hot, with double-digit price increases, high levels of household mortgage and consumer borrowing, and sizable withdrawals of home equity.

The Canadian economy picked up steam in the first half of 2004 after a year plagued with difficulties including SARS, mad cow disease, and a regional power outage. Sizable gains in consumption and investment boosted output in the first quarter, and indicators are pointing to continued good performance in these sectors. Export growth was strong, as the robust economic performance of the United States appears to have outweighed the negative effect of Canadian dollar appreciation on trade. The unemployment rate was relatively stable over the first half, and employment bounced back in the second quarter from a first-quarter lull. Consumer price inflation decreased early in the year, but energy costs helped drive up the rate to 2½ percent over the twelve months ending in June. Prices excluding food, energy, and indirect taxes have remained more subdued, rising slightly less than 1½ percent over the same period.

Emerging-Market Economies

Estimates suggest that real GDP in China surged in the first quarter with continued outsized gains in fixed-asset investment. Fears of overinvestment, particularly in the steel, cement, and aluminum industries, led Chinese officials to intensify their tightening measures early in the second quarter. These measures included increases in reserve requirements and in some interest rates as well as stricter criteria for the approval of investment projects. A sharp slowdown in estimated real GDP for the second quarter suggests that these steps are working. Despite the recent slowing in growth, Chinese exports and imports soared in the first half of the year, and trade was close to balanced.

Growth in the other Asian emerging-market economies slowed only moderately in the first quarter from the fast pace at the end of last year. Exports, which continued to be the driving force behind that growth, were fueled by Chinese demand as well as by the recovery in the global high-tech market and stronger world demand overall. Consumer demand generally rose across the region with the notable exception of Korea, where high levels of consumer debt are weighing on spending. Although still only moderate, inflation across the Asian emerging-market economies is beginning to rise as stronger aggregate demand takes hold and higher energy and commodity prices pass through to prices more generally.

The Mexican economy has been propelled this year by strong demand from the United States. Gains have been broadly based, with sharp increases in industrial production, exports, construction, and retail sales. Employment in the industries most closely linked to U.S. trade also has started to increase. Responding to a rise in twelve-month inflation to slightly above its 2 percent to 4 percent target range, the Bank of Mexico has tightened policy several times so far this year. Elevated oil prices boosted the Mexican public-sector fiscal surplus to a record high during the first five months of the year and facilitated an increase in federal transfers to state governments.

In Brazil, GDP grew robustly in the first quarter, and indications are that economic activity continued to expand in the second quarter with support from strong external demand. Job growth has been robust, although unemployment has remained high. Inflation, however, continues to concern authorities. Asset prices weakened earlier this year, in part because of rising global interest rates but also because of market participants' unease about the direction of structural and fiscal reforms; since then, asset prices have partially rebounded.

The recovery in Argentina has continued at a rapid pace in recent quarters, but limited investment in the energy sector, reflecting a lack of structural reforms, has forced the government to import electricity, natural gas, and fuel oil from neighboring countries. Creditors have shown little enthusiasm for the country's latest debt restructuring plan, and the federal government faces difficult challenges in normalizing its international financial situation and reforming its fiscal relations with the provinces. ■

Federal Reserve Operations

Consumer and Community Affairs

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

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

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

Implementation of Statutes Designed to Inform and Protect Consumers

The Board of Governors writes regulations to implement federal laws involving consumer financial services and fair lending. The Board revises and updates these regulations to address the introduction of new products, to implement legislative changes to existing laws, and to address problems consumers may encounter in their financial transactions. To interpret and clarify the regulations, Board staff issues commentaries and other guidance. In addition, the staff may undertake studies on aspects of consumer financial products and services at the request of Congress.

During 2004, the Board issued final rules implementing provisions of the Fair and Accurate Credit Transactions Act, an act that significantly amends the Fair Credit Reporting Act. The Board also issued guidance on the standards it and the Federal Deposit Insurance Corporation (FDIC) will use when determining whether to take supervisory or enforcement actions in cases involving the unfair and deceptive trade practices provisions of the Federal Trade Commission Act. The Board produced two reports for Congress summarizing the findings of Board studies on the disclosure of fees related to debit card purchases and on the ability of consumers to avoid receiving unsolicited written offers of credit or insurance. In addition, the Board revised its Truth in Lending Act regulation and the associated commentary, issued interim final rules incorporating technical changes to the regulation implementing the Community Reinvestment Act, raised certain thresholds that would trigger additional requirements under the Home Ownership and Equity Protection Act, and issued a final rule revising the disclosure tables that the federal financial regulatory agencies use to publicly release Home Mortgage Disclosure Act data reported by covered institutions.

Fair and Accurate Credit Transactions Act

In December 2003, the President signed the Fair and Accurate Credit Transactions Act (the FACT Act) into law. The FACT Act amends the Fair Credit

Reporting Act (FCRA) in numerous respects, including making permanent an FCRA provision that preempts states from enacting laws in seven areas addressed by the FCRA. The FACT Act also includes provisions to address identity theft, the accuracy of consumer reports, the duties of furnishers of information, the ability of consumers to opt out of receiving marketing solicitations from an organization when the solicitation is based on information provided to that organization by its affiliate, and the ability of creditors to obtain or use medical information in connection with determining credit eligibility. (The FACT Act also established the Financial Literacy and Education Commission. See "Promotion of Community Economic Development in Historically Underserved Markets" later in this chapter.)

The FACT Act requires the Board to issue regulations or guidelines to implement various provisions of the statute. In 2004, the Board issued three final rules: one pertaining to effective dates for certain provisions of the FACT Act, one pertaining to the furnishing of negative information to consumer reporting agencies, and one pertaining to the disposal of consumer information. The Board is currently working on several additional regulations or guidelines required by the FACT Act.

Effective Dates

In February, the Board and the Federal Trade Commission (FTC) issued joint final rules to implement section 3 of the FACT Act, which required these agencies to establish effective dates for provisions of the act that did not already contain specific effective dates. The Board and the FTC had jointly adopted interim rules in December 2003 that established December 31, 2003, as the effective date for the preemption provisions of the FACT Act, as well as for provisions authorizing the agencies to adopt rules or take other actions to implement the FACT Act. The final joint rules the agencies adopted in February 2004 included the same schedule of effective dates contained in the interim rules. The Board's final rule amended its Regulation V, which implements the FCRA.

Also in December 2003, the Board and the FTC had issued for comment proposed joint rules that would establish a schedule of effective dates for other provisions of the FACT Act that did not contain effective dates. After reviewing the comments on the proposal, the agencies, in the February 2004 joint final rules, established March 31, 2004, as the effective date for provisions of the FACT Act that did not require significant changes to business procedures. For those FACT Act provisions that would likely entail significant changes to business procedures, the agencies established December 1, 2004, as the effective date, to allow a reasonable time for the industry to establish systems that comply with the statute.

Furnishing of Negative Information

In June, the Board issued a final rule amending Regulation V to add model notices that financial institutions may use to comply with the notice requirement for furnishing negative information to nationwide consumer reporting agencies. Under section 217 of the FACT Act, a financial institution that furnishes negative information about credit extended to a customer (such as information on a customer's delinquencies or late payments) to a nationwide consumer reporting agency is required to provide a clear and conspicuous written notice to the customer about furnishing negative information. The required notice is a one-time notice, and a financial institution may provide the notice before, or no later than thirty days after, furnishing the negative information to a nationwide consumer reporting agency. Section 217 of the FACT Act became effective on December 1, 2004.

The FACT Act required the Board to issue a concise model form not to exceed thirty words that institutions may, but are not required to, use to comply with the notice requirement. The Board's final rule added two model notices to Regulation V. One notice may be used by financial institutions that give the notice before furnishing negative information to a nationwide consumer reporting agency. The other may be used by financial institutions that give the notice after furnishing negative information to a nationwide consumer reporting agency. The Board also amended Regulation V to incorporate a statutory safe harbor relating to the use of the model notices. The safe harbor in the FACT Act provides that a financial institution will be considered to be in compliance with the notice requirement if the institution uses the model notice issued by the Board, or if it uses the model notice and rearranges the format. The Board also provided additional guidance about using the model notices, including guidance on how financial institutions may rearrange the format of the notices without losing the safe harbor from liability that the model notices provide.

Disposal of Consumer Information

In December, the Board along with the other federal financial regulatory agencies issued interagency final rules to require financial institutions to adopt measures for properly disposing of consumer information derived from consumer reports (such as credit reports). The agencies' final rules implement section 216 of the FACT Act by amending the Interagency Guidelines Establishing Standards for Safeguarding Customer Information (retitled the Interagency Guidelines Establishing Standards for Information Security), which were adopted in 2001 (as appendix D-2 of Regulation H). The National Credit Union Administration, the FTC, and the Securities and Exchange Commission adopted similar standards for their institutions.

The interagency guidelines currently require financial institutions to protect customer information by implementing information security programs. An institution's information security program must include measures for the proper disposal of "customer information." Such information is generally defined as nonpublic personal information about a "customer," namely, an individual who obtains a financial product or service to be used primarily for personal, family, or household purposes, and who has a continuing relationship with the financial institution. The final rules amend the interagency guidelines to require institutions to also include measures for the proper disposal of "consumer information," which is generally defined as information that is a consumer report (such as a credit report), or that is derived from a consumer report about an individual (regardless of whether that individual is a customer), and that is maintained or otherwise possessed by, or on behalf of, the institution for a business purpose. The final rules will take effect on July 1, 2005; however, financial institutions do not need to modify existing contracts with their service providers until July 1, 2006.

Interagency Guidance on Unfair and Deceptive Practices

In March, the Board and the FDIC jointly issued a statement outlining the standards the agencies will use to determine when state-chartered banks are engaging in unfair or deceptive trade practices. Such practices are illegal under section 5 of the Federal Trade Commission Act. The Board and the FDIC will apply these standards when weighing the need to take supervisory or enforcement actions and when seeking to ensure that unfair or deceptive practices do not recur. The statement also provides best practices and general guidance to state-chartered banks to help them manage risks relating to unfair or deceptive acts or practices, as well as to help them avoid engaging in such acts or practices. The best practices address some of the business areas that have the greatest potential for unfair or deceptive acts and practices: advertising and solicitation, servicing and collections, and managing and monitoring employees and third-party service providers.

Board Study of the Disclosure of Point-of-Sale Debit Fees under the Electronic Fund Transfer Act

In November, the Board issued a report summarizing the results of its study of the disclosure of fees related to debit card purchases. The study focused specifically on the debit fees that a financial institution may impose when a customer engages in a point-of-sale (POS) debit transaction and provides a personal identification number (PIN). These fees are referred to as "PIN fees." Some members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs requested the study because they were concerned that consumers may be unaware of the existence or the source of PIN fees. The primary conclusions of the study address four principal areas: (1) the prevalence of PIN fees; (2) the degree of compliance by depository institutions with current disclosure requirements under the Electronic Fund Transfer Act (EFTA), as implemented by the Board's Regulation E; (3) the adequacy of existing disclosures and the likely benefits and costs of new requirements for disclosure statements; and (4) the feasibility of real-time disclosure (namely, disclosing PIN fees at the time of a transaction on a POS terminal display).

Prevalence of PIN Fees

The Board estimated that in 2004 about 15 percent of all customers with debit cards had accounts that were subject to PIN fees. Because customers can modify their behavior to avoid PIN fees (for example, by using a signature instead of a PIN to secure a transaction), the fraction of customers with debit cards who actually pay these fees is likely between 10 percent and 15 percent.

Degree of Compliance by Depository Institutions

The EFTA and the Board's Regulation E require depository institutions to disclose certain fees to consumers on the initial disclosure of account terms, on change-in-terms notices, and on periodic statements of account activity. The Board found that more than 95 percent of depository institutions satisfy all the current regulatory requirements for any electronic funds transfer, and that an even higher percentage satisfy the specific requirements for the disclosure of PIN fees at the point of sale.

Adequacy of Existing Disclosures

Consumer and other data suggest that the PIN fee information in initial disclosures and in change-in-terms notices is of limited value to consumers. Some consumers first learn of debit fees from their periodic statements, and many institutions' periodic statements do not identify the recipient of a debit fee. These findings suggest that improving periodic statements, and potentially initial disclosures and change-in-terms notices, could be a relatively low-cost way to provide consumers with better information about the PIN fees their depository institutions impose.

Feasibility of Real-Time Disclosures

The Board found that disclosing debit fees in real time at a POS terminal (for example, showing fee information on a POS terminal display before a customer commits to a method of payment) would involve the most extensive changes to the infrastructure of the payments system. Although such disclosures would improve consumers' knowledge of debit fees, these improvements would be achieved at extremely high costs.

Board Study of Prescreened Solicitations under the Fair Credit Reporting Act

In December, the Board issued a report to Congress summarizing the Board's study of unsolicited written offers of credit or insurance in which the sender of the offer has prescreened the recipients for creditworthiness and suitability on the basis of consumer credit records in the files of consumer reporting agencies. The FCRA allows consumer credit records to be used for these so-called prescreened solicitations. In section 213(e) of the FACT Act, Congress directed the Board to study the ability of consumers to avoid (or opt out of) receiving written offers of credit or insurance in connection with transactions the consumer did not initiate. The Board also studied the potential effect on consumers of any further restrictions on providing them with such written offers of credit or insurance. In particular, Congress directed the Board to address the following five issues: (1) the availability to consumers of opt-out mechanisms, that is, methods for consumers to opt out of having their names and other information used for prescreened solicitations; (2) the extent to which consumers use existing opt-out mechanisms; (3) the benefits to consumers of receiving written offers; (4) the costs to consumers of receiving written offers, or any adverse effects on consumers from receiving the offers; and (5) the potential effects on certain factors, such as the cost and availability of credit, if further restrictions were imposed on the ability of creditors and insurers to make written offers.

Availability and Use of Opt-Out Provisions

The Board found that currently about 6 percent of consumers with credit records have opted out of receiving prescreened written offers of credit or insurance. Further, most consumers who elect to opt out use the statutory mechanisms provided in section 604 of the FCRA, which governs the use of prescreening techniques. Beyond that statutory provision, industry groups and individual companies have voluntarily established ways for consumers to eliminate their name from the listings companies use to make prescreened written offers of credit or insurance. These voluntary mechanisms are important in the marketplace; an estimated one-third of the individuals on the opt-out lists of the national consumer reporting agencies used a voluntary mechanism to request that their personal information not be used for prescreened offers.

Benefits and Costs of Receiving Written Offers

The Board found that the benefits to consumers of receiving prescreened written offers of credit or insurance are significant. Because prescreened offers must be "firm offers" of credit or insurance, a consumer generally receives offers for only those products for which he or she is likely qualified. Consequently, consumers shopping for credit or insurance are able to quickly identify products suitable for them. These prescreened offers also contain pricing and product information, often in a form that allows a consumer to compare the terms of products offered with those of accounts he or she already holds—and with products offered by other companies. Thus, the widespread availability of pricing and product information in prescreened offers helps to make the market for these products more competitive, an advantage that benefits all consumers.

For creditors and insurers, the ability to tailor offers of credit or insurance to consumers' pricing and product preferences at a relatively low cost enhances competition and marketing efficiency. Moreover, by having access to credit record information for the purposes of prescreening, creditors and insurers are better able to control certain risks related to offering these products. In a competitive market, cost savings for creditors and insurers translate into lower prices and wider credit and insurance availability for consumers, possibly benefiting traditionally underserved consumers.

The Board found that prescreened written solicitations for credit and insurance carry some potential costs for consumers, including the inconvenience of receiving unwanted mail, the possibility of identity theft, the possible loss of privacy, and the potential for additional debt burden. Although these are important considerations, the Board did not find that restricting written offers of credit or insurance would mitigate these problems; the alternatives to prescreening may even exacerbate some of them.

Potential Effects of Further Restrictions

The Board found that written offers of credit or insurance sent directly to consumers have the potential to increase competition in the market for those consumer financial services. The primary benefits of competition are lower prices and an increased availability of the product or service in question. As a result, the Board concluded that actions undertaken to restrict the ability of lenders and insurers to provide written offers of credit or insurance to consumers would, on balance, result in a less competitive marketplace and thus relatively higher prices and the reduced availability of credit or insurance.

Other Regulatory Actions

The Board also took the following regulatory actions during 2004:

- In March, the Board revised Regulation Z (Truth in Lending) and its official staff commentary to add an interpretative rule of construction clarifying that the word "amount" referred to a numerical amount. The revisions also provided guidance on consumers' exercise of rescission rights for certain home-secured loans.

- In July, the Board and the other federal financial regulatory agencies issued joint interim final rules containing technical changes to their regulations implementing the Community Reinvestment Act (CRA). The changes conform those regulations to changes in (1) the Standards for Defining Metropolitan and Micropolitan Statistical Areas, published by the U.S. Office of Management and Budget in December 2000; (2) the census tracts designated by the U.S. Bureau of the Census; and (3) the Board's Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). The joint interim rules did not make substantive changes in the requirements of the CRA regulations. The Board's regulation implementing the CRA is Regulation BB.

- In August, the Board amended the official staff commentary to Regulation Z to raise from $499 to $510 the total dollar amount of points and fees that triggers additional requirements for certain mortgage loans under the Home Ownership and Equity Protection Act. As prescribed by the statute, the increased amount (effective January 2005) reflects changes in the consumer price index.

- In December, the Board issued a final rule revising disclosure tables the Board and the other federal financial regulatory agencies use to publicly release data collected by lenders under HMDA and the Board's Regulation C. In particular, the final rule revised the formats for some of the existing disclosure tables, deleted one set of existing tables, and added new tables. These changes reflect the Board's 2002 revisions to Regulation C that required lenders to collect new data beginning January 1, 2004.

- In December, the Board raised to $34 million the exemption threshold for depository institutions required to collect data in 2005 under HMDA and Regulation C. As prescribed by the statute, the increased threshold reflects changes in the consumer price index.

Economic Effects of the Electronic Fund Transfer Act

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

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

Direct deposit was almost as widely used. About 67 percent of U.S. families had funds deposited directly into their checking or savings account. Use of the service is particularly common in the public sector; during fiscal year 2004, approximately 75 percent of all government payments were made using EFT, including 81 percent of Social Security payments, 98 percent of federal salary and retirement payments, and 45 percent of federal income tax refunds.

About 47 percent of U.S. families use debit cards, which consumers can use at merchant terminals to pay for purchases. Approximately 16.2 billion debit card transactions took place in 2003, an increase of approximately 21 percent from the previous year's volume. Direct payment is a less widely used EFT payment mechanism; about 40 percent of U.S. families have payments automatically deducted from their accounts.

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

Supervision for Compliance with Consumer Protection and Community Reinvestment Laws

Activities Related to the Community Reinvestment Act

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

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

Examinations for Compliance with the CRA

The Federal Reserve assesses and rates the CRA performance of state member banks in the course of examinations conducted by staff at the twelve Reserve Banks. During the 2004 reporting period, the Reserve Banks conducted 242 CRA examinations. Of the banks examined, 43 were rated "outstanding" in meeting community credit needs, 198 were rated "satisfactory," none was rated "needs to improve," and 1 was rated as being in "substantial noncompliance."[1]

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

Under the Bank Holding Company Act and the Bank Merger Act, the Board considers applications for which CRA protests are raised or significant issues exist regarding CRA or consumer compliance. Other cases are decided by the Reserve Banks under delegated authority.

During 2004, the Board of Governors considered applications for several significant banking mergers and acquisitions. The Board sponsored four public meetings in connection with two of these applications. For the application by Bank of America Corporation (Charlotte, North Carolina) to acquire Fleet Financial Group, Inc. (Boston, Massachusetts), public meetings were held at the Federal Reserve Banks of Boston and San Francisco. Two public meetings

1. The 2004 reporting period was July 1, 2003, through June 30, 2004.

were held at the Federal Reserve Banks of New York and Chicago in connection with the merger of J.P. Morgan Chase & Company (New York, New York) with Bank One Corporation (Chicago, Illinois). Members of the public submitted numerous comments on these two applications during the thirty-day comment period allocated for such applications. The public meetings, however, allowed the public to enter oral or written testimony into the record of information considered by the Board. The Board approved the application by Bank of America Corporation in March and the application by J.P. Morgan Chase & Company in June. Several other significant applications are summarized below.

- An application by NewAlliance Bancshares (New Haven, Connecticut) to acquire New Haven Savings Bank (New Haven, Connecticut) was approved in February.

- Three applications by National City Corporation (Cleveland, Ohio) were approved in March, June, and August.

- An application by Regions Financial Corporation (Birmingham, Alabama) to acquire Union Planters Corporation (Memphis, Tennessee) was approved in June.

- An application by Royal Bank of Scotland and Citizens Financial Group (both in Providence, Rhode Island) to acquire Charter One Financial Group, Inc. (Cleveland, Ohio), was approved in August.

- An application by Wachovia Corporation (Charlotte, North Carolina) to acquire SouthTrust Corporation (Birmingham, Alabama) was approved in October.

The public submitted comments on each of these applications. Most of the commenters expressed concerns that lending to lower-income communities and populations was insufficient and that the institutions had failed to address the convenience and needs of affected communities. Commenters also raised issues relating to potentially abusive lending practices involving subprime and payday lenders; the potentially adverse effects of branch closings; the failure of minority-owned and -operated institutions to adequately serve other minority populations; the loss of local ownership; institutions' alleged attempts to circumvent state consumer laws; and alleged fraud.

In addition to considering these applications for significant banking mergers and acquisitions, the Board acted on thirteen other bank and bank holding company applications that involved protests by members of the public concerning the performance under the CRA of insured depository institutions. The System also approved one application that involved an institution having a CRA rating of lower than satisfactory and another thirty-three applications involving other issues related to CRA, fair lending, or compliance with consumer credit protection laws.[2]

Other Consumer Compliance Activities

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

2. In addition, five applications involving other CRA or compliance issues were withdrawn.

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

Examinations are the Federal Reserve's primary means of enforcing compliance with consumer protection laws. During the 2004 reporting period, the Reserve Banks conducted 329 consumer compliance examinations—305 of state member banks and 24 of foreign banking organizations (FBOs).[3]

The Board periodically issues guidance for Reserve Bank examiners on consumer protection laws and regulations. In addition to updating examination procedures for a number of regulations in concert with the other federal financial institution regulatory agencies, the Board revised the procedures that Federal Reserve consumer compliance examiners are to use when assessing whether a compliance or CRA examination of an FBO or special-purpose bank is necessary. Further, the Board updated its risk-focused supervision program to reflect new regulations and the level of risk associated with existing regulations. The Board also completed a pilot program for an interdisciplinary electronic banking profile to identify and monitor risk factors associated with the rapid changes in electronic banking.

Fair Lending

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

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

The ECOA also obligates the Board and other agencies with enforcement responsibilities under the act to refer any pattern or practice of ECOA violations to the Department of Justice

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

(DOJ). When a violation of the ECOA also violates the Fair Housing Act, the matter may be referred to the Department of Housing and Urban Development. To promote consistency in how fair lending issues are analyzed throughout the System, Division of Consumer and Community Affairs staff coordinate the investigation of potential fair lending violations with Reserve Bank staff and develop recommendations for the division director regarding whether referral is necessary or appropriate.

During 2004, division staff received and analyzed six reports from Reserve Banks regarding possible referral matters. Four of these reports had to do with potentially discriminatory underwriting standards affecting applicants on the basis of marital status or sex; the other two matters involved apparent discriminatory loan-pricing practices on the basis of marital status. In two of the six cases, the Board determined that referrals were not warranted; two cases were referred to the DOJ; and two cases are pending.

In early 2004, division staff, together with staff from the Board's Legal Division and the Federal Reserve Bank of New York, negotiated a consent order to finalize an investigation of a major holding company subsidiary. The order addressed issues raised during the investigation, including regulatory compliance violations, the making of loans that were unsafe and unsound and that borrowers could not afford, and misleading and incorrect statements made by lending personnel to examiners. In addition to a substantial civil money penalty, the consent order provided for extensive corrective measures, including the payment of restitution to victims.

The ECOA prohibits not only practices that constitute intentional discriminatory treatment of credit applicants on a prohibited basis but also practices that have an unintended but unjustified discriminatory "disparate impact." In 2004, division staff determined that a lender's adoption of a "housing proxy" debt payment constituted a disparate-impact violation of the ECOA on the basis of the prohibited characteristic of age. The lender had been adding a multi-hundred-dollar payment to the monthly debt of persons who applied for credit but reported no housing cost on their loan application—and for whom no housing cost appeared on their credit bureau report. This proxy practice was shown to adversely affect a disproportionate number of younger applicants, and the lender failed to demonstrate an adequate "business-necessity" justification for its adoption of the proxy.

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

Flood Insurance

The National Flood Insurance Act imposes certain requirements on loans secured by buildings or mobile homes located in, or to be located in, areas determined to have special flood hazards. Under the Federal Reserve's Regulation H, which implements the act, state member banks in general are prohibited from making, extending, increasing, or renewing any such loan unless the building or mobile home and any personal property securing the loan are covered by flood insurance for the term of the loan. The act requires the Federal Reserve to impose civil money penalties when it finds a pattern or practice of violations of the regulation. The civil money penalties are turned over to the Federal Emergency Management Agency for deposit into the National Flood Mitigation Fund.

During 2004, the Board imposed civil money penalties on three state member banks. The penalties, which were assessed via consent orders, ranged from $3,250 to $10,000.

Coordination with Other Federal Banking Agencies

The member agencies of the Federal Financial Institutions Examination Council (FFIEC) develop uniform examination principles, standards, procedures, and report formats.[4] In 2004, the FFIEC issued revised examination procedures for determining compliance with the fair lending provisions of Regulation B (which implements the Equal Credit Opportunity Act), the Homeowners Protection Act, and the new subpart D of Regulation CC. Subpart D implements the Check Clearing for the 21st Century Act, or Check 21. (Regulation CC continues to implement the Expedited Funds Availability Act.) In addition to issuing revised examination procedures to implement Check 21, staff from the FFIEC member agencies developed a Check 21 web site to provide examiners and the financial industry with educational tools, reference materials, and answers to frequently asked questions (www.ffiec.gov/exam/check21).

The FFIEC also issues guidance to the agencies' consumer compliance examination staff and to supervised financial institutions. To ensure that CRA performance evaluations are comprehensive and include facts and data to support the evaluation results, the FFIEC in 2004 developed interagency guidance on examiners' use of data tables in CRA evaluations. Additionally, the FFIEC member agencies developed interagency guidance on overdraft protection programs, which was released for public comment in 2004. Finally, in response to a review of preliminary 2004 HMDA data submissions, the FFIEC issued guidance to HMDA data reporters regarding proper collection and reporting of the new data fields being collected for the first time in 2004.

The Board and the FDIC issued joint guidance outlining standards the two agencies will consider when determining whether specific acts or practices at state-chartered banks are unfair or deceptive. The Board, the OCC, and the FDIC also updated the host-state loan-to-deposit ratios used to determine compliance with section 109 of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994.

Training for Bank Examiners

Ensuring that financial institutions comply with laws that protect consumers and encourage community reinvestment is an important part of the bank examination and supervisory process. As the number and complexity of consumer financial transactions grow, training for examiners of the state member banks for

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

which the Federal Reserve has supervisory responsibility becomes even more important. The consumer affairs curriculum comprises courses on various consumer protection laws, regulations, and examining concepts. In 2004, these courses were offered in eleven sessions to more than 225 Federal Reserve consumer compliance examiners.

Board and Reserve Bank staff regularly review the core curriculum for examiner training, updating subject matter and adding new elements as appropriate. During 2004, staff conducted curriculum reviews for two courses to incorporate technical changes in policy and laws, along with changes in instructional delivery techniques. The two courses reviewed were

- *Community Reinvestment Act Examination Techniques.* Equips assistant examiners and others to write the performance evaluation for the CRA portion of a consumer compliance bank examination.

- *Commercial Lending Essentials for Consumer Affairs.* Equips assistant examiners with the basic techniques to underwrite and price commercial loans.

Staff members also look for opportunities to deliver courses via alternative channels such as the Internet or other distance-learning technologies. The two courses discussed above are now taught using several instructional methods: classroom instruction focusing on case studies, specially developed computer-based instruction, electronic bulletin boards, and vendor-delivered online instruction. Additionally, the new examiner training on the consumer compliance aspects of the Check 21 Act was delivered on both an interactive web site and an interactive CD-ROM.

In 2004, the consumer affairs function added a new course to the core curriculum, Consumer Affairs Risk-Focused Examination Techniques. The course is designed to enhance examiners' analytical, decisionmaking, and leadership skills.

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

Reporting on Home Mortgage Disclosure Act Data

The Home Mortgage Disclosure Act (HMDA) requires that mortgage lenders collect and make public certain data about their home purchase, home improvement, and refinancing loan transactions. A depository institution generally is covered by the act if (1) it is located in a metropolitan statistical area, (2) it met the asset threshold at the end of the preceding calendar year (for 2002 and 2003, assets of more than $32 million; for 2004, assets of more than $33 million), and (3) it originated at least one home purchase loan (or refinancing) in the preceding calendar year. A for-profit mortgage company is covered if (1) it has offices in a metropolitan statistical area, (2) it had assets of more than $10 million (when combined with the assets of any parent company) at the end of the preceding calendar year or it originated 100 or more home purchase loans or refinancings in the preceding calendar year, and (3) in the preceding calendar year, its home purchase loan originations and refinancings accounted for at least 10 percent of its total loans by dollar volume, or if such loans equaled at least $25 million.

In 2004, a total of 6,935 depository institutions and affiliated mortgage companies and 1,186 independent mortgage companies reported HMDA data for calendar year 2003. Lenders submitted information about the disposition of loan applications, the geographic location of the properties related to loans and loan applications, and, in most cases, the race or national origin, income, and sex of applicants and borrowers. The FFIEC processed the data and produced disclosure statements on behalf of the FFIEC member agencies and the Department of Housing and Urban Development (HUD).

The FFIEC prepared individual disclosure statements for each lender that reported data—one statement for each metropolitan statistical area in which the lender had offices and reported loan activity for 2003. In 2004, the FFIEC prepared 65,808 disclosure statements.[5] In July, each institution made its disclosure statement public, and reports containing aggregate data for all mortgage and home improvement loans in each of the 337 metropolitan statistical areas in the United States were also made available to the public at central depositories.[6] These data are used by the FFIEC agencies, the reporting institutions, HUD, the Department of Justice (DOJ), and members of the public. They also assist HUD, the DOJ, and state and local agencies in responding to allegations of lending discrimination and in targeting lenders for further inquiry.

The HMDA data reported for 2003 covered about 42 million loans and loan applications, about 33 percent more than in 2002. The greater volume was due primarily to an increase of about 41 percent in refinancing activity. The number of covered home purchase loans extended in 2003, compared with 2002, increased 16 percent for Asians, 18 percent for Hispanics, 15 percent for blacks, and 11 percent for whites. Native Americans experienced a 5 percent decline in such lending from 2002 through 2003. Over the period from 1993 through 2003, the number of home purchase loans extended to Hispanics rose 236 percent; to Asians, 163 percent; to blacks, 106 percent; to Native Americans, 50 percent; and to whites, 44 percent. For each income category, the number of home purchase loans reported was higher in 2003 than in 2002; the increase was 6 percent for lower-income applicants; 8.6 percent for middle-income applicants; and 13 percent for upper-income applicants. From 1993 through 2003, the number of home purchase loans to lower-, middle-, and upper-income applicants increased by 102 percent, 68 percent, and 88 percent, respectively.

In 2003, 19 percent of Hispanic applicants and 21 percent of black applicants for home purchase loans reported under HMDA applied for government-backed mortgages; the comparable figures for Asians, whites, and Native Americans were 4 percent, 12 percent, and 15 percent, respectively. Twenty-one percent of lower-income applicants for home purchase loans, compared with 5 percent of upper-income applicants, applied for government-backed mortgages.

Overall, the denial rate in 2003 for conventional home purchase loans

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

6. Central depository sites include libraries, universities, and city planning offices. A list of sites can be found at www.ffiec.gov/hmdacf/centdep/default2.cfm.

(that is, loans that are not government-backed) was 14 percent, a rate unchanged from 2002. The denial rate rose from 1993 through 1998 but has fallen since then. In 2003, denial rates for conventional home purchase loans reported under HMDA declined slightly for black applicants, to 24 percent; the rates rose modestly for Native Americans and Asians, to 24 percent and 11 percent, respectively. Denial rates for whites and Hispanics remained the same from 2002 to 2003, at 12 percent and 18 percent, respectively.

Agency Reports on Compliance with Consumer Protection Laws

The Board reports annually on compliance with consumer protection laws by entities supervised by federal agencies. This section summarizes data collected from the twelve Federal Reserve Banks, the FFIEC member agencies, and other federal enforcement agencies.[7]

Regulation B (Equal Credit Opportunity)

The FFIEC agencies reported that 88 percent of the institutions examined during the 2004 reporting period were in compliance with Regulation B, compared with 84 percent for the 2003 reporting period. The most frequent violations involved failure to take one or more of the following actions:

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

During 2004, the Federal Trade Commission (FTC) entered into one settlement with a telecommunications corporation for alleged violations of the ECOA and Regulation B. The defendants were required to pay civil money penalties of $1.125 million and provide injunctive relief. Additionally, the FTC continued litigation against a mortgage lender for alleged violations of the ECOA and Regulation B, and continued its enforcement efforts against other organizations.

The other agencies that enforce the ECOA—the Farm Credit Administration (FCA), the Department of Transportation, the Securities and Exchange Commission, the Small Business Administration, and the Grain Inspection, Packers and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise. The FCA's examination and enforcement activities revealed that most Regulation B violations involved

7. Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2004 reporting period was July 1, 2003, through June 30, 2004.

creditors' providing inadequate statements of specific reasons for denial or involved creditors' failure to request or provide information for government-monitoring purposes. These agencies did not initiate any formal enforcement actions relating to Regulation B during 2004, although the FCA indicated that its supervisory process requires corrective actions for violations noted.

Regulation E
(Electronic Fund Transfers)

The FFIEC agencies reported that approximately 95 percent of the institutions examined during the 2004 reporting period were in compliance with Regulation E, compared with 94 percent for the 2003 reporting period. The most frequent violations involved failure to comply with the following requirements:

- determine whether an error occurred, and transmit the results of the investigation to the consumer within ten business days

- when a determination is made that no error has occurred, provide a written explanation and note the consumer's right to request documentation supporting the institution's findings

- provide initial disclosures that a consumer may retain, at the time he or she contracts for an electronic fund transfer service or before the first electronic fund transfer involving the consumer's account is made

- provide initial disclosures at the time a consumer contracts for an electronic fund transfer service that contain required information, including limitations on the types of transfers permitted and error-resolution procedures

In 2004, the FTC settled two cases in federal district court involving violations of the Electronic Fund Transfer Act (EFTA). In one case, the complaint alleged that the defendants had deceptively marketed videos and charged consumers' credit and debit cards on a recurring basis, without obtaining written authorization from the consumers to initiate preauthorized electronic fund transfers from their accounts, in violation of the EFTA. Under the stipulated court order in this case, defendants were required to pay approximately $1.1 million in combined consumer redress and civil penalties and were barred from a range of unlawful activities. In the second case, the complaint alleged that the defendants initiated recurring automatic charges from consumers' accounts at the conclusion of a "free" trial period associated with a variety of offered services, without disclosing the cancellation policy or obtaining the consumers' written authorization. The court order in this case included injunctive relief and required payment of $2.4 million.

Regulation M
(Consumer Leasing)

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2004 reporting period were in compliance with Regulation M, which is comparable to the level of compliance for the 2003 reporting period. The few violations noted involved failure to adhere to specific disclosure requirements. The agencies did not issue any formal enforcement actions relating to Regulation M during the period.

Regulation P
(Privacy of Consumer
Financial Information)

The FFIEC agencies reported that 96 percent of the institutions examined during the 2004 reporting period were in compliance with Regulation P, compared with 97 percent for the 2003 reporting period. The most frequent violations involved failure to comply with the following requirements:

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

- provide a clear and conspicuous annual privacy notice to customers

- disclose the institution's information-sharing practices in initial, annual, and revised privacy notices

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

Regulation Z
(Truth in Lending)

The FFIEC agencies reported that 84 percent of the institutions examined during the 2004 reporting period were in compliance with Regulation Z, compared with 78 percent for the 2003 reporting period. The most frequent violations involved failure to take one or more of the following actions:

- accurately disclose the finance charge, using that term, and provide a brief definition of "finance charge"

- accurately disclose the payment schedule for closed-end credit

- on certain residential mortgage transactions, provide a good faith estimate of the required disclosures before consummation, or not later than three business days after receipt of the loan application

- ensure that disclosures reflect the terms of the legal obligation between the parties, and when any information necessary for an accurate disclosure is unknown, ensure that the creditor states that the disclosure is an estimate

- ensure that disclosures reflect that the creditor has or will acquire a security interest in the property identified

The OCC issued one formal enforcement action containing provisions relating to Regulation Z during the 2004 reporting period. In addition, 114 institutions supervised by the Federal Reserve and the FDIC were required, under the Interagency Enforcement Policy on Regulation Z, to refund a total of approximately $500,000 to consumers.

The FTC continued its enforcement activities to halt unlawful subprime-lending practices. The FTC filed two federal district court actions (currently in litigation) and continued litigating three cases; all five cases concern alleged violations of the Truth in Lending Act, Regulation Z, and the Federal Trade Commission Act. The defendants in these cases include mortgage brokers, a mortgage corporation, a finance company, and a tax-shelter consulting firm.

The FCA's examination and enforcement activities revealed that most Regulation Z violations involved inadequate or incorrect disclosures for closed-end credit. FCA examiners determined that all violations had been or were being corrected or adequately addressed by the respective institutions.

Regulation AA
(Unfair or Deceptive Acts or Practices)

The three banking regulators with responsibility for enforcing Regulation AA's Credit Practices Rule—the Federal Reserve, the OCC, and the FDIC—along with the NCUA, reported that more than 99 percent of the institutions examined during the 2004 reporting period were in compliance with Regulation AA, which is comparable to the level of compliance for the 2003 reporting period. The few violations involved the following actions:

- failing to provide a clear and conspicuous disclosure regarding a cosigner's liability for a debt
- entering into a consumer credit obligation that contains a waiver of exemption, or enforcing provisions in a purchased consumer credit obligation that contains such a waiver, unless the waiver applies solely to property subject to a security interest executed in connection with the obligation

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

Regulation CC
(Availability of Funds and Collection of Checks)

The FFIEC agencies reported that 93 percent of institutions examined during the 2004 reporting period were in compliance with Regulation CC, compared with 90 percent for the 2003 reporting period. Among the institutions not in full compliance, the most frequently cited violations involved the failure to take one or more of the following actions:

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

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

Regulation DD
(Truth in Savings)

The FFIEC agencies reported that 92 percent of institutions examined during the 2004 reporting period were in compliance with Regulation DD, compared with 89 percent for the 2003 reporting period. Among the institutions not in full compliance, the most frequently cited violations involved

- using the phrase "annual percentage yield" in an advertisement without disclosing additional terms and conditions of customer accounts;
- failing to provide account disclosures containing certain required information;

- failing to provide timely maturity notification for time deposits;
- failing to provide account disclosures clearly and conspicuously, in writing, and in a form that the consumer may keep; and
- providing an advertisement that did not disclose that fees could reduce the earnings on the account.

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

Consumer Complaints

The Federal Reserve investigates complaints against state member banks and forwards to the appropriate enforcement agency complaints that involve other creditors and businesses. Each Reserve Bank investigates complaints against state member banks in its District. Complaints and inquiries received by the Federal Reserve System are entered into its online database, Complaint Analysis Evaluation System and Reports (CAESAR).

The Board provides guidance to the Reserve Banks on complaint program policies and procedures through advisory letters and periodic updates to the Consumer Complaint Manual. In 2004, the Board issued guidance about new codes for the CAESAR database. The new codes will be used to track consumer concerns about emerging issues, such as stored-value cards, reaffirmed debt, the Check Clearing for the 21st Century Act, and the Fair and Accurate Credit Transactions Act. Additional guidance on the CAESAR database was issued to strengthen the documentation of complaint investigations. In addition to the CAESAR guidance, the Board issued guidance on new procedures that are intended to better focus the scope of complaint investigations and improve the quality and timeliness of responses to consumers.

During 2004, the CAESAR Users Advisory Group finalized business and technical requirements for a web-based CAESAR application that will streamline the System's consumer complaint process. These requirements entailed the development of new reports for analyzing and monitoring complaint trends. In addition, the advisory group developed a new consumer code structure for the web-based system to allow users to classify consumer complaints in more detail and identify investigation findings more easily.

Complaints against State Member Banks

In 2004 the Federal Reserve received approximately 5,130 complaints from consumers—by mail, by telephone, in person, and electronically via the Internet (see tables). About 45 percent of the

Consumer Complaints against State Member Banks, by Classification, 2004

Classification	Number
Regulation B (Equal Credit Opportunity)	36
Regulation C (Home Mortgage Disclosure Act)	1
Regulation E (Electronic Fund Transfers)	75
Regulation H (Bank Sales of Insurance)	2
Regulation M (Consumer Leasing)	0
Regulation P (Privacy of Consumer Financial Information)	17
Regulation Q (Payment of Interest)	1
Regulation Z (Truth in Lending)	215
Regulation BB (Community Reinvestment)	1
Regulation CC (Expedited Funds Availability)	25
Regulation DD (Truth in Savings)	28
Fair Credit Reporting Act	155
Fair Debt Collection Practices Act	24
Fair Housing Act	3
Flood insurance rules	11
Regulations T, U, and X	4
Real Estate Settlement Procedures Act	12
Unregulated practices	1,708
Total	**2,318**

Consumer Complaints against State Member Banks, by Subject of Complaint, 2004

Subject of complaint	Total		Not investigated	
	Number	Percent	Unable to obtain sufficient information from consumer	Explanation of law provided to consumer
Loans				
Discrimination alleged				
Real estate loans	15	1	1	1
Credit cards	13	1	1	1
Other loans	8	0	1	1
Other type of complaint				
Real estate loans	463	20	4	35
Credit cards	892	38	4	74
Other loans	174	8	1	16
Deposits	460	20	6	59
Electronic fund transfers	75	3	1	3
Trust services	30	1	8	5
Other	188	8	5	30
Total	**2,318**	**100**	**32**	**225**

complaints (2,318) were against state member banks. Of the complaints against state member banks, 68 percent involved consumer loans: 2 percent alleged discrimination on a basis prohibited by law (race, color, religion, national origin, sex, marital status, age, the fact that the applicant's income comes from a public assistance program, or the fact that the applicant has exercised a right under the Consumer Credit Protection Act), and 66 percent concerned other credit-related practices, such as the imposition of annual membership fees on credit card accounts, the amount of interest banks charge on credit card accounts, or credit denial on a basis not prohibited by law (for example, credit history or length of residence). Twenty percent of the complaints involved disputes about interest on deposits and other deposit account practices; the remaining 12 percent concerned disputes about electronic fund transfers, trust services, or other practices. Information on the outcomes of the investigations of these complaints is provided in the table.

During 2004, the Federal Reserve System completed the investigation of 125 complaints against state member banks that were pending at year-end 2003, finding no violations of regulations. In 84 percent of the state member bank complaints investigated in 2004, the banks had correctly handled a customer's account. In 44 percent of these cases, the banks nevertheless chose to reimburse or otherwise accommodate the customer.

The Federal Reserve also handled more than 1,600 inquiries about consumer credit and banking policies and practices during 2004. 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.

Consumer Complaints—Continued

Investigated								Pending, December 31
Bank legally correct		Customer error	Bank error	Factual or contractual dispute—resolvable only by the courts	Possible bank violation—bank took corrective action	Matter in litigation	Withdrawn by customer	
No reimbursement or other accommodation	Goodwill reimbursement or other accommodation							
6	2	0	0	0	1	0	0	4
6	0	0	0	0	0	0	0	5
6	0	0	0	0	0	0	0	0
192	125	0	49	6	13	20	10	9
257	379	1	54	14	5	3	27	74
86	25	0	23	11	1	4	5	2
203	100	0	45	19	4	6	13	5
20	27	0	7	2	10	1	3	1
8	3	0	2	0	0	0	3	1
72	25	0	9	8	2	14	5	18
856	**686**	**1**	**189**	**60**	**36**	**48**	**66**	**119**

Unregulated Practices

As required by section 18(f) of the Federal Trade Commission Act, the Board monitors complaints about banking practices that are not subject to existing regulations, focusing on those that concern possible unfair or deceptive practices. In 2004 the Board received approximately 1,700 complaints against state member banks that involved unregulated practices. The categories that received the most complaints involved real estate loans, credit card accounts, and checking accounts. Consumers most frequently complained about escrow account problems (78 complaints); other complaints involved customer service problems (75), debt collection practices (70), insufficient-funds charges and procedures (67), loan and deposit account fees (64), and interest rates and terms (61). The remainder of the complaints concerned a wide range of unregulated practices in other areas, including credit card fraud, the amount charged for late payments, and disputes about the amount withdrawn from checking accounts.

Complaint Referrals to HUD

In accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies, in 2004 the Federal Reserve referred six complaints to HUD that alleged state member bank violations of the Fair Housing Act. In five of the six cases the Federal Reserve's investigations revealed no evidence of illegal discrimination. The remaining case was pending at year-end.

Advice from the Consumer Advisory Council

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

In 2004, the council met in March, June, and October. In March, council members discussed the Board's proposal to provide more uniform and consistent guidance on what constitutes a "clear and conspicuous" disclosure for its consumer regulations. The discussion focused on whether the standards and guidance in Regulation P, which implements the financial privacy provisions of the Gramm–Leach–Bliley Act, could be used as the model for providing clear and conspicuous standards. While members applauded the Board's effort to make disclosures more understandable, they did not support adopting the Regulation P standard as a means of providing more consistent standards and guidance for consumer protection disclosures.

The council also discussed the January 2004 General Accounting Office (GAO) study on predatory lending. The GAO recommended that Congress consider making certain statutory changes to consumer financial services and fair lending laws. Members commented on a proposal that would grant the Board the authority to routinely monitor and, as necessary, examine nonbank mortgage lending subsidiaries of bank and financial holding companies to potentially deter predatory lending. Members who supported this proposal believed that the Federal Reserve has the ability and the expertise to conduct rigorous and consistent examinations. Others did not favor the recommendation.

The Community Reinvestment Act (CRA) was a topic at each of the three meetings. The discussions focused on regulatory changes proposed by the Board and three other federal financial institution regulators (the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation). The agencies proposed changing the criteria for designation as a small bank and adding a caveat that abusive asset-based lending might reduce a bank's CRA rating. Some members expressed concern about the proposal to change the criteria for small-bank designation because a larger number of banks would qualify for a more limited CRA examination, and some banks located in rural geographies might not have incentives to participate in community and economic development initiatives. Further, some members asserted that additional regulation of regulated depository institutions is not necessary and should instead be targeted at unregulated and unsupervised bank affiliates and other loosely supervised organizations.

In June, council members discussed an ongoing review to identify outdated and unduly burdensome regulatory requirements pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Members did not reach consensus on the necessity of the Truth in Lending Act provision giving consumers a three-day right to rescind certain mortgage loan transactions before financial institutions disburse the funds, nor did they agree on the importance of Home Mortgage Disclosure Act data from small banks and rural areas. Members agreed that the CRA provisions of the Gramm–Leach–Bliley Act, which require financial institutions and other community-based organizations that are parties to certain written CRA agreements to make the agreements available to the public and their primary regulator, serve no useful purpose. Furthermore, the provisions have created a data collection and reporting burden for all parties involved in the agreements. Another topic of discussion at the June meeting was the remittance market, or the transfer of funds by immigrant workers to families and friends in their native countries (see the related box "Remittances and Immigrant Markets: Opportunities and Challenges" later in this chapter). Members emphasized the importance of lowering the cost of remittances and of providing immigrants with access to banking services—especially for lower-income immigrant workers who regularly send money to their home countries.

Courtesy overdraft protection, frequently referred to as bounced-check protection, was a topic at the June and October meetings. The courtesy overdraft-protection services offered by some financial institutions are covered under the Truth in Savings Act. Some members had concerns about the adequacy of disclosures, the need for additional regulatory coverage, and deceptive marketing practices for these services. Council members discussed whether the Truth in Savings Act or the Truth in Lending Act is the most effective way to inform and protect consumers. Some council members asserted that bounced-check protection programs are short-term extensions of credit that fit the definition of credit under the Truth in Lending Act; others believed that the programs do not qualify as credit extensions because there is no loan application, underwriting, note, or annual percentage rate calculation in connection with the service.

At the October meeting, members discussed anti-predatory-lending laws. Members reviewed various state and federal legislative approaches, including the Home Ownership and Equity Protection Act (HOEPA), which was established to respond to predatory mortgage lending practices and to protect consumers from these abusive lending practices. Members had differing opinions on whether state laws or federal legislation is the most effective means of addressing predatory lending. Some members believed that state laws provide the necessary protections for deterring predatory lending practices—protections that HOEPA does not offer. Other members strongly preferred federal legislation that preempts state laws because of its uniform application and consistency. The council also discussed proposed amendments to Regulation E, which implements the Electronic Fund Transfer Act. Members commented on a revision that would require that payroll card accounts, established on behalf of a consumer for the purpose of providing salary, wages, and other employee compensation on a recurring basis, be covered by Regulation E. Specific comments addressed whether periodic statements should apply to payroll cards. Some members agreed that employers issuing payroll cards either directly or through service providers should provide periodic statements to employees. Other members noted that payroll cards are a low-profit service for financial institutions; the additional costs associated with providing payroll statements could discourage institutions from offering the cards.

Promotion of Community Economic Development in Historically Underserved Markets

During 2004, the community affairs function within the Federal Reserve System engaged in a variety of initiatives to promote community economic development that benefit low- and moderate-income communities and populations. The function continued to focus on financial literacy and education, the sustainability of community development organizations, emerging and immigrant markets, and community economic development. Activities included conducting research, publishing newsletters and articles, sponsoring conferences and seminars, and providing advisory services, all of which helped to deliver pertinent information to both general and targeted audiences.

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

In 2004, Board staff actively participated in interagency working groups created to fulfill the legislative mandates of the U.S. Department of the Treasury's Financial Literacy and Education Commission (the commission), established under the Fair and Accurate Credit Transactions Act (the FACT Act). The commission consists of the chiefs of twenty federal agencies; Governor Edward Gramlich represents Chairman Alan Greenspan as the Board's member. Board staff participated on two of the commission's working groups: one to help design and launch a web site to link consumers with financial education resources available from federal government agencies, and one to frame a national strategy for the federal government to improve the level of financial literacy among American consumers. In October, the web site www.MyMoney.gov and a toll-free number (1-888-my-money [1-888-696-6639]) were launched to provide consumers with easy access to information resources. The national strategy working group will continue its work, incorporating public remarks submitted in response to a request for comment and finalizing the national strategy in a report to Congress due in June 2005.

Consistent with the national goal to increase financial literacy among consumers, community affairs staff assisted in the planning and delivery of financial and consumer education programs to Board employees. Four programs were offered in 2004, and a web site for online personal finance education was established for Board employees.

Board staff use surveys and focus groups to learn about what issues are important to consumers and to test and develop educational materials. Last year Board staff updated the "Consumer's Guide to Mortgage Settlement Costs" and the "Choosing a Credit Card" brochures and issued two new publications dealing with checks and the new Check 21 provisions: the "Consumer Guide to Check 21 and Substitute Checks" and "What You Should Know about Your Checks." The Board, in cooperation with the other federal bank, thrift, and credit union regulators, produced materials on "phishing," "Internet Pirates Are Trying to Steal Your Personal Financial Information," and on bounced-check fees, "Protecting Yourself from Overdraft and Bounced-Check Fees." These publications are available on the Board's consumer information web site (www.federalreserve.gov/consumers.htm).

Board staff are involved in ongoing research projects related to financial privacy disclosures, consumers' use of electronic banking services and stored-value cards, remittances and immigrants' use of financial services (see the related box "Remittances and Immigrant Markets: Opportunities and Challenges"), and the role of financial education in community development. Board staff are also working with the Department of Defense on a longitudinal study on the effects of financial education conducted on military installations.

Board staff assisted with national financial education initiatives throughout the year. The director of the Division of Consumer and Community Affairs served as an adviser to the board of Operation HOPE, a national nonprofit organization dedicated to delivering financial education programs to low-income populations through schools and community centers, as well as to communities suffering from natural disasters. In addition, staff participated in two national forums: one sponsored by the National Endowment for Financial Education to explore strategies for promoting positive financial management behaviors, and another convened by the Government Accountability Office (formerly the General Accounting Office) to define the federal government's role in personal financial education.

System financial education projects supplemented the Board's efforts. The community affairs and public information officers at the Reserve Banks collaborated with the U.S. Conference of Mayors to explore strategies for establishing financial education initiatives in cities throughout the country. The resulting "Dollar Wi$e" initiative enables cities to create programs that meet the needs of their citizens. For example, the campaign in Detroit, Michigan, focuses on providing financial education training to community educators, while the program in Providence, Rhode Island, offers programs to teach seniors about credit card use, predatory lending, and financial planning. By serving as advisers to the mayors in the nearly thirty-five cities involved in the campaign, the Federal Reserve Banks are helping to increase the public's awareness of and access to resources for financial literacy and education. In addition, Federal Reserve System community affairs staff continued to work closely with national leaders from the Native American community to develop a financial education policy and other resources that are responsive to the unique needs of residents in Indian Country. Board staff hosted a meeting of the Native American Financial Education Task Force in December. The meeting provided an opportunity for the five committees of the task force to focus on the financial education needs of Native Americans and on how to deliver education resources to these communities.

The Community Affairs Offices at the Reserve Banks continued their financial education initiatives. The Federal Reserve Bank of Cleveland worked with bank and community partners in Cleveland, Pittsburgh, and Cincinnati to form regional collaborations to develop and deliver financial education resources. The Federal Reserve Bank of Minneapolis was instrumental in forming the Montana Financial Education Coalition. The Federal Reserve Bank of Boston partnered with a community group to provide train-the-trainer workshops to social service workers, hosted a conference on best practices, and worked with Operation HOPE to launch a financial literacy campaign in the schools in Providence, Rhode Island. In addition, the Federal Reserve Bank of Kansas City sponsored a number of financial education events that specifically targeted youth, Native Ameri-

Remittances and Immigrant Markets: Opportunities and Challenges

The provision of remittance services is a potentially effective method by which mainstream financial institutions can attract unbanked immigrants.

Ben S. Bernanke, *Member*, Board of Governors
April 16, 2004

Immigrant workers typically send a large portion of their earnings back to their home countries. The United States is the largest source country for these cross-border funds transfers, known as remittances: About $32 billion was remitted in 2003, according to a recent report from the Inter-American Dialogue. (As used in this article, the term *remittances* refers specifically to the international transfer of funds between individuals.) Because they are such a significant flow of funds, remittances have attracted the attention of lawmakers, bankers, consumer and community groups, and domestic and international banking agencies.

The Inter-American Development Bank's Multilateral Investment Fund reports that the highest volume of remittance traffic—an estimated 100 million transactions each year—occurs between the United States and Latin America. *Billions in Motion*, a 2002 report published by the Pew Hispanic Center, described a typical remitter in the United States as a thirty-seven-year-old, lower-skilled immigrant from Mexico or another Latin American country who earns less than $30,000 annually, has not completed high school, does not have a credit card, does not own his or her home, and is among the 43 percent of Latino immigrants who do not have a bank account.

The process of remitting funds has changed significantly since 1990, when many immigrants used informal networks, such as friends and family, to transfer funds. Today, money-transfer organizations are the dominant providers of remittance services. But these firms typically charge service fees as high as 15 percent of the transfer, thus eroding the amount of money an immigrant's family receives. Many factors influence the fees charged, including the service provider's operating costs and geographic coverage.

To facilitate cost-effective funds transfers to Canada, Mexico, and five transatlantic countries, the Reserve Banks offer FedACH International products to banks. These products allow banks to send international credit transactions electronically via the same process used to send domestic transactions. Intended primarily for international corporate payments, the products provide a potentially less costly way for consumers to remit funds. In 2004, the service was expanded to include Mexico. The Reserve Banks worked cooperatively with the Central Bank of Mexico to make it easier for Mexican retail banking systems to support remittances—an effort that may also encourage consumers in the United States and Mexico to develop banking relationships.

Along with the other Federal Financial Institutions Examination Council agencies, the Federal Reserve Board examined the role of the Community Reinvestment Act in encouraging banks to provide financial services to immigrants—who are typically a low-income, underserved population. As a result of policy guidance issued in June 2004, banks that offer remittance services may receive CRA credit if these services are affordable and meet the needs of the lower-income remitters in their markets.

For banks, immigrants and remittances present a market opportunity. *The Remittance Marketplace*, a 2004 report from the

Pew Hispanic Center, found that only about 3 percent of remittance transactions to Mexico were conducted through banks. Despite recent efforts by banks and credit unions to increase account ownership among Hispanic markets, the report also found that 8 million Latinos remain "unbanked."

Banks, however, need to understand the many issues involved in serving immigrants. For example, many immigrants are uncomfortable using banks and do not understand how banks charge for their services. In 2004, the Federal Reserve System undertook several initiatives to share information on reaching immigrant markets.

- The Federal Reserve Bank of Chicago launched the Center for the Study of Financial Access for Immigrants, which hosted a national conference, "Financial Access for Immigrants: Learning from Diverse Perspectives," in collaboration with the Brookings Institution. In addition, the Chicago Reserve Bank's Community Affairs Office convened several forums throughout the Seventh District to gain insight into the social, economic, and other issues that inhibit immigrants from using banks.
- The Federal Reserve Bank of Atlanta hosted "Payments in the Americas," a conference that explored the policy and regulatory challenges of providing remittance services. Staff from the Board and the Atlanta Reserve Bank are also sponsoring focus groups with Mexican immigrants to learn about the factors influencing their banking and remitting behaviors.
- Federal Reserve Board staff participated on a remittances panel at the 2004 conference of the American Council of Consumer Interests. The panel addressed consumer information, disclosure, and protection issues.
- The Community Affairs Office of the Federal Reserve Bank of Dallas hosted "The Business of Immigrant Markets: Providing Access to Financial Services." Conference participants shared insights on essential policies and practices.
- The Federal Reserve Bank of Boston's Community Affairs Office conducted in-depth market research on immigrant communities in the First District. The office's other financial education initiatives targeted Hispanic communities in Boston, Massachusetts, and Providence, Rhode Island.

As the U.S. population becomes more diverse, the Federal Reserve System will continue to work with policymakers, community groups, and bankers to ensure that immigrants have fair and equal access to the U.S. financial system. The following Reserve Bank publications provide more information on remittances and immigrant banking.

- "Financial Access for Immigrants Conference: Learning from Diverse Perspectives," *Profitwise News and Views*, Federal Reserve Bank of Chicago, October 2004, www.chicagofed.org/community_development/
- "Meeting in the Mainstream," *Banking and Community Perspectives*, Federal Reserve Bank of Dallas, issue 1, 2004, www.dallasfed.org/ca/index.html
- "FedACH International Services Opens Payments Channel to Mexico," *Partners in Community and Economic Development*, Federal Reserve Bank of Atlanta, volume 14, number 1, 2004, www.atl.frb.org/comm.cfm
- "Banking Unbanked Immigrants through Remittances," *Communities and Banking*, Federal Reserve Bank of Boston, Fall 2003, www.bos.frb.org/commdev/index.htm
- *Community Investments Online*, Federal Reserve Bank of San Francisco, November 2003, www.sf.frb.org/community/index.html
- "Banking Latino Immigrants: A Lucrative New Market for Progressive Financial Institutions," *Bridges*, Federal Reserve Bank of St. Louis, Autumn 2002, www.stlouisfed.org/community/

can, and Hispanic populations. The Federal Reserve Banks of Atlanta, Chicago, and Philadelphia hosted events on wealth-building and asset-accumulation strategies and initiatives throughout their Districts. An article highlighting the various financial education efforts of the Federal Reserve System was published in the Autumn 2004 edition of the *Federal Reserve Bulletin* (www.federalreserve.gov/pubs/bulletin/default.htm).

In recent years, reduced funding and changing priorities among government and philanthropic organizations have diminished access to resources for many community development organizations. As it did in 2003, the Board's Community Affairs Office convened meetings of federal government officials and national community development leaders to explore the sustainability and capitalization of community economic development finance (CEDF) organizations. The Board's Community Affairs Office convened a policy forum in April with the Aspen Institute, a national research and leadership development organization. The forum discussed Aspen's research on the attributes of industries, organizations, and products that achieve scale and become self-sustaining. The research compared and contrasted the funding and business strategies of sustainable enterprises with those of CEDF institutions, identifying areas where the field needs to focus efforts to increase its future viability. The forum assembled leaders from financial institutions, government agencies, foundations, and membership associations.

Reserve Bank Community Affairs Offices explored new sources of capital to increase the sustainability of CEDF organizations. The Federal Reserve Bank of San Francisco expanded the scope of its Center for Community Development Investments; the Bank's staff worked closely with an advisory board of industry experts to develop a web site of resources, training, and technical assistance on community development investments. The System's Community Affairs Offices also continued to work with the Wall Street Without Walls initiative to help community development organizations increase their access to the capital markets for funding. The Federal Reserve Banks of Chicago, San Francisco, and New York hosted training events that attracted nearly 370 community development leaders interested in understanding the requirements of the capital markets. In addition, the Community Affairs Office of the Boston Reserve Bank collaborated with Wall Street Without Walls and Southern New Hampshire University to sponsor the inaugural session of the "Capital Markets Training Institute" in Manchester, New Hampshire. Participants at this three-day event learned how they can use the capital markets to fulfill their organizations' missions more efficiently and learned how to adapt their operations to allow their organizations to access the capital markets. Demonstrating the ongoing commitment of the System's Community Affairs Offices, the director of the Board's Division of Consumer and Community Affairs began serving on the Walls Street Without Walls advisory board in 2004.

Reserve Bank efforts also explored ways to increase the effectiveness of community development finances in their Districts. The Federal Reserve Bank of Dallas sponsored "Momentum Texas: The Texas Community Development Finance Summit" to examine the state's strategies for securing and using community economic development funds. The Cleveland Reserve Bank organized a policy summit, "Recapitalization of Communities," in which regional and national community development leaders discussed challenges to and opportunities for attracting new capital to fund CEDF institutions' initiatives for infrastructure development, wealth-building, and other asset-accumulation programs.

The System's Community Affairs Offices remain committed to increasing the role of research in their work. Preparations have begun for the biennial community affairs research conference in April 2005; Chairman Greenspan will be a keynote speaker at the two-day event. System community affairs staff collaborated with their research colleagues at the Board and the Cleveland Reserve Bank to identify and review papers that would best address the conference's theme, "Promises and Pitfalls: As Consumer Finance Options Multiply, Who Is Being Served and at What Cost?" Studies chosen will assess the impact that consumer behavior, alternative financial services providers, financial education, and other factors have on consumers' access to and experiences with the financial sector.

The New York, Philadelphia, and Cleveland Reserve Banks collaborated to host a community development finance research conference in December. The conference commissioned papers from leading researchers on a broad range of topics, including strategies for asset creation among lower-income populations, the role of microlending in community development, methods for measuring the impact of community development, and the relationship between subprime markets and predatory lending. In addition, scholars and practitioners explored the roles of alternative depository institutions and public policy in helping traditionally underserved populations and communities access capital for asset accumulation and development. Senator Hillary Rodham Clinton was the keynote speaker.

The Board's Community Affairs Office continued to improve and support its Fiscal Impact Tool (FIT), a web-based modeling tool designed to support the evaluation of prospective community and economic development projects in midsize communities. This analytic tool enables community economic developers to conduct a cost–benefit analysis of a proposed development project by estimating its effect on local sales and property tax revenues and on costs to local government. Available at no cost on the Board's web site (www.federalreserve.gov/forms/fiscalimpactrequest.cfm), FIT can aid decisionmakers in determining the economic value of a proposed activity for their community.

The Board's Community Affairs Office, in partnership with the Chicago, Kansas City, Philadelphia, Richmond, and St. Louis Reserve Banks, continued to develop best-practice case studies for the web-based database Lessons Learned: Community and Economic Development Case Studies (www.chicagofed.org/cedric/lesle_index.cfm). The database provides detailed case studies that identify a community development issue, present one community's solution, describe the results, and offer "lessons learned" to community developers addressing similar concerns in their communities. The database can be accessed on the System's research repository web site, the Community and Economic Development Research Information Center (CEDRIC).

Outreach Activities

The Board engages in outreach activities throughout the year to provide information to the public about the Board's responsibilities, to facilitate understanding of changes in banking regulations and their impact on banks and consumers, to promote community development and consumer education, and to foster discussion of public policy issues. Board staff periodically meet with financial institutions, community groups, and other members of the public in formal and informal settings. The Board sponsors and participates in meetings, conferences, and seminars for the general public and targeted audiences. This year, the Board again participated in the Congressional Black Caucus Foundation's 2004 annual legislative conference, which provides a national forum for examining strategies and viable solutions to public policy issues facing African Americans. Board staff distributed consumer education materials provided by the Federal Reserve System and used the opportunity to inform conference attendees about the Federal Reserve and its multifaceted responsibilities. ■

Banking Supervision and Regulation

Earnings of insured commercial banks exceeded the $100 billion mark for the second consecutive year in 2004 amid significant changes in the interest rate environment, an end to the boom period in mortgage refinancings, and several mergers among large bank holding companies.

At $106.7 billion, profits rose 6.4 percent from 2003, fueled by growth in loans (11.0 percent overall) and investment securities (6.4 percent) and by a decline in provisions for loan loss (22.3 percent). The net interest margin on all earning assets fell 7 basis points, to 3.72 percent, low by historical standards. Non-interest income grew modestly overall (3.9 percent) despite lower revenues from mortgage originations and soft trading income. Servicing income, income from fiduciary activities, and deposit fees accounted for most of the growth. Expenses rose sharply (9.4 percent), significantly influenced by nonrecurring items related to mergers and the creation of litigation reserves at a few large institutions.

Return on total shareholders' equity fell a full percentage point, to a still-strong 14.27 percent. The decline in this profitability ratio was due primarily to significant merger-related increases in equity that were largely offset by increases in merger-related intangible assets.[1] Return on assets fell only slightly, to 1.35 percent, the third consecutive year in which this ratio exceeded 1.30 percent.

Loans grew a remarkable 11.0 percent, or $480 billion, in 2004, with most growth occurring in commercial real estate ($131 billion), home equity ($114 billion), residential mortgages ($89 billion), and credit card loans ($61 billion). The growth of commercial real estate lending was even more rapid than in the past few years, with construction lending up 25.2 percent and loans secured by nonfarm nonresidential properties up 10.7 percent. Home equity loans grew an extraordinary 40.2 percent, the fifth consecutive year in which their growth exceeded 20 percent. The growth of residential mortgages came mostly in the first half of the year and slowed considerably once short-term market interest rates began to rise in June. Some of the increase in credit card lending was technical in nature, related to the reclassification of balances from credit-card-related securities to loans as accounting treatments were harmonized at newly merged large banks. Commercial and industrial (C&I) loans rose $37 billion, or 4.3 percent, for the year despite having declined modestly in the first quarter amid weak loan demand.

Holdings of investment securities grew less rapidly than loans, expanding 6.4 percent overall (or $93 billion) for the full year while experiencing substantial shifts as the year progressed in response to changing market conditions. Essentially all the net growth for the year could be attributed to mortgage

1. The number and size of bank-related merger transactions significantly affected the aggregation of commercial bank reports of income and condition (Call Reports) in 2004. The data used in this discussion have been adjusted to address the effects of purchase accounting and, in particular, push-down accounting for bank subsidiaries of large holding companies acquired by other bank holding companies.

pass-through securities acquired during the first quarter. Reacting to changes in the interest rate environment, banks sold off $36 billion (or 5.9 percent) of their mortgage pass-through securities holdings in the second and third quarters and then purchased roughly the same amount during the fourth quarter as longer-term interest rates stabilized. Banks also sold off a modest proportion of their structured mortgage securities (for example, collateralized mortgage obligations) and asset-backed securities in the third quarter and then acquired additional foreign-issued debt securities during the fourth quarter. These repositioning transactions came in response to actual and anticipated movements in market interest rates (together with unexpected stability in long-term rates, leading to a flatter yield curve) and the associated volatility in the carrying value of mortgage-servicing assets.

Supporting this robust asset growth, core deposits continued their recent strong expansion. Money market deposit account (MMDA) deposits and savings deposits grew $270 billion, or 11.7 percent, slightly exceeding the remarkable growth rate for loans. Noteworthy increases were evident among other core deposit categories, including other transaction accounts (up $6.1 billion) and demand deposits (up $24.5 billion). The increase in demand deposits was influenced by an inflow of balances from corporate customers in the latter half of the year as short-term market interest rates rose, boosting earnings credits on compensating balances.[2] Time deposits under $100,000 grew less significantly ($10.5 billion, or 1.6 percent); the bulk of the increase came in the final quarter of the year as consumers sought to take advantage of rising interest rates. Time deposits over $100,000 rose $128.3 billion, or 21.5 percent, and foreign deposits grew $125 billion, or 16.8 percent; these categories include large-denomination deposits raised in wholesale and offshore money markets, which, along with a modest rise in short-term non-deposit borrowings (4.6 percent), accommodated the growth in assets.

Influenced by both balance sheet changes and movements in market interest rates, net interest margins narrowed 7 basis points, to 3.72 percent. Yields on domestic real estate loans—including commercial real estate and home equity loans—fell 25 basis points despite higher short-term interest rates. Overall yields on securities holdings rose modestly—in part because of rising short-term interest rates—while yields on C&I loans held steady at 6.00 percent amid reports that bankers were easing their lending standards through the year. Changes in the effective rates for credit cards and other consumer loans were mixed. Funding costs reflected some resistance to higher interest rates, as the effective cost of MMDA and savings deposits remained essentially unchanged from 2003, at 0.73 percent, while the effective cost of other deposits and borrowings declined 20–30 basis points.

Equity-to-assets ratios rose a full percentage point in 2004, primarily as a result of the merger-related increases in shareholders' equity noted earlier. Regulatory capital ratios, in contrast, remained relatively steady, as the merger-related increase in equity was

2. Although banks are prohibited from paying interest on transaction accounts held by commercial customers, these customers in many cases receive "earnings credits" on their transaction balances that may be used to offset service charges they incur. The amounts of such earnings credits are determined by a number of factors, including the size of collected balances and prevailing short-term market interest rates.

largely offset by goodwill-related intangible assets, which are deducted from regulatory capital measures. Dividends paid by commercial banks fell sharply, declining $18 billion, or 23.4 percent. Most of the decline (61 percent) came in dividends paid to the five largest bank holding companies (Citigroup, JPMorgan Chase, Bank of America, Wachovia and Wells Fargo, all on a merger-adjusted basis) by their commercial bank subsidiaries; dividend payments from the holding companies to their shareholders rose.

Already-strong asset quality improved further in 2004 according to all conventional measures. Nonperforming assets fell to 0.62 percent of loans and related assets, well below both the 0.94 percent rate for 2003 and the previous credit-cycle low point in 1997–99 (0.75 percent). Net charge-offs fell to 0.63 percent of loans, from 0.88 percent in 2003, roughly in line with the 1997–99 period. Reserves fell in absolute terms (4.2 percent), but reserve coverage of nonperforming assets still improved substantially.

Reflecting ongoing consolidation in the industry, the number of insured commercial banks declined by 142 (on a net basis), to 7,621. Still, some 122 new charters were granted in 2004 (105 of these by state authorities), a sign of the continuing attractiveness of commercial bank charters. Assuming a minimum initial capitalization of $8 million, these newly chartered institutions attracted nearly $1 billion of new capital into the banking industry.

Consistent with the industry's strong earnings and balance sheets, only three banks failed in 2004 (combined assets of roughly $200 million), one more than in 2003. The number of problem banks (that is, those receiving a supervisory rating of 4 or 5 on overall condition) declined by 28, to 90 institutions.

Scope of Responsibilities for Supervision and Regulation

The Federal Reserve is the federal supervisor and regulator of all U.S. bank holding companies, including financial holding companies formed under the authority of the 1999 Gramm–Leach–Bliley Act, and of state-chartered commercial banks that are members of the Federal Reserve System. In overseeing these organizations, the Federal Reserve seeks primarily to promote their safe and sound operation, including their compliance with laws and regulations.[3]

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

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

3. The Board's Division of Consumer and Community Affairs coordinates the Federal Reserve's supervisory activities with regard to compliance with consumer protection and civil rights laws. Those activities are described in the chapter "Consumer and Community Affairs." Compliance with other banking laws and regulations, which is treated in this chapter, is the responsibility of the Board's Division of Banking Supervision and Regulation and the Federal Reserve Banks, whose examiners also check for safety and soundness.

activities with other federal banking agencies, state agencies, functional regulators, and the bank regulatory agencies of other nations.

Supervision for Safety and Soundness

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

Examinations and Inspections

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

State Member Banks

At the end of 2004, 919 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented approximately 12 percent of all insured U.S. commercial banks and held approximately 15 percent of all insured commercial bank assets in the United States. The guidelines for Federal Reserve examinations of state member banks are fully consistent with section 10 of the Federal Deposit Insurance Act, as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and by the Riegle Community Development and Regulatory Improvement Act of 1994. A full-scope, on-site examination of these banks is required at least once a year; exceptions are certain well-capitalized, well-managed organizations having assets of less than $250 million, which may be examined once every eighteen months.

Bank Holding Companies

At year-end 2004, a total of 5,863 U.S. bank holding companies were in operation, of which 5,151 were top-tier bank holding companies. These organizations controlled 6,235 insured commercial banks and held approximately 96 percent of all insured commercial bank assets in the United States.

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

State Member Banks and Holding Companies, 2000–2004

Entity/Item	2004	2003	2002	2001	2000
State member banks					
Total number	919	935	949	970	991
Total assets (billions of dollars)	1,275	1,912	1,863	1,823	1,645
Number of examinations	809	822	814	816	899
By Federal Reserve System	581	581	550	561	610
By state banking agency	228	241	264	255	289
Top-tier bank holding companies					
Large (assets of more than $1 billion)					
Total number	355	365	329	312	309
Total assets (billions of dollars)	8,429	8,295	7,483	6,905	6,213
Number of inspections	500	454	439	413	352
By Federal Reserve System[1]	491	446	431	409	346
On site	440	399	385	372	309
Off site	51	47	46	37	37
By state banking agency	9	8	8	4	6
Small (assets of $1 billion or less)					
Total number	4,796	4,787	4,806	4,816	4,800
Total assets (billions of dollars)	852	847	821	768	716
Number of inspections	3,703	3,453	3,726	3,486	3,347
By Federal Reserve System	3,526	3,324	3,625	3,396	3,264
On site[2]	186	183	264	730	835
Off site	3,340	3,141	3,361	2,666	2,429
By state banking agency	177	129	101	90	83
Financial holding companies					
Domestic	600	612	602	567	462
Foreign	36	32	30	23	21

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

2. In 2002, the supervisory program for small bank holding companies was revised, resulting in more inspections being performed off site versus on site. See text section "Bank Holding Companies" for more information.

the supervision of those banks, thereby minimizing duplication of effort and reducing the burden on banking organizations.

Small, noncomplex bank holding companies—those that have consolidated assets of $1 billion or less—are subject to a special supervisory program that was implemented in 1997 and modified in 2002.[4] The program permits a more flexible approach to supervision of such companies. If all of a company's subsidiary depository institutions have composite and management ratings of "satisfactory" or better, and if no material outstanding issues at the holding company or consolidated level are otherwise indicated, only a composite rating and a management rating based on the ratings of the lead subsidiary depository institution are assigned to the company. In 2004 the Federal Reserve conducted 3,703 reviews of such bank holding companies. If a company's subsidiary depository institutions have ratings lower than "satisfactory" or have other significant supervisory issues, a more thorough off-site review of the organization is conducted using surveillance results and other information. If the information obtained off-site from these sources is not sufficient to determine the overall financial condition of the holding company and to assign the composite and management ratings, the holding

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

company is subject to increased supervisory review that may include an on-site review and off-site monitoring.

Financial Holding Companies

Under the Gramm–Leach–Bliley Act, bank holding companies that meet certain capital, managerial, and other requirements may elect to become financial holding companies and thereby engage in full-scope securities underwriting, merchant banking, and insurance underwriting and sales activities. The statute streamlines the Federal Reserve's supervision of all bank holding companies, including financial holding companies, and sets forth parameters for the relationship between the Federal Reserve and other regulators. The statute also differentiates between the Federal Reserve's relations with regulators of depository institutions and its relations with functional regulators (that is, regulators for insurance, securities, and commodities).

As of year-end 2004, 600 domestic bank holding companies and 36 foreign banking organizations had financial holding company status. Of the domestic financial holding companies, 34 had consolidated assets of $15 billion or more; 110, between $1 billion and $15 billion; 82, between $500 million and $1 billion; and 374, less than $500 million.

Anti-Money-Laundering Examinations

The U.S. Department of the Treasury regulations (31 CFR 103) implementing the Bank Secrecy Act (BSA) generally require banks and other types of financial institutions to file certain reports and maintain certain records that are useful in criminal or regulatory proceedings.

The BSA and separate Board regulations require banking organizations supervised by the Board to file reports on suspicious activity related to possible violations of federal law, including money laundering, terrorist financing, and other financial crimes. In addition, BSA and Board regulations require that banks develop written programs on BSA compliance and that the programs be formally approved by bank boards of directors. An institution's compliance program must (1) establish a system of internal controls to ensure compliance with the BSA, (2) provide for independent compliance testing, (3) identify individuals responsible for coordinating and monitoring day-to-day compliance, and (4) provide training for personnel as appropriate.

The Federal Reserve is responsible for examining supervised institutions for compliance with various anti-money-laundering regulations. During examinations of state member banks and U.S. branches and agencies of foreign banks and, when appropriate, inspections of bank holding companies, examiners review the institution's compliance with the BSA and determine whether adequate procedures and controls to guard against money laundering are in place.

The Anti-Money-Laundering Policy and Compliance Section of the Board's Division of Banking Supervision and Regulation is responsible for BSA/anti-money-laundering matters. The section develops BSA polices and examination guidance and oversees the Federal Reserve Banks' implementation of this guidance.

Business Continuity

In 2004 the Federal Reserve continued its efforts to strengthen the resilience of the U.S. financial system in the event of unexpected disruptions. Throughout the year, the Federal Reserve monitored financial institutions' progress toward implementing the sound practices identified in the April 2003 "Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System," a joint publication with the Office of the Comptroller of the Currency (OCC) and the Securities and Exchange Commission (SEC), which specifies 2005–06 implementation dates. The agencies also began analyzing the risks associated with business continuity testing, in order to develop examiner guidance, and continue to coordinate efforts to ensure a consistent supervisory approach toward implementation of the sound practices.

Specialized Examinations

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

Information Technology Activities

In recognition of the importance of information technology to safe and sound operations in the financial industry, the Federal Reserve reviews the information technology activities of supervised banking organizations as well as certain independent data centers that provide information technology services to these organizations. Several years ago, the information technology reviews of banking organizations were integrated into the overall supervisory process, and thus all safety and soundness examinations are now expected to include a review of information technology risks and activities. During 2004 the Federal Reserve was the lead agency in two examinations of large, multiregional data processing servicers examined in cooperation with the other federal banking agencies.

Fiduciary Activities

The Federal Reserve has supervisory responsibility for organizations that together hold more than $24 trillion of assets in various fiduciary capacities, including custodial capacities. During on-site examinations of fiduciary activities, the organization's compliance with laws, regulations, and general fiduciary principles and potential conflicts of interest are reviewed; its management and operations, including its asset- and account-management, risk-management, and audit and control procedures, are also evaluated. In 2004 Federal Reserve examiners conducted 163 on-site fiduciary examinations.

Transfer Agents and Securities Clearing Agencies

As directed by the Securities Exchange Act of 1934, the Federal Reserve conducts specialized examinations of those state member banks and bank holding companies that are registered with the Board as transfer agents. Among other things, transfer agents countersign and monitor the issuance of securities, register the transfer of securities, and exchange or convert securities. On-site examinations focus on the effectiveness of an organization's operations and its compliance with relevant securities regulations. During 2004 the Federal Reserve conducted on-site examinations at 21 of the 86 state member banks and bank holding companies that were registered as transfer agents. Also during the year the Federal Reserve examined 1 state member limited-purpose trust company acting as a national securities depository.

Government and Municipal Securities Dealers and Brokers

The Federal Reserve is responsible for examining state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with Department of the Treasury regulations governing dealing and brokering in government securities. Twenty-eight state member banks and 7 state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 2004 the Federal Reserve conducted 6 examinations of broker–dealer activities in government securities at these organizations. These examinations are generally conducted concurrently with the Federal Reserve's examination of the state member bank or branch.

The Federal Reserve is also responsible for ensuring compliance with the Securities Act Amendments of 1975 by state member banks and bank holding companies that act as municipal securities dealers, which are examined pursuant to the Municipal Securities Rulemaking Board's rule G-16 at least once every two calendar years. Of the 22 entities that dealt in municipal securities during 2004, 6 were examined during the year.

Securities Credit Lenders

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

At the end of 2004, 679 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 215 of these lenders, and the remaining 464 were subject to limited Federal Reserve supervision. On the basis of regulatory requirements and annual reports, the Federal Reserve exempted 245 lenders from its on-site inspection program. The securities credit activities of the remaining 219 lenders were subject to either biennial or triennial inspection. Fifty-five inspections were conducted during the year, compared with 89 in 2003.

Enforcement Activities and Special Investigations

The Federal Reserve has enforcement authority over the banking organizations it supervises and their affiliated parties. Enforcement action may be taken to address unsafe and unsound practices or violations of any law or regulation. Formal enforcement actions include orders to cease and desist, written agreements, removal and prohibition orders, and civil money penalties. Informal enforcement actions include memorandums of understanding and board of directors resolutions.

In 2004 the Federal Reserve completed 64 formal enforcement actions, including the issuance of cease-and-desist orders, written agreements, and removal and prohibition orders and the imposition of civil money penalties. Civil money penalties totaling $188 million were assessed. All civil money penalties, as directed by statute, are remitted either to the Department of the Treasury or to the Federal Emergency Management Agency. Enforcement orders, which are issued by the Board, and written agreements, which are executed by the Reserve Banks, are public information and are posted on the Board's web site (www.federalreserve.gov/boarddocs/enforcement). In addition to formal enforcement actions, the Reserve Banks completed 102 informal enforcement actions in 2004. Information about these actions is not available to the public.

The Special Investigations Section of the Division of Banking Supervision and Regulation conducts financial investigations, provides expertise to U.S. law enforcement in connection with financial crimes investigations, and offers training to foreign and domestic government agencies. Board staff also work with law enforcement, the financial industry, and other regulatory agencies on various task forces and groups established to combat bank fraud and other financial crimes.

Risk-Focused Supervision Programs

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

Regional Banking Organizations

The risk-focused supervision program for regional banking organizations applies to organizations having a management structure organized by function or business line, a broad array of products, and operations that span multiple supervisory jurisdictions. For smaller regional banking organizations, the supervisory program may be implemented with a point-in-time inspection. For larger organizations, it may take the form of a series of targeted reviews. For the largest, most complex organizations, the process is continuous, as described in the next section. To minimize burden on the organization, work is performed off-site to the greatest extent possible. Additionally, to minimize the number of requests for information from organizations, examiners make use of public and regulatory financial reports, market data, information from automated screening systems (see the section "Surveillance and Off-Site Monitoring"), and internal management reports.

Large, Complex Banking Organizations

The Federal Reserve applies a risk-focused supervision program to large, complex banking organizations (LCBOs).[5] The key features of the LCBO supervision program are (1) identifying those LCBOs that are judged, on the basis of their shared risk characteristics, to present the highest level of supervisory risk to the Federal Reserve System, (2) maintaining continual supervision of these organizations to keep current the Federal Reserve's assessment of each organization's condition,

5. For more information, see Lisa M. DeFerrari and David E. Palmer, "Supervision of Large Complex Banking Organizations," *Federal Reserve Bulletin*, vol. 87 (February 2001), pp. 47–57 (www.federalreserve.gov/pubs/bulletin/default.htm).

(3) assigning to each LCBO a supervisory team composed of Reserve Bank staff members who have skills appropriate for the organization's risk profile (the team leader is the central point of contact, has responsibility for only one LCBO, and is supported by specialists skilled in evaluating the risks of LCBO business activities and functions), and (4) promoting Systemwide and interagency information-sharing through automated systems.

Community Banks

The risk-focused supervision program for community banks emphasizes the review of activities posing the greatest risk to an organization and provides for a tiered approach to the examination of those activities. Examination procedures are tailored to the bank's characteristics, keeping in mind its size, complexity, and risk profile. The examination entails both off-site and on-site work, including planning, completing a pre-examination visit, preparing a detailed scope-of-examination memorandum, documenting the work done, and preparing an examination report tailored to the scope and findings of the examination. The framework for risk-focused supervision of community banks was developed jointly with the Federal Deposit Insurance Corporation (FDIC) and has been adopted by the Conference of State Bank Supervisors.

Surveillance and Off-Site Monitoring

The Federal Reserve uses automated screening systems that monitor supervisory data and regulatory financial reports in order to analyze the financial condition and performance of state member banks and bank holding companies between on-site examinations and inspections. This analysis aids in directing examination resources to those organizations that exhibit relatively high-risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities. The Federal Reserve also has systems that monitor market data, including equity prices, debt spreads, agency ratings, and measures of expected default frequency, to gauge market perceptions of the risk in banking organizations.

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

During 2004 the web-based Performance Report Information and Surveillance Monitoring (PRISM) application received major upgrades. PRISM is a querying tool used by Federal Reserve analysts to access and display financial, surveillance, and examination data. In the analytical module, users can customize the presentation of institutional financial data drawn from Call Reports, Uniform Bank Performance Reports, FR Y-9 statements, Bank Holding Company Performance Reports, and other regulatory reports. In the surveillance module, users can generate reports summarizing the results of surveillance screens for banks and bank holding companies. The upgrades established direct links between PRISM and other automated supervisory tools (the Banking Organization National Desktop, or BOND, and the National Examination Database), expanded the number of surveillance screens available from BOND, and enhanced the range of regulatory data available for querying.

The Federal Reserve works through the Federal Financial Institutions Examination Council (FFIEC) Task Force on Surveillance Systems to coordinate surveillance activities with the other federal banking agencies.[6]

International Activities

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

Foreign Operations of U.S. Banking Organizations

The Federal Reserve examines the international operations of state member banks, Edge Act and agreement corporations, and bank holding companies generally at the U.S. head offices of these organizations, where the ultimate responsibility for their foreign offices lies. Examiners also visit the overseas offices of U.S. banks to obtain financial and operating information and, in some instances, to evaluate the organizations' efforts to implement corrective measures or to test their adherence to safe and sound banking practices. Examinations abroad are conducted with the cooperation of the supervisory authorities of the countries in which they take place; when appropriate, the examinations are coordinated with the OCC.

At the end of 2004, 56 member banks were operating 763 branches in foreign countries and overseas areas of the United States; 32 national banks were operating 706 of these branches, and 24 state member banks were operating the remaining 57. In addition, 16 nonmember banks were operating 17 branches in foreign countries and overseas areas of the United States.

Edge Act and Agreement Corporations

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

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

6. The member agencies of the FFIEC 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. State supervisory authorities also participate in some FFIEC initiatives.

At year-end 2004, 79 banking organizations, operating 9 branches, were chartered as Edge Act or agreement corporations. These corporations are examined annually.

U.S. Activities of Foreign Banks

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

As of year-end 2004, 188 foreign banks from 54 countries were operating 228 state-licensed branches and agencies (of which 8 were insured by the FDIC) as well as 51 branches licensed by the OCC (of which 5 had FDIC insurance). These foreign banks also directly owned 14 Edge Act and agreement corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 88 U.S. commercial banks.

Altogether, the U.S. offices of these foreign banks at the end of 2004 controlled approximately 16 percent of U.S. commercial banking assets. These foreign banks also operated 68 representative offices; an additional 56 foreign banks operated in the United States solely through a representative office.

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

The Federal Reserve conducts a joint program for supervising the U.S. operations of foreign banking organizations in cooperation with the other federal banking agencies and state banking agencies. The program has two main parts. One part addresses the examination process for those foreign banking organizations that have multiple U.S. operations and is intended to ensure coordination among the various U.S. supervisory agencies. The other part is a review of the financial and operational profile of each organization to assess its general ability to support its U.S. operations and to determine what risks, if any, the organization poses through its U.S. operations. Together, these two processes provide critical information to U.S. supervisors in a logical, uniform, and timely manner. The Federal Reserve conducted or participated with state and federal regulatory authorities in 256 examinations in 2004.

Technical Assistance

In 2004 the Federal Reserve System continued to provide technical assistance on bank supervisory matters to foreign central banks and supervisory authorities. Technical assistance involves visits by System staff members to foreign authorities as well as consultations with foreign supervisors who visit the Board or the Reserve Banks. Technical assistance in 2004 was concentrated in Latin America, Asia, and former Soviet bloc countries.

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

Supervisory Policy

The Federal Reserve's supervisory policy function is responsible for developing guidance for examiners and banking organizations as well as regulations for banking organizations under the Federal Reserve's supervision. Staff members participate in international supervisory forums and provide support for the work of the FFIEC.

Capital Adequacy Standards

During 2004 the Federal Reserve, together with the OCC, the FDIC, and the OTS (collectively, the federal banking agencies), issued a final rule on capital requirements for asset-backed commercial paper programs. The agencies also continued to consider possible revisions to their risk-based capital adequacy regulations to reflect the new Basel II framework and issued proposed guidance for internal-ratings-based systems that may be used to determine capital for retail credit risk. In addition, the Federal Reserve requested public comment on a proposed rule concerning the treatment of trust preferred securities in the tier 1 capital of bank holding companies.

Asset-Backed Commercial Paper Programs

In July the Federal Reserve and the other federal banking agencies adopted a final rule that amended the agencies' risk-based capital rules for asset-backed commercial paper (ABCP) programs. The rule permits banking organizations to continue to exclude from their risk-weighted asset base, for purposes of calculating their risk-based capital ratios, ABCP program assets that are consolidated onto the balance sheets of sponsoring banking organizations as a result of Financial Accounting Standards Board Financial Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN 46). Sponsoring banking organizations must continue to hold risk-based capital against all other risk exposures arising in connection with ABCP programs, including direct credit substitutes, recourse obligations, residual interests, long-term liquidity facilities, and loans, in accordance with existing risk-based capital standards. In addition, any minority interests in ABCP programs that are consolidated as a result of FIN 46 are to be excluded from the sponsoring banking organization's minority interest component of tier 1 capital and, hence, from risk-based capital. The amended capital treatment does not alter the accounting rules for balance sheet consolidation, nor does it affect the denominator of the tier 1 leverage capital ratio calculation, which continues to be based primarily on on-balance-sheet assets as reported under generally accepted accounting principles. Thus, as a result of FIN 46, banking organizations must include all assets of consolidated ABCP programs in on-balance-sheet assets for purposes of calculating their tier 1 leverage capital ratio.

In addition, the rules impose a risk-based capital charge on liquidity facilities having an original maturity of one year or less that organizations provide to ABCP programs by imposing a 10 percent credit conversion factor on such facilities. This treatment recognizes that such facilities expose banking organizations to credit risk and is consistent with the industry's practice of internally allocating economic capital against the risk associated with such facilities. A separate capital charge on liquidity facilities provided to an ABCP program is not required of banking organizations that consolidate the program for purposes of risk-based capital.

Risk-Based Capital Standards for Certain Internationally Active Banking Organizations

In August 2003 the Federal Reserve, together with the other federal banking agencies, issued for public comment an advance notice of proposed rulemaking and draft supervisory guidance setting forth the agencies' views on implementing the Basel II framework in the United States. The proposed plan would allow banking organizations that meet specific criteria to use their own estimates of certain risk parameters as key inputs in determining their regulatory capital requirements.

Over the course of 2004, working both independently and with the member countries of the Basel Committee on Banking Supervision, the federal banking agencies continued to modify the methodologies in the Basel II framework. In October the agencies issued proposed guidance on internal-ratings-based systems that may be used to determine regulatory capital for retail credit risk under the Basel II framework. The proposed guidance describes the agencies' views on the components and characteristics of a qualifying internal-ratings-based system for measuring the credit risk associated with retail exposures, including residential mortgages, consumer credit cards, automobile loans, personal loans, and some small business loans. The comment period was scheduled to end in January 2005. (For more information on the Basel II framework, see the box "Implementing the Basel II Framework in the United States.")

Capital Treatment of Trust Preferred Securities

In May the Federal Reserve Board proposed to allow the continued inclusion of outstanding and prospective issuances of trust preferred securities in the tier 1 capital of bank holding companies while imposing stricter quantitative limits and clarifying qualitative standards for capital instruments included in regulatory capital. The stricter quantitative limits would apply to the aggregate amount of trust preferred securities, cumulative perpetual preferred stock, and minority interests in the equity accounts of certain consolidated subsidiaries (collectively, restricted core capital elements) included in bank holding company tier 1 capital. The proposed rule would make explicit a general expectation that internationally active bank holding companies would limit the amount of restricted core capital elements to 15 percent of the sum of core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability, consistent with a 1998 Basel agreement. Other bank holding companies would be subject to a 25 percent limit on the amount of restricted core capital elements. The proposal provides for a three-year transition period for compliance with the stricter quantitative limits.

These revisions were proposed to address supervisory concerns, competitive equity considerations, and changes in generally accepted accounting principles. They would have the effect of strengthening the definition of regulatory capital for bank holding companies. A final rule is to be issued in early 2005.

Bank-Owned Life Insurance

In December 2004, the Federal Reserve and the other federal banking agencies issued guidance on the safety-and-soundness and risk-management implications of purchases and holdings of life insurance by banks and savings associations. The guidance addresses the unique characteristics of bank-owned life insurance (BOLI) as well as the need for a comprehensive pre- and post-purchase analysis of the risks and rewards of BOLI.

Bank Holding Company Rating System

To more closely align the supervisory rating system for bank holding companies with its supervisory practices, the Federal Reserve in December 2004 adopted a revised bank holding company rating system, effective January 1, 2005. The increased complexity of the U.S. banking industry has necessitated a shift over time in the focus of the Federal Reserve's supervisory practices for bank holding companies away from historical analyses of financial condition toward more-forward-looking assessments of risk management and financial factors. Under the revised rating system, each bank holding company is assigned a composite rating based on an evaluation and rating of its managerial and financial condition and an assessment of future potential risk to its subsidiary depository institution(s). The three main components of the new RFI/C (D) rating system are Risk management, Financial condition, and potential Impact of the parent company and nondepository subsidiaries (collectively, nondepository entities) on the subsidiary depository institution(s). The rating of a fourth component, Depository institution, will generally mirror the primary regulator's assessment of the subsidiary depository institution(s), as had been the case for the bank rating under the previous rating system, BOPEC (Bank subsidiaries, Other subsidiaries, Parent, Earnings, Capital).

To provide a consistent framework for assessing risk management, the risk-management component of the new rating system is supported by four subcomponents that reflect the effectiveness of the banking organization's risk management and controls: board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems; and internal controls. The financial-condition component is similarly supported by four subcomponents that reflect an assessment of the quality of the banking organization's capital, assets, earnings, and liquidity. A simplified version of the rating system that requires only the assignment of the risk-management component rating and composite rating (C) will be applied to noncomplex bank holding companies having assets of less than $1 billion.

Bank Secrecy Act and Anti–Money Laundering

The Federal Reserve in 2004 issued a number of supervisory letters to domestic and foreign banking organizations on such topics as examination procedures for customer identification programs and the imposition of "special measures" by the Department of the Treasury on certain jurisdictions and foreign financial institutions suspected of being of "primary money laundering concern."

The Federal Reserve is actively working with the other federal and state banking agencies to develop interagency Bank Secrecy Act/anti-money-laundering examination procedures to be

Implementing the Basel II Framework in the United States

We are embarking on an effort to achieve considerably more precision in correlating the riskiness of an institution's activities and its regulatory capital.

Roger Ferguson, *Vice Chairman*, Board of Governors
November 2004

Preparation continued during 2004 for implementation in the United States of a new international agreement on capital adequacy for banking organizations.[1] The new agreement, familiarly known as Basel II, sets forth a framework for ensuring that banks hold adequate capital against risk and builds on the initial international capital agreement adopted in 1988.

The original Basel Capital Accord, though widely considered to have achieved its principal objectives of promoting financial stability and providing an equitable basis for competition among internationally active banks, has in recent years been viewed as too simple to address the activities of today's large, complex banking organizations. Basel II creates a stronger framework for these organizations through minimum capital requirements that are more sensitive to each organization's risk profile and that reinforce incentives for strong risk management.[2]

The Basel II framework contains provisions addressing credit risk (the risk of loss due to failure of a counterparty to meet its obligations) and operational risk (the risk of loss resulting from inadequate or failed internal processes, people, or systems or from external events).[3] It relies on three pillars—minimum capital requirements, supervisory review, and market discipline—and is the basis on which revisions to existing U.S. capital adequacy regulations and standards are being developed.

Scope of Application in the United States

Final rules for application of the Basel II framework in the United States are still being developed. It is expected that only a small number of large, internationally active U.S. banking organizations will be subject to the new framework. Those institutions would be required to use the most advanced options of the framework for determining their risk-based capital requirements (the advanced internal-ratings-based approach, or A-IRB, for credit risk and the advanced measurement approaches, or AMA, for operational risk). Other U.S. banking organizations would not be required to adopt Basel II but could opt to do so, provided they could demonstrate the ability to develop the risk measures required as inputs to determine capital requirements. Those banks not adopting Basel II would continue to operate under existing capital rules.

Implementation Plan and Timetable

The U.S. banking and thrift agencies have been coordinating their efforts to imple-

1. The final agreement, titled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" and published in June 2004, was developed by the Basel Committee on Banking Supervision, which is made up of representatives of the central banks or other supervisory authorities of the G-10 countries plus Luxembourg and has its secretariat at the Bank for International Settlements in Basel, Switzerland. See www.bis.org/publ/bcbs107.htm.

2. See "Capital Standards for Banks: The Evolving Basel Accord," *Federal Reserve Bulletin*, vol. 89 (September 2003), pp. 395–405 (www.federalreserve.gov/pubs/bulletin/default.htm).

3. Basel I was updated in 1996 to account for market risk.

ment Basel II. The new rules are expected to take effect on January 1, 2008; before then, institutions subject to the new rules will be required to conduct a year of parallel calculations—that is, to simultaneously calculate capital requirements according to the Basel II-based rules and the current rules. Both supervisors and bankers have much to accomplish before the target 2008 date, including the writing of final rules and guidance by the agencies and the development and execution of an acceptable, detailed written plan for implementation by each adopting institution.

Revision of Regulations

Comments on an advance notice of proposed rulemaking issued in August 2003 that set forth possible revisions to the capital adequacy regulations are currently being reviewed. Importantly, all U.S. banking organizations would continue to be subject to leverage ratio requirements and to prompt corrective action regulations, which closely link enforcement actions to banks' capital levels.

The agencies expect that a notice of proposed rulemaking on possible revisions to the regulations will be published in mid-2005. Final rules are expected in the second quarter of 2006. The agencies are also considering possible changes to risk-based capital regulations for U.S. institutions not subject to the Basel II-based regulations; these changes are expected to become effective at the same time as the Basel II-based regulations.

Qualification for Using Advanced Approaches

The agencies have issued guidance setting forth their ideas about the qualification process for Basel II in the United States. The development of a detailed written plan for implementing the A-IRB and AMA approaches for determining risk-based capital requirements is seen as among the most significant steps institutions can take in advance of the issuance of final rules and associated guidance. The qualification process will be iterative. The plans will serve as instruments of communication between institutions and their supervisors in their home country and other jurisdictions. They are expected to include a self-assessment by the institution, a gap analysis (based on the self-assessment) identifying areas needing additional work, an action plan for addressing shortcomings, objectively measurable milestones, and an assessment of resources needed.

Issuance of Supervisory Guidance

During 2005 the agencies will continue to develop supervisory guidance concerning the various portfolios and risk exposures addressed by Basel II; draft supervisory guidance on corporate and retail credit risk and operational risk has already been published. The guidance will set forth supervisory expectations for banking organizations adopting the Basel II-based rules, for example, the components and characteristics of an acceptable risk-measurement and risk-management infrastructure.

Completion of Quantitative Studies

In 2004 the agencies began a fourth Quantitative Impact Study (QIS-4) to evaluate the potential effects of U.S. implementation of the Basel II framework and a "loss data collection exercise" (LDCE) focused on operational risk. About thirty banking organizations are participating in QIS-4; about twenty are participating in the LDCE. These studies are intended to help banking organizations and their supervisors better understand the implications of the Basel II framework for regulatory capital and may provide some insight on implications of the new approaches for competition within the banking industry.

released in 2005. The Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) has participated in this initiative.

To support this work and to provide a forum for the federal banking agencies to discuss matters related to Bank Secrecy Act/anti-money-laundering examination and training, a Bank Secrecy Act Working Group was formed in 2004 under the FFIEC. The working group, which also includes FinCEN and state bank regulators, complements other interagency and international efforts, such as the Bank Fraud Working Group, the Financial Action Task Force, and various supervisors committees within the Basel Committee on Banking Supervision.

The Federal Reserve participates in another such group, the BSA Advisory Group, which was established by statute to seek ways to reduce unnecessary burden created by the BSA and to increase the utility of data gathered under the act to aid regulators and law enforcement. In addition, through this group, the Federal Reserve assists the Treasury Department in providing feedback to financial institutions on the reporting of suspicious activity. Finally, staff of the Division of Banking Supervision and Regulation engage in outreach to the financial services industry by, for example, speaking at banking conferences to promote best practices to combat money laundering and terrorist financing.

International Guidance on Supervisory Policies

As a member of the Basel Committee on Banking Supervision, the Federal Reserve in 2004 participated in efforts to revise the international capital regime and to develop international supervisory guidance. The Federal Reserve's goals in these activities are to advance sound supervisory policies for internationally active banking organizations and to improve the stability of the international banking system. The efforts are described in the following sections.

Capital Adequacy

During 2004 the Federal Reserve continued to participate in a number of technical working groups of the Basel Committee in efforts to develop the revised Basel framework (familiarly referred to as Basel II), which was published in June, and to address issues not fully resolved in that framework. In particular, the Federal Reserve participated in a joint Basel Committee–International Organization of Securities Commissions (IOSCO) working group on the trading book to review issues related to counterparty credit risk, double default effects (reflecting the low probability that both a borrower and its guarantor will default at the same time), and the definition of the trading book.

Risk Management

The Federal Reserve contributed to several supervisory policy papers, reports, and recommendations issued by the Basel Committee during 2004 that were generally aimed at improving the supervision of banking organizations' risk-management practices.

- "Consolidated Know-Your-Customer Risk Management," issued in October, provides guidance to help international banking organizations establish centralized processes for sharing information and for coordinating and promulgating customer due diligence policies and procedures on a consolidated basis. The guidance, which builds on Basel Committee publications issued in 2001 and 2003, also encourages government jurisdictions to facilitate consolidated customer due diligence risk management by providing a legal framework that allows overseas subsidiaries and affiliates of banking organizations to share information with their head offices or parent banks.

- "Principles for the Management and Supervision of Interest Rate Risk," issued in July, describes the pillar 2 (supervisory review) approach to calculating interest rate risk under Basel II. The paper reflects comments received on a September 2003 consultative paper.

- "Implementation of Basel II: Practical Considerations," issued in July, discusses the costs and benefits of Basel II implementation from the point of view of non–G10 countries, focusing in particular on potential changes to the legal and regulatory framework and on resource and training requirements.

- In January the Basel Committee issued changes to the internal-ratings-based approach to securitization exposures under Basel II, in response to industry concerns related to the complexity of the proposal and the operational burdens of implementation.

- In January the Basel Committee announced its decision to base the Basel II framework on unexpected losses rather than a combination of unexpected and expected losses, in response to industry requests and comments. However, under the framework, banks would be required to compare provisions with expected losses and to deduct any deficiency from capital. Excess provisions would be eligible for inclusion in tier 2 capital, subject to a cap.

- "Principles for the Home–Host Recognition of AMA Operational Risk Capital," issued in January, addresses industry concerns about practical impediments to the cross-border implementation of the advanced measurement approaches for operational risk, an element of the Basel II framework.

Joint Forum

In its work with the Basel Committee, the Federal Reserve also continued its participation in the Joint Forum—a group made up of representatives of the committee, IOSCO, and the International Association of Insurance Supervisors. The Joint Forum works to increase mutual understanding of issues related to the supervision of firms operating in each of the financial sectors. The Joint Forum issued three publications in 2004:

- "Credit Risk Transfer," issued in October, reviews the rapid growth in credit risk transfer products, such as single-name credit default swaps and collateralized debt obligations, and concludes that these markets have provided banking organizations with significantly more liquid and efficient methods of trading and diversifying their credit risks. The report notes that although these products do not raise immediate and significant financial stability concerns, financial organizations should adopt appropriate risk-management practices when conducting business in these products.

- "Outsourcing in Financial Services," issued in August, discusses the key issues and risks associated with financial firms' outsourcing of significant parts of their regulated and unregulated activities to third parties and sets forth principles to help firms mitigate these risks.

- "Financial Disclosure in the Banking, Insurance and Securities Sectors: Issues and Analysis," issued in May, outlines the findings of a working group established to follow up on recommendations contained in a 1999 report that provided advice to supervisors on enhancing financial institutions' public disclosures of their financial risks.

International Accounting and Disclosure

The Federal Reserve participates in the Basel Committee's Accounting Task Force and represents the Basel Committee at international meetings on accounting, auditing, and disclosure issues affecting global banking organizations. In particular, officials of the Federal Reserve represent the Basel Committee at meetings that address financial instruments accounting and disclosure issues associated with international accounting standards. In addition, an official of the Federal Reserve is a member of the Standards Advisory Council of the International Accounting Standards Board (IASB).

During 2004 the Federal Reserve had a key role in development of the Basel Committee's comments on the IASB's proposed amendment to the guidance in International Accounting Standard 39 on the optional use of fair value accounting for financial instruments. In addition, the Federal Reserve strongly supported the Basel Committee's efforts to develop guidance on improving disclosure for the purpose of enhancing market discipline. This support contributed to the finalization of pillar 3 guidance on improved disclosures in support of Basel II.

The Federal Reserve and the Basel Committee also worked with other international regulatory organizations, such as IOSCO, the International Association of Insurance Supervisors, the World Bank, and the Financial Stability Forum, as part of an organization called the Monitoring Group, to promote stronger international audit standards and practices. This effort led to the adoption by the International Federation of Accountants (IFAC) of comprehensive reforms that will result in greater public oversight of IFAC's audit-standard-setting activities.

Sarbanes–Oxley Act

During 2004 the Federal Reserve continued to evaluate the effects of the Sarbanes–Oxley Act on banking organizations. The effort involved the Federal Reserve's working closely with banking organizations and their external auditors to better understand the challenges they are encountering in complying with the sections of the act that relate to internal controls. It also involved dialogue with the SEC and the Public Company Accounting Oversight Board (PCAOB) on various interpretative issues related to these matters.

In addition, an official of the Federal Reserve serves on the Standing Advisory Group of the PCAOB, which is advising the PCAOB as it develops standards for the external audits of publicly traded companies in the United States. The Federal Reserve also continued in 2004 to work with the FDIC and other banking agencies to consider changes that should be made to the regulations implementing the Federal Deposit Insurance Corporation Improvement Act to promote strong internal controls and consistency with the Sarbanes–Oxley Act requirements.

Efforts to Enhance Transparency

As part of ongoing efforts to promote sound accounting and disclosure practices by banking organizations, the Federal Reserve, together with the other banking agencies, in February issued guidance on the appropriate accounting treatment for obligations under certain types of deferred compensation agreements (see SR Letter 04-4). In March the Federal Reserve and the other banking agencies issued guidance identifying current sources of generally accepted accounting principles (GAAP) and supervisory guidance that should be used by banking organizations in determining their allowance for loan and lease losses (see SR Letter 04-5). The Federal Reserve also worked with foreign supervisors in developing pillar 3 of the Basel II framework, which aims to enhance banking organizations' public disclosure of their risk exposures, capital, and capital adequacy.

In October the Federal Reserve submitted a comment letter to the Financial Accounting Standards Board (FASB) on its "Fair Value Measurements Exposure Draft." In addition, Federal Reserve staff provided comments to FASB on an accounting interpretation that addressed impairment of securities.

Bank Holding Company Regulatory Financial Reports

The Federal Reserve requires that U.S. bank holding companies periodically submit reports providing financial and structure information. This information is essential to the supervision of the organizations and the formulation of regulations and supervisory policies. The information is also used in responding to requests from Congress and the public for information on bank holding companies and their nonbank subsidiaries.

The FR Y-9 series of reports provides standardized financial statements for bank holding companies on a consolidated and parent-only basis. The reports are used to detect emerging financial problems, review performance and conduct pre-inspection analysis, monitor and evaluate risk profiles and capital adequacy, evaluate proposals for bank holding company mergers and acquisitions, and analyze the holding company's overall financial condition. The nonbank subsidiary reports—FR Y-11, FR 2314, and FR Y-7N—aid the Federal Reserve in determining the condition of bank holding companies that are engaged in nonbanking activities and in monitoring the volume, nature, and condition of their nonbanking subsidiaries. The FR Y-8 report collects information on transactions between an insured depository institution and its affiliate that are subject to section 23A of the Federal Reserve Act; it enhances the Federal Reserve's ability to monitor bank exposures to affiliates and to ensure compliance with section 23A of the act.

In March 2004, several revisions to the FR Y-9C report were implemented for the purpose of collecting preliminary data from selected large bank holding companies on a voluntary basis, improving the reporting of trust preferred securities, and collecting from some of the largest bank holding companies the addresses of their web pages displaying risk disclosures. In September and December the electronic filing process for the FR Y-9 series of reports was enhanced to require respondents to perform data validation checks prior to filing.

In May revisions were made to clarify the language in the reporting forms and instructions for three reports—the Annual Report of Bank Holding Companies (FR Y-6), the Report of Changes in Organizational Structure (FR Y-10), and the Report of Changes in FBO Organizational Structure for foreign banking organizations (FR Y-10F).

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

Commercial Bank Regulatory Financial Reports

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

The Federal Reserve and the other banking agencies have begun a Call Report modernization project to improve the timeliness and quality of supervisory data and to enhance market discipline by ensuring more timely access by the public. Proposed enhancements to the data collection and disclosure process include requiring electronic submission of Call Reports to a central data repository, moving forward the deadline for filing reports, and requiring respondents to validate their data before filing. The effort to set up a central data repository is currently in the testing phase, and the repository is expected to be operational in 2005.

No significant changes were made to the Call Report in 2004. A proposal was issued in April to make two instructional clarifications to the report.

Also in 2004, the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002) was revised, effective in March, to include additional information on derivatives contracts. A proposal was issued in August to revise the Country Exposure Report (FFIEC 009) and the Country Exposure Information Report (FFIEC 009a) to harmonize U.S. data with data on cross-border exposures collected by other countries.

Federal Financial Institutions Examination Council

During 2004 the Federal Financial Institutions Examination Council focused on coordinating the agencies' efforts in the area of Bank Secrecy Act examination and training by enhancing communication and cooperation with FinCEN, an agency within the Treasury Department whose mission is to safeguard the financial system from terrorist financing, money laundering, and other financial crimes. It also continued its efforts to identify and eliminate outdated, unnecessary, or unduly burdensome regulations, pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. The FFIEC made significant progress on a project to modernize and streamline the way in which the banking agencies collect, process, and distribute quarterly bank financial reports. In addition, the FFIEC continued its efforts related to examiner training and education, consumer compliance issues, bank surveillance processes, and information-sharing.

Supervisory Information Technology

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

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

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

SIT Project Management

In 2004 the SIT project management staff, in partnership with other Federal Reserve System staff, developed a strategic plan for 2005–09 that identifies opportunities for enhancing business value through the use of information technology. Another major activity was development of a program to ensure compliance with the Federal Information Security Management Act. In addition, staff members supported modernization of the Shared National Credit program as well as assessments of opportunities in the areas of electronic applications, administrative systems, and learning management systems to improve information technology services in conjunction with efforts of Board and Reserve Bank internal IT providers.

National Information Center

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

In 2004 the structure data system was modified to adhere to the industry standards for use of NAICS (North American Industry Classification System) business activity codes. Changes were made to NED to accommodate the new bank holding company supervisory rating system and to provide user interoperability with PRISM and the CDTR. The CDTR was expanded to contain examination reports for regional and community banking organizations prepared by Reserve Banks. Significant resources continue to be devoted to Call Report modernization for the FFIEC Central Data Repository initiative, with implementation expected in 2005.

Banking Organization National Desktop

Supervision of domestic banking organizations and the U.S. operations of foreign banking organizations is supported by an automated application—the Banking Organization National Desktop (BOND)—that facilitates secure, real-time electronic information-sharing and collaboration among federal and state banking regulators. During 2004 BOND was enhanced to improve its usability, reduce administrative burden, increase the effectiveness of management reporting, and facilitate the sharing of information related to Basel II and the tracking of parallel-owned banks or bank holding companies (that is, organizations in the United States and another country that have the same controlling shareholder). Other enhancements included financial holding company compliance monitoring, improved data quality edits, the addition of applications data, and changes to accommodate the new RFI/C (D) rating scheme for bank holding companies (see the section "Bank Holding Company Rating System"). BOND has been updated to include seamless links to the Federal Reserve's Applications Management and Processing System and to a new system for accessing data on the Shared National Credit program, an interagency effort that aims to reduce examination costs and improve the timeliness and reliability of data associated with the review of large, syndicated credit facilities of commercial banks. At year-end 2004, BOND had 2,850 registered users across the Federal Reserve System, the OCC, the FDIC, and ten state banking departments.

Staff Development

The Federal Reserve System's staff development program trains staff members at the Board, the Reserve Banks, and state banking departments who have supervisory and regulatory responsibilities as well as students from foreign supervisory authorities. Training is offered at the basic, intermediate, and advanced levels in several disciplines within bank supervision: safety and soundness, information technology, international banking, and consumer affairs. Classes are conducted in Washington, D.C., as well as at Reserve Banks and other locations.

The Federal Reserve System also participates in training offered by the FFIEC and by certain other regulatory agencies. The System's involvement includes developing and implementing basic and advanced training in relation to various emerging issues as well as in specialized areas such as international banking, information technology, municipal securities dealing, capital markets, payment systems risk, white collar crime, and real estate lending. In addition, the System co-hosts the World Bank Seminar for students from developing countries.

In 2004 the Federal Reserve trained 2,365 students in System schools, 721 in schools sponsored by the FFIEC, and 20 in other schools, for a total of 3,106, including 293 representatives of foreign

Training Programs for Banking Supervision and Regulation, 2004

Program	Number of sessions conducted	
	Total	Regional
Schools or seminars conducted by the Federal Reserve		
Core schools		
Banking and supervision elements	8	7
Operations and analysis	5	43
Bank management	1	2
Report writing	12	12
Management skills	9	8
Conducting meetings with management	13	13
Other schools		
Credit risk analysis	5	3
Examination management	6	5
Real estate lending seminar	4	3
Senior forum for current banking and regulatory issues	2	2
Basel II corporate activities	1	0
Basel II retail activities	1	0
Principles of fiduciary supervision	2	1
Commercial lending essentials for consumer affairs	1	1
Consumer compliance examinations I	2	0
Consumer compliance examinations II	2	1
CRA examination techniques	2	2
CRA risk-focused examinations	2	2
Fair lending examination techniques	2	2
Foreign banking organizations	1	1
Information systems continuing education	5	5
Capital markets seminars	9	7
Technology risk integration	6	6
Leadership dynamics	6	6
Internal bank ratings and credit risk modeling	2	2
Seminar for senior supervisors of foreign central banks[1] and seven other international courses	8	0
Other agencies conducting courses[2]		
Federal Financial Institutions Examination Council	65	5
The Options Institute	2	2

1. Conducted jointly with the World Bank.

2. Open to Federal Reserve employees.

central banks (see table). The number of training days in 2004 totaled 17,738.

The System gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program, 410 state examiners were trained—242 in Federal Reserve courses, 158 in FFIEC programs, and 10 in other courses.

A staff member seeking an examiner's commission is required to take a first proficiency examination, which tests knowledge of a core body of information, and also a second proficiency examination in one of three specialty areas: safety and soundness, consumer affairs, or information technology. In 2004, 135 examiners passed the first proficiency examination. In the second proficiency examination, 87 examiners passed the safety and soundness examination, 29 passed the consumer affairs examination, and 6 passed the information technology examination. The overall pass rate for these examinations was 79 percent. At the end of 2004, the System had 1,223 field examiners, of which 950 were commissioned (see table).

Year-End Reserve Bank Supervision Levels, 2000–2004

Type of staff	2004	2003	2002	2001	2000
Field examination staff	1,223	1,239	1,234	1,242	1,172
Commissioned field staff	950	936	892	861	786

Regulation of the U.S. Banking Structure

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

Bank Holding Company Act

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

When reviewing a bank holding company application or notice that requires prior approval, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, and the applicant's ability to make available to the Federal Reserve information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. Data on decisions regarding domestic and international applications in 2004 are shown in the accompanying table.

Bank holding companies generally may engage in only those activities that the Board has previously determined to be closely related to banking under section 4(c)(8) of the Bank Holding Company Act. Since 1996, the act has provided an expedited prior-notice procedure for certain permissible nonbank activities and for acquisitions of small banks and nonbank entities. Since that time the act has also permitted well-run bank holding companies that satisfy certain criteria to commence certain other nonbank activities on a de novo basis without first obtaining Federal Reserve approval.

Since 2000, the Bank Holding Company Act has permitted the creation of a special type of bank holding company called a financial holding com-

Decisions by the Federal Reserve on Domestic and International Applications, 2004

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	9	0	0	0	0	0	135	43	187
Merger of bank holding company	14	0	1	0	0	3	27	25	70
Acquisition or retention of bank	16	0	1	0	0	11	114	26	168
Acquisition of nonbank	0	0	31	0	0	5	0	108	144
Merger of bank	4	0	0	0	0	9	67	0	80
Change in control	0	0	1	0	0	0	0	124	125
Establishment of a branch, agency, or representative office by a foreign bank	1	0	0	8	0	0	0	0	9
Other	134	0	0	85	0	98	941	507	1,765
Total	**178**	**0**	**34**	**93**	**0**	**126**	**1,284**	**833**	**2,548**

pany. Financial holding companies are allowed to engage in a broader range of nonbank activities than are traditional bank holding companies. Among other things, they may affiliate with securities firms and insurance companies and engage in certain merchant banking activities. Bank holding companies seeking financial holding company status must file a written declaration with the Federal Reserve. In 2004, 47 domestic financial holding company declarations and 5 foreign bank declarations were approved.

Bank Merger Act

The Bank Merger Act requires that all proposals involving the merger of insured depository institutions be acted on by the appropriate federal banking agency. If the institution surviving the merger is a state member bank, the Federal Reserve has primary jurisdiction. Before acting on a merger proposal, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of the existing and combined organizations, the convenience and needs of the community to be served, and the competitive effects of the proposed merger. It also considers the views of certain other agencies regarding the competitive factors involved in the transaction. In 2004 the Federal Reserve approved 80 merger applications.

When the FDIC, the OCC, or the OTS has jurisdiction over a merger, the Federal Reserve is asked to comment on the competitive factors related to the proposal. By using standard terminology in assessing competitive factors in merger proposals, the four agencies have sought to ensure consistency in administering the Bank Merger Act. The Federal Reserve submitted 534 reports on competitive factors to the other agencies in 2004.

Change in Bank Control Act

The Change in Bank Control Act requires persons seeking control of a U.S. bank or bank holding company to obtain approval from the appropriate federal banking agency before completing the transaction. The Federal Reserve is responsible for reviewing changes in the control of state member banks and bank holding companies. In its review, the Federal Reserve considers the financial position, competence, experience, and integrity of the acquiring person; the effect of the proposed change on the financial condition of the bank or bank holding company being acquired; the effect of the proposed change on competition in any relevant market; the completeness of the information submitted by the acquiring person; and whether the proposed change would have an adverse effect on the federal deposit insurance funds. As part of the process, the Federal Reserve may contact other regulatory or law enforcement agencies for information about relevant individuals.

In 2004 the Federal Reserve approved 125 changes in control of state member banks and bank holding companies.

International Banking Act

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

In reviewing proposals, the Federal Reserve generally considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. It also considers whether the home country supervisor has consented to the establishment of the U.S. office; the financial condition and resources of the foreign bank and its existing U.S. operations; the managerial resources of the foreign bank; whether the home country supervisor shares information regarding the operations of the foreign bank with other supervisory authorities; whether the foreign bank has provided adequate assurances that information concerning its operations and activities will be made available to the Federal Reserve, if deemed necessary to determine and enforce compliance with applicable law; whether the foreign bank has adopted and implemented procedures to combat money laundering and whether the home country of the foreign bank is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering; and the record of the foreign bank with respect to compliance with U.S. law.

In 2004 the Federal Reserve approved 9 applications by foreign banks to establish branches, agencies, and representative offices in the United States.

Overseas Investments by U.S. Banking Organizations

U.S. banking organizations may engage in a broad range of activities overseas. Many of the activities are conducted indirectly through Edge Act and agreement corporation subsidiaries. Although most foreign investments are made under general consent procedures that involve only after-the-fact notification to the Federal Reserve, large and other significant investments require prior approval. In 2004 the Federal Reserve approved 27 proposals for significant overseas investments by U.S. banking organizations. The Federal Reserve also approved 14 applications to make additional investments through an Edge Act or agreement corporation, 5 applications to extend the corporate existence of or acquire an Edge Act corporation, and 4 applications to establish or acquire an agreement corporation.

Applications by Member Banks

State member banks must obtain Federal Reserve approval to establish domestic branches, and all member banks (including national banks) must obtain Federal Reserve approval to establish foreign branches. When reviewing proposals to establish domestic branches, the Federal Reserve considers the scope and nature of the banking activities to be conducted. When reviewing proposals for foreign branches, the Federal Reserve considers, among other things, the condition of the bank and the bank's experience in international banking. In 2004 the Federal Reserve acted on new and merger-related branch proposals for 1,428 domestic branches and granted prior approval for the establishment of 34 new foreign branches.

State member banks must also obtain Federal Reserve approval to establish financial subsidiaries. These subsidiaries may engage in activities that are financial in nature or incidental to financial activities, including securities and insurance agency-related activities. In 2004, 2 applications for financial subsidiaries were approved.

Stock Repurchases by Bank Holding Companies

A bank holding company may repurchase its own shares from its shareholders. When the company borrows money to buy the shares, the transaction increases the company's debt and decreases its equity. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's capital adequacy guidelines. In 2004 the Federal Reserve reviewed 16 stock repurchase proposals by bank holding companies; all were approved by a Reserve Bank under delegated authority.

Public Notice of Federal Reserve Decisions

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

Timely Processing of Applications

The Federal Reserve sets internal target time frames for the processing of applications. The setting of internal targets promotes efficiency at the Board and the Reserve Banks and reduces the burden on applicants. Generally, the length of the target period ranges from twelve to sixty days, depending on the type of application or notice filed. In 2004, 92 percent of decisions were made within the target time period.

Enforcement of Other Laws and Regulations

The Federal Reserve's enforcement responsibilities also extend to financial disclosures by state member banks, securities credit, and extensions of credit to executive officers.

Financial Disclosures by State Member Banks

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including annual and quarterly financial reports and proxy statements. By statute, the Board's financial disclosure rules must be substantially similar to those of the SEC. At the end of 2004, 15 state member banks were registered with the Board under the Securities Exchange Act.

Securities Credit

Under the Securities Exchange Act, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. The Board's Regulation T limits the amount of credit that may be provided by securities brokers and dealers when the credit is used to trade debt and equity securities. The Board's Regulation U limits the amount of credit that may be provided by lenders other than brokers and dealers when the credit is used to purchase or carry publicly held equity securities if the loan is secured by those or other publicly held equity securities. The Board's Regulation X applies these credit limitations, or margin requirements, to certain borrowers and to certain credit extensions, such as credit obtained from foreign lenders by U.S. citizens.

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

Since 1998, the Board has published a list of foreign stocks that meet the requirements of section 220.11 of Regulation T (Credit by Brokers and Dealers), thereby making them eligible for margin treatment at broker–dealers on the same basis as domestic margin securities. In March 2004 the Board removed all the stocks from its Foreign Margin Stock List because the stocks had not been recertified under procedures approved by the Board in 1990. Foreign stocks may also qualify as margin securities by being deemed to have a "ready market" under the SEC's net capital rule (17 CFR 240.15c3-3) (see the March 3, 2004, press release at www.federalreserve.gov/boarddocs/press/all/2004/).

Extensions of Credit by State Member Banks to their Executive Officers, 2003 and 2004

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
2003			
October 1–December 31	590	66,901,000	0.0–18.0
2004			
January 1–March 31	545	62,624,000	0.0–18.0
April 1–June 30	576	79,207,000	0.0–18.0
July 1–September 30	479	72,401,000	0.0–19.8
October 1–December 31	476	53,083,000	0.0–20.8

SOURCE. Call Reports.

Extensions of Credit to Executive Officers

Under section 22(g) of the Federal Reserve Act, a state member bank must include in its quarterly Call Report information on all extensions of credit by the bank to its executive officers since the date of the preceding report. The accompanying table summarizes this information for 2004.

Federal Reserve Membership

At the end of 2004, 2,794 banks were members of the Federal Reserve System and were operating 51,864 branches. These banks accounted for 37 percent of all commercial banks in the United States and for 73 percent of all commercial banking offices. ■

Federal Reserve Banks

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

Major Initiatives

In 2004, the Federal Reserve Banks continued to pursue efficiencies in their operations, including the provision of priced services, and in support and overhead.

The Reserve Banks are processing a declining number of checks as consumers and businesses make more payments electronically. Because of the decline, the Banks have found it challenging to fully recover their costs as required by the Monetary Control Act of 1980. In response, the Banks are fundamentally restructuring their check operations. During the year, they completed the first phase of a check restructuring initiative, reducing the number of Federal Reserve check-processing and check-adjustment locations. The initiative has reduced Reserve Bank check operating expenses and staffing levels; since 1999, the number of employees processing checks has declined about 25 percent, to approximately 4,000 at the end of 2004. As the market for check collection services continues to decline, the Banks will pursue additional restructuring efforts and staffing reductions to achieve full cost recovery. (For a broad discussion of the Reserve Banks' response to today's environment, see the box "Reserve Bank Services in a Changing Payments Market.")

In addition to acting to control costs for priced services, the Reserve Banks have undertaken a number of projects to reduce support and overhead costs. They have consolidated operations locally and nationally, adopted more-efficient practices, and adjusted staffing levels commensurate with a shrinking base of internal customers requiring support services. Reserve Bank support and overhead costs, including national support services, decreased $68 million, or 6 percent, from 2003 to 2004.[1] Over the same period, ANP associated with support and overhead areas declined 700, or 8 percent.[2]

Over the past several years, the Reserve Banks have consolidated their employee health and welfare plans, human resources information systems, and payroll-processing operations. These plans, systems, and operations previously were unique to each Bank and were managed and administered from each Reserve Bank head office. Although some of the consolidations are not yet complete, each has already generated significant cost savings. The savings resulting from staff reductions in support and overhead functions is expected to be $3.9 million when fully implemented in 2006. The savings resulting from lower vendor fees and

1. National support services include functions and projects managed by a Reserve Bank on behalf of the other Reserve Banks.

2. ANP is the number of employees during a year in terms of full-time positions.

Reserve Bank Services in a Changing Payments Market

More payments in the United States are now being made electronically than by check. The number of checks written annually peaked in the mid-1990s at around 50 billion. By 2003, the number was down to about 37 billion. In contrast, the number of payments made electronically via credit and debit cards, the automated clearinghouse (ACH), and electronic benefit transfer cards was about 45 billion in 2003, up from approximately 15 billion in the mid-1990s.

The shift largely reflects a growing consumer and business preference for making payments electronically, particularly by debit card. It has also been spurred by the financial services industry through its use of new technologies, introduction of new products and services, and adoption of operating rules and standards that support the greater use of electronic payments. For example, recent industry rule changes have enabled businesses to use the information on a consumer's check to transfer funds electronically using the ACH, a process now commonly known as check conversion.

The Federal Reserve has supported and helped facilitate this ongoing transition to a more-electronic payments system. Its Payments System Development Committee, chaired by Vice Chairman Roger Ferguson and Minneapolis Federal Reserve Bank President Gary Stern, has promoted a wide-ranging dialogue on improving the payments system by sponsoring several conferences and seminars and by conducting other outreach activities.

The Federal Reserve also worked with the financial services industry, the legal community, consumer and business representatives, and Congress to enact the Check Clearing for the 21st Century Act (Check 21), which facilitates (but does not mandate) the greater use of electronics in the processing of checks. The Board amended two of its regulations concerned with check processing (Regulations J and CC) to implement the law and has worked closely with the Reserve Banks and the industry to educate the public about the implications of Check 21 for consumers. The Board also clarified the application of the consumer protections in Regulation E to electronic payments made via check conversion.[1]

The ongoing shift to electronic payments has affected the Reserve Banks' check-processing operations. The number of checks collected annually through the Banks has fallen nearly 20 percent since

1. Consumer information on Check 21 and electronic check conversion is available at www.federalreserve.gov/consumers.htm. Banking industry educational and reference material on Check 21 is available at www.ffiec.gov/exam/check21/default.htm.

from lower plan costs due to consolidation of health and welfare plans is expected to be $25 million in 2005.

The other significant initiative affecting Reserve Bank check operations in 2004 was the introduction of products, services, and associated infrastructure related to the Check Clearing for the 21st Century Act (Check 21), which took effect in October. Check 21 is intended to foster payments system innovation and to increase payments system efficiency by reducing legal impediments to check truncation.

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

1999, to fewer than 14 billion in 2004. And the decline is accelerating, as the Banks processed 12 percent fewer checks in 2004 than in 2003. As a result, the revenue the Banks earn from providing check collection services to depository institutions has begun to decline. Over the past five years, the Banks also made a significant investment in modernizing and improving the longer-term efficiency of their check-processing operations.

This combination of market and business factors has challenged the Reserve Banks' ability to meet the expectations of the Monetary Control Act of 1980 (MCA). The MCA requires that the Banks set fees for providing payment services (including check collection services) to depository institutions to recover, over the long run, all the direct, indirect, and imputed costs of providing the services, including the 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.

To better meet the MCA requirements, the Reserve Banks have undertaken a range of cost-reduction and revenue-generation initiatives as part of a long-term business strategy to facilitate the greater use of electronics in check processing. These initiatives have included streamlining management structures, reducing staffing levels, increasing productivity, and selectively raising fees. To better align their operations with a declining check market, the Banks also have begun to fundamentally restructure the location and nature of their national check-processing operations. The number of offices at which checks are processed was reduced from forty-five at the beginning of 2003 to thirty-two by the end of 2004. A further reduction, to twenty-three offices, will be completed in early 2006. As part of these changes, five regional sites dedicated solely to processing checks have been closed. Additional restructuring will occur in response to continued market changes in the use of checks.

Major improvements in the operational efficiency and productivity of Reserve Bank check-collection operations have resulted from these initiatives. The Cincinnati check-processing office, for example, now processes both its own usual volume and the checks previously processed at the Indianapolis, Louisville, and Charleston offices. The number of employees providing check-collection services has been reduced to approximately 4,000, about one-fourth fewer than in 1999 and the lowest level since enactment of MCA. Although the one-time charges associated with the restructuring efforts have been substantial, the costs of ongoing operations have decreased. As a result, the Reserve Banks expect to recover fully all the costs of providing check-collection services in 2005 and to continue to meet their broader statutory obligations over the longer term.

long run, recover all the direct and indirect costs of providing the services as well as the imputed costs, such as the income taxes that would have been paid and the return on equity that would have been earned had the services been provided by a private firm. The imputed costs and imputed profit are collectively referred to as the private-sector adjustment factor (PSAF).[3] Over the past ten years, the Federal Reserve Banks have recovered 97.5 percent of their priced services costs, including the PSAF (table).

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

Priced Services Cost Recovery, 1995–2004
Millions of dollars except as noted

Year	Revenue from services[1]	Operating expenses and imputed costs[2]	Targeted return on equity	Total costs	Cost recovery (percent)[3]
1995	765.2	752.7	31.5	784.2	97.6
1996	815.9	746.4	42.9	789.3	103.4
1997	818.8	752.8	54.3	807.1	101.5
1998	839.8	743.2	66.8	809.9	103.7
1999	867.6	775.7	57.2	832.9	104.2
2000	922.8	818.2	98.4	916.6	100.7
2001	960.4	901.9	109.2	1,011.1	95.0
2002	918.3	891.7	92.5	984.3	93.3
2003	881.7	931.3	104.7	1,036.1	85.1
2004	914.6	842.6	112.4	955.0	95.8
1995–2004	8,705.1	8,156.4	769.9	8,926.5	97.5

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

1. For the ten-year period, includes revenue from services of $8,444.2 million and other income and expense (net) of $261.0 million.

2. For the ten-year period, includes operating expenses of $7,490.2 million, imputed costs of $387.7 million, and imputed income taxes of $259.1 million. Also includes the effect of a one-time accounting change net of taxes of $19.4 million for 1995.

3. Revenue from services divided by total costs.

Overall, the price index for priced services increased 6.7 percent from 2003. Revenue from priced services amounted to $865.9 million, other income related to priced services was $48.7 million, and costs related to priced services were $842.6 million, resulting in net income of $72.0 million. In 2004, the Reserve Banks recovered 95.8 percent of total costs of $955 million, including the PSAF.[4]

Commercial Check Collection Service

In 2004, operating expenses and imputed costs for the Reserve Banks' commercial check collection service totaled $709.6 million, of which $45.3 million was attributable to the transportation of commercial checks between Reserve Bank check-processing centers. Revenue amounted to $719.7 million, of which $45.8 million was attributable to estimated revenues derived from the transportation of commercial checks between Reserve Bank check-processing centers, and other income was $40.5 million. The resulting net income was $50.5 million. Check service revenue in 2004 declined $22.3 million from 2003, largely because of declining volume and customers' moving to lower-priced products.

The Reserve Banks handled 13.9 billion checks in 2004, a decrease of 12.0 percent from the 15.8 billion checks handled in 2003 (table). The decline in Reserve Bank check volume is consistent with nationwide trends

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

Activity in Federal Reserve Priced Services, 2002–2004
Thousands of items

Service	2004	2003	2002	Percent change	
				2003 to 2004	2002 to 2003
Commercial check	13,904,382	15,805,894	16,586,804	−12.0	−4.7
Funds transfer	128,270	125,936	117,133	1.9	7.5
Securities transfer	9,208	10,071	8,480	−8.6	18.8
Commercial ACH	6,486,091	5,588,381	4,986,152	16.1	12.1
Noncash	211	280	333	−24.7	−15.8

NOTE. Activity in *commercial check* is the total number of commercial checks collected, including processed and fine-sort items; in *funds transfer* and *securities transfer*, the number of transactions originated online and offline; in *commercial ACH*, the total number of commercial items processed; and in *noncash*, the number of items on which fees were assessed.

away from the use of checks and toward greater use of electronic payment methods.[5] Overall, the price index for check services increased 8.7 percent from 2003.

In response to the continuing decline in check volume, the Reserve Banks took further steps in 2004 to reduce check service operating costs by implementing a business and operational strategy that will position the service to achieve its financial and payment system objectives over the long term. The strategy will reduce operating costs through a combination of measures: streamlining management structures, reducing staff, decreasing the number of check-processing locations, and increasing processing capacity at some locations. In 2004, check-processing facilities were closed at some locations and the work moved to others. Checks that would have been processed in Miami are now processed in Jacksonville. Omaha check processing has been consolidated to Des Moines; Richmond to Baltimore; Little Rock to Memphis; and Columbia (South Carolina) to Charlotte. Both El Paso and San Antonio have been consolidated to Dallas, and both Milwaukee and Peoria to Chicago. Volume from Charleston (West Virginia), Louisville, and Indianapolis is now processed in Cincinnati.

Of all the checks presented by the Reserve Banks to paying banks, 23.1 percent (approximately 3.2 billion checks) were presented electronically, compared with 22.7 percent in 2003. The Banks captured images of 10.4 percent of the checks they collected, an increase from 9.3 percent in 2003.

The Reserve Banks also expanded the services available to depository institutions through the web during the year. These investments are expected to increase operating efficiency and the Reserve Banks' ability to offer additional services to depository institutions.

Commercial Automated Clearinghouse Services

Reserve Bank operating expenses and imputed costs for commercial automated

5. The Federal Reserve System's recent retail payments research suggests that the number of checks written in the United States has been declining since the mid-1990s. See Federal Reserve System, "The 2004 Federal Reserve Payments Study: Analysis of Noncash Payments Trends in the United States, 2000–2003" (December 2004). (www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf)

clearinghouse (ACH) services totaled $64.0 million in 2004. Revenue from ACH operations totaled $71.1 million and other income totaled $4.0 million, resulting in net income of $11.1 million. The Banks processed 6.5 billion commercial ACH transactions (worth $12.5 trillion), an increase of 16.1 percent from 2003. Overall, the price index for ACH services decreased 10.2 percent from 2003.

In 2004, the Reserve Banks began offering international ACH funds transfer service from the United States to Austria, Canada, Germany, Mexico, and the Netherlands. The Banks also offer service to Switzerland and the United Kingdom.

Fedwire Funds and National Settlement Services

Reserve Bank operating expenses and imputed costs for the Fedwire Funds and National Settlement Services totaled $50.7 million in 2004. Revenue from these operations totaled $54.1 million, and other income amounted to $3.0 million, resulting in net income of $6.5 million.

Fedwire Funds Service

The Fedwire Funds Service allows participants to draw on their reserve or clearing balances at the Reserve Banks and transfer funds to other institutions that maintain accounts at the Banks. In 2004, the number of Fedwire funds transfers originated by depository institutions increased 1.9 percent from 2003, to approximately 128.3 million. In May, the Banks expanded the operating hours for the online service. The service is now open three and one-half hours earlier—at 9:00 p.m. eastern time the preceding calendar day rather than the previous opening time of 12:30 a.m. eastern time. The impetus for the expansion of operating hours was industry requests to achieve greater overlap of wholesale payments system operating hours in U.S. and Asia–Pacific markets.

National Settlement Service

Private clearing arrangements that exchange and settle transactions may use the Reserve Banks' National Settlement Service to settle their transactions. This service is provided to approximately seventy local and national private arrangements, primarily check clearinghouse associations but also other types of arrangements. In 2004, the Reserve Banks processed slightly fewer than 435,000 settlement entries for these arrangements.

Fedwire Securities Service

The Fedwire Securities Service allows participants to electronically transfer securities issued by the U.S. Treasury, federal government agencies, government-sponsored enterprises, and certain international organizations to other participants in the United States.[6] Reserve Bank operating expenses and imputed costs for providing this service totaled $16.9 million in 2004. Revenue from the service totaled $19.3 million, and other income totaled $1.1 million, resulting in net income of $3.4 million. Approximately 9.2 million transfers of Treasury and other securities

6. The expenses, revenues, and volumes reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and international institutions. The Treasury Department assesses fees on depository institutions for some of the transfer, account maintenance, and settlement services for U.S. Treasury securities provided by the Reserve Banks. For details, see the section "Debt Services" later in this chapter.

were processed by the service during the year, a decrease of 8.6 percent from 2003. In 2004, the fee for securities transfers decreased from $0.40 to $0.32, and the surcharge for offline transfers increased from $25 to $28.

Noncash Collection Service

The Reserve Banks provide a service to collect and process municipal bearer bonds and coupons issued by state and local governments (referred to as "noncash" items). The service, which is centralized at one Federal Reserve office, processed slightly less than 211,000 noncash transactions in 2004, representing a 24.7 percent decline in volume from 2003. Operating expenses and imputed costs for noncash operations totaled $1.4 million in 2004, and revenue and other income totaled $1.9 million, resulting in net income of $0.5 million. The fee for return items increased from $20 to $35.

In October, the Board requested comment on a proposal to withdraw from the noncash collection service at year-end 2005. The volume of coupons and bonds presented for collection is declining, a result of a continuing decline in the number of physical municipal securities outstanding since passage of the Tax Equity and Fiscal Responsibility Act of 1982, which removed tax advantages for investors and effectively led to the end of issuance of bearer municipal securities.

Float

The Federal Reserve had daily average credit float of $76.4 million in 2004, compared with $43.0 million in 2003.[7] The Federal Reserve includes the cost of or income from float associated with priced services as part of the fees for those services.

Developments in Currency and Coin

The Reserve Banks received 37.5 billion Federal Reserve notes from circulation in 2004, a 5.1 percent increase from 2003, and made payments of 37.9 billion notes into circulation, a 3.6 percent increase from 2003. They received 55.7 billion coins from circulation in 2004, a 15.6 percent increase from 2003, and made payments of 67.5 billion coins into circulation, a 9.8 percent increase from 2003.[8]

In October 2004, the Reserve Banks began issuing the redesigned $50 Federal Reserve note, which has enhanced security features and subtle background colors. In connection with issuance of the new notes, the Federal Reserve and the Bureau of Engraving and Printing conducted a public education campaign to raise awareness of the note's design and security features.

In 2003, the Board requested comments on a proposed cash-recirculation policy intended to change its cash-services policy to reduce overuse of Reserve Bank cash-processing services. Currently, many depository institutions order currency late in the week to meet temporary, cyclical demand and then return the currency to a Federal Reserve facility several days later to minimize their holdings of vault cash, which does not earn interest. The process repeats each week, and the Federal Reserve facility receiving the returned currency must process it each time. To test the effectiveness of a program that supports

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

8. Percentages reflect restatements of previously reported data.

the proposed cash-recirculation policy, the Banks established eleven custodial inventory sites in 2004. Custodial inventories allow depository institutions to transfer a portion of their cash holdings to the books of a Reserve Bank and are intended to encourage depository institutions to recirculate fit currency rather than return it to the Federal Reserve for processing. The program will operate for six months, after which the Federal Reserve will evaluate the program's effectiveness in promoting currency recirculation.

In 2004, the Federal Reserve also established a group to study the potential effects of the proposed cash-recirculation policy on the quality of currency in circulation. The group is working with the vending industry and manufacturers of currency-handling equipment to evaluate the importance of currency quality for their industries.

Developments in Fiscal Agency and Government Depository Services

As fiscal agents and depositories for the federal government, the Federal Reserve Banks provide services related to the federal debt, help the Treasury collect funds owed to the government, process electronic and check payments for the Treasury, maintain the Treasury's bank account, and invest excess Treasury balances. The Reserve Banks also provide limited fiscal agency and depository services to other entities.

The total cost of providing fiscal agency and depository services to the Treasury and other entities in 2004 amounted to $369.8 million, compared with $327.0 million in 2003 (table). Treasury-related costs were $341.4 million in 2004, compared with $291.7 million in 2003, an increase of 17 percent. The cost of providing services to other entities was $28.4 million, compared with $35.3 million in 2003. In 2004, as in 2003, the Treasury and other entities reimbursed the Reserve Banks for the costs of providing these services.

The most significant development in relation to the fiscal agency service in 2004 was the Reserve Banks' consolidation of operations that support the Treasury's retail securities programs, through which retail investors purchase and hold marketable Treasury securities and savings bonds. As the Treasury replaced paper processes in retail securities with more-efficient electronic processes, fewer operations sites were needed. In December 2003, the Treasury directed the Banks to consolidate their retail securities operations from seven sites to two. The consolidation has proceeded ahead of schedule and should be completed late in 2005. The Banks expect that in 2006, annual operating costs for the retail securities operations will decline significantly because of lower personnel costs.

Debt Services

The Reserve Banks auction, provide safekeeping for, and transfer marketable Treasury securities. Reserve Bank operating expenses for these activities totaled $23.4 million in 2004, an 8.3 percent increase from 2003. The Banks processed more than 156,000 tenders for Treasury securities, compared with 140,000 in 2003, and handled 2 million reinvestment requests, compared with 2.2 million in 2003. The Banks originated 10.7 million transfers of Treasury securities in 2004, a 13.6 percent increase from 2003. As of December 31, 2004, the Reserve Banks' Fedwire Securities Service maintained custody of $3.9 trillion (par value) of Treasury securities.

Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2002–2004

Thousands of dollars

Agency and service	2004	2003	2002
DEPARTMENT OF THE TREASURY			
Bureau of the Public Debt			
Treasury retail securities			
Savings bonds	72,385.1	66,403.7	68,888.3
TreasuryDirect and Treasury coupons	30,872.7	33,013.5	33,953.6
Treasury securities safekeeping and transfer	6,267.0	4,836.3	8,830.1
Treasury auction	17,159.5	16,802.6	14,597.6
Computer infrastructure development and support	5,935.1	7,836.7	2,349.6
Other services	1,709.8	1,460.7	2,385.8
Total	134,329.1	130,353.4	131,005.0
Financial Management Service			
Payment services			
Government check processing	24,245.4	25,624.7	30,284.4
Automated clearinghouse	5,352.9	6,253.9	6,280.0
Fedwire funds transfers	111.6	187.3	201.4
Other payment-related services	33,646.9	23,630.8	20,172.1
Collection services			
Tax and other revenue collections	34,248.4	29,782.9	26,361.3
Other collection-related services	12,922.8	12,532.6	10,296.4
Cash management services	21,835.8	18,227.8	17,310.8
Computer infrastructure development and support	52,673.3	24,575.3	7,592.6
Other services	6,931.6	6,666.2	5,415.8
Total	191,968.6	147,481.5	123,914.7
Other Treasury			
Total	15,106.1	13,913.5	14,471.2
Total, Treasury	341,403.7	291,748.5	269,390.9
OTHER FEDERAL AGENCIES			
Department of Agriculture			
Food coupons	4,519.0	7,791.4	10,240.8
U.S. Postal Service			
Postal money orders	7,774.6	10,959.5	12,381.6
Other agencies			
Other services	16,104.0	16,508.2	16,494.1
Total, other agencies	28,397.5	35,259.2	39,116.5
Total reimbursable expenses	369,801.2	327,007.7	308,507.4

In support of the Treasury's retail securities programs, the Reserve Banks operate TreasuryDirect, a program that allows retail investors to purchase and hold Treasury securities directly with the Treasury instead of through a broker. As the program was designed for investors who plan to hold their securities to maturity, TreasuryDirect provides custody services only. Reserve Bank operating expenses for TreasuryDirect totaled $30.9 million in 2004, compared with $33.0 million in 2003. In 2004, investors purchased 13.7 billion of Treasury securities through TreasuryDirect. As of December 31, 2004, TreasuryDirect held $62.2 billion (par value) of marketable Treasury securities.

TreasuryDirect customers may sell their securities for a fee through Sell Direct, a program operated by one of the Reserve Banks. That Bank sold approximately 15,000 securities worth $673.3 million in 2004, compared with more than 14,000 securities worth $671.6 million in 2003. It collected approximately $504,000 in fees on behalf of the Treasury, an increase of 2.6 percent from the more than $491,000 in fees collected in 2003.

Reserve Bank operating expenses for issuing, servicing, and redeeming savings bonds totaled $72.4 million in 2004, an increase of 9 percent from 2003. The Banks printed and mailed more than 35 million savings bonds, an 11.4 percent decrease from 2003. They issued more than 4.2 million Series I (inflation indexed) bonds and 25.4 million Series EE bonds. Reissued or exchanged bonds accounted for the remaining bonds printed. The Banks processed about 601,000 redemption, reissue, and exchange transactions, a 5.8 percent increase from 2003.

Payments Services

The Reserve Banks process both electronic and check payments for the Treasury. Reserve Bank operating expenses for processing government payments totaled $63.4 million in 2004, compared with $55.7 million in 2003. The Banks processed 940 million ACH payments for the Treasury, an increase of 3.0 percent from 2003, and 876,000 Fedwire funds transfers, a decrease of 11.5 percent from 2003 (the latter percentage reflects a restatement of previously reported data). They also processed 234.1 million paper government checks, a decline of 12.3 percent from 2003. In addition, the Banks issued more than 278,000 fiscal agency checks, a decrease of 10.4 percent from 2003.

In addition to processing payments, the Reserve Banks operate programs to help the Treasury increase the use of electronic payments. They operate a program that enables recipients of federal grants to request payments using the Internet. This application, the Automated Standard Application for Payment, processed $404.7 billion in Fedwire funds transfers and ACH payments in 2004, compared with $384.2 billion in 2003. The Banks also operate Treasury's stored value card program, which provides salary and allowance payments to military personnel, via a smart card, for use at military bases. In 2004, the Banks worked with the Treasury on plans for a web-based application to allow federal agencies and vendors to electronically exchange purchase orders and invoices and initiate ACH payments. The operating costs for these three programs totaled $15.4 million in 2004, compared with $14.3 million in 2003.

Collection Services

The Reserve Banks support several Treasury programs to collect funds owed the government. Reserve Bank operating expenses related to these programs totaled $47.2 million in 2004, compared with $42.3 million in 2003. The Banks operate the Federal Reserve Electronic Tax Application (FR-ETA) as an adjunct to the Treasury's Electronic Federal Tax Payment System (EFTPS). EFTPS allows businesses and individual taxpayers to pay their taxes electronically. Because EFTPS uses the automated clearinghouse to collect funds, tax payments must be scheduled at least one day in advance. Some business taxpayers, however, do not know their tax liability until the tax due date. FR-ETA, for wire payments, allows these taxpayers to use EFTPS by providing a sameday electronic federal tax payment alternative. FR-ETA collected $344.8 billion for the Treasury in 2004, compared with $275.8 billion in 2003.

The Reserve Banks also operate Pay.gov, a Treasury program that allows members of the public to make payments to the federal government over the Internet. They also operate the Treasury's Paper Check Conversion and Electronic Check Processing programs, whereby checks written to government agencies are converted at the point of sale or at lockbox locations into automated clearinghouse transactions. In 2004, the Reserve Banks originated more than 1.9 million ACH transactions through these programs, a 58.3 percent increase from the 1.2 million originated in 2003.

Cash Management Services

The Treasury maintains its bank account at the Reserve Banks and invests the funds it does not need for making current payments with qualified depository institutions through the Treasury Tax and Loan (TT&L) program, which the Reserve Banks operate. Reserve Bank operating expenses related to this program totaled $21.8 million in 2004, compared with $18.2 million in 2003. The investments either are callable on demand or are for a set term. In 2004, the Reserve Banks placed a total of $17.1 billion in immediately callable investments. The rate for term investments is set at Term Investment Option (TIO) auctions; the Reserve Banks held 45 TIO auctions in 2004, placing $309 billion in term investments, compared with 12 auctions placing $66 billion in 2003. In 2004, the Treasury's investment income, which comes from the TT&L program, was $87 million.

Services Provided to Other Entities

The Reserve Banks provide fiscal agency and depository services to other domestic and international entities when required to do so by the Secretary of the Treasury or when required or permitted to do so by federal statute. The majority of the work is securities-related.

Electronic Access

In November 2004, the Reserve Banks announced the general availability of FedLine Advantage, the next-generation platform for providing PC-based electronic access to Federal Reserve financial services. The new platform uses web technology to provide financial institutions with more-efficient access to such payments services as the Fedwire Funds Service, the Fedwire Securities Service, and FedACH Services. To complement the transition to web-based electronic access, the Reserve Banks completed consolidation of the electronic-access customer support function to two offices. The consolidation will improve the efficiency and consistency of customer support.

Information Technology

In 2004, the Federal Reserve Banks completed an initiative to standardize desktop hardware and software across Banks. In addition to reducing costs over the long term, the standardization is expected to facilitate interoperability, increase productivity, and improve the Federal Reserve's ability to respond to cyber security threats. Projects are now under way to standardize local area network components and telephone private branch exchange systems and to implement reduced-cost wide area network telecommunications services.

In partnership with the agencies that make up the Financial and Banking Information Infrastructure Committee, the Federal Reserve continued in 2004 to sponsor clearing and settlement utilities, key financial institutions, and key market participants in the national security/emergency preparedness programs offered by the Department of Homeland Security's National Communications System, which coordinates the preparedness of critical telecommunications services to meet natural disasters and national emergencies. During the year, the Federal Reserve participated in the President's National Security Telecommunications Advisory Committee Financial Services Task Force, which in April 2004 released a report on network resilience in support of critical financial services. The Reserve Banks are currently working with telecommunications vendors and other government agencies to identify policies that would improve the resilience of the telecommunications infrastructure for critical financial services functions.

Examinations of the Federal Reserve Banks

Section 21 of the Federal Reserve Act requires the Board of Governors to order an examination of each Federal Reserve Bank at least once a year. The Board engages a public accounting firm to perform an annual audit of the combined financial statements of the Reserve Banks (see the section "Federal Reserve Banks Combined Financial Statements"). The public accounting firm also audits the annual financial statements of each of the twelve Banks. The Reserve Banks use the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in assessing their internal controls over financial reporting, including the safeguarding of assets. In 2004, the Reserve Banks enhanced their assessments under the COSO framework, strengthening the key control assertion process, consistent with the requirements of the Sarbanes–Oxley Act of 2002. Within this framework, management of each Reserve Bank provides an assertion letter to its board of directors annually confirming adherence to COSO standards, and a public accounting firm certifies management's assertion and issues an attestation report to the Bank's board of directors and to the Board of Governors.

The firm engaged for the audits of the individual and combined financial statements of the Reserve Banks for 2004 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $2.0 million. To ensure auditor independence, the Board requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2004 the Reserve Banks did not engage PwC for non-audit services other than a training session at one Reserve Bank that was obtained at a rate available to the general public.

The Board's annual examination of the Reserve Banks includes a wide range of off-site and on-site oversight activities conducted by the Division of Reserve Bank Operations and Payment Systems. Division personnel monitor the activities of each Reserve Bank on an ongoing basis and conduct on-site reviews based on the division's risk-assessment methodology. The 2004 examinations also included assessing the efficiency and effectiveness of the internal audit function. To assess compliance with the policies established by the Federal Reserve's Federal Open Market Committee (FOMC), the division also reviews 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, PwC audits the schedule of participated asset and liability accounts and the related schedule of participated

Income, Expenses, and Distribution of Net Earnings of the Federal Reserve Banks, 2004 and 2003

Millions of dollars

Item	2004	2003
Current income	23,540	23,793
Current expenses	2,239	2,463
Operating expenses[1]	2,123	2,342
Earnings credits granted	116	121
Current net income	21,301	21,330
Net additions to (deductions from, −) current net income	918	2,481
Assessments by the Board of Governors	776	805
For expenditures of Board	272	297
For cost of currency	504	508
Net income before payments to Treasury	21,443	23,006
Dividends paid	582	518
Transferred to surplus	2,783	467
Payments to Treasury[2]	18,078	22,022

1. Includes a net periodic pension credit of $37 million in 2004 and net periodic pension costs of $58 million in 2003.

2. Interest on Federal Reserve notes.

income accounts at year-end. The FOMC receives the external audit reports and the report on the division's examination.

Income and Expenses

The accompanying table summarizes the income, expenses, and distributions of net earnings of the Federal Reserve Banks for 2003 and 2004.

Income in 2004 was $23,540 million, compared with $23,793 million in 2003. Expenses totaled $3,015 million ($2,123 million in operating expenses, $116 million in earnings credits granted to depository institutions, $272 million in assessments for expenditures by the Board of Governors, and $504 million for the cost of new currency). Revenue from priced services was $866 million. The profit and loss account showed a net profit of $918 million. The profit was due primarily to unrealized gains on assets denominated in foreign currencies revalued to reflect current market exchange rates. Statutory dividends paid to member banks totaled $582 million, $64 million more than in 2003; the increase reflects an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Reserve Banks.

Payments to the U.S. Treasury in the form of interest on Federal Reserve notes totaled $18,078 million in 2004, down from $22,022 million in 2003; the payments equal net income after the deduction of dividends paid and of the amount necessary to bring the surplus of the Reserve Banks to the level of capital paid in.

In the "Statistical Tables" section of this volume, table 5 details the income and expenses of each Reserve Bank for 2004 and table 6 shows a condensed statement for each Bank for the years 1914 through 2004. A detailed account of the assessments and expenditures of the Board of Governors appears in the section "Board of Governors Financial Statements."

Securities and Loans of the Federal Reserve Banks, 2002–2004
Millions of dollars except as noted

Item and year	Total	U.S. government securities[1]	Loans[2]
Average daily holdings[3]			
2002	621,834	621,721	113
2003	683,438	683,294	144
2004	719,647	719,494	153
Earnings[4]			
2002	25,527	25,525	2
2003	22,598	22,597	1
2004	22,347	22,344	3
Average interest rate (percent)			
2002	4.11	4.11	1.94
2003	3.31	3.31	1.00
2004	3.11	3.11	1.74

1. Includes federal agency obligations.
2. Does not include indebtedness assumed by the Federal Deposit Insurance Corporation.
3. Based on holdings at opening of business.
4. Earnings have not been netted with the interest expense on securities sold under agreements to repurchase.

Holdings of Securities and Loans

The Federal Reserve Banks' average daily holdings of securities and loans during 2004 amounted to $719,647 million, an increase of $36,209 million from 2003 (table). Holdings of U.S. government securities increased $36,200 million, and holdings of loans increased $9 million. The average rate of interest earned on the Reserve Banks' holdings of government securities declined to 3.11 percent, from 3.31 percent in 2003, and the average rate of interest earned on loans increased to 1.74 percent, from 1.00 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 2001 through 2004.

Federal Reserve Bank Premises

In 2004, construction continued on the new buildings for the Dallas Federal Reserve Bank's Houston Branch and the Chicago Bank's Detroit Branch.

Security enhancement programs prompted by the events of September 11, 2001, continue at several facilities. One such project is an ongoing external perimeter security improvement project at the Boston Bank that involves restoration of the Bank's property after recently completed construction of the Central Artery, an underground roadway.

The Kansas City Bank purchased property and retained design and construction consultants for its new headquarters building project. The Board approved the project's schematic design, and work continues on the final design. The Board approved the St. Louis Bank's purchase of a building to be renovated as a business-continuity relocation facility.

The Richmond Bank purchased and renovated a building as a relocation site for critical staff. Design work on additional security improvements continued.

The Dallas Bank continues to pursue the purchase of property behind its headquarters building for the construction of a remote vehicle screening and shipping/receiving facility.

As part of its long-term facility redevelopment program, the St. Louis Bank purchased and renovated a parking garage for staff parking and a warehouse for remote screening of deliveries. The Bank retained design consultants for expansion of the Bank's headquarters building, and design work began.

The San Francisco Bank retained design and construction consultants for the new Seattle Branch building and finalized an agreement to purchase property for the new building. Design work has begun.

The multiyear renovation program continued at the New York Bank's headquarters building.

Several Banks continue to implement facility renovation projects to accommodate the consolidation of check activities.

Agreements were reached in 2004 to sell the buildings housing the New York Bank's Buffalo Branch, the St. Louis Bank's Louisville Branch, and the Chicago Bank's Milwaukee facility. Administration activities for the Buffalo and Louisville Branches will be moved to leased space. ■

Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 2004 and 2003

Millions of dollars

Item	2004		2003	
Short-term assets (Note 1)				
Imputed reserve requirements on clearing balances	1,115.7		1,296.4	
Imputed investments	9,691.9		11,332.5	
Receivables	75.8		77.1	
Materials and supplies	1.9		2.3	
Prepaid expenses	31.8		35.6	
Items in process of collection	6,107.1		5,271.9	
Total short-term assets		17,024.1		18,015.8
Long-term assets (Note 2)				
Premises	471.8		494.6	
Furniture and equipment	152.8		179.4	
Leases, leasehold improvements, and long-term prepayments	107.9		103.2	
Prepaid pension costs	795.4		787.9	
Total long-term assets		1,528.0		1,565.1
Total assets		18,552.1		19,580.9
Short-term liabilities				
Clearing balances and balances arising from early credit of uncollected items	11,909.5		11,788.1	
Deferred-availability items	5,354.3		6,448.3	
Short-term debt	.0		.0	
Short-term payables	92.2		78.1	
Total short-term liabilities		17,355.9		18,314.4
Long-term liabilities				
Long-term debt	.0		.0	
Postretirement/postemployment benefits obligation	268.6		287.5	
Total long-term liabilities		268.6		287.5
Total liabilities		17,624.5		18,601.9
Equity		927.6		979.0
Total liabilities and equity (Note 3)		18,552.1		19,580.9

NOTE. Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

Pro Forma Income Statement for Federal Reserve Priced Services, 2004 and 2003

Millions of dollars

Item	2004		2003	
Revenue from services provided to depository institutions (Note 4)		865.9		886.9
Operating expenses (Note 5)		800.6		941.6
Income from operations		65.3		−54.7
Imputed costs (Note 6)				
Interest on float	−.1		−.7	
Interest on debt	.0		.0	
Sales taxes	11.6		12.1	
FDIC insurance	.0	11.4	.0	11.4
Income from operations after imputed costs		53.8		−66.1
Other income and expenses (Note 7)				
Investment income	156.8		108.0	
Earnings credits	−108.1	48.7	−113.2	−5.2
Income before income taxes		102.5		−71.3
Imputed income taxes (Note 6)		30.6		−21.7
Net income		72.0		−49.6
MEMO: Targeted return on equity (Note 6)		112.4		104.7

NOTE. Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 2004

Millions of dollars

Item	Total	Commercial check collection	Fedwire funds	Fedwire securities	Commercial ACH	Noncash services
Revenue from services (Note 4)	865.9	719.7	54.1	19.3	71.1	1.8
Operating expenses (Note 5)	800.6	678.5	47.2	15.2	58.6	1.2
Income from operations	65.3	41.2	6.9	4.1	12.5	.6
Imputed costs (Note 6)	11.4	9.7	.7	.3	.7	.0
Income from operations after imputed costs	53.8	31.4	6.2	3.8	11.8	.6
Other income and expenses, net (Note 7)	48.7	40.5	3.0	1.1	4.0	.1
Income before income taxes	102.5	71.9	9.2	4.9	15.8	.7
Imputed income taxes (Note 6)	30.6	21.4	2.8	1.4	4.7	.2
Net income	72.0	50.5	6.5	3.4	11.1	.5
MEMO: Targeted return on equity (Note 6)	112.4	93.6	6.8	2.9	8.9	.2

NOTE. Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

FEDERAL RESERVE BANKS

Notes to Pro Forma Financial Statements for Priced Services

(1) Short-Term Assets

The imputed reserve requirement on clearing balances held at Reserve Banks by depository institutions reflects a treatment comparable to that of compensating balances held at correspondent banks by respondent institutions. The reserve requirement imposed on respondent balances must be held as vault cash or as non-earning balances maintained at a Reserve Bank; thus, a portion of priced services clearing balances held with the Federal Reserve is shown as required reserves on the asset side of the balance sheet. Another portion of the clearing balances is used to finance short-term and long-term assets. The remainder of clearing balances is assumed to be invested in a portfolio of investments, shown as imputed investments. For 2003, imputed investments were assumed to be three-month Treasury bills.

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 a credit to expenses of $7.5 million in 2004 and expenses of $21.3 million in 2003 and a corresponding increase and decrease in this asset account.

(3) Liabilities and Equity

Under the matched-book capital structure for assets, short-term assets are financed with short-term payables and clearing balances. Long-term assets are financed with long-term liabilities and clearing balances. As a result, no short- or long-term debt is imputed. 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.

Equity is imputed at 5 percent of total assets based on the Federal Deposit Insurance Corporation's definition of a well-capitalized institution for deposit insurance premium purposes.

(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 $7.6 million in 2004 and $6.4 million in 2003. The credit to expenses under SFAS 87 (see note 2) is reflected in operating expenses.

The income statement by service reflects revenue, operating expenses, and imputed costs. Certain corporate overhead costs not closely related to any particular priced service are allocated to priced services in total based on an expense-ratio method, but are allocated among priced services based on management decision. Corporate overhead was allocated among the priced services during 2004 and 2003 as follows (in millions):

	2004	2003
Check	33.5	38.9
ACH	3.4	3.3
Fedwire funds	2.5	2.1
Fedwire securities	1.3	1.1
Noncash services	.1	.1
Total	40.8	45.5*

(6) Imputed Costs

Imputed costs consist of income taxes, return on equity, interest on debt, sales taxes, the FDIC assessment, and interest on float. Many imputed costs are derived from the private-sector adjustment factor (PSAF) model, which uses bank holding companies as the proxy for a private-sector firm. The cost of debt and the effective tax rate from the PSAF model are used to impute debt and income taxes. The after-tax rate of return on equity is used to impute the profit that would have been earned had the services been provided by a private-sector firm.

Interest is imputed on the debt assumed necessary to finance priced-service assets; however, no debt was

* Restatement of previously reported total.

imputed in 2004 or 2003. The sales taxes and FDIC assessment that the Federal Reserve would have paid had been a private-sector firm are also among the components of the PSAF.

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.

Float cost or income is based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses less shipping expenses for each 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 actual float by the Reserve Banks for 2004 in millions of dollars:

Total float	−13.5
Unrecovered float	19.4
Float subject to recovery	−33.0
Sources of recovery of float	
Income on clearing balances	−3.3
As-of adjustments	−62.8
Direct charges	823.4
Per-item fees	−915.9

Unrecovered float includes float generated by services to government agencies and by other central bank services. Float recovered through income on clearing balances is the result of the increase in investable clearing balances; the increase is produced by a deduction for float for cash items in process of collection, which reduces imputed reserve requirements. The income on clearing balances reduces the float to be recovered through other means. As-of adjustments and direct charges refer to float that is created by interterritory check transportation and the observance of non-standard holidays by some depository institutions. Such float may be recovered from the depository institutions through adjustments to institution reserve or clearing balances or by billing institutions directly. Float recovered through direct charges and per-item fees is valued at the federal funds rate; credit float recovered through per-item fees has been subtracted from the cost base subject to recovery in 2004.

(7) Other Income and Expenses

Consists of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances for 2004 represents the average coupon-equivalent yield on three-month Treasury bills plus a constant spread, based on the return on a portfolio of investments. For 2003, the investment income is based on the yield of the three-month Treasury bill. In both years, the return is 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 a discounted average coupon-equivalent yield on three-month Treasury bills in 2004 and the average federal funds rate in 2003 to the *required* portion of the clearing balances, adjusted for the net effect of reserve requirements on clearing balances.

The Board of Governors and the Government Performance and Results Act

Under the Government Performance and Results Act of 1993 (GPRA), federal agencies are required to prepare, in consultation with Congress and outside stakeholders, a strategic plan covering a multiyear period and to submit annual performance plans and performance reports. Though not covered by the act, the Board of Governors is voluntarily complying with many of the act's mandates.

Strategic Plan, Performance Plan, and Performance Report

The Board's latest strategic plan in the GPRA format, released in August 2004, covers the period 2004–08. The document articulates the Board's mission, sets forth major goals for the period, outlines strategies for achieving those goals, and discusses the environment and other factors that could affect their achievement. It also addresses issues that cross agency jurisdictional lines, identifies key quantitative measures of performance, and discusses performance evaluation.

The 2004–05 performance plan and the 2002–03 performance report were posted on the Board's public web site in August 2004 for access by Congress, the public, and the Government Accountability Office (formerly the General Accounting Office). The performance plan sets forth specific targets for some of the performance measures identified in the strategic plan. The performance plan also describes the operational processes and resources needed to meet those targets and discusses data validation and verification of results. The performance report indicates that the Board generally met its explicit goals for 2002–03.

The strategic plan, performance plan, and performance report are available on the Board's public web site (www.federalreserve.gov/boarddocs/rptcongress/). The Board's mission statement and a summary of the goals and objectives set forth in the strategic plan and performance plan are given below.

Mission

The mission of the Board is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems so as to promote optimal macroeconomic performance.

Goals and Objectives

The Federal Reserve has five primary goals with interrelated and mutually reinforcing elements:

Goal

To conduct monetary policy that promotes the achievement of maximum sustainable long-term growth and the price stability that fosters that goal.

Objectives

- Stay abreast of recent developments and prospects in the U.S. economy and financial markets, and in those abroad, so that monetary policy decisions will be well informed.

- Enhance our knowledge of the structural and behavioral relationships in the macroeconomic and financial markets, and improve the quality of the data used to gauge economic performance, through developmental research activities.
- Implement monetary policy effectively in rapidly changing economic circumstances and in an evolving financial market structure.
- Contribute to the development of U.S. international policies and procedures, in cooperation with the U.S. Department of the Treasury and other agencies.
- Promote an understanding of Federal Reserve policy among other government policy officials and the general public.

Goal

To promote a safe, sound, competitive, and accessible banking system and stable financial markets.

Objectives

- Promote overall financial stability, manage and contain systemic risk, and ensure that emerging financial problems are identified early and successfully resolved before they become crises.
- Provide a safe, sound, competitive, and accessible banking system through comprehensive and effective supervision of U.S. banks, bank and financial holding companies, foreign banking organizations, and related entities.
- Enhance efficiency and effectiveness, while remaining sensitive to the burden on supervised institutions, by addressing the supervision function's procedures, technology, resource allocation, and staffing issues.
- Promote adherence by domestic and foreign banking organizations supervised by the Federal Reserve with applicable laws, rules, regulations, policies, and guidelines through a comprehensive and effective supervision program.

Goal

To enforce the consumer financial services laws fully and fairly, protect and promote the rights of consumers under these laws, and encourage banks to meet the credit needs of consumers, including those in low- and moderate-income neighborhoods.

Objectives

- Maintain a strong consumer compliance supervision and complaint investigation program that protects consumers and reflects the rapidly changing financial services industry.
- Implement statutes designed to inform and protect consumers that reflect congressional intent, while achieving the proper balance between consumer protection and industry costs.
- Promote equal access to banking services.
- Promote community development in historically underserved areas.

Goal

To provide high-quality professional oversight of Reserve Banks

Objective

- Produce high-quality assessments of Federal Reserve Bank operations, projects, and initiatives to help Federal Reserve management foster and strengthen sound internal control systems and efficient and effective performance.

Goal

To foster the integrity, efficiency, and accessibility of U.S. payment and settlement systems.

Objectives

- Develop sound, effective policies and regulations that foster payment system integrity, efficiency, and accessibility. Support and assist the Board in overseeing U.S. dollar payment and securities settlement systems against relevant policy objectives and standards.
- Conduct research and analysis that contributes to policy development and increases the Board's and others' understanding of payment system dynamics and risk.

Interagency Coordination

Interagency coordination helps focus efforts to eliminate redundancy and lower costs. As mandated by GPRA and in conformance with past practice, the Board has worked closely with other federal agencies to consider plans and strategies for programs such as bank supervision that transcend the jurisdiction of each agency. Coordination of activities with the U.S. Department of the Treasury and other agencies is evident throughout both the strategic plan and the performance plan. Given the degree of similarity in the agencies' missions and the existence of the Federal Financial Institutions Examination Council (FFIEC), the most formal coordination effort has occurred jointly with the other depository institution regulatory agencies.[1] In addition, a coordinating committee of the depository institution regulatory agencies was created to address and report on issues of mutual concern. This interagency working group has been meeting since June 1997 to work on issues related to those general goals and objectives that cross agency functions, programs, and activities. Whether interagency coordination was effected through the FFIEC, the coordinating group, or interaction between agency staff, the results have been positive—resulting in improved planning for the agencies and substantial benefits to the public. ■

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

Federal Legislative Proposals

In 2004, the Board of Governors proposed and supported a number of legislative initiatives that would reduce regulatory burden on financial institutions and benefit consumers without undermining the safety and soundness of insured depository institutions, consumer protection, or other important public policy principles, such as the principle of competitive fairness. The Board recommended that Congress adopt legislation that, among other things, would remove restrictions on the payment of interest on balances held at Federal Reserve Banks and on demand deposits. The Board also recommended that Congress adopt legislation that would give the Board greater flexibility in setting reserve requirements for depository institutions and would ease restrictions on interstate branching by banks. These proposals are summarized below.

Interest on Depository Institution Balances Held at Federal Reserve Banks

The Board is obliged by law to establish reserve requirements for certain deposits held at depository institutions, for the purpose of implementing monetary policy. Banks, thrift institutions, and credit unions may satisfy their reserve requirements by holding vault cash, a balance in an account at a Federal Reserve Bank, or a combination thereof. Unnecessary restrictions on the payment of interest on balances at Reserve Banks could distort market prices and lead to economically wasteful efforts to circumvent the restrictions. The payment of interest on balances at Reserve Banks would remove a substantial portion of the incentive for depository institutions to engage in avoidance measures, and the resulting improvements in efficiency could be expected to eventually be passed through to bank borrowers and depositors. When depository institutions keep their balances at Reserve Banks as low as possible to minimize the cost of holding these non-interest-bearing assets, their actions could lead to volatility in the federal funds rate. Payment of interest on balances at Reserve Banks could help eliminate the need for these actions and help ensure that the Federal Reserve can continue to implement monetary policy using existing procedures. The Board therefore recommended legislation that explicitly authorizes the payment of interest on balances held by depository institutions at Federal Reserve Banks.

Interest on Demand Deposits

The Board restated in 2004 its longstanding recommendation that Congress repeal the statutory prohibition against the payment of interest on demand deposits. Since the advent of NOW accounts, the prohibition has effectively applied only to checking accounts held by businesses and other for-profit entities. At the time it enacted the Depression-era legislation, Congress was concerned that large money center banks were bidding deposits away from smaller community banks to make loans to stock market speculators, depriving rural areas of financing. This rationale no longer appears applicable, as funds flow freely around the country and among banks of all sizes to find the most profitable lending opportunities. The prohibition against the payment of interest on demand deposits distorts the pricing of transaction deposits and associated bank services; to compete for businesses' liquid assets, banks have set up complicated procedures for implicitly paying interest. The prohibition also distorts the pricing of other bank products. Because banks cannot pay explicit interest on demand deposits, they often try to attract those deposits by pricing other bank services below their actual cost. When services are offered below cost, they tend to be overused to the extent that the benefits of consuming them are less than the costs to society of producing them.

The prohibition against the payment of interest on demand deposits has also led to the introduction of deposit "sweep" services, which permit institutions and their customers to avoid the prohibition's effects to a large extent. Banks spend resources—and charge fees—for nightly sweeping businesses' excess demand deposits into money market investments. The progress of computer technology has reduced the cost of sweep services, but the expenses are not trivial, particularly when systems must be upgraded or the diverse systems of merging banks must be integrated. From the standpoint of the overall economy, such expenses are a waste of resources and would be unnecessary if the payment of interest on demand deposits was allowed.

Depository Institution Reserve Requirements

The Federal Reserve Act requires that banks and other depository institutions maintain reserves against certain types of deposit accounts, also for the purpose of implementing monetary policy. Currently, the Board is constrained in its flexibility to adjust reserve requirements: By law, the ratio of required reserves to transaction account deposits above a certain level must be set between 8 percent and 14 percent. The Board in 2004 supported a legislative proposal to increase the range within which it may set transaction account reserve requirements, so that it could lower the requirements to zero percent if, at some point in the future, the Board believes it in the best interests of monetary policy to do so. Lower reserve requirement ratios could be possible if explicit statutory authority to pay interest on balances held by depository institutions at Federal Reserve Banks were to be granted concurrently with greater flexibility in setting reserve requirements.

Interstate Branching

Currently, national and state banks are permitted to expand into additional states through the acquisition of another bank. However, if they do not acquire another bank, they may open a branch in an additional state only if the host state has adopted legislation that expressly permits de novo interstate branching (an "opt-in requirement"). As of 2004, only eighteen states had enacted legislation expressly authorizing interstate branching.

The restriction on de novo branching is an obstacle to interstate banking, particularly for small banks that seek to operate across state lines, and may limit competition and access to banking services. Branch entry into new markets leads to less concentration in local banking markets, which in turn results in better banking services for households and small businesses, lower interest rates on loans, and higher interest rates on deposits. Allowing banks to operate freely across state lines also benefits customers as they become more mobile and live, work, and operate in multiple states. The restriction also places banks at a competitive disadvantage in relation to federal savings associations, which are allowed to open de novo branches in any state.

In light of the benefits, the Board recommended that Congress eliminate the opt-in requirement for interstate branching by banks and affirmatively authorize national and state banks to establish interstate branches on a de novo basis. Under the Board's proposal, the establishment and operation of new interstate branches by banks would continue to be subject to the other regulatory provisions and conditions established by Congress for de novo interstate branches, including the financial, managerial, and Community Reinvestment Act requirements set forth in the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994.

A special exception in existing law allows companies to own an FDIC-insured industrial loan company (ILC) without being subject to the type of consolidated supervision and activities restrictions generally applicable to the owners of insured banks. The number, size, and powers of ILCs generally were limited when the ILC exception was adopted in 1987; however, the number and size of ILCs operating under this exception recently have increased significantly, and some states have granted ILCs essentially all the powers of commercial banks.

If legislative changes were to permit ILCs to branch de novo on an interstate basis, companies that are not supervised or regulated on a consolidated basis would be able to operate a nationwide banking institution. Such a result would be inconsistent with the basis on which the exception for ILCs initially was granted—that the activities of these institutions were, and would remain, limited in scope. In addition, allowing companies to own an ILC that operates a nationwide banking franchise without being subject to the type of consolidated supervision generally required of the owners of other insured banks would raise significant safety and soundness concerns and place commercial banks and their owners at a substantial competitive disadvantage. Moreover, because any type of firm, including a commercial or retail firm, may own an ILC, permitting these institutions to branch de novo nationwide has the potential to undermine seriously the separation of banking and commerce.

For these reasons, the Board's proposal would require the owners of ILCs that establish interstate branches to operate within the same supervisory regime that generally applies to other companies that own insured banks. Importantly, the Board's proposal would not alter the rights of companies that own ILCs that continue to operate on a limited basis. ■

Records

Record of Policy Actions of the Board of Governors

Regulation B
Equal Credit Opportunity

Regulation E
Electronic Fund Transfers

Regulation M
Consumer Leasing

Regulation Z
Truth in Lending

Regulation DD
Truth in Savings

[Docket Nos. R-1168, R-1169, R-1170, R-1167, and R-1171]

On June 22, 2004, the Board withdrew revisions proposed in December 2003 to define more specifically the standard for providing "clear and conspicuous" disclosures to consumers and to provide a more uniform standard for those disclosures among the regulations. In light of public comment, the Board concluded that improving the effectiveness of the disclosures required by each regulation rather than adopting general definitions and standards would better ensure that consumers receive noticeable and understandable information about consumer financial products and services.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

NOTE. Full texts of the policy actions are available via the online version of the Annual Report, from the "Reading Rooms" on the Board's FOIA web page, and on request from the Board's Freedom of Information Office.

Regulation C
Home Mortgage Disclosure

[Docket No. R-1186]

On December 10, 2004, the Board revised the tables used to publicly disclose mortgage lending data in light of revisions to the regulation that require lending institutions to report additional data, including loan pricing and other data, under the Home Mortgage Disclosure Act. The new data reporting requirements begin January 1, 2004, and the revised tables are expected to be implemented in summer or fall 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Olson, Bernanke, and Kohn. Absent and not voting: Governor Bies.

Regulation D
Reserve Requirements of Depository Institutions

[Docket No. R-1213]

On October 5, 2004, the Board approved amendments to reflect the annual indexing of the low reserve tranche and of the reserve requirement exemption for use in 2005 reserve requirement calculations. The amendments increase the 3 percent low reserve tranche for net transaction accounts to $47.6 million (from $45.4 million in 2004) and the reserve requirement exemption to $7 million (from $6.6 million in 2004).

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

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

Regulation Y
Bank Holding Companies and
Change in Bank Control

[Docket No. R-1162]

On July 19, 2004, the Board, acting with the other federal bank and thrift regulatory agencies, approved interagency amendments to provide for the risk-based capital treatment of asset-backed commercial paper program assets that have been consolidated in accordance with Financial Accounting Standards Board Interpretation No. 46, as revised (FIN 46-R). The amendments are effective September 30, 2004, and replace an interim risk-based capital treatment approved in October 2003 and extended in April 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

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

Regulation K
International Banking Operations

Regulation V
Fair Credit Reporting

Regulation Y
Bank Holding Companies and
Change in Bank Control

[Docket No. R-1199]

On December 16, 2004, the Board, acting with the other federal bank and thrift regulatory agencies, approved interagency amendments to implement provisions of the Fair and Accurate Credit Transactions Act that require financial institutions to adopt measures for properly disposing of consumer information derived from consumer reports. The amendments are effective July 1, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Regulation J
Collection of Checks
and Other Items by
Federal Reserve Banks and
Funds Transfers through Fedwire

[Docket No. R-1202]

On October 22, 2004, the Board approved amendments to provide for the rights and obligations of depository institutions and Federal Reserve Banks in connection with items handled in electronic form by the Reserve Banks. The amendments ensure that the regulation covers the entire range of check-processing services that the Reserve Banks will offer in light of the Check Clearing for the 21st Century Act. They are effective October 28, 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Regulation V
Fair Credit Reporting

[Docket Nos. R-1172, R-1175, and R-1187]

On February 5, 2004, the Board, acting with the Federal Trade Commission, approved interagency amendments to establish effective dates for certain provisions of the Fair and Accurate Credit Transactions Act (FACT Act). The amendments establish December 31, 2003, as the effective date for the FACT Act provisions that preempt state laws regulating areas governed by the Fair Credit Reporting Act. The amendments also establish March 31, 2004, as the effective date for FACT Act provisions that require no changes, or minimal changes, to existing business procedures and December 1, 2004, as the effective date for provisions that involve changes requiring a significant implementation period or regulatory action. The amendments are effective March 12, 2004, and replace an interim rule adopted in December 2003 that established the December 31 effective date.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

On June 8, 2004, the Board approved amendments providing model notices that financial institutions may use to comply with the notice requirements of the FACT Act when furnishing negative information to consumer reporting agencies. The amendments are effective July 16, 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Regulation Z
Truth in Lending

[Docket No. R-1167]

On March 25, 2004, the Board approved amendments to clarify that the term "amount" in the description of disclosure requirements refers to a numerical amount and to provide guidance on consumers' exercise of the right to rescind certain home-secured loans. The amendments are effective April 1, 2004, and compliance is mandatory by October 1, 2004.

Votes for this action: Chairman Greenspan and Governors Gramlich, Bies, Olson, Bernanke, and Kohn. Absent and not voting: Vice Chairman Ferguson.

Regulation BB
Community Reinvestment

[Docket No. R-1181]

On July 16, 2004, the Board withdrew proposed amendments that would have (1) raised the asset threshold for streamlined Community Reinvestment Act (CRA) evaluations of state member banks from $250 million to $500 million and (2) allowed examiners to lower a state member bank's CRA rating if the bank engaged in a pattern or practice of abusive asset-based lending. In light of public comment, the Board concluded that the uncertain savings to institutions from increasing the threshold did not clearly justify the potential adverse effects on community development in certain rural communities. It also noted that commenters were united in their opposition to defining abusive asset-based lending in the regulation to the exclusion of other abusive practices. The Board and the other federal bank and thrift regulatory agencies had proposed identical amendments to their CRA regulations in February 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Regulation CC
Availability of Funds and Collection of Checks

[Docket No. R-1176]

On July 27, 2004, the Board approved amendments that add a subpart D, with commentary, to implement the Check Clearing for the 21st Century Act. Subpart D sets forth the new requirements for banks, including indorsement and identification requirements for substitute checks, and contains model notices, including a model consumer-awareness disclosure. The amendments also clarify provisions of the regulation and its commentary. They are effective October 28, 2004, with the exception of appendix C's model consumer-awareness disclosure, which is effective immediately, and appendix D's requirement that bank indorsements and identifications be printed in black ink, which is effective January 1, 2006.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, Bernanke, and Kohn. Absent and not voting: Governor Gramlich.

Rules of Practice for Hearings

[Docket No. OP-1211]

On September 20, 2004, the Board approved amendments to increase the maximum amount of each statutory civil money penalty under its jurisdiction to account for inflation, as required by the Debt Collection Improvement Act. The amendments are effective October 12, 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Policy Statements and Other Actions

Unfair or Deceptive Acts or Practices by State-Chartered Banks [Interagency Guidance]

On March 9, 2004, the Board, acting with the Federal Deposit Insurance Corporation, issued interagency guidance on the standards used by the two agencies to determine whether acts or practices by state-chartered banks are unfair or deceptive under the Federal Trade Commission Act. The guidance also addresses measures and "best practices" that banks may use to avoid such acts or practices.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Policy Statement on Payments System Risk

[Docket Nos. OP-1182 and OP-1191]

On September 22, 2004, the Board revised its policy to modify the daylight overdraft measurement rules for interest and redemption payments on securities issued by government-sponsored enterprises (GSEs) and certain international organizations and to align the treatment of the general corporate account activity of these entities with that of other Federal Reserve account holders that do not have regular access to the discount window. The revised policy also reflects recent changes to the operating hours of the online Fedwire Funds Service and clarifies or updates certain items. The revisions related to GSEs and certain international organizations are effective July 20, 2006, and the other revisions are effective September 22, 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

On November 24, 2004, the Board revised the part of its policy dealing with risks and risk management in payments and securities settlement systems. In general, the revisions expand the policy's scope to include those Federal Reserve Bank payments and securities settlement systems that meet the policy's application criteria, revise general risk-management expectations for systems subject to the policy, and incorporate standards for payments and securities settlement systems that are systemically important. The revisions are effective January 2, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Bank Holding Company Rating System

[Docket No. OP-1207]

On December 1, 2004, the Board revised its bank holding company rating system to emphasize risk management, implement a comprehensive and adaptable framework for analyzing and rating financial factors, and provide a framework for assessing and rating the potential impact of a bank holding company's nondepository entities on its subsidiary depository institutions. The revised rating system is effective January 1, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

Discount Rates in 2004

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, subject to review and determination by the Board of Governors.

Primary Credit Rate

Primary credit is the Federal Reserve's main lending program. Primary credit is made available with minimal administration for very short terms as a backup source of liquidity to depository institutions that, in the judgment of the lending Federal Reserve Bank, are in generally sound financial condition. Primary credit is extended at a rate above the Federal Open Market Committee's (FOMC's) federal funds rate target.

During 2004, the Board approved five increases in the primary credit rate, bringing the rate from 2 percent to 3¼ percent. The Board reached its determinations on the primary credit rate recommendations of the Reserve Bank boards of directors in conjunction with the FOMC's decisions to raise the target federal funds rate from 1 percent to 2¼ percent and related economic and financial developments. In the first half of the year, disappointing employment growth and the continued slack in resource utilization led the Board and FOMC to maintain a highly accommodative stance of monetary policy. By midyear, however, output and employment had begun to show persistent improvements and there were indications of some increase in inflation, so the Board and FOMC began to gradually move the structure of policy rates toward a more neutral setting. Monetary policy developments are reviewed more fully elsewhere in this report (see the section "Monetary Policy and Economic Developments" and the minutes of FOMC meetings held in 2004).

Secondary and Seasonal Credit Rates

Secondary credit is available in appropriate circumstances to depository institutions that do not qualify for primary credit. The secondary credit rate is set on the basis of a formula at a spread—50 basis points in 2004—above the primary credit rate.

Seasonal credit is available to smaller depository institutions to meet liquidity needs that arise from regular swings in their loans and deposits. The rate on seasonal credit is calculated every two weeks as an average of selected money market yields, typically resulting in a rate close to the federal funds rate target.

At year-end, the secondary and seasonal credit rates were 3¾ percent and 2.35 percent, respectively.

Votes on Discount Rate Changes

About every two weeks during 2004, the Board approved proposals by the Reserve Banks to maintain the formulas for computing the secondary and seasonal credit rates. Details on the five actions by the Board to approve changes in the primary credit rate are provided below.

June 30, 2004. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 2¼ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective July 1, 2004.

> Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn. Votes against this action: None.

August 10, 2004. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 2½ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective August 11, 2004.

> Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn. Votes against this action: None.

September 21, 2004. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 2¾ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective September 22, 2004.

> Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn. Votes against this action: None.

November 10, 2004. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, and Kansas City to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 3 percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective November 12, 2004.

The Board also approved identical actions subsequently taken by the directors of the Federal Reserve Banks of San Francisco, effective November 10, 2004, and Dallas, effective November 12, 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn. Votes against this action: None.

December 14, 2004. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 3¼ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective December 15, 2004.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn. Votes against this action: None. ■

Minutes of Federal Open Market Committee Meetings

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

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

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

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market operations, the Federal Reserve Bank of New York operates under three sets of instructions from the Federal Open Market Committee: an Authorization for Domestic Open Market Operations, Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues, and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Committee operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations. These policy instruments are shown below in the form in which they were in effect at the beginning of 2004. 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, 2004

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

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the

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

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account;

(c) To sell U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding. The Federal Reserve Bank of New York shall set a minimum lending fee consistent with the objectives of the program and apply reasonable limitations on the total amount of a specific issue that may be auctioned and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat

in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues

In Effect January 1, 2004

1. System open market operations in Federal agency issues are an integral part of total System open market operations designed to influence bank reserves, money market conditions, and monetary aggregates.

2. System open market operations in Federal agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

Domestic Policy Directive

In Effect January 1, 2004[1]

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1 percent.

The Committee also approved the sentences below for inclusion in the press statement to be released shortly after the December 9, 2003, meeting:

1. Adopted by the Committee at its meeting on December 9, 2003.

The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation.

Authorization for Foreign Currency Operations

In Effect January 1, 2004

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

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

Canadian dollars	Mexican pesos
Danish kroner	Norwegian kroner
Euro	Swedish kronor
Pounds sterling	Swiss francs
Japanese yen	

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

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

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

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

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada	2,000
Bank of Mexico	3,000

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

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

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

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

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency 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, 2004

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

2. To achieve this end the System shall:

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

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

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

3. Transactions may also be undertaken:

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

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

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

4. System foreign currency operations shall be conducted:

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

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

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

Procedural Instructions with Respect to Foreign Currency Operations

In Effect January 1, 2004

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 January 27–28, 2004

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., starting at 2:00 p.m. on Tuesday, January 27, 2004, and continuing at 9:00 a.m. on Wednesday, January 28, 2004.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Messrs. McTeer, Moskow, Santomero, 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. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Fuhrer, Hakkio, Howard, Madigan, Rasche, Slifman, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Ettin[2], Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Oliner and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Clouse,[2] and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

2. Attended Wednesday's session only.

Mr. Kamin and Ms. Zickler,[3] Deputy Associate Directors, Divisions of International Finance and Research and Statistics respectively, Board of Governors

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

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Messrs. Nelson and Wood,[3] Senior Economists, Divisions of Monetary Affairs and International Finance respectively, Board of Governors

Mr. Carpenter,[3] Economist, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Messrs. Eisenbeis, Evans, Goodfriend, Ms. Mester, Messrs. Rolnick and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Chicago, Richmond, Philadelphia, Minneapolis, and Dallas respectively

Messrs. Elsasser and Rudebusch, Vice Presidents, Federal Reserve Banks of New York and San Francisco respectively

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 2004, and ending December 31, 2004, had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

Timothy F. Geithner, President of the Federal Reserve Bank of New York, with a vacancy in the position of alternate member for the Federal Reserve Bank of New York

Cathy E. Minehan, President of the Federal Reserve Bank of Boston, with Anthony M. Santomero, President of the Federal Reserve Bank of Philadelphia, as alternate

Sandra Pianalto, President of the Federal Reserve Bank of Cleveland, with Michael H. Moskow, President of the Federal Reserve Bank of Chicago, as alternate

William Poole, President of the Federal Reserve Bank of St. Louis, with Robert D. McTeer, Jr., President of the Federal Reserve Bank of Dallas, as alternate

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

Following this meeting the board of directors of the Federal Reserve Bank of New York appointed Christine M. Cumming to the position of First Vice President of the Bank, effective February 6, 2004. The directors also elected her to serve as an alternate member of the Federal Open Market Committee representing the Federal Reserve Bank of New York. Subsequently, Ms. Cumming executed her oath of office as an alternate member of the Committee, effective for the period from February 20 to December 31, 2004.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until

3. Attended portion of meeting relating to the Committee's review of the economic outlook.

the election of their successors at the first regularly scheduled meeting of the Committee after December 31, 2004, 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
Timothy F. Geithner	Vice Chairman
Vincent R. Reinhart	Secretary and Economist
Normand R.V. Bernard	Deputy Secretary
Michelle A. Smith	Assistant Secretary
J. Virgil Mattingly, Jr.	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Karen H. Johnson	Economist
David J. Stockton	Economist

Thomas A. Connors, Christine M. Cumming, Jeffrey C. Fuhrer, Craig S. Hakkio, David H. Howard, Brian F. Madigan, Robert H. Rasche, Lawrence Slifman, Mark S. Sniderman, and David W. Wilcox, Associate Economists

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first regularly scheduled meeting of the Committee after December 31, 2004.

By unanimous vote, Dino Kos was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.[4]

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

By unanimous vote, the Committee amended its Program for Security of FOMC Information on January 27, 2004, by making small clarifying additions or changes relating especially to electronic transmissions of confidential information.

By unanimous vote, the Authorization for Domestic Open Market Operations was amended in the form shown below.

Authorization for Domestic Open Market Operations

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

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

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal

Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

(c) To sell U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding. The Federal Reserve Bank of New York shall set a minimum lending fee consistent with the objectives of the program and apply reasonable limitations on the total amount of a specific issue that may be auctioned and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York and accounts maintained at the Federal Reserve Bank of New York as fiscal agent of the United States pursuant to Section 15 of the Federal Reserve Act, 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 accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities in 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and such foreign, international, and fiscal agency accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

The amendment to the authorization for domestic open market operations involved the addition of a reference in paragraph 3 to accounts held at the Federal Reserve Bank of New York pursuant to fiscal agency instructions from the Secretary of the Treasury. Accounts listed in paragraph 3, which include those maintained by the Bank on behalf of official foreign and international accounts, are eligible for participation in the Bank's short-term investment facility, the so-called "repo pool."

By unanimous vote, the Authorization for Foreign Currency Operations was reaffirmed in the form shown below.

Authorization for Foreign Currency Operations

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

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

Canadian dollars	Mexican pesos
Danish kroner	Norwegian kroner
Euro	Swedish kronor
Pounds sterling	Swiss francs
Japanese yen	

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

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

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

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

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada	2,000
Bank of Mexico	3,000

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

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

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

By unanimous vote, the Foreign Currency Directive was reaffirmed in the form shown below.

Foreign Currency Directive

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 IMF Article IV, Section 1.

2. To achieve this end the System shall:

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

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

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

3. Transactions may also be undertaken:

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

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

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

4. System foreign currency operations shall be conducted:

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

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

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

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

Procedural Instructions with Respect to Foreign Currency Operations

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.

On January 9, 2004, the continuing rules, regulations, and other instructions of the Committee had been distributed with the advice that, in accordance with procedures approved by the Committee, they were being called to the Committee's attention before the January 27–28 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. Accordingly, all of these instruments remained in effect in their existing form.

The Committee considered a report from the Manager of the System Open Market Account that discussed the feasibility and costs of purchasing mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA), a federal government agency. A potential advantage of transactions in such GNMA obligations was their use to supplement purchases of direct Treasury securities in periods when large federal surpluses reduced market supplies of Treasury debt. However, the resumption of large federal deficits had led to sizable increases in market supplies of Treasury obligations, which members saw as the preferred vehicle to supply the need for permanent additions to the System Open Market Account. The report concluded that outright transactions in mortgage-backed GNMA securities were feasible but would involve sizable start-up costs and would tend to complicate the conduct of System open market operations. Against this background the Committee decided not to initiate outright transactions in mortgage-backed GNMA obligations. It was understood, however, that such GNMA obligations would continue to be eligible as collateral for System repurchase agreements.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on December 9, 2003, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's Account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period December 9, 2003 to January 27, 2004. By unanimous vote, the Committee ratified these transactions.

At this meeting the Committee engaged in a broad-ranging discussion of its communication practices.

A portion of this discussion focused on the report of a working group that had been directed to study how the Committee's announcements might be improved. In the course of the discussion, members stressed the importance that they attached to conveying clearly to the public information regarding the reasons for policy decisions and how those decisions related to the Committee's longer-term objectives. However, only limited support emerged for the use of particular standard wording to express the Committee's appraisals of the economic outlook and views about the balance of risks. Indeed, several members were in favor of discontinuing the use of statements regarding the balance of risks to the outlook and instead focusing mostly on the reasons for their policy decisions in the announcement. At the same time, all the members indicated that they could support a flexible approach in which the wording of the Committee's announcements, including the assessment of the balance of risks going forward, would be adjusted gradually over time in keeping with evolving economic conditions.

In further discussion the members reviewed the potential value and drawbacks of accelerating the publication of Committee minutes. Possible benefits would include the provision of more complete information sooner after meetings on the considerations that led the Committee to adopt the current stance of policy. Some members expressed concern, however, that accelerated release of the minutes might have the potential to feed back adversely on the deliberations of the Committee and on the minutes themselves. The members also emphasized the importance of allowing sufficient time for them to review and comment on the minutes and for reconciling differences of opinion among the members of a large and geographically dispersed committee. At the conclusion of this discussion, staff was asked to study the issue further.

The members also discussed the possible advantages of making some changes in the content, time horizon, and frequency of the individual forecasts that are summarized in the semiannual Monetary Policy Reports to the Congress. In general, the members saw little to be gained by altering the Committee's current practices in any significant way, although some proposed relatively minor changes. It was agreed that there was no need to reach a decision on such changes at this time, but staff was instructed to ascertain the degree of interest on the part of the members in making possible minor adjustments to current procedures.

The Committee then turned to a discussion of the economic outlook and the conduct of monetary policy over the intermeeting period.

The economy appeared to have expanded at a robust pace in the fourth quarter, though well below the exceptional pace recorded in the third quarter. Consumer spending continued to increase at a solid rate over the final three months of the year, and activity in the residential sector remained at a very high level. On the business side, outlays for equipment and software likely posted moderate gains in the fourth quarter, and firms apparently accumulated inventories for the first time in three quarters. Despite the strong pace of economic activity, the labor market was improving only slowly, with private payrolls showing a small acceleration in the fourth quarter. Core consumer price inflation continued to slow, and inflation expectations remained subdued over the closing months of 2003.

The December employment report suggested that the labor market had not gained as much momentum as previously appeared to be under way. Private nonfarm payrolls increased only slightly in that month, and their level in November was revised down appreciably. The average monthly increase in employment in the fourth quarter was indicative of a fairly weak recovery in the labor market, although it was a clear improvement over the average monthly loss during the first half of the year. Manufacturing payrolls continued to shrink in December at about the same pace as in the previous few months, and holiday-related hiring in retail trade was below average. In other sectors, job gains were recorded in construction, education and health services, and professional and business services. Average weekly hours of production or nonsupervisory workers declined somewhat in December, reversing the gains of the previous two months. Aggregate hours worked by nonfarm employees fell in December but in the fourth quarter as a whole posted their first quarterly increase since 2000. Despite the weak payroll data, the unemployment rate, which is measured by the household survey, fell to 5.7 percent in December, in part because of a further decline in the labor force participation rate. Initial claims for unemployment insurance continued to drift down in the weeks following the reference week for the December employment report, suggesting improved job growth in January.

The pace of expansion in the industrial sector picked up in the fourth quarter. Total industrial production rose at the fastest rate since the second quarter of 2002, and manufacturing production posted solid and widespread gains. High-tech industries, including those producing semiconductors, computers, and communications equipment, accounted for nearly one-third of the increase in total industrial production in the fourth quarter. After having surged in the third quarter, the production of motor vehicles and parts moved up in the fourth quarter at about the same rate as overall manufacturing. Outside the manufacturing sector, output at mines increased modestly in the quarter, while output at utilities rose appreciably, led by a solid advance in electricity generation that mirrored the strengthening in the manufacturing sector. Capacity utilization was unchanged in December and remained well below its long-term average.

Sales of light vehicles jumped in December, and the fourth-quarter average, although below the torrid third-quarter pace, was well above that recorded for the first half of the year. These data, along with those on retail sales excluding autos, were consistent with a solid increase in real personal consumption expenditures in the fourth quarter. Real disposable personal income advanced smartly in November. Spending was also supported by the recent stock market gains, and by greater consumer confidence as reflected in the Michigan Survey Research Center's index of consumer sentiment and the Conference Board's index of consumer confidence, both of which stood significantly above their average readings for 2003.

Activity in the housing market remained very robust. In December, single-family starts edged down only a bit from the exceptional rate they had reached in November, and multifamily starts moved up to the highest level in almost four years. New home sales declined in November for the third consecutive month, but they were still not far below the record highs registered earlier in the year. Existing home sales had fallen back from September's high, though the level in November was still noticeably higher than average monthly sales in the first half of 2003.

The available data suggested that business purchases of transportation equipment strengthened in the fourth quarter and that spending on other capital goods advanced at a moderate pace. Business expenditures on aircraft rebounded noticeably in the fourth quarter, albeit to a level that was still far below the levels that prevailed before the downturn following the terrorist attacks in 2001. Both fleet sales of light vehicles and truck sales also rose significantly. In the high-tech sector, real outlays for computing equipment and for software again appeared to have posted sizable increases in the fourth quarter, while spending on communications equipment was little changed after three quarters of double-digit growth. Outside transportation and high tech, nominal shipments were about unchanged in the fourth quarter, but the upward trend in orders established since the beginning of last year was consistent with further gains in spending. After holding roughly steady, on balance, in the first half of 2003, real spending on private nonresidential construction appeared to have slipped further in the third and fourth quarters. In the commercial and health-care sector and in the manufacturing sector, average nominal outlays in October and November were about unchanged from the previous quarter. However, spending on other types of construction moved down.

The book value of manufacturing and trade inventories excluding motor vehicles posted the third consecutive significant monthly increase in November. Stocks at manufacturers were down a little on average in October and November, but non-auto wholesalers and retailers accumulated inventories at a brisk pace. Strong increases in sales, however, kept book-value inventory–sales ratios at or near their recent lows. Motor vehicle and parts inventories ended the year noticeably above the level at the end of the third quarter.

The international trade deficit in November shrank to its lowest level in about a year. Exports of goods and services increased to a level not recorded since early 2001, while imports fell moderately. Recent data indicated that the pickup in economic activity in the major foreign industrial countries continued in the fourth quarter. Japanese exports, machinery orders, and industrial production rose strongly in October and November. Euro-area manufacturing data exhibited increasing strength, particularly in Germany. In the United Kingdom, indicators of business and retail sales in December pointed to a maintained expansion. And Canadian employment and sales data were strong in the fourth quarter, with the housing sector continuing to make a significant contribution to growth.

Prices of consumer goods and services other than food and energy continued to decelerate through the end of 2003. Overall consumer prices were flat, on balance, over the past three months, as a small increase in core prices and a large rise in food prices were offset by a sizable drop in energy prices. Over the year, the consumer price index posted a moderate increase that was noticeably below that in the previous year. Core consumer prices decelerated more sharply and rose only slightly over the year. Producer prices for finished goods were up moderateiy over the year, and the advance was substantially above that over the previous year. The rise last year was due almost entirely to substantial increases in food and energy prices as core producer prices rose only a little after having edged down over 2002. With regard to labor costs, the average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls rose modestly in the twelve months ending in December, an increase somewhat below that over 2002.

At its meeting on December 9, 2003, the Federal Open Market Committee (FOMC) adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the federal funds rate at around 1 percent. In reaching this decision, the Committee members generally perceived the upside and downside risks to the attainment of sustainable growth for the next few quarters to be roughly equal. They also judged that the probability of an unwelcome fall in inflation had diminished in recent months and now appeared almost equal to that of a rise in inflation. Nevertheless, with inflation quite low and resource use slack, the Committee believed that policy accommodation could be maintained for a considerable period.

The Committee's decision at the December meeting to keep its target for the federal funds rate at 1 percent appeared to have been fully anticipated in financial markets, and interest rate futures for the first half of 2004 were essentially unchanged after the announcement. But futures rates for the second half of the year rose a few basis points, presumably in response to the Committee's assessment that the probability of an unwelcome decline in inflation had fallen in recent months to a level almost equal to that of a rise in inflation. Subsequently, however, the release of the minutes for the October FOMC meeting, which indicated that at that time the Committee was concerned about the possibility of persistent slack arising from rapid productivity growth, and the publication of surprisingly modest growth in employment in December led most market participants to push back the date of the expected onset of tightening by several months to some time in the fall. Reflecting the change in policy expectations, intermediate- and longer-term nominal Treasury yields declined substantially over the intermeeting period. Yields on inflation-indexed debt fell by nearly as much, suggesting that the drop in nominal yields owed more to lower real interest rates than to reduced inflation compensation. Yields on investment-grade and most speculative-grade securities moved down by about the same amount as Treasury yields. Major equity indexes rose strongly in response to the declines in yields and positive news about the outlook for profits.

The exchange value of the dollar, as measured by the major currencies index, declined moderately on net over the intermeeting period. Ongoing investor concerns about the ability of the United States to finance its current account deficit reportedly were again a primary factor exerting pressure on the dollar.

M2 fell in December, the fourth consecutive monthly decline. The decline in M2 over the fourth quarter was the largest on record since the start of consistent data collection in 1959. The weakness was concentrated in liquid deposits and, to a lesser extent, in retail money market mutual funds and appeared to be due in large part to the unwinding of a previous buildup in deposits associated with heavy mortgage refinancing activity and to portfolio shifts by households into equities.

The staff forecast prepared for this meeting indicated that the momentum in economic activity that had built up in the second half of 2003 would carry over into the first half of the current year and that the ongoing gains in spending and production would soon result in a more visible improvement in labor market conditions. The considerable stimulus being provided by fiscal and monetary policies was expected to keep aggregate demand on a solid uptrend. In addition, improving labor market conditions and the effects of strong productivity growth on permanent income were projected to support household spending, while business investment spending was seen as strengthening in response to the acceleration in business output, swelling profits, and continued favorable financing conditions. Some slight downward pressure on core consumer price inflation was anticipated in the forecast given the ongoing slack in labor and product markets.

In the Committee's discussion of current and prospective economic developments, the members commented that the information that had become available since the December meeting had tended to validate their earlier assessment that the expansion was firmly established and that robust economic growth, under way since about mid-2003, was likely to continue as the year progressed. Many emphasized that business expenditures now appeared to be on a solid upward trajectory amid widespread reports of much improved business sentiment. Indeed, business expenditures had broadened the sources of significant strength in the expansion, which earlier had been sustained mainly by household and government spending. Factors underlying a favorable outlook for economic activity continued to include stimulative fiscal and monetary policies, accommodative conditions in financial markets, and the positive effects of a strong uptrend in productivity on business investment incentives and, with some lag, on household incomes. The members nonetheless expressed disappointment that the acceleration in economic activity had thus far failed to generate significant strengthening in employment, though they pointed to a number of positive signs in labor markets. Given their expectations of persisting above-trend economic growth, they saw increasing demand for workers as a likely prospect going forward. Regarding the outlook for inflation, members observed that wide margins of slack in labor and product markets continued to hold down wages and prices, especially given the concurrent strength in productivity. Core consumer inflation appeared to have drifted lower recently, and a number of members mentioned the possibility of a modest further decline in such inflation from its current subdued level. Over the year ahead, however, the members generally anticipated little net change in consumer price inflation.

In keeping with the practice at meetings preceding the Federal Reserve's semi-annual report to the Congress on the economy and monetary policy, the members of the Board of Governors and the presidents of the Federal Reserve Banks had provided individual projections of the growth of GDP, the rate of unemployment, and consumer price inflation for the year 2004. The forecasts pointed to a continuation of relatively vigorous growth in economic activity, some further decline in unemployment, and a quite low rate of inflation. Specifically, the forecasts of the expansion in real GDP between the fourth quarter of 2003 and the fourth quarter of 2004 had a central tendency of 4½ to 5 percent and a full range of 4 to 5½ percent. The projections of the civilian unemployment rate in the fourth quarter of 2004 were all in a range of 5¼ to 5½ percent. Forecasts of consumer price inflation for the year, as measured by the PCE chain-type price index, were centered in a range of 1 to 1¼ percent, with a full range of 1 to 1½ percent.

In their discussion of developments across the nation, members emphasized growing indications of rising business confidence and, despite persisting softness in a number of industries, more widespread signs of increasing business spending for equipment and software and for inventories. The members cited a variety of factors that pointed to a further pickup in business capital expenditures over the coming year, including the strength in new orders and shipments, increasing profits and cash flow, the improved financial condition of many business firms, the general availability of financing on favorable terms, and the temporary tax incentive on expenditures for new equipment. Anecdotal reports from business contacts about capital spending plans were indicative of appreciable further acceleration in business expenditures on a widening range of capital goods. While many contacts indicated that replacement demand or the cost-saving opportunities provided by more productive new equipment were still the driving factors in guiding investment decisions, there were more reports of investment spending to expand capacity.

The members also viewed business inventory investment as likely to provide some support to the economic expansion over the year ahead. Business inventories were at exceptionally low levels in relation to sales, and if further brisk growth in demand broadly in line with current forecasts materialized this year, business firms could be expected to make commensurate additions to their inventories. Indeed, inventories appeared to have turned up in the fourth quarter after declining on balance earlier in 2003 as businesses evidently became more confident that increases in their sales would be sustained.

While business expenditures had turned up, employers had continued to display a high degree of caution in hiring new workers. Employment had trended up since mid-2003 after a protracted period of job losses, but the gains were significantly weaker than was typical at similar stages of earlier business cycles. A key factor that had tended to hold down hiring was the continuing ability of business firms to meet increasing demand by improving productivity with existing workforces rather than hiring new workers. Against this background, labor markets continued to be described as soft in most areas, albeit with more signs of at least modest improvement. In this regard, members referred to positive developments such as the decline in initial claims and the rise in aggregate hours worked in the fourth quarter. Looking ahead, the members saw considerably faster growth in employment as a likely prospect in the context of further strengthening in aggregate demand and expectations of some slowing in the growth of productivity from its extraordinary pace in recent quarters. Several emphasized, however, that the timing and extent of the improvement in employment were subject to considerable uncertainty.

The household sector was continuing to supply major impetus to the expansion. Household spending was benefiting from stimulative fiscal and monetary policies, the wealth effects of rising real estate and equity prices, and increased consumer confidence about the economic outlook. Members noted that retailers in many parts of the country reported solid sales during the holiday period. With respect to the outlook for overall consumer spending, it was suggested that the elevated growth of productivity could be expected to raise incomes over time and thereby help to buttress consumption even as the stimulus from earlier tax cuts faded. Residential construction activity remained at a high level, evidently supported in part by recent declines in mortgage interest rates. Contacts in the housing industry indicated that they expected a high level of construction activity in 2004, though perhaps not as robust as in 2003.

Fiscal policy was providing considerable stimulus to the economy and would continue to do so in the first part of this year, reflecting the large tax refunds anticipated as a result of overwithholdings in 2003. Beyond the nearer term, however, the fiscal stimulus was projected to diminish under existing legislation. In this regard, one member questioned whether a robust expansion would be sustained once the fiscal impulse was removed. Some members expressed concern about the longer-run prospects for large federal deficits and their implications for the future performance of the economy.

In their comments about the international economy, members noted that the strengthening in economic activity abroad and the decline in the foreign exchange value of the dollar had boosted exports. Even so, the ongoing strength in imports was still producing a widening trade deficit, and net exports were expected to be a small arithmetic drag on domestic economic activity over the year ahead. Some members indicated that they were concerned about the implications of the nation's rapidly growing external debt for domestic financial markets and the economy over time.

In the Committee's discussion of the outlook for inflation, the members agreed that increases in core consumer prices were likely to remain muted this year, with ongoing strength in the expansion only gradually reducing the current output gap and anticipated gains in productivity exerting downward pressure on costs and prices. Some members commented, however, that the relationship between the output gap and inflation was quite loose and that the outlook for productivity remained uncertain. Accordingly, while members agreed that changes in core consumer price inflation were likely to be limited, there was some divergence of opinion about the most probable direction. In the view of many, some modest further disinflation appeared to be the most likely prospect. A few members noted that such disinflation, if it was associated with rapid growth in productivity, could be viewed as non-threatening. Moreover, the expected strength in aggregate demand would curb the extent of disinflation over time. A few members expressed the differing view that core consumer prices might well edge up over the course of the year in light of the considerable stimulus stemming from current monetary and fiscal policies and the possibility that the expected pickup in economic activity and employment, especially if it were on the high side of current forecasts, would be associated with slower growth in productivity. The evidence pointing to the possibility of an uptick in inflation was still quite limited, but some members noted that in addition to sizable advances in the prices of many commodities including oil, reports from business contacts indicated that a few firms had been able to raise their selling prices and maintain them at higher levels in an effort to pass on increases in costs. Overall, however, the pricing power of business firms remained quite limited.

In the Committee's discussion of policy for the intermeeting period ahead, all the members favored an unchanged policy stance that was directed toward maintaining reserve conditions consistent with a target federal funds rate of 1 percent. While the members were persuaded that a relatively vigorous economic expansion was now firmly established and was likely at some point to call for a move toward a more neutral policy stance, they concluded that such an adjustment was not warranted under current circumstances. In this regard they stressed that unused labor and other resources remained substantial, that inflation was at a very low level, and that inflation was not expected to change appreciably in either direction over the year ahead. Members acknowledged that there were risks in maintaining what might eventually prove to be an overly accommodative policy stance, but for now they judged that it was desirable to take risks on the side of assuring the rapid elimination of economic slack.

With regard to the wording of the Committee's press statement to be released shortly after the meeting, members discussed at some length the desirability of retaining a reference from earlier statements to the prospect that an accommodative policy could be maintained "for a considerable period." The existing language had been explicitly qualified at the December meeting by tying it to low inflation and slack in resource use, thereby underscoring the notion that a move away from the current degree of policy accommodation would depend on economic conditions rather than simply on the passage of time. All the members agreed that a change in wording was desirable, not to signal a policy tightening move in the near term, but rather to increase the Committee's flexibility to take such an action when it was deemed to be desirable and to underline that any such decision would be made on the basis of evolving economic conditions. However, some differences of opinion arose with regard to the specific proposal under consideration, namely to remove the reference to "considerable period" and to substitute one referring to "patience." Those who fully endorsed the proposal believed that the new wording conveyed important information about the Committee's strategy in an environment of price stability and economic slack and under those circumstances was unlikely to have outsized effects in financial markets. A number of members commented that expectations of sustained policy accommodation appeared to have contributed to valuations in financial markets that left little room for downside risks, and the change in wording might prompt those markets to adjust more appropriately to changing economic circumstances in the future. A few members, while expressing agreement with respect to the merits of a language change, nonetheless preferred to drop the reference to a "considerable period" entirely without substituting a reference to the Committee's ability to be patient. In this view, even the replacement language would tend to shape expectations in ways that could complicate the conduct of policy, and with the economy in a strong uptrend, the Committee no longer needed to utilize such special language.

At the conclusion of the meeting, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1 percent.

The vote encompassed approval of the paragraph below for inclusion in the press statement to be released shortly after the meeting:

> The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation. With inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, March 16, 2004.

The meeting adjourned at 1:45 p.m. on January 28, 2004.

Vincent R. Reinhart
Secretary

Meeting Held on March 16, 2004

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 16, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Messrs. McTeer, Moskow, Santomero, 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. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Fuhrer, Howard, Madigan, Rasche, Sniderman, Slifman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

Messrs. Struckmeyer and Oliner, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Clouse, Freeman, and Whitesell, Deputy Associate Directors, Divisions of Monetary Affairs, International Finance, and Monetary Affairs respectively, Board of Governors

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

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Sack, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Mr. Moore, First Vice President, Federal Reserve Bank of San Francisco

Messrs. Eisenbeis, Evans, Judd, Lacker, Mses. Mester and Perelmuter, Messrs. Rolnick, Rosenblum, and Steindel, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Chicago, San Francisco, Richmond, Philadelphia, New York, Minneapolis, Dallas, and New York respectively

Mr. Kahn, Vice President, Federal Reserve Bank of Kansas City

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period January 28, 2004, through March 15, 2004. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that economic activity continued to expand at a solid pace in early 2004. Consumer spending growth appeared to have picked up somewhat, and activity in the housing market remained at high levels. In the business sector, spending for equipment and software was apparently advancing vigorously, and firms were adding modestly to their inventories. Still, the increases in economic activity had not yet generated sizable gains in employment. Core consumer price inflation remained low, and expectations of future inflation continued to be subdued.

The January and February employment reports depicted a labor market that was slow to pick up momentum. The modest gains posted in private nonfarm payrolls over the period were smaller than had been expected by most forecasters. Employment in the manufacturing sector, which had fallen continually for over three years, was essentially unchanged in February, while employment in other sectors showed mixed changes. Average weekly hours of production or nonsupervisory workers edged above the average level of the fourth quarter of 2003. Despite the weakness in employment, the unemployment rate in January and February came in below its fourth-quarter level.

Industrial production moved up briskly in January and February following strong increases in the fourth quarter. These gains in production were realized across a wide set of industries. High-tech industries, including semiconductors, computers, and communications equipment, posted particularly strong advances, while the production of motor vehicles and the output of other manufacturing sectors were also strong. Outside the manufacturing sector, power generation by utilities surged in January but fell back in February in response to outsized swings in average temperatures during those months. Capacity utilization continued to move higher in January and February, although it remained below its longer-run average.

Consumer spending growth in recent months appeared to pick up somewhat from its pace in the fourth quarter of 2003. Retail sales rose briskly, on average, in January and February, and spending on services was up in January (the most recent month for which data were available). In contrast, purchases of motor vehicles slipped in January and February from the strong pace in the fourth quarter. Overall, expenditures were supported by sizable gains in real disposable personal income and increases in household wealth owing to rising home and equity prices. Disposable income was boosted by significant growth in private wages and salaries and by a drop in taxes that was due to the lower final payments and higher refunds associated with last year's tax cut. Surveys indicated that consumer sentiment moved higher in January but subsequently fell back. Despite the pullback, sentiment remained above the levels seen during most of 2003.

Activity in the housing market moderated in January and February from its elevated pace in the fourth quarter. Single-family housing starts and permits stepped down, although both measures remained above their average levels of the first three quarters of 2003. Housing starts in the multifamily sector slipped only slightly from the fourth quarter pace, even though vacancy rates reached a record high level in the fourth quarter. Sales of new and existing homes slowed in January, but this change retraced only a small part of the extraordinary run-up in home sales that began last spring. Home prices continued to rise briskly.

Spending on capital goods had advanced at a vigorous pace in the fourth quarter and appeared to be continuing that growth early this year. Spending by businesses was supported by increases in their sales and the continuation of strong cash flows and a low user cost of capital. Nominal shipments of computing and communication equipment moved up sharply in recent months, as did shipments outside the high-tech sector. By contrast, business investment in transportation equipment was mixed. Data for new orders of nondefense capital goods excluding aircraft suggested that the strength in capital expenditures would continue going forward. As has been the case for some time, real spending on private nonresidential structures languished, and vacancies in industrial buildings and office properties were at high levels.

Real nonfarm inventory investment remained modest in recent months. Although manufacturers' inventories moved higher in January, that increase primarily reflected stockbuilding at producers of petroleum and coal products. Retail inventories also rose in January, as stocks at auto dealers increased;

wholesalers accumulated inventories at a modest pace. Inventory–sales ratios in these sectors lingered at or near their historical lows.

The U.S. international trade deficit rose to a record high level in January. Exports of goods and services fell, owing importantly to a drop in agricultural exports. Imports edged lower, with higher oil imports partly offsetting declines in most other categories. Recent data suggested that economic activity in major foreign industrial countries strengthened outside the euro area, notably including a sizable jump in Japan's output in the fourth quarter. Growth in the euro area remained tepid.

Core consumer price inflation stayed very low in early 2004. Over the twelve months ending in January, the increase in core consumer prices was around 1 percent—about ¾ percentage point below the increase over the preceding twelve months. Total consumer price inflation, however, was boosted in January by a surge in energy prices. Incoming information on trends in labor costs were more mixed. The average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls rose modestly over the twelve months ending in February, decelerating from its year-earlier pace. By contrast, the employment cost index for hourly compensation in private industry grew a bit faster over the twelve months ending in December than over the year-earlier period.

At its meeting on January 27–28, 2004, the Federal Open Market Committee decided to leave its target for the federal funds rate unchanged at 1 percent. The Committee also retained its assessment that the upside and downside risks to the attainment of sustainable growth were roughly equal as well as its judgment that the probability of an unwelcome fall in inflation had diminished and was almost equal to that of a rise in inflation. With inflation low and resource use slack, the Committee saw no need for tightening policy in the near future. However, to provide additional flexibility to adjust monetary policy at a later date once such action was deemed appropriate given economic developments, the Committee removed from its post-meeting statement the explicit reference to a "considerable period" and substituted a statement that conveyed the sense that it could be patient in removing its policy accommodation.

Although the Committee's decision at the January meeting to keep the federal funds rate unchanged had been widely anticipated, the changes in the wording of the accompanying statement elicited a sharp reaction in financial markets. Investors moved up the date when they expected policy tightening to commence, resulting in a jump in Treasury yields. Over the balance of the intermeeting period, however, the Chairman's testimony on monetary policy and data on nonfarm payroll employment with a weakish cast persuaded investors that policy tightening was still some ways off. Treasury yields declined considerably in response and ended the intermeeting period lower, on balance. Yields on inflation-indexed securities also fell, leaving measures of inflation compensation little changed.

Yields on investment-grade bonds generally moved in tandem with those on Treasuries over the intermeeting period, but spreads on high-yield bonds widened as investors reassessed credit risks in light of the negative tone of some incoming economic data. The disappointing employment data and renewed concerns about terrorism contributed to a decline in broad equity price indexes. Technology-related issues, which had registered very large gains over the preceding year or so, fell more sharply. The foreign exchange value of the dollar against other major currencies declined through the middle of February but subsequently rebounded to end the intermeeting period higher.

After four consecutive months of decline, M2 rose slightly in January and accelerated markedly in February. The effects of mortgage refinancing, which had depressed M2 growth in the second half of last year, appeared to wane, allowing the expansion in nominal income to show through to M2 growth.

The staff forecast prepared for this meeting indicated that economic activity would continue to expand at a solid pace through 2005. Monetary policy is expected to support growth over the projection period, and fiscal policy is anticipated to remain accommodative through 2004. In addition, structural productivity growth is projected to remain substantial this year and next. Strong advances in real disposable income were expected to keep consumer spending on a solid upward trajectory. Business spending on equipment and software was seen as increasing briskly as a result of sizable profits, an improving outlook for demand, and continued favorable financing conditions. Also, inventory investment was anticipated to rise gradually as businesses became more convinced that final demand was expanding along a sustainable track. The pace of economic expansion was forecasted to be sufficient to reduce resource slack over this year and next, although the employment data received over the intermeeting period indicated that this process would begin from a higher rate of unused resources than had been previously expected. Core inflation was projected to remain low over the forecast period.

In the Committee's discussion of current and prospective economic developments, the members noted that overall economic activity still seemed to be increasing at a solid pace, though perhaps not quite as quickly as some members had anticipated at the time of the January meeting. Investment spending had continued to advance, and the manufacturing sector, which had lagged the rest of the economy earlier in the expansion, had extended recent gains. Residential construction activity was down somewhat from the very high levels posted late last year, but increases in household wealth and the effects of last year's tax cuts continued to buoy consumer spending. Despite the gains in spending and production, however, employment growth had been disappointing. While job losses had moderated, hiring had yet to strengthen, holding down net increases in employment. Nonetheless, the breadth of the expansion was seen as providing considerable assurance of its sustainability, and Committee members generally expected that accommodative monetary policy, favorable financial market conditions, and, at least in the near term, fiscal stimulus would continue to foster a pace of output growth that exceeded that of its potential. Although economic slack likely would be declining, it was expected to be a little higher than previously had been anticipated. Prices for energy, commodities, and non-oil imports were rising, however, and some business contacts had reported seeing a return of "pricing power." On balance, inflation was expected to remain near its current low level.

In their discussion of economic developments across the nation, a number of Committee members noted some slippage in business and consumer confidence from the high levels reached late last year. While business contacts in some regions remained optimistic about prospects for their sales and planned to increase investment and, in some cases, employment, firms in other parts of the country had become somewhat more uncertain about the pace of the expansion going forward. Those firms, as a result, were more wary about committing to new investment plans or increased hiring. Financial markets also seemed a little less positive about the outlook, with stock prices lower and some risk spreads wider than at the time of the last meeting. The reasons for the reduced optimism were not entirely clear but may have included higher energy and commodity prices as well as renewed concerns about terrorism. Some members also pointed to the persistent weakness in employment, which might be seen as reducing the odds that household spending would continue to expand briskly once the stimulative effects of tax cuts waned. Lingering business caution likely accounted for a good deal of the lag in job creation, but some members also pointed to a number of other factors that might be restraining hiring, including ongoing opportunities to increase efficiency through organizational changes and new investments, the effects on labor costs of increases in the costs of benefits, and, in some selected industries and regions, a shortage of job candidates with appropriate skills. The extent and duration of the resulting restraint on hiring were difficult to assess, however, and the Committee continued to expect employment growth to pick up as the expansion progressed.

In their comments about demand in key sectors of the economy, members indicated that investment spending had continued to expand at a robust pace. Members anticipated vigorous growth in investment outlays going forward, supported by rapid productivity growth, high profits and cash flow, and accommodative financial markets. Despite this generally upbeat assessment, a number of members reported that firms were investing primarily to replace old equipment or to reduce costs, but remained hesitant to expand capacity. The commercial real estate sector remained weak, on balance, although some members suggested that market conditions were stabilizing and, in a few cases, even beginning to improve.

Committee members noted that activity in the housing sector, while still quite elevated, had fallen back from its extraordinary pace of late last year. However, some of the moderation may have owed to the effects of severe winter weather rather than more lasting influences, and the recent decline in mortgage interest rates was expected to support the housing sector going forward. Reports from some contacts suggested that speculative forces might be boosting housing demand in some parts of the country, with concomitant effects on prices, suggesting the possibility that house prices might be moving into the high end of the range that could be consistent with fundamentals.

Consumer spending outside the auto sector had remained strong, with data and retail contacts generally suggesting continued growth in sales this year. Committee members noted that sales had been bolstered by rising asset prices and the effects of last year's tax cuts on refunds and final payments. By contrast, sales of motor vehicles had fallen back noticeably, reflecting in part reductions in incentives. However, members anticipated that sales would pick up again, partly in response to an anticipated rebound in incentives. Looking forward, gains in employment and the pass-through of higher productivity to wages and salaries were also expected to boost consumer spending, even as the stimulus to growth from tax cuts faded and increases in home and equity prices likely slowed from their rapid pace in recent quarters.

The Committee anticipated that government spending would provide some further support for aggregate demand going forward. The budget pressures that had constrained state and local government expenditures of late were easing in some cases, and federal outlays were expected to rise. Fiscal policy was seen as providing less stimulus to aggregate demand in 2005 than this year, but the federal budget deficit was expected to remain substantial.

In their remarks concerning the external sector of the economy, members cited the decline in the value of the dollar on foreign exchange markets since the middle of last year and stronger economic growth in many of our trading partners as factors boosting the demand for exports in a variety of industries. While exports were likely to continue to advance, the value of U.S. imports was expected to rise as well, implying continued very large current account deficits. Some Committee members noted that opportunities to cut costs had led some of their business contacts to consider moving production abroad.

In their review of the outlook for prices, members generally anticipated that core inflation would remain near current low levels, with output growth only gradually eliminating slack in labor and goods markets and strong growth in productivity limiting increases in unit labor costs. Some members thought that core inflation had stabilized and was unlikely to move lower. Increases in the prices of energy, other commodities, and non-oil imports, as well as reports from some business contacts that higher costs were increasingly being passed through to prices, suggested that the downtrend in inflation had ended. Moreover, if, as some members thought likely, productivity growth slowed as employment picked up, the result could be reductions in slack accompanied by higher unit labor costs and associated pressures on prices. Other members were less certain that inflation had leveled out. Recent price trends were not clear, with some measures of core inflation still declining. Increases in commodity prices remained limited to a few selected industries, and with the persistence of slack in labor and product markets, core inflation might well edge lower once any transitory influences had ebbed. Moreover, if productivity were to expand at a rapid pace rather than slowing, unit labor costs could fall, putting downward pressure on prices.

In the Committee's discussion of policy for the intermeeting period, all the members favored the retention of the current target rate of 1 percent for the federal funds rate. This preference for an unaltered stance of policy was based on the absence of significant changes in economic conditions or in the members' basic assessment of the outlook since the January meeting. To be sure, some of the incoming information—notably with regard to labor market developments—had been somewhat disappointing, but the Committee continued to see the conditions in place for further solid economic growth. Similarly, despite the rise in energy and commodity prices and reports of increased pricing power in some sectors, many Committee members commented that persisting slack in labor and output markets would keep inflation low. In these circumstances, the current accommodative stance of monetary policy remained appropriate. Some members, while supporting an unchanged policy at this meeting, nonetheless emphasized that the maintenance of a very accommodative monetary policy over an extended period in concert with a stimulative fiscal policy called for careful attention to the possible emergence of inflationary pressures. And, while adjustments in financial markets to low rates had generally been consistent with the usual operation of the monetary transmission mechanism, some members were concerned that keeping monetary policy stimulative for so long might be encouraging increased leverage and excessive risk-taking. Such developments could heighten the potential for the emergence of financial and economic instability when policy tightening proved necessary in the future. At present, however, the persistence of low inflation coupled with soft labor markets underscored the desirability of a monetary policy strategy characterized by continued patience.

In the Committee's discussion of its statement to be released shortly after this meeting, the members saw merit in not changing the characterization of the risks to the outlook for inflation and economic activity. Many members held that a case could be made for moving to a balanced risk assessment with regard to the outlook for inflation, with a number of them expressing a marginal preference for such a change. However, other members thought the evidence for a balanced risk assessment was not yet compelling and pointed out that with inflation quite low and slack in labor and output markets likely to persist for a while longer, the costs to the economy associated with a further decline in inflation likely outweighed those associated with a comparable increase. While many viewed it as a close call, all members indicated that they could support a proposal to retain the existing wording involving a slight tilt toward the possibility of some further disinflation. The members also agreed on the desirability of retaining the assessment that the risks with regard to the outlook for economic growth were balanced. Accordingly, it was agreed that the only changes in the post-meeting statement would be to update the descriptions of the economic expansion and labor market conditions in light of the information received over the intermeeting period.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive.

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1 percent.

The vote encompassed approval of the paragraph below for inclusion in the Committee's statement to be released shortly after the meeting:

> The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation. With inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 4, 2004.

The meeting adjourned at 1:00 p.m.

Notation Vote

By notation vote completed on March 18, 2004, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on January 27–28, 2004.

Vincent R. Reinhart
Secretary

Meeting Held on May 4, 2004

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 4, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

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

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

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Fuhrer, Hakkio, Howard, Madigan, Rasche, Struckmeyer, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

Messrs. Slifman and Oliner, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

Messrs. English and Sheets, Assistant Directors, Divisions of Monetary Affairs and International Finance respectively, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Bassett, Economist, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Messrs. Connolly and Moore, First Vice Presidents, Federal Reserve Banks of Boston and San Francisco respectively

Messrs. Eisenbeis, Evans, Goodfriend, Judd, Ms. Mester, and Mr. Rolnick, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Chicago, Richmond, San Francisco, Philadelphia, and Minneapolis respectively

Mr. Altig, Ms. Hargraves, and Mr. Koenig, Vice Presidents, Federal Reserve Banks of Cleveland, New York, and Dallas respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 16, 2004, were approved.

By unanimous vote, Joseph S. Tracy was elected to serve as associate economist until the first regularly scheduled meeting of the Committee after December 31, 2004, with the understanding that in the event of the discontinuance of his official connection with a Federal Reserve Bank or with the Board of Governors, he would cease to have any official connection with the Committee.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

By unanimous vote, the Committee voted to extend for one year beginning in mid-December 2004 the reciprocal currency ("swap") arrangements with the Bank of Canada and the Bank of Mexico. The arrangement with the Bank of Canada is in the amount of $2 billion equivalent and that with the Bank of Mexico in the amount of $3 billion equivalent. Both arrangements are associated with the Federal Reserve's participation in the North American Framework Agreement. The vote to renew the System's participation in the swap arrangements maturing in December was taken at this meeting because of the provision that each party must provide six months prior notice of an intention to terminate its participation.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period March 16, 2004, through May 3, 2004. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that the economy expanded at a rapid pace in the first quarter. Consumer spending and the housing market continued to exhibit strength. Business fixed investment grew smartly, reflecting increased outlays for equipment and software that more than offset a significant fall in investment in nonresidential structures. The labor market displayed further signs of improvement during the quarter, capped by a significant increase in private payrolls in March. Recent increases in the prices of imports and commodities showed through to a pickup in core consumer price inflation during the first quarter, although some of the categories that registered large gains had posted unusually small increases earlier.

The labor market showed renewed vigor during the first quarter. The growth in payroll employment during March pushed the average monthly gain for the first quarter as a whole well above that of the fourth quarter of last year. Hiring during the quarter was widespread across industries, with large increases in construction, retail trade, and business and nonbusiness services. Net job losses in manufacturing, which had waned during the winter, reportedly came to an end by March. Some surveys of business hiring intentions also suggested renewed strength. However, a small decline in the average workweek during March held down the increase in aggregate hours, which rose at a slightly slower pace in the first quarter than in the fourth quarter. Moreover, the unemployment rate ticked up to 5.7 percent in March, and the labor force participation rate remained low.

Despite a weather-related decline in output at utilities during March, the pace of industrial production quickened during the first quarter, and the gains were widespread across industry and market groups. The high-tech sector accounted for a significant part of the increase, as output of computers and semiconductors rose rapidly. Production of other business equipment also increased markedly, and indexes for business and construction supplies were up notably. Motor vehicle assemblies were slightly higher for the first quarter as a whole, although they slowed in March. Manufacturing capacity utilization rose for the second consecutive quarter, but to a rate well below its long-run average. Available weekly physical product data for April were up slightly.

Real consumer spending grew at a somewhat faster pace in the first quarter than it had in the fourth quarter. Retail sales rose briskly, with strength widespread across spending categories, while expenditures on services also posted a substantial increase. Light vehicle sales were down slightly for the first quarter as a whole, but they firmed in March. Solid growth in wages and salaries and an increase in tax refunds generated a large increase in real disposable personal income in the first quarter. Measures of consumer confidence were roughly stable in March and April.

Residential housing activity remained high in the first quarter despite a marked rise in mortgage interest rates. Smoothing through weather-related swings in the volatile monthly data, the underlying pace of single-family housing starts continued to display appreciable strength. Sales of new homes jumped to a record level in March, and sales of existing homes increased to their highest level since last September. In the multifamily sector, construction activity also remained robust through March, even though the vacancy rate for multifamily units reached a record high in the first quarter.

Business fixed investment continued to be supported by favorable underlying fundamentals, including increased corporate cash flow, a low user cost of capital, and, at least as judged by survey data, increased business confidence in the sustainability of the economic expansion. Outlays for equipment and software expanded at a vigorous pace in the first quarter, with the exception of spending on transportation equipment. Shipments of nondefense capital goods excluding aircraft were strong, especially outside the high-tech industries. Within the high-tech sectors, rapid growth of shipments of communications equipment offset declines in the computers and peripherals category. By contrast, investment in nonresidential structures fell considerably in the first quarter, and vacancy rates for industrial buildings and office properties remained high.

Real nonfarm inventories increased a bit more in the first quarter than they had in the fourth quarter. Motor vehicle inventories at the retail and wholesale levels accounted for the entire increase, while non-auto inventories ran off slightly. In particular, manufacturers continued to reduce their stocks, though at a slower pace than last year. Inventory accumulation lagged growth in sales and shipments, and the inventory–sales ratio edged down further.

The U.S. international trade deficit shrank in February from January's record high, with exports increasing across a range of major categories of goods. Economic growth in the major industrialized countries in the first quarter was uneven. The economies of Japan and the United Kingdom likely continued to expand, though at paces below those of late last year. In the euro area, economic indicators were mixed. A moderation of growth in Canada led the Bank of Canada to ease monetary policy for the third time this year, citing a need to support aggregate demand. Inflation was little changed in Canada and the euro area, but it slipped further in the United Kingdom. In Japan, consumer prices were about unchanged, while wholesale prices edged up in March relative to their level of a year earlier and posted the first increase on a twelve-month basis since July 2000.

In the United States, the core consumer price index advanced at a faster rate in the first quarter than it had in the fourth quarter, reflecting the pass-through of higher energy prices and a leveling off of goods prices after sizable declines last year. The higher goods price inflation owed, in part, to the recent run-up in the prices of non-oil imports, energy, and other commodities. The price index for core personal consumption expenditures also rose at a faster rate in the first quarter than it had late last year. Despite the rise in inflation this year, however, the cumulative increase in the overall consumer price index for the year ending in March was somewhat less than the advance for the twelve months ending in March 2003. In the year ending in March, the increase in the price index for total personal consumption expenditures was similar to that of a year earlier. Survey measures of near-term inflation expectations edged up somewhat in March and April, but measures of longer-term expectations decreased. With regard to labor costs, average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls rose notably less for the twelve months ending in March than they had in the year-earlier period. The overall increase in the employment cost index for private industry for the twelve months ending in March was about the same as that for the twelve-month period ending a year earlier, as wages and salaries decelerated and benefits accelerated.

At its meeting on March 16, 2004, the Federal Open Market Committee decided to keep its target for the federal funds rate unchanged at 1 percent. In its announcement of this decision, the Committee indicated that the upside and downside risks to sustainable growth were roughly equal and that the probability of an unwelcome fall in inflation had declined further so that it was almost equal to that of a rise. The Committee also noted in March that although output had continued to expand at a solid pace, new hiring had lagged, and increases in core consumer prices were muted and expected to remain low. As a result, the Committee determined that it could remain patient in removing its policy accommodation.

The Committee's decision at its March meeting to leave the intended level of the federal funds rate unchanged had been fully anticipated in financial markets. However, market participants reportedly viewed the accompanying statement as suggesting that the Committee had a slightly weaker outlook for the economy than had been expected, and longer-dated futures rates and Treasury yields declined a few basis points after the announcement. In response to the generally positive tone of economic data—especially the release of the much stronger-than-expected employment report for March—and congressional testimony by

Chairman Greenspan, investors pushed market interest rates substantially higher over the intermeeting period. By the time of the FOMC meeting in early May, quotes on federal funds futures contracts suggested that market participants expected policy tightening to begin sooner than previously anticipated and to proceed at a faster pace once it began. The revision to policy expectations showed through to interest rates on nominal Treasury securities, which climbed significantly. Yields on inflation-indexed Treasury securities rose almost as much, implying that inflation compensation only edged a little higher. Yields on investment-grade corporate bonds rose a bit less than those on comparable-maturity Treasuries, but risk spreads on below-investment-grade bonds narrowed significantly as their yields increased by a more modest amount. Major equity price indexes were about unchanged, as the downward pressure exerted by higher interest rates was offset by the effects of strong earnings reports, upward revisions to expected future earnings, and other positive economic news.

In foreign exchange markets, the dollar appreciated against most major currencies over the intermeeting period, and it also gained against an index of the currencies of other major U.S. trading partners. The dollar fell sharply against the yen early in the intermeeting period, but subsequently about reversed the decline. Market participants attributed the dollar's overall gains particularly to the stronger-than-expected U.S. economic data and the weaker-than-expected performance of the Canadian economy and economies in the euro area.

M2 grew briskly during March and April as continued low opportunity costs and the temporary effects of mortgage refinancing boosted liquid deposits. The strength was likely offset somewhat by the effects of individual non-withheld tax payments in April, which were lower than last year and therefore probably led to a smaller buildup in liquid deposits than incorporated in the seasonal adjustment factors. Although currency growth continued to be held down in the first quarter by weak demand from abroad, it moved closer to its long-term trend in April.

The staff forecast prepared for this meeting suggested that the economy would continue to expand briskly for the rest of 2004 before decelerating somewhat in 2005 as fiscal policy shifted to a slightly restrictive stance. The considerable monetary and fiscal stimulus this year and still-strong advances in structural productivity were expected to cause businesses to shed still more of the caution they had been exhibiting in investing and hiring. The labor market was projected to show steady improvement through the end of 2004, but the forecasted pace of hiring was expected to slow a little next year as economic growth moderated. The staff anticipated that inventories would increase at a modest rate during the forecast horizon as businesses responded to continued strength in demand. Business spending on equipment and software was expected to remain strong, with the expiration of the partial-expensing tax provision at the end of 2004 adding impetus this year. The rise in mortgage rates was not likely to show through to demand for housing until the second half of 2004 and was expected to be partially offset in the longer term by rising employment and personal income. The increases in employment and income were also projected to continue to boost consumer spending. In light of recent increases in some price measures, the staff anticipated a transitory rise in the pace of core inflation in the near term. However, it was expected that the remaining slack in resource utilization and strong productivity growth would keep core inflation at a low level over the forecast period.

In the Committee's discussion of current and prospective economic developments, a number of members noted that the outlook for production and employment had improved distinctly in the period since the March FOMC meeting. Newly available data as well as commentary from business contacts almost uniformly suggested that the expansion had continued to broaden and had become more firmly established. Statistical releases confirmed that consumer spending was rising at a brisk rate, housing activity remained at a high level, and business fixed investment was growing vigorously. Significantly, the most recent data also provided evidence that the pace of hiring had begun to pick up, a development that was expected to provide further support to the expansion going forward. Anecdotal information gathered from business contacts across the nation—particularly commentary suggesting rising orders, improving confidence, and a growing willingness to increase payrolls—tended to confirm the data that pointed to increasingly solid expansion. Prospects for growth continued to be supported by fiscal policy, which was expected to remain stimulative through 2004, and by the effects of monetary policy accommodation. Overall, Committee members were now more convinced that robust growth would be sustained, and most likely at a pace that would be adequate to make appreciable headway in narrowing margins of unutilized resources. Regarding the outlook for inflation, members took particular note of recent data pointing to jumps in consumer and producer prices. Many members indicated that the surprisingly large advances had substantially reduced the odds of further disinflation and also had increased their uncertainty about prospective price trends. Still, most members saw low inflation as the most likely outcome.

In their comments about key economic sectors, a number of members pointed to developments that were likely to support increased investment spending going forward. Many business firms appeared to be experiencing a significant pickup in demand. Anecdotal information suggested that some manufacturers had seen a notable rebound in orders, with several members citing, in particular, stronger demand for high-tech products as well as for machine tools, various types of heavy machinery, and aircraft. Also, optimism regarding economic prospects among business executives seemed to be mounting, no doubt prompted in part by the increased demand they were experiencing and robust growth in profits. Business contacts in several districts had indicated that, as a result of the improved outlook, they were taking steps to expand their capacity to produce, both by starting to augment work forces and by boosting fixed investment. Committee members generally perceived overall business fixed investment as accelerating considerably, especially for equipment and software. In contrast, investment in nonresidential structures remained sluggish, as vacancy rates in many markets were elevated and considerable excess capacity persisted in many production plants. Drilling, however, was said to be strengthening in response to high oil and gas prices.

While Committee members saw an overall brightening in the outlook for business fixed investment, a number of policymakers commented that some of the considerable caution that had earlier marked business attitudes apparently lingered. The pace of hiring seemed to be picking up only gradually, fixed investment was still moderate in comparison with the strong cash flow being generated by robust profits, and anecdotal information indicated that firms in most industries were continuing to exercise tight control over inventories. Indeed, several members remarked that the rate of inventory investment was surprisingly modest in the first quarter, although motor vehicle inventories were on the high side. On the whole, the evidence of continued caution and disciplined spending in the business sector was seen as boding well for the durability of the expansion.

Members viewed the household sector as continuing to play a key role in the expansion, with recent data as well as anecdotal information indicating that consumer spending was rising at a solid pace. After dropping back in January, auto sales had accelerated over the remainder of the first quarter and appeared to be well maintained in April. Expenditures for consumer services seemed to be expanding steadily. Several members noted that tourism in their regions was picking up. In addition, housing activity had stayed strong across the nation and was still climbing in some regions, with reports of growing backlogs in deliveries and substantial price increases in some markets. The overall vigor in household spending was being supported by substantial gains in disposable income, partly reflecting tax cuts, generally sound balance sheets, accommodative financial conditions, and increases in consumer sentiment over the past year or so. To date, the backup in fixed mortgage interest rates in recent months seemed to have had little adverse effect on homebuying, although it was noted that an appreciable further rise in longer-term market rates would represent a potential source of restraint on future household spending.

Fiscal policy was viewed as likely to buoy the expansion of economic activity through 2004. Real federal expenditures had jumped in the first quarter and were expected to rise further over the balance of the year. Next year, fiscal impetus was likely to diminish, largely owing to the expiration of the tax provision permitting partial expensing of certain capital outlays. Assessing the prospects for fiscal policy, however, was complicated by a lack of legislative progress to date in passing federal appropriations bills. Regarding the longer-term federal budgetary outlook, an apparent breakdown in fiscal discipline was seen as an ongoing concern. However, some progress was noted in reducing budgetary imbalances at the state and local levels.

The external sector was expected to provide limited support for U.S. economic growth over the next two years. Expansion of foreign economies was likely to fuel increases in U.S. exports, with strength expected particularly in computers and semiconductors. Real imports, however, also appeared likely to continue rising strongly as domestic demand climbed further, leading to a widening of already substantial trade and current account deficits. Some members saw a risk that growth in certain rapidly expanding regions abroad could slow, perhaps sharply, with potentially significant effects on the demand for U.S. exports as well as on global commodity prices.

After a protracted period of meager gains in employment, conditions in the U.S. labor market evidently were improving in recent weeks. In addition to noting the substantial jump in payrolls in March, several members relayed anecdotal information from business contacts around the nation that hiring was continuing to pick up and that firms were planning further increases in workforces. Some temporary help firms reported rising demand, a possible precursor of a pickup in permanent hiring. A number of members cited reports of difficulties in hiring within certain job families in which specialized skills were in short supply together with indications that wage increases in those occupations tended to be larger than average. Even so, considerable slack seemed to remain in the labor market overall, and wage gains on the whole were moderate.

Data on consumer and producer prices over the intermeeting period had generally come in on the high side of expectations, following considerable increases in commodity prices. A significant number of Committee members reported information from their contacts that businesses were increasingly able to pass on cost increases to their customers and to boost prices more generally. Some members cited instances in which earlier price discounts had been canceled and noted that surcharges for higher energy and steel prices were being added to base prices for certain goods. Nonetheless, the extent to which these developments signaled an upturn in underlying inflation was unclear. To some degree, the recent uptick in various price measures partly reflected factors, such as jumps in the prices of energy and non-oil imports, that were unlikely to be repeated. Also, the recent evidence could be interpreted as indicating that the surprisingly sharp decline in measured inflation in 2003 exaggerated the drop in the underlying rate of inflation. Indeed, some members saw underlying inflation as relatively stable and put low odds on the possibility that prices now were accelerating. In their view, a range of factors was continuing to restrain inflation, including slack in resource utilization, strong productivity gains and corresponding downward pressures on unit labor costs, currently high price markups, and longer-term inflation expectations that apparently remained contained. Others, however, were less confident about the degree of restraint on prices, noting that inflation predictions based on estimated output or employment gaps were subject to considerable error.

In the Committee's discussion of policy for the intermeeting period, all of the members favored maintenance of the existing target of 1 percent for the federal funds rate. It was recognized that the Committee would need to initiate a process of removing monetary policy accommodation at some point, and the recent experience suggested that the time at which policy firming appropriately would commence might be closer than previously had seemed most probable. However, the appreciable rise in real long-term interest rates over the intermeeting period implied that financial market conditions had already tightened on balance. Moreover, the evidence of a significant acceleration in hiring was still limited, and some members referred to the possibility that growth could falter, particularly if market yields were to rise sharply further. With inflation low and resource use slack, the Committee saw a continuation of its existing policy stance as providing a degree of support to the economic expansion that was still appropriate.

With regard to the Committee's announcement to be released after the meeting, it was understood that the recent evidence that hiring had picked up, as well as the continued solid growth in output, would be highlighted. Policymakers also concurred that, with the expansion apparently well established, the statement should again indicate that the upside and downside risks to sustainable growth for the next few quarters seemed to be roughly equal. Members saw both downside and upside risks to prospects for inflation. The probable persistence of slack in the economy for at least several more quarters, together with the likelihood that recent substantial gains in productivity would be extended, should continue to exert slight downward pressures on inflation. At the same time, though, the recent stronger-than-expected increases in a number of price measures, anecdotal information suggesting a greater ability of businesses to implement and sustain price hikes, and multiplying signs of solid economic growth suggested that the upside risks to inflation had increased. The members agreed that, all things considered, the risks to the goal of price stability had moved into balance in the period since the last meeting.

The Committee also discussed at length the advantages and disadvantages of modifying or dropping its statement in the announcement following the March meeting that "With inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation." All of the members agreed that, with policy tightening likely to begin sooner than previously expected, the reference to patience was no longer warranted. The Committee focused instead on a formulation that would emphasize that policy tightening, once it began, probably could proceed at a pace that would be "measured." A number of policymakers were concerned that such an assertion could unduly constrain future adjustments to the stance of policy should the evidence emerging in coming months suggest that an appreciable firming would be appropriate. Others, however, saw substantial benefits to inclusion of the proposed language. These members noted that current economic circumstances made it likely that the process of returning policy to a more neutral setting would be more gradual, once under way, than in past episodes when inflation was well above levels consistent with price stability. In addition, some policymakers observed that the timing and magnitude of future policy adjustments would ultimately be determined by the Committee's interpretation of the incoming data on the economy and prices rather than by its current expectation of those developments. On balance, all the members agreed that they could accept an indication in the statement that ". . . policy accommodation can be removed at a pace that is likely to be measured."

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Open Market Account in accordance with the following domestic policy directive.

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1 percent.

The vote encompassed approval of the paragraph below for inclusion in the press statement to be released shortly after the meeting:

> The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. Similarly, the risks to the goal of price stability have moved into balance. At this juncture, with inflation quite low and resource use slack, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, June 29–30, 2004.

The meeting adjourned at 1:15 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on June 29–30, 2004

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 29, 2004, at 2:30 p.m. and continued on Wednesday, June 30, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

Ms. Cumming, Messrs. McTeer, Moskow, Santomero, and Stern, Alternate Members of the Federal Open Market Committee

Mr. Guynn and Ms. Yellen, Presidents of the Federal Reserve Banks of Atlanta and San Francisco respectively

Mr. Lacker, President-Elect of the Federal Reserve Bank of Richmond

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Mattingly, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Fuhrer, Hakkio, Howard, Madigan, Sniderman, Slifman, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Oliner and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

Mr. Kamin,[5] Deputy Associate Director, Division of International Finance, Board of Governors

Messrs. Gagnon,[5] Leahy,[5] and Sheets, Assistant Directors, Division of International Finance, Board of Governors

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

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Thomas,[5] Section Chief, Division of International Finance, Board of Governors

Ms. Kusko[6] and Mr. Zakrajšek, Senior Economists, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

5. Attended portion of the meeting relating to the discussion of prospective external adjustment.

6. Attended portion of the meeting relating to the discussion of economic developments.

Mr. Carpenter,[6] Economist, Division of Monetary Affairs, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Mr. Lyon, First Vice President, Federal Reserve Bank of Minneapolis

Mr. Judd, Executive Vice President, Federal Reserve Bank of San Francisco

Messrs. Eisenbeis, Evans, Goodfriend, Mses. Mester and Perelmuter,[5] Messrs. Rolnick and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Chicago, Richmond, Philadelphia, New York, Minneapolis, and Dallas respectively

Ms. Goldberg[5] and Mr. Thornton, Vice Presidents, Federal Reserve Banks of New York and St. Louis respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on May 4, 2004, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period May 4, 2004, through June 29, 2004. By unanimous vote, the Committee ratified these transactions.

At this meeting, the Committee discussed staff papers and presentations on adjustment of the U.S. external accounts. At more than $500 billion, the deficits in trade and current account balances are quite large in comparison with aggregate income. Financing of the deficits had recently included both large foreign private purchases of U.S. securities and increased foreign official inflows. The sizable current account deficit could be viewed as reflecting very low levels of national saving, in both its government and private components, in relation to investment opportunities in the United States that were very attractive. The staff noted that outsized external deficits could not be sustained indefinitely. However, the historical evidence indicated that such deficits could be quite persistent, and the adjustment of imbalances was not necessarily imminent. The adjustment, once under way, might well proceed in a relatively benign fashion, particularly if fiscal, monetary, and trade policies were appropriate, but the possibility that the adjustment could involve more wrenching changes could not be ruled out. In any case, a movement toward balance in the trade and current accounts would likely have effects that differ appreciably across sectors of the U.S. economy. Members of the Committee noted that monetary policy was not well equipped to promote the adjustment of external imbalances but could best contribute by maintaining an environment of price stability that would foster maximum sustainable economic growth. Fiscal policy had a potentially larger role to play by promoting an increase in national saving, but the adjustment would involve shifts in demand and output both domestically and abroad, and changes to U.S. fiscal policy alone probably would not be sufficient to foster the adjustment.

The information reviewed at this meeting suggested that the economy continued to expand at a solid pace during the second quarter. Although growth in consumer spending appeared to have slowed somewhat, the demand for housing increased from its robust first-quarter pace. Business fixed investment, boosted by surging outlays on equipment and software, also grew rapidly. The labor market improved further during the quarter, with large gains in employment registered in April and May. Core consumer price inflation picked up, reflecting in part the pass-through of substantial advances in energy prices and non-energy import prices.

The labor market rebounded strongly in recent months. Private nonfarm payrolls grew rapidly in April and May, with hiring widespread across industries. The manufacturing sector appeared to be on a more solid footing, as manufacturers added jobs in each of the past four months after more than three years of declines. Aggregate hours moved up in both April and May, bringing the level of hours substantially above its trough of last summer. Despite the recent strength in hiring, the unemployment rate changed little in recent months, and the labor force participation rate remained low.

Industrial production accelerated in April and May after a sizable advance in the first quarter. Output at utilities surged in the latter month, reflecting weather-related factors, and factory output excluding motor vehicles, buoyed by strong gains in both high-tech manufacturing industries and in most non-high-tech industries, expanded sharply in both months. In contrast, the production of motor vehicles declined as automakers trimmed outsized inventory positions. Capacity utilization moved higher but stayed below its long-run average.

Growth in real consumer spending appeared to have slowed somewhat in recent months from its first-quarter pace. Although outlays for motor vehicles in May more than retraced their April decline and purchases of services advanced at an appreciable rate, spending on nondurable goods remained sluggish. Despite higher energy prices, real disposable personal income continued its uptrend in recent months, benefiting from an improved labor market and last year's tax cut. Home prices also continued to rise at a rapid pace, contributing importantly to increases in household wealth. Survey measures of consumer confidence moved up in June from already favorable levels.

Activity in the housing market increased in April and May despite a considerable rise in mortgage interest rates. Single-family housing starts edged above their rapid first-quarter pace, and sales of both new and existing homes reached record levels in May. In the volatile multifamily sector, housing starts fell somewhat in May, but, more generally, construction activity in this sector had been surprisingly resilient in light of the high vacancy rate for such units.

Business investment spending appeared to have advanced at a brisk pace in the second quarter, as rising output, low user cost of capital, and increased corporate cash flow continued to foster a favorable environment for capital spending. Although new orders and shipments of nondefense capital goods excluding aircraft dipped in May, both series remained on a solid uptrend, and, with orders exceeding shipments, backlogs continued to grow. Spending on transportation equipment, which dropped in the first quarter, appeared to rebound in recent months, while outside the transportation and high-tech sectors, increases in spending moderated from their rapid first-quarter pace. After declining in the first quarter, overall investment in nonresidential structures appeared to pick up a little in the second quarter, though the performance of the major types of construction remained mixed. Spending on office buildings and manufacturing structures continued to be depressed by high vacancy rates, while outlays for commercial buildings moved up in conjunction with declines in vacancy rates for such structures. In addition, judging by the number of natural gas drilling rigs in operation, spending on drilling and mining structures rose in recent months.

The pace of inventory accumulation remained subdued. Although the book value of manufacturing and trade inventories increased appreciably in the first quarter and continued to rise at about the same pace in April, the recent large increases in the book-value data were due importantly to a jump in the price of oil and a run-up in the prices of intermediate materials. Inventory–sales ratios in manufacturing and retail trade edged higher in April but remained near their historical lows; meanwhile, inventory–sales ratios in the wholesale trade sector trended lower.

The U.S. international trade deficit reached a new record in April, reflecting in large part a sharp decline in exports of goods. The fall in goods exports was widespread, with notable decreases in capital goods, industrial supplies, and agricultural products. Exports of services, in contrast, increased in April. Imports of goods edged higher, as a large decline in the value of imported oil was offset by an increase in imports of non-oil products, and imports of services increased. Real GDP in the major foreign industrial countries expanded at a healthy pace in the first quarter. Indicators of economic activity in the second quarter for Canada and the United Kingdom were also favorable, whereas those for the euro area were somewhat mixed. Japan's economy, supported by robust private domestic demand and rising consumer confidence, evidently continued to expand strongly in the second quarter. Mainly as a result of higher energy prices, consumer price inflation moved up a bit in the second quarter in Canada, the United Kingdom, and the euro area, while slight deflation persisted in Japan.

Consumer price inflation turned up this year from the very low rates registered in 2003, both for overall measures and for those that exclude food and energy. Overall consumer prices rose more quickly than core prices, reflecting the direct contributions of substantial increases in prices of food and energy. But the step-up in core inflation was also due in part to the pass-through of higher energy and import costs into core consumer prices. Some survey measures of short-term inflation expectations moved higher in recent months, but longer-term expectations remained reasonably well contained. Commodity prices escalated sharply during the early months of 2004, but indexes of spot prices for industrial materials and for wholesale gasoline retreated appreciably in recent weeks. Meanwhile, labor costs appeared to have turned up in the first half of the year. Hourly compensation in private industry rose in the first quarter at the same rate as in 2003, but with the pace of productivity advance moderating, unit labor costs moved higher. In April and May, increases in average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls exceeded the monthly gains registered in the first quarter and were well above the increases in the fourth quarter of 2003.

At its meeting on May 4, 2004, the Federal Open Market Committee decided to leave its target for the federal funds rate unchanged at 1 percent. The Committee retained its assessment that the upside and downside risks to the attainment of sustainable growth were roughly equal, but it announced that the risks to the goal of price stability had moved into balance. The Committee also noted that output had continued to expand at a solid pace, new hiring had appeared to pick up, and although incoming data on inflation showed that it had moved somewhat higher, longer-term inflation expectations had remained well contained. Reflecting these developments, the Committee concluded that it could remove policy accommodation at a pace that was likely to be measured.

The Committee's decision at its May meeting to leave the intended level of the federal funds rate unchanged had been fully anticipated by market participants. Likewise, the replacement of the sentence in the announcement reporting that the Committee could be patient in removing policy accommodation with one indicating that policy accommodation can be removed at a pace that is likely to be measured had little net effect on money market futures rates on the day of the announcement. Over the balance of the intermeeting period, however, market participants marked up significantly the extent of expected policy tightening in response to data that indicated robust gains in employment and spending and somewhat elevated inflation, as well as to comments by Committee members providing reassurance that policy would be tightened as necessary to contain any incipient inflationary pressures. Revisions to policy expectations showed through to interest rates on nominal Treasury securities, which increased commensurately. Yields on inflation-indexed Treasury securities rose almost as much as those on their nominal counterparts, leaving inflation compensation only slightly higher, on net, by the end of the intermeeting period. Yields on investment- and speculative-grade corporate securities rose about the same amount as those on comparable Treasuries, leaving risk spreads about unchanged. Generally positive economic news and further improvements in the outlook for corporate earnings evidently offset the influence of higher interest rates, and major equity indexes edged higher over the intermeeting period. In foreign exchange markets, the dollar depreciated somewhat against major currencies, and it rose a bit against an index of currencies of other major U.S. trading partners.

M2 continued to expand rapidly in May. The upswing in M2 growth since late winter stemmed in part from the temporary effects of mortgage refinancing, which boosted liquid deposits over this period, though M2 was also buoyed by strong gains in nominal income. In recent months, a rebound in currency growth and reduced portfolio shifts by households from monetary assets to equities and bonds also supported the expansion of M2. The growth of M2 slowed appreciably during the first half of June. Commercial bank credit decelerated in May, reflecting a contraction in bank holdings of securities and a slowdown in the growth of loans. The slowing in loan growth was concentrated mainly in real estate credits and was due partly to heavy securitizations.

The staff forecast prepared for this meeting suggested that the economy would continue to expand at a solid pace through 2005. Monetary policy was expected to support economic activity over the projection period, and fiscal policy was anticipated to remain accommodative through 2004. Moreover, persisting strong gains in structural productivity would likely continue to provide significant impetus to spending. With firms shedding their unusual caution of the past few years, further large additions to payrolls over the next several quarters were anticipated, followed by a gradual moderation in the rate of increase in employment. Strong profits, sustained increases in aggregate demand, and a favorable financing environment were expected to keep business spending on equipment and software on a healthy upward trajectory over the forecast period. The impending expiration of the partial-expensing tax provision was likely to provide an additional boost to capital spending later this year, although the shifting forward of some investment was expected to dampen capital spending in early 2005. In addition, inventory investment was forecast to increase gradually in order to bring changes in stocks closer in line with rising sales. Robust employment growth and the cumulative productivity gains of recent years were expected to contribute to strong advances in real disposable income, sustaining the expansion of consumption spending over the forecast period. Core inflation was projected to fall back later this year from its pace in the first five months and to remain low in 2005, as the transitory effects of higher energy and non-oil import prices waned.

In the Committee's discussion of current and prospective economic conditions, members commented that the evidence accumulated over the intermeeting period continued to portray an economy that was expanding briskly and was likely to continue to do so for some time. Business and consumer expenditures were on a strong uptrend, and related growth in output was associated with notable improvement in labor market conditions and in manufacturing activity. Members saw the persistence of a relatively vigorous expansion in overall economic activity as a likely prospect in the context of continuing stimulus from fiscal and monetary policies, accommodative financial conditions, growing business optimism, favorable consumer sentiment, and robust increases in productivity. Solid increases in economic activity and employment should in turn provide ongoing support to business and consumer spending. Members acknowledged that their favorable outlook for economic activity was based on the assumption that major terrorist disruptions would be averted.

In light of the strength of economic activity and recent indications of somewhat increased price pressures, the members focused particular attention on the outlook for inflation. They referred to statistical and anecdotal evidence that on the whole pointed to some recent acceleration of consumer prices and to some increase in near-term inflation expectations. Factors cited in this regard included large increases in prices of energy and intermediate materials, both of which appeared to be passing through at least in part to core consumer prices. Members referred to some limited inflationary impetus as well from the depreciation of the dollar and larger increases in labor compensation. Considerable uncertainty still surrounded the overall extent to which competitive pressures would allow producers to pass through rising costs to prices of finished goods; anecdotal reports suggested that the ability of many producers to do so was increasing but was far from universal at this point. With regard to the prospective course of inflation, members suggested that some of the rise in core inflation in recent months appeared to have resulted from what might well prove to be transitory factors, notably including increases in energy and other import prices, which were not seen as likely to persist and indeed might be partially reversed. Just how much slowing of price increases was likely after some relatively elevated readings was difficult to forecast. Those who anticipated a noticeable deceleration emphasized the contribution of the one-time price increases that had boosted inflation recently, persisting, albeit diminishing, margins of unemployed labor and other productive resources, the anticipation of strong further gains in productivity and declines in markups of goods prices over costs, and steady long-term inflation expectations. Others tended to emphasize the changes in business attitudes and expectations, the strength in labor compensation, and the tendency for underlying inflation trends to be subject to considerable momentum that was unlikely to be reversed quickly. Whatever their inflation forecasts, several noted that they now had less confidence in those forecasts than earlier. A number of members qualified their inflation outlook by noting that its realization likely would require an adjustment to monetary policy over time that brought the latter to a neutral stance as the economy continued to move toward full utilization of its resources.

In preparation for the midyear monetary policy report to Congress, the members of the Board of Governors and the presidents of the Federal Reserve Banks submitted individual projections of the growth of GDP, the rate of unemployment, and the rate of inflation for the years 2004 and 2005. The forecasts of the rate of expansion in real GDP were concentrated in the upper part of a 4 to 4¾ percent range for 2004, implying expectations by most members of a pickup over the second half of the year; for 2005 the forecasts were in a reduced range of 3½ to 4 percent. These rates of growth were associated with ranges for the civilian rate of unemployment of 5¼ to 5½ percent in the fourth quarter of 2004 and 5 to 5½ percent in the fourth quarter of 2005. Forecasts of the rate of inflation, as measured by the core PCE price index, pointed to marginally higher rates of inflation encompassed by ranges of 1½ to 2 percent for this year and 1½ to 2½ percent for 2005.

In their comments about developments in key sectors of the economy, many of the members emphasized the strength in business capital spending. Explanatory factors included the sustained demand for business output, strong profit margins and cash flow, low capital costs, and the partial-expensing tax provision. Weakness persisted, however, in the nonresidential construction sector, though signs of improvement were emerging in some areas. Many business contacts were expressing a marked degree of optimism about the outlook for business activity in the second half of the year. Currently low inventory-to-sales ratios, indeed reports of emerging bottlenecks in some markets, were expected to foster efforts to rebuild inventories and thus add support to the expansion going forward.

Consumer outlays were rising more moderately in the second quarter and somewhat below expectations. The slowing was not universal, however. Some members reported a continuation of robust consumer expenditures in various parts of the country. Looking ahead, members, in part echoing the sentiment of contacts among retailers, anticipated renewed strength in consumer spending in the context of sizable further growth in employment and disposable incomes and a generally high level of consumer confidence. In housing markets, activity had remained at generally high levels, with only a few signs that rising mortgage rates were beginning to hold down sales and construction. There was evidence in some areas that inventories of unsold homes had risen. Members noted that persisting overall strength in housing might to some extent be a response to expectations of further increases in mortgage rates, implying that a slowdown might be likely later in the year.

Members commented that fiscal policy was continuing to provide appreciable impetus to the economy, in part because of the incentives for business investment associated with the partial-expensing tax legislation. Following the scheduled expiration of that legislation at the end of this year and with more moderate gains in federal spending forecast in the absence of new legislation, the federal budget was expected to become mildly contractionary in 2005, although a marked degree of uncertainty surrounded this outlook. Many state and local governments were increasing their spending more rapidly in response to brightening budget situations.

Expanding foreign economies and the depreciation of the dollar were expected to foster appreciable growth in U.S. exports, but with imports still considerably larger than exports, the external sector was likely to make a measurable negative contribution to U.S. GDP growth this year and next. On the inflation side, higher import prices and, importantly, the rise in domestic and imported oil prices were adding to domestic inflationary pressures, although improving oil supplies had recently contributed to somewhat lower domestic gasoline prices.

In the Committee's discussion of policy for the intermeeting period, all of the members indicated that they could support an upward adjustment in the target for the federal funds rate from a level of 1 percent to 1¼ percent. Recent developments, notably the persistence of solid gains in output and employment along with indications of some increase in inflation, were seen as warranting a first step in the process of removing policy accommodation. The timing and pace of further policy moves would depend, of course, on the members' reading of the incoming economic information and their interpretation of its implications for economic activity and inflation. In this regard, members commented that they could envision a series of gradual or "measured" policy moves as likely to be consistent with the attainment of the Committee's objectives for sustaining progress toward higher levels of resource utilization and maintaining price stability. A few indicated, however, that their preference would be to remove any characterization of possible future policy actions from the Committee's statements. Partly reflecting anticipated monetary policy actions, financial market conditions had tightened in recent months, but short-term interest rates were quite low, especially when judged against the recent level of inflation. Depending on the rate at which resource utilization increased and the level and trend of inflation, a more aggressive pace toward reaching a neutral policy stance might be called for so as to provide assurance of containing emerging inflationary pressures and averting the potential need for greater overall tightening over time.

In the Committee's review of the announcement to be released shortly after this meeting, members agreed that an updating of the reasons for its policy decision was desirable, specifically by adding a reference to the possibility that some of the recent acceleration in inflation might reflect transitory factors. The members also decided to modify the reference to labor market conditions by referring in general terms to improved conditions rather than more narrowly to a pickup in hiring to acknowledge the broad range of labor market indicators considered by the Committee. They agreed to retain the assessments adopted at the May meeting indicating that they viewed the upside and downside risks to both the attainment of sustainable economic growth and to the goal of price stability as roughly in balance for the next few quarters. However, with regard to the outlook for inflation, a number of members emphasized that they would view the risks as tilted to the upside in the absence of further policy tightening actions that would bring the stance of policy to a more neutral setting. Many members also underscored their view that the statement should make clear that the Committee would be prepared to respond to significant changes in economic prospects and take actions that were deemed necessary to meet the Committee's commitment to maintain price stability.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive.

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 1¼ percent.

The vote encompassed approval of the paragraph below for inclusion in the press statement to be released shortly after the meeting:

> The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters are roughly equal. With underlying inflation still expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

> Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

The next meeting of the Committee was scheduled to be held on Tuesday, August 10, 2004.

The meeting adjourned at 1:35 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on August 10, 2004

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 10, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

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

Messrs. Guynn, Lacker, and Ms. Yellen, Presidents of the Federal Reserve Banks of Atlanta, Richmond, and San Francisco respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Hakkio, Howard, Madigan, Rasche, Sniderman, Slifman, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Oliner and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

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

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Nelson, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Messrs. Goodfriend and Rudesbusch and Ms. Mester, Senior Vice Presidents, Federal Reserve Banks of Richmond, San Francisco, and Philadelphia respectively

Messrs. Cunningham, Hilton, Marshall, Tootell, and Wynne, Vice Presidents, Federal Reserve Banks of Atlanta, New York, Chicago, Boston, and Dallas 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 29–30, 2004, were approved.

By unanimous vote, the Federal Open Market Committee approved the election of Scott G. Alvarez as General Counsel of the Committee to serve until the election of a successor at the first regularly scheduled meeting after December 31, 2004.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on recent developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period June 29, 2004, through August 9, 2004. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that economic growth softened somewhat in recent months. While strength in the housing market persisted and business outlays remained healthy, growth in consumer spending fell off significantly. Additionally, gains in employment, which were robust in earlier months, slowed sharply in June and July. Industrial production also decelerated modestly in June, but available indicators suggested a bounceback in July. Core consumer price inflation moderated in May and June, despite further increases in energy prices.

Growth in employment slowed in June and July after displaying significant improvement in preceding months. The weakness was reported to be widespread, with the retail trade, information, financial activities, and government sectors registering declines on average over the two months. The construction and services sectors posted gains, but at a pace well below those of previous months. In contrast, after little change in June, payrolls in manufacturing rose appreciably in July. The average workweek declined in June but edged up in July, and aggregate hours of private production workers showed a similar pattern. Labor force participation moved up slightly in recent months, and the unemployment rate, which was unchanged in June, edged down to 5½ percent in July.

After rising rapidly in April and May, industrial production declined modestly in June, although manufacturing output, excluding motor vehicles and parts, increased a bit. Production of motor vehicles and parts declined noticeably, as automakers scaled back assemblies in response to elevated inventories. Output at utilities also fell in June as temperatures returned to more normal levels after an unseasonably warm May. Activity in the mining sector changed little. Overall capacity utilization was off slightly in June, but utilization on average over the quarter was above that of the first quarter. However, data on the growth in production-worker hours and other indicators of production suggested that manufacturing output bounced back in July.

Growth in consumer spending slowed sharply in the second quarter, posting only a small increase after a robust expansion in the first quarter. Although gains in outlays for services continued at a solid rate in the second quarter, expenditures for goods declined markedly. Data on consumer expenditures showed particular weakness in June, with either declines or no growth in purchases across most categories of goods and services. Purchases of cars and trucks contracted in that month but rebounded in July. Real disposable income was unchanged in June, held back by increases in prices of food and, especially, energy.

Activity in the housing market remained strong in June despite some variation across segments. Single-family housing starts fell back from very high levels in April and May. Multifamily housing starts also declined in June, though only a bit. Sales of existing homes jumped again in June to set a new record, and sales of new homes came in just below the record pace posted in May.

Business investment spending on equipment and software was solid in the second quarter, posting growth a little above the pace of the first quarter. Performance across categories, however, was uneven. Spending in the transportation equipment sector bounced back from a first-quarter decline, and outlays in the high-tech sector grew twice as fast as overall equipment and software spending in the quarter. Excluding transportation and high-tech equipment, however, gains were minimal. Real business investment in nonresidential structures turned up in the second quarter, albeit to a still-depressed level. Increased spending on office buildings, commercial structures, and various other types of buildings more than offset a sizable decline in the power generation component.

Real nonfarm inventories excluding motor vehicles picked up in the second quarter as the manufacturing, merchant wholesalers, and retail trade segments all boosted stocks. Book-value inventory–sales ratios edged up, but remained at fairly low levels.

The U.S. international trade deficit declined somewhat in May after reaching a record high in April. The value of exports of goods and services climbed substantially, with exports of goods more than accounting for the entire rise, as exports of services edged down. The value of imports of goods and services also increased in the month, but by less than exports. Available data indicated that major foreign industrial economies continued to expand at a solid pace in recent months. In Japan, gains in exports and household expenditures fueled the advance in output, and surveys of business and consumer confidence were also favorable. Real GDP accelerated in the United Kingdom, and economic activity grew at a solid pace in Canada, led by a surge in investment. Indicators for the euro area suggested that activity decelerated a bit in the second quarter. Growth of real GDP in China slowed significantly in the spring.

Core consumer price inflation moderated substantially in May and June, though sizable increases in food and energy prices continued to push up overall consumer price inflation. Increases in the food and energy components of the CPI were smaller in June than in May, and further deceleration was expected as gasoline and natural gas prices eased in July and supply conditions in a number of agricultural segments improved. In July, households' expectations for consumer inflation in the year ahead fell somewhat. Overall producer prices for finished goods were down in June, as declines in prices for food and energy were only partially offset by modest growth in the core components of the index. With regard to labor costs, the employment cost index for hourly compensation of private workers for the three months ending in June advanced at about the same rate as it had over the previous year-and-a-half. Unit labor costs, however, increased faster in the second quarter than in the first.

At its meeting on June 29–30, 2004, the Federal Open Market Committee adopted a directive that called for conditions in reserve markets consistent with increasing the federal funds rate to an average of around 1¼ percent. The Committee continued to perceive that the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters were roughly equal. In its public statement, the Committee noted that, with underlying inflation still expected to be relatively low, it believed that policy accommodation could be removed at a pace that was likely to be measured, but that, nonetheless, it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

This decision to raise the intended level of the federal funds rate by 25 basis points was anticipated in the financial markets, yet investors revised down their expectations for the path of policy upon the release of the accompanying statement. In particular, investors noted that the Committee attributed some of the recent increase in inflation to transitory factors, retained its earlier balance of risks assessment, and reiterated its belief that policy accommodation could be removed at a pace that would likely be measured. Subsequently, the Chairman's Congressional testimony on monetary policy, which suggested that recent softness in consumer spending should prove short-lived and emphasized the FOMC's commitment to price stability, spurred an upward tilt in the market's expected path of monetary policy. Over the remainder of the intermeeting period, though, expectations of policy tightening were revised down somewhat, on balance, as incoming data pointed to weaker-than-anticipated spending and employment and more subdued core inflation. Yields on intermediate- and long-term nominal Treasury securities dropped significantly over the intermeeting period. Available data suggested that corporate credit quality remained strong, and yields on investment-grade bonds moved roughly in line with those on Treasury securities. Speculative-grade yields, however, fell by less. In equity markets, broad indexes declined appreciably, reflecting the soft economic data, concerns about energy prices, and guidance from corporations pointing to a less-optimistic trajectory for earnings than investors apparently had been expecting. In foreign exchange markets, the dollar's trade-weighted value against other major currencies ended the period little changed, on net.

Following several months of robust expansion, M2 grew at a slower pace in June and available data implied a slight contraction in July. Most of the weakness owed to a slowdown in liquid deposit growth that was related in part to the decline in mortgage refinancing activity. In addition, retail money market funds resumed their earlier decline. Currency growth, however, strengthened over the two months, partly as a result of a pickup in foreign demand.

The staff forecast prepared for this meeting suggested that the economy would continue to expand at a solid pace through 2005, supported by a relatively accommodative monetary policy over the projection period and by stimulative fiscal policy through 2004. Consumer spending was expected to strengthen in the near term, boosted by strong consumer confidence and rising disposable income, which would likely continue to be propelled by robust growth in structural productivity. Favorable financial conditions, higher profits, and the partial-expensing tax incentives over the remainder of this year were projected to lead to a near-term acceleration in business fixed investment. Subsequently, growth in capital spending was expected to moderate somewhat but still to remain on a healthy upward trajectory. Despite recent weakness in employment growth, the waning of firms' unusual caution of recent years was expected to foster a pickup in hiring over the next several quarters. Consumer price inflation was projected to remain low over the forecast period as the sharp increases in energy and import prices experienced earlier in the year partially unwound. Slack resource utilization through 2005 was also expected to help hold down inflation.

In the Committee's discussion of current and prospective economic developments, members noted that the pace of the expansion had moderated. In particular, consumer spending, which had previously provided considerable support to aggregate demand, had slowed sharply in the second quarter. At the same time, growth in payrolls had fallen back in June and July after posting significant gains in the spring. While the recent moderation in growth might portend a substantially slower expansion going forward than had previously been expected, the Committee did not see such a sizable shortfall as the most likely outcome. Activity in the housing sector remained strong, and investment outlays continued to advance at a good pace. With economic growth buoyed by accommodative monetary policy and supportive credit conditions more generally as well as by robust underlying growth in productivity, the Committee believed that conditions were in place for the pace of expansion to strengthen enough to continue to trim margins of slack in resource utilization. Indeed, the limited available evidence pointed to a rebound in household spending, especially on motor vehicles, in July and early August, and some indicators suggested continued improvement in labor market conditions. Regarding the outlook for inflation, the most recent data were seen as consistent with an assessment that a portion of the higher rates of price increases recorded earlier in the year had reflected transitory factors.

Committee members generally agreed that higher energy prices had played an important role in the recent moderation of economic growth. While the direct effect of higher energy prices on real disposable income could account for only a relatively small part of the reduction in the growth of consumer spending, some members suggested that those effects may have been exacerbated by substantial increases in expected future energy costs as well as greater uncertainty about those costs. Moreover, the economy seemed to have responded in some past episodes to sharp increases in energy costs by much more than could be explained by most models. Still, some Committee members doubted that higher energy prices were sufficient to explain all of the recent slowdown in spending. Effects of increased energy prices on consumer and business confidence, which might have led to a larger spending response, had not been evident, and the consequences for growth in other industrialized countries dependent on imported oil appeared to have been fairly modest thus far. Informed in part by prices in futures markets, Committee members anticipated that energy costs would level out and perhaps fall back from their recent highs, but they noted that there was considerable uncertainty about that outlook.

Policymakers focused their comments about key sectors of the economy on the slowdown in consumer spending toward the end of the second quarter. Business contacts in some parts of the country suggested that, in addition to higher energy prices, unseasonable weather may have limited spending for a time. The Committee discussed a number of other factors that may have contributed to the slowdown, including a waning of the stimulus from last year's tax cuts, which had previously provided considerable impetus to spending, and the possibility that, with stock prices down, saving rates near historic lows, and the outlook more uncertain, households may have felt the need to boost saving. Although a complete accounting for the moderation in growth was not possible, the Committee agreed that a resumption of faster growth in consumer spending was very likely. Continued strength in home construction did not suggest that households were in the process of retrenching, and gains in income, low interest rates, and robust consumer confidence were seen as undergirding further gains in household spending going forward. Members noted that reports of rising motor vehicle sales in July and early August and a firming of chain store sales in recent weeks provided some limited evidence that consumption spending was picking up.

Investment spending had continued to advance, though perhaps at a somewhat slower pace than some members had anticipated. Several policymakers noted that businesses remained cautious about capital spending and hiring and were attempting to boost production as much as possible with existing capacity and payrolls. Indeed, some members suggested that heightened uncertainty, reflecting the effects of higher energy prices and increased concerns about geopolitical risks, might have contributed to greater business caution of late. Nonetheless, business confidence generally remained high, and the fundamentals for investment—including solid growth in productivity, robust profits and cash flow, and accommodative financial markets—pointed to continued healthy gains in business outlays. A few members also noted that the commercial real estate sector, which had been weak for some time, was showing signs of improvement.

In their remarks regarding the external sector of the economy, members noted that on average growth abroad had remained reasonably robust, which should support U.S. exports. However, the U.S. trade deficit was expected to remain large as imports increased in response to solid growth in the United States.

In their discussion of recent labor market trends, Committee members noted the slowing of job growth reported in June and July. Committee members pointed to several factors that that might have contributed to the recent weakness. Firms' focus on controlling costs and implementing further productivity improvements were doubtless continuing to play a role. Higher labor costs, particularly those related to health benefits, were also reportedly weighing on some firms' hiring decisions. However, policymakers noted that the monthly payrolls data might be providing an incomplete picture of expansion in economic activity because of near-term variation in the rate of growth of productivity. In addition, many members pointed to data from the survey of households, which showed both a rise in labor force participation and a decline in the unemployment rate in July, as well as to initial claims for unemployment compensation, which remained near recent lows. Moreover, survey data on labor market attitudes of both consumers and businesses had not signaled a significant deterioration in employment prospects. All things considered, the Committee expected the pace of employment gains to improve in coming months.

In their review of the outlook for prices, members noted that incoming data over the intermeeting period had shown a slowing in core inflation from the high levels posted earlier in the year, consistent with the Committee's view that a portion of the earlier increase had reflected transitory factors. Information from business contacts suggested that a number of firms had been able to pass on at least some of their higher energy and other costs to customers, but few signs of more widespread price increases were apparent. Some members expressed concern about developments in the transportation sector, where trucking costs were reportedly on the rise and bottlenecks in the railroad industry were triggering delivery delays. Looking forward, however, most members thought that rapid productivity growth and flat or declining energy prices would limit increases in the overall unit costs of businesses. Despite the higher rates of headline inflation earlier in the year, longer-term inflation expectations remained well contained and slack in resource markets was seen as persisting, leading the Committee to expect underlying inflation to be relatively low.

In the Committee's discussion of policy for the intermeeting period, all the members favored an increase in the target for the federal funds rate from 1¼ to 1½ percent. Although the pace of economic growth had moderated in the second quarter, the Committee believed that the softness would prove short-lived and that the economy was poised to resume a stronger rate of expansion going forward. Given the current quite low level of short-term rates, especially when judged against the recent level of inflation, members noted that significant cumulative policy tightening likely would be needed to foster conditions consistent with the Committee's objectives for price stability and sustainable economic growth. In this context, a relatively small tightening move at this meeting would help to limit the risk of a rise in inflation expectations and reduce the likelihood that policy might need to be adjusted more sharply in the future, thereby lowering the attendant risks to financial markets and the economy. The members thought that policy accommodation probably could be removed gradually—a view that had been reinforced by the slower pace of growth and more moderate rates of price increase that had become evident over the intermeeting period. However, members also recognized that the timing and pace of additional policy tightening would depend importantly on incoming economic data and the Committee's assessment of their implications for economic activity and inflation.

With regard to the Committee's announcement to be released after the meeting, members agreed that the description of recent economic circumstances should acknowledge the slowing in output and employment growth, as well as highlight the role of higher energy prices in those developments. They also agreed to retain the assessments adopted at the June meeting that the risks to the Committee's goals of sustainable economic growth and price stability were balanced over the next few quarters. While a more persistent slowing of household spending was possible, and more subdued inflation readings over the intermeeting period had eased concerns about a potential increase in underlying inflation, policymakers continued to judge the risks to sustainable growth and the inflation outlook as roughly balanced. The Committee chose to reiterate its belief that policy accommodation could be removed at a pace that is likely to be measured as well as its intention to respond to changes in economic prospects as needed to fulfill its obligation to achieve its goal of price stability.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive.

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 1½ percent.

The vote encompassed approval of the paragraph below for inclusion in the press statement to be released shortly after the meeting:

> The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters are roughly equal. With underlying inflation still expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 21, 2004.

The meeting adjourned at 1:00 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on September 21, 2004

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 21, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

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

Messrs. Guynn and Lacker, and Ms. Yellen, Presidents of the Federal Reserve Banks of Atlanta, Richmond, and San Francisco respectively

Mr. Reinhart, Secretary and Economist
Mr. Bernard, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Fuhrer, Hakkio, Howard, Madigan, Slifman, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

Messrs. Oliner and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

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

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Ms. Danker, Special Assistant to the Board, Division of Monetary Affairs, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Ms. Weinbach, Senior Economist, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Mr. Judd, Executive Vice President, Federal Reserve Bank of San Francisco

Messrs. Eisenbeis, Evans, and Goodfriend, Mses. Mester and Perelmuter, and Messrs. Rolnick and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Chicago, Richmond, Philadelphia, New York, Minneapolis, and Dallas respectively

Messrs. Bryan and Gavin, Vice Presidents, Federal Reserve Banks of Cleveland and St. Louis respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 10, 2004, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on recent developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period August 10, 2004, through September 20, 2004. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that economic growth regained some vigor in recent months after having slowed in late spring. The August labor market report showed a moderate gain in payrolls. After contracting in June, industrial production strengthened modestly on average in July and August, and the increases were widespread across sectors. Consumer spending rose sharply in July, housing activity increased further in August, and business outlays picked up last month. Core consumer price inflation moderated in June and July, and a decline in energy prices further damped overall inflation in July.

The labor market improved in August, and the unemployment rate edged down to 5.4 percent. Private nonfarm payrolls grew moderately, with gains registered in the manufacturing, construction, financial activities, and nonbusiness services categories. In addition, the figures for June and July were revised upward and suggested that the deceleration in hiring over that period was not as abrupt as had been previously thought. The average workweek was unchanged in August from the upward-revised July level and was a bit higher than its second-quarter average. The labor force participation rate edged down in August.

Total industrial production advanced modestly on average in July and August, down slightly from its second-quarter pace. The increases in manufacturing production since the end of the second quarter were widespread. Output of motor vehicles and parts jumped in August. Excluding motor vehicles and parts, the expansion in manufacturing output was brisk in July but more subdued in August. In the high-tech sector, computer production continued to rise in August, and the output of communications equipment posted its fourth consecutive monthly increase. In contrast, output at utilities declined further in July and August, while mining-related production was about flat on average over those same months. The rate of capacity utilization ticked up in July from its average over the first half of the year and remained steady in August.

Real consumer spending grew sharply in July after having slowed in the second quarter, and the available indicators suggest that spending held fairly steady in August. Expenditures on goods jumped in July and moderated in August, while spending on services moved up somewhat in July. Purchases of motor vehicles surged in July and fell back in August. For the two months together, the average pace of these outlays exceeded that seen in the first half of the year, reflecting in part a further sweetening of incentives. Real disposable income was up slightly in July, as increases in compensation were largely offset by declines in other income categories. The latest readings on consumer confidence showed a drop in August amid labor market slack and near-record gasoline prices, and a further slight decline in September, but the readings for the third quarter averaged above those for the second quarter.

Housing activity increased further in August. Housing starts for new single-family homes bounced up in July and remained about unchanged in August, and starts of multi-family homes rose somewhat each month. Taken together, total housing starts in August reached the highest level in five months. Home sales remained robust in July for both existing and new homes, although sales were below the monthly peaks recorded earlier in the year. Interest rates on thirty-year conventional mortgages receded over the past couple of months, retracing much of the runup in rates that occurred earlier in the year. Weekly data on mortgage applications to purchase homes continued to move up, on average, through mid-September.

Business outlays for equipment and software increased at a significant pace in the second quarter, and the available data pointed to a similar advance more recently. Spending was being supported by the continued gains in business output, low financing costs, ongoing price declines for high-tech capital, and the corporate sector's large cushion of liquid assets. Spending on transportation equipment and other capital goods was brisk in the second quarter, although expenditures in the high-tech sector decelerated. In July, shipments of capital goods excluding aircraft fell substantially from the rate seen in the first half of the year, but orders were relatively strong. Real business investment in nonresidential structures remained depressed, but the most recent data provided a sign of some improvement. In the office sector, the vacancy rate came in only a little below its recent peak, although property values had inched up, and the vacancy rate for industrial space also remained near its high. The retail sector, in contrast, continued to fare better.

Excluding motor vehicles, the pace of inventory accumulation in July continued at its second-quarter rate. A decline in stocks in the retail trade segment was more than offset by stockbuilding in the manufacturing and wholesale trade segments. Although the book value of manufacturing and trade inventories rose appreciably in July, these gains were again inflated by price increases in the petroleum sector. Inventory–sales ratios in the manufacturing sector, as in the retail and wholesale trade sectors (excluding motor vehicles and parts), remained about flat in July.

The U.S. international trade deficit reached a record high in June, bringing it to a new high in the second quarter as a percentage of nominal GDP. While the deficit fell back in July, it remained much above May's reading. In June, exports fell sharply, with declines widespread, while imports rose, owing in part to a surge in petroleum imports. In July, exports registered a modest recovery, driven by capital goods, industrial supplies, and automotive products, while the value of imports fell with the sharp decline in oil imports. Economic activity in the major foreign industrial countries continued to expand in the second quarter, although growth slowed in Japan and in the euro area. Indicators to date for the third quarter were mixed.

Core consumer prices edged up slightly over the months of June and July, as inflation in both goods and services moderated. The core PCE price index was flat in July but, like the core CPI, was up a bit on balance over June and July. The twelve-month change in core consumer prices based on either measure was somewhat higher this July than for the same period last year. Retail energy prices fell in July, led by a drop in gasoline prices after large gains in a number of earlier months. During the summer, gasoline inventories climbed above seasonal norms because of lower demand and increased imports, and the resulting downward pressure on margins led gasoline prices to fall even as crude oil prices moved higher. Owing to the decline in energy prices in July, inflation in overall consumer prices slowed that month. In August, households' expectations for consumer inflation in the year ahead edged lower for the second consecutive month. Meanwhile, after a small rise in July, the prices of finished goods faced by producers moved down a bit in August. Turning to labor costs, hourly compensation in the nonfarm business sector rose at a faster pace in the second quarter than it did in the first, but the advance was in line with the average rate of increase over the preceding four quarters. Unit labor costs measured at nonfinancial corporations also registered an increase in the second quarter.

At its meeting on August 10, 2004, the Federal Open Market Committee decided to increase the target federal funds rate by 25 basis points, to 1½ percent, and to retain its assessment of balanced risks with respect to sustainable economic growth and price stability. In its announcement, the Committee noted that output growth had moderated in recent months and that the pace of improvement in labor market conditions had slowed, but that the softness likely owed importantly to the substantial rise in energy prices. It also noted that while inflation was somewhat elevated this year, a portion of the pickup seemed to reflect transitory factors. The Committee went on to comment that the economy appeared poised to resume a stronger pace of expansion going forward, that it continued to believe that policy accommodation could be removed at a pace that was likely to be measured, and that it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Although the Committee's decision to raise the intended level of the federal funds rate by 25 basis points was widely anticipated in financial markets, the accompanying statement was read as setting a more optimistic tone about economic prospects than had been anticipated and prompted investors to mark up their expectations for the near-term path of policy. That sentiment was apparently reinforced over the remainder of the period by the comments of several Federal Reserve officials and the release of the August employment report, which seemed to convey the view that the economy was emerging from its "soft patch." As a result, policy rate expectations for the next two quarters ended the intermeeting period slightly firmer. Longer-term policy expectations, however, moved noticeably lower, reflecting the release of relatively benign readings on inflation and the Chairman's comments on the inflation outlook in testimony to the House Budget Committee. In line with these revised expectations for the path of policy, the term structure of interest rates flattened over the intermeeting period, as the two-year Treasury yield ended about unchanged and the ten-year Treasury yield dropped somewhat. While credit spreads on investment-grade corporate bonds narrowed a bit, spreads on speculative-grade issues fell significantly more, particularly in riskier segments of the market, probably reflecting greater confidence about prospects in the business sector. Further evidence of such confidence was visible in equity markets, where broad indexes advanced 5½ to 7½ percent. The exchange value of the dollar against other major currencies was about unchanged over the intermeeting period.

M2 balances were about flat on average over the previous two months: After contracting a bit in July, M2 expanded slightly in August. Money growth was damped by a rise in the opportunity cost of holding M2 assets (as typically occurs in periods of policy tightening). In addition, the lift to M2 from mortgage refinancings in evidence during the spring was likely still unwinding over the past couple of months, depressing the growth of liquid deposits. Business loans at banks expanded in August for the third consecutive month.

The staff forecast prepared for this meeting suggested that the economy would continue expanding at a solid pace through the end of 2006. Labor market improvements and accommodative monetary policy were seen as counterbalancing the drag from the swing in fiscal policy from considerable stimulus this year to modest restraint next year. Consumer spending was expected to pick up in conjunction with the strengthening labor market and associated gains in wages and salaries that would offset the effects of an anticipated rise in the savings rate from its recent low level. The contour of business spending was expected to be affected by the expiration of the partial-expensing tax provisions at year-end, which gave an incentive for businesses to invest more heavily this year. Supported by a favorable financing environment, ample stocks of liquid assets, and the ongoing need to replace aging or obsolete equipment and software, investment outlays were expected to grow robustly once the tax-related swings were completed. After the current period of below-average employment gains, employers were expected to hire at a relatively robust pace next year. At the same time, as labor market conditions improved, individuals who had withdrawn from the labor force were thought likely to return, so that job gains were expected to have a muted effect on the unemployment rate. Consumer price inflation was projected to remain at or below its current level. Slack in resource utilization, continued rapid growth in structural productivity, and the pass-through of declining energy prices were expected to contribute to the restraint on inflation.

In the Committee's discussion of current and prospective developments, the members agreed that the economy had strengthened somewhat after going through a "soft patch" in late spring and early summer. Recent data and anecdotal information suggested solid growth ahead, but at a pace that could well be less brisk than previously anticipated. Consumer spending appeared to have rebounded in the third quarter. Business investment also was robust, but executives, especially those at larger firms, seemed more cautious about the outlook than they had been several months ago. Although higher energy prices had played an important role in damping growth, questions remained about the reasons for the shortfall from expectations held this spring, and several policymakers remarked that their uncertainty about the likely pace of the expansion going forward had risen. Members commented that the benign incoming data on prices tended to confirm their previous judgment that the increase in inflation earlier in the year had importantly reflected temporary factors and that core inflation would probably remain relatively low.

In their discussion of developments in key sectors of the economy, policymakers agreed that business investment would most likely continue to provide considerable impetus to the overall economic expansion going forward. The anticipated further expansion of aggregate demand should boost investment. Also, low real interest rates, strong business balance sheets, and high levels of profits and cash flow were expected to support capital spending. However, the extent to which the federal tax provision permitting partial expensing of most investment expenditures had been boosting capital expenditures was difficult to discern, and it was possible that the expiration of that provision at year-end could result in a fairly sharp slowing in investment, at least for a time. In addition, recent discussions with business contacts, as well as a range of statistical information, suggested a persisting tendency for corporate executives to limit capital spending commitments. The reasons for this tendency were unclear, but a continuing focus on corporate governance issues might still be playing a role, and business concerns about terrorism and other geopolitical risks might have risen this year. Some members also noted that the pace of technological advance could be slowing a bit, trimming the rate of decline in the cost of capital for high-tech equipment and software. High vacancy rates for office buildings and industrial structures would likely continue to weigh on nonresidential investment, although activity in that sector was showing some signs of revival.

Committee members interpreted recent data and anecdotal information as indicating that growth in consumer spending was rebounding from its relatively slow rate of late spring. They saw household spending as most likely continuing to expand at a solid pace going forward. Gains in nominal income, partly resulting from gradual increases in employment, were expected to continue to support consumer spending and low interest rates to buoy residential investment. However, members perceived several possible sources of downside risk to household spending. In particular, households might hold back on spending in an attempt to increase their saving, which had fallen to a very low level relative to income. The ebbing of stimulus from last year's tax cuts also could tend to slow growth in consumer spending. And a failure of employment to accelerate as expected could undermine consumer confidence as well as hold down the growth in personal income.

With regard to the external sector, foreign economies were seen as generally expanding steadily, with the high level of crude oil prices apparently having restrained growth abroad somewhat less than in the United States. Still, expectations for foreign economic growth had been marked down somewhat, with adverse implications for U.S. exports and for overall U.S. growth. Indeed, some policymakers noted that domestic demand in several major U.S.

trading partners was relatively weak and that aggregate demand in those economies was being sustained importantly by exports to the United States. That pattern was contributing to a worrisome further widening of the U.S. trade and current account balances, and the Committee discussed the significance of wide external deficits and various adjustments that might occur in the process of their return to more sustainable levels.

Committee members generally viewed labor market conditions as having improved modestly of late. Although payroll growth had been weak in June and July, it registered a somewhat better performance in August, and initial claims for unemployment insurance continued to hover around relatively low levels. Some members noted a mismatch between demand and supply for certain types of labor. In particular, unskilled workers were said to be having considerable difficulty finding jobs, while firms were facing challenges in hiring workers with some specific skills, including truck drivers and heavy-equipment operators. Partly as a result, businesses in a few sectors, such as transportation and construction, reportedly were experiencing constraints on their output. Overall, however, some slack appeared to remain in labor markets. Looking forward, policymakers expected gradual improvement in labor market conditions as the economy expanded. However, anecdotal information suggested that many firms remained quite cautious about expanding payrolls, citing, among other factors, continued uncertainty about economic prospects and the high cost of providing health care benefits.

Partly reflecting the likely persistence of some economic slack, members expected inflation to stay low. Although non-energy commodity prices remained relatively high, energy prices had declined noticeably from record levels in recent weeks, and the effects of the energy price shock on inflation were expected to wane. In this regard, a number of policymakers commented that data on consumer and producer inflation had generally come in at or below expectations over the intermeeting period, tending to confirm the Committee's judgment that the upturn in inflation earlier in the year had owed importantly to temporary factors. Moreover, inflation expectations appeared to be well-contained, although those expectations probably were conditioned in part on investors' anticipation that the stance of monetary policy would likely be tightened over time.

In the Committee's discussion of policy for the intermeeting period, all of the members favored raising the target for the federal funds rate by 25 basis points to 1¾ percent at this meeting. The expansion evidently was resilient and self-sustaining and appeared no longer to require the unusual degree of monetary stimulus that had previously been necessary. A gradual increase in interest rates seemed likely to be consistent with continued solid economic growth that would be sufficient to erode remaining margins of slack in resource utilization over time. In view of these considerations, the Committee believed that another modest reduction in the degree of monetary policy accommodation at today's meeting was warranted. With today's action, the real federal funds rate—measured as the difference between the nominal funds rate and a moving average of core PCE inflation—would move slightly into positive territory.

With regard to the Committee's announcement to be released after the meeting, the members agreed that the statement should indicate that, after moderating earlier in the year, partly in response to the substantial rise in energy prices, output growth appeared to have regained some traction and that labor market conditions had improved modestly. In addition, policymakers concurred that the statement should indicate that inflation and inflation expectations had eased in recent months. They also agreed again to characterize the risks to sustainable growth and price stability as balanced. Members commented that recent evidence had boosted their confidence that moderate economic growth would continue and that inflation would be contained. With aggregate demand probably expanding at least as rapidly as the economy's potential to produce over the next several quarters, policymakers continued to see economic conditions as likely to warrant a further reduction in policy accommodation in coming quarters. However, in the view of many members, policy actions would need to be increasingly keyed to incoming data. Indeed, it was noted that market participants now appeared to anticipate some slowing in the pace of policy firming before long and did not interpret the removal of policy accommodation at a measured rate as necessarily involving the same policy action at each meeting.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive.

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 1¾ percent.

The vote encompassed approval of the paragraph below for inclusion in the press statement to be released shortly after the meeting:

> The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal. With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

The Committee noted that Deputy Secretary Normand R.V. Bernard had announced his intention to retire in the period before the next FOMC meeting, following more than four decades at the Federal Reserve. The Committee thanked Mr. Bernard for his dedication, integrity, and steadfast support through the more than 345 FOMC meetings he attended during his career.

It was agreed that the next meeting of the Committee would be held on Wednesday, November 10, 2004.

The meeting adjourned at 1:15 p.m.

Vincent R. Reinhart
Secretary

Meeting Held on November 10, 2004

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 Wednesday, November 10, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

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

Messrs. Guynn, Lacker, and Ms. Yellen, Presidents of the Federal Reserve Banks of Atlanta, Richmond, and San Francisco respectively

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Fuhrer, Hakkio, Howard, Madigan, Slifman, Sniderman, Rasche, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

Messrs. Oliner and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

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

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Brady, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Ms. Holcomb and Mr. Rasdall, First Vice Presidents, Federal Reserve Banks of Dallas and Kansas City respectively

Messrs. Eisenbeis, Estrella, Evans, and Goodfriend, Ms. Mester, Messrs. Rosenblum and Williams, Senior Vice Presidents, Federal Reserve Banks of Atlanta, New York, Chicago, Richmond, Philadelphia, Dallas, and San Francisco respectively

Mr. Hilton, Vice President, Federal Reserve Bank of New York

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 September 21, 2004, were approved.

By unanimous vote, the Federal Open Market Committee approved the selection of Deborah J. Danker as Deputy Secretary of the Committee to serve until the selection of a successor at the first regularly scheduled meeting after December 31, 2004.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager reported on recent developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period September 21, 2004, through November 9, 2004. By unanimous vote, the Committee ratified these transactions.

The Manager also discussed the pressures on the federal funds rate prior to, and volatility in the rate that has ensued at times after, recent FOMC meetings as depository institutions sought to satisfy a larger portion of their reserve requirements before anticipated increases in the FOMC's target funds rate. The Committee agreed that the Desk would continue to conduct open market operations as it has in such situations—leaning against anticipatory pressures in the funds market while taking account of the reserve management implications of such operations for the remainder of the reserve maintenance period.

The information received at this meeting suggested that the economy expanded at a moderate pace over the third quarter. Low interest rates helped to maintain a buoyant housing market and spending by both consumers and businesses was firm. Available information suggested that the recent tempo of economic activity continued into the current quarter despite the restraint imparted on real incomes and consumer confidence from higher oil prices. However, industrial production was flat in recent months, and hiring activity was lackluster through September before advancing sharply in October. Inflation measures continued at low levels through September.

Employment gains were subdued in the third quarter, but showed substantial strength in October. Job growth last month was fairly widespread, although heavy hiring in the construction sector was due partly to efforts to repair damage from the four hurricanes that hit the southeastern states. Employment increases were particularly large in the financial and services sectors. However, a small decline was registered in employment in the manufacturing sector. The average workweek held steady in October at its third-quarter level and was a bit above the average for the second quarter. Despite the strong increase in payroll employment, the household survey indicated a slight increase in the unemployment rate to 5.5 percent in October.

Industrial production was about unchanged in September, likely restrained by the hurricanes that month. A decline in manufacturing was about offset by a jump in utilities output and expansion in high-tech industries. The available data suggested that industrial production rebounded in October. Capacity utilization was unchanged in September at about the third-quarter average but was up from its level earlier in the year.

Consumer spending advanced strongly in the third quarter from the sluggish pace of the second quarter. The acceleration reflected a surge in expenditures on motor vehicles that owed partly to attractive incentives, but spending on other durables and nondurables was also up. Spending on services was steady for the third quarter on average, but advanced in September on a boost to electricity consumption related to unseasonably warm weather. Real disposable income slowed in the third quarter to a moderate pace and was flat in September, probably in part because of effects of the hurricanes. Measures of consumer confidence moved down in September and again in October. Activity in housing markets remained generally strong in September, supported by favorable mortgage rates. Although starts of single-family homes slowed to well below the level of preceding months, multifamily starts rose and sales of both existing and new homes were elevated.

Business investment spending on equipment and software continued to expand at a rapid pace in the third quarter, supported by positive fundamentals that included robust business output, low interest rates and readily available credit, and healthy business balance sheets. Outlays for high-tech equipment and software stepped down in the third quarter, but spending on other types of equipment, including transportation, was at a high level. At the same time, investment in nonresidential structures, which had turned up in the second quarter, softened in the third quarter. Construction spending for retail buildings and warehouses advanced, but high vacancy rates for office buildings held back investment in that sector.

Accumulation of nonfarm inventories excluding motor vehicles picked up smartly over the third quarter. The level of sales also rose, however, keeping inventory–sales ratios fairly steady at low levels.

The U.S. international trade deficit rose in the third quarter on average, reflecting some weakening in the growth of service exports and an increase in the price and quantity of petroleum imports. The deficit narrowed in September, however, as imports fell while exports expanded moderately. The lower level of imports in September mainly reflected declines in the petroleum and services categories. Economic expansion abroad on average appeared to slow in the third quarter, although it remained solid.

Consumer prices continued to advance at a moderate rate in recent months, although both overall and core consumer price measures rose a bit faster in the twelve months ending in September 2004 than in the year-earlier period. Expectations of near-term inflation picked up in October, consistent with the increase in energy prices. Labor costs continued to rise moderately. The increase in the employment cost index for private compensation over the third quarter was a bit below the average pace of the last two years.

At its meeting of September 21, 2004, the Federal Open Market Committee adopted a directive that called for conditions in reserves markets consistent with increasing the federal funds rate to an average of around 1¾ percent. In its public statement, the Committee expressed a belief that monetary policy remained accommodative even after this tightening, and judged the upside and downside risks to the attainment of both sustainable growth and price stability over the next few quarters to be roughly equal. The Committee noted its expectation that the underlying rate of inflation would continue to be low and that policy accommodation could be removed at a pace that is likely to be measured, but also stated that it would nonetheless respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

The FOMC's decision in September to raise the intended level of the federal funds rate 25 basis points and its attendant public statement were anticipated by the market, and the reaction was muted. Over subsequent weeks, however, a reference in the minutes of the August FOMC meeting to the need for "significant cumulative tightening" and comments by the Chairman and other FOMC members, which were read as minimizing the likely damping effect on the economy of higher energy prices, led markets to raise their expectations of forthcoming policy tightenings. These expectations were boosted further by the release of the strong employment data for October. The shift in the market's outlook for monetary policy contributed to noticeable upward pressure on short-term interest rates, and most long-term rates also moved up. Yields on investment-grade corporate bonds rose about in line with those on comparable-maturity Treasuries, but yields on speculative-grade bonds edged down and equity markets posted strong advances. In foreign exchange markets, the dollar declined appreciably, apparently in part on continuing market concerns about the financing of the U.S. current account deficit.

M2 expanded in October at about the sluggish pace of the third quarter. The growth of M2 was restrained in recent months by increases in its opportunity cost. Rates paid on its liquid asset components have lagged increases in market rates associated with the three monetary tightenings since midyear.

In the staff forecast prepared for this meeting, the economy was seen as likely to expand next year at around this year's solid pace under an assumption of generally accommodative financial conditions. Recent declines in the dollar were expected to support domestic economic activity by boosting net exports. Fiscal policy was expected to become much less stimulative after the current quarter, owing to the expiration of the temporary partial-expensing provisions of the tax code. Oil prices were anticipated to decline somewhat with the repair of hurricane-related damage to oil infrastructure in the Gulf of Mexico, leading to some slowing in inflation. With the economy expected to advance over the coming year at a rate a bit above its longer-run potential, the pace of hiring should firm and the unemployment rate should edge lower. In response to rising real incomes, consumer spending was forecast to strengthen after the early part of next year. The staff expected business investment spending to slow sharply early next year as partial-expensing provisions expired, but then to pick up noticeably in response to favorable financing conditions, ample business liquidity, and the need to replace or upgrade aging equipment and software.

In the Committee's discussion of current and prospective developments, the members generally expressed assessments that economic expansion in the neighborhood of the rate of growth of the economy's potential appeared to have become even more firmly established over recent months, despite the drag from higher energy prices. Recent data and anecdotal information suggested that spending by businesses and households had been reasonably robust of late, supported by accommodative financial conditions, continuing gains in productivity, and increasing employment. Looking forward, economic fundamentals appeared to be favorable for continued solid growth, and while fiscal stimulus would abate next year, a flattening out of energy prices, as markets seemed to anticipate, would bolster economic expansion. However, significant uncertainties surrounded the prospects for energy prices and fiscal policy, as well as the external sector. The Committee anticipated that underlying inflation pressures would remain contained as monetary accommodation was withdrawn. Core consumer price inflation had been quite damped on average in recent months and longer-term inflation expectations remained well anchored, despite further increases in energy prices and prospective increases in near-term headline inflation.

In their discussion of key sectors of the economy, policymakers noted that business investment had been expanding robustly and was likely to continue to be buoyed by the strength of productivity and profits. Some sectors, such as trucks and heavy equipment, had experienced rapid growth. However, even after taking account of likely effects of higher oil prices, the pace of overall business investment spending was still boosting GDP growth somewhat less than might have been expected given accommodative financial conditions and tax incentives. Some uncertainties, such as those associated with the election, had been resolved, but others persisted, including the prospects for oil prices and their consequences for the economy. Many business firms seemed hesitant about large-scale investment to increase productive capacity and hiring commitments, perhaps partly reflecting an environment of greater scrutiny regarding corporate governance and internal control systems. The high-tech sector, and investment in information technology more generally, had been growing less rapidly of late and was seen as posing a possible downside risk to the outlook. If the recent slower rate of price declines on high-tech products implied a softer underlying pace of technological change, both the outlook for investment demand and the prospects for persisting high trend growth in productivity could be damped relative to previous expectations.

While acknowledging data indicating a rebound in consumption spending in recent months, Committee members reported contacts with retail merchants that suggested mixed readings on the ongoing pace of consumer buying. The effect of higher energy prices on real incomes was likely still restraining consumer spending. Moreover, the stock of automobiles owned by households had risen substantially in recent years, and the willingness of households to purchase autos was seen as continuing to depend importantly on the provision of incentives by manufacturers. Home buying and residential construction generally remained robust, although a few members pointed to some moderation in activity in selected markets. It was noted that a slowdown in the rate of increase in home prices going forward might lead households to increase their desired saving. However, the risk of any significant drop-off in the growth of consumer spending would likely diminish with a sustained rebound in the pace of hiring.

In their comments on fiscal policy, Committee members indicated an expectation that the economic stimulus provided in recent years by discretionary fiscal measures was likely to fade next year. However, considerable uncertainty surrounded the likely evolution of the federal budget. Members stressed the importance of fiscal discipline to facilitate a better balance between net national saving and investment and thereby promote an adjustment of the imbalance in the current account of the balance of payments.

Committee members noted that the balance of trade had improved a little in September and commented that the decline in the value of the dollar over the past few years had been boosting demand seen by some exporting firms. However, with foreign economic growth moderating and the large excess of imports over exports, members generally viewed the prospects for net exports as likely to provide a continuing drag on U.S. economic expansion. One implication of this outlook was that U.S. external indebtedness relative to GDP would be increasing further.

Committee members remarked on signs of improvement in labor market conditions. While acknowledging the need to be cautious about readings from a single labor market report, members saw the increase in payroll employment in October and the upward revisions to previous months as encouraging. Furthermore, business contacts in several regions were indicating greater difficulty in filling some types of positions, both skilled and unskilled. Nevertheless, many firms evidently remained slow to expand hiring, in part because of rising benefit costs. One member commented on the performance of a few key industries, citing evidence that the job losses since the business cycle peak had been driven primarily by weak demand rather than productivity improvements. Although the extent of economic slack was uncertain, some members indicated a sense that the economy needed to grow faster than trend in order to take up remaining unused resources.

Wage and price pressures were generally still modest. While some firms reportedly were finding it easier to pass higher oil and other commodity costs on to their business customers, most business contacts indicated considerable difficulty in passing cost increases on to consumers. Longer-term inflation expectations had remained reasonably low, helping to restrain the spillover of elevated energy prices to the prices of other goods and services. Some members noted that any remaining resource slack would probably exert downward pressure on inflation and that the depreciation of the dollar seemed to be having a muted effect on import prices to date. However, upside risks to the inflation outlook included possible further depreciation of the dollar or increases in energy prices. In addition, a few members cited the possibility that the elevated pace of trend productivity growth experienced since the mid-1990s would begin to slow.

In the Committee's discussion of the setting of policy, all of the members favored raising the target for the federal funds rate by 25 basis points to 2 percent at this meeting. The economy appeared to be continuing to expand at a moderate pace that was likely to be rapid enough to gradually reduce margins of underutilized resources. In that regard, the Committee was encouraged by more evident signs of improvement in hiring. The Committee felt that the outlook justified the further removal of the policy accommodation that had been appropriate when the economic expansion was more tentative. Today's action would move the real funds rate, measured using core PCE inflation, toward a more positive setting.

In discussing the FOMC announcement for this meeting and going forward, several members commented that policy actions would likely become increasingly dependent on incoming data and their implications for future activity and prices. This might imply a more gradual path of tightening going forward than that of the last several months, as for example now seemed to be built into the term structure of interest rates, or it might mean that the Committee on occasion would need to firm policy more rapidly. A few members felt that, because of greater uncertainties, it might become appropriate eventually to move away from the recent practice of providing guidance about the likely future path of policy, while others emphasized the desirability of continuing to be as informative as possible about the Committee's perceived outlook. For now, most members agreed that the current statement language provided considerable flexibility with regard to the Committee's future actions and that market participants understood that flexibility. As regards the announcement to be released after the meeting, most members felt that little change in the statement language was required. Policymakers concurred that the statement should indicate that output appears to be growing at a moderate pace despite the rise in energy prices, that labor market conditions have improved, and that inflation and longer-term inflation expectations remain well contained. They agreed to characterize the risks to sustainable growth and price stability as balanced and to reiterate that policy accommodation could be removed at a pace that was likely to be measured but that the Committee will respond to changes in economic prospects as needed to maintain price stability.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive.

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 2 percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

> The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal. With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

> Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 14, 2004.

The meeting adjourned at 1:15 p.m.

Notation Vote

By notation vote completed on December 10, 2004, the Committee authorized Mr. Santomero, an alternate member of the Committee, to accept the honor of the title of "Cavaliere" to be awarded by the government of Italy.

> Votes for this action: Messrs Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

Vincent R. Reinhart
Secretary

Meeting Held on December 14, 2004

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 14, 2004, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Hoenig
Mr. Kohn
Ms. Minehan
Mr. Olson
Ms. Pianalto
Mr. Poole

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

Messrs. Guynn, Lacker, and Ms. Yellen, Presidents of the Federal Reserve Banks of Atlanta, Richmond, and San Francisco, respectively

Ms. Holcomb, First Vice President, Federal Reserve Bank of Dallas

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Fuhrer, Hakkio, Howard, Madigan, Slifman, Sniderman, Rasche, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

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

Messrs. Oliner and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

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

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

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Messrs. Brayton and Carpenter, Senior Economists, Divisions of Research and Statistics and Monetary Affairs, respectively, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Ms. Cumming, First Vice President, Federal Reserve Bank of New York

Messrs. Eisenbeis and Goodfriend, Ms. Mester, Messrs. Rosenblum and Williams, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Richmond, Philadelphia, Dallas and San Francisco, respectively

Messrs. Elsasser, Peach, and Sullivan, Vice Presidents, Federal Reserve Banks of New York, New York, 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 November 10, 2004, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on recent developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period November 10, 2004, through December 13, 2004. By unanimous vote, the Committee ratified these transactions.

The information received at this meeting suggested that the economy expanded at a moderate pace over the third quarter and into the current quarter. Consumer spending was solid, and investment spending remained strong. Manufacturing production increased at a modest pace, and employment gains in October and November indicated that the labor market continued to improve gradually. Core inflation measures remained subdued, albeit running at a slightly higher pace than last year, owing, in part, to the indirect effects of higher energy prices.

Gains in employment were moderate in November after a surge in October. Job growth was fairly widespread, with the exception of slightly weak seasonal hiring in the retail sector. Construction employment grew rapidly in November even after the outsized gains in October due to hurricane-related repair work. In contrast, employment in manufacturing edged lower. The average workweek in November was a touch below its level in October, but still a bit above the third-quarter average. The unemployment rate ticked down to 5.4 percent in November.

Industrial production expanded a little more slowly in November than it had in recent months. Output at mines increased noticeably for a second month, and manufacturing output posted a moderate gain. At utilities, output fell back in November after large increases in the preceding two months. Utilization rates moved higher in November.

Consumer spending appeared to be expanding at a more moderate pace in the fourth quarter, after growing at a robust rate in the third quarter. Although sales of motor vehicles declined in November, spending on other goods rose further after the large increase posted in October. Spending on services continued to register solid gains. Real disposable income, restrained by sharply higher energy prices, rose slightly. Even so, measures of consumer confidence were little changed and remained consistent with sustained increases in spending.

Activity in housing markets, buoyed by mortgage rates only modestly above their recent lows, remained strong in October. Starts of both single-family and multifamily homes increased and were above their third-quarter levels. Home sales remained at near-record levels.

Shipments of nondefense capital goods stepped up in October against the backdrop of solid expansion in business output, low user cost of capital, and an ample stock of liquid assets in the corporate sector. Shipments of computers jumped in October, while gains in the transportation sector were more modest. Outside the high-tech and transportation sectors, shipments moved up considerably in October from their robust third-quarter pace. Outlays on nonresidential construction edged down in October.

After a rapid rise in the third quarter, nonfarm inventories appeared to accumulate at a moderate pace in October. The book value of manufacturers' inventories increased notably; however, shipments also stepped up, an increase that left the inventory-shipments ratio in this sector unchanged.

The U.S. international trade deficit widened in October, primarily because of a surge in merchandise imports. Economic activity in most of the major foreign industrial countries slowed in the third quarter, and data for the fourth quarter pointed to continued subpar growth.

Consumer prices jumped in October, as hurricane damage contributed to higher prices for food and energy. For the twelve months ending in October, consumer prices rose considerably faster than they did in the year-earlier period. Core consumer prices increased much more modestly in October than did overall consumer prices, although the twelve-month change for core prices was also somewhat higher than it was a year before. The employment cost index for private compensation advanced moderately in the year ending the third quarter, and the markup of prices over labor costs remained somewhat elevated.

At its meeting on November 10, 2004, the Federal Open Market Committee (FOMC) adopted a directive that called for conditions in reserves markets consistent with increasing the federal funds rate to an average of around 2 percent. In its public statement, the Committee expressed a belief that monetary policy remained accommodative even after this tightening and judged that the upside and downside risks to the attainment of both sustainable growth and price stability over the next few quarters were roughly equal. The Committee noted its expectation that the underlying rate of inflation would continue to be low and that policy accommodation could be removed at a pace that is likely to be measured, but it also stated that it would nonetheless respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

The FOMC's decision in November to raise the intended federal funds rate 25 basis points and its attendant public statement were apparently anticipated by the market, so that the reaction was muted. Subsequently, higher-than-expected inflation data, remarks by the Chairman that were viewed as pointing to future rate increases, and the depreciation of the dollar all led market participants to price in a somewhat steeper path for future policy. The upward revision in policy expectations prompted modest increases in shorter-term Treasury coupon security yields. The yield on the ten-year Treasury note, however, was unchanged on net. Yields on both investment-grade and speculative-grade corporate bonds edged lower. The value of the dollar relative to other major currencies declined.

M2 accelerated a bit in November from its sluggish pace in October, but growth in money continued to be restrained by increases in its opportunity cost. Rates paid on the liquid components of M2 lagged increases in market rates associated with the monetary policy tightenings this year. Bank credit rebounded in November, with both securities and loans registering gains.

In the staff forecast prepared for this meeting, the economy was seen as likely to expand at a moderate pace, supported by accommodative monetary policy and financial conditions. Consistent with readings from futures markets, oil prices were anticipated to edge lower. With economic activity projected to expand at a pace a little above that of its longer-run potential over the coming year, hiring was projected to continue to firm, causing the unemployment rate to edge down next year. The steep run-up in housing prices, recent increases in equity prices, and anticipated gains in payrolls were viewed as likely to boost the growth of consumption spending next year to a pace somewhat above that recorded this year. Business investment was anticipated to decline a bit early next year in light of the expiration of the partial-expensing tax provision at the end of 2004 but was projected to resume vigorous growth in response to a favorable economic outlook, supportive financial conditions, ample liquid assets in the corporate sector, and an ongoing need to replace or upgrade aging equipment and software. Measures of total consumer price inflation were expected to decline from current levels reflecting the direct effect of the downturn in energy prices. By contrast, core inflation was seen in the staff forecast as remaining stable. The upward pressure on inflation from a slight step-down in structural productivity growth and a narrowing margin of resource slack was expected to be about counterbalanced by diminishing pressure from the pass-through of the earlier rise in energy prices and decline in the dollar.

In their discussion of the economic outlook, the participants at the meeting (the members of the Board of Governors and the Reserve Bank Presidents or those acting in their place) generally regarded incoming data since the prior meeting as consistent with an expectation that the economy would continue to expand at a pace that would likely prove sufficient to reduce margins of underutilized resources further. Recent data and anecdotal information indicated that the economic expansion was firmly established and had proven quite resilient in the face of rising oil prices and the reduction in policy accommodation. Although the November employment report had been disappointing, when viewed over several months, labor market conditions were generally seen as gradually improving. That improvement was expected to persist and, along with higher wealth and relatively low interest rates, would support further gains in spending by households. Rising demand, elevated underlying productivity growth, and accommodative financial conditions should keep business spending on a strong uptrend. With some economic slack persisting and longer-term inflation expectations well-anchored, inflation was anticipated to remain subdued. A number of participants cited the recent depreciation of the dollar on foreign exchange markets, elevated energy costs, and the possibility of a slowing in underlying productivity growth as factors tending to boost the upside risks to their inflation outlook, though, on net, they saw the risks to stable underlying inflation as still balanced.

In their discussion of important sectors of the economy, participants noted that increasing equity and home prices had boosted household net worth, leaving consumers well positioned to maintain a brisk pace of spending. Continued gains in employment were thought likely to provide additional support to spending by bolstering consumer confidence and income. Participants commented that real disposable incomes should receive a further lift from the recent drop in oil prices. Moreover, intermediate- and long-term interest rates remained low in both nominal and real terms despite the recent firming in the stance of policy, encouraging spending on consumer durables and housing.

Many of the fundamentals underlying the demand for capital goods—expanding output, a low cost of capital, strong profits, and ample liquid assets—appeared quite favorable, and participants generally were upbeat in their assessment of the prospects for investment. While some participants noted that their business contacts seemed more confident about the future and that the sense of caution previously evident in business spending and hiring behavior seemed to be waning, others believed that many businesses remained quite wary. Most participants acknowledged some significant uncertainties in their outlook, including the effects of the expiration of the partial-expensing provision for investment at the end of 2004 and recent indications of a softening in high-tech spending in the United States and elsewhere. The possible downshift in the pace of high-tech spending also raised the possibility of an erosion of profit margins that could result from a slackening in the pace of technology-led productivity growth and the associated increase in cost pressures.

A number of participants voiced concerns about domestic and global financial imbalances. On the domestic front, such concerns focused on the magnitude of current and projected fiscal deficits, which seemed likely to keep national saving low. Views about the prospects for fiscal restraint in the years ahead were mixed; some participants believed that the odds of significant deficit reduction over the next few years were remote while others were more optimistic. Regarding global imbalances and the current account deficit in the United States, a number of participants expressed doubts that such imbalances would be reduced in the near-term. Better global balance would require not only greater national saving in the United States but also a notable strengthening in domestic demand among major trading partners. Such a strengthening seemed unlikely in the near term given the recent softening in the economies of several important industrial countries.

In their discussion of financial market conditions, participants noted that investors anticipated further increases in the federal funds rate over the coming year, but intermediate- and long-term interest rates along with financial conditions more generally had remained quite supportive of growth. A few participants commented that the generally low level of interest rates across a wide range of maturities and the recent flattening of the slope of the yield curve (measured as the spread between ten- and two-year Treasury yields) might signal that expectations of longer-term growth had been marked down. Some participants believed that the prolonged period of policy accommodation had generated a significant degree of liquidity that might be contributing to signs of potentially excessive risk-taking in financial markets evidenced by quite narrow credit spreads, a pickup in initial public offerings, an upturn in mergers and acquisition activity, and anecdotal reports that speculative demands were becoming apparent in the markets for single-family homes and condominiums.

Although the November employment report had been disappointing and recent readings on initial claims for unemployment insurance had risen, participants viewed labor market conditions still as improving gradually. Averaging over recent months, or even the entire year, employment growth had been fast enough to absorb unutilized labor resources over time. Anecdotal information suggested a significant tightening in the market for skilled workers in some industries and regions, although demand for less skilled workers still appeared soft. Recent surveys of hiring plans by businesses were read as signaling future gains in employment. Despite the further improvement in labor markets, a number of participants noted that wage and compensation increases had not picked up materially and generally remained moderate.

In their discussion of the outlook for prices, a number of participants cited developments that could pose upside inflation risks. Although oil prices had fallen of late, they were still considerably higher than they had been in the spring, and the recent decline in the dollar would raise import prices and diminish competitive pressures on many industries. The pass-through from both sources should be limited, but they were still a potential source of upward pressure on prices that could get embedded in higher inflation under certain circumstances. In addition, productivity growth had slowed appreciably in the most recent quarter and unit labor costs had increased, raising questions about cost pressures going forward. A few participants also noted that uncertainty about the extent of resource slack in the economy was considerable and that it was quite possible that the economy could soon be operating close to potential, particularly if labor force participation rates did not turn up much while employment continued to register gains. The increase over the last few months in five-year measures of inflation compensation derived from Treasury nominal and inflation-indexed securities might be a warning sign that expectations were not as well anchored as they had been over the summer.

Despite these concerns, participants generally expected that inflation would remain low in the foreseeable future. While the depreciation of the dollar over recent months had been notable, some participants found persuasive the evidence from recent studies pointing to a decline over time and across countries in the pass-through of exchange rate movements into domestic prices. Forward market-based measures of inflation compensation beyond the next five years as well as survey measures of both short- and long-term inflation expectations had been quite stable of late, despite the previous rise in energy prices and the lower dollar. Moreover, several participants cited factors that likely would continue to provide a counterweight to any upside risks. Although participants generally acknowledged that the degree of economic slack was quite uncertain, the moderate pace of wage and compensation growth in recent months in the face of higher energy prices and several years of rapid productivity growth was consistent with an economy still operating somewhat below its potential. In a similar vein, the recent quarterly dip in productivity growth notwithstanding, there were no clear signs that underlying productivity had slowed appreciably of late, and a close reading of recent history suggested that upside risks to the outlook for productivity growth could be significant. Even if structural productivity growth were to slow, price markups remained quite elevated and some participants noted that further increases in unit labor costs could well be absorbed for some time by a return of markups to more normal levels.

In the Committee's discussion of policy for the intermeeting period, all of the members (the members of the Board of Governors and the five voting Reserve Bank Presidents) favored raising the target for the federal funds rate by 25 basis points to 2¼ percent at this meeting. All members judged that a further quarter-point tightening in the target federal funds rate at this meeting was appropriate in light of the prospects for solid growth and diminished slack. Even with this action, the current level of the real funds rate target remained below the level it most likely would need to reach to keep inflation stable and output at its potential. With the economic expansion more firmly entrenched, cost and price pressures were likely to become a clearer intermediate-term risk to sustained good economic performance absent further reduction of accommodation.

With regard to the Committee's announcement to be released after the meeting, members generally agreed that overall economic prospects were similar to those prevailing at the time of the November meeting and that consequently the statement should be altered only to the minor extent required to reflect recent economic developments. They concurred that the statement should note that output appears to be growing at a moderate pace despite the earlier rise in energy prices, that labor market conditions continue to improve gradually, and that inflation and longer-term inflation expectations remain well-contained. They also agreed again to characterize the risks to sustainable growth and price stability as balanced. A few members believed that the Committee's flexibility would be enhanced by eliminating the forward-looking elements of the Committee's statement referring to the pace of removal of policy accommodation. More of the members believed that this language was useful in conveying the Committee's sense of the outlook for the economy and the stance of monetary policy and was appropriately conditioned on economic developments. All members agreed that the FOMC statement for this meeting should again indicate that policy accommodation could be removed at a pace that was likely to be measured but that the Committee would respond to changes in economic prospects as needed to maintain price stability.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive.

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 2¼ percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

> The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal. With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

> Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Hoenig, Kohn, Ms. Minehan, Mr. Olson, Ms. Pianalto, and Mr. Poole. Vote against this action: None.

The meeting then turned to consideration of releasing FOMC minutes on an accelerated schedule. Meeting participants agreed that an experiment with accelerating the preparation of the minutes that had been conducted since early in the year had been successful in identifying the procedural changes that would be necessary if an accelerated schedule were to be followed going forward. Participants noted that the minutes contained a more complete and nuanced explanation of the reasons for the Committee's decisions and view of the risks to the outlook than was possible in the post-meeting announcement, and their earlier release would help markets interpret economic developments and predict the course of interest rates. They also would provide the public a more up-to-date context for individual policymakers' public remarks. Meeting participants supported the principle of openness and transparency, but debated the possibility that the markets would misinterpret the minutes and that the prospect of early release would lead to either less productive discussions at the meetings or to less comprehensive, and therefore less useful, minutes. A few participants expressed support for trimming the length and forward-looking elements of the post-meeting announcements, should the Committee decide to accelerate release of the minutes. Others, however, preferred not to link the two decisions or viewed the more extensive announcements as useful regardless of the minutes' publication schedule.

The clear consensus of the participants at the meeting was to release the minutes on an expedited schedule, and the Committee voted unanimously to begin publishing the minutes of regularly scheduled meetings three weeks after the day of the policy decision. The minutes of any other Committee meetings, such as conference calls, would be handled somewhat differently. In those cases, if a policy action were taken, an announcement of that action would be made as soon as practicably possible. If, however, no action were taken, the fact that the conference call took place would be reflected in the statement following the subsequent regular meeting, and, in any case, the minutes of the call would be released along with the minutes of the subsequent regular meeting.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, February 1–2, 2005.

The meeting adjourned at 1:25 p.m.

Vincent R. Reinhart
Secretary

Litigation

During 2004, the Board of Governors was a party in eight lawsuits or appeals filed that year and was a party in nine other cases pending from previous years, for a total of seventeen cases; in 2003, the Board had been a party in a total of twelve cases. Two of the lawsuits or appeals filed in 2004 raised questions under the Bank Holding Company Act. As of December 31, 2004, nine cases were pending.

Judicial Review of Board Orders under the Bank Holding Company Act

Haili et al. v. Greenspan et al., No. 04-00089 DAE-LEK (D. Hawaii, filed February 6, 2004), was an action seeking an order requiring the Board to enforce an alleged commitment made under the Community Reinvestment Act. The action also sought a declaratory judgment and an injunction preventing the approval of an application under the Bank Holding Company Act until the asserted commitment was fulfilled. On February 23, 2004, the district court granted the Board's motion to dismiss the action.

CB Bancshares, Inc. v. Board of Governors, No. 04-70229 (9th Circuit, filed January 14, 2004), was a petition for review of the Board order granting Central Pacific Financial Corp. of Honolulu, Hawaii, approval to acquire CB Bancshares, Inc., also of Honolulu. On June 3, 2004, the court dismissed the action on the motion of the petitioner.

Litigation under the Financial Institutions Supervisory Act

Board of Governors v. Thomas, et al., No. 1:04-CV-0777 (N.D. Georgia, filed March 19, 2004), is an injunctive action brought to compel eighteen individuals named in a separate Board administrative enforcement proceeding to deposit sufficient funds into the registry of the court to satisfy civil money penalties sought by the Board in the administrative action. On April 2, 2004, the court issued a temporary restraining order granting the relief sought by the Board, and on April 28, 2004, the court issued a preliminary injunction extending this relief until completion of the Board's enforcement proceeding.

Ulrich v. Board of Governors, No. 03-73854 (9th Circuit, filed October 24, 2003), and *Diehl McCarthy v. Board of Governors*, No. 03-73997 (9th Circuit, filed October 28, 2003), are petitions for review of orders of prohibition issued by the Board on October 15, 2003. On December 12, 2003, the court consolidated these cases with related petitions for review of orders issued by the Office of the Comptroller of the Currency imposing civil money penalties and restitution against the petitioners.

Other Actions

Inner City Press/Community on the Move v. Board of Governors, No. 04-CV-8337 (S.D. New York, filed October 21, 2004), is a case brought under the Freedom of Information Act.

Texas State Bank v. United States, No. 04-5126 (Federal Circuit, filed July 28, 2004), is an appeal of a decision of the United States Court of Federal Claims dismissing an action (*Community Bank & Trust v. United States*, No. 01-571C, 60 Fed. Cl. 815 (2004)) challenging on constitutional grounds the failure to pay interest on reserve accounts held at Federal Reserve Banks.

Sciba v. Board of Governors, No. 04-CV-1011 (D. District of Columbia, filed June 21, 2004), is a case brought under the Freedom of Information Act.

Price v. Greenspan, No. 04-CV-0973 (D. District of Columbia, filed June 14, 2004), is an employment discrimination action.

Thomas v. Board of Governors, No. 04-CV-1554 (N.D. Georgia, removed from Superior Court of Gwinnett County, Georgia, on May 28, 2004), was an action against the Board, its enforcement staff, and others by individuals involved in a pending enforcement action. On October 4, 2004, the court granted the Board's motion to dismiss the action.

Skanska USA Building, Inc. v. Board of Governors, No. 304CV00675 SRU (D. Connecticut, filed April 22, 2004), was a Freedom of Information Act case. The case was dismissed by stipulation of the parties on November 29, 2004.

Laigo v. Board of Governors, No. 03-CV-03576-MJP (W.D. Washington, filed November 19, 2003), was a claim regarding redemption of U.S. savings bonds. On June 9, 2004, the court granted the Board's motion to dismiss the action.

Apffel v. Board of Governors, No. 03-343 (S.D. Texas, filed May 20, 2003), was a case brought under the Freedom of Information Act. On January 9, 2004, the court granted the Board's motion to dismiss the case.

Carter v. Greenspan, No. 03-1026 (D. District of Columbia, filed May 9, 2003), was an employment discrimination action. On February 19, 2004, the court granted the Board's motion to dismiss the case.

Albrecht v. Board of Governors, No. 02-5235 (D.C. Circuit, filed October 18, 2002), was an appeal of a district court order dismissing a challenge to the pension funding method applicable to certain Board employees under the Board's retirement plan. The district court's dismissal was affirmed by the Court of Appeals on February 10, 2004.

Artis v. Greenspan, No. 01-0400 (D. District of Columbia, filed February 22, 2001), is an employment discrimination action. An identical action, No. 99-2073 (EGS) (D. District of Columbia, filed August 3, 1999), was consolidated with this action on August 15, 2001.

Fraternal Order of Police v. Board of Governors, No. 98-3116 (D. District of Columbia, filed December 22, 1998), is an action seeking a declaratory judgment regarding the Board's labor policy governing Federal Reserve Banks. ■

Federal Reserve System Organization

Board of Governors

December 31, 2004

Members

	Term expires January 31,
Alan Greenspan, Chairman[1]	2006
Roger W. Ferguson, Jr., *Vice Chairman*[1]	2014
Edward M. Gramlich	2008
Susan S. Bies	2012
Mark W. Olson	2010
Ben S. Bernanke	2018
Donald L. Kohn	2016

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1. The designations as Chairman and Vice Chairman expire on June 19, 2008, and October 28, 2007, respectively, unless the service of these members of the Board shall have terminated sooner.

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Federal Open Market Committee

December 31, 2004

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TIMOTHY F. GEITHNER, *Vice Chairman,* President, Federal Reserve Bank of New York

BEN S. BERNANKE, Board of Governors

SUSAN SCHMIDT BIES, Board of Governors

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LAWRENCE SLIFMAN, *Associate Economist*

MARK S. SNIDERMAN, *Associate Economist*

JOSEPH S. TRACY, *Associate Economist*

DAVID W. WILCOX, *Associate Economist*

DINO KOS, *Manager, System Open Market Account*

During 2004 the Federal Open Market Committee held eight regularly scheduled meetings (see "Minutes of Federal Open Market Committee Meetings" in this volume).

Federal Advisory Council

December 31, 2004

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District 1—WILLIAM J. RYAN, *Chairman, President, and Chief Executive Officer*, Banknorth Group, Inc., Portland, Maine

District 2—THOMAS A. RENYI, *Chairman and Chief Executive Officer*, The Bank of New York, New York, New York

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District 4—MARTIN G. MCGUINN, *Chairman and Chief Executive Officer*, Mellon Financial Corp., Pittsburgh, Pennsylvania

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District 6—VACANT

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District 9—JERRY A. GRUNDHOFER, *President and Chief Executive Officer*, U.S. Bancorp, Minneapolis, Minnesota

District 10—BYRON G. THOMPSON, *Chairman*, Country Club Bank, N.A., Kansas City, Missouri

District 11—GAYLE M. EARLS, *President and Chief Executive Officer*, TIB—The Independent BankersBank, Dallas, Texas

District 12—VACANT

Officers

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VACANT, *Vice President*

JAMES E. ANNABLE, *Secretary*

The Federal Advisory Council, which is composed of one representative of the banking industry from each of the twelve Federal Reserve Districts, is required by the Federal Reserve Act to meet in Washington at least four times each year and is authorized by the act to consult with, and advise, the Board of Governors on all matters within the jurisdiction of the Board. The council met on February 5–6, May 6–7, September 9–10, and December 2–3, 2004. The Board met with the council on February 6, May 7, September 10, and December 3, 2004.

Consumer Advisory Council

December 31, 2004

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Dennis L. Algiere, *Senior Vice President*, The Washington Trust Company, Westerly, Rhode Island

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Kenneth P. Bordelon, *Chief Executive Officer*, E Federal Credit Union, Baton Rouge, Louisiana

Susan Bredehoft, *Senior Vice President/ Compliance Risk Management*, Commerce Bank, N.A., Cherry Hill, New Jersey

Sheila Canavan, *Consumer Attorney*, Law Office of Sheila Canavan, Moab, Utah

Robin Coffey, *Vice President*, Harris Bank, Chicago, Illinois

Ann Diedrick, *Senior Vice President*, JPMorgan Chase Bank, New York, New York

Dan Dixon, *Group Senior Vice President*, World Savings Bank, FSB, Washington, District of Columbia

Hattie B. Dorsey, *President and Chief Executive Officer*, Atlanta Neighborhood Development Partnership, Atlanta, Georgia

Thomas Fitzgibbon, *Senior Vice President*, MB Financial Bank, Chicago, Illinois

James Garner, *Senior Vice President and General Counsel*, North America Consumer Finance for Citigroup, Baltimore, Maryland

Charles Gatson, *Vice President*, Midtown Community Development Corporation, Kansas City, Missouri

Larry Hawkins, *President and Chief Executive Officer*, Unity National Bank, Houston, Texas

W. James King, *President and Chief Executive Officer*, Community Redevelopment Group, Cincinnati, Ohio

Ruhi Maker, *Senior Attorney*, Law Office of Rochester, Rochester, New York

Patricia McCoy, *Professor of Law*, University of Connecticut School of Law, Hartford, Connecticut

Elsie Meeks, *Executive Director*, First Nations Oweesta Corporation, Rapid City, South Dakota

Bruce B. Morgan, *Chairman, President,*

Debra S. Reyes, *President*, Neighborhood Lending Partners, Inc., Tampa, Florida

Benson Roberts, *Vice President for Policy*, Local Initiatives Support Corporation, Washington, District of Columbia

Benjamin Robinson III, *President and Chief Executive Officer*, Innovative Risks Solutions, LLC, Charlotte, North Carolina

Mary Jane Seebach, *Executive Vice President, Chief Compliance Officer*, Countrywide Financial Corporation, Calabasas, California

Paul J. Springman, *Group Executive, Predictive Sciences*, Equifax, Atlanta, Georgia

Forrest F. Stanley, *Senior Vice President and Deputy General Counsel*, KeyBank National Association, Cleveland, Ohio

Lori R. Swanson, *Solicitor General*, Office of the Minnesota Attorney General, St. Paul, Minnesota

Diane Thompson, *Supervising Attorney*, Land of Lincoln Legal Assistance Foundation, Inc., East St. Louis, Illinois

Hubert van Tol, *Co-Director*, Fairness in Rural Lending, Sparta, Wisconsin

Clint Walker, *General Counsel/Chief Administrative Officer*, Juniper Bank, Wilmington, Delaware

Officers

Agnes Bundy Scanlan, *Chair*
Senior Vice President,
Regulatory Relations Executive
Bank of America
Boston, Massachusetts

Mark Pinsky, *Vice Chair*
President and Chief Executive Officer
National Community Capital Association
Philadelphia, Pennsylvania

The Consumer Advisory 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 of Governors on consumer financial services. The council met

Thrift Institutions Advisory Council

December 31, 2004

Members

ELDON R. ARNOLD, *President and Chief Executive Officer*, Citizens Equity First Credit Union (CEFCU), Peoria, Illinois

H. BRENT BEESLEY, *Chairman and Chief Executive Officer*, Heritage Bank, St. George, Utah

MICHAEL J. BROWN, SR., *President and Chief Executive Officer*, Harbor Federal Savings Bank, Fort Pierce, Florida

RICHARD J. DRISCOLL, *Chief Executive Officer*, First Savings Bank, FSB, Arlington, Texas

DOUGLAS K. FREEMAN, *Chairman and Chief Executive Officer*, NetBank, Alpharetta, Georgia

CURTIS L. HAGE, *Chairman and Chief Executive Officer*, Home Federal Bank, Sioux Falls, South Dakota

DAVID H. HANCOCK, *Chief Executive Officer*, North American Savings Bank, Grandview, Missouri

OLAN O. JONES, JR., *President and Chief Executive Officer*, Eastman Credit Union, Kingsport, Tennessee

D. TAD LOWREY, *Chairman, President, and Chief Executive Officer*, Jackson Federal Bank, Brea, California

GEORGE W. NISE, *President and Chief Executive Officer*, Beneficial Savings Bank, Philadelphia, Pennsylvania

WILLIAM J. SMALL, *Chairman and Chief Executive Officer*, First Federal Bank, Defiance, Ohio

ROY M. WHITEHEAD, *President and Chief Executive Officer*, Washington Federal Savings, Seattle, Washington

Officers

WILLIAM J. SMALL, *President*

D. TAD LOWREY, *Vice President*

The Thrift Institutions Advisory Council, which is composed of representatives from credit unions, savings and loan associations, and savings banks, consults with, and advises, the Board of Governors on issues pertaining to the thrift industry and on various other matters within the Board's jurisdiction. The members of the council met with the Board on March 5, July 9, and December 10, 2004.

Federal Reserve Banks and Branches

December 31, 2004

Officers

BANK or Branch	Chairman[1] / Deputy Chairman	President / First Vice President	Vice President in charge of Branch
BOSTON[2]	Samuel O. Thier Blenda J. Wilson	Cathy E. Minehan Paul M. Connolly	
NEW YORK[2]	John E. Sexton Jerry I. Speyer	Timothy F. Geithner Christine M. Cumming	
Buffalo	Marguerite D. Hambleton		Barbara L. Walter[3]
PHILADELPHIA	Ronald J. Naples Doris M. Damm	Anthony M. Santomero William H. Stone, Jr.	
CLEVELAND[2]	Robert W. Mahoney Charles E. Bunch	Sandra Pianalto Robert Christy Moore	
Cincinnati	Dennis C. Cuneo		Barbara B. Henshaw
Pittsburgh	Roy W. Haley		Robert B. Schaub
RICHMOND[2]	Wesley S. Williams, Jr. Thomas J. Mackell, Jr.	Jeffrey M. Lacker Walter A. Varvel	
Baltimore	Owen E. Herrnstadt		David Beck[4]
Charlotte	Michael A. Almond		Jeffrey S. Kane[3]
ATLANTA	David M. Ratcliffe V. Larkin Martin	Jack Guynn Patrick K. Barron	James M. McKee[3]
Birmingham	Catherine Crenshaw		Lee C. Jones
Jacksonville	Julie Hilton		Christopher L. Oakley
Miami	Rosa Sugranes		Juan del Busto
Nashville	Rodney Lawler		Melvyn K. Purcell[3]
New Orleans	Dave Dennis		Robert J. Musso[3]
CHICAGO[2]	W. James Farrell Miles D. White	Michael H. Moskow Gordon R.G. Werkema	
Detroit	Edsel B. Ford II		Glenn Hansen[3]
ST. LOUIS	Walter L. Metcalfe, Jr. Gayle P. W. Jackson	William Poole W. LeGrande Rives	
Little Rock	Scott T. Ford		Robert A. Hopkins[5]
Louisville	Cornelius A. Martin		Thomas A. Boone[5]
Memphis	Meredith B. Allen		Martha Perine Beard[5]
MINNEAPOLIS	Linda Hall Whitman Frank L. Sims	Gary H. Stern James M. Lyon	
Helena	Dean Folkvord		Samuel H. Gane

Officers—Continued

BANK or Branch	Chairman[1] Deputy Chairman	President First Vice President	Vice President in charge of Branch
KANSAS CITY	Richard H. Bard Robert A. Funk	Thomas M. Hoenig Richard K. Rasdall	
Denver	Thomas Williams		Pamela L. Weinstein
Oklahoma City	Tyree O. Minner		Dwayne E. Boggs
Omaha	A.F. Raimondo		Kevin A. Drusch
DALLAS	Ray L. Hunt Patricia M. Patterson	 Helen E. Holcomb[6]	
El Paso	Ron C. Helm		Robert W. Gilmer[4]
Houston	Lupe Fraga		Robert Smith III[3]
San Antonio	Ron R. Harris		D. Karen Diaz[8]
SAN FRANCISCO	George M. Scalise Sheila D. Harris	Janet L. Yellen John F. Moore	
Los Angeles	William D. Jones		Mark L. Mullinix[7]
Portland	Karla S. Chambers		Richardson B. Hornsby
Salt Lake City	H. Roger Boyer		Andrea P. Wolcott
Seattle	Mic R. Dinsmore		Mark Gould[3]

NOTE. A current list of these officers appears each quarter in the *Federal Reserve Bulletin*.

1. The chairman of a Federal Reserve Bank serves, by statute, as Federal Reserve agent.
2. Additional offices of these Banks are located at Windsor Locks, Connecticut; Utica at Oriskany, New York; East Rutherford, New Jersey; Columbus, Ohio; Des Moines, Iowa; Midway at Bedford Park, Illinois, and Phoenix, Arizona.
3. Senior vice president.
4. Acting vice president.
5. Senior branch executive.
6. Served as acting president as of November 5, 2004, following the resignation of President Robert D. McTeer, Jr.
7. Executive vice president.
8. Acting assistant vice president.

Conference of Chairmen

The chairmen of the Federal Reserve Banks are organized into the Conference of Chairmen, which meets to consider matters of common interest and to consult with and advise the Board of Governors. Such meetings, attended also by the deputy chairmen, were held in Washington on June 2 and 3, and on December 1 and 2, 2004.

The members of the executive committee of the Conference of Chairmen during 2004 were Wesley S. Williams, Jr., chair; George M. Scalise, vice chair; and Walter L. Metcalfe, Jr., member.

On December 2, 2004, the conference elected its executive committee for 2005, naming George M. Scalise as chair; Walter L. Metcalfe, Jr., as vice chair; and John E. Sexton as the third member.

Conference of Presidents

The presidents of the Federal Reserve Banks are organized into the Conference of Presidents, which meets periodically to consider matters of common interest and to consult with and advise the Board of Governors.

Michael H. Moskow, president of the Federal Reserve Bank of Chicago, served as chair of the conference in 2004, and Cathy E. Minehan, president of the Federal Reserve Bank of Boston, served as its vice chair. Valerie J. Van Meter, of the Federal Reserve Bank of Chicago, served as its secretary, and Michael P. Malone, of the Federal Reserve Bank of Boston, served as its assistant secretary.

On October 27, 2004, the conference elected Cathy E. Minehan as its chair for

2005–06 and Anthony M. Santomero, president of the Federal Reserve Bank of Philadelphia, 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.

Walter A. Varvel, first vice president of the Federal Reserve Bank of Richmond, served as chair of the conference in 2004, and Helen E. Holcomb, first vice president of the Federal Reserve Bank of Dallas, served as its vice chair. Janice E. Clatterbuck, of the Federal Reserve Bank of Richmond, served as its secretary, and Harvey R. Mitchell, of the Federal Reserve Bank of Dallas, served as its assistant secretary.

Directors

Each Federal Reserve Bank has a nine-member board: three Class A and three Class B directors, who are elected by the stockholding member banks, and three Class C directors, who are appointed by the Board of Governors of the Federal Reserve System.

Class A directors represent the stockholding member banks in each Federal Reserve District. Class B and Class C directors represent the public and are chosen with due, but not exclusive, consideration to the interests of agriculture, commerce, industry, services, labor, and consumers; they may not be officers, directors, or employees of any bank or bank holding company. In addition, Class C directors may not be stockholders of any bank or bank holding company.

For the election of Class A and Class B directors, the member banks of each Federal Reserve District are classified into three groups. Each group, which comprises banks with similar capitalization, elects one Class A director and one Class B director. Annually, the Board of Governors designates one of the Class C directors as chair of the board 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 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.

The chairs and deputy chairs of the Reserve Bank boards of directors, and the chairs of the Branches, are listed in the preceding table, titled "Officers." The directors of the Banks and Branches are listed in the following table. For each director, the class of directorship, the director's principal organizational affiliation, and the date the director's term expires is shown.

Directors

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
	DISTRICT 1—BOSTON	
RESERVE BANK		
Class A		
Lawrence K. Fish	Chairman, President, and Chief Executive Officer, Citizens Financial Group, Inc., Providence, Rhode Island	2004
James R. Wood	President, First National Bank of Suffield, Suffield, Connecticut	2005
Peter A. Blyberg	President and Chief Executive Officer, Union Trust Company, Ellsworth, Maine	2006
Class B		
Robert K. Kraft	Chairman and Chief Executive Officer, The Kraft Group, Foxborough, Massachusetts	2004
Orit Gadiesh	Chairman, Bain & Company, Inc., Boston, Massachusetts	2005
Kirk P. Pond	President, Chief Executive Officer, and Chairman, Fairchild Semiconductor International, South Portland, Maine	2006
Class C		
Samuel O. Thier	Professor of Medicine and Health Care Policy, Harvard Medical School, Massachusetts General Hospital, Boston, Massachusetts	2004
Blenda J. Wilson	President and Chief Executive Officer, Nellie Mae Education Foundation, Quincy, Massachusetts	2005
Lisa M. Lynch	William L. Clayton Professor of International Affairs, The Fletcher School of Law and Diplomacy, Medford, Massachusetts	2006
	DISTRICT 2—NEW YORK	
RESERVE BANK		
Class A		
Jill M. Considine	Chairman and Chief Executive Officer, The Depository Trust Company, New York, New York	2004
Charles V. Wait	President, Chief Executive Officer, and Chairman, The Adirondack Trust Company, Saratoga Springs, New York	2005
Sanford I. Weill	Chairman, Citigroup Inc., New York, New York	2006
Class B		
Ronay Menschel	Chairman, Phipps Houses, New York, New York	2004
Marta Tienda	Maurice P. During Professor of Demographic Studies, Princeton University, Princeton, New Jersey	2005
Denis M. Hughes	President, New York State AFL-CIO, New York, New York	2006
Class C		
John E. Sexton	President, New York University, New York, New York	2004
Loretta E. Lynch	Partner, Hogan & Hartson LLC, New York, New York	2005
Jerry I. Speyer	President and Chief Executive Officer, Tishman Speyer Properties, New York, New York	2006

Directors—Continued

BANK or BRANCH, *Category* Name	Title	Term expires Dec. 31
BUFFALO BRANCH		
Appointed by the Federal Reserve Bank		
Emerson L. Brumback	President and Chief Operating Officer, Manufacturers and Traders Trust Company, Buffalo, New York	2004
Geraldine C. Ochocinska	Regional Director, Region 9, UAW, Amherst, New York	2005
Maureen Torrey Marshall	Vice President, Torrey Farms, Inc., Elba, New York	2006
Peter G. Humphrey	Chairman, President, and Chief Executive Officer, Financial Institutions, Inc., Warsaw, New York	2006
Appointed by the Board of Governors		
Marguerite D. Hambleton	President and Chief Executive Officer, AAA Western and Central New York, Williamsville, New York	2004
Brian J. Lipke	Chairman and Chief Executive Officer, Gibraltar, Buffalo, New York	2005
Alphonso O'Neil-White	President and Chief Executive Officer, HealthNow New York, Inc., Buffalo, New York	2006
	DISTRICT 3—PHILADELPHIA	
RESERVE BANK		
Class A		
Walter E. Daller, Jr.	Chairman, President, and Chief Executive Officer, Harleysville National Corporation, Harleysville, Pennsylvania	2004
Kenneth R. Shoemaker	President and Chief Executive Officer, Orrstown Bank, Shippensburg, Pennsylvania	2005
Eugene W. Rogers	Chief Executive Officer, Newfield National Bank, Newfield, New Jersey	2006
Class B		
P. Coleman Townsend, Jr.	Chairman and Chief Executive Officer, Townsends, Inc., Wilmington, Delaware	2004
Robert E. Chappell	Chairman and Chief Executive Officer, Penn Mutual Life Insurance Co., Horsham, Pennsylvania	2005
Garry L. Maddox	President and Chief Executive Officer, A. Pomerantz & Company, Philadelphia, Pennsylvania	2006
Class C		
Doris M. Damm	President and Chief Executive Officer, ACCU Staffing Services, Cherry Hill, New Jersey	2004
Ronald J. Naples	Chairman and Chief Executive Officer, Quaker Chemical Corporation, Conshohocken, Pennsylvania	2005
William F. Hecht	Chairman, President, and Chief Executive Officer, PPL Corporation, Allentown, Pennsylvania	2006

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
	DISTRICT 4—CLEVELAND	
Reserve Bank		
Class A		
John R. Cochran	Chairman and Chief Executive Officer, FirstMerit Corporation, Akron, Ohio	2004
Bick Weissenrieder	Chairman and Chief Executive Officer, Hocking Valley Bank, Athens, Ohio	2005
Stephen P. Wilson	President and Chief Executive Officer, Lebanon Citizens National Bank, Lebanon, Ohio	2006
Class B		
Wayne R. Embry	Former President and Chief Operating Officer, Cleveland Cavaliers, Cleveland, Ohio	2004
Tanny Crane	President and Chief Executive Officer, Crane Group Company, Columbus, Ohio	2005
V. Ann Hailey	Executive Vice President and Chief Financial Officer, Limited Brands, Columbus, Ohio	2006
Class C		
Charles E. Bunch	President and Chief Operating Officer, PPG Industries, Inc., Pittsburgh, Pennsylvania	2004
Phillip R. Cox	President and Chief Executive Officer, Cox Financial Corporation, Cincinnati, Ohio	2005
Robert W. Mahoney	Retired Chairman and Chief Executive Officer, Diebold, Incorporated, Canton, Ohio	2006
Cincinnati Branch		
Appointed by the Federal Reserve Bank		
James H. Booth	President, Czar Coal Corporation, Lovely, Kentucky	2004
V. Daniel Radford	Executive Secretary-Treasurer, Cincinnati AFL-CIO Labor Council, Cincinnati, Ohio	2005
Glenn D. Leveridge	President, Bank One, NA, Lexington, Kentucky	2005
Charlotte W. Martin	President and Chief Executive Officer, Great Lakes Bankers Bank, Gahanna, Ohio	2006
Appointed by the Board of Governors		
Herbert R. Brown	Senior Vice President, Western and Southern Financial Group, Cincinnati, Ohio	2004
Dennis C. Cuneo	Senior Vice President, Toyota Motor North America, Inc., New York, New York	2005
Charles Whitehead	Retired President, Ashland Inc. Foundation, Villa Hills, Kentucky	2006
Pittsburgh Branch		
Appointed by the Federal Reserve Bank		
Michael J. Hagan	President and Chief Executive Officer, Iron and Glass Bank, Pittsburgh, Pennsylvania	2004
Ronnie L. Bryant	President and Chief Operating Officer, CEcD, Pittsburgh Regional Alliance, Pittsburgh, Pennsylvania	2005

Directors—Continued

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Georgiana N. Riley	President and Chief Executive Officer, TIGG Corporation, Bridgeville, Pennsylvania	2005
Kristine N. Molnar	Executive Vice President, WesBanco Bank, Inc., Wheeling, West Virginia	2006
Appointed by the Board of Governors		
Robert O. Agbede	President and Chief Executive Officer, ATS-Chester Engineers, Pittsburgh, Pennsylvania	2004
Roy W. Haley	Chairman and Chief Executive Officer, WESCO International, Inc., Pittsburgh, Pennsylvania	2005
James I. Mitnick	Senior Vice President, Turner Construction Company, Pittsburgh, Pennsylvania	2006
	DISTRICT 5—RICHMOND	
Reserve Bank		
Class A		
Eddie Canterbury	President and Chief Executive Officer, Logan Bank & Trust Company, Logan, West Virginia	2004
Barry J. Fitzpatrick	Chairman, Branch Banking & Trust Co. of Virginia, Falls Church, Virginia	2005
Ernest J. Sewell	President and Chief Executive Officer, FNB Southeast, Greensboro, North Carolina	2006
Class B		
Joe Edens	Chairman, Edens & Avant, Columbia, South Carolina	2004
W. Henry Harmon	President and Chief Executive Officer, Columbia Natural Resources, LLC, Charleston, West Virginia	2005
Kenneth R. Sparks	President and Chief Executive Officer, Ken Sparks Associates LLC, White Stone, Virginia	2006
Class C		
Theresa M. Stone	Chief Financial Officer, Jefferson-Pilot Corporation, President, Jefferson-Pilot Communications Company, Greensboro, North Carolina	2004
Thomas J. Mackell, Jr.	President and Chief Operating Officer, The Kamber Group, Washington, D.C.	2005
Wesley S. Williams, Jr.	Partner, Covington & Burling, Washington, D.C.	2006
Baltimore Branch		
Appointed by the Federal Reserve Bank		
Donald P. Hutchinson	President and Chief Executive Officer, SunTrust Bank, Maryland, Baltimore, Maryland	2004
Dyan Brasington	President (Retired), Technology Council of Maryland, Rockville, Maryland	2005
Kenneth C. Lundeen	President, C.J. Langenfelder & Son, Inc., Baltimore, Maryland	2006

BANK or BRANCH, *Category* Name	Title	Term expires Dec. 31
Michael L. Middleton	Chairman and President, Community Bank of Tri-County, Waldorf, Maryland	2006
Appointed by the Board of Governors		
Owen E. Herrnstadt	Director, International Department, International Association of Machinists and Aerospace Workers, AFL-CIO, Upper Marlboro, Maryland	2004
Cynthia Collins Allner	Principal, Miles & Stockbridge PC, Baltimore, Maryland	2005
William C. Handorf	Professor of Finance, George Washington University, Washington, D.C.	2006
CHARLOTTE BRANCH		
Appointed by the Federal Reserve Bank		
William H. Nock	Chairman and Chief Executive Officer, Wayfarer Financial Group, Sumter, South Carolina	2004
Lucy J. Reuben	Durham, North Carolina	2005
Michael C. Miller	Chairman and President, FNB Corp. and First National Bank and Trust Company, Asheboro, North Carolina	2006
Donald K. Truslow	Chief Risk Officer, Wachovia Corporation, Charlotte, North Carolina	2006
Appointed by the Board of Governors		
James F. Goodmon	President and Chief Executive Officer, Capitol Broadcasting Company, Inc., Raleigh, North Carolina	2004
Michael A. Almond	President and Chief Executive Officer, Charlotte Regional Partnership, Charlotte, North Carolina	2005
Jim Lowry	Dealer Operator, Crown Automotive, High Point, North Carolina	2006
	DISTRICT 6—ATLANTA	
RESERVE BANK		
Class A		
James F. Beall	Chairman, President, and Chief Executive Officer, Farmers & Merchants Bank, Centre, Alabama	2004
Richard G. Hickson	Chairman and Chief Executive Officer, Trustmark Corporation, Jackson, Mississippi	2005
William G. Smith, Jr.	Chairman, President, and Chief Executive Officer, Capital City Bank Group, Inc., Tallahassee, Florida	2006
Class B		
Suzanne E. Boas	President, Consumer Credit Counseling Service of Greater Atlanta, Inc., Atlanta, Georgia	2004

Directors—Continued

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Egbert L.J. Perry	Chairman and Chief Executive Officer, The Integral Group, LLC, Atlanta, Georgia	2005
Teri G. Fontenot	President and Chief Executive Officer, Woman's Hospital, Baton Rouge, Louisiana	2006
Class C		
David M. Ratcliffe	Chairman, President, and Chief Executive Officer, Southern Company, Atlanta, Georgia	2004
V. Larkin Martin	Managing Partner, Martin Farm, Courtland, Alabama	2005
D. Scott Davis	Chief Financial Officer, United Parcel Service, Atlanta, Georgia	2006
Birmingham Branch *Appointed by the Federal Reserve Bank*		
John B. Barnett III	Monroeville President and Chairman, BankTrust, Monroeville, Alabama	2004
John H. Holcomb III	Chairman and Chief Executive Officer, Alabama National Bancorporation, Birmingham, Alabama	2005
Samuel F. Dodson	Business Manager, International Union of Operating Engineers-Local 312, Birmingham, Alabama	2006
Bobby A. Bradley	Retired Senior Vice President and Group Manager, Science Applications International Corporation, Huntsville, Alabama	2006
Appointed by the Board of Governors		
Catherine Sloss Crenshaw	President, Sloss Real Estate Group, Inc., Birmingham, Alabama	2004
James H. Sanford	Chairman of the Board, HOME Place Farms, Inc., Prattville, Alabama	2005
W. Miller Welborn	President, Welborn and Associates, Inc., Lookout Mountain, Tennessee	2006
Jacksonville Branch *Appointed by the Federal Reserve Bank*		
Harvey R. Heller	President, Heller Brothers Packing Corporation, Winter Garden, Florida	2004
Jerry M. Smith	Chairman and President, First National Bank of Alachua, Alachua, Florida	2005
Robert L. Fisher	President and Chief Executive Officer, MacDill Federal Credit Union, Tampa, Florida	2006
Ellen S. Titen	President, E.T. Consultants, Winter Park, Florida	2006
Appointed by the Board of Governors		
Julie K. Hilton	Vice President and Co-Owner, Paradise Found Resorts & Hotels, Panama City Beach, Florida	2004
Fassil Gabremariam	President and Founder, U.S.-Africa Free Enterprise Education Foundation, Tampa, Florida	2005
Linda H. Sherrer	President and Chief Executive Officer, Prudential Network Realty, Jacksonville, Florida	2006

BANK or BRANCH, *Category* Name	Title	Term expires Dec. 31
MIAMI BRANCH		
Appointed by the Federal Reserve Bank		
Rudy Everett Schupp	President and Chief Executive Officer, First United Bank, North Palm Beach, Florida	2004
Francis V. Gudorf	President and Executive Director, Jubilee Community Development Corporation, Miami, Florida	2005
Joseph C. Schwartzel	President, Meridian Broadcasting, Inc., Fort Myers, Florida	2005
Miriam Lopez	Chairman and Chief Executive Officer, TransAtlantic Bank, Miami, Florida	2006
Appointed by the Board of Governors		
Rosa Sugranes	Chairman, Iberia Tiles Corp, Miami, Florida	2004
Edwin A. Jones, Jr.	President, Angus Investments, Inc., Port St. Lucie, Florida	2005
Brian E. Keeley	President and Chief Executive Officer, Baptist Health South Florida, Coral Gables, Florida	2006
NASHVILLE BRANCH		
Appointed by the Federal Reserve Bank		
Sam O. Franklin III	Retired Chairman, SunTrust Bank, Nashville, Nashville, Tennessee	2004
Michael B. Swain	President and Chief Executive Officer, First National Bank, Oneida, Tennessee	2005
James W. Spradley, Jr.	President and Chief Executive Officer, Standard Candy Company, Inc., Nashville, Tennessee	2006
Daniel A. Gaudette	Senior Vice President, North American Manufacturing and Quality Assurance, Nissan North America, Inc., Smyrna, Tennessee	2006
Appointed by the Board of Governors		
F. Rodney Lawler	Co-Founder and Chief Executive Officer, Lawler-Wood, LLC, Knoxville, Tennessee	2004
Beth Dortch Franklin	Chief Executive Officer, Star Transportation, Inc., Nashville, Tennessee	2005
David Williams II	Vice Chancellor and General Counsel, Vanderbilt University, Nashville, Tennessee	2006
NEW ORLEANS BRANCH		
Appointed by the Federal Reserve Bank		
David E. Johnson	Chairman and Chief Executive Officer, The First Bancshares, Inc., and The First, A National Banking Association, Hattiesburg, Mississippi	2004
C. R. Cloutier	President and Chief Executive Officer, MidSouth Bank, Lafayette, Louisiana	2005
Lawrence E. Kurzius	President and Chief Executive Officer, Zatarain's, Gretna, Louisiana	2006
Christel C. Slaughter	Partner, General Business, SSA Consultants, LLC, Baton Rouge, Louisiana	2006

Directors—Continued

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Appointed by the Board of Governors		
Dave Dennis	President, Specialty Contractors & Assoc., Inc., Gulfport, Mississippi	2004
Earl L. Shipp	Vice President and Site Director, The Dow Chemical Company, Louisiana Operations, Plaquemine, Louisiana	2005
Ben Tom Roberts	Senior Executive Vice President/Owner, Roberts Brothers, Inc., Realtors, Mobile, Alabama	2006
	DISTRICT 7—CHICAGO	
Reserve Bank		
Class A		
Alan R. Tubbs	President, Maquoketa State Bank and Ohnward Bancshares Inc., Maquoketa, Iowa	2004
William A. Osborn	Chairman and Chief Executive Officer, Northern Trust Corporation and The Northern Trust Company, Chicago, Illinois	2005
Michael L. Kubacki	Chairman, President, and Chief Executive Officer, Lakeland Financial Corporation, Warsaw, Indiana	2006
Class B		
James H. Keyes	Chairman of the Board-Retired, Johnson Controls, Inc., Milwaukee, Wisconsin	2004
Connie E. Evans	President and Chief Executive Officer, WSEP Ventures, Chicago, Illinois	2005
Mark T. Gaffney	President, Michigan AFL-CIO, Lansing, Michigan	2006
Class C		
Miles D. White	Chairman and Chief Executive Officer, Abbott Laboratories, Abbott Park, Illinois	2004
John A. Canning, Jr.	Chairman and Chief Executive Officer, Madison Dearborn Partners, Inc., Chicago, Illinois	2005
W. James Farrell	Chairman and Chief Executive Officer, Illinois Tool Works, Inc., Glenview, Illinois	2006
Detroit Branch		
Appointed by the Federal Reserve Bank		
Robert E. Churchill	Chairman and Chief Executive Officer, Citizens National Bank, Cheboygan, Michigan	2004
Tommi A. White	Chief Operating Officer, Compuware Corporation, Detroit, Michigan	2005
Linda S. Likely	Executive Director, Kalamazoo Neighborhood Housing Services, Kalamazoo, Michigan	2005
Ralph W. Babb, Jr.	Chairman, President, and Chief Executive Officer, Comerica Incorporated, Detroit, Michigan	2006
Appointed by the Board of Governors		
Irvin D. Reid	President, Wayne State University, Detroit, Michigan	2004
Edsel B. Ford II	Board Director, Ford Motor Company, Dearborn, Michigan	2005
Roger A. Cregg	Executive Vice President and Chief Financial Officer, Pulte Homes, Inc., Bloomfield Hills, Michigan	2006

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
	DISTRICT 8—ST. LOUIS	
Reserve Bank		
Class A		
Lewis F. Mallory, Jr.	Chairman and Chief Executive Officer, National Bank of Commerce, Starkville, Mississippi	2004
Lunsford W. Bridges	President and Chief Executive Officer, Metropolitan National Bank, Little Rock, Arkansas	2005
Bradley W. Small	Principal, Mathis, Marifian, Richter & Grandy, Ltd., Belleville, Illinois	2006
Class B		
Bert Greenwalt	Partner, Greenwalt Company, Hazen, Arkansas	2004
J. Stephen Barger	Taft-Hartley Coordinator, Indiana/Kentucky Regional Council of Carpenters, Louisville, Kentucky	2005
A. Rogers Yarnell II	President, Yarnell Ice Cream Co., Inc., Searcy, Arkansas	2006
Class C		
Charles W. Mueller	Retired Chairman and Chief Executive Officer, Ameren Corporation, St. Louis, Missouri	2004
Gayle P.W. Jackson	Managing Director, FondElec Clean Energy Group, Inc., St. Louis, Missouri	2005
Walter L. Metcalfe, Jr.	Partner, Bryan Cave LLP, St. Louis, Missouri	2006
Little Rock Branch		
Appointed by the Federal Reserve Bank		
Lawrence A. Davis, Jr.	Chancellor, University of Arkansas at Pine Bluff, Pine Bluff, Arkansas	2004
David R. Estes	President and Chief Executive Officer, First State Bank, Lonoke, Arkansas	2005
Robert A. Young III	Chairman, President, and Chief Executive Officer, Arkansas Best Corporation, Fort Smith, Arkansas	2005
Raymond E. Skelton	Little Rock, Arkansas	2006
Appointed by the Board of Governors		
Sonja Yates Hubbard	Chief Executive Officer, E-Z Mart Stores, Inc., Texarkana, Texas	2004
Stephen M. Erixon	Chief Executive Officer, Baxter Regional Medical Center, Mountain Home, Arkansas	2005
Scott T. Ford	President and Chief Executive Officer, ALLTEL Corporation, Little Rock, Arkansas	2006
Louisville Branch		
Appointed by the Federal Reserve Bank		
David H. Brooks	Chairman and Chief Executive Officer, Stock Yards Bank & Trust Company, Louisville, Kentucky	2004
Marjorie Z. Soyugenc	Executive Director and Chief Executive Officer, Welborn Foundation, Evansville, Indiana	2005

Directors—Continued

BANK OF BRANCH, *Category* Name	Title	Term expires Dec. 31
L. Clark Taylor, Jr.	Chief Executive Officer, Ephraim McDowell Health, Danville, Kentucky	2005
Gordon B. Guess	Chairman, President, and Chief Executive Officer, The Peoples Bank, Marion, Kentucky	2006
Appointed by the Board of Governors		
Cornelius A. Martin	President and Chief Executive Officer, Martin Management Group, Bowling Green, Kentucky	2004
Maria Gerwing Hampton	President, The Housing Partnership, Inc., Louisville, Kentucky	2005
Norman E. Pfau, Jr.	President and Chief Executive Officer, Geo. Pfau's Sons Company, Inc., Jeffersonville, Indiana	2006
MEMPHIS BRANCH *Appointed by the Federal Reserve Bank*		
Walter L. Morris, Jr.	President, H&M Lumber Co., Inc., West Helena, Arkansas	2004
James A. England	Chairman, President, and Chief Executive Officer, Decatur County Bank, Decaturville, Tennessee	2005
Tom A. Wright	Chairman and Chief Executive Officer, Enterprise National Bank, Memphis, Tennessee	2005
David P. Rumbarger, Jr.	President and Chief Executive Officer, Community Development Foundation, Tupelo, Mississippi	2006
Appointed by the Board of Governors		
Gregory M. Duckett	Senior Vice President and Corporate Counsel, Baptist Memorial Health Care Corporation, Memphis, Tennessee	2004
Meredith Baird Allen	Vice President, Marketing, Staple Cotton Cooperative Association, Greenwood, Mississippi	2005
Russell Gwatney	President, Gwatney Companies, Memphis, Tennessee	2006
	DISTRICT 9—MINNEAPOLIS	
RESERVE BANK *Class A*		
Kay Clevidence	President, Farmers State Bank, Victor, Montana	2004
Robert Dickson	Chairman and Chief Executive Officer, The First National Bank of Fairfax, Fairfax, Minnesota	2005
Douglas C. Morrison	Chief Financial Officer, Citibank (South Dakota) N.A., Sioux Falls, South Dakota	2006
Class B		
Jay F. Hoeschler	President and Owner, Hoeschler Corporation, La Crosse, Wisconsin	2004
Randy Peterson	General Manager, Precision Edge Surgical Products Co., LLC, Sault Ste. Marie, Michigan	2005

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
D. Greg Heineman	Chairman, Williams Insurance Agency, Sioux Falls, South Dakota	2006
Class C		
Frank L. Sims	Corporate Vice President, Transportation, Cargill, Inc., Minnetonka, Minnesota	2004
Linda Hall Whitman	Chief Executive Officer, MinuteClinic, Minneapolis, Minnesota	2005
James J. Hynes	Executive Administrator, Twin City Pipe Trades Service Association, St. Paul, Minnesota	2006
Helena Branch		
Appointed by the Federal Reserve Bank		
Marilyn F. Wessel	Former Dean and Director, Museum of the Rockies, Bozeman, Montana	2004
Joy N. Ott	Regional President and Chief Executive Officer, Wells Fargo Bank Montana, N.A., Billings, Montana	2004
Ronald D. Scott	President and Chief Executive Officer, The First State Bank of Malta, Malta, Montana	2005
Appointed by the Board of Governors		
Dean Folkvord	President and Chief Executive Officer, Wheat Montana Farms and Bakery, Three Forks, Montana	2004
Lawrence R. Simkins	President, Washington Corporations, Missoula, Montana	2005
	DISTRICT 10—KANSAS CITY	
Reserve Bank		
Class A		
Jeffrey L. Gerhart	President and Chief Executive Officer, First National Bank of Newman Grove, Newman Grove, Nebraska	2004
Rick L. Smalley	Chief Executive Officer, Dickinson Financial Corporation, Kansas City, Missouri	2005
Mark W. Schifferdecker	President and Chief Executive Officer, Girard National Bank, Girard, Kansas	2006
Class B		
Frank Moore	President, Spearhead Ranch Company, Douglas, Wyoming	2004
Dan L. Dillingham	Chief Executive Officer, Dillingham Insurance, Enid, Oklahoma	2005
Kevin K. Nunnink	Chairman, Integra Realty Resources, Westwood, Kansas	2006
Class C		
Richard H. Bard	Chairman and Chief Executive Officer, International Surface Preparation Corporation, Golden, Colorado	2004

Directors—Continued

BANK or BRANCH, *Category* Name	Title	Term expires Dec. 31
Vacancy		2005
Robert A. Funk	Chairman and Chief Executive Officer, Express Personnel Services International, Oklahoma City, Oklahoma	2006
DENVER BRANCH		
Appointed by the Federal Reserve Bank		
Michael R. Stanford	President and Chief Executive Officer, First State Bancorporation, Albuquerque, New Mexico	2004
Virginia K. Berkeley	President, CoBiz Bank, N.A., Denver, Colorado	2005
James A. Helzer	President and Chief Executive Officer, Unicover Corporation, Cheyenne, Wyoming	2006
Kristy A. Schloss	President and Chief Executive Officer, Schloss Engineered Equipment, Inc., Aurora, Colorado	2006
Appointed by the Board of Governors		
James A. King	Chief Executive Officer, BT, Inc., Riverton, Wyoming	2004
Kathleen Avila	Managing Member, Avila Retail Development & Management, Albuquerque, New Mexico	2005
Thomas Williams	President and Chief Executive Officer, Williams Group LLC, Golden, Colorado	2006
OKLAHOMA CITY BRANCH		
Appointed by the Federal Reserve Bank		
W. Carlisle Mabrey III	President and Chief Executive Officer, Citizens Bank & Trust Co., Okmulgee, Oklahoma	2004
Robert R. Gilbert III	President and Chief Operating Officer, The F&M Bank & Trust Company, Tulsa, Oklahoma	2004
Fred M. Ramos	President, Greater Tulsa Hispanic Chamber of Commerce, Tulsa, Oklahoma	2005
Richard K. Ratcliffe	Chairman, Ratcliffe's Inc., Weatherford, Oklahoma	2006
Appointed by the Board of Governors		
J. Larry Nichols	Chairman and Chief Executive Officer, Devon Energy Corporation, Oklahoma City, Oklahoma	2004
Michael J. Packnett	President and Chief Executive Officer, Mercy Health System of Oklahoma, Inc., Oklahoma City, Oklahoma	2005
Tyree O. Minner	Plant Manager, Oklahoma City Assembly, General Motors, Oklahoma City, Oklahoma	2006
OMAHA BRANCH		
Appointed by the Federal Reserve Bank		
Cynthia Hardin Milligan	Dean, College of Business Administration, University of Nebraska-Lincoln, Lincoln, Nebraska	2004
Judith A. Owen	Retired President and Chief Executive Officer, Wells Fargo Bank, N.A., Omaha, Nebraska	2005

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Rodrigo Lopez	President and Chief Executive Officer, AmeriSphere Multifamily Finance, LLC, Omaha, Nebraska	2006
Michael J. Nelson	Chairman, FirsTier Bank, Kimball, Nebraska	2006
Appointed by the Board of Governors		
Terry L. Moore	President, Omaha Federation of Labor, Omaha, Nebraska	2004
James A. Timmerman	Chief Financial Officer and Secretary/Treasurer, Timmerman and Sons Feeding Co., Springfield, Nebraska	2005
A.F. Raimondo	Chairman and Chief Executive Officer, Behlen Mfg. Co., Columbus, Nebraska	2006
	DISTRICT 11—DALLAS	
Reserve Bank		
Class A		
David S. Barnard	Chairman and Chief Executive Officer, National Bank, Gatesville, Texas	2004
Richard W. Evans, Jr.	Chairman and Chief Executive Officer, Cullen/Frost Bankers, Inc., San Antonio, Texas	2005
Matthew T. Doyle	Vice Chairman and Chief Executive Officer, Texas First Bank, Texas City, Texas	2006
Class B		
Vacancy		2004
Malcolm Gillis	University Professor and Past President, Rice University, Houston, Texas	2005
Judy Ley Allen	Partner, Allen Investments, Houston, Texas	2006
Class C		
Ray L. Hunt	Chairman, President, and Chief Executive Officer, Hunt Consolidated, Inc., Dallas, Texas	2004
Patricia M. Patterson	President, Patterson Investments, Inc., Dallas, Texas	2005
Anthony R. Chase	Chairman and Chief Executive Officer, ChaseCom, LP, Houston, Texas	2006
El Paso Branch		
Appointed by the Federal Reserve Bank		
F. James Volk	Regional President, State National Bank, El Paso, Texas	2004
Pete Cook	President and Chief Executive Officer, First National Bank of Alamogordo, Alamogordo, New Mexico	2005
Fred J. Loya	Chairman, Fred Loya Insurance, El Paso, Texas	2005
Gerald J. Rubin	Chairman, President, and Chief Executive Officer, Helen of Troy Corporation Limited, El Paso, Texas	2006
Appointed by the Board of Governors		
Cecilia Ochoa Levine	President, MFI International Mfg., LLC, El Paso, Texas	2004

Directors—Continued

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Ron C. Helm	Owner, Helm Land and Cattle Company, Van Horn, Texas	2005
William V. Flores	Provost, New Mexico State University, Las Cruces, New Mexico	2006
Houston Branch		
Appointed by the Federal Reserve Bank		
Richard W. Weekley	Chairman, Weekley Development Company, Houston, Texas	2004
Priscilla D. Slade	President, Texas Southern University, Houston, Texas	2005
S. Reed Morian	Chairman, Chief Executive Officer, and President, DX Service Company, Inc., Houston, Texas	2005
Timothy N. Bryan	Chairman and Chief Executive Officer, The First National Bank of Bryan, Bryan, Texas	2006
Appointed by the Board of Governors		
James T. Hackett	President and Chief Executive Officer, Anadarko Petroleum Corporation, Houston, Texas	2004
Lupe Fraga	Chairman and Chief Executive Officer, Tejas Office Products, Inc., Houston, Texas	2005
Vacancy		2006
San Antonio Branch		
Appointed by the Federal Reserve Bank		
R. Tom Roddy	Chairman, Lone Star Capital Bank, N.A., San Antonio, Texas	2004
Matt F. Gorges	Chairman and Chief Executive Officer, Valley International Cold Storage, Inc., Harlingen, Texas	2005
Daniel B. Hastings, Jr.	President and Owner, Daniel B. Hastings, Inc., Laredo, Texas	2005
Steven R. Vandegrift	Founder and President, SRV Holdings, Austin, Texas,	2006
Appointed by the Board of Governors		
Ron R. Harris	General Partner, Southwest Capital Partners, Austin, Texas	2004
Elizabeth Chu Richter	Chairman and Chief Executive Officer, Richter Architects, Corpus Christi, Texas	2005
Marvin L. Ragsdale	President, Iron Workers District Council of the State of Texas, Georgetown, Texas	2006
	DISTRICT 12—SAN FRANCISCO	
Reserve Bank		
Class A		
Richard W. Decker, Jr.	Chairman and Co-Founder, Belvedere Capital Partners, LLC, San Francisco, California	2004
Candace Hunter Wiest	President, Inland Empire National Bank, Riverside, California	2005
Richard C. Hartnack	Vice Chairman, Union Bank of California, Los Angeles, California	2006

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Class B		
Jack McNally	Principal, JKM Consulting, Sacramento, California	2004
David K.Y. Tang	Partner, Preston Gates & Ellis LLP, Seattle, Washington	2005
Barbara L. Wilson	Consultant and Regional Vice President (Retired), Qwest Communications, Boise, Idaho	2006
Class C		
Sheila D. Harris	Director, Arizona Department of Housing, Phoenix, Arizona	2004
George M. Scalise	President, Semiconductor Industry Association, San Jose, California	2005
Vacancy		2006
Los Angeles Branch		
Appointed by the Federal Reserve Bank		
Russell Goldsmith	Chairman and Chief Executive Officer, City National Bank, Beverly Hills, California	2004
Peter M. Thomas	Managing Partner, Thomas & Mack Co., Las Vegas, Nevada	2005
D. Linn Wiley	President and Chief Executive Officer, Citizens Business Bank, Ontario, California	2006
Karen Caplan	President and Chief Executive Officer, Frieda's, Inc., Los Alamitos, California	2006
Appointed by the Board of Governors		
William D. Jones	Chairman, President, and Chief Executive Officer, CityLink Investment Corporation, San Diego, California	2004
Diane Donoghue	Executive Director, Esperanza Community Housing Corporation, Los Angeles, California	2005
Anita Santiago	President, Anita Santiago Advertising, Santa Monica, California	2006
Portland Branch		
Appointed by the Federal Reserve Bank		
George J. Passadore	Chairman, Oregon, Wells Fargo Bank, Portland, Oregon	2004
William D. Thorndike, Jr.	President, Medford Fabrication, Medford, Oregon	2005
James H. Rudd	Chief Executive Officer, Ferguson Wellman Capital Management, Inc., Portland, Oregon	2005
Robert D. Sznewajs	President and Chief Executive Officer, West Coast Bancorp, Lake Oswego, Oregon	2006
Appointed by the Board of Governors		
Karla S. Chambers	Vice President, Stahlbush Island Farms, Inc., Corvallis, Oregon	2004
Peter O. Kohler	President, Oregon Health & Science University, Portland, Oregon	2005
Judi Johansen	President and Chief Executive Officer, PacifiCorp, Portland, Oregon	2006

Directors—Continued

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Salt Lake City Branch		
Appointed by the Federal Reserve Bank		
Curtis H. Harris	Chairman, President, and Chief Executive Officer, Barnes Banking Company, Kaysville, Utah	2004
A. Scott Anderson	President and Chief Executive Officer, Zions First National Bank, Salt Lake City, Utah	2005
Deborah Bayle Nielsen	President and Chief Executive Officer, United Way of Salt Lake, Salt Lake City, Utah	2005
Annette K. Herman	President and Chief Executive Officer, UnitedHealthcare, Salt Lake City, Utah	2006
Appointed by the Board of Governors		
Gary L. Crocker	Chairman and Chief Executive Officer, AnZenBio, Salt Lake City, Utah	2004
H. Roger Boyer	Chairman, The Boyer Company, Salt Lake City, Utah	2005
William C. Glynn	President, Intermountain Industries, Inc., Boise, Idaho	2006
Seattle Branch		
Appointed by the Federal Reserve Bank		
Peter H. van Oppen	Chairman and Chief Executive Officer, Advanced Digital Information Corp., Redmond, Washington	2004
Mary E. Pugh	President, Pugh Capital Management, Inc., Seattle, Washington	2005
Kenneth M. Kirkpatrick	President, U.S. Bank, Seattle, Washington	2005
Helvi K. Sandvik	President, NANA Development Corp., Anchorage, Alaska	2006
Appointed by the Board of Governors		
Mic R. Dinsmore	Chief Executive Officer, Port of Seattle, Seattle, Washington	2004
James R. Gill	President, Pacific Northwest Title, Seattle, Washington	2005
David W. Wyckoff	Chairman and Chief Executive Officer, Wyckoff Farms, Inc., Grandview, Washington	2006

Members of the Board of Governors, 1913–2004

Appointed Members

Name	Federal Reserve District	Date initially took oath of office	Other dates[1]
Charles S. Hamlin	Boston	Aug. 10, 1914	Reappointed in 1916 and 1926. Served until Feb. 3, 1936.[2]
Paul M. Warburg	New York	Aug. 10, 1914	Term expired Aug. 9, 1918.
Frederic A. Delano	Chicago	Aug. 10, 1914	Resigned July 21, 1918.
W.P.G. Harding	Atlanta	Aug. 10, 1914	Term expired Aug. 9, 1922.
Adolph C. Miller	San Francisco	Aug. 10, 1914	Reappointed in 1924. Reappointed in 1934 from the Richmond District. Served until Feb. 3, 1936.[2]
Albert Strauss	New York	Oct. 26, 1918	Resigned Mar. 15, 1920.
Henry A. Moehlenpah	Chicago	Nov. 10, 1919	Term expired Aug. 9, 1920.
Edmund Platt	New York	June 8, 1920	Reappointed in 1928. Resigned Sept. 14, 1930.
David C. Wills	Cleveland	Sept. 29, 1920	Term expired Mar. 4, 1921.
John R. Mitchell	Minneapolis	May 12, 1921	Resigned May 12, 1923.
Milo D. Campbell	Chicago	Mar. 14, 1923	Died Mar. 22, 1923.
Daniel R. Crissinger	Cleveland	May 1, 1923	Resigned Sept. 15, 1927.
George R. James	St. Louis	May 14, 1923	Reappointed in 1931. Served until Feb. 3, 1936.[3]
Edward H. Cunningham	Chicago	May 14, 1923	Died Nov. 28, 1930.
Roy A. Young	Minneapolis	Oct. 4, 1927	Resigned Aug. 31, 1930.
Eugene Meyer	New York	Sept. 16, 1930	Resigned May 10, 1933.
Wayland W. Magee	Kansas City	May 18, 1931	Term expired Jan. 24, 1933.
Eugene R. Black	Atlanta	May 19, 1933	Resigned Aug. 15, 1934.
M.S. Szymczak	Chicago	June 14, 1933	Reappointed in 1936 and 1948. Resigned May 31, 1961.
J.J. Thomas	Kansas City	June 14, 1933	Served until Feb. 10, 1936.[2]
Marriner S. Eccles	San Francisco	Nov. 15, 1934	Reappointed in 1936, 1940, and 1944. Resigned July 14, 1951.
Joseph A. Broderick	New York	Feb. 3, 1936	Resigned Sept. 30, 1937.
John K. McKee	Cleveland	Feb. 3, 1936	Served until Apr. 4, 1946.[2]
Ronald Ransom	Atlanta	Feb. 3, 1936	Reappointed in 1942. Died Dec. 2, 1947.
Ralph W. Morrison	Dallas	Feb. 10, 1936	Resigned July 9, 1936.
Chester C. Davis	Richmond	June 25, 1936	Reappointed in 1940. Resigned Apr. 15, 1941.
Ernest G. Draper	New York	Mar. 30, 1938	Served until Sept. 1, 1950.[2]
Rudolph M. Evans	Richmond	Mar. 14, 1942	Served until Aug. 13, 1954.[2]
James K. Vardaman, Jr.	St. Louis	Apr. 4, 1946	Resigned Nov. 30, 1958.
Lawrence Clayton	Boston	Feb. 14, 1947	Died Dec. 4, 1949.
Thomas B. McCabe	Philadelphia	Apr. 15, 1948	Resigned Mar. 31, 1951.
Edward L. Norton	Atlanta	Sept. 1, 1950	Resigned Jan. 31, 1952.
Oliver S. Powell	Minneapolis	Sept. 1, 1950	Resigned June 30, 1952.
Wm. McC. Martin, Jr.	New York	April 2, 1951	Reappointed in 1956. Term expired Jan. 31, 1970.
A.L. Mills, Jr.	San Francisco	Feb. 18, 1952	Reappointed in 1958. Resigned Feb. 28, 1965.
J.L. Robertson	Kansas City	Feb. 18, 1952	Reappointed in 1964. Resigned Apr. 30, 1973.
C. Canby Balderston	Philadelphia	Aug. 12, 1954	Served through Feb. 28, 1966.
Paul E. Miller	Minneapolis	Aug. 13, 1954	Died Oct. 21, 1954.

Appointed Members—Continued

Name	Federal Reserve District	Date initially took oath of office	Other dates[1]
Chas. N. Shepardson	Dallas	Mar. 17, 1955	Retired Apr. 30, 1967.
G.H. King, Jr.	Atlanta	Mar. 25, 1959	Reappointed in 1960. Resigned Sept. 18, 1963.
George W. Mitchell	Chicago	Aug. 31, 1961	Reappointed in 1962. Served until Feb. 13, 1976.[2]
J. Dewey Daane	Richmond	Nov. 29, 1963	Served until Mar. 8, 1974.[2]
Sherman J. Maisel	San Francisco	Apr. 30, 1965	Served through May 31, 1972.
Andrew F. Brimmer	Philadelphia	Mar. 9, 1966	Resigned Aug. 31, 1974.
William W. Sherrill	Dallas	May 1, 1967	Reappointed in 1968. Resigned Nov. 15, 1971.
Arthur F. Burns	New York	Jan. 31, 1970	Term began Feb. 1, 1970. Resigned Mar. 31, 1978.
John E. Sheehan	St. Louis	Jan. 4, 1972	Resigned June 1, 1975.
Jeffrey M. Bucher	San Francisco	June 5, 1972	Resigned Jan. 2, 1976.
Robert C. Holland	Kansas City	June 11, 1973	Resigned May 15, 1976.
Henry C. Wallich	Boston	Mar. 8, 1974	Resigned Dec. 15, 1986.
Philip E. Coldwell	Dallas	Oct. 29, 1974	Served through Feb. 29, 1980.
Philip C. Jackson, Jr.	Atlanta	July 14, 1975	Resigned Nov. 17, 1978.
J. Charles Partee	Richmond	Jan. 5, 1976	Served until Feb. 7, 1986.[2]
Stephen S. Gardner	Philadelphia	Feb. 13, 1976	Died Nov. 19, 1978.
David M. Lilly	Minneapolis	June 1, 1976	Resigned Feb. 24, 1978.
G. William Miller	San Francisco	Mar. 8, 1978	Resigned Aug. 6, 1979.
Nancy H. Teeters	Chicago	Sept. 18, 1978	Served through June 27, 1984.
Emmett J. Rice	New York	June 20, 1979	Resigned Dec. 31, 1986.
Frederick H. Schultz	Atlanta	July 27, 1979	Served through Feb. 11, 1982.
Paul A. Volcker	Philadelphia	Aug. 6, 1979	Resigned August 11, 1987.
Lyle E. Gramley	Kansas City	May 28, 1980	Resigned Sept. 1, 1985.
Preston Martin	San Francisco	Mar. 31, 1982	Resigned April 30, 1986.
Martha R. Seger	Chicago	July 2, 1984	Resigned March 11, 1991.
Wayne D. Angell	Kansas City	Feb. 7, 1986	Served through Feb. 9, 1994.
Manuel H. Johnson	Richmond	Feb. 7, 1986	Resigned August 3, 1990.
H. Robert Heller	San Francisco	Aug. 19, 1986	Resigned July 31, 1989.
Edward W. Kelley, Jr.	Dallas	May 26, 1987	Resigned Dec. 31, 2001.
Alan Greenspan	New York	Aug. 11, 1987	Reappointed in 1992.
John P. LaWare	Boston	Aug. 15, 1988	Resigned April 30, 1995.
David W. Mullins, Jr.	St. Louis	May 21, 1990	Resigned Feb. 14, 1994.
Lawrence B. Lindsey	Richmond	Nov. 26, 1991	Resigned Feb. 5, 1997.
Susan M. Phillips	Chicago	Dec. 2, 1991	Served through June 30, 1998.
Alan S. Blinder	Philadelphia	June 27, 1994	Term expired Jan. 31, 1996.
Janet L. Yellen	San Francisco	Aug. 12, 1994	Resigned Feb. 17, 1997.
Laurence H. Meyer	St. Louis	June 24, 1996	Term expired Jan. 31, 2002.
Alice M. Rivlin	Philadelphia	June 25, 1996	Resigned July 16, 1999.
Roger W. Ferguson, Jr.	Boston	Nov. 5, 1997	Reappointed in 2001.
Edward M. Gramlich	Richmond	Nov. 5, 1997	
Susan S. Bies	Chicago	Dec. 7, 2001	
Mark W. Olson	Minneapolis	Dec. 7, 2001	
Ben S. Bernanke	Atlanta	Aug. 5, 2002	Reappointed in 2003.
Donald L. Kohn	Kansas City	Aug. 5, 2002	

Appointed Members—Continued

Name	Term
Chairmen [3]	
Charles S. Hamlin	Aug. 10, 1914–Aug. 9, 1916
W.P.G. Harding	Aug. 10, 1916–Aug. 9, 1922
Daniel R. Crissinger	May 1, 1923–Sept. 15, 1927
Roy A. Young	Oct. 4, 1927–Aug. 31, 1930
Eugene Meyer	Sept. 16, 1930–May 10, 1933
Eugene R. Black	May 19, 1933–Aug. 15, 1934
Marriner S. Eccles	Nov. 15, 1934–Jan. 31, 1948 [4]
Thomas B. McCabe	Apr. 15, 1948–Mar. 31, 1951
Wm. McC. Martin, Jr.	Apr. 2, 1951–Jan. 31, 1970
Arthur F. Burns	Feb. 1, 1970–Jan. 31, 1978
G. William Miller	Mar. 8, 1978–Aug. 6, 1979
Paul A. Volcker	Aug. 6, 1979–Aug. 11, 1987
Alan Greenspan	Aug. 11, 1987– [5]
Vice Chairmen [3]	
Frederic A. Delano	Aug. 10, 1914–Aug. 9, 1916
Paul M. Warburg	Aug. 10, 1916–Aug. 9, 1918
Albert Strauss	Oct. 26, 1918–Mar. 15, 1920
Edmund Platt	July 23, 1920–Sept. 14, 1930
J.J. Thomas	Aug. 21, 1934–Feb. 10, 1936
Ronald Ransom	Aug. 6, 1936–Dec. 2, 1947
C. Canby Balderston	Mar. 11, 1955–Feb. 28, 1966
J.L. Robertson	Mar. 1, 1966–Apr. 30, 1973
George W. Mitchell	May 1, 1973–Feb. 13, 1976
Stephen S. Gardner	Feb. 13, 1976–Nov. 19, 1978
Frederick H. Schultz	July 27, 1979–Feb. 11, 1982
Preston Martin	Mar. 31, 1982–Apr. 30, 1986
Manuel H. Johnson	Aug. 4, 1986–Aug. 3, 1990
David W. Mullins, Jr.	July 24, 1991–Feb. 14, 1994
Alan S. Blinder	June 27, 1994–Jan. 31, 1996
Alice M. Rivlin	June 25, 1996–July 16, 1999
Roger W. Ferguson, Jr.	Oct. 5, 1999–

NOTE. Under the original Federal Reserve Act, the Federal Reserve Board was composed of five appointed members, the Secretary of the Treasury (ex officio chairman of the Board), and the Comptroller of the Currency. The original term of office was ten years; the five original appointed members had terms of two, four, six, eight, and ten years. In 1922 the number of appointed members was increased to six, and in 1933 the term of office was raised to twelve years. The Banking Act of 1935 changed the name to the Board of Governors of the Federal Reserve System and provided that the Board be composed of seven appointed members; that the Secretary of the Treasury and the Comptroller of the Currency continue to serve until Feb. 1, 1936; that the appointed members in office on Aug. 23, 1935, continue to serve until Feb. 1, 1936, or until their successors were appointed and had qualified; and that thereafter the terms of members be fourteen years and that the designation of Chairman and Vice Chairman of the Board be for four years.

1. Date following "Resigned" and "Retired" denotes final day of service.
2. Successor took office on this date.
3. Before Aug. 23, 1935, Chairmen and Vice Chairmen were designated Governor and Vice Governor.
4. Served as Chairman Pro Tempore from February 3, 1948, to April 15, 1948.
5. Served as Chairman Pro Tempore from March 3, 1996, to June 20, 1996.

Ex Officio Members

Name	Term
Secretaries of the Treasury	
W.G. McAdoo	Dec. 23, 1913–Dec. 15, 1918
Carter Glass	Dec. 16, 1918–Feb. 1, 1920
David F. Houston	Feb. 2, 1920–Mar. 3, 1921
Andrew W. Mellon	Mar. 4, 1921–Feb. 12, 1932
Ogden L. Mills	Feb. 12, 1932–Mar. 4, 1933
William H. Woodin	Mar. 4, 1933–Dec. 31, 1933
Henry Morgenthau, Jr.	Jan. 1, 1934–Feb. 1, 1936
Comptrollers of the Currency	
John Skelton Williams	Feb. 2, 1914–Mar. 2, 1921
Daniel R. Crissinger	Mar. 17, 1921–Apr. 30, 1923
Henry M. Dawes	May 1, 1923–Dec. 17, 1924
Joseph W. McIntosh	Dec. 20, 1924–Nov. 20, 1928
J.W. Pole	Nov. 21, 1928–Sept. 20, 1932
J.F.T. O'Connor	May 11, 1933–Feb. 1, 1936

Statistical Tables

1. Statement of Condition of the Federal Reserve Banks, by Bank, December 31, 2004 and 2003

Millions of dollars

Item	Total		Boston	
	2004	2003	2004	2003
ASSETS				
Gold certificate account	11,041	11,039	494	495
Special drawing rights certificate account	2,200	2,200	115	115
Coin	728	722	19	23
Loans				
To depository institutions	43	62	1	0
Other	0	0	0	0
Securities purchased under agreements to resell (triparty)	33,000	43,750	0	0
Federal agency obligations				
Bought outright	0	0	0	0
Held under repurchase agreements	0	0	0	0
U.S. Treasury securities				
Bought outright[1]	717,819	666,665	33,707	32,230
Held under repurchase agreements	0	0	0	0
Total loans and securities	750,863	710,477	33,708	32,230
Items in process of collection	7,964	9,236	457	531
Bank premises	1,778	1,630	99	93
Other assets				
Denominated in foreign currencies[2]	21,368	19,868	1,083	1,034
Other[3]	19,004	18,722	1,182	762
Interdistrict settlement account	0	0	2,979	3,079
Total assets	**814,946**	**773,894**	**40,136**	**38,363**
LIABILITIES				
Federal Reserve notes outstanding (issued to Bank)	848,370	799,933	38,054	38,627
Less: Notes held by Federal Reserve Bank	128,933	110,176	4,137	4,750
Federal Reserve notes, net	719,437	689,757	33,917	33,877
Securities sold under agreements to repurchase	30,783	25,652	1,445	1,240
Deposits				
Depository institutions	24,043	23,058	1,050	1,633
U.S. Treasury, general account	5,912	5,723	0	0
Foreign, official accounts	80	162	2	2
Other[4]	1,288	730	2	19
Total deposits	31,323	29,673	1,054	1,653
Deferred credit items	7,038	9,026	578	576
Other liabilities and accrued dividends[5]	2,821	2,092	151	119
Total liabilities	**791,402**	**756,200**	**37,145**	**37,466**
CAPITAL ACCOUNTS				
Capital paid in	11,914	8,847	1,638	448
Surplus	11,630	8,847	1,353	448
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	**814,946**	**773,894**	**40,136**	**38,363**
FEDERAL RESERVE NOTE STATEMENT				
Federal Reserve notes outstanding	848,370	799,933	...	...
Less: Held by Banks not subject to collateralization	128,933	110,176	...	...
Collateralized Federal Reserve notes	**719,437**	**689,757**	...	...
Collateral for Federal Reserve notes				
Gold certificate account	11,041	11,039	...	...
Special drawing rights certificate account	2,200	2,200	...	...
Other eligible assets	0	0	...	...
U.S. Treasury and federal agency securities	706,196	676,518	...	...
Total collateral	**719,437**	**689,757**	...	...

For notes see end of table.

1.—Continued

New York		Philadelphia		Cleveland		Richmond	
2004	2003	2004	2003	2004	2003	2004	2003
4,651	4,706	382	380	452	477	819	808
874	874	83	83	104	104	147	147
42	30	56	37	52	33	62	83
0	15	5	0	0	0	0	0
0	0	0	0	0	0	0	0
33,000	43,750	0	0	0	0	0	0
0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0
311,256	285,221	21,350	20,843	30,673	31,238	54,557	51,269
0	0	0	0	0	0	0	0
344,256	328,986	21,354	20,843	30,673	31,238	54,558	51,269
407	803	360	493	814	595	341	714
196	189	53	53	157	151	144	146
4,905	4,289	624	552	1,757	1,665	5,009	4,915
9,176	9,264	530	588	966	793	1,337	1,384
−24,125	−19,034	4,007	905	−495	−2,103	−420	2,793
340,381	**330,106**	**27,449**	**23,934**	**34,479**	**32,954**	**61,996**	**62,258**
335,998	325,387	32,698	29,636	34,511	33,115	64,991	59,949
35,347	23,793	7,973	8,288	5,408	4,740	12,275	9,855
300,651	301,594	24,725	21,347	29,103	28,375	52,716	50,094
13,348	10,975	916	802	1,315	1,202	2,340	1,973
11,388	5,607	603	719	1,272	1,259	1,645	5,087
5,912	5,723	0	0	0	0	0	0
57	139	1	1	2	3	7	7
527	324	28	10	2	26	169	108
17,884	11,792	632	730	1,277	1,288	1,820	5,203
651	1,025	490	451	505	521	544	628
988	658	99	87	149	113	280	213
333,522	**326,045**	**26,861**	**23,417**	**32,349**	**31,500**	**57,700**	**58,110**
3,430	2,031	294	259	1,065	727	2,148	2,074
3,430	2,031	294	259	1,065	727	2,148	2,074
0	0	0	0	0	0	0	0
340,381	**330,106**	**27,449**	**23,934**	**34,479**	**32,954**	**61,996**	**62,258**
...	...	...	...	...	...	...	...
...	...	...	...	...	...	...	...
...	...	...	...	...	...	...	...

1. Statement of Condition of the Federal Reserve Banks, by Bank, December 31, 2004 and 2003—Continued

Millions of dollars

Item	Atlanta 2004	Atlanta 2003	Chicago 2004	Chicago 2003
ASSETS				
Gold certificate account	894	863	924	982
Special drawing rights certificate account	166	166	212	212
Coin	82	82	111	90
Loans				
To depository institutions	8	5	14	17
Other	0	0	0	0
Securities purchased under agreements to resell (triparty)	0	0	0	0
Federal agency obligations				
Bought outright	0	0	0	0
Held under repurchase agreements	0	0	0	0
U.S. Treasury securities				
Bought outright[1]	48,408	45,037	64,660	67,367
Held under repurchase agreements	0	0	0	0
Total loans and securities	48,415	45,043	64,674	67,384
Items in process of collection	637	723	559	942
Bank premises	276	278	157	125
Other assets				
Denominated in foreign currencies[2]	1,181	1,127	2,232	2,033
Other[3]	1,076	1,108	1,374	1,571
Interdistrict settlement account	9,939	4,274	225	−6,831
Total assets	**62,666**	**53,664**	**70,469**	**66,509**
LIABILITIES				
Federal Reserve notes outstanding (issued to Banks)	74,144	66,711	72,517	66,835
Less: Notes held by Federal Reserve Banks	17,376	18,415	9,046	8,141
Federal Reserve notes, net	56,768	48,296	63,470	58,694
Securities sold under repurchase agreements	2,076	1,733	2,773	2,592
Deposits				
Depository institutions	1,722	1,608	1,762	2,349
U.S. Treasury, general account	0	0	0	0
Foreign, official accounts	2	2	3	3
Other[4]	56	22	246	29
Total deposits	1,780	1,632	2,011	2,382
Deferred credit items	796	855	421	781
Other liabilities and accrued dividends[5]	214	170	267	211
Total liabilities	**61,634**	**52,686**	**68,942**	**64,660**
CAPITAL ACCOUNTS				
Capital paid in	516	489	763	924
Surplus	516	489	763	924
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	**62,666**	**53,664**	**70,469**	**66,509**

NOTE. Components may not sum to totals because of rounding.

1. Includes securities loaned—fully guaranteed by U.S. Treasury securities pledged with Federal Reserve Banks—and excludes securities purchased under agreements to resell.

2. Valued daily at market exchange rates.

3. The System total includes depository institution overdrafts of $1 million for 2004 and $3 million for 2003.

1.—Continued

	St. Louis		Minneapolis		Kansas City		Dallas		San Francisco	
	2004	2003	2004	2003	2004	2003	2004	2003	2004	2003
	325	331	218	224	302	303	525	507	1,055	963
	71	71	30	30	66	66	98	98	234	234
	36	53	22	23	48	42	93	141	105	84
	2	0	13	2	1	2	0	0	0	20
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	21,089	20,974	15,657	14,881	18,863	17,916	32,729	26,126	64,871	53,563
	0	0	0	0	0	0	0	0	0	0
	21,090	20,974	15,669	14,883	18,864	17,919	32,729	26,126	64,871	53,583
	348	341	512	426	653	596	334	383	2,542	2,689
	68	49	123	125	82	56	257	187	168	179
	551	472	835	805	392	476	267	442	2,532	2,058
	487	516	351	368	416	439	716	641	1,395	1,287
	1,401	–1,330	–969	–166	1,584	25	1,461	6,997	4,414	11,391
	24,377	**21,477**	**16,790**	**16,720**	**22,408**	**19,921**	**36,479**	**35,522**	**77,316**	**72,467**
	25,006	23,244	16,370	15,491	24,535	21,599	41,146	39,785	88,401	79,553
	2,819	3,961	1,982	1,335	4,497	4,083	7,503	7,129	20,570	15,685
	22,187	19,283	14,387	14,155	20,038	17,516	33,643	32,657	67,831	63,868
	904	807	671	573	809	689	1,404	1,005	2,782	2,061
	479	509	473	564	721	813	684	953	2,244	1,957
	0	0	0	0	0	0	0	0	0	0
	1	1	1	1	1	1	0	1	4	3
	27	14	115	12	32	48	26	88	57	30
	507	524	590	577	753	861	710	1,041	2,305	1,990
	197	308	548	650	409	450	301	487	1,599	2,296
	111	98	85	74	92	81	152	110	234	157
	23,906	**21,020**	**16,281**	**16,029**	**22,101**	**19,596**	**36,209**	**35,301**	**74,751**	**70,371**
	236	228	254	346	153	162	135	111	1,283	1,048
	236	228	254	346	153	162	135	111	1,283	1,048
	0	0	0	0	0	0	0	0	0	0
	24,377	**21,477**	**16,790**	**16,720**	**22,408**	**19,921**	**36,479**	**35,522**	**77,316**	**72,467**

4. Includes international organization deposits of $144 million for 2004 and $139 million for 2003.

5. Includes exchange-translation account reflecting the monthly revaluation at market exchange rates of foreign exchange commitments.

. . . Not applicable.

2. Federal Reserve Open Market Transactions, 2004

Millions of dollars

Type of security and transaction	Jan.	Feb.	Mar.	Apr.
U.S. TREASURY SECURITIES[1]				
Outright transactions[2]				
Treasury bills				
Gross purchases	619	747	341	3,516
Gross sales	0	0	0	0
Exchanges	80,276	61,389	56,267	74,959
For new bills	80,276	61,389	56,267	74,959
Redemptions	0	0	0	0
Others within 1 year				
Gross purchases	0	1,311	0	0
Gross sales	0	0	0	0
Maturity shifts	0	10,791	16,544	7,293
Exchanges	0	−10,700	−16,333	−8,333
Redemptions	0	0	0	0
1 to 5 years				
Gross purchases	0	1,555	1,293	0
Gross sales	0	0	0	0
Maturity shifts	0	−9,361	−16,544	−7,293
Exchanges	0	9,627	16,333	8,333
5 to 10 years				
Gross purchases	0	510	741	0
Gross sales	0	0	0	0
Maturity shifts	0	−357	0	0
Exchanges	0	1,072	0	0
More than 10 years				
Gross purchases	0	235	40	0
Gross sales	0	0	0	0
Maturity shifts	0	−1,072	0	0
Exchanges	0	0	0	0
All maturities				
Gross purchases	619	4,358	2,414	3,516
Gross sales	0	0	0	0
Redemptions	0	0	0	0
Net change in U.S. Treasury securities	619	4,358	2,414	3,516

For notes see end of table.

2.—Continued

May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
409	3,831	952	83	3,473	500	3,155	512	18,138
0	0	0	0	0	0	0	0	0
66,123	63,302	78,894	66,355	80,572	59,837	60,682	73,029	821,685
66,123	63,302	78,894	66,355	80,572	59,837	60,682	73,029	821,685
0	0	0	0	0	0	0	0	0
1,693	0	1,898	0	0	1,593	0	1,499	7,994
0	0	0	0	0	0	0	0	0
9,748	6,998	0	17,703	6,535	0	19,781	7,987	103,380
−8,913	−13,879	0	−21,489	−7,652	0	−23,125	−7,948	−118,373
0	0	0	0	0	0	0	0	0
783	1,760	3,078	428	899	2,765	2,284	2,404	17,249
0	0	0	0	0	0	0	0	0
−4,066	−6,998	0	−10,029	−6,535	0	−16,031	−7,987	−84,844
6,620	13,879	0	19,771	7,652	0	20,655	7,948	110,819
713	275	244	568	695	1,225	453	340	5,763
0	0	0	0	0	0	0	0	0
−2,520	0	0	−5,051	0	0	−84	0	−8,012
2,293	0	0	1,718	0	0	2,471	0	7,554
84	0	29	0	405	400	86	85	1,364
0	0	0	0	0	0	0	0	0
−3,163	0	0	−2,624	0	0	−3,666	0	−10,524
0	0	0	0	0	0	0	0	0
3,681	5,866	6,202	1,078	5,473	6,484	5,977	4,840	50,507
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
3,681	5,866	6,202	1,078	5,473	6,484	5,977	4,840	50,507

2. Federal Reserve Open Market Transactions, 2004—Continued

Millions of dollars

Type of security and transaction	Jan.	Feb.	Mar.	Apr.
FEDERAL AGENCY OBLIGATIONS				
Outright transactions[2]				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Redemptions	0	0	0	0
Net change in federal agency obligations	0	0	0	0
TEMPORARY TRANSACTIONS				
Repurchase agreements[3]				
Gross purchases	138,250	121,750	167,500	163,650
Gross sales	158,500	116,500	168,750	165,900
Reverse repurchase agreements[4]				
Gross purchases	416,239	391,676	444,402	443,463
Gross sales	410,716	393,309	444,341	442,966
Net change in temporary transactions	−14,727	3,617	−1,189	−1,752
Total net change in System Open Market Account	**−14,108**	**7,975**	**1,225**	**1,764**

NOTE. Sales, redemptions, and negative figures reduce holdings of the System Open Market Account; all other figures increase such holdings. Components may not sum to totals because of rounding.

1. Transactions exclude changes in compensation for the effects of inflation on the principal of inflation-indexed securities. Transactions include the rollover of inflation compensation into new securities.

2. Excludes the effect of temporary transactions—repurchase agreements, matched sale–purchase agreements (MSPs), and reverse repurchase agreements (RRPs).

3. Cash value of agreements, which are collateralized by U.S. government and federal agency securities.

4. Cash value of agreements, which are collateralized by U.S. Treasury securities.

2.—Continued

May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
138,500	138,750	173,500	179,500	180,000	153,500	166,750	155,250	1,876,900
133,000	136,000	182,250	172,000	183,000	157,500	158,250	156,000	1,887,650
392,021	427,319	416,602	465,642	510,205	510,553	547,160	655,872	5,621,153
391,293	426,071	417,540	468,417	512,957	511,896	548,325	658,454	5,626,285
6,227	3,998	−9,688	4,725	−5,752	−5,343	7,335	−3,332	−15,882
9,908	**9,864**	**−3,487**	**5,804**	**−280**	**1,140**	**13,312**	**1,508**	**34,626**

3. Federal Reserve Bank Holdings of U.S. Treasury and Federal Agency Securities, December 31, 2002–04

Millions of dollars

Description	December 31			Change	
	2004	2003	2002	2003 to 2004	2002 to 2003
U.S. TREASURY SECURITIES					
Held outright[1]	**717,819**	**666,665**	**629,406**	**51,154**	**37,259**
By remaining maturity					
Bills					
1–90 days	179,748	168,381	153,311	11,367	15,070
91 days to 1 year	83,222	76,452	73,372	6,770	3,080
Notes and bonds					
1 year or less	116,443	113,301	96,827	3,142	16,474
More than 1 year through 5 years	208,269	180,074	172,758	28,195	7,316
More than 5 years through 10 years	54,372	51,312	53,300	3,060	−1,988
More than 10 years	75,765	77,146	79,840	−1,381	−2,694
By type					
Bills	262,970	244,833	226,682	18,137	18,151
Notes	360,832	323,361	297,893	37,471	25,468
Bonds	94,017	98,471	104,832	−4,454	−6,361
FEDERAL AGENCY SECURITIES					
Held outright[1]	**0**	**0**	**10**	**0**	**−10**
By remaining maturity					
1 year or less	0	0	10	0	−10
More than 1 year through 5 years	0	0	0	0	0
More than 5 years through 10 years	0	0	0	0	0
More than 10 years	0	0	0	0	0
By issuer					
Federal National Mortgage Association	0	0	10	0	−10
TEMPORARY TRANSACTIONS					
Repurchase agreements[2]	**33,000**	**43,750**	**39,500**	**−10,750**	**4,250**
Matched sale–purchase agreements	**0**	**0**	**0**	**0**	**0**
Foreign official and international accounts	0	0	0	0	0
Dealers	0	0	0	0	0
Reverse repurchase agreements[3]	**30,783**	**25,652**	**21,091**	**5,131**	**4,561**
Foreign official and international accounts	30,783	25,652	21,091	5,131	4,561
Dealers	0	0	0	0	0

NOTE. Components may not sum to totals because of rounding.

1. Excludes the effect of temporary transactions—repurchase agreements, matched sale–purchase agreements (MSPs), and reverse repurchase agreements (RRPs).

2. Cash value of agreements, which are collateralized by U.S. government and federal agency securities.

3. Cash value of agreements, which are collateralized by U.S. Treasury securities.

4. Number and Annual Salaries of Officers and Employees of the Federal Reserve Banks, December 31, 2004

Federal Reserve Bank (including Branches)	President	Other officers		Employees			Total	
	Salary (dollars)[1]	Number	Salaries (dollars)[1]	Number: Full-time	Number: Part-time	Salaries (dollars)[1]	Number	Salaries (dollars)[1]
Boston	270,900	61	9,284,100	914	112	66,615,928	1,088	76,170,928
New York	310,000	265	47,044,590	2,732	56	190,097,746	3,054	237,452,336
Philadelphia	245,300	57	7,989,500	990	48	48,614,628	1,096	56,849,428
Cleveland	240,500	64	8,719,300	1,400	38	62,609,238	1,503	71,569,038
Richmond	235,000	76	10,407,200	1,715	76	90,915,466	1,868	101,557,666
Atlanta	294,300	74	11,099,000	1,947	39	96,235,343	2,061	107,628,643
Chicago	293,700	92	13,030,938	1,562	62	100,031,698	1,717	113,356,336
St. Louis	248,100	74	10,270,100	985	55	50,158,181	1,115	60,676,381
Minneapolis	275,000	43	6,172,000	1,158	132	57,721,267	1,334	64,168,267
Kansas City	269,800	76	10,645,200	1,350	46	67,793,739	1,473	78,708,739
Dallas	Vacant[2]	54	7,089,154	1,184	35	58,676,998	1,273	65,766,152
San Francisco	300,000	73	12,051,966	1,761	38	108,706,295	1,873	121,058,261
Federal Reserve Information Technology		32	4,761,900	691	4	53,371,219	727	58,133,119
Office of Employee Benefits	...	6	1,201,300	29	0	2,369,000	35	3,570,300
Total	**2,982,600**	**1,047**	**159,766,248**	**18,418**	**741**	**1,053,916,746**	**20,217**	**1,216,665,594**

1. Annualized salary liability based on salaries in effect on December 31, 2004.

2. Dallas president separated in November 2004.

... Not applicable.

5. Income and Expenses of the Federal Reserve Banks, by Bank, 2004

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
Current Income					
Loans	2,653	185	379	70	47
U.S. Treasury and federal agency securities	22,344,362	1,040,391	9,855,437	662,490	962,401
Foreign currencies	269,424	13,677	61,630	7,852	22,172
Priced services	865,924	37,678	124,144	38,469	61,225
Other	57,579	975	40,846	622	1,410
Total	**23,539,942**	**1,092,906**	**10,082,437**	**709,504**	**1,047,256**
Current Expenses					
Salaries and other personnel expenses	1,350,934	76,036	261,274	65,141	76,054
Retirement and other benefits	310,508	14,679	71,851	9,462	26,723
Net periodic pension costs[1]	−33,957	179	−35,938	139	169
Fees	96,778	2,206	8,908	1,196	6,606
Travel	56,528	2,051	7,419	1,918	4,067
Software expenses	116,624	5,047	12,820	4,273	11,549
Postage and other shipping costs	87,304	1,780	4,415	1,539	2,897
Communications	14,110	1,904	2,472	421	657
Materials and supplies	45,679	2,296	8,551	3,046	3,470
Building expenses					
Taxes on real estate	31,079	4,707	4,452	1,561	1,921
Property depreciation	88,214	4,983	14,581	3,595	6,558
Utilities	32,217	2,900	6,472	2,464	1,998
Rent	40,812	778	16,083	305	351
Other	34,944	933	6,854	2,002	2,605
Equipment					
Purchases	26,881	1,050	4,752	834	1,713
Rentals	31,836	1,770	1,847	640	342
Depreciation	101,172	5,575	9,049	5,838	5,937
Repairs and maintenance	92,374	6,079	8,662	5,513	6,668
Earnings-credit costs	116,033	5,900	38,756	7,454	8,230
Other	70,805	29,769	48,381	9,532	9,865
Recoveries	−79,364	−11,838	−9,695	−3,196	−2,542
Expenses capitalized[2]	−22,825	−495	−6,880	−2,006	−265
Total	**2,608,684**	**158,288**	**485,085**	**121,669**	**175,573**
Reimbursements	−369,979	−23,030	−74,709	−21,111	−42,854
Net expenses	2,238,705	135,259	410,377	100,559	132,718

For notes see end of table.

5.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
55	109	551	178	549	256	28	247
1,676,581	1,483,890	2,041,238	657,563	482,515	581,234	967,792	1,932,829
63,356	14,915	28,114	6,920	10,545	5,030	3,515	31,696
66,718	160,899	114,006	39,916	45,601	52,761	46,416	78,090
2,520	2,003	2,677	899	439	550	886	3,752
1,809,230	**1,661,817**	**2,186,586**	**705,476**	**539,649**	**639,831**	**1,018,637**	**2,046,613**
178,316	127,914	121,506	71,919	66,896	91,096	74,450	140,332
38,006	24,164	22,251	13,643	16,270	14,410	19,045	40,004
249	177	167	186	197	137	151	229
50,376	6,546	5,514	6,564	1,603	1,156	2,278	3,826
8,089	5,790	6,500	3,506	2,992	4,223	3,145	6,829
51,250	4,579	3,984	3,384	2,505	3,704	5,183	8,349
4,164	51,388	4,473	2,377	2,734	3,138	2,361	6,038
1,780	1,034	1,239	979	1,011	742	708	1,164
6,029	5,647	3,665	2,450	1,682	2,497	2,983	3,363
2,157	3,417	1,590	477	3,860	1,112	2,834	2,992
7,919	10,080	9,042	4,602	4,548	4,223	5,646	12,438
3,502	2,801	1,885	1,837	1,668	1,683	1,935	3,072
14,586	899	3,186	1,291	233	1,666	1,288	148
4,413	3,467	5,034	1,117	1,577	916	3,739	2,287
7,672	2,002	1,701	1,283	1,339	1,587	1,165	1,783
23,509	726	565	197	541	316	939	445
36,588	8,255	4,831	3,617	2,314	4,746	5,062	9,360
20,302	11,142	8,855	3,755	2,948	3,362	5,346	9,741
16,512	5,318	13,704	1,786	2,309	3,644	2,326	10,094
−235,234	15,106	43,740	65,884	17,747	19,042	31,328	15,646
−26,824	−2,660	−6,227	−1,656	−843	−2,847	−6,196	−4,840
−1,933	−455	−782	−3,819	−1,265	−1,639	−1,133	−2,153
211,428	**287,336**	**256,420**	**185,379**	**132,864**	**158,914**	**164,583**	**271,146**
−31,751	−16,555	−7,044	−90,742	−21,350	−13,648	−11,578	−15,607
179,677	270,780	249,376	94,636	111,514	145,265	153,005	255,539

5. Income and Expenses of the Federal Reserve Banks, by Bank, 2004—Continued

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
Profit and Loss					
Current net income	21,301,238	957,648	9,672,060	608,945	914,537
Additions to and deductions from (–) current net income [3]					
Profits on sales of U.S. Treasury and federal agency securities	0	0	0	0	0
Profits on foreign exchange transactions	1,230,325	62,418	281,819	35,898	101,203
Other additions	396	2	40	21	15
Total additions	1,230,721	62,420	281,859	35,918	101,219
Losses on sales of U.S. Treasury and federal agency securities	0	0	0	0	0
Losses on foreign exchange transactions	–13,175	0	0	0	–13,175
Interest expense on reverse repurchase agreements	–290,153	–14,315	–131,228	–9,101	0
Other deductions	–9,487	–1	–19	–4	–1
Total deductions	–312,815	–14,316	–131,247	–9,105	–13,176
Net addition to or deduction from (–) current net income	917,906	48,104	150,612	26,813	88,042
Cost of unreimbursed Treasury services	35	0	25	10	0
Assessments by Board					
Board expenditures [4]	272,331	14,095	62,507	8,023	22,192
Cost of currency	503,784	33,919	117,119	26,153	23,070
Net income before payment to U.S. Treasury	21,442,992	957,738	9,643,022	601,573	957,317
Dividends paid	582,402	53,156	136,390	16,824	45,121
Payments to U.S. Treasury (interest on Federal Reserve notes)	18,078,003	0	8,107,022	549,401	574,815
Transferred to/from surplus	2,782,587	904,581	1,399,011	35,348	337,381
Surplus, January 1	8,846,916	448,422	2,030,557	258,560	727,244
Surplus, December 31	11,629,504	1,353,004	3,429,567	293,908	1,064,625

Note. Components may not sum to totals because of rounding.

1. Reflects the effect of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). The System Retirement Plan for employees is recorded on behalf of the System on the books of the Federal Reserve Bank of New York, resulting in a decrease in expenses of $36,556 thousand. The expenses related to the Benefit Equalization Plan and the Supplemental Retirement Plan are recorded by each Federal Reserve Bank.

2. Includes expenses for labor and materials capitalized and depreciated or amortized as charges to activities in the periods benefited.

3. 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.

4. For additional details, see the chapter "Board of Governors Financial Statements."

5.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
1,629,553	1,391,037	1,937,209	610,840	428,135	494,565	865,633	1,791,074
0	0	0	0	0	0	0	0
288,950	68,071	128,442	31,658	48,113	22,814	15,780	145,157
8	5	5	5	3	8	279	4
288,958	68,077	128,448	31,663	48,116	22,822	16,059	145,162
0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0
−23,101	−20,462	−27,892	−9,019	−6,642	−8,002	−13,498	−26,893
−3	−184	−1,404	−3	−2	−1	−4	−7,860
−23,104	−20,646	−29,296	−9,022	−6,644	−8,003	−13,502	−34,753
265,854	47,430	99,152	22,641	41,472	14,819	2,556	110,409
0	0	0	0	0	0	0	0
63,193	15,051	28,933	6,979	9,912	4,851	3,514	33,083
39,010	61,605	47,395	16,115	13,671	17,234	42,533	65,960
1,793,204	1,361,811	1,960,033	610,387	446,024	487,299	822,143	1,802,440
125,013	30,224	56,831	13,930	16,461	9,118	7,513	71,819
1,593,869	1,304,705	2,063,931	589,070	520,699	487,495	790,246	1,496,150
74,322	26,882	−160,728	7,387	−91,136	−9,314	24,383	234,471
2,073,888	489,053	924,227	228,257	345,531	162,382	110,570	1,048,225
2,148,210	515,935	763,499	235,644	254,396	153,068	134,953	1,282,696

6. Income and Expenses of the Federal Reserve Banks, 1914–2004

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.

6.—Continued

Dividends paid	Payments to U.S. Treasury		Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Statutory transfers [2]	Interest on Federal Reserve notes		
217	...	...	...	...
1,743	...	...	...	...
6,804	1,134	...	...	1,134
5,541	...	...	...	48,334
5,012	2,704	...	...	70,652
5,654	60,725	...	...	82,916
6,120	59,974	...	...	15,993
6,307	10,851	...	...	−660
6,553	3,613	...	...	2,546
6,682	114	...	...	−3,078
6,916	59	...	...	2,474
7,329	818	...	...	8,464
7,755	250	...	...	5,044
8,458	2,585	...	...	21,079
9,584	4,283	...	...	22,536
10,269	17	...	...	−2,298
10,030	...	...	...	−7,058
9,282	2,011	...	...	11,021
8,874	...	...	...	−917
8,782	...	...	−60	6,510
8,505	298	...	28	607
7,830	227	...	103	353
7,941	177	...	67	2,616
8,019	120	...	−419	1,862
8,110	25	...	−426	4,534
8,215	82	...	−54	17,617
8,430	141	...	−4	571
8,669	198	...	50	3,554
8,911	245	...	135	40,327
9,500	327	...	201	48,410
10,183	248	...	262	81,970
10,962	67	...	28	81,467
11,523	36	75,284	87	8,366
11,920	...	166,690	...	18,523
12,329	...	193,146	...	21,462
13,083	...	196,629	...	21,849
13,865	...	254,874	...	28,321
14,682	...	291,935	...	46,334
15,558	...	342,568	...	40,337
16,442	...	276,289	...	35,888
17,712	...	251,741	...	32,710
18,905	...	401,556	...	53,983
20,081	...	542,708	...	61,604
21,197	...	524,059	...	59,215
22,722	...	910,650	...	−93,601
23,948	...	896,816	...	42,613
25,570	...	687,393	...	70,892
27,412	...	799,366	...	45,538
28,912	...	879,685	...	55,864
30,782	...	1,582,119	...	−465,823
32,352	...	1,296,810	...	27,054
33,696	...	1,649,455	...	18,944
35,027	...	1,907,498	...	29,851
36,959	...	2,463,629	...	30,027
39,237	...	3,019,161	...	39,432

6. Income and Expenses of the Federal Reserve Banks, 1914–2004—Continued

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (–)[1]	Assessments by Board of Governors	
				Board expenditures	Costs of currency
1970	3,877,218	276,572	11,442	21,228	23,574
1971	3,723,370	319,608	94,266	32,634	24,943
1972	3,792,335	347,917	–49,616	35,234	31,455
1973	5,016,769	416,879	–80,653	44,412	33,826
1974	6,280,091	476,235	–78,487	41,117	30,190
1975	6,257,937	514,359	–202,370	33,577	37,130
1976	6,623,220	558,129	7,311	41,828	48,819
1977	6,891,317	568,851	–177,033	47,366	55,008
1978	8,455,309	592,558	–633,123	53,322	60,059
1979	10,310,148	625,168	–151,148	50,530	68,391
1980	12,802,319	718,033	–115,386	62,231	73,124
1981	15,508,350	814,190	–372,879	63,163	82,924
1982	16,517,385	926,034	–68,833	61,813	98,441
1983	16,068,362	1,023,678	–400,366	71,551	152,135
1984	18,068,821	1,102,444	–412,943	82,116	162,606
1985	18,131,983	1,127,744	1,301,624	77,378	173,739
1986	17,464,528	1,156,868	1,975,893	97,338	180,780
1987	17,633,012	1,146,911	1,796,594	81,870	170,675
1988	19,526,431	1,205,960	–516,910	84,411	164,245
1989	22,249,276	1,332,161	1,254,613	89,580	175,044
1990	23,476,604	1,349,726	2,099,328	103,752	193,007
1991	22,553,002	1,429,322	405,729	109,631	261,316
1992	20,235,028	1,474,531	–987,788	128,955	295,401
1993	18,914,251	1,657,800	–230,268	140,466	355,947
1994	20,910,742	1,795,328	2,363,862	146,866	368,187
1995	25,395,148	1,818,416	857,788	161,348	370,203
1996	25,164,303	1,947,861	–1,676,716	162,642	402,517
1997	26,917,213	1,976,453	–2,611,570	174,407	364,454
1998	28,149,477	1,833,436	1,906,037	178,009	408,544
1999	29,346,836	1,852,162	–533,557	213,790	484,959
2000	33,963,992	1,971,688	–1,500,027	188,067	435,838
2001	31,870,721	2,084,708	–1,117,435	295,056	338,537
2002	26,760,113	2,227,078	2,149,328	205,111	429,568
2003	23,792,725	2,462,658	2,481,127	297,020	508,144
2004	23,539,942	2,238,705	917,870	272,331	503,784
Total, 1914–2004	**641,749,857**	**47,193,869**	**7,777,545**	**4,138,045**	**7,862,963**
Aggregate for each Bank, 1914–2004					
Boston	34,556,554	3,140,957	338,671	175,263	459,567
New York	222,443,921	7,280,428[4]	2,102,239	1,009,352	2,573,085
Philadelphia	23,869,631	2,542,934	200,363	169,950	318,524
Cleveland	39,693,014	2,968,781	540,433	296,428	463,041
Richmond	49,669,998	4,141,554	1,059,465	531,065	643,402
Atlanta	33,833,187	4,890,082	546,057	316,723	536,289
Chicago	79,234,017	5,961,783	925,960	488,548	901,978
St. Louis	22,208,274	2,398,978	153,844	107,149	286,799
Minneapolis	10,784,532	2,299,447	218,125	129,234	131,198
Kansas City	23,543,939	3,081,674	198,986	139,470	287,617
Dallas	29,310,581	3,090,244	457,869	211,688	382,645
San Francisco	72,602,208	5,397,008	1,035,534	563,174	878,816
Total	**641,749,857**	**47,193,869**	**7,777,545**	**4,138,045**	**7,862,963**

NOTE. Components may not sum to totals because of rounding.

. . . Not applicable.

1. For 1987 and subsequent years, includes the cost of services provided to the Treasury by Federal Reserve Banks for which reimbursement was not received.

2. Represents transfers made as a franchise tax from 1917 through 1932; transfers made under section 13b of the Federal Reserve Act from 1935 through 1947; and transfers made under section 7 of the Federal Reserve Act for 1996 and 1997.

6.—Continued

Dividends paid	Payments to U.S. Treasury		Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Statutory transfers [2]	Interest on Federal Reserve notes		
41,137	. . .	3,493,571	. . .	32,580
43,488	. . .	3,356,560	. . .	40,403
46,184	. . .	3,231,268	. . .	50,661
49,140	. . .	4,340,680	. . .	51,178
52,580	. . .	5,549,999	. . .	51,483
54,610	. . .	5,382,064	. . .	33,828
57,351	. . .	5,870,463	. . .	53,940
60,182	. . .	5,937,148	. . .	45,728
63,280	. . .	7,005,779	. . .	47,268
67,194	. . .	9,278,576	. . .	69,141
70,355	. . .	11,706,370	. . .	56,821
74,574	. . .	14,023,723	. . .	76,897
79,352	. . .	15,204,591	. . .	78,320
85,152	. . .	14,228,816	. . .	106,663
92,620	. . .	16,054,095	. . .	161,996
103,029	. . .	17,796,464	. . .	155,253
109,588	. . .	17,803,895	. . .	91,954
117,499	. . .	17,738,880	. . .	173,771
125,616	. . .	17,364,319	. . .	64,971
129,885	. . .	21,646,417	. . .	130,802
140,758	. . .	23,608,398	. . .	180,292
152,553	. . .	20,777,552	. . .	228,356
171,763	. . .	16,774,477	. . .	402,114
195,422	. . .	15,986,765	. . .	347,583
212,090	. . .	20,470,011	. . .	282,122
230,527	. . .	23,389,367	. . .	283,075
255,884	5,517,716	14,565,624	. . .	635,343
299,652	20,658,972	0	. . .	831,705
343,014	17,785,942	8,774,994	. . .	731,575
373,579	. . .	25,409,736	. . .	479,053
409,614	. . .	25,343,892	. . .	4,114,865
428,183	. . .	27,089,222	. . .	517,580
483,596	. . .	24,495,490	. . .	1,068,598
517,705	. . .	22,021,528	. . .	466,796
582,402	. . .	18,078,003	. . .	2,782,587
7,086,659	**44,113,958**	**523,408,737**	**–4**	**15,723,176** [3]
338,234	2,579,504	26,661,526	135	1,540,038
1,739,744	17,307,161	190,344,011	–433	4,292,813
296,712	1,312,118	18,993,444	291	436,021
521,358	2,827,043	31,805,942	–10	1,350,863
964,861	3,083,928	38,208,638	–72	3,156,085
511,227	2,713,230	24,601,609	5	810,079
814,121	4,593,811	66,258,309	12	1,141,414
183,699	1,833,837	17,213,488	–27	338,194
226,818	416,227	7,399,208	65	400,462
227,829	1,249,703	18,486,949	–9	269,691
330,064	1,510,802	23,968,266	55	274,686
931,991	4,686,594	59,467,347	–17	1,712,829
7,086,659	**44,113,958**	**523,408,737**	**–4**	**15,723,176** [3]

3. The $15,723,176 thousand transferred to surplus was reduced by direct charges of $500 thousand for charge-off on Bank premises (1927), $139,300 thousand for contributions to capital of the Federal Deposit Insurance Corporation (1934), $4 thousand net upon elimination of section 13b surplus (1958), and $106,000 thousand (1996), $107,000 thousand (1997), and as statutorily required; and was increased by transfer of $11,131 thousand from reserves for contingencies (1955), leaving a balance of $11,629,504 thousand on December 31, 2004.

4. This amount is reduced by $2,675,308 thousand for expenses of the System Retirement Plan. See note 1, table 5.

7. Acquisition Costs and Net Book Value of Premises of the Federal Reserve Banks and Branches, December 31, 2004

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	116,556	19,284	157,914	98,853	...
NEW YORK	20,103	218,243	60,251	298,596	192,722	...
Buffalo	888	4,142	3,699	8,729	3,462	...
PHILADELPHIA	2,561	75,796	11,857	90,214	53,306	...
CLEVELAND	3,112	121,824	23,924	148,859	114,370	...
Cincinnati	2,247	28,740	11,474	42,460	23,160	...
Pittsburgh	1,658	18,806	11,967	32,432	19,349	...
RICHMOND	12,923	84,560	38,545	136,028	94,468	...
Baltimore	6,482	27,956	5,490	39,929	23,530	...
Charlotte	3,130	28,568	6,104	37,802	25,553	...
ATLANTA	22,735	146,569	15,786	185,090	171,374	...
Birmingham	7,194	46,118	4,170	57,483	52,501	...
Jacksonville	1,812	20,302	3,839	25,953	17,656	48
Miami	4,266	17,672	4,728	26,667	17,139	...
Nashville	687	6,147	3,305	10,139	5,845	...
New Orleans	3,952	9,530	4,943	18,425	11,339	...
CHICAGO	4,512	147,541	18,392	170,445	108,476	1,386
Detroit	4,706	46,497	3,358	54,561	48,865	...
ST. LOUIS	4,774	52,240	11,160	68,173	45,459	...
Little Rock	1,148	4,861	2,155	8,165	4,697	...
Louisville	800	4,735	2,068	7,603	3,422	...
Memphis	1,136	13,743	4,418	19,297	14,247	...
MINNEAPOLIS	15,666	104,234	13,742	133,643	112,292	...
Helena	2,890	9,716	958	13,564	10,216	...
KANSAS CITY	29,059	28,921	7,999	65,979	48,004	...
Denver	3,511	8,859	4,573	16,943	9,310	...
Oklahoma City	977	12,195	3,488	16,660	8,574	...
Omaha	7,165	11,824	2,477	21,466	15,992	...
DALLAS	31,597	111,755	20,675	164,027	124,925	2
El Paso	262	3,533	1,487	5,283	2,330	...
Houston	19,908	102,810	0	122,718	122,718	7,202
San Antonio	826	7,414	3,103	11,343	6,713	...
SAN FRANCISCO	20,084	92,910	22,148	135,142	84,251	...
Los Angeles	6,306	69,700	12,533	88,539	60,223	...
Portland	1,287	8,764	2,532	12,584	6,801	...
Salt Lake City	1,294	4,785	1,600	7,679	3,492	...
Seattle	380	14,406	4,699	19,484	12,765	515
Total	**274,111**	**1,832,974**	**372,933**	**2,480,018**	**1,778,399**	**9,154**

NOTE. Components may not sum to totals because of rounding.

1. Includes expenditures for construction at some offices, pending allocation to appropriate accounts.

2. Excludes charge-offs of $17,699 thousand before 1952.

3. Covers acquisitions for banking-house purposes and Bank premises formerly occupied and being held pending sale.

. . . Not applicable.

8. Operations in Principal Departments of the Federal Reserve Banks, 2001–2004

Operation	2004	2003	2002	2001
Millions of pieces (except as noted)				
Currency processed	36,242	34,832	34,208	33,740
Currency destroyed	6,748	7,375	8,363	7,850
Coin received[1]	55,655	48,138	**43,445**	**39,735**
Checks handled				
U.S. government checks	234	267	289	346
Postal money orders	187	198	216	229
Other	13,904	15,806	16,587	16,905
Government securities transfers	20	20	17	15
Transfer of funds	125	123	115	112
Automated clearinghouse transactions				
Commercial	6,486	5,588	4,986	4,448
Government	941	914	883	900
Food stamps redeemed	48	287	500	587
Millions of dollars				
Currency processed	625,127	584,915	565,302	540,746
Currency destroyed	90,943	101,338	92,511	86,298
Coin received[1]	5,403	4,879	**4,579**	**4,296**
Checks handled				
U.S. government checks	277,649	308,055	307,627	333,849
Postal money orders	29,045	29,197	30,161	30,461
Other	14,287,740	15,431,625	15,033,298	14,853,072
Government securities transfers	313,425,252	267,644,194	228,907,121	212,343,034
Transfer of funds	469,898,863	436,706,269	405,761,750	423,606,365
Automated clearinghouse transactions				
Commercial	12,543,907	13,951,600	13,135,350	12,707,247
Government	2,913,189	2,810,283	2,711,384	2,528,562
Food stamps redeemed	239	1,510	2,543	2,989

1. Amounts in bold are restatements due to the inclusion of coin activity at Federal Reserve off-site coin terminals.

9. Federal Reserve Bank Interest Rates on Loans to Depository Institutions, December 31, 2004

Reserve Bank	Primary credit[1]	Secondary credit[2]	Seasonal credit[3]
All Federal Reserve Banks	3.25	3.75	2.35

1. Primary credit is available for very short terms as a backup source of liquidity to depository institutions that are in generally sound financial condition in the judgment of the lending Federal Reserve Bank.

2. Secondary credit is available in appropriate circumstances to depository institutions that do not qualify for primary credit.

3. Seasonal credit is available to help relatively small depository institutions meet regular seasonal needs for funds that arise from a clear pattern of intra-yearly movements in their deposits and loans. The discount rate on seasonal credit takes into account rates charged by market sources of funds and is reestablished on the first business day of each two-week reserve maintenance period.

10. Reserve Requirements of Depository Institutions, December 31, 2004

Type of deposit	Requirements	
	Percentage of deposits	Effective date
Net transaction accounts[1]		
$0 million–$7.0 million[2]	0	12-23-04
More than $7.0 million–$47.6 million[3]	3	12-23-04
More than $47.6 million	10	12-23-04
Nonpersonal time deposits	0	12-27-90
Eurocurrency liabilities	0	12-27-90

NOTE. Required reserves must be held in the form of vault cash and, if vault cash is insufficient, also in the form of a deposit with a Federal Reserve Bank. An institution that is a member of the Federal Reserve System must hold that deposit directly with a Reserve Bank; an institution that is not a member of the System can maintain that deposit directly with a Reserve Bank or with another institution in a pass-through relationship. Reserve requirements are imposed on commercial banks, savings banks, savings and loan associations, credit unions, U.S. branches and agencies of foreign banks, Edge corporations, and agreement corporations.

1. Total transaction accounts consists of demand deposits, automatic transfer service (ATS) accounts, NOW accounts, share draft accounts, telephone or preauthorized transfer accounts, ineligible bankers acceptances, and obligations issued by affiliates maturing in seven days or less. Net transaction accounts are total transaction accounts less amounts due from other depository institutions and less cash items in the process of collection.

For a more detailed description of these deposit types, see Form FR 2900 at www.federalreserve.gov/boarddocs/reportforms/.

2. The amount of net transaction accounts subject to a reserve requirement ratio of zero percent (the "exemption amount") is adjusted each year by statute. The exemption amount is adjusted upward by 80 percent of the previous year's (June 30 to June 30) rate of increase in total reservable liabilities at all depository institutions. No adjustment is made in the event of a decrease in such liabilities.

3. The amount of net transaction accounts subject to a reserve requirement ratio of 3 percent is the "low-reserve tranche." By statute, the upper limit of the low-reserve tranche is adjusted each year by 80 percent of the previous year's (June 30 to June 30) rate of increase or decrease in net transaction accounts held by all depository institutions.

11. Initial Margin Requirements under Regulations T, U, and X

Percent of market value

Effective date	Margin stocks	Convertible bonds	Short sales, T only[1]
1934, Oct. 1	25–45	...	...
1936, Feb. 1	25–55	...	...
Apr. 1	55	...	...
1937, Nov. 1	40	...	50
1945, Feb. 5	50	...	50
July 5	75	...	75
1946, Jan. 21	100	...	100
1947, Feb. 1	75	...	75
1949, Mar. 3	50	...	50
1951, Jan. 17	75	...	75
1953, Feb. 20	50	...	50
1955, Jan. 4	60	...	60
Apr. 23	70	...	70
1958, Jan. 16	50	...	50
Aug. 5	70	...	70
Oct. 16	90	...	90
1960, July 28	70	...	70
1962, July 10	50	...	50
1963, Nov. 6	70	...	70
1968, Mar. 11	70	50	70
June 8	80	60	80
1970, May 6	65	50	65
1971, Dec. 6	55	50	55
1972, Nov. 24	65	50	65
1974, Jan. 3	50	50	50

NOTE. These regulations, adopted by the Board of Governors pursuant to the Securities Exchange Act of 1934, limit the amount of credit to purchase and carry "margin securities" (as defined in the regulations) when such value is collateralized by securities. Margin requirements on securities are the difference between the market value (100 percent) and the maximum loan value of collateral as prescribed by the Board. Regulation T was adopted effective October 1, 1934; Regulation U, effective May 1, 1936; and Regulation X, effective November 1, 1971. The former Regulation G, which was adopted effective March 11, 1968, was merged with Regulation U, effective April 1, 1998.

1. From October 1, 1934, to October 31, 1937, the requirement was the margin "customarily required" by the brokers and dealers.

12. Principal Assets and Liabilities of Insured Commercial Banks in the United States, by Class of Bank, June 30, 2004 and 2003

Millions of dollars, except as noted

Item	Total	Member banks			Nonmember banks
		Total	National	State	
	2004				
Assets					
Loans and investments	5,788,749	4,567,717	3,321,077	1,246,640	1,221,031
Loans, gross	4,267,979	3,381,763	2,481,333	900,430	886,216
Net	4,266,463	3,380,928	2,480,744	900,183	885,535
Investments	1,520,770	1,185,955	839,744	346,210	334,815
U.S. Treasury and federal agency securities	333,691	212,367	122,046	90,320	121,324
Other	1,187,079	973,588	717,698	255,890	213,491
Cash assets, total	271,089	218,068	156,194	61,874	53,021
Liabilities					
Deposits, total	4,454,462	3,413,426	2,442,362	971,063	1,041,036
Interbank	68,720	54,897	37,078	17,819	13,824
Other transaction	675,846	487,519	343,929	143,589	188,327
Other nontransaction	3,709,896	2,871,010	2,061,355	809,655	838,886
Equity capital	721,273	576,917	419,886	157,031	144,356
Number of banks	7,676	2,885	1,955	930	4,791
	2003				
Assets					
Loans and investments	5,338,735	4,201,136	2,969,072	1,232,064	1,137,599
Loans, gross	3,922,431	3,105,061	2,225,277	879,784	817,370
Net	3,920,108	3,103,351	2,223,849	879,502	816,757
Investments	1,416,304	1,096,075	743,795	352,280	320,229
U.S. Treasury and federal agency securities	289,327	186,267	101,918	84,349	103,060
Other	1,126,977	909,808	641,877	267,931	217,169
Cash assets, total	301,052	246,847	177,579	69,267	54,205
Liabilities					
Deposits, total	4,206,473	3,240,228	2,292,202	948,026	966,245
Interbank	67,939	56,239	40,330	15,909	11,699
Other transaction	684,284	504,700	361,115	143,585	179,585
Other nontransaction	3,454,250	2,679,289	1,890,756	788,533	774,961
Equity capital	658,407	526,805	371,055	155,750	131,602
Number of banks	7,813	2,995	2,044	951	4,818

Note. Data are domestic assets and liabilities (except for those components reported on a consolidated basis only). Components may not sum to totals because of rounding.

13A. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1984–2004 and Month-End 2004

Millions of dollars

Period	Factors supplying reserve funds								
	Federal Reserve Bank credit outstanding						Gold stock	Special drawing rights certificate account	Treasury currency outstanding[3]
	Securities held outright[1]	Repurchase agreements[2]	Loans	Float	Other Federal Reserve assets	Total			
1984	167,612	2,015	3,577	833	12,347	186,384	11,096	4,618	16,418
1985	186,025	5,223	3,060	988	15,302	210,598	11,090	4,718	17,075
1986	205,454	16,005	1,565	1,261	17,475	241,760	11,084	5,018	17,567
1987	226,459	4,961	3,815	811	15,837	251,883	11,078	5,018	18,177
1988	240,628	6,861	2,170	1,286	18,803	269,748	11,060	5,018	18,799
1989	233,300	2,117	481	1,093	39,631	276,622	11,059	8,518	19,628
1990	241,431	18,354	190	2,566	39,880	302,421	11,058	10,018	20,402
1991	272,531	15,898	218	1,026	34,524	324,197	11,059	10,018	21,014
1992	300,423	8,094	675	3,350	30,278	342,820	11,056	8,018	21,447
1993	336,654	13,212	94	963	33,394	384,317	11,053	8,018	22,095
1994	368,156	10,590	223	740	33,441	413,150	11,051	8,018	22,994
1995	380,831	13,862	135	231	33,483	428,543	11,050	10,168	24,003
1996	393,132	21,583	85	5,297	32,222	452,319	11,048	9,718	24,966
1997	431,420	23,840	2,035	561	32,044	489,901	11,047	9,200	25,543
1998	452,478	30,376	17	1,009	37,692	521,573	11,046	9,200	26,270
1999	478,144	140,640	233	407	34,799	654,223	11,048	6,200	28,013
2000	511,833	43,375	110	795	36,896	593,009	11,046	2,200	31,643
2001	551,685	50,250	34	698	36,885	639,552	11,045	2,200	33,017
2002	629,416	39,500	40	832	38,574	708,363	11,043	2,200	34,597
2003	666,665	43,750	62	211	40,214	750,901	11,043	2,200	35,475
2004	717,819	33,000	43	927	42,161	793,950	11,045	2,200	36,505

For notes see end of table.

13A.—Continued

Factors absorbing reserve funds								Reserve balances with Federal Reserve Banks[6]
Currency in circulation	Reverse repurchase agreements[4]	Treasury cash holdings[5]	Deposits with Federal Reserve Banks, other than reserve balances			Required clearing balances	Other Federal Reserve liabilities and capital	
			Treasury	Foreign	Other			
183,796	0	513	5,316	253	867	1,126	5,952	20,693
197,488	0	550	9,351	480	1,041	1,490	5,940	27,141
211,995	0	447	7,588	287	917	1,812	6,088	46,295
230,205	0	454	5,313	244	1,027	1,687	7,129	40,097
247,649	0	395	8,656	347	548	1,605	7,683	37,742
260,456	0	450	6,217	589	1,298	1,618	8,486	36,713
286,963	0	561	8,960	369	242	1,960	8,147	36,698
307,756	0	636	17,697	968	1,706	3,946	8,113	25,467
334,701	0	508	7,492	206	372	5,897	7,984	26,182
365,271	0	377	14,809	386	397	6,332	9,292	28,619
403,843	0	335	7,161	250	876	4,196	11,959	26,593
424,244	0	270	5,979	386	932	5,167	12,342	24,444
450,648	0	249	7,742	167	892	6,601	13,829	17,923
482,327	0	225	5,444	457	900	6,679	15,500	24,159
517,484	0	85	6,086	167	1,605	6,781	16,354	19,525
628,359	0	109	28,402	71	1,261	7,482	17,256	16,545
593,694	0	450	5,149	216	1,382	6,332	17,962	12,713
643,301	0	425	6,645	61	820	8,525	17,083	8,953
687,518	21,091	367	4,420	136	1,152	10,533	18,977	12,008
724,194	25,652	321	5,723	162	717	11,828 r	19,793	11,230 r
754,948	30,783	270	5,912	80	1,285	9,963	26,378	14,080

13A. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1984–2004 and Month-End 2004—Continued

Millions of dollars

Period	Factors supplying reserve funds								
	Federal Reserve Bank credit outstanding						Gold stock	Special drawing rights certificate account	Treasury currency outstanding[3]
	Securities held outright[1]	Repurchase agreements[2]	Loans	Float	Other Federal Reserve assets	Total			
2004									
Jan.	667,242	23,500	19	–26	41,456	732,191	11,043	2,200	35,567
Feb.	671,583	28,750	23	520	38,754	739,630	11,045	2,200	35,649
Mar.	674,084	27,500	64	–586	40,169	741,231	11,045	2,200	35,761
Apr.	677,687	25,250	84	–829	40,345	742,537	11,045	2,200	35,842
May	681,472	30,750	122	–155	38,354	750,543	11,045	2,200	35,924
June	687,391	33,500	323	116	39,465	760,795	11,045	2,200	36,039
July	693,727	24,750	260	–23	40,581	759,294	11,044	2,200	36,087
Aug.	694,859	32,250	457	1,002	38,043	766,610	11,043	2,200	36,211
Sept.	700,341	29,250	236	–25	39,557	769,359	11,043	2,200	36,279
Oct.	706,834	25,250	121	–114	41,681	773,772	11,043	2,200	36,364
Nov.	712,870	33,750	77	810	39,844	787,351	11,043	2,200	36,435
Dec.	717,819	33,000	43	927	42,161	793,950	11,045	2,200	36,505

13A.—Continued

Factors absorbing reserve funds								Reserve balances with Federal Reserve Banks[6]
Currency in circulation	Reverse repurchase agreements[4]	Treasury cash holdings[5]	Deposits with Federal Reserve Banks, other than reserve balances			Required clearing balances	Other Federal Reserve liabilities and capital	
			Treasury	Foreign	Other			
708,952	20,129	356	4,184	84	426	10,614	20,365	15,889
712,613	21,762	318	6,513	82	302	10,078	20,033	16,823
716,136	21,701	366	5,884	83	231	10,410	20,880	14,545
717,528	21,204	321	6,392	96	368	10,561	20,804	14,350
726,367	20,477	320	4,637	86	267	10,145	21,718	15,696
733,183	19,228	303	6,032	280	226	10,861	21,198	18,767
733,020	20,167	283	4,917	81	304	9,802	21,302	18,751
736,506	22,941	330	2,456	158	275	10,206	23,084	20,109
738,372	25,693	291	5,987	128	243	10,718	23,502	13,946
741,440	27,037	299	5,116	92	310	10,571	23,918	14,597
754,226	28,201	283	3,759	89	326	10,024	25,627	14,494
754,948	30,783	270	5,912	80	1,285	9,963	26,378	14,080

NOTE. Components may not sum to totals because of rounding.

1. Includes U.S. Treasury and federal agency securities. U.S. Treasury securities contain securities lent to dealers and are fully collateralized by other U.S. Treasury securities. Federal agency securities are included at face value.

2. Cash value of agreements, which are collateralized by U.S. Treasury and federal agency securities.

3. Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are fractional and dollar coins. For details see "Currency and Coin in Circulation," *Treasury Bulletin*.

4. Cash value of agreements, which are collateralized by U.S. Treasury securities.

5. Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

6. Excludes required clearing balances and adjustments to compensate for float.

r. Revised.

13B. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1918–1983

Millions of dollars

Period	Factors supplying reserve funds									
	Federal Reserve Bank credit outstanding							Gold stock[6]	Special drawing rights certificate account	Treasury currency outstanding[7]
	Securities held outright[1]	Repurchase agreements[2]	Loans	Float[3]	All other[4]	Other Federal Reserve assets[5]	Total			
1918......	239	0	1,766	199	294	0	2,498	2,873	...	1,795
1919......	300	0	2,215	201	575	0	3,292	2,707	...	1,707
1920......	287	0	2,687	119	262	0	3,355	2,639	...	1,709
1921......	234	0	1,144	40	146	0	1,563	3,373	...	1,842
1922......	436	0	618	78	273	0	1,405	3,642	...	1,958
1923......	80	54	723	27	355	0	1,238	3,957	...	2,009
1924......	536	4	320	52	390	0	1,302	4,212	...	2,025
1925......	367	8	643	63	378	0	1,459	4,112	...	1,977
1926......	312	3	637	45	384	0	1,381	4,205	...	1,991
1927......	560	57	582	63	393	0	1,655	4,092	...	2,006
1928......	197	31	1,056	24	500	0	1,809	3,854	...	2,012
1929......	488	23	632	34	405	0	1,583	3,997	...	2,022
1930......	686	43	251	21	372	0	1,373	4,306	...	2,027
1931......	775	42	638	20	378	0	1,853	4,173	...	2,035
1932......	1,851	4	235	14	41	0	2,145	4,226	...	2,204
1933......	2,435	2	98	15	137	0	2,688	4,036	...	2,303
1934......	2,430	0	7	5	21	0	2,463	8,238	...	2,511
1935......	2,430	1	5	12	38	0	2,486	10,125	...	2,476
1936......	2,430	0	3	39	28	0	2,500	11,258	...	2,532
1937......	2,564	0	10	19	19	0	2,612	12,760	...	2,637
1938......	2,564	0	4	17	16	0	2,601	14,512	...	2,798
1939......	2,484	0	7	91	11	0	2,593	17,644	...	2,963
1940......	2,184	0	3	80	8	0	2,274	21,995	...	3,087
1941......	2,254	0	3	94	10	0	2,361	22,737	...	3,247
1942......	6,189	0	6	471	14	0	6,679	22,726	...	3,648
1943......	11,543	0	5	681	10	0	12,239	21,938	...	4,094
1944......	18,846	0	80	815	4	0	19,745	20,619	...	4,131
1945......	24,252	0	249	578	2	0	15,091	20,065	...	4,339
1946......	23,350	0	163	580	1	0	24,093	20,529	...	4,562
1947......	22,559	0	85	535	1	0	23,181	22,754	...	4,562
1948......	23,333	0	223	541	1	0	24,097	24,244	...	4,589
1949......	18,885	0	78	534	2	0	19,499	24,427	...	4,598
1950......	20,725	53	67	1,368	3	0	22,216	22,706	...	4,636
1951......	23,605	196	19	1,184	5	0	25,009	22,695	...	4,709
1952......	24,034	663	156	967	4	0	25,825	23,187	...	4,812
1953......	25,318	598	28	935	2	0	26,880	22,030	...	4,894
1954......	24,888	44	143	808	1	0	25,885	21,713	...	4,985
1955......	24,391	394	108	1,585	29	0	26,507	21,690	...	5,008
1956......	24,610	305	50	1,665	70	0	26,699	21,949	...	5,066
1957......	23,719	519	55	1,424	66	0	25,784	22,781	...	5,146
1958......	26,252	95	64	1,296	49	0	27,755	20,534	...	5,234
1959......	26,607	41	458	1,590	75	0	28,771	19,456	...	5,311

For notes see end of table.

13B.—Continued

Factors absorbing reserve funds								Member bank reserves[9]			
Currency in circulation	Treasury cash holdings[8]	Deposits with Federal Reserve Banks, other than reserve balances			Other Federal Reserve accounts[5]	Required clearing balances	Other Federal Reserve liabilities and capital[5]				
		Treasury	Foreign	Other				With Federal Reserve Banks	Currency and coin[10]	Required[11]	Excess[11, 12]
4,951	288	51	96	25	118	0	0	1,636	0	1,585	51
5,091	385	51	73	28	208	0	0	1,890	0	1,822	68
5,325	218	57	5	18	298	0	0	1,781	0	0	0
4,403	214	96	12	15	285	0	0	1,753	0	1,654	99
4,530	225	11	3	26	276	0	0	1,934	0	0	0
4,757	213	38	4	19	275	0	0	1,898	0	1,884	14
4,760	211	51	19	20	258	0	0	2,220	0	2,161	59
4,817	203	16	8	21	272	0	0	2,212	0	2,256	–44
4,808	201	17	46	19	293	0	0	2,194	0	2.250	–56
4,716	208	18	5	21	301	0	0	2,487	0	2,424	63
4,686	202	23	6	21	348	0	0	2,389	0	2,430	–41
4,578	216	29	6	24	393	0	0	2,355	0	2,428	–73
4,603	211	19	6	22	375	0	0	2,471	0	2,375	96
5,360	222	54	79	31	354	0	0	1,961	0	1,994	–33
5,388	272	8	19	24	355	0	0	2,509	0	1,933	576
5,519	284	3	4	128	360	0	0	2,729	0	1,870	859
5,536	3,029	121	20	169	241	0	0	4,096	0	2,282	1,814
5,882	2,566	544	29	226	253	0	0	5,587	0	2,743	2,844
6,543	2,376	244	99	160	261	0	0	6,606	0	4,622	1,984
6,550	3,619	142	172	235	263	0	0	7,027	0	5,815	1,212
6,856	2,706	923	199	242	260	0	0	8,724	0	5,519	3,205
7,598	2,409	634	397	256	251	0	0	11,653	0	6,444	5,209
8,732	2,213	368	1,133	599	284	0	0	4,026	0	7,411	6,615
11,160	2,215	867	774	586	291	0	0	12,450	0	9,365	3,085
15,410	2,193	799	793	485	256	0	0	13,117	0	11,129	1,988
20,499	2,303	579	1,360	356	339	0	0	12,886	0	11,650	1,236
25,307	2,375	440	1,204	394	402	0	0	14,373	0	12,748	1,625
28,515	2,287	977	862	446	495	0	0	15,915	0	14,457	1,458
28,952	2,272	393	508	314	607	0	0	16,139	0	15,577	562
28,868	1,336	870	392	569	563	0	0	17,899	0	16,400	1,499
28,224	1,325	1,123	642	547	590	0	0	20,479	0	19,277	1,202
27,600	1,312	821	767	750	106	0	0	16,568	0	15,550	1,018
27,741	1,293	668	895	565	714	0	0	17,681	0	16,509	1,172
29,206	1,270	247	526	363	746	0	0	20,056	0	19,667	389
30,433	1,270	389	550	455	777	0	0	19,950	0	20,520	–570
30,781	761	346	423	493	839	0	0	20,160	0	19,397	763
30,509	796	563	490	441	907	0	0	18,876	0	18,618	258
31,158	767	394	402	554	925	0	0	19,005	0	18,903	102
31,790	775	441	322	426	901	0	0	19,059	0	19,089	–30
31,834	761	481	356	246	998	0	0	19,034	0	19,091	–57
32,193	683	358	272	391	1,122	0	0	18,504	0	18,574	–70
32,591	391	504	345	694	841	0	0	18,174	310	18,619	–135

13B. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1918–1983—Continued

Millions of dollars

Period	Factors supplying reserve funds									
	Federal Reserve Bank credit outstanding							Gold stock[6]	Special drawing rights certificate account	Treasury currency outstanding[7]
	Securities held outright[1]	Repurchase agreements[2]	Loans	Float[3]	All other[4]	Other Federal Reserve assets[5]	Total			
1960......	26,984	400	33	1,847	74	0	29,338	17,767	...	5,398
1961......	30,478	159	130	2,300	51	0	31,362	16,889	...	5,585
1962......	28,722	342	38	2,903	110	0	33,871	15,978	...	5,567
1963......	33,582	11	63	2,600	162	0	36,418	15,513	...	5,578
1964......	36,506	538	186	2,606	94	0	39,930	15,388	...	5,405
1965......	40,478	290	137	2,248	187	0	43,340	13,733	...	5,575
1966......	43,655	661	173	2,495	193	0	47,177	13,159	...	6,317
1967......	48,980	170	141	2,576	164	0	52,031	11,982	...	6,784
1968......	52,937	0	186	3,443	58	0	56,624	10,367	...	6,795
1969......	57,154	0	183	3,440	64	2,743	64,584	10,367	...	6,852
1970......	62,142	0	335	4,261	57	1,123	67,918	10,732	400	7,147
1971......	69,481	1,323	39	4,343	261	1,068	76,515	10,132	400	7,710
1972......	71,119	111	1,981	3,974	106	1,260	78,551	10,410	400	8,313
1973......	80,395	100	1,258	3,099	68	1,152	86,072	11,567	400	8,716
1974......	84,760	954	299	2,001	999	3,195	92,208	11,652	400	9,253
1975......	92,789	1,335	211	3,688	1,126	3,312	102,461	11,599	500	10,218
1976......	100,062	4,031	25	2,601	991	3,182	110,892	11,598	1,200	10,810
1977......	108,922	2,352	265	3,810	954	2,442	118,745	11,718	1,250	11,331
1978......	117,374	1,217	1,174	6,432	587	4,543	131,327	11,671	1,300	11,831
1979......	124,507	1,660	1,454	6,767	704	5,613	140,705	11,172	1,800	13,083
1980......	128,038	2,554	1,809	4,467	776	8,739	146,383	11,160	2,518	13,427
1981......	136,863	3,485	1,601	1,762	195	9,230	153,136	11,151	3,318	13,687
1982......	144,544	4,293	717	2,735	1,480	9,890	63,659	11,148	4,618	13,786
1983......	159,203	1,592	918	1,605	418	8,728	172,464	11,121	4,618	15,732

NOTE. For a description of figures and discussion of their significance, see *Banking and Monetary Statistics, 1941–1970* (Board of Governors of the Federal Reserve System, 1976), pp. 507–23.

Components may not sum to totals because of rounding.

1. In 1969 and thereafter, includes securities loaned—fully guaranteed by U.S. government securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale–purchase transactions. On September 29, 1971, and thereafter, includes federal agency issues bought outright.

2. On December 1, 1966, and thereafter, includes federal agency obligations held under repurchase agreements.

3. In 1960 and thereafter, figures reflect a minor change in concept; see *Federal Reserve Bulletin*, vol. 47 (February 1961), p. 164.

4. Principally acceptances and, until August 21, 1959, industrial loans, the authority for which expired on that date.

5. For the period before April 16, 1969, includes the total of Federal Reserve capital paid in, surplus, other capital accounts, and other liabilities and accrued dividends, less the sum of bank premises and other assets, and is reported as "Other Federal Reserve accounts"; thereafter, "Other Federal Reserve assets" and "Other Federal Reserve liabilities and capital" are shown separately.

6. Before January 30, 1934, includes gold held in Federal Reserve Banks and in circulation.

7. Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are fractional and dollar coins. For details see "Currency and Coin in Circulation," *Treasury Bulletin*.

13B.—Continued

Factors absorbing reserve funds								Member bank reserves [9]			
Currency in circulation	Treasury cash holdings [8]	Deposits with Federal Reserve Banks, other than reserve balances			Other Federal Reserve accounts [5]	Required clearing balances	Other Federal Reserve liabilities and capital [5]				
		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

8. Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

9. In November 1979 and thereafter, includes reserves of member banks, Edge Act corporations, and U.S. agencies and branches of foreign banks. On November 13, 1980, and thereafter, includes reserves of all depository institutions.

10. Between December 1, 1959, and November 23, 1960, part was allowed as reserves; thereafter, all was allowed.

11. Estimated through 1958. Before 1929, data were available only on call dates (in 1920 and 1922 the call date was December 29). Since September 12, 1968, the amount has been based on close-of-business figures for the reserve period two weeks before the report date.

12. For the week ending November 15, 1972, and thereafter, includes $450 million of reserve deficiencies on which Federal Reserve Banks are allowed to waive penalties for a transition period in connection with bank adaptation to Regulation J as amended, effective November 9, 1972. Allowable deficiencies are as follows (beginning with first statement week of quarter, in millions): 1973—Q1, $279; Q2, $172; Q3, $112; Q4, $84; 1974—Q1, $67; Q2, $58. The transition period ended with the second quarter of 1974.

13. For the period before July 1973, includes certain deposits of domestic nonmember banks and foreign-owned banking institutions held with member banks and redeposited in full with Federal Reserve Banks in connection with voluntary participation by nonmember institutions in the Federal Reserve System program of credit restraint.

As of December 12, 1974, the amount of voluntary nonmember bank and foreign-agency and branch deposits at Federal Reserve Banks that are associated with marginal reserves is no longer reported. However, two amounts are reported: (1) deposits voluntarily held as reserves by agencies and branches of foreign banks operating in the United States and (2) Eurodollar liabilities.

14. Adjusted to include waivers of penalties for reserve deficiencies, in accordance with change in Board policy, effective November 19, 1975.

. . . Not applicable.

14. Banking Offices and Banks Affiliated with Bank Holding Companies (BHCs) in the United States, December 31, 2003 and 2004

Type of office	Total	Commercial banks[1]						State-chartered savings banks
		Total	Member			Nonmember		
			Total	National	State			
	All banking offices							
BANKS								
Number, Dec. 31, 2003	**8,116**	**7,725**	**2,892**	**1,963**	**929**	**4,833**		**391**
Changes during 2004								
New banks	131	126	29	19	10	97		5
Banks converted into branches	−248	−236	−121	−79	−42	−115		−12
Ceased banking operation[2]	−39	−27	−16	−13	−3	−11		−12
Other[3]	0	−2	10	−10	20	−12		2
Net change	−156	−139	−98	−83	−15	−41		−17
Number, Dec. 31, 2004	**7,960**	**7,586**	**2,794**	**1,880**	**914**	**4,792**		**374**
BRANCHES AND ADDITIONAL OFFICES								
Number, Dec. 31, 2003	**72,936**	**69,440**	**50,628**	**36,553**	**14,075**	**18,812**		**3,496**
Changes during 2004								
New branches	2,190	2,078	1,535	1,124	411	543		112
Branches converted from banks	248	241	138	99	39	103		7
Discontinued[2]	−883	−666	−437	−295	−142	−229		−217
Other[3]	0	81	0	1,202	−1,202	81		−81
Net change	1,555	1,734	1,236	2,130	−894	498		−179
Number, Dec. 31, 2004	**74,491**	**71,174**	**51,864**	**38,683**	**13,181**	**19,310**		**3,317**
	Banks affiliated with BHCs							
BANKS								
Number, Dec. 31, 2003	**6,403**	**6,287**	**2,486**	**1,672**	**814**	**3,801**		**116**
Changes during 2004								
BHC-affiliated new banks	171	159	47	33	14	112		12
Banks converted into branches	−201	−196	−107	−70	−37	−89		−5
Ceased banking operation[2]	−40	−30	−17	−16	−1	−13		−10
Other[3]	0	−2	9	−6	15	−11		2
Net change	−70	−69	−68	−59	−9	−1		−1
Number, Dec. 31, 2004	**6,333**	**6,218**	**2,418**	**1,613**	**805**	**3,800**		**115**

1. For purposes of this table, banks are entities that are defined as banks in the Bank Holding Company Act, as amended, which is implemented by Federal Reserve Regulation Y. Generally, a bank is any institution that accepts demand deposits and is engaged in the business of making commercial loans or any institution that is defined as an insured bank in section 3(h) of the FDIC Act. Covers entities in the United States and its territories and possessions (affiliated insular areas).

2. Institutions that no longer meet the Regulation Y definition of bank.

3. Interclass changes and sales of branches.

Federal Reserve System Audits

Audits of the Federal Reserve System

The Board of Governors, the Federal Reserve Banks, and the Federal Reserve System as a whole are all subject to several levels of audit and review. The Board's financial statements, and its compliance with laws and regulations affecting those statements, are audited annually by an outside auditor retained by the Board's Office of Inspector General. The Office of Inspector General also audits and investigates the Board's programs and operations, as well as those Board functions delegated to the Reserve Banks.

The financial statements of the Reserve Banks are also audited annually by an independent outside auditor. In addition, the Reserve Banks are subject to annual examination by the Board. As discussed in the chapter "Federal Reserve Banks," the Board's examination includes a wide range of ongoing oversight activities conducted on and off site by staff of the Board's Division of Reserve Bank Operations and Payment Systems.

Federal Reserve operations are also subject to review by the Government Accountability Office. ■

Board of Governors Financial Statements

The financial statements of the Board for 2004 and 2003 were audited by KPMG LLP, independent auditors.

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Financial Statements

To the Board of Governors of the Federal Reserve System:

We have audited the accompanying balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2004 and 2003, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended. These financial statements are the responsibility of the Board' s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Board's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Board at December 31, 2004 and 2003, and the results of its operations, and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our reports dated April 1, 2005, on our consideration of the Board's internal control over financial reporting and its compliance with certain provisions of laws, regulations, and contracts. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit conducted in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

KPMG LLP

April 1, 2005

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEETS

	As of December 31, 2004	2003
ASSETS		
CURRENT ASSETS		
Cash	$ 60,107,292	$ 56,179,654
Accounts receivable	1,696,480	1,251,117
Prepaid expenses and other assets	4,015,067	2,614,354
Total current assets	65,818,839	60,045,125
NONCURRENT ASSETS		
Property and equipment, net (Note 2)	149,028,686	149,595,059
Collections (Note 1)		
Total noncurrent assets	149,028,686	149,595,059
Total assets	$214,847,525	$209,640,184
LIABILITIES AND CUMULATIVE RESULTS OF OPERATIONS		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	$ 13,891,861	$ 15,347,390
Accrued payroll and related taxes	4,552,039	5,056,647
Accrued annual leave	14,195,910	13,428,993
Capital lease payable (current portion)	250,794	206,590
Unearned revenues and other liabilities	467,664	390,698
Total current liabilities	33,358,268	34,430,318
LONG-TERM LIABILITIES		
Capital lease payable (non-current portion)	675,271	763,699
Accumulated retirement benefit obligation (Note 3)	594,169	595,601
Accumulated postretirement benefit obligation (Note 4)	5,789,566	5,322,053
Accumulated postemployment benefit obligation (Note 5)	5,308,565	4,949,892
Total long-term liabilities	12,367,571	11,631,245
Total liabilities	45,725,839	46,061,563
CUMULATIVE RESULTS OF OPERATIONS		
Working capital	32,711,365	25,821,397
Unfunded long-term liabilities	(11,692,300)	(10,867,546)
Net investment in property and equipment	148,102,621	148,624,770
Total cumulative results of operations	169,121,686	163,578,621
Total liabilities and cumulative results of operations	$214,847,525	$209,640,184

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF REVENUES AND EXPENSES AND CHANGES IN CUMULATIVE RESULTS OF OPERATIONS

	For the years ended December 31, 2004	2003
Board Operating Revenues		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures	$272,331,500	$297,020,200
Other revenues (Note 6)	8,336,581	8,835,440
Total operating revenues	280,668,081	305,855,640
Board Operating Expenses		
Salaries	166,797,724	156,547,392
Retirement and insurance contributions	30,850,441	28,263,776
Contractual services and professional fees	24,835,904	17,501,035
Depreciation and net losses on disposals	12,445,708	12,194,612
Utilities	8,273,801	7,664,716
Travel	7,088,444	5,981,254
Software	6,302,695	5,910,128
Postage and supplies	6,116,355	8,175,120
Repairs and maintenance	3,954,263	4,029,441
Printing and binding	1,944,552	1,864,006
Other expenses (Note 6)	6,515,129	6,642,118
Total operating expenses	275,125,016	254,773,598
Results of Operations	5,543,065	51,082,042
Issuance and Redemption of Federal Reserve Notes		
Assessments levied on Federal Reserve Banks for currency costs	503,784,304	508,144,248
Expenses for currency printing, issuance, retirement, and shipping	503,784,304	508,144,248
Currency Assessments over (under) Expenses	0	0
Total Results of Operations	5,543,065	51,082,042
Cumulative Results of Operations, Beginning of year	163,578,621	112,496,579
Cumulative Results of Operations, End of year	$169,121,686	$163,578,621

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF CASH FLOWS

	For the years ended December 31, 2004	2003
Cash Flows from Operating Activities		
Results of Operations	$ 5,543,065	$51,082,042
Adjustments to reconcile results of operations to net cash provided by (used in) operating activities:		
Depreciation and net losses on disposals	12,445,708	12,194,612
Increase in assets:		
Accounts receivable, prepaid expenses, and other assets	(1,846,076)	(2,192,814)
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	(1,455,529)	3,897,291
Accrued payroll and related taxes	(504,608)	(3,046,063)
Accrued annual leave	766,917	1,555,466
Unearned revenues and other liabilities	76,966	(51,368)
Accumulated retirement benefit obligation	(1,432)	(18,507)
Accumulated postretirement benefit obligation	467,513	404,266
Accumulated postemployment benefit obligation	358,673	650,640
Net cash provided by operating activities	15,851,197	64,475,565
Cash Flows from Investing Activities		
Proceeds from disposals	4,005	15,790
Capital expenditures	(11,715,861)	(16,809,964)
Net cash used in investing activities	(11,711,856)	(16,794,174)
Cash Flows from Financing Activities		
Capital lease payments	(211,703)	(136,901)
Net cash used in financing activities	(211,703)	(136,901)
Net Increase in Cash	3,927,638	47,544,490
Cash Balance, Beginning of year	56,179,654	8,635,164
Cash Balance, End of year	$60,107,292	$ 56,179,654
Supplemental Disclosure of Cash Flow Information		
Capital lease obligations incurred	$ 190,538	$ 1,024,491

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOTES TO FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

(1) Significant Accounting Policies

Organization—The Federal Reserve System was established by Congress in 1913 and consists of the Board of Governors (Board), the Federal Open Market Committee, the twelve regional Federal Reserve Banks, the Federal Advisory Council, and the private commercial banks that are members of the System. The Board, unlike the Reserve Banks, was established as a federal government agency and is supported by Washington staff numbering approximately 1,800, as it carries out its responsibilities in conjunction with other components of the Federal Reserve System.

The Board is required by the Federal Reserve Act to report its operations to the Speaker of the House of Representatives. The Act also requires the Board, each year, to order a financial audit of each Federal Reserve Bank and to publish each week a statement of the financial condition of each such Reserve Bank and a consolidated statement for all of the Reserve Banks. Accordingly, the Board believes that the best financial disclosure consistent with law is achieved by issuing separate financial statements for the Board and for the Reserve Banks. Therefore, the accompanying financial statements include only the operations and activities of the Board. Combined financial statements for the Federal Reserve Banks are included in the Board's annual report to the Speaker of the House of Representatives.

Basis of Accounting—The financial statements have been prepared on the accrual basis of accounting.

Revenues—Assessments for operating expenses and additions to property are based on expected cash needs. Amounts over or under assessed due to differences between actual and expected cash needs flow in to or out of "Cumulative Results of Operations" during the year.

Issuance and Redemption of Federal Reserve Notes—The Board incurs expenses and assesses the Federal Reserve Banks for currency printing, issuance, retirement, and shipping of Federal Reserve Notes. These assessments and expenses are separately reported in the statements of revenues and expenses because they are not Board operating transactions.

Property and Equipment—The Board's property, buildings, and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 3 to 10 years for furniture and equipment and from 10 to 50 years for building equipment and structures. Upon the sale or other disposition of a depreciable asset, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is recognized.

Collections—The Board has collections of works of art, historical treasures, and similar assets. These collections are maintained and held for public exhibition in furtherance of public service. Proceeds from any sales of collections are used to acquire other items for collections. As permitted by FAS 116, the cost of collections purchased by the Board is charged to expense in the year purchased and donated collection items are not recorded. The value of the Board's collections has not been determined.

Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications—Certain 2003 amounts have been reclassified to conform with the 2004 presentation.

(2) Property and Equipment

The following is a summary of the components of the Board's property and equipment, at cost, net of accumulated depreciation.

	As of December 31, 2004	2003
Land	$ 18,640,314	$ 18,640,314
Buildings and improvements	132,891,551	129,161,957
Furniture and equipment	44,450,522	43,890,215
Software	12,207,125	11,425,411
Construction in process	4,380,259	0
	212,569,771	203,117,897
Less accumulated depreciation	(63,541,085)	(53,522,838)
Property and equipment, net	$149,028,686	$149,595,059

Furniture and equipment includes $1,230,000 and $1,156,000 for capitalized leases as of December 31, 2004 and 2003 respectively. Accumulated depreciation includes $356,000 and $195,000 for capitalized leases as of December 31, 2004 and 2003, respectively. The Board paid interest related to these capital leases in the amount of $104,000 and $76,000 for 2004 and 2003, respectively.

The future minimum lease payments required under the capital leases and the present value of the net minimum lease payments as of December 31, 2004, are as follows:

	Year ending December 31	Amount
	2005	$ 427,659
	2006	416,274
	2007	416,274
	2008	138,279
Total minimum lease payments		1,398,486
Less: Amount representing maintenance included in total amounts above		(301,512)
Net minimum lease payments		1,096,974
Less: Amount representing interest		(170,909)
Present value of net minimum lease payments		926,065
Less: Current maturities of capital lease obligations		(250,794)
Long-term capital lease obligations		$ 675,271

Construction in process includes costs incurred in 2004 for two long-term security projects. The first, the Electronic Security System, has an estimated cost of $5.1 million and expected completion in 2005. The second, the Security Perimeter Barrier Project, has an estimated cost of $11.8 million and expected completion in 2006.

(3) Retirement Benefits

Substantially all of the Board's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). The System Plan is a multi-employer plan which covers employees of the Federal Reserve Banks, the Board, and the Plan Administrative Office.

Employees of the Board who became employed prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who became employed after 1983 are covered by a noncontributory 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 2004 and 2003, and the Board was not assessed a contribution for these years. Excess Plan assets are expected to continue to fund future years' contributions. Because the plan is part of a multi-employer plan, information as to vested and nonvested benefits, as well as plan assets, as it relates solely to the Board, is not readily available.

A relatively small number of Board employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). The Board matches employee contributions to these plans. These defined benefit plans are administered by the Office of Personnel Management. The Board's contributions to these plans totaled $330,000 and $312,000 in 2004 and 2003, respectively. The Board has no liability for future payments to retirees under these programs, and it is not accountable for the assets of the plans.

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan. Under the Thrift Plan, members may contribute up to a fixed percentage of their salary. Board contributions are based upon a fixed percentage of each member's basic contribution and were $8,314,000 and $7,692,000 in 2004 and 2003, respectively.

Effective January 1, 1996, Board employees covered under the System Plan are also covered under a Benefits Equalization Plan (BEP). Benefits paid under the BEP are limited to those benefits that cannot be paid from the System Plan due to limitations imposed by Sections 401(a)(17), 415(b) and 415(e) of the Internal Revenue Code of 1986. Pension costs attributed to the System Plan reduce the pension costs of the BEP. Activity for the BEP for 2004 and 2003 is summarized in the following table:

	2004	2003
Change in projected benefit obligation		
Benefit obligation at beginning of year	$ 74,956	$ 12,866
Service cost	23,239	13,689
Interest cost	6,170	3,412
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss	36,588	44,989
Benefits paid	0	0
Benefit obligation at end of year	$ 140,953	$ 74,956
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	0	0
Plan participants' contributions	0	0
Benefits paid	0	0
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
Funded status	$ (140,953)	$ (74,956)
Unrecognized net actuarial (gain)/loss	(177,773)	(231,189)
Unrecognized prior service cost	(817,732)	(934,339)
Unrecognized net transition obligation	542,289	644,883
Retirement benefit liability	$ (594,169)	$ (595,601)

	2004	2003
Information for pension plans with an accumulated benefit obligation in excess of plan asset:		
Projected benefit obligation	$ 140,953	$ 74,956
Accumulated benefit obligation	33	28
Weighted-average assumptions used to determine benefit obligation as of December 31		
Discount rate	5.75%	6.25%
Rate of compensation increase	4.25%	4.00%
Components of net periodic benefit cost		
Service cost—benefits earned during the period	$ 23,239	$ 13,689
Interest cost on projected benefit obligation	6,170	3,412
Expected return on plan assets	0	0
Amortization of prior service cost	(116,607)	(116,607)
Amortization of (gains)/losses	(16,828)	(21,595)
Amortization of initial (asset)/obligation	102,594	102,594
Net periodic benefit cost (credit)	$ (1,432)	$ (18,507)
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31		
Discount rate	6.25%	6.75%
Rate of compensation increase	4.00%	4.25%

(4) POSTRETIREMENT BENEFITS

The Board provides certain life insurance programs for its active employees and retirees. Activity for 2004 and 2003 is summarized in the following table:

	2004	2003
Change in benefit obligation		
Benefit obligation at beginning of year	$ 7,166,146	$ 6,134,395
Service cost	203,229	170,636
Interest cost	443,043	414,319
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss	845,851	673,998
Benefits paid	(253,717)	(227,202)
Benefit obligation at end of year	$ 8,404,552	$ 7,166,146

	2004	2003
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contribution	253,717	227,202
Plan participants' contributions	0	0
Benefits paid	(253,717)	(227,202)
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
Funded status	$(8,404,551)	$(7,166,146)
Unrecognized net actuarial (gain)/loss	2,537,211	1,760,246
Unrecognized prior service cost	77,774	83,847
Prepaid/(accrued) postretirement benefit liability	$(5,789,566)	$(5,322,053)
Components of net periodic cost for year		
Service cost	$ 203,229	$ 170,636
Interest cost	443,043	414,319
Amortization of prior service cost	6,073	6,073
Amortization of (gains)/losses	68,885	40,440
Total net periodic cost	$ 721,230	$ 631,468

The liability and costs for the postretirement benefit plan were determined using discount rates of 5.75 percent and 6.25 percent as of December 31, 2004 and 2003, respectively. Unrecognized losses of $2,537,211 and $1,760,246 as of December 31, 2004 and 2003, respectively, result from changes in the discount rate used to measure the liabilities. Under Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, the Board may have to record some of these unrecognized losses in operations in future years. The assumed salary trend rate for measuring the increase in postretirement benefits related to life insurance was an average of 4.25 percent.

The above accumulated postretirement benefit obligation is related to the Board sponsored life insurance programs. The Board has no liability for future payments to employees who continue coverage under the federally sponsored life and health programs upon retiring. Contributions for active employees participating in federally sponsored health programs totaled $8,223,000 and $7,188,000 in 2004 and 2003, respectively.

(5) Postemployment Benefit Plan

The Board provides certain postemployment benefits to eligible former or inactive employees and their dependents during the period subsequent to employment but prior to retirement. Costs were projected using the same discount rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Board for the years ended December 31, 2004 and 2003, were $733,000 and $957,000, respectively.

(6) Other Revenues and Other Expenses

The following are summaries of the components of Other Revenues and Other Expenses.

	As of December 31, 2004	2003
Other revenues		
Data processing revenue	$3,984,610	$4,639,084
Rent	2,332,089	2,029,514
Subscription revenue	787,053	799,356
Reimbursable services to other agencies	673,730	588,894
National Information Center	15,422	24,422
Board sponsored conferences	0	275,110
Miscellaneous	543,677	479,060
Total other revenues	$8,336,581	$8,835,440
Other expenses		
Tuition, registration, and membership fees	$2,048,610	$1,615,074
Contingency operations	782,052	704,699
Public transportation subsidy	800,724	732,124
Subsidies and contributions	635,336	627,854
Administrative law judges	492,155	307,173
Meals and representation	377,963	534,618
Equipment and facilities rental	307,999	439,751
Security investigations	286,711	473,659
Former employee related payments	205,627	507,082
Miscellaneous	577,952	700,084
Total other expenses	$6,515,129	$6,642,118

(7) Commitments

The Board has entered into several operating leases to secure office, training and warehouse space for remaining periods ranging from one to four years. In addition, the Board has entered into an agreement with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, through the Federal Financial Institutions Examination Council (the "Council") to fund a portion of enhancements for a central data repository project through 2013.

Mimimum annual payments under the operating leases having an initial or remaining noncancelable lease term in excess of one year at December 31, 2004, are as follows:

2005	$163,363
2006	71,991
After 2006	0
	$235,354

Rental expenses under the operating leases were $156,000 in 2004 and 2003.

(8) Federal Financial Institutions Examination Council

The Board is one of the five member agencies of the Council, and currently performs certain management functions for the Council. The five agencies which are represented on the Council are the Board, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision. The Board's financial statements do not include financial data for the Council. Activity related to the Board and Council for 2004 and 2003 is summarized in the following table:

	2004	2003
Board paid to the Council:		
Assessments for operating expenses of the Council	$ 112,020	$ 105,920
Central Data Repository	326,640	630,000
Uniform Bank Performance Report	199,230	201,666
Total Board paid to the Council	$ 637,890	$ 937,586
Council paid to the Board:		
Data processing related services	3,360,055	3,485,701
Administrative services	133,500	72,250
Total Council paid to the Board	$3,493,555	$3,557,951

(9) Federal Reserve Banks

The Board performs certain functions for the Reserve Banks in conjunction with its responsibilities for the Federal Reserve System, and the Federal Reserve Banks provide certain administrative functions for the Board. Activity related to the Board and Reserve Banks for 2004 and 2003 is summarized in the following table:

	2004	2003
Board paid to the Reserve Banks:		
Assessments for employee benefits ..	$ 2,151,078	$ 2,137,781
Data processing and communication	1,920,996	1,963,247
Contingency site	1,481,452	704,699
Total Board paid to the Reserve Banks	$ 5,553,526	$ 4,805,727
Reserve Banks paid to the Board:		
Assessments for currency costs	$503,784,304	$508,144,248
Assessments for operating expenses of the Board	272,331,500	297,020,200
Data processing	686,312	1,484,015
Total Reserve Banks paid to the Board	$776,802,116	$806,648,463

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Internal Control over Financial Reporting

To the Board of Governors of the Federal Reserve System:

We have audited the balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2004 and 2003, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended, and have issued our report thereon dated April 1, 2005. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

In planning and performing our fiscal year 2004 audit, we considered the Board's internal control over financial reporting by obtaining an understanding of the Board's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards*. The objective of our audit was not to provide assurance on the Board's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses under standards issued by the American Institute of Certified Public Accountants. Material weaknesses are conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. However, we noted no matters involving the internal control and its operation that we consider to be material weaknesses as defined above.

We noted other matters involving internal control and its operation that we have reported to the management of the Board in a separate letter dated April 1, 2005.

This report is intended solely for the information and use of the members of the Board and its management, the Office of the Inspector General, and Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

April 1, 2005

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Compliance and Other Matters

To the Board of Governors of the Federal Reserve System:

We have audited the balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2004 and 2003, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended, and have issued our report thereon dated April 1, 2005. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

The management of the Board is responsible for complying with laws, regulations, and contracts applicable to the Board. As part of obtaining reasonable assurance about whether the Board's 2004 financial statements are free of material misstatement, we performed tests of the Board's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contracts applicable to the Board. However, providing an opinion on compliance with laws, regulations, and contracts was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance described in the preceding paragraph of this report disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards.*

This report is intended solely for the information and use of the members of the Board and its management, the Office of the Inspector General, and Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

April 1, 2005

Federal Reserve Banks Combined Financial Statements

The combined financial statements of the Federal Reserve Banks were audited by PricewaterhouseCoopers LLP, independent auditors, for the years ended December 31, 2004 and 2003.

PRICEWATERHOUSECOOPERS

REPORT OF INDEPENDENT AUDITORS

To the Board of Governors of the Federal Reserve System
and the Board of Directors 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, 2004 and 2003, and the related combined statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These combined financial statements are the responsibility of the Reserve Banks' management. Our responsibility is to express an opinion on these combined financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined 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 described in Note 3, these 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 accounting principles generally accepted in the United States of America.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the combined financial position of the Reserve Banks as of December 31, 2004 and 2003, and the combined results of their operations for the years then ended, on the basis of accounting described in Note 3.

April 4, 2005
Washington, D.C.

PricewaterhouseCoopers LLP

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CONDITION
December 31, 2004 and 2003

(in millions)

Assets	2004	2003
Gold certificates	$ 11,041	$ 11,039
Special drawing rights certificates	2,200	2,200
Coin	728	722
Items in process of collection	6,233	7,793
Loans to depository institutions	43	62
Securities purchased under agreements to resell	33,000	43,750
U.S. government securities, net	725,584	675,569
Investments denominated in foreign currencies	21,368	19,868
Accrued interest receivable	5,104	5,064
Bank premises and equipment, net	2,216	2,117
Other assets	3,350	3,303
Total assets	$810,867	$771,487

Liabilities and Capital		
Liabilities		
Federal Reserve notes outstanding, net	$719,437	$689,757
Securities sold under agreements to repurchase	30,783	25,652
Deposits		
Depository institutions	24,043	23,058
U.S. Treasury, general account	5,912	5,723
Other deposits	332	394
Deferred credit items	5,306	7,582
Interest on Federal Reserve notes due U.S. Treasury	329	428
Accrued benefit costs	891	956
Other liabilities	290	243
Total liabilities	787,323	753,793
Capital		
Capital paid-in	11,914	8,847
Surplus	11,630	8,847
Total capital	23,544	17,694
Total liabilities and capital	$810,867	$771,487

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

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF INCOME
for the years ended December 31, 2004 and 2003

(in millions)

	2004	2003
Interest income		
Interest on U.S. government securities	$22,344	$22,597
Interest on investments denominated in foreign currencies	269	260
Interest on loans to depository institutions	3	1
Total interest income	22,616	22,858
Interest expense		
Interest expense on securities sold under agreements to repurchase	290	215
Net interest income	22,326	22,643
Other operating income		
Income from services	866	887
Reimbursable services to government agencies	370	328
Foreign currency gains, net	1,217	2,695
Other income	89	79
Total other operating income	2,542	3,989
Operating expenses		
Salaries and other benefits	1,604	1,819
Occupancy expense	222	213
Equipment expense	245	257
Assessments by Board of Governors	776	805
Other expenses	578	532
Total operating expenses	3,425	3,626
Net income prior to distribution	$21,443	$23,006
Distribution of net income		
Dividends paid to member banks	$ 582	$ 518
Transferred to surplus	2,783	467
Payments to U.S. Treasury as interest on Federal Reserve notes	18,078	22,021
Total distribution	$21,443	$23,006

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

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CHANGES IN CAPITAL
for the years ended December 31, 2004 and 2003

(in millions)

	Capital paid-in	Surplus	Total capital
Balance at January 1, 2003 (167 million shares)	$ 8,380	$ 8,380	$16,760
Transferred to surplus	...	467	467
Net change in capital stock issued (9 million shares)	467	...	467
Balance at December 31, 2003 (176 million shares)	$ 8,847	$ 8,847	$17,694
Transferred to surplus	...	2,783	2,783
Net change in capital stock issued (61 million shares)	3,067	...	3,067
Balance at December 31, 2004 (238 million shares)	$11,914	$11,630	$23,544

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

Notes to the Combined Financial Statements of the Federal Reserve Banks

(1) Structure

The twelve Federal Reserve Banks (Reserve Banks) are part of the Federal Reserve System (System) created by Congress under the Federal Reserve Act of 1913 (Federal Reserve Act) which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. Other major elements of the System are the Board of Governors of the Federal Reserve System (Board of Governors), the Federal Open Market Committee (FOMC) and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York (FRBNY) and, on a rotating basis, four other Reserve Bank presidents. Banks that are members of the System include all national banks and any state-chartered bank that applies and is approved for membership in the System.

Although the Reserve Banks are chartered as independent organizations overseen by the Board of Governors, the Reserve Banks work jointly to carry out their statutory responsibilities. The majority of the assets, liabilities, and income of the Reserve Banks is derived from central bank activities and responsibilities with regard to monetary policy and currency. For this reason, the accompanying combined set of financial statements for the twelve independent Reserve Banks is prepared with adjustments to eliminate interdistrict accounts and transactions.

Board of Directors

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

(2) Operations and Services

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

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

In performing fiscal agency functions for the U.S. Treasury, seven Reserve Banks provide U.S. securities direct purchase and savings bond processing services. In March 2004, the U.S. Treasury provided an implementation plan for consolidating the provision of these services at the Cleveland and Minneapolis Reserve Banks. The costs for the associated restructuring for the affected Banks have been included in footnote 10.

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY is also authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange ("F/X") and securities contracts in, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. In addition, FRBNY is authorized to maintain reciprocal currency arrangements ("F/X swaps") with various central banks, and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks.

(3) SIGNIFICANT ACCOUNTING POLICIES

Accounting principles for entities with the unique powers and responsibilities of the nation's central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared with the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* (*Financial Accounting Manual*), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the *Financial Accounting Manual.*

These combined financial statements have been prepared in accordance with the *Financial Accounting Manual.* Differences exist between the accounting principles and practices of the System and generally accepted accounting principles in the United States of America (GAAP). The primary difference is the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP. In addition, the Board of Governors and the Reserve Banks have elected not to present a Statement of Cash Flows. The Statement of Cash Flows has not been included, because the liquidity and cash position of the Reserve Banks are not of primary concern to users of these combined financial statements. Other information regarding the Reserve Banks' activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. A Statement of Cash Flows, therefore, would not provide any additional useful information. There are no other significant differences between the policies outlined in the *Financial Accounting Manual* and GAAP.

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

(A) *Gold Certificates*

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged and the Reserve Banks' gold certificate account is lowered. The value of gold for purposes of backing the gold certificates is set by law at $42\frac{2}{9}$ 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 United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate account is increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. There were no SDR transactions in 2004 or 2003.

(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 loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

the Board of Directors of each Reserve Bank, subject to review by the Board of Governors.

(D) *U.S. Government Securities and Investments Denominated in Foreign Currencies*

The FOMC has designated the FRBNY to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account (SOMA). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. Such authorizations are reviewed and approved annually by the FOMC.

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

The FRBNY has sole authorization by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements on behalf of the System, in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires FRBNY to take possession of collateral in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by the FRBNY on a daily basis, with additional collateral obtained as necessary. The securities lent are accounted for in the SOMA.

F/X contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with two authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to foreign currencies that it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The Bank will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

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

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

U.S. government 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. Securities sold under agreements to repurchase are accounted for as secured borrowing transactions with the associated interest expense recognized over the life of the transaction. Such transactions are settled by FRBNY. Interest income is accrued on a straight-line basis. 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. Foreign-currency-denominated assets are revalued daily at current market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency gains (losses), net."

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Activity related to U.S. government securities bought outright, securities sold under agreements to repurchase, securities loaned, investments denominated in foreign currency, excluding those held under an F/X swap arrangement, and deposit accounts of foreign central banks and governments above core balances are allocated to each Reserve Bank. U.S. government securities purchased under agreements to resell and unrealized gains and losses on the revaluation of foreign currency holdings under F/X swaps and warehousing arrangements are allocated to the FRBNY and not to other Reserve Banks.

In 2003, additional interest income of $61 million, representing one day's interest on the SOMA portfolio, was accrued to reflect a change in interest accrual calculations. The effect of this change was not material; therefore, it was included in 2003 interest income.

(E) *Bank Premises, Equipment, and Software*

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from two to fifty years. Major alterations, renovations and improvements are capitalized at cost as additions to the asset accounts and are amortized over the remaining useful life of the asset. Maintenance, repairs and minor replacements are charged to operations in the year incurred. Costs incurred for software, either developed internally or acquired for internal use, during the application stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which range from two to five years.

(F) *Federal Reserve Notes*

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank. In 2003, the Federal Reserve Act was amended to expand the assets eligible to be pledged as collateral security to include all Federal Reserve Bank assets. Prior to the amendment, only gold certificates, special drawing rights certificates, U.S. government securities, securities purchased under agreements to resell, loans to depository institutions, and investments denominated in foreign currencies could be pledged as collateral. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, whose collateral value is equal to the par value of the securities tendered and securities purchased under agreements to resell, which are valued at the contract amount. The par value of securities pledged for securities sold under agreements to repurchase is similarly deducted. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides that certain assets of the Reserve Banks are jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents Federal Reserve notes outstanding reduced by the Reserve Banks' currency holdings of $128,933 million and $110,176 million at December 31, 2004 and 2003, respectively.

At December 31, 2004, all Federal Reserve notes outstanding were fully collateralized. All gold certificates, all special drawing rights certificates, and $706,196 million of domestic securities and securities purchased under agreements to resell were pledged as collateral. At December 31, 2004, no loans or investments denominated in foreign currencies were pledged as collateral.

(G) *Capital Paid-In*

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. As a member bank's capital and surplus changes, its holdings of the Reserve Bank's stock must be adjusted. Member banks are state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of $100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

The Financial Accounting Standards Board (FASB) has deferred the implementation date for SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" for the Banks. When applicable, the Banks will determine the impact and provide the appropriate disclosures.

(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.

Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury as interest on Federal Reserve notes excess earnings, after providing for the

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

In the event of losses or an increase in capital paid-in, payments to the U.S. Treasury are suspended and earnings are retained until the surplus is equal to the capital paid-in. Weekly payments to the U.S. Treasury may vary significantly.

In the event of a decrease in capital paid-in, the excess surplus, after equating capital paid-in and surplus at December 31, is distributed to U.S. Treasury in the following year. This amount is reported as a component of "Payments to U.S. Treasury as interest on Federal Reserve notes."

(I) *Income and Costs Related to Treasury Services*

Reserve Banks are required by the Federal Reserve Act to serve as fiscal agents and depositories of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services.

(J) *Taxes*

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. Real property taxes were $33 million for each of the years ended December 31, 2004 and 2003, and are reported as a component of "Occupancy expense."

(K) *Restructuring Charges*

In 2003, the System started the restructuring of several operations, primarily check, cash, and Treasury services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in the remaining locations. These restructuring activities continued in 2004.

Footnote 10 describes the restructuring and provides information about the Banks' costs and liabilities associated with employee separations and contract terminations. The costs associated with the write-down of certain Bank assets are discussed in footnote 6. Costs and liabilities associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY.

(4) U.S. GOVERNMENT SECURITIES

Securities bought outright are held in the SOMA at the FRBNY.

Total securities held in the SOMA at December 31 that were bought outright, were as follows (in millions):

	2004	2003
Par value		
U.S. government		
Bills	$262,970	$244,833
Notes	360,832	323,361
Bonds	94,017	98,471
Total par value	717,819	666,665
Unamortized premiums	9,405	9,797
Unaccreted discounts	(1,640)	(893)
Total	$725,584	$675,569

The maturity distribution of U.S. government securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase, which were held in the SOMA at December 31, 2004, was as follows (in millions):

Maturities of securities held	U.S. government securities (Par)	Securities purchased under agreements to resell (Contract amount)	Securities sold under agreements to repurchase (Contract amount)
Within 15 days	$ 30,647	$33,000	$30,783
16 days to 90 days	178,355	...	...
91 days to 1 year	170,411	...	...
Over 1 year to 5 years	208,269	...	...
Over 5 years to 10 years	54,372	...	...
Over 10 years	75,765	...	...
Total	$717,819	$33,000	$30,783

At December 31, 2004 and 2003, U.S. government securities, net with par values of $6,609 million and $4,426 million, respectively, were loaned from the SOMA.

At December 31, 2004 and 2003, securities sold under agreements to repurchase with a contract amount of $30,783 million and $25,652 million, respectively, were outstanding. At December 31, 2004 and 2003, securities sold under agreements to repurchase with a par value of $30,808 million and $25,658 million, respectively, were outstanding.

(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 purchased under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

Notes to the Combined Financial Statements of the Federal Reserve Banks—Continued

Total investments denominated in foreign currencies, valued at current foreign currency market exchange rates at December 31, were as follows (in millions):

	2004	2003
European Union euro		
Foreign currency deposits	$ 6,063	$ 6,870
Securities purchased under agreements to resell	2,142	2,057
Government debt instruments	3,840	2,033
Japanese yen		
Foreign currency deposits	1,540	1,475
Government debt instruments	7,660	7,341
Accrued interest	123	92
Total	$21,368	$19,868

The maturity distribution of investments denominated in foreign currencies at December 31, 2004, was as follows (in millions):

Maturities of investments denominated in foreign currencies	European Union euro	Japanese yen	Total
Within 1 year	$ 8,978	$9,199	$18,177
Over 1 year to 5 years	3,006	...	3,006
Over 5 years to 10 years	185	...	185
Over 10 years	...	...	...
Total	$12,169	$9,199	$21,368

At December 31, 2004 and 2003, there were no outstanding F/X swaps or material open foreign exchange contracts.

At December 31, 2004 and 2003, the warehousing facility was $5,000 million, with no balance outstanding.

(6) Bank Premises, Equipment, and Software

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

	Maximum useful life (in years)	2004	2003
Bank premises and equipment			
Land	N/A	$ 274	$ 244
Buildings	50	1,631	1,559
Building machinery and equipment	20	373	364
Construction in progress	N/A	202	96
Furniture and equipment	10	1,200	1,334
Subtotal		$3,680	$3,597
Accumulated depreciation		(1,464)	(1,480)
Bank premises and equipment, net		$2,216	$2,117
Depreciation expense, for the years ended		$ 179	$ 184

Bank premises and equipment at December 31 include the following amounts for leases that have been capitalized (in millions):

	2004	2003
Bank premises and equipment	$11	$ 9
Accumulated depreciation	(6)	(6)
Capitalized leases, net	$ 5	$ 3

Certain of the Reserve Banks lease unused space to outside tenants. Those leases have terms ranging from 1 to 12 years. Rental income from such leases totaled $21 million and $20 million for the years ended December 31, 2004 and 2003, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2004, were (in millions):

2005	$ 20
2006	17
2007	12
2008	11
2009	10
Thereafter	43
Total	$113

The Reserve Banks have capitalized software assets, net of amortization, of $203 million and $164 million at December 31, 2004 and 2003, respectively. Amortization expense was $56 million and $54 million for the years ended December 31, 2004 and 2003, respectively.

Several Reserve Banks impaired assets as a result of the System's restructuring plans, as discussed in footnote 10. Impaired assets include software, buildings, leasehold improvements, furniture, and equipment. Asset impairment losses related to the restructuring and check processing standardization of $21 million and $11 million for the years ended December 31, 2004 and 2003, respectively, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

Three Reserve Banks are constructing new buildings, one to replace the head office and two to replace branch offices. At December 31, 2004, the contractual obligation for these projects has been recognized or is reported as a commitment in footnote 7 below.

(7) Commitments and Contingencies

At December 31, 2004, the Reserve Banks were obligated under noncancelable leases for premises and equipment with terms ranging from 1 to 20 years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $70 million and $71 million for the years ended December 31, 2004 and 2003, respectively. Certain of the Reserve Banks' leases have options to renew.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Future minimum rental payments under noncancelable operating and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 2004, were (in millions):

	Operating	Capital
2005	$ 10.2	$ 1.6
2006	8.9	1.5
2007	8.0	.6
2008	7.1	.2
2009	7.2	.1
Thereafter	114.3	...
	$155.7	$ 4.0
Amount representing Interest		(.3)
Present value of minimum lease payments		$ 3.7

At December 31, 2004, the Reserve Banks had contractual commitments through the year 2011 totaling $307 million, $58 million of which has been recognized. Purchases of $117 million and $76 million were made against these commitments during 2004 and 2003, respectively. These commitments are for goods and services for the maintenance of currency machines, check-processing-related services, and check transportation services, and have variable and fixed components. The variable portion of the commitment is for additional services above fixed contractual service limits. The fixed payments for the next five years under these commitments are (in millions):

	Fixed commitment
2005	$89.5
2006	66.2
2007	23.9
2008	.7
2009	.7

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

(8) RETIREMENT AND THRIFT PLANS

Retirement Plans

The Reserve Banks currently offer two defined benefit retirement plans to their employees, based on length of service and level of compensation. Substantially all of the Reserve Banks', Board of Governors', and the Plan Administrative Office's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan) and the Benefit Equalization Retirement Plans offered by each individual Reserve Bank (BEP). In addition, certain Bank officers participate in a Supplemental Employee Retirement Plan (SERP).

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. Certain Board employees not covered by the Social Security Act also contribute to the plan. No separate accounting is maintained of assets contributed by the participating employers. FRBNY acts as a sponsor of the Plan for the System and costs associated with the Plan are not redistributed to other participating employers. The prepaid pension cost includes amounts related to the participating employees of all employers who participate in the plans.

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

	2004	2003
Estimated actuarial present value of projected benefit obligation at January 1	$3,930	$3,523
Service cost—benefits earned during the period	116	109
Interest cost on projected benefit obligation	245	232
Actuarial loss	457	192
Special termination loss	20	67
Contributions by plan participants	3	4
Benefits paid	(247)	(197)
Plan amendments	...	...
Estimated actuarial present value of projected benefit obligation at December 31	$4,524	$3,930

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 assets, the funded status, and the prepaid pension benefit costs (in millions):

	2004	2003
Estimated fair value of plan assets at January 1	$5,703	$4,997
Actual return on plan assets	428	899
Contributions by plan participants	3	4
Employer contributions	...	...
Benefits paid	(247)	(197)
Estimated fair value of plan assets at December 31	$5,887	$5,703
Funded status	$1,362	$1,774
Unrecognized prior service cost	173	197
Unrecognized net actuarial loss	1,182	710
Prepaid pension benefit costs	$2,717	$2,681

Prepaid pension benefit costs are reported as a component of "Other assets."

The accumulated benefit obligation for the defined benefit pension plan was $3,894 million and $3,456 million at December 31, 2004 and 2003, respectively.

The weighted-average assumptions used in developing the pension benefit obligation for the System Plan as of December 31 are as follows:

	2004	2003
Discount rate	5.75%	6.25%
Rate of compensation increase	4.25%	4.00%

The weighted-average assumptions used in developing net periodic benefit cost for the System Plan for the years ending December 31 are as follows:

	2004	2003
Discount rate	6.25%	6.75%
Expected asset return	8.25%	8.50%
Rate of compensation increase	4.00%	4.25%

The long-term rate of return on assets was based on a combination of methodologies including the System Plan's historical returns, surveys of other plans' expected rates of return, building a projected return for equities and fixed income investments based on real interest rates, inflation expectations and equity risk premiums and finally, surveys of expected returns in equity and fixed income markets.

The components of net periodic pension benefit (credit) cost for the System Plan as of December 31 are shown below (in millions):

	2004	2003
Service cost—benefits earned during the period	$ 116	$ 109
Interest cost on projected benefit obligation	245	232
Amortization of prior service cost	24	26
Recognized net loss	20	42
Expected return on plan assets	(462)	(418)
Net periodic pension benefit credit	(57)	(9)
Special termination benefits	20	67
Net periodic pension benefit (credit) cost	$ (37)	$ 58

The recognition of special termination benefits is the result of enhanced retirement benefits provided to 384 System employees in conjunction with the restructuring disclosed in footnote 10. Net periodic pension benefit (credit) cost is reported as a component of "Salaries and other benefits."

The expected benefit payments for the next ten years (in millions) are:

	Expected benefit payments
2005	$ 206
2006	219
2007	224
2008	228
2009	235
2010–2014	1,406
Total	$2,518

The Federal Reserve System's pension plan weighted-average asset allocations at December 31, by asset category, are as follows:

	2004	2003
Equities	67.5%	61.9%
Fixed income	30.0%	34.8%
Cash	2.5%	3.3%
Total	100.0%	100.0%

The System's Committee on Investment Performance (CIP) contracts with investment managers who are responsible for implementing the System Plan's investment policies. The managers' performance is measured against a trailing 36-month-benchmark of 60 percent of a market value weighted index of predominantly large capitalization stocks trading on the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers Automated Quotation National Market System and 40 percent of a broadly diversified investment-grade fixed income index (rebalanced monthly). The managers invest Plan funds within CIP-established guidelines for investment in equities and fixed income instruments. Equity investments can range between 40 percent and 80 percent of the portfolio. Investments, however, cannot be concentrated in particular industries and equity security holdings of any one company are limited. Fixed income securities

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

must be investment grade and the effective duration of the fixed income portfolio must remain within a range of 67 percent and 150 percent of a broadly diversified investment-grade fixed income index. CIP guidelines prohibit margin, short sale, foreign exchange, and commodities trading as well as investment in bank, bank holding company, savings and loan, and government securities dealer's stocks. In addition, investments in non-dollar denominated securities are prohibited; however, a small portion of the portfolio can be invested in American Depositary Receipts/Shares and foreign-issued dollar denominated fixed income securities.

The Federal Reserve System does not expect to make a cash contribution to the Retirement Plan during 2005.

The Reserve Banks' projected benefit obligations and net pension costs for the BEP and the SERP at December 31, 2004 and 2003, 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 $63 million for the year ended December 31, 2004, and $64 million for the year ended December 31, 2003, and are reported as a component of "Salaries and other benefits."

(9) POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits Other Than Pensions

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

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

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

	2004	2003
Accumulated postretirement benefit obligation at January 1	$942	$742
Service cost—benefits earned during the period	19	18
Interest cost of accumulated benefit obligation	52	50
Actuarial loss	10	157
Curtailment (gain)/loss	(2)	7
Special termination loss	1	2
Contributions by plan participants	9	6
Benefits paid	(50)	(40)
Plan amendments	(112)	...
Accumulated postretirement benefit obligation at December 31	$869	$942

At December 31, 2004 and 2003, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.75 percent and 6.25 percent, respectively.

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

	2004	2003
Fair value of plan assets at January 1	$...	$...
Contributions by the employer	42	34
Contributions by plan participants	8	6
Benefits paid	(50)	(40)
Fair value of plan assets at December 31	$...	$...
Unfunded postretirement benefit obligation	$869	$942
Unrecognized net curtailment gain	5	2
Unrecognized prior service cost	128	122
Unrecognized net actuarial loss	(247)	(246)
Accrued postretirement benefit costs	$755	$820

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

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

	2004	2003
Health care cost trend rate assumed for next year	9.00%	10.00%
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	4.75%	5.00%
Year that the rate reaches the ultimate trend rate	2011	2011

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2004 (in millions):

	One percentage point increase	One percentage point decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ 10	$ (8)
Effect on accumulated postretirement benefit obligation	105	(86)

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

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

	2004	2003
Service cost—benefits earned during the period	$ 19	$18
Interest cost of accumulated benefit obligation	52	50
Amortization of prior service cost	(17)	(15)
Recognized net actuarial loss	8	4
Total periodic expense	62	57
Curtailment (gain)/loss	(86)	5
Special termination loss	1	2
Net periodic postretirement benefit (credit)/costs	$(23)	$64

At December 31, 2004 and 2003, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 6.25 percent and 6.75 percent, respectively.

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

A plan amendment that modified the credited service period eligibility requirements created curtailment gains. The recognition of special termination losses is primarily the result of enhanced retirement benefits provided to employees during the restructuring described in footnote 10.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) was enacted in December 2003. The Act established a prescription drug benefit under Medicare (Medicare Part D) and a federal subsidy to sponsors of retiree health care benefit plans that provide benefits that are at least actuarially equivalent to Medicare Part D. Following the guidance of the Financial Accounting Standards Board, the Bank elected to defer recognition of the financial effects of the Act until further guidance was issued in May 2004.

Benefits provided to certain participants are at least actuarially equivalent to Medicare Part D. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic postretirement benefit costs.

Following is a summary of the effects of the expected subsidy (in millions):

	2004
Decrease in the accumulated postretirement benefit obligation	$120
Decrease in the net periodic postretirement benefit costs	16

Expected benefit payments:

	Without subsidy	With subsidy
2005	$ 45	$ 45
2006	47	43
2007	49	44
2008	51	46
2009	52	47
2010–2014	288	257
Total	$532	$482

Postemployment Benefits

The Reserve Banks offer benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2004, measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. For 2004, the Banks changed their practices for estimating postemployment costs and used a 5.25 percent discount rate and the same health care trend rates as were used for projecting postretirement costs. Costs for 2003, however, 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 Banks at December 31, 2004 and 2003, were $128 million and $130 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2004 and 2003 operating expenses were $17 million and $26 million, respectively.

10. BUSINESS RESTRUCTURING CHARGES

In 2003, several Banks announced consolidation and restructuring plans to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions. In 2004, additional consolidation and restructuring initiatives were announced in the check and fiscal services operations. These actions resulted in the following business restructuring charges:

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Major categories of expense (in millions):

	Total estimated costs
Employee separation	$61
Contract termination	1
Other	1
Total	$63

	Accrued liability 12/31/03	Total charges	Total paid	Accrued liability 12/31/04
Employee separation	$29	$25	$(26)	$28
Contract termination	1	...	...	1
Other	...	...	...	...
Total	$30	$25	$(26)	$29

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 1,290, including some of the 1,483 staff reductions related to restructuring that was announced in 2003, and have not been paid out. These costs are reported as a component of "Salaries and other benefits." Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of "Other expenses."

Restructing costs associated with the write-downs of certain Bank assets, including software, buildings, leasehold improvements, furniture, and equipment are discussed in footnote 6. Costs associated with enhanced pension benefits for all Reserve Banks are discussed in footnote 8. Costs associated with enhanced postretirement benefits are disclosed in footnote 9.

Future costs associated with the restructuring that are not estimable and are not recognized as liabilities will be incurred in 2005 and 2006.

The Reserve Banks anticipate substantially completing their announced restructuring plans by March 2006.

Office of Inspector General Activities

The Board's Office of Inspector General (OIG) functions in accordance with the Inspector General Act of 1978, as amended. In addition to retaining an independent auditor each year to audit the Board's financial statements, the OIG plans and conducts audits and investigations of the Board's programs and operations and its delegated functions at the Federal Reserve Banks. The OIG also reviews existing and proposed legislation and regulations for economy and efficiency. It recommends policies, and it supervises and conducts activities that promote economy and efficiency and that prevent and detect waste, fraud, and abuse in Board and Board-delegated programs and operations, as well as in activities administered or financed by the Board. The OIG keeps the Congress and the Chairman of the Board fully informed about serious abuses and deficiencies and about the status of any corrective actions.

During 2004, the OIG completed ten audits, reviews, and other assessments and conducted a number of follow-up reviews to evaluate action taken on earlier recommendations. The OIG also closed nine investigations and performed numerous legislative and regulatory reviews.

Audits, Reviews, and Assessments Completed during 2004

Report title	Month issued
Audit of the FFIEC's Financial Statements (Year Ended December 31, 2003)	February
Review of Internal Control Assessments Performed during Community Bank Examinations	March
Evaluation of Key Emergency Preparedness and Security Enhancements	March
Audit of the Board's Financial Statements (Year Ended December 31, 2003)	April
Audit of the Board's Outsourcing Operations	April
Evaluation of the Fine Arts Program	April
Evaluation of the Administrative Controls Over an Outsourced Contract	June
Review of the Oversight Function of the Division of Reserve Bank Operations and Payment Systems	August
Audit of the Board's Information Security Program	September
Audit of the Board's Automated Travel System	November

Government Accountability Office Reviews

Under the Federal Banking Agency Audit Act (Public Law 95–320), most Federal Reserve System operations are under the purview of the Government Accountability Office (GAO). In 2004, the GAO completed six reports on selected aspects of Federal Reserve operations. In addition, five projects concerning the Federal Reserve were in various stages of completion at year-end. The Federal Reserve also provided information to the GAO during the year in relation to numerous other GAO investigations.

The completed reports are available directly from the GAO.

Reports Completed during 2004

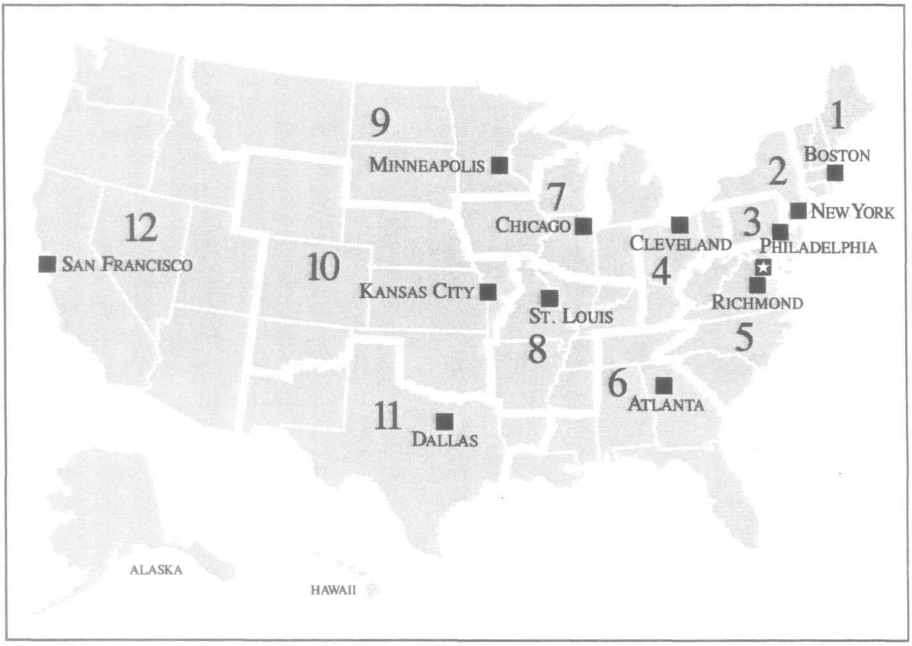
Report title	Report number	Month issued (2004)
Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending	GAO-04-280	January
Federal Reserve Banks: Areas for Improvement in Computer Controls	GAO-04-336R	March
Coins and Currency: How the Costs and Earnings Associated with Producing Coins and Currency Are Budgeted and Accounted For	GAO-04-283	April
Regulatory Information Sharing: Better Information Sharing among Financial Services Regulators Could Improve Protections for Consumers	GAO-04-882R	June
Foreign Regimes' Assets: The United States Faces Challenges in Recovering Assets, but Has Mechanisms that Could Guide Future Efforts	GAO-04-1006	September
Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure	GAO-05-61	October

Projects Active at Year-End 2004

Subject of project	Month initiated (2004)
USA Patriot Act implementation	January
Bank Secrecy Act examinations	January
Industrial loan corporations	May
Information security at financial organizations	November
Consumer impact on remittance transfer system	December

Maps of the Federal Reserve System

The Federal Reserve System



LEGEND

Both pages

- ■ Federal Reserve Bank city
- ⛋ Board of Governors of the Federal Reserve System, Washington, D.C.

Facing page

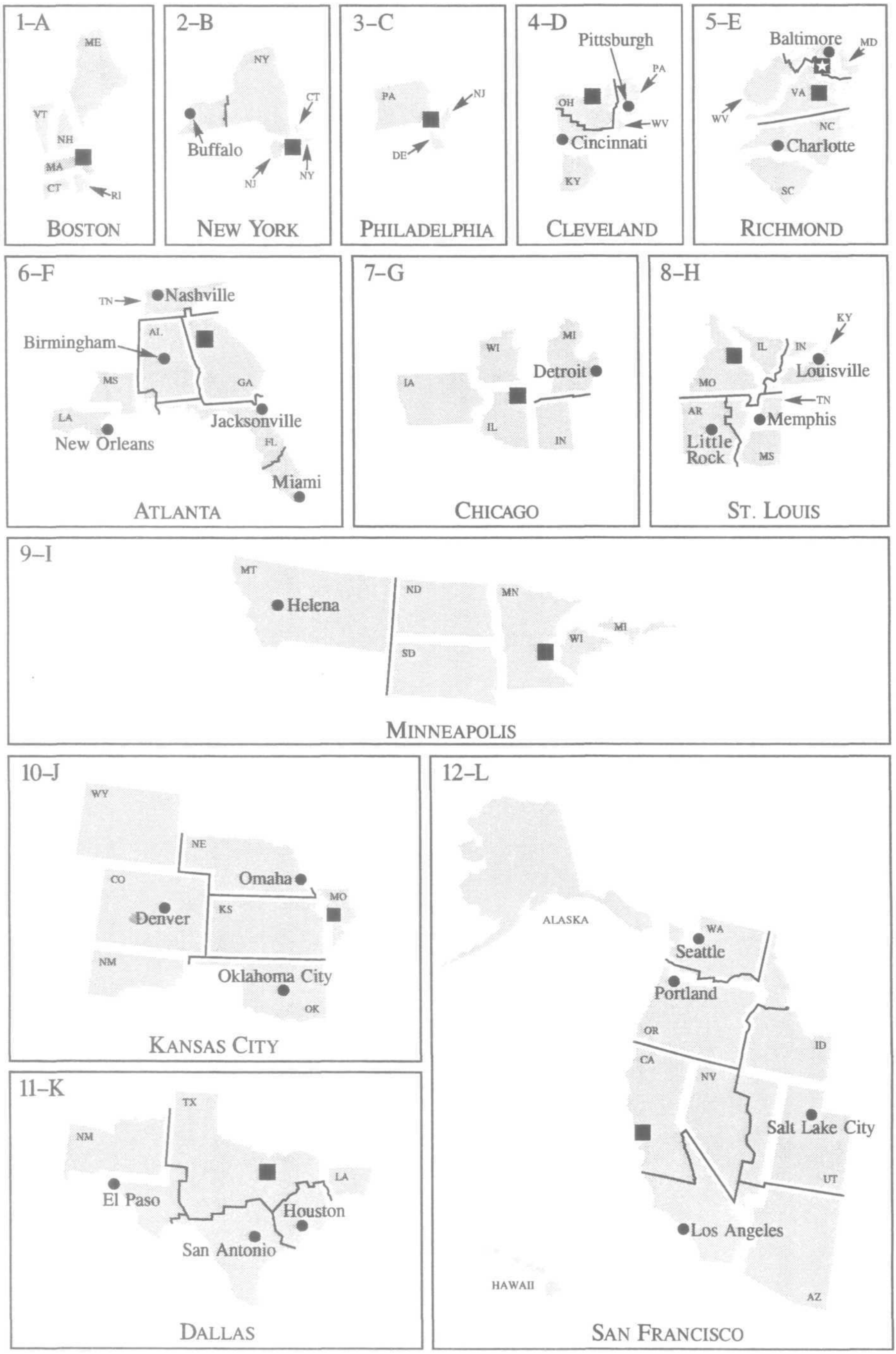
- • Federal Reserve Branch city
- — Branch boundary

NOTE

The Federal Reserve officially identifies Districts by number and by Reserve Bank city (shown on both pages) and by letter (shown on the facing page).

In the 12th District, the Seattle Branch serves Alaska, and the San Francisco Bank serves Hawaii.

The System serves commonwealths and territories as follows: The New York Bank serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands; the San Francisco Bank serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands. The maps show the boundaries within the System as of year-end 2004.


1–A
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Buffalo
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NY
NEW YORK
3–C
PA
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