Federal Reserve Bank of Richmond

1999 ANNUAL REPORT

THE ROLE OF A REGIONAL BANK IN A SYSTEM OF CENTRAL BANKS

Mission

As a regional Reserve Bank, we work within the Federal Reserve System to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payments systems. In doing so, we inspire trust and confidence in the U.S. financial system.

Vision

We want to be a standard of excellence within the Federal Reserve System and continuously improve our service to our customers and the public. Because success depends on each of us, we are striving to create a workplace where we all live our Bank's values and can reach our full potential.

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A Message from the President and First Vice President

It is our pleasure to present the Bank's *1999 Annual Report*. The final year of the millennium saw continued extraordinary growth in both the national and District economies, while inflation remained well contained. Stimulated by rising productivity growth and the expectation it created of higher future income, domestic demand grew strongly and the foreign trade deficit expanded further. These events led the Federal Reserve to tighten monetary policy on three occasions during the second half of the year. Continued rapid consolidation in the banking industry challenged the Fed to enhance its capacity to supervise and regulate very large, far-flung banking organizations efficiently. Meanwhile, the Fed, like all financial institutions, ran hard to stay abreast of advances in information technology in order to provide better service to the public.

The "Year in Review" section highlights the Bank's contributions to System efforts in this environment to support the financial system and foster stable economic growth. Our staff worked diligently and successfully to help ensure that the century date rollover occurred with no disruptions in internal systems or services to the Bank's customers. We are exceedingly proud of the contributions of our employees to this achievement and grateful to them for their extra effort.

Equally important was the high level of teamwork and dedication that went into reformulating the Bank's strategic plan. Staff members throughout the District joined forces across functions to develop a plan that speaks directly to all of us about the Bank's mission and future vision. With broad-based internal support for the plan and its initiatives, the Bank will be better positioned to serve its customers and the public in the years to come.

As we enter a new era, a key international monetary development has been the recent establishment of the European Central Bank whose constituent national central banks will now play roles somewhat analogous to those of the regional Reserve Banks of the Federal Reserve System. Reserve Banks perform crucial functions in the conduct of monetary policy. Our regional presence facilitates surveillance of current economic and financial conditions. We assist in communicating the System's policy strategies and decisions to local and regional audiences. And healthy competition among the Reserve Banks in producing policy-related research stimulates innovative thinking on policy issues and critical scrutiny of particular policy proposals. In this year's feature article, Marvin Goodfriend, senior vice president and policy advisor, discusses how the national central banks in the Eurosystem might perform these same functions.

We thank all of our customers, employees, and other stakeholders for their support in 1999, and we look forward to working with and serving you in the years ahead.

J. Alfred Broaddus, Jr.
PRESIDENT

Walter A. Varvel
FIRST VICE PRESIDENT

THE ROLE OF A REGIONAL BANK IN A SYSTEM OF CENTRAL BANKS

MARVIN GOODFRIEND

INTRODUCTION

A modern central bank seeks to maintain a financial environment within which competitive markets support the efficient use of productive resources. The overarching principle is that a central bank should provide the necessary monetary and financial stability in a way that leaves the maximum freedom of action to private markets. In keeping with this principle, monetary policy is implemented by indirect means, with an interest rate policy instrument rather than with direct credit controls. In the banking sphere every effort is made to minimize as far as possible the regulatory burden associated with financial oversight.

The principle that markets should be given free reign wherever possible creates three difficulties of understanding that a central bank must overcome in order to carry out its policies effectively. The presumption that monetary and banking policies are best when they are as unobtrusive as possible creates the first difficulty. Inevitably, central banks seem shadowy and distant from the public's point of view. Yet, to work well, central bank policies need to shape the expectations of households and businesses. Monetary policy encourages economic growth and stabilizes employment over the business cycle by anchoring inflation and inflation expectations. Bank supervision and regulation aims to promote confidence in the banking system.

The need to influence expectations and promote confidence puts a premium on credibility, a commitment to goals, and a central bank's perceived independence and competence to achieve its objectives. Thus, a central bank must create in the public's mind an understanding of the methods by which its objectives can be sustained. This formidable problem has to be overcome in spite of the fact that a central bank operates in the background, with obscure methods and procedures.

The second and third difficulties arise because central bankers must understand markets. Dynamic markets introduce evermore efficient productive technologies and create new goods and services to better satisfy consumer wants. Economic dynamism complicates the measurement of macroeconomic conditions. A central bank seeks to under-

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stand the latest market developments in order to implement monetary and banking policies appropriately. Policy actions are inevitably benchmarked against historical correlations in data. Yet a central bank must be prepared to question its interpretation of data in light of anecdotal and other information that suggests behavior different from historical averages.

The third difficulty of understanding is in the area of economic analysis. Because policies influence economic activity indirectly, central bankers must use economic analysis to think about how their policies are transmitted to the economy. Some sort of quantitative theoretical model must be used to think about how markets respond to monetary and banking policies, and how monetary and banking policies ought to react to the economy.

The role of regional banks in a system of central banks is about creating understanding in the three senses described above. For example, decentralization enhances credibility because the diffusion of power makes it more difficult for outside pressures to be brought to bear on a central bank. The regional presence helps a central bank to get its policy message out and to gather anecdotal and specialized information on regional economies. Information gathering and dissemination are particularly important for central banks such as the Eurosystem and the Federal Reserve System, whose currency areas span large and populous regions. For this reason, the Central Bank of the Russian Federation and the Peoples Bank of China might profitably restructure themselves as a system of regional central banks.[1]

A regional presence also benefits a central bank with responsibilities for bank supervision and regulation, and the power to extend emergency credit assistance to troubled financial institutions. Specialized knowledge of local economies, industries, and businesses is of use to bank examiners and helpful in determining whether a troubled bank deserves emergency credit assistance. Likewise, central banks that play a role in the provision of payments services run far-flung operations through their regional offices.

Last but not least, the diversification of research within a system of central banks brings a variety of analytical perspectives to policy deliberations that is invaluable in our increasingly complex economy. Moreover, a system of regional banks led by the center institution harnesses competitive forces to encourage innovative thinking within the central bank.

The first half of this paper, which includes Sections 1 though 4, highlights the role played by the Reserve Banks in the Federal Reserve System. The remainder of the paper, Sections 5 through 8, offers some observations on the new Eurosystem based on the experience of the Federal Reserve System. There is a short concluding section.

Having spent 20 years as an economist at the Federal Reserve Bank of Richmond, I welcome the opportunity to clarify my thinking on these matters. I hope that my discussion of the Federal Reserve System helps the European national banks and the European Central Bank to think about their respective roles in the Eurosystem. Early in the century the Federal Reserve System looked to European central banks for guidance in designing its institutional structure and operating procedures. The Federal Reserve will be pleased if it can now return the favor.

THE FEDERAL RESERVE BANK PERSPECTIVE

The improvement over time in communication, information, and transportation technologies has enhanced the role of Reserve Banks in the Federal Reserve System. The United States has seen a deconcentration of metropolitan employment that appears to be the result of urban congestion and technologies that make it increasingly possible to locate businesses away from traditional urban centers.[2] The tendency is toward an equalization of regional economic activity.[3] Think of the growth of California, Florida, and Texas, and the tremendous growth in the South and Southwest. Atlanta, Georgia has become a major commercial center; Charlotte, North Carolina is a major banking center; Seattle is the home of aircraft and software production.

The growing dispersion of economic activity increases the value of local information that Reserve Bank presidents bring to the Federal Open Market Committee. The presence of Reserve Banks in the midst of the various regional economies makes possible a deeper understanding of these than can be acquired from Washington. Personal contacts built up over time create trusting relationships that facilitate the timely acquisition of information about local businesses and markets. Personal contacts are particularly valuable in periods of financial stress when it is especially difficult to know what is happening in certain sectors. Reserve Banks tend to specialize in knowledge concerning industries concentrated in their respective districts. For instance, the New York Fed follows financial markets generally, the Chicago Fed follows commodity markets and heavy manufacturing, the Dallas Fed follows oil production and developments in Mexico, etc.

Thanks to the progress in information and communication technology, Reserve Banks are no longer at an information disadvantage relative to the Federal Reserve Board or the New York Fed with respect to general market information. All receive news and data instantaneously from everywhere. Reserve Bank presidents, in turn, contribute to policy discussions with speeches and articles transmitted instantaneously around the world by wire services and by the Internet.

Reserve Bank officials are familiar with both their regional private sector world and the world of the Federal Reserve Board. Reserve Banks help bridge the two worlds. Responsibilities and pressures at the Board create a culture very different from the private sector. The Board staff relies on aggregate data and abstract concepts to think about the whole economy. Thinking at the Board reflects consensus beliefs and attitudes, and is cautious in adopting and even considering new ideas. Because the Board has ultimate responsibility for much that is done in the System, it has little trouble attracting hard-working, dedicated, and highly skilled employees. Yet because of the responsibility, the pressure, the need for consensus, and the need to focus on abstractions and aggregates, the Board staff can be distant from the private sector. This is a manifestation of the remoteness described in the introduction that plagues central bankers.

With important exceptions there is less ultimate responsibility for System matters at Reserve Banks. On the other hand, there is opportunity for distinguishing one's Reserve Bank from the others. This is a manifestation of the competitive innovation, described in the introduction, that a system of central banks promotes.

One of the Federal Reserve Board's most important duties is to manage relations with Congress. The Board also handles international relationships and deals directly with large financial institutions and national interest groups. Board members testify and give speeches frequently. While these are critically important responsibilities, such communications are nevertheless rather abstract and remote.

Because of its regional presence and focus, the staff at Reserve Banks is more engaged with the rank and file public. Much of what Reserve Banks do involves direct relations with people in the private sector. For instance, Reserve Bank officials manage relations with their Boards of Directors made up of private citizens. Officials speak to local groups about Federal Reserve policies and current economic conditions. Staff members supervise and examine banks, collect data on banking and regional business conditions, provide financial services, promote economic education, and help facilitate community development. The staff at Reserve Banks understands core policy, regulatory, and operational issues and knows how to explain these to its constituencies. In short, Reserve Banks keep the central bank from becoming disembodied, isolated, and out of touch.

FEDERAL OPEN MARKET COMMITTEE MEETINGS[4]

The Federal Open Market Committee (FOMC) meets every six weeks on average at the Federal Reserve Board in Washington. The meetings are attended by the seven governors of the Federal Reserve System, the 12 Reserve Bank presidents, and research directors and other staff members from the Reserve Banks and the Board. The Chairman of the Board of Governors sets the agenda, leads the discussions, shapes the policy decisions, and develops the consensus to support the Committee's policy actions.

The meetings routinely include a report from the open market desk at the Federal Reserve Bank of New York, a briefing by the Board staff on current economic and financial conditions in the United States and abroad, a couple of "go arounds" in which the governors and presidents present their views on the economy and policy, and a discussion and vote on the intended federal funds rate. Normally, an FOMC meeting lasts four to five hours, but twice a year the Committee meets for two days to set annual target ranges for the monetary aggregates and to consider longer-run procedural and strategic issues.

Even though all Reserve Bank presidents but the New York Fed president vote on a rotating basis, all 19 members of the Committee participate on equal terms at every meeting. The time for discussion among the members is, accordingly, limited. More often than not, Committee members influence each other incrementally by revisiting issues as time passes, rather than by exchanging views at any particular meeting. Economic conditions usually do not call for a change in the intended federal funds rate. The Committee uses such occasions to prepare itself for possible future policy actions. Such "down time" affords ample opportunity to consider strategic and procedural questions. All in all, there is time for Committee members to educate and influence each other, and to reach consensus. But, again, much of the back and forth among Committee members takes place over time. In this regard, the verbatim written transcript that is prepared and circulated after each FOMC meeting (but released with a five-year lag) is of great help in enabling members to review each other's statements in detail.

The deliberative process works reasonably well in practice. The repeated interaction creates a mutual understanding that enables a variety of geographical and professional perspectives (academic economist, banker, business economist, businessman, financial market professional, government administrator, lawyer, and regulator) to be brought to bear in making policy decisions.

Two related pitfalls have the potential to weaken the FOMC. First, the bonding that takes place as a consequence of repeated meetings can cause Committee members to

begin to think alike. As a result, the FOMC could be blindsided by a risk or side effect of a policy stance that it had not taken into account. To some extent, that risk is diminished by the external community of "Fed watchers" offering professional advice on monetary policy.

The sheer size of the FOMC reduces the likelihood that Committee members will think alike. One of the great strengths of policy made by representatives from a system of regional central banks is the diversity and number of points of view brought to the table. But the size of the FOMC actually creates the second potential pitfall: a free rider problem. Recognizing that their influence in the Committee may be small, members may be inclined to free-ride on the preparations of others more interested, expert, or responsible for monetary policy, such as the Chairman and the Board staff.

The free rider problem is dangerous because it has the potential to make the effective size of the FOMC much smaller than the full Committee. Even worse, free riding is hard to detect because free riders can continue to participate with thoughtful-sounding statements. Widespread free riding would weaken the Committee in much the same way as the tendency to think alike.

The Chairman of the Federal Reserve Board

Even though the Chairman has only one vote in the FOMC, he is preeminent for a number of reasons. The Chairman and the other Board members are appointed by the President of the United States, and the Chairman is named by the President to lead the Federal Reserve System. The Chairman has command of the large staff at the Federal Reserve Board. Most importantly, only he is involved in every key central bank operation (monetary policy, bank supervision and regulation, financial services, foreign exchange operations, relations with Congress and the Treasury, and public relations). The Chairman is the only member of the FOMC fully aware of all the potential interconnections in what the Federal Reserve does. Consequently, no major decision can be taken without the Chairman's assent for fear of not having all the facts. For all these reasons it is difficult to challenge the Chairman's leadership.

By the same token, a good Chairman is aware of the risks of excessively centralizing power in his hands. For the reasons discussed above he must encourage diverse points of view in the FOMC. Central bankers worry about a variety of risks to the economy and the Chairman must encourage Committee members to bring their concerns to the table. The Chairman must help prioritize the concerns and suggest a course of action to achieve the central bank's goals. Finally, the Chairman must mobilize the Committee to action. All in all, the Chairman must use his preeminence to make the most of the diversity in the FOMC while preserving the decisiveness needed to make monetary policy.

Reserve Bank Presidents at the FOMC

Broadly speaking, Reserve Bank presidents contribute to FOMC meetings in two important ways. They make regular reports on their respective regional economies, and they provide their own analysis of the national economy and the policy options.

Regional information compiled by Reserve Banks for the FOMC in the Beige Book is of great importance.[5] But information in the Beige Book can be stale by the time of an FOMC meeting. Presidents bring more timely information to the meeting, including confidential information from personal or other sources not included in the Beige Book. Anecdotal information brought

to the FOMC can signal changing sentiment before it becomes evident in aggregate data. Mutually supportive signals from various regions may help to identify or confirm a change in trend or a turning point in the aggregate data. It is particularly important that a central bank recognize and react promptly to turning points in inflation and employment trends.

Besides the Chairman, the Board staff presents the most influential economic analysis at FOMC meetings. The staff's analysis is primarily presented in two briefing documents with which Committee members' views are invariably compared. The Greenbook summarizes national and international economic conditions and presents a forecast; the Bluebook lays out the policy alternatives.

Although the briefing books are comprehensive, the analysis of individual members provides essential perspective. Governors and presidents alike contribute substantively to the interpretation of current economic conditions and the analysis of alternative policy options. Many important possibilities such as the risk of an inflation or deflation scare or the chance of a crisis of confidence in financial markets are particularly difficult to assess and take account of in econometric models. The state of consumer and business confidence is also difficult to assess formally. Such issues are addressed in the statements of Committee members themselves.

Economic analysis is a great equalizer among members of the FOMC. An argument based on economic reasoning that can be challenged and debated in the language of economics is ultimately more influential than an intuitive assertion about the economy or policy, no matter who expresses it and how strongly it is held.

ECONOMIC RESEARCH AT FEDERAL RESERVE BANKS

Reserve Bank research departments are staffed with an average of 15 or so research economists (except for the New York Fed, which has more than twice as many). Economists graduate from top schools where they acquire the latest analytical skills and an appreciation of how to think about macroeconomics, monetary policy, and banking policy. For the most part, there is a belief in the power and practical value of economic theory and empirical work, and a drive to use economics to make good policy.

Reserve Banks are able to attract and retain good economists because they offer a unique combination of opportunities. Above all, there is the opportunity to prepare the bank president for FOMC meetings. In their role as policy advisors, Reserve Bank economists acquire an intimate empirical understanding of the macroeconomy and a broad understanding of policy issues. Economists produce policy essays for the Bank's *Economic Review* and may be encouraged to publish articles in professional economics journals. The best of these essays may influence the way that the Federal Reserve, other central banks, and academic economists think about policy. It is possible for a Reserve Bank economist to become increasingly effective as a policy advisor while acquiring a research reputation in the economics profession at large.

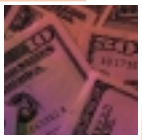
Reserve Bank research departments need not specialize. The expression of alternative points of view is an important strength of a system of central banks. Nevertheless, Reserve Bank research departments often develop a specialization. A Reserve Bank president may encourage research of one type or another; or a particularly skillful economist may happen to make a department strong in a particular sort of research.

A Bank may also exploit a feature of its regional economy or its operational responsibilities to develop a research advantage.

Differences of opinion among Federal Reserve economists are discussed at regular System research meetings. From time to time, there are differences of opinion involving essays in a Reserve Bank *Economic Review*. Reserve Banks send review articles to the Board for a prepublication review. Ordinarily essays benefit from comments by the Board staff. On occasion, the Board staff may recommend against publication because an article is thought to be technically flawed or because the article takes a position regarded as inconsistent with System policy. Conflicts arise because the Board staff prepares speeches and testimony for the Chairman and other Board members in which the Federal Reserve explains current policies to Congress and others. Policy essays published by a Reserve Bank that implicitly or explicitly question current policies may be a nuisance or worse from the perspective of the Board.

Obviously, Reserve Bank economists could be prevented from publishing essays critical of current policy. But that would deny the public the work of economists most knowledgeable about central banking. It would leave the field wide open to others less familiar with the subject. Besides, policy essays reveal a healthy open debate within the Federal Reserve System. In keeping with the mission of a central bank to worry about the economy and policy, it is helpful to have policy questioned by enterprising economists at the Reserve Banks. Furthermore, the best essays facilitate policy advances by suggesting alternatives.

Ultimately, a Reserve Bank has both the incentive and the ability to discipline the output of its economists. The Reserve Bank itself has the most to lose by publishing a poor essay in its *Review*. Reserve Bank research is regularly presented at Federal Reserve System committees and at academic conferences and seminars. Research directors have ample opportunity to judge the professional reception of a particular piece of research prior to publishing it in the Bank's *Review*.



PUBLIC INFORMATION

The modern era of monetary policy at the Federal Reserve began when Chairman Paul Volcker took responsibility publicly for inflation in the early 1980s, and subsequently brought it down. This was a watershed event because before that Federal Reserve officials and much of the public, too, generally blamed inflation on a variety of causes beyond the central bank's control. Since then, the public has come to understand that Federal Reserve monetary policy determines the trend rate of inflation over any substantial span of time.

The acceptance of the responsibility for low inflation by the Federal Reserve greatly elevated the importance of public information and communication in the policy process. Previously, the Federal Reserve preferred to operate in the background and out of the limelight. The public thought that important economic policy decisions were made elsewhere, and the Fed felt relatively little need to communicate with the public about its policy intentions. All that changed after the disinflation initiated by Chairman Volcker, for two reasons. First, the Fed thrust itself into the limelight with inflation-fighting policy actions that raised interest rates and weakened economic activity in order to bring down inflation. Second, the Fed realized that bringing down inflation and maintaining price stability would be easier if the Fed had credibility for low inflation. Thus, the public became more interested in what the Fed was doing, and Fed officials came to see communication with the public as a tool useful for building credibility.

The Fed has two primary public information objectives with respect to monetary policy.[6] A consensus has emerged among monetary economists and central bankers that some sort of explicit mandate for low inflation is beneficial. Yet, Congress has not mandated in a clear way that the Fed place a priority on low inflation. Consequently, Fed officials bear the burden of responsibility for educating the public about the benefits of low inflation. Second, the guiding tactical principle of monetary policy is to preempt inflation, or deflation for that matter. A well-timed preemptive increase in the intended federal funds rate is nothing to be feared. For instance, the 1994 monetary tightening was almost certainly necessary to keep inflation from ending the business expansion. If the Fed is to successfully maintain price stability, it must create an understanding of the need for policy to be preemptive; and the Fed must build a consensus for specific preemptive policy actions when they are needed.

The regional presence of the Reserve Banks is a great advantage in getting the Fed's message out to the public. The participation of Reserve Bank presidents in the FOMC puts them in great demand as speakers in their districts. Economists and other staff members at the Reserve Banks also carry the Fed's message to the public. Reserve Banks produce a variety of literature aimed at educating the public about the Federal Reserve. There are extensive economic education programs through which the staff at Reserve Banks explains monetary policy to schoolteachers and college professors.

Sometimes market participants complain that speeches by members of the FOMC complicate the business of understanding the Fed's current thinking. As mentioned above, the great strength of the Federal Reserve System is that it brings a number of different points of view to the FOMC. There is no reason why the public should not hear these diverse views.

Markets know that the Chairman, and only the Chairman, speaks for the whole FOMC, and the Chairman's rhetoric is understood to represent the current consensus thinking of the FOMC on policy. The Chairman makes use of his numerous appearances before Congress and elsewhere to update or elaborate upon the current thinking of the FOMC. Moreover, the FOMC announces any change in its intended federal funds rate immediately after any meeting in which the rate is changed. Minutes of each FOMC meeting, released shortly after the following meeting, give a fairly comprehensive idea of the concerns and inclinations of Committee members, though without individual attribution. Included with the minutes is the policy directive from the FOMC to the open market desk. The directive contains "symmetry language" that indicates any inclination on the part of the Committee as a whole to be more concerned with the risk of inflation or recession over the next few weeks. The minutes also contain the voting record and any statements of dissent expressed by members of the FOMC.

The public does not seem to mistake the personal views of individual members for information about the FOMC as a whole. Transparency of a Committee member's views, rather than secrecy, seems more likely to build understanding and credibility for the Federal Reserve over time. Not to air differences among Committee members would deprive markets of useful information, and it would put the public at a permanent disadvantage in understanding monetary policy.

It is worth emphasizing that the Federal Reserve's most effective voice is that of its Chairman. The great respect accorded the Fed Chairman is largely due to his own analytical ability and experience, and the informational and analytical support of the capable Board staff. A good measure of credit is no doubt due to recent monetary policy successes. But an important source of the Chairman's personal credibility probably

comes from the fact that he represents the views of the diverse members of the FOMC. If the public were to believe that the Chairman was acting alone, the public would be more inclined to worry that the Chairman could be co-opted, i.e., that he might take policy actions for political rather than economic reasons. The Chairman's credibility and influence would suffer accordingly. Even here, the regional nature of the Federal Reserve System plays an important role. The Federal Reserve Chairman needs the FOMC as much as the Committee needs its Chairman.

THE EUROSYSTEM[7]

The Eurosystem shares the basic structure of the Federal Reserve System. The Eurosystem consists of the European Central Bank (ECB) headquartered in Frankfurt am Main, more or less the equivalent of the Federal Reserve Board, and 11 national central banks (NCBs), which are like the 12 Federal Reserve Banks. Monetary policy in the Eurosystem is made by the Governing Council (the equivalent of the FOMC). The Governing Council includes six members of an Executive Board housed at the ECB (the rough equivalent of the seven-member Board of Governors of the Federal Reserve System) and the governors of the 11 national central banks. The President of the ECB chairs the Governing Council, playing a role similar to the Chairman of the Board of Governors.

Power in the Eurosystem is more decentralized than in the Federal Reserve System. First of all, the governors of the NCBs all vote on policy matters in the Governing Council on each occasion. The seven members of the Board of Governors and the New York Fed president vote all the time in the FOMC, but the other 11 Reserve Bank presidents have only four votes on a rotating basis. As is the case in the FOMC, policy decisions in the Governing Council require a simple majority vote.

Secondly, the Board of Governors exercises more power in the Federal Reserve System than the ECB does in the Eurosystem. For instance, the Board of Governors exercises general supervision over the Reserve Banks: the Board approves Reserve Bank budgets, approves the appointment of Reserve Bank presidents, and appoints three of nine directors at each Reserve Bank, including the chairman. In contrast, the Maastricht Treaty gives the NCB governors control over the terms and conditions of employment of the staff at the ECB. The NCBs are financially independent of both the ECB and their respective national governments. Decentralized control, the so-called principle of subsidiarity, is enshrined in the preamble of the Maastricht Treaty.

Even the ECB itself is more decentralized than the Board of Governors. For instance, the Economic and Research Directorates, which employ the bulk of the ECB's professional economists, do not report to the President of the ECB but to another member of the Executive Board. The fact that there is no Chief Executive of Europe to give his assent to the President of the ECB and other Executive Board members, as in the United States, probably makes for a weaker ECB within the Eurosystem. The NCB governors are appointed by their respective national governments, without approval of the Executive Board.

On the objectives for monetary policy, the Maastricht Treaty states unambiguously that the primary objective of the Eurosystem shall be to maintain price stability. Although the treaty obliges the Eurosystem to support the general economic policies of the European Union, that support is to be without prejudice to the objective of price stability.

Accordingly, the Eurosystem mandate is considerably more definite than the objectives given in the Federal Reserve Act.

The Maastricht Treaty safeguards the independence of the Eurosystem. The Eurosystem charter is an international treaty that cannot be revoked without unanimous consent of the signatories. Moreover, the treaty itself actually tells the Eurosystem not to take instructions from other institutions in the European Union. The greatest threat to the Eurosystem's independence and the pursuit of price stability could come from the ambiguity in the treaty on exchange rate policy, which is to be established by the European Council. It is not completely clear how a conflict between exchange rate and price stability objectives would be settled.

On transparency, the Maastricht Treaty mandates that the ECB publish quarterly and annual reports. Executive Board members have signaled their willingness to testify regularly before the European Parliament. The ECB intends to keep the public informed of its policy actions and thinking through press conferences, speeches, and other regular publications. The President of the ECB holds a press conference to discuss monetary policy immediately after one of the two Governing Council meetings held each month. Notably, the treaty specifies that the proceedings of the meetings shall be confidential, but that the Governing Council may decide to make the outcome of its deliberations public.

For now, the Eurosystem does not coordinate and centralize bank supervision and regulation, or emergency credit provision. NCBs carry on in these areas according to their respective national policies. This, of course, differs from Federal Reserve practice, where the Board exercises control over emergency credit assistance and over the supervision and regulation of banks.

DECENTRALIZATION IN THE EARLY FEDERAL RESERVE: Implications for the Eurosystem

The decentralized Governing Council described above is reminiscent of the early Open Market Committee of the Federal Reserve System. Established informally in 1922 with five of the 12 Reserve Banks represented, the Committee's membership was broadened to include all 12 banks in 1930. The FOMC took its modern form with the Banking Act of 1935, which gave the seven members of the Federal Reserve Board a vote in open market policy for the first time, and reduced the Reserve Bank votes to five.

As is well known from the account by Milton Friedman and Anna Schwartz, the decentralized structure of the Open Market Committee in the 1920s depended for its decisiveness on the leadership of Benjamin Strong, Governor of the Federal Reserve Bank of New York.[8] Governor Strong's powers of persuasion, personal courage, and good judgment gave coherence and purpose to Federal Reserve policy. After Governor Strong died in October 1928, the Open Market Committee became unworkable. Without Strong's leadership the decentralized Open Market Committee made for drift and indecisiveness in Federal Reserve policy.

The Governing Council of the Eurosystem appears to be susceptible to the same indecisiveness as was the early Open Market Committee. A closer look, however, shows why this is not likely to be the case.

First, the objectives of Federal Reserve monetary policy in the early years were ambiguous. The United States was on a gold standard, and the Fed was committed to defend the dollar price of gold. Yet for much of the 1920s Governor Strong sterilized gold flows and instead tried to stabilize the price level.[9] In large part, Strong's personal discretion

substituted for the lack of an agreed objective. The Eurosystem's price stability mandate should go a long way toward preserving the decisiveness of the Governing Council.

Second, it will take some time for the Eurosystem to develop and become familiar with euro-area data. But on the whole, much better macroeconomic data exist today than were available to the early Fed. This, too, should make the Governing Council more decisive than the early Open Market Committee.

Third, today's central banks can draw on the considerable theoretical and practical knowledge that economists have accumulated since the early years of the Fed. Central bankers have accumulated a good deal of practical knowledge themselves. The early Fed had little experience in managing monetary policy and very little in the way of analytical skills at its disposal to help guide policy.

Fourth, professional central bank watchers today provide external advice and discipline.[10] This, too, should act against policy indecision. Fifth, the Fed did not yet have the tradition of making the Chairman of the Board of Governors the Chairman of the FOMC. In effect, the Fed then lacked an institutional leader designated by the President of the United States. This was a great weakness in a decentralized structure such as the Open Market Committee. The President of the ECB is the designated leader. He is appointed by the European Council and confirmed by the European Parliament. In any case, it should be pointed out that centralization of power in the FOMC such as occurred with the Banking Act of 1935 did not guarantee good monetary policy, as the Great Inflation from the late 1960s to the early 1980s showed.

To sum up, the analogy with the early Fed is far from conclusive. With the help of the support systems described above, the Governing Council should be able to strike a reasonable balance between decentralization and decisiveness.

SUBSIDIARITY AND ECB STAFFING

One problematic issue facing the Eurosystem is the nature of the control that the NCBs will exercise over the staffing budget of the ECB according to the principle of subsidiarity. This is critical because, as the discussion of the Federal Reserve System makes clear, the Eurosystem cannot function effectively without a sufficiently strong ECB. The ECB must perform certain tasks. For instance, the ECB must represent the Eurosystem in its external relationships. Presumably, only the President of the ECB can speak for the Governing Council. Also, the ECB is the natural home for economists following the euro-area economy as a whole. The ECB is a natural repository for euro-area data, and its economists will assume primary responsibility (though by no means an exclusive one) for following and interpreting these data for the Eurosystem.

In addition, the ECB needs a staff with analytical capabilities sufficient to support the President in his role as leader of the Eurosystem. Among other things, the ECB's staff, working with the staff at the NCBs, must devise an analytical framework that can help the President of the ECB guide the members of the Governing Council in their monetary policy deliberations.

The funding of the ECB staff must be authorized by the NCB governors. Yet the NCBs lack the experience to judge the ECB's priorities and needs. The problem is two-fold. First, NCBs know relatively little about managing independent monetary policy. Second, NCBs have little experience as regional banks in a system of central banks. The division of labor between the NCBs and the ECB will have to be worked out gradually over time.

One hopes that the NCBs will agree to build up staff at the ECB fast enough to provide the leadership that the Eurosystem needs. The analogy with the Fed system makes clear that critical responsibilities should be

borne by the ECB. NCBs have responsibilities and comparative advantages of their own that they should exploit for the benefit of the Eurosystem.[11]

NATIONAL CENTRAL BANKS AND THE CREDIBILITY OF THE EUROSYSTEM

The Eurosystem will establish full credibility for low inflation over time by satisfying three conditions. First, the Eurosystem must manage monetary policy competently. Second, the NCB governors and Executive Board members on the Governing Council must learn to work together. Third, the Eurosystem must build on its price stability mandate to broaden the public's support for price stability and the preemptive policy actions necessary to sustain it. The NCBs play a central role in seeing that these three conditions are satisfied.

Competence

It seems fair to say that the Eurosystem's expertise in maintaining price stability derives in large part from the Bundesbank, which has had a long and successful track record in managing independent monetary policy.[12] Other NCBs have less experience because for the most part they have chosen to fix their exchange rates to the Deutsche Mark. The Eurosystem adopted many of the Bundesbank's operational procedures to facilitate the transfer of the Bundesbank's monetary policy credibility to the Governing Council.

One significant difference between the Eurosystem and its fixed exchange rate system predecessor led by the Bundesbank is that monetary policy will now take account of euro-area aggregate data. Since those data are only recently being created, little is known about their historical behavior or their relationship to euro-area monetary policy. Until the Eurosystem becomes more familiar with the new area-wide aggregates, the Governing Council needs to rely on anecdotal regional information and the intimate knowledge that NCBs possess of their own country's data.

Finally, the NCBs have relatively large research departments compared to the ECB and extensive operational experience in financial and banking markets. The competence of the Eurosystem will depend on the ability of the ECB to draw on the talents of staff at the NCBs, as need be, for the good of the system as a whole.

Working Relationships on the Governing Council

Despite the safeguards in the Maastricht Treaty, the independence of the Eurosystem is at risk because the regional members of the Governing Council represent countries. Members could be influenced by their governments. Votes on the Governing Council could be traded for those on other governing bodies of the European Union. As mentioned above, the ambiguity on exchange rate policy opens the door to political interference in monetary policy. Politically motivated disputes could greatly complicate the business of the Governing Council. Such conflicts could cause indecisiveness, inconsistent policy actions, and a loss of credibility.

FOMC experience suggests a number of additional measures to prevent the politicization of the Governing Council. First, a macroeconomic framework should be developed to guide policy deliberations. The framework should be rich enough to encompass a wide variety of views and sufficiently coherent to provide the basis for prioritizing concerns and building a consensus for policy actions. The Governing Council should utilize economic arguments disciplined by the

price stability objective to smoke out and defuse political rhetoric. Economic reasoning is, to repeat, a great equalizer.

Second, the ECB President's role in the Governing Council should be strengthened so that he can guide the debate within the agreed upon framework. The ECB President should act against free riding by encouraging members of the Governing Council to prepare thoroughly and to participate actively. The effectiveness of members would be enormously enhanced if each were allowed to bring an economist advisor to the meetings. A verbatim transcript of the meetings should be produced, if only for internal use, to facilitate the give and take that must occur over time.

Third, the macroeconomic framework should be explained to the public in some detail so that Eurosystem watchers can more readily exercise professional discipline on the internal debate.[13] Minutes without individual attribution, published shortly after each Governing Council meeting would help focus Eurosystem watchers on issues of concern to policymakers. Over the long run, greater transparency can serve as a powerful safeguard against political interference.

Admittedly, the FOMC never had the potential for internal international disputes that exists in the Governing Council. However, FOMC experience suggests that the above-mentioned practices would facilitate the development of productive professional working relationships in the Council.

Broadening Public Support for the Eurosystem

The Bundesbank has an admirable monetary policy record in large part because it always had the full support of the German public for its price stability objective. That support was there because the Bundesbank was associated in the public's mind with the postwar economic miracle that began in the late 1940s at the time that the Deutsche Mark and the Bundesbank were created.

The European public has little natural affinity for the new Eurosystem. As was the case for the Federal Reserve System, the Eurosystem will have to earn the public's confidence. If anything, public relations will be more difficult for the Eurosystem than they have been for the Federal Reserve System because the euro area is made up of 11 different countries whose citizens speak many different languages. The Eurosystem should make extensive use of the regional presence of its NCBs to broaden the understanding of its mission and methods, much as the Fed uses the Reserve Banks.

The Eurosystem has one big advantage over the Fed in explaining itself to the public. In contrast to the Fed, whose mandate only exists in the Federal Reserve Act and is ambiguous at that, the Eurosystem's price stability mandate is unambiguous and part of one of the founding documents of the European Union.

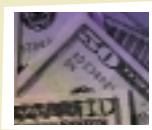
SUMMARY

The main message of this paper is that regional (national) banks play an especially important role in central banks whose currency areas span a continent, such as the Eurosystem and the Federal Reserve System. A regional presence facilitates the acquisition of specialized information on the economy and positions the staff to reach out to the public with an explanation of the central bank's policy objectives and practices. Presidents (governors) of regional central banks bring analytical diversity to the monetary policy committee. Above all, a system of central banks promotes a healthy competition that stimulates innovative thinking on operational, regulatory, research, and policy questions.

Federal Reserve experience teaches that a decentralized system needs a strong center. Staff at the center needs to be large enough to support a strong Chairman (President) of the system. The Chairman must be strong enough to encourage diverse views in the policy committee and to build a consensus for decisive and timely policy actions. The Chairman should exploit diversity and promote decisiveness.

The key to success in the Eurosystem, in addition to the above-mentioned points, is to establish good working relationships on the Governing Council. To facilitate this, the staff at the center should take the lead in developing a macroeconomic framework within which diverse policy views can be expressed and debated productively. Personal advisors should accompany members to the policy meetings. Verbatim transcripts should be prepared for internal use to facilitate an exchange of views over time. Minutes without individual attribution should be published to present opposing views clearly, to focus central bank watchers, and to guard against the potential for politically motivated policy mistakes.

The Eurosystem and the Federal Reserve System will succeed in the long run by broadening the public's understanding and support for low inflation and the preemptive policy procedures to maintain price stability. The way to do that is to involve the Reserve Bank presidents (national central bank governors) and their advisors fully in the policymaking process, and to utilize the system's regional presence to take the central bank's monetary policy message to the public.



ENDNOTES

1. In late 1998, the Peoples Bank of China announced its intention to establish nine provincial branches.

2. See, for example, Chatterjee and Carlino (1998).

3. Barro and Sala-í-Martin (1992) present evidence of convergence within the United States.

4. See Meyer (1998).

5. See Balke and Petersen (1998).

6. See Goodfriend (1997).

7. *European Union* (1995) contains the Maastricht Treaty, which, in turn, contains the language governing the structure, administration, and objectives of the Eurosystem. Wynne (1999) summarizes the documentation authorizing the establishment of the Eurosystem.

8. See Friedman and Schwartz (1963).

9. See Hetzel (1985).

10. See, for example, Begg et al. (1998).

11. See, for instance, Liebscher (1998).

12. See Deutsche Bundesbank (1999).

13. See Issing (1998).

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Both the national and Fifth District economies continued to grow robustly in 1999, with sizable gains in employment and production.

With rising current income, and higher expected future income driven by increased productivity growth, domestic U.S. demand for goods and services was exceptionally strong throughout most of the year — indeed, so strong that many economists concluded that greater monetary restraint was needed to sustain the expansion over time. In response, the Fed raised the federal funds rate one-quarter percentage point on three occasions in the second half of the year. Two of these increases were accompanied by quarter point increases in the discount rate. The impacts of these policy actions were still being assessed in early 2000.

Far easier to ascertain was the success of the Bank's preparation for a smooth transition to the year 2000. The Bank completed the century date rollover with no service disruptions to internal operations or external customers. Preparing for the successful transition required the dedication and commitment of staff in every area of the Bank. The financial services areas made extensive operating and contingency preparations and worked closely with customers to ensure readiness. Customer Support staff played a key role in testing, monitoring, and communicating with Fifth District financial institutions. Staff in the Reserve Accounts and Loans areas assisted depository institutions in preparing to use the discount window as a contingency source of funds. Banking Supervision ensured that supervised institutions successfully completed their preparations for the transition. Federal Reserve efforts to inform the public about the banking system's readiness for the rollover helped reduce anxiety in the period leading up to the event. Bank staff provided information about the industry's preparations through 247 speeches and panel presentations that reached an estimated 11,000 individuals. Videos and print and broadcast media interviews, including radio and television appearances, reached even broader audiences.

Bank management and staff also took steps in 1999 to ensure continued success in the dynamic economy envisioned for the 21st century. Most importantly, a new strategic plan was completed that better aligns the Bank's mission, vision, and longer-term goals to the new challenges presented by the rapidly changing banking and financial system. The plan was developed with substantial input from customers and employees and includes new strategies and initiatives to improve performance in all areas of the Bank. Mr. Broaddus and Mr. Varvel introduced the plan in a series of meetings throughout the District to ensure that all staff members understood the contribution of their individual job assignments to the Bank's overall strategy.

Economic Research and Public Outreach

The Bank continued to produce economic research relevant to the Federal Reserve's monetary and banking policies, the Fifth District economy, and the payments system. Research staff supplied timely analyses of current policy issues and advised the Bank president in his preparation for the Federal Open Market Committee meetings. They also provided senior management with comprehensive analytical support in meeting banking and payments system responsibilities.

The Bank conveyed information about the Fifth District, the national economy, and Federal Reserve monetary policy through its public outreach. In 1999, over 200,000 copies of 16 Bank publications were distributed. The Bank's business magazine, *Region Focus*, increased circulation and garnered four more awards for journalistic merit, bringing the total number of awards to 10 since it was first published in 1997. The *Economic Quarterly* continued to receive positive feedback from respected economists and institutions at home and abroad, and the Bank's Web site provided expanded access to Bank publications, the president's speeches, and regional economic information.

Several economic education programs provided further opportunities for information-sharing. The Bank joined forces with the E. Angus Powell Endowment for Economic Education to host a national teachers' conference attended by 100 teachers from 28 states.

The Bank also sponsored its first Districtwide Fed Challenge competition for high school students and cosponsored an innovative graduate course for economics teachers of deaf and hard-of-hearing students with Gallaudet University in Washington, D.C.

The Community Affairs Office supported the Federal Reserve System's efforts to encourage community reinvestment in several ways. These included a joint initiative with the Board of Governors' Community Affairs staff to promote better small business access to capital and credit in the District of Columbia's lower income neighborhoods.

Banking Supervision

The overall condition of banking organizations in the Fifth District remained strong in 1999. At year-end, the Bank supervised 230 bank holding companies that controlled total assets of approximately $1.1 trillion — the second highest total in the Federal Reserve System. Additionally, both the number of state member banks and the total assets of these banks were among the highest in the System. While merger activity decreased the number of state member banks by 23, five new state member banks opened, and three existing banks converted to state member status for a total of 128 banks with $94 billion in assets.

The Bank implemented a comprehensive strategy involving specialized teams of examiners to supervise large, complex banking organizations headquartered in the District and assigned senior examiners as central points of contact for all financial institutions with more than $1 billion in assets. In order to improve supervisory coordination, the Bank participated in joint, targeted reviews of the three largest banking organizations in the District with the Comptroller of the Currency and conducted joint meetings with senior management of these organizations. Coordination of examinations and inspections with regulators of other District banks improved in 1999; 30 state member bank examinations were conducted jointly with state regulators.

Financial Services and Other Operations

The financial services areas provided high quality, customer-focused services to depository institutions and the U.S. Treasury during 1999 and further improved most service-level effectiveness and quality measures. The Bank realized a financial services cost recovery rate of 103.9 percent for the year and met nearly all key service quality targets.

During 1999 the Bank participated in the first Federal Reserve System survey to measure customer satisfaction. In addition, it conducted a Fifth District quality survey for the Accounting, Automated Clearinghouse, Business Development, and Funds Transfer services. The results of both surveys indicated a high level of satisfaction with these services. Additionally, the District led efforts to enlist large credit unions as savings bond agents and trained their staffs in savings bond marketing. The financial services areas also took steps to utilize new technology to improve services. Check Processing introduced high-speed commercial check imaging systems in three District offices and increased the number of customers using check imaging services by 19. Bank staff also introduced new technology to process savings bond applications more efficiently and converted additional offline customers to electronic connections.

Staff at the Charlotte Office successfully met the challenges associated with serving as the key Federal Reserve account management office for four of the nation's largest banking organizations. The rapid expansion of these institutions added significantly to that office's account management responsibilities during the year.

The Bank also provided extensive support to the U.S. Treasury and other government agencies in 1999. A Bank officer continued to serve as the System's liaison to the Treasury; he coordinated a number of joint Treasury and Federal Reserve initiatives during the year and provided consultative support. Also, Bank staff worked closely with the Treasury to improve the efficiency of government payment and collection systems. The Currency Technology Office worked actively with the Bureau of Engraving and Printing on the design for the new $5 and $10 notes.

As a new century begins, and in keeping with its mission and vision, the Bank will continue to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payments systems.

DECEMBER 31, 1999

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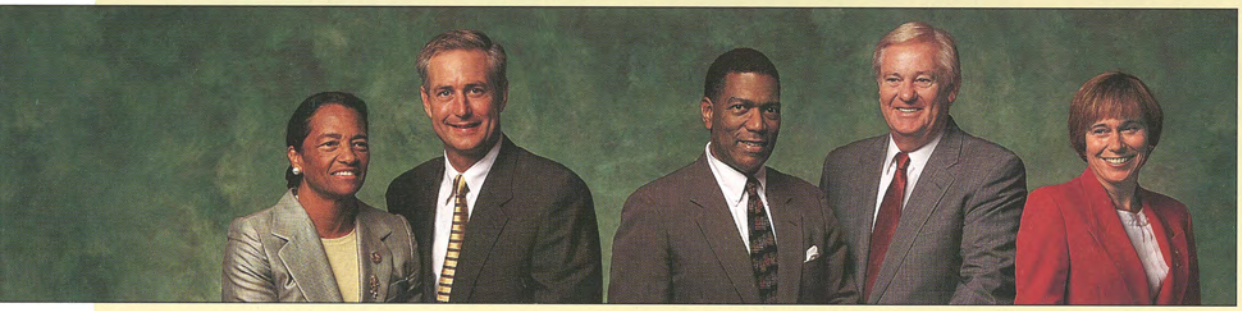

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DECEMBER 31, 1999

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DECEMBER 31, 1999

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DECEMBER 31, 1999

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Maryland Department of Housing
and Community Development
Crownsville, Maryland

DECEMBER 31, 1999

Changes in Official Staff

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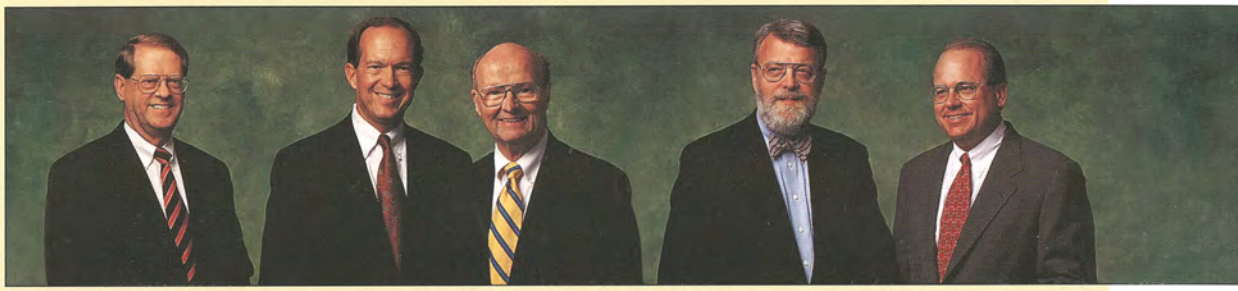
OF RICHMOND



James D. Reese; Robert E. Wetzel, Jr.; Lloyd W. Bostian, Jr.; James McAfee; Michael W. Newton

Dan M. Bechter; Joseph C. Ramage; Jeffrey S. Kane; Jeffrey M. Lacker; Marvin S. Goodfriend

Marvin S. Goodfriend assumed new responsibilities as senior vice president and policy advisor to the Bank president. Jeffrey M. Lacker was promoted to succeed Mr. Goodfriend as senior vice president and director of research.

Senior Vice President Lloyd W. Bostian, Jr., retired after 40 years of service to the Bank. Jeffrey S. Kane was promoted to succeed Mr. Bostian as senior vice president over the Banking Supervision and Regulation Department.

Gary W. Schemmel was appointed vice president in the Audit Department. Claudia N. MacSwain* was promoted to vice president with responsibility for the Strategic and Financial Planning Department.

In the Banking Supervision and Regulation Department, A. Linwood Gill, III*, was promoted to vice president and Barbara J. Moss* was promoted to assistant vice president. Vice President Fred L. Bagwell retired after 37 years of service to the Bank.

Hattie R. C. Barley* was promoted to assistant vice president in the Human Resources Department. Roland Costa* was promoted to assistant vice president over the Currency Technology Office, and Catherine S. Tyler* was promoted to assistant vice president in the Century Date Change Project Office. Raymond E. Owens, III, was promoted to research officer.

In the Legal Department, William R. McCorvey, Jr.*, and P. A. L. Nunley* were promoted to assistant general counsel. James R. Slate, assistant general counsel, retired after 29 years of service.

Alan H. Crooker* was appointed information technology officer and Rebecca J. Snider* was appointed discount officer over the Loans Department.

In Baltimore, David E. Beck was promoted to vice president with responsibility for the Cash and Fiscal Services Department and the Payment Services Department.

In Charlotte, Richard J. Kuhn was promoted to assistant vice president with responsibility for the Accounting and Planning Departments. A. Thomas Ray* was appointed operations officer with responsibility for the Check Processing, Check Services, and Check Support Departments. Helen S. Williams was appointed operations officer with responsibility for the Cash Department.

Carlisle C. Jones, Jr.*, was appointed assistant vice president over the Charleston, West Virginia, Regional Check Processing Center.

* indicates changes effective January 1, 2000

DECEMBER 31, 1999

Officers

FEDERAL RESERVE BANK
OF RICHMOND

RICHMOND

J. Alfred Broaddus, Jr.
PRESIDENT

Walter A. Varvel
FIRST VICE PRESIDENT

Marvin S. Goodfriend
SENIOR VICE PRESIDENT AND POLICY ADVISOR

Jeffrey S. Kane
SENIOR VICE PRESIDENT

Jeffrey M. Lacker
SENIOR VICE PRESIDENT AND DIRECTOR OF RESEARCH

James McAfee
SENIOR VICE PRESIDENT AND GENERAL COUNSEL

Michael W. Newton
SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER

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OPERATIONS OFFICER

CHARLESTON

Richard L. Hopkins
VICE PRESIDENT

COLUMBIA

Ronald D. Steele
VICE PRESIDENT

December 31, 1999

To the Board of Directors:

The management of the Federal Reserve Bank of Richmond (FRB Richmond) is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 1999 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks, and as such, include amounts, some of which are based on judgments and estimates of management.

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

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

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

Federal Reserve Bank of Richmond

J. Alfred Broaddus, Jr.
PRESIDENT

Walter A. Varvel
FIRST VICE PRESIDENT

Report of Independent Accountants

To the Board of Directors of the Federal Reserve Bank of Richmond:

We have examined management's assertion that the Federal Reserve Bank of Richmond ("FRB Richmond") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the Financial Statements as of December 31, 1999, included in the accompanying Management's Assertion.

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

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

In our opinion, management's assertion that the FRB Richmond maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the Financial Statements as of December 31, 1999, is fairly stated, in all material respects, based upon criteria described in "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

PricewaterhouseCoopers LLP

Richmond, Virginia
March 3, 2000

Report of Independent Accountants

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

We have audited the accompanying statements of condition of the Federal Reserve Bank of Richmond (the "Bank") as of December 31, 1999 and 1998, and the related statements of income and changes in capital for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on the financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 1999 and 1998, and results of its operations for the years then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

Richmond, Virginia
March 3, 2000

STATEMENTS OF CONDITION

(IN MILLIONS)	AS OF DECEMBER 31, 1999	1998
Assets		
Gold certificates	**$ 834**	$ 807
Special drawing rights certificates	**516**	792
Coin	**38**	53
Items in process of collection	**493**	624
Loans to depository institutions	**12**	—
U.S. government and federal agency securities, net	**36,404**	35,974
Investments denominated in foreign currencies	**3,356**	3,066
Accrued interest receivable	**366**	340
Interdistrict settlement account	**646**	4,985
Bank premises and equipment, net	**201**	201
Other assets	**90**	85
Total assets	**$42,956**	$46,927
Liabilities and Capital		
Liabilities:		
Federal Reserve notes outstanding, net	**$36,876**	$41,577
Deposits:		
Depository institutions	**1,957**	1,898
Other deposits	**48**	54
Deferred credit items	**566**	676
Surplus transfer due U.S. Treasury	**31**	157
Accrued benefit cost	**70**	64
Other liabilities	**26**	25
Total liabilities	**39,574**	44,451
Capital:		
Capital paid-in	**1,691**	1,238
Surplus	**1,691**	1,238
Total capital	**3,382**	2,476
Total liabilities and capital	**$42,956**	$46,927

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

STATEMENTS OF INCOME

(IN MILLIONS) FOR THE YEARS ENDED DECEMBER 31,	1999	1998
Interest Income		
Interest on U.S. government and federal agency securities	**$2,085**	$2,212
Interest on foreign currencies	**45**	65
Interest on loans to depository institutions	**1**	—
Total interest income	**2,131**	2,277
Other Operating Income (Loss)		
Income from services	**66**	65
Reimbursable services to government agencies	**31**	31
Foreign currency (losses) gains, net	**(105)**	290
U.S. government securities (losses) gains, net	**(2)**	3
Other income	**5**	4
Total other operating income (loss)	**(5)**	393
Operating Expenses		
Salaries and other benefits	**170**	157
Occupancy expense	**23**	24
Equipment expense	**74**	84
Assessments by Board of Governors	**85**	57
Other credits	**(48)**	(60)
Total operating expenses	**304**	262
Net income prior to distribution	**$1,822**	$2,408
Distribution of Net Income		
Dividends paid to member banks	**$ 86**	$ 61
Transferred to surplus	**453**	420
Payments to U.S. Treasury as interest on Federal Reserve notes	**1,283**	733
Payments to U.S. Treasury as required by statute	**—**	1,194
Total distribution	**$1,822**	$2,408

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

STATEMENTS OF CHANGES IN CAPITAL

FOR THE YEARS ENDED DECEMBER 31, 1999 AND DECEMBER 31, 1998
(IN MILLIONS)

	Capital Paid-in	Surplus	Total Capital
Balance at January 1, 1998			
(16.7 million shares)	$ 833	$ 818	$1,651
Net income transferred to surplus	—	420	420
Net change in capital stock issued			
(8.0 million shares)	405	—	405
Balance at December 31, 1998			
(24.7 million shares)	$1,238	$1,238	$2,476
Net income transferred to surplus	—	453	453
Net change in capital stock issued			
(9.1 million shares)	453	—	453
Balance at December 31, 1999			
(33.8 million shares)	**$1,691**	**$1,691**	**$3,382**

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

NOTES TO FINANCIAL STATEMENTS

1. Organization

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

Structure

The Bank and its branches in Richmond, Virginia; Baltimore, Maryland; and Charlotte, North Carolina, serve the Fifth Federal Reserve District, which includes Maryland, North Carolina, South Carolina, Virginia, the District of Columbia, and a portion of West Virginia. In accordance with the Federal Reserve Act, supervision and control of the Bank is exercised by a board of directors. Banks that are members of the System include all national banks and any state chartered bank that applies and is approved for membership in the System.

Board of Directors

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

2. Operations and Services

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

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of securities, matched sale-purchase transactions, the purchase of securities under agreements to resell, and the lending of U.S. government securities. Additionally, the FRBNY is authorized by the FOMC to hold balances of and to execute spot and forward foreign exchange and securities contracts in fourteen foreign currencies, maintain reciprocal currency arrangements ("F/X swaps") with various central banks, and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks.

3. Significant Accounting Policies

Accounting principles for entities with the unique powers and responsibilities of the nation's central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared to the private sector. These accounting principles and practices are documented in the "Financial Accounting Manual for Federal Reserve Banks" ("Financial Accounting Manual"), which is issued by the Board of Governors. All Reserve Banks are required to adopt and

apply accounting policies and practices that are consistent with the Financial Accounting Manual.

The financial statements have been prepared in accordance with the Financial Accounting Manual. Differences exist between the accounting principles and practices of the System and generally accepted accounting principles in the United States ("GAAP"). The primary differences are the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP, and the accounting for matched sale-purchase transactions as separate sales and purchases, rather than secured borrowings with pledged collateral, as is required by GAAP. In addition, the Bank has elected not to present a Statement of Cash Flows or a Statement of Comprehensive Income. The Statement of Cash Flows has not been included as the liquidity and cash position of the Bank are not of primary concern to the users of these financial statements. The Statement of Comprehensive Income, which comprises net income plus or minus certain adjustments, such as the fair value adjustment for securities, has not been included because as stated above the securities are recorded at amortized cost and there are no other adjustments in the determination of Comprehensive Income applicable to the Bank. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. Therefore, a Statement of Cash Flows or a Statement of Comprehensive Income would not provide any additional useful information. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

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

a. Gold Certificates

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

b. Special Drawing Rights Certificates

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDRs, at the direction of the U.S. Treasury, for the purpose of financing SDR certificate acquisitions or for financing exchange stabilization operations. The Board of Governors allocates each SDR transaction among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year.

c. Loans to Depository Institutions

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

The Board of Governors established a Special Liquidity Facility (SLF) to make discount window credit readily available to depository institutions in sound financial condition around the century date change (October 1, 1999, to April 7, 2000) in order

to meet unusual liquidity demands and to allow institutions to confidently commit to supplying loans to other institutions and businesses during this period. Under the SLF, collateral requirements are unchanged from normal discount window activity and loans are made at a rate of 150 basis points above FOMC's target federal funds rate.

d. U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies

The FOMC has designated the FRBNY to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account ("SOMA"). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or other needs specified by the FOMC in carrying out the System's central bank responsibilities.

Purchases of securities under agreements to resell and matched sale-purchase transactions are accounted for as separate sale and purchase transactions. Purchases under agreements to resell are transactions in which the FRBNY purchases a security and sells it back at the rate specified at the commencement of the transaction. Matched sale-purchase transactions are transactions in which the FRBNY sells a security and buys it back at the rate specified at the commencement of the transaction.

Effective April 26, 1999 FRBNY was given the 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, 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 amounts in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by FRBNY on a daily basis, with additional collateral obtained as necessary. The securities loaned continue to be accounted for in the SOMA. Prior to April 26, 1999 all Reserve Banks were authorized to engage in such lending activity.

Foreign exchange contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed upon period of time (up to twelve months), at an agreed upon interest rate. These arrangements give the FOMC temporary access to foreign currencies that it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank, and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The FRBNY will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

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

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts which contain varying degrees of off-balance sheet market risk, because they represent contractual commitments involving future settlement, and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

While the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio from time to time involve transactions that can result in gains or losses when holdings are sold prior to maturity. However, decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, earnings and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government and federal agency securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income is accrued on a straight-line basis and is reported as "Interest on U.S. government and federal agency securities" or "Interest on foreign currencies," as appropriate. Income earned on securities lending transactions is reported as a component of "Other income." Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Gains and losses on the sales of U.S. government and federal agency securities are reported as "U.S. government securities (losses) gains, net." Foreign currency denominated assets are revalued monthly at current market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency (losses) gains, net." Foreign currencies held through F/X swaps, when initiated by the counter party, and warehousing arrangements are revalued monthly, with the unrealized gain or loss reported by the FRBNY as a component of "Other assets" or "Other liabilities," as appropriate.

Balances of U.S. government and federal agencies securities bought outright, investments denominated in foreign currency, interest income, amortization of premiums and discounts on securities bought outright, gains and losses on sales of securities, and realized and unrealized gains and losses on investments denominated in foreign currencies, excluding those held under an F/X swap arrangement, are allocated to each Reserve Bank. Effective April 26, 1999 income from securities lending transactions undertaken by FRBNY was also allocated to each Reserve Bank. Securities purchased under agreements to resell and unrealized gains and losses on the revaluation of foreign currency holdings under F/X swaps and warehousing arrangements are allocated to FRBNY and not to other Reserve Banks.

e. Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from 2 to 50 years. New assets, major alterations, renovations and improvements are capitalized at cost as additions to the asset accounts. Maintenance, repairs and minor replacements are charged to operations in the year incurred.

f. Interdistrict Settlement Account

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

g. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents to the Reserve Banks upon deposit with such Agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve Agent must be equal to the sum of the notes applied for by such Reserve Bank. In accordance with the Federal Reserve Act, gold certificates, special drawing rights certificates, U.S. government and agency securities, loans, and investments denominated in foreign currencies are pledged as collateral for net Federal Reserve notes outstanding. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, whose collateral value is equal to the par value of the securities tendered. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. The Reserve Banks have entered into an agreement which provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks in order to satisfy their obligation of providing sufficient collateral for outstanding Federal Reserve notes. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents Federal Reserve notes reduced by cash held in the vaults of the Bank of $17,884 million and $9,343 million at December 31, 1999 and 1998, respectively.

h. Capital Paid-in

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

the Reserve Bank's stock must be adjusted. Member banks are those state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of $100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6% on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

i. Surplus

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

The Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66, Section 3002) codified the existing Board surplus policies as statutory surplus transfers, rather than as payments of interest on Federal Reserve notes, for federal government fiscal years 1998 and 1997 (which ended on September 30, 1998 and 1997, respectively). In addition, the legislation directed the Reserve Banks to transfer to the U.S. Treasury additional surplus funds of $107 million and $106 million during fiscal years 1998 and 1997, respectively. Reserve Banks were not permitted to replenish surplus for these amounts during this time. Payments to the U.S. Treasury made after September 30, 1998, represent payment of interest on Federal Reserve notes outstanding.

The Consolidated Appropriations Act of 1999 (Public Law 106-113, Section 302) directed the Reserve Banks to transfer to the U.S. Treasury additional surplus funds of $3,752 million during the Federal Government's 2000 fiscal year. The Reserve Banks will make this payment prior to September 30, 2000.

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

j. Income and Cost Related to Treasury Services

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services. The costs of providing fiscal agency and depository services to the Treasury Department that have been billed but not paid are immaterial and included in "Other credits."

k. Taxes

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

4. U.S. Government and Federal Agency Securities

Securities bought outright and held under agreements to resell are held in the SOMA at the FRBNY. An undivided interest in SOMA activity, with the exception of securities held under agreements to resell and the related premiums, discounts and income, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings. The settlement, performed in April of each year, equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was approximately 7.523% and 7.877% at December 31, 1999 and 1998, respectively.

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

	1999	1998
Par value:		
Federal agency	$ 14	$ 27
U.S. government:		
Bills	13,279	15,343
Notes	16,435	14,801
Bonds	6,243	5,473
Total par value	35,971	35,644
Unamortized premiums	684	582
Unaccreted discounts	(251)	(252)
Total allocated to Bank	**$36,404**	**$35,974**

Total SOMA securities bought outright were $483,902 million and $456,667 million at December 31, 1999 and 1998, respectively.

The maturities of U.S. government and federal agency securities bought outright, which were allocated to the Bank at December 31, 1999, were as follows (in millions):

	PAR VALUE		
Maturities of Securities Held	**U.S. Government Securities**	**Federal Agency Obligations**	**Total**
Within 15 days	$ 348	$—	$ 348
16 days to 90 days	6,916	2	6,918
91 days to 1 year	10,522	2	10,524
Over 1 year to 5 years	9,341	1	9,342
Over 5 years to 10 years	3,845	9	3,854
Over 10 years	4,985	—	4,985
Total	**$35,957**	**$14**	**$35,971**

At December 31, 1999, and 1998, matched sale-purchase transactions involving U.S. government securities with par values of $39,182 million and $20,927 million, respectively, were outstanding, of which $2,948 million and $1,648 million were allocated to the Bank. Matched sale-purchase transactions are generally overnight arrangements.

5. Investments Denominated in Foreign Currencies

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

Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on F/X swaps and warehousing transactions. This allocation is based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. The Bank's allocated share of investments denominated in foreign currencies was approximately 20.792% and 15.499% at December 31, 1999 and 1998, respectively.

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

	1999	1998
German Marks:		
Foreign currency deposits	$ —	$1,620
Government debt instruments including agreements to resell	—	368
European Union Euro:		
Foreign currency deposits	901	—
Government debt instruments including agreements to resell	528	—
Japanese Yen:		
Foreign currency deposits	67	103
Government debt instruments including agreements to resell	1,850	960
Accrued interest	10	15
Total	**$3,356**	**$3,066**

Total investments denominated in foreign currencies were $16,140 million and $19,769 million at December 31, 1999 and 1998, respectively. The 1998 balance includes $15 million in unearned interest collected on certain foreign currency holdings that is allocated solely to the FRBNY.

The maturities of investments denominated in foreign currencies which were allocated to the Bank at December 31, 1999, were as follows (in millions):

MATURITIES OF INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES	
Within 1 year	$3,134
Over 1 year to 5 years	103
Over 5 years to 10 years	119
Total	**$3,356**

At December 31, 1999 and 1998, there were no open foreign exchange contracts or outstanding F/X swaps.

At December 31, 1999 and 1998, the warehousing facility was $5,000 million with nothing outstanding.

6. Bank Premises and Equipment

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

	1999	1998
Bank premises and equipment:		
Land	$ 16	$ 16
Buildings	116	115
Building machinery and equipment	35	32
Construction in progress	3	3
Furniture and equipment	234	288
	404	454
Accumulated depreciation	(203)	(253)
Bank premises and equipment, net	**$201**	**$201**

Depreciation expense was $35 million and $44 million for the years ended December 31, 1999 and 1998, respectively.

Bank premises and equipment at December 31 include the following amounts for leases that have been capitalized (in millions):

	1999	1998
Bank premises and equipment	$33	$86
Accumulated depreciation	(19)	(77)
Capitalized leases, net	**$14**	**$ 9**

The Bank leases unused space to outside tenants. Those leases have terms ranging from 1 to 2 years. Rental income from such leases was $1.4 million for each of the years ended December 31, 1999 and 1998. Future minimum lease payments under agreements in existence at December 31, 1999, were (in millions):

2000	$1.1
2001	0.9
	$2.0

7. Commitments and Contingencies

At December 31, 1999, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from 1 to approximately 5 years. These leases provide for increased rentals based upon increases in real estate taxes, operating costs or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $36 million and $37 million for the years ended December 31, 1999 and 1998, respectively. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases and capital leases, net of sub-lease rentals, with terms of one year or more, at December 31, 1999, were (in thousands):

	OPERATING	CAPITAL
2000	$1,119	$1,158
2001	847	692
2002	455	344
2003	236	55
2004	138	—
	$2,795	2,249
Amount representing interest		(123)
Present value of net minimum lease payment		**$2,126**

At December 31, 1999, there were no other commitments and long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks dated as of March 2, 1999, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of 1% of the capital paid-in of the claiming Reserve Bank, up to 50% of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 1999 or 1998.

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

8. Retirement and Thrift Plans

Retirement Plans

The Bank currently offers two defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank's employees participate in the Retirement Plan for Employees of the Federal Reserve System ("System Plan") and the Benefit Equalization Retirement Plan ("BEP"). The System Plan is a multi-employer plan with contributions fully funded by participating employers. No separate accounting is maintained of assets contributed by the participating employers. The Bank's projected benefit obligation and net pension costs for the BEP at December 31, 1999 and 1998, and for the years then ended, are not material.

Thrift plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled $5 million and $3 million for the years ended December 31, 1999 and 1998, respectively, and are reported as a component of "Salaries and other benefits."

9. Postretirement Benefits Other Than Pensions and Postemployment Benefits

Postretirement benefits other than pensions

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

The Bank funds benefits payable under the medical and life insurance plans as due and, accordingly, has no plan assets. Net postretirement benefit cost is actuarially determined using a January 1 measurement date. Following is a reconciliation of beginning and ending balances of the benefit obligation (in millions):

	1999	1998
Accumulated postretirement benefit obligation at January 1	$67.2	$54.1
Service cost-benefits earned during the period	2.1	1.8
Interest cost of accumulated benefit obligation	4.0	3.9
Actuarial (gain)/loss	(7.5)	9.3
Contributions by plan participants	0.3	0.3
Benefits paid	(2.3)	(2.2)
Accumulated postretirement benefit obligation at December 31	**$63.8**	**$67.2**

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

	1999	1998
Fair value of plan assets at January 1	$ —	$ —
Actual return on plan assets	—	—
Contributions by the employer	2.0	1.9
Contributions by plan participants	0.3	0.3
Benefits paid	(2.3)	(2.2)
Fair value of plan assets at December 31	**$ —**	**$ —**
Unfunded postretirement benefit obligation	$63.8	$67.2
Unrecognized prior service cost	0.7	0.7
Unrecognized net actuarial (loss)	(5.0)	(12.7)
Accrued postretirement benefit cost	**$59.5**	**$55.2**

Accrued postretirement benefit cost is reported as a component of "Accrued benefit cost."

The weighted-average assumption used in developing the postretirement benefit obligation as of December 31, 1999 and 1998 was 7.5% and 6.25%, respectively.

For measurement purposes, an 8.75% annual rate of increase in the cost of covered health care benefits was assumed for 2000. Ultimately, the health care cost trend rate is expected to decrease gradually to 5.50% by 2006, and remain at that level thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 1999 (in millions):

	1 PERCENTAGE POINT INCREASE	1 PERCENTAGE POINT DECREASE
Effect on aggregate of service and interest cost components of net periodic postretirement benefit cost	$ 1.5	$(1.1)
Effect on accumulated postretirement benefit obligation	11.3	(9.3)

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

	1999	1998
Service cost-benefits earned during the period	$2.1	$1.8
Interest cost of accumulated benefit obligation	4.0	3.9
Recognized net actuarial loss	0.2	—
Net periodic postretirement benefit cost	**$6.3**	**$5.7**

Net periodic postretirement benefit cost is reported as a component of "Salaries and other benefits."

Postemployment benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, and disability benefits. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank at December 31, 1999 and 1998, were $10.1 million and $8.8 million, respectively. This cost is included as a component of "Accrued benefit cost." Net periodic postemployment benefit costs included in 1999 and 1998 operating expenses were $2.0 million and $1.9 million, respectively.

SUMMARY OF OPERATIONS

(UNAUDITED)	DOLLAR AMOUNT 1999	DOLLAR AMOUNT 1998	VOLUME 1999	VOLUME 1998
Cash				
Currency received and counted	**39.3 Billion**	30.9 Billion	**3.3 Billion**	2.5 Billion
Currency destroyed	**6.8 Billion**	7.0 Billion	**638.9 Million**	609.5 Million
Coin bags received and counted	**55.0 Million**	71.5 Million	**84.6 Thousand**	124.5 Thousand
Noncash Payments				
Commercial checks processed	**1.3 Trillion**	1.2 Trillion	**1.7 Billion**	1.6 Billion
Commercial checks, packaged items handled	**574.9 Billion**	494.2 Billion	**837.8 Million**	783.2 Million
U.S. government checks processed	**45.7 Billion**	62.2 Billion	**30.6 Million**	35.7 Million
Automated Clearing House transactions:				
Commercial	**789.4 Billion**	650.5 Billion	**226.3 Million**	178.0 Million
Government	**368.1 Billion**	347.3 Billion	**3.7 Million**	17.8 Million
Fedwire funds transfers	**18.9 Trillion**	18.7 Trillion	**10.3 Million**	9.9 Million
Loans to Depository Institutions				
Discount window loans made	**2.8 Billion**	2.0 Billion	**146**	39
Securities Services				
Safekeeping balance of book-entry securities as of December 31	**241.4 Billion**	278.0 Billion	**N/A**	N/A
Fedwire securities transfers	**16.5 Trillion**	10.1 Trillion	**855.5 Thousand**	674.9 Thousand
Services to U.S. Treasury and Government Agencies				
Issues, redemptions, and exchanges of U.S. savings bonds	**776.5 Million**	760.2 Million	**6.5 Million**	8.8 Million
Federal tax deposits processed	**236.9 Million**	239.8 Million	**9.2 Thousand**	10.9 Thousand
Food stamps redeemed	**513.8 Million**	902.7 Million	**106.0 Million**	176.1 Million

N/A = not applicable

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