
84th Annual Report
1997



Board of Governors of the Federal Reserve System

This publication is available from the Board of Governors of the Federal Reserve System, Publications Services, Mail Stop 127, Washington, DC 20551. It is also available at the Board's World Wide Web site, at <http://www.bog.frb.fed.us/>

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., May 29, 1998

THE SPEAKER OF
THE HOUSE OF REPRESENTATIVES

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

This report covers operations of the Board during calendar year 1997.

Sincerely,

A handwritten signature in black ink, appearing to read "Alan Greenspan". The signature is fluid and cursive, with the first name "Alan" and the last name "Greenspan" clearly distinguishable.

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Part 1

*Monetary Policy and
the U.S. Economy in 1997*

Overview: Monetary Policy and the Economy in 1997

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

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

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

Robust growth of spending early in the year heightened concerns among members of the Federal Open Market Committee (FOMC) that growing strains on productive resources might touch off a faster rate of cost and price rise that could eventually undermine the expansion. Financial market participants seemed to share these concerns: Intermediate- and long-term interest rates began moving up in December 1996, effectively anticipating Federal Reserve action. When the FOMC firmed policy slightly at its March 1997 meeting by raising the intended federal funds rate from 5¼ percent to 5½ percent, the market response was small.

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

NOTE. The discussion here and in the next chapter is adapted from *Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978* (Board of Governors, February 1998).

cit was becoming more apparent. As a consequence, by the end of September, longer-term interest rates fell $\frac{3}{4}$ percentage point from their peaks in mid-April, leaving them about $\frac{1}{4}$ percentage point below their levels at the end of 1996. The decline in interest rates, together with continued reports of brisk growth in corporate profits, sparked steep increases in equity prices between April and September.

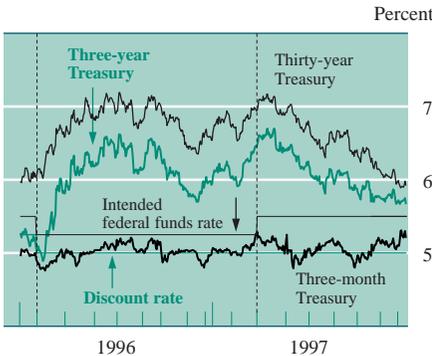
Even with a more moderate pace of growth, labor markets continued to tighten, generating concern among FOMC members over this period that rising costs might trigger a rise in inflation. Consequently, at its meetings from May through November, the Committee adopted directives for the conduct of policy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

additional restraint against the possible emergence of greater inflation pressures.

In the latter part of the year, developments in other parts of the world began to alter the perceived risks attending the U.S. economic outlook. Foreign economies generally had seemed to be on a strengthening growth path at midyear. But over the remainder of the summer and during the autumn, severe financial strains surfaced in a number of economies in Asia, weakening somewhat the outlook for growth abroad and thus the prospects for U.S. exports. The problems these economies encountered generally resulted in severe downward pressures on the foreign exchange values of their currencies; in some cases, steep depreciations occurred despite substantial upward movement of interest rates. Asset values in parts of Asia, notably equity and real estate prices, also declined appreciably, leading to losses by financial institutions that had either invested in those assets or lent against them; nonfinancial firms began to encounter problems servicing their obligations. In many instances the debts of nonfinancial and financial firms were denominated in dollars and unhedged. Concerted international efforts to bring economic and financial stability to the region were under way as the year drew to a close. Meanwhile, economic activity in Japan stagnated, and the weaknesses in the Japanese financial system became more apparent.

The difficulties in Asia contributed to additional declines of $\frac{1}{4}$ to $\frac{1}{2}$ percentage point in the yields on intermediate- and long-term Treasury securities in the United States between mid-autumn and the end of the year. The decreases were due in part to an international flight to the safe haven of dollar assets, but they also reflected expectations that these difficulties would exert a moderating influence on the growth of aggregate

Selected Interest Rates



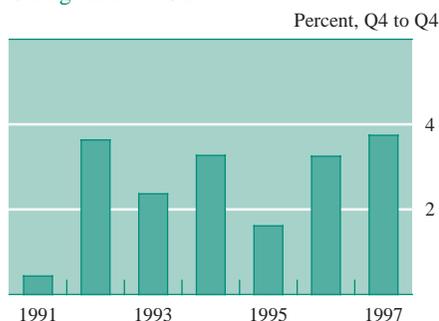
NOTE. Small tick marks refer to dates in 1996 and 1997 on which the Federal Open Market Committee held scheduled meetings. Dashed lines indicate dates of meetings at which the Committee announced a monetary policy action: January 31, 1996, and March 25, 1997. The data are daily.

gate demand and inflation in the United States. In light of the ongoing difficulties in Asia and the possible effects on the United States, the FOMC not only left interest rates unchanged in December but shifted its instructions to the Manager of the System Open Market Account to symmetry between ease and tightening in the near term. The inflation risk from a tight labor market and accelerating wages seemed to be roughly balanced over the near term by the effects of a number of other factors, including the economic weakness in Asia, a slump in the prices of oil and other commodities in the latter part of 1997, and the restraint on import prices from the substantial appreciation of the dollar against most other currencies over the preceding few quarters. ■

U.S. Economic and Financial Developments in 1997

The year 1997 was an exceptionally good one for the U.S. economy. Real GDP increased 3¾ percent over the four quarters of the year. Household and business expenditures continued to rise rapidly, owing in part to supportive financial conditions, including a strong stock market, ample availability of credit, and, from April onward, declining intermediate- and long-term interest rates. In the aggregate, private domestic spending on consumption and investment rose 5 percent on an inflation-adjusted basis. The strength of spending, along with a further sizable appreciation of the foreign exchange value of the U.S. dollar, brought a surge of imports, the largest in many years. The growth of exports, while lagging that of imports, also was substantial despite the appreciation of the dollar and the emergence after midyear of severe financial difficulties in several foreign economies, particularly among the advanced developing countries in Asia.

Change in Real GDP



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

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

The Household Sector

Consumption Spending, Income, and Saving

Bolstered by increases in income and wealth, personal consumption expenditures rose more than 3½ percent in 1997. Expenditures were strong for a wide variety of durable goods. Real outlays on home computers continued to soar, rising even faster than they had over the previous few years. Strength was also reported in purchases of home goods, and consumer expenditures on motor vehicles more than reversed the small declines of the previous two years. At the same time, real expenditures on services scored the largest gain of the past several years, rising 4 percent.

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

Measured in terms of annual averages, the personal saving rate fell further in 1997. The yearly average of 3.9 percent was almost $\frac{1}{2}$ percentage point below the 1996 average and nearly a full percentage point below the 1995 average. It also was the lowest annual reading in several decades. Various surveys of households indicated that consumers had become more optimistic about prospects for the economy, and their optimism may have led them to spend more freely from current income. Support for additional spending came from the further rise in the stock market, as the capital gains accruing to households increased the chances of their meeting longer-run net worth objectives even as they consumed a larger proportion of current income.

Residential Investment

Real residential investment increased about $5\frac{1}{2}$ percent during 1997. Outlays for the construction of new single-family structures rose moderately, and spending on the construction of multifamily units continued to recover from the extreme lows that were reached earlier in the decade. Real outlays for home improvements and brokers' commissions, categories that have a combined weight of more than 35 percent in total residential investment, moved up substantially from the final quarter of 1996 to the final quarter of 1997. Spending on mobile homes, a small part of the total, also advanced.

The indicators of single-family housing activity were almost uniformly strong during the year. Sales of houses surged, driven by declines in mortgage interest rates and the increasingly favorable economic circumstances of households. Annual sales of new single-family houses were up 6 percent from the number sold in the preceding year,

and sales of existing homes increased about 3 percent. House prices moved up more quickly than prices in general. Responding to the strong demand, starts of new single-family units remained at a high level, only a touch below that of 1996; the annual total for single-family units exceeded 1 million units for a sixth consecutive year, putting the current expansion in single-family housing construction nearly on a par with that of the 1980s in terms of longevity and strength.

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

The home-ownership rate—the number of households that own their dwellings divided by the total number of households—moved up further in 1997, to about $65\frac{3}{4}$ percent, a historical high. The rate fell in the 1980s but has risen almost 2 percentage points in this decade.

Household Finance

Household net worth grew more than $\$3\frac{1}{2}$ trillion during 1997, ending the year at its highest multiple relative to disposable personal income on record. Most of the increase was the result of upward revaluations of household assets rather than additional saving. In particular, capital gains on corporate equities accounted for about three-fourths of the increase. Flows of household assets into mutual funds, pensions, and other vehicles for holding equities indirectly were

exceeded by outflows from directly held equities.

Household borrowing not backed by real estate, including credit card balances, auto loans, and other consumer credit, increased 4½ percent in 1997. These obligations grew at double-digit rates in 1994 and 1995 but slowed fairly steadily thereafter. Mortgage borrowing, which has experienced relatively muted swings in growth during the current expansion, increased 7¼ percent in 1997, a gain that was only a bit less than the rise in 1996. Within the mortgage category, however, home equity loans advanced sharply, reflecting in part the increased use of these loans in refinancing and consolidating credit card and other consumer obligations.

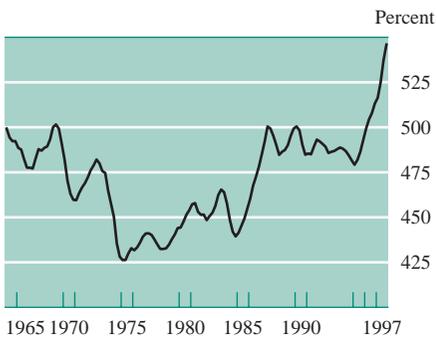
An element in the slowing of consumer credit growth may have been assessments by some households that they were reaching the limits of their capacity for carrying debt and by some lenders that they needed to selectively tighten their standards for granting new loans. In the mid-1990s, the percentage of household income required to meet debt obligations rose to the upper end of its historical range, in large part because of a sharp rise in credit card debt. Between 1994 and 1996 personal bankruptcies grew at an annual rate of more

than 20 percent, to some extent because of households' rising debt burden; a change in the federal bankruptcy law and a secular trend toward associating less social stigma with bankruptcy also may have contributed. Over the same period, delinquency and charge-off rates on consumer loans increased significantly.

In 1997, however, because the growth of household debt only moderately outpaced that of income at the same time that interest rates were drifting lower, the household debt-service burden did not change. Reflecting, in part, the stability of the aggregate household debt burden, delinquency rates for many segments of consumer credit plateaued, although charge-off rates generally continued to rise somewhat. Personal bankruptcies advanced again in 1997 but slowed considerably in the second half of the year.

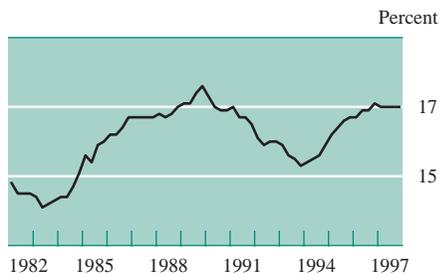
Some of the apparent flattening of household debt-repayment problems may also have resulted from efforts by lenders to stem the growth of losses on consumer loans. In both 1996 and 1997, a large percentage of the respondents to the Federal Reserve's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices reported tightened standards on consumer loans. However,

Household Net Worth



NOTE. As a percentage of disposable personal income; four-quarter moving average.

Household Debt-Service Burden



NOTE. As a percentage of disposable personal income. Debt service is the sum of estimated required interest and principal payments on consumer and household-sector mortgage debt. The data are quarterly.

the percentages reporting tightening fell a bit in the latter part of that period, suggesting that many banks felt that they had altered their standards sufficiently.

Although banks pulled back a bit from consumer lending in 1997, most households had little trouble obtaining credit. Bank restraint most commonly took the form of lower credit limits or higher finance charges on outstanding balances; credit card solicitations continued at a record pace.

The Business Sector

Investment Expenditures

Adjusted for inflation, business outlays for fixed investment rose 9 percent over 1997 after gaining about 12 percent over 1996. Spending continued to be spurred by rapid growth of the economy, favorable financial conditions, attractive purchase prices for new equipment, and optimism about the future. Business outlays for equipment, which account for more than three-fourths of total business fixed investment, moved up about 13 percent over 1997, making it the fourth year of the last five in which the annual gains have exceeded 10 percent. As in previous years of the expansion, the most striking gains were posted for computers, the power of which continued to advance rapidly at the same time prices continued to decline. Spending also moved up briskly for many other types of equipment, including communications equipment, commercial aircraft, industrial machinery, and construction machinery.

Real outlays for nonresidential construction, the remaining portion of business fixed investment, declined slightly in 1997 after moving up in each of the four previous years. Construction of office buildings continued to increase in 1997, but sluggishness was reported in

the expenditure data for other commercial buildings and industrial buildings. Other indicators of market conditions pointed to underlying firmness in nonresidential construction. Vacancy rates declined, for example, and rents seemed to be picking up. In some regions of the country, more builders were putting up new office buildings on “spec”—that is, undertaking new construction before occupants had been lined up. The new projects were apparently being spurred to some degree by the ready availability of financing.

Business inventory investment picked up considerably in 1997. The level of inventories held by nonfarm businesses rose more than 5 percent in real terms over the course of the year after increasing roughly 2 percent in 1996. Accumulation was especially rapid in the commercial aircraft industry, in which production was being ramped up in response to a huge backlog of orders for new jet aircraft. With the rate of inventory growth outpacing the growth of final sales in 1997, the stock-to-sales ratio for the nonfarm sector ticked up slightly after declining slightly in the preceding year. Nonetheless, businesses in general did not appear to be uncomfortable with the levels of stocks they were carrying at year-end.

Corporate Profits and Business Finance

Despite a fourth-quarter downturn, the annual economic profits of corporate businesses—that is, book profits after inventory valuation and capital consumption adjustments—increased about 9½ in 1997 after gaining 13¼ percent in 1996. Profits from the foreign operations of these corporations rose only moderately in 1997, but the profits from domestic operations, by far the larger share of the total, posted further strong

gains—about 16 percent for financial corporations and more than 9 percent for nonfinancial corporations, in terms of annual totals. For the year, the profits of nonfinancial corporations from domestic operations amounted to about 13½ percent of the nominal domestic output of those corporations, up from 7¾ percent in 1982 and the highest annual share since the late 1960s. The elevated profit share reflected both a high level of cash flow before interest costs, which was also at a multiyear peak relative to output, and the declines in interest costs that have taken place in the 1990s. In their profit announcements for the fourth quarter, few corporations reported that they had experienced much fallout from the events in Asia, but many warned that profits in the first half of 1998 could be significantly affected.

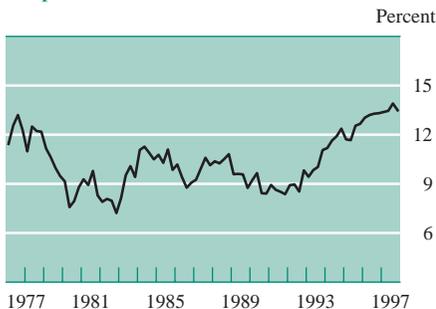
Despite the rapid growth of profits, the financing gap for nonfinancial corporations—capital expenditures less internal cash flow—widened over the year, reflecting the strong expansion of spending on capital equipment and inventories. Furthermore, on net, firms continued to retire a large volume of equity, adding further to borrowing needs, as substantial gross issuance was swamped by stock repurchases and

merger-related retirements. Given these financing requirements, the growth of nonfinancial corporate debt picked up to 8 percent in 1997.

With the debt of nonfinancial corporations advancing briskly, the ratio of their interest payments to cash flow was about unchanged in 1997 after several years of decline that had left the ratio at quite a low level. Consequently, measures of debt-repayment difficulties also were very favorable: The default rate on corporate bonds remained extremely low, and the number of upgrades of debt about equaled the number of downgrades. Similarly, only small percentages of business loans at banks were delinquent or charged off. The rate of business bankruptcies increased a bit but was still fairly low.

Businesses continued to find credit amply supplied at advantageous terms in 1997. The spreads between yields on investment-grade bonds and yields on Treasury securities of similar maturities remained narrow, varying only a little during the year. The spreads between yields on below-investment-grade bonds and those on Treasury securities fell during the year, touching new lows before widening a bit in the fall; the widening occurred in large part because these securities benefited less from the flight to U.S. assets in response to events in Asia than did securities of the Treasury. Banks also appeared eager to lend to businesses. Large percentages of respondents to the Federal Reserve surveys, citing stiff competition as the reason, said they had eased terms on business loans—particularly the spreads between loan rates and banks' cost of funds. Much smaller percentages reported having eased standards on these loans. The high ratios of stock prices to earnings indicate that equity finance was also quite cheap in 1997. Nevertheless, the market for initial public offerings of

Corporate Profits before Taxes



NOTE. Profits of nonfinancial corporations from domestic operations, with inventory valuation and capital consumption adjustments, as a percentage of the gross domestic product of the nonfinancial corporate sector.

equity was cooler than in 1996: New issues were priced below the expected range more often than above it, and first-day trading returns were smaller on average.

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

The Government Sector

Federal Expenditures, Receipts, and Finance

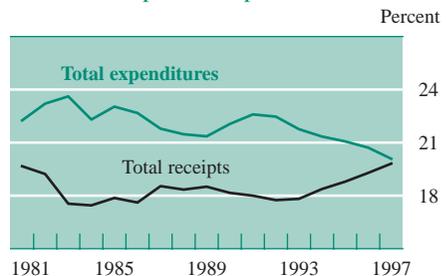
Nominal outlays in the unified budget increased about 2½ percent in fiscal year 1997 after moving up 3 percent in fiscal 1996. Fiscal 1997 was the sixth consecutive year in which the growth of spending was less than the growth of nominal GDP. During that period, spending as a percentage of nominal GDP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

the strength of the economy, which has reduced outlays for income support.

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

Real federal outlays for consumption and gross investment, the part of federal spending that is counted in GDP, declined slightly, on net, from the fourth quarter of 1996 to the fourth quarter of 1997. Real outlays for defense, which account for about two-thirds of the spending for consumption and invest-

Federal Receipts and Expenditures



NOTE. As a percentage of nominal GDP. Data on receipts and expenditures are from the unified budget; years are fiscal years.

ment, edged lower, as did nondefense outlays. Because of much larger declines in most other recent years, the level of real defense outlays at the end of 1997 was down about 23 percent from its level at the end of the 1980s; total real outlays for consumption and investment dropped nearly 15 percent over that period.

Federal receipts rose faster than nominal GDP in fiscal 1997 for a fifth consecutive year; receipts were 19³/₄ percent of GDP, up from 17³/₄ percent in fiscal 1992. The ratio tends to rise during business expansions, mainly because of cyclical increases in the share of profits in nominal GDP. In recent years, the ratio has also been boosted by the tax increases included in the Omnibus Reconciliation Act of 1993, by a rise in the share of income going to high-income taxpayers, and by receipts from surging capital gains realizations, which raise the numerator of the ratio but not the denominator because capital gains realizations are not part of GDP. In fiscal 1997, combined receipts from individual income taxes and social insurance taxes, which account for about 80 percent of total receipts, moved up about 9¹/₂ percent, even more than in fiscal 1996. Receipts from taxes on corporate profits were up about 6 percent after increasing about 9¹/₂ percent in fiscal 1996. The total rise in receipts in fiscal 1997, coupled with the subdued rate of increase in nominal outlays, resulted in a budget deficit of \$22 billion, down from \$107 billion in the preceding fiscal year.

With the budget moving close to balance, federal borrowing slowed sharply in 1997. The Treasury responded to the smaller-than-expected borrowing need by selling fewer bills so as to keep its auctions of coupon securities predictable and of sufficient volume to maintain the liquidity of the secondary markets. The result was an unusually large

net redemption of bills, which at times pushed yields on short-term bills down relative to yields on other Treasury securities and on short-term private obligations.

The year saw the first issuance by the Treasury of inflation-indexed securities. The Treasury sold indexed ten-year notes in January and April, and five-year notes in July and October; a sale of indexed thirty-year bonds was scheduled for April 1998. At Treasury auctions, investor interest in the securities was substantial, with the ratios of received bids to accepted bids resembling those for nominal securities. As expected, most of the securities were quickly acquired by final investors, and the trading volume as a share of the outstanding amount was much smaller than for nominal securities.

An important macroeconomic implication of the reduced federal deficit was that the federal government ceased to be a negative influence on the level of national saving. The improvement in the federal government's saving position in recent years has more than accounted for a rise in the total gross saving of households, businesses, and governments, from about 14¹/₂ percent of gross national product earlier in the decade, when federal government saving was at a cyclical low and highly negative, to more than 17 percent in 1997. This rise in domestic saving, along with increased borrowing from abroad, has financed the rise in domestic investment during this expansion. Still higher rates of saving and investment were the norm two or three decades ago, when the personal saving rate was a good bit above its level in recent years.

State and Local Governments

The real outlays of state and local governments for consumption and invest-

ment moved up 2 percent over the four quarters of 1997, a rise similar to the average rate of increase since the start of the 1990s. Investment expenditures, which have grown about 2½ percent a year in this decade, rose at less than half that pace in 1997. However, real consumption expenditures increased 2¼ percent, a touch above the average thus far in the decade. Compensation of government employees, which accounts for about three-fifths of real consumption and investment expenditures, rose about 1¾ percent in 1997 and has increased at an annual rate of only about 1¼ percent since the end of the 1980s.

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

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

been larger than 3 percent of receipts in each of the past three years.

State and local debt expanded about 5½ percent in 1997 after changing little in 1996 and declining in the two preceding years. In those earlier years, municipal debt outstanding had been held down by the retirement of bonds that were “advance refunded” in the early 1990s. In such operations, funds that had earlier been raised and set aside were used to refund debt as it became callable. By the end of 1996, however, the stock of such debt had apparently been largely worked down.

The Labor Market

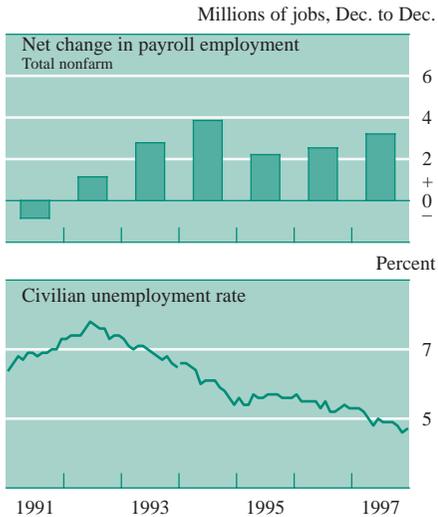
Employment, Productivity, and Labor Supply

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

Labor productivity has risen rapidly over the past two years. The 1996 gain in output per hour in the nonfarm business sector was about 1¾ percent, and the 1997 increase was larger still—a bit more than 2 percent, according to the estimates as of March 1998. Although the average rate of productivity increase since the end of the 1980s has been only a little above 1 percent a year, the data for the past two years provide indications that sustained high levels of investment in new technologies may finally be translating into a stronger trend.

The civilian unemployment rate fell more than ½ percentage point from the fourth quarter of 1996 to the fourth quarter of 1997, to an average of just under 4¾ percent. For most of the year, the rate was somewhat below the lowest rate during the expansion of the 1980s. A variety of survey data indicated that firms were having increased difficulty filling jobs.

Labor Market Conditions



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

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

Wages and Hourly Compensation

The employment cost index for hourly compensation in private industry increased 3.4 percent from December 1996 to December 1997. This rise exceeded that of the preceding year by 0.3 percentage point and that of 1995 by 0.8 percentage point. Although the patterns of change in hourly pay varied considerably by industry and occupation from 1995 to 1997, the overall step-up seems to have been prompted, in large part, by the tightening of labor markets. The implementation of a higher minimum wage also appears to have been a factor in some industries and occupations, although its impact is difficult to assess precisely.

The wage and salary component of hourly compensation rose faster in 1997

than in any previous year of the expansion. Annual increases in the employment cost index for wages and salaries in private industry amounted to 2.8 percent in both 1994 and 1995, but the increases in 1996 and 1997 were 3.4 percent and 3.9 percent respectively. Wages and salaries in the service-producing industries accelerated nearly a full percentage point in 1997, pushed up, especially, by sharp pay increases in the finance, insurance, and real estate sector, in which commissions and bonuses were boosted by high levels of mortgage refinancing and trading activity. By contrast, hourly wages in the goods-producing industries slowed a couple of tenths of a percentage point in 1997; the annual gains in these industries have been around 3 percent, on average, in each of the past six years.

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

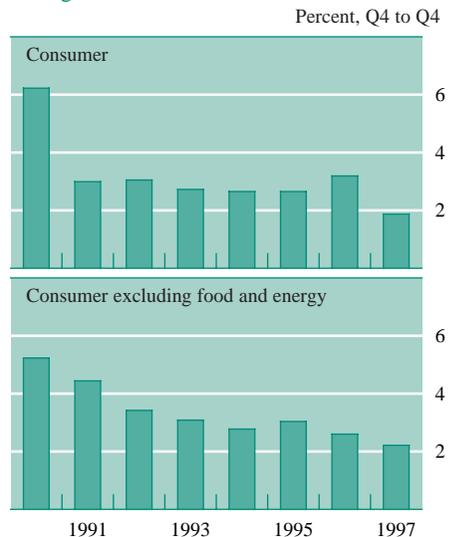
With nominal hourly compensation in almost all industries moving ahead at a pace faster than inflation, workers' pay generally increased in real terms—and the real gains were substantial in many occupations. Indeed, the employment cost index does not capture some of the forms of compensation that employers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

workers—stock options and signing bonuses, for example.

Prices

Indications of a slowing of inflation in 1997 were widespread in the various measures of aggregate price change. The consumer price index, which rose more than 3 percent over the four quarters of 1996, increased slightly less than 2 percent over the four quarters of 1997 as energy prices turned down and increases in food prices slowed. The CPI excluding food and energy—a widely used gauge of the underlying trend of inflation—rose only 2¼ percent in 1997 after increasing 3 percent in 1995 and 2½ percent in 1996. The CPI for commodities other than food and energy rose about ½ percent over the four quarters of 1997 after moving up slightly more than 1 percent over 1996. Price increases for non-energy services, which have a much larger weight than commodities in the CPI excluding food and

Change in Prices



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

Change in Prices

Percent

Price measure	1996	1997
<i>Fixed-weight</i>		
Consumer price index	3.2	1.9
Excluding food and energy	2.6	2.2
<i>Chain-type</i>		
Personal consumption expenditures .	2.7	1.5
Excluding food and energy	2.3	1.5
Gross domestic purchases	2.3	1.3
Gross domestic product	2.3	1.8

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

energy, also slowed a little in 1997; the 3 percent rise was about $\frac{1}{4}$ percentage point less than the increase during 1996. Only small portions of the slowdowns from 1996 to 1997 in the total CPI and in the CPI excluding food and energy were the result of technical changes implemented by the Bureau of Labor Statistics.¹

Other aggregate price measures also decelerated in 1997. The chain-type price index for gross domestic purchases—the broadest measure of prices paid by U.S. households, businesses, and governments—increased slightly more than $1\frac{1}{4}$ percent in 1997 after moving up $2\frac{1}{4}$ percent in 1996. The chain-type price index for gross domestic product—a measure of price change for the goods and services produced in this country (rather than

the goods and services purchased)—increased $1\frac{3}{4}$ percent after rising $2\frac{1}{4}$ percent in 1996. The smaller 1997 rise in the price index for aggregate purchases relative to that for aggregate production was mainly a reflection of declines in the prices of imports. Both the price measure for production and the price measure for purchases were influenced importantly by falling computer prices; the CPI was less influenced by these prices, as it gave small weight to computers through 1997. (It has started weighting them more heavily in 1998.)

In real terms, imports of goods and services account for approximately 15 percent of the total purchases of households, businesses, and governments located in the United States. However, that figure probably understates the degree of restraint that falling import prices have imposed on inflation in recent years, because the lower prices for imports also make domestic producers of competing products less likely to raise prices. Prices have also been restrained by large additions to manufacturing capacity in this country, amounting to more than 5 percent a year over the past three years; this capacity growth has helped to stave off the bottlenecks that have so often developed in the advanced stages of other postwar business expansions. A gain in manufacturing production of more than 6 percent in 1997 was accompanied by only a moderate increase in the factory operating rate, which at year-end remained well below the highs reached in other recent expansions and the peak for this expansion, which was recorded at the start of 1995.

Reflecting the ample domestic supply and the effects of competition from goods produced abroad, the producer price index for finished goods declined about $\frac{3}{4}$ percent from the fourth quarter of 1996 to the fourth quarter of 1997;

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

excluding food and energy, it rose only fractionally. Prices of domestically produced intermediate materials (other than food and energy) also rose only slightly, on net. The prices of raw industrial commodities, many of which are traded in international markets, declined over the year; the weakness of prices in these markets was especially pronounced in late 1997, when the crises in Asia were worsening.

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

The CPI for energy traced out an even larger swing than the price of food: A jump of 7½ percent over the four quarters of 1996 was followed by a decline of about 1 percent over the four quarters of 1997. As is usually the case in this sector, the key to the changes in consumer energy prices was the price of crude oil, which in 1997 more than reversed the run-up of the preceding year.

Surveys in which respondents are asked to state their expectations of future rates of price increase showed inflation expectations coming down a bit further in 1997. A lowering of inflation expectations has long been viewed as an essential ingredient in the pursuit of price stability, and the data of recent years have pointed to ongoing progress in that regard.

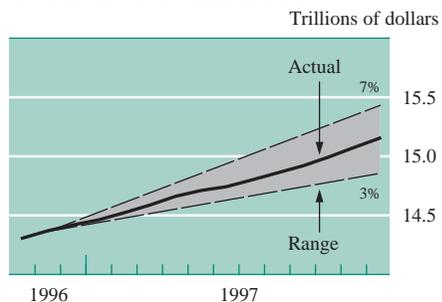
Credit, Money, Interest Rates, and Equity Prices

Credit and Depository Intermediation

The debt of the domestic nonfinancial sectors grew about 5 percent in 1997, in the middle of the range established by the FOMC and about the same as in 1996, when it grew 5¼ percent. The slight deceleration was attributable to the federal component, which, because of the reduced budget deficit, rose less than 1 percent after having risen 3¾ percent in 1996. Nonfederal debt grew 6½ percent, a bit more than in 1996, as the step-ups in borrowing by businesses and by state and local governments more than offset the deceleration of household debt.

Depository institutions increased their share of credit flows in 1997, with credit on their books expanding 6¾ percent, up appreciably from growth in 1996. The growth of bank credit, adjusted to remove the effects of mark-to-market accounting rules, picked up to an 8½ percent pace, the largest rise in ten years; and banks' share of domestic nonfinancial debt outstanding climbed to its highest level since 1988. Holdings of securities—which constitute about one-fourth of bank credit—expanded at

Total Domestic Nonfinancial Debt



NOTE. The range was adopted by the FOMC for the period from 1996:Q4 to 1997:Q4.

a brisk pace in 1997 after declining in 1995 and remaining flat in 1996. Loans—which make up the remainder of bank credit—advanced a bit more quickly in 1997 than in 1996, though more slowly than in 1995.

The increase in bank loans occurred despite a net decline in consumer loans on banks' books resulting both from sharply slower growth in loans originated by banks and from continued securitization of those loans. Real estate loans at banks, by contrast, posted solid growth, boosted by a pickup in home mortgages, rapid growth in home equity loans, which in part were substituting for consumer loans, an acceleration in commercial real estate lending, and the acquisition of thrift institutions by banks. Commercial and industrial loans also expanded considerably in 1997, reflecting both the general rise in the demand by businesses for funds and an increase in banks' share of the nonmortgage business credit market as they competed vigorously for business loans.

The rapid growth of banks' assets was facilitated by their continued high profitability and abundance of capital; at the end of the fourth quarter, 98 percent of bank assets were at well-capitalized institutions. Problems with the repayment performance of consumer loans—which, while not deteriorating further, remained elevated by historical standards—hurt some banks; however, overall loan delinquency and charge-off rates stayed quite low, and measures of banks' profitability held at the elevated levels they have occupied for several years. Profits at a few large bank holding companies were reduced in the fourth quarter by trading losses resulting from the events in Asia. Nonetheless, the profits of the industry as a whole remained robust.

The profits and capital levels of thrift institutions, like those of banks, were

high in 1997, and thrifts also were aggressive lenders. The outstanding amount of credit extended by thrifts grew about ½ percent, but the sluggishness was due entirely to the acquisitions of thrifts by commercial banks; among thrifts not acquired during the year, asset growth was similar to that of banks.

The Monetary Aggregates

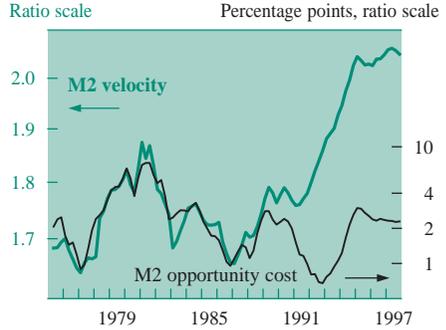
Boosted in part by the need of depository institutions to fund substantial growth in their credit, M3 shot up in 1997, expanding 8¾ percent; this growth was well above the 2 percent to 6 percent annual range established by the FOMC and intended to suggest the rate of growth over the long run that would be consistent with price stability. M3 was also boosted by a shift in sources of funding—mostly at U.S. branches and agencies of foreign banks—from borrowings from related offices abroad, which are not included in M3, to large time deposits issued in the United States, which are. Also contributing to the strength in M3 was the rapid growth of institution-only money funds, a result of gains by such funds in providing corporate cash management services. Corporations that manage their own cash often keep their funds in short-term assets that are not included in M3.

Although the growth of M2 did not match that of M3, it did increase at a brisk 5½ percent rate in 1997. As the Committee had anticipated, the growth of this aggregate was somewhat above the upper bound of its 1 percent to 5 percent annual range, which, like that of M3, had been chosen to be consistent with expected M2 growth under conditions of price stability. Because short-term interest rates responded only slightly to System tightening in March, the opportunity cost of holding M2—the interest earnings forgone by owning M2

assets rather than money market instruments such as Treasury bills—was about unchanged over the year. As M2 grew at about the same rate as nominal GDP, its velocity was also essentially unchanged. The ups and downs of M2 growth in 1997 tended to mirror those of the growth of nominal output. M2 expanded more slowly in the second quarter than in the first, consistent with the cooling of nominal GDP growth and almost unchanged opportunity costs. In the second half of the year, M2 growth picked up, roughly pacing the growth of nominal GDP. In the fall, M2 may also have been boosted a little by volatility in equity markets, which may have led some households to seek the relative safety of M2 assets.

For several decades before 1990, M2 velocity responded positively to changes in its opportunity costs and otherwise showed little net movement over time. This pattern was disturbed in the early 1990s in part by households' apparent decision to shift funds out of lower-yielding M2 deposits into higher-yielding stock and bond mutual funds, which raised M2 velocity even as opportunity costs were declining. The movements in the velocity of M2 from 1994 into 1997 appear to have again been explained by changes in opportunity

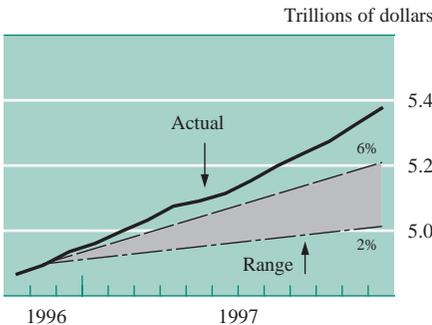
M2 Velocity and M2 Opportunity Cost



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

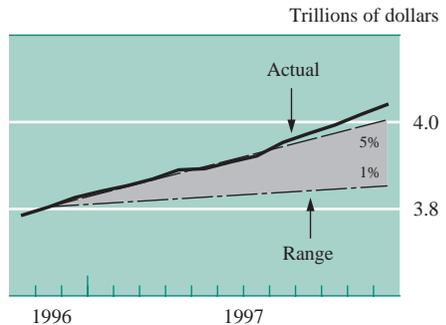
costs, along with some residual upward drift. This drift suggests that some households may still have been in the process of shifting their portfolios toward non-M2 assets. There was no uptrend in velocity over the second half of 1997, perhaps because of the declining yields on intermediate- and long-term debt and the greater volatility and lower average returns of stock mutual funds. However, given the aberrant behavior of velocity during the 1990s in general, considerable uncertainty remains about the relationship between the velocity and opportunity cost of M2 in the future.

Stock of M3



NOTE. The range was adopted by the FOMC for the period from 1996:Q4 to 1997:Q4.

Stock of M2



NOTE. The range was adopted by the FOMC for the period from 1996:Q4 to 1997:Q4.

Annual Rate of Change in Reserves, Money Stock, and Debt Aggregates

Percent

Item	1994	1995	1996	1997				
				Year	Q1	Q2	Q3	Q4
Depository institution reserves¹								
Total	-1.2	-4.9	-11.6	-6.3	-8.3	-14.3	-1.8	-1.3
Nonborrowed plus extended credit	-1.4	-4.9	-11.6	-6.4	-7.2	-16.0	-3.4	.7
Required	-1.1	-5.2	-11.9	-7.3	-8.4	-15.0	-2.4	-4.1
Monetary base ²	8.4	4.0	3.8	6.0	5.3	3.7	6.3	8.1
Concepts of money³								
M1								
M1	2.5	-1.6	-4.5	-1.2	-1.4	-4.5	.3	.8
Currency	10.1	5.4	5.7	7.5	6.9	6.4	7.0	8.7
Demand deposits .....	.6	1.4	2.9	-2.0	.6	-4.9	.0	-3.7
Other checkable deposits	-1.8	-10.6	-22.8	-12.2	-16.0	-20.1	-10.1	-4.7
M2								
M2 .....	.6	3.9	4.6	5.6	5.1	4.4	5.4	6.8
Non-M1 components	-2	6.6	8.7	8.2	7.7	7.9	7.3	9.0
Savings (including MMDAs)	-4.2	-3.3	12.0	9.9	9.3	9.6	7.1	12.2
Small denomination time deposits	2.4	15.3	1.8	1.9	1.8	2.4	2.6	.7
Retail money market mutual funds	7.6	18.5	14.5	15.8	14.7	13.5	16.1	15.6
M3								
M3	1.7	6.1	6.9	8.8	8.0	7.7	8.1	10.2
Non-M2 components	6.7	15.4	15.7	20.0	18.0	18.9	16.8	20.8
Large-denomination time deposits	7.3	15.9	16.4	18.1	18.4	20.9	16.1	12.7
Institution-only money market mutual funds	-4.1	24.7	20.9	21.0	18.4	18.1	19.6	22.0
Repurchase agreements	13.5	5.8	4.5	17.0	6.1	6.8	13.5	38.3
Eurodollars	21.5	11.4	21.7	30.4	35.8	32.2	18.6	23.4
Domestic nonfinancial sector debt								
Federal	4.9	5.4	5.3	4.9	4.4	5.0	4.2	5.8
Federal	5.7	4.4	3.7	.6	1.8	.4	-6	.9
Nonfederal	4.6	5.8	5.8	6.5	5.4	6.6	5.9	7.4

NOTE. Changes for quarters are calculated from the average amounts outstanding in each quarter. Changes for years are measured from Q4 to Q4. Based on seasonally adjusted data.

1. Data on reserves and the monetary base incorporate adjustments for discontinuities associated with regulatory changes in reserve requirements.

2. The monetary base consists of total reserves; plus the currency component of the money stock; plus, for all quarterly reporters, and for all weekly reporters without required reserve balances, the excess of current vault cash over the amount applied to satisfy current reserve requirements. For further details, see the Federal Reserve's H.3 Statistical Release.

3. M1 consists of currency in circulation excluding vault cash; travelers checks of nonbank issuers; demand deposits at all commercial banks other than those due to depository institutions, the U.S. government, and foreign banks and official institutions, less cash items in the process of collection and Federal Reserve float; and other checkable deposits, which consist of negotiable orders of withdrawal and automatic transfer service accounts at depository institutions, credit union share draft accounts, and demand deposits at thrift institutions.

M2 is M1 plus savings deposits (including money market deposit accounts); small-denomination time deposits (including retail repurchase agreements), from which have been subtracted all individual retirement accounts (IRAs) and Keogh accounts at commercial banks and thrift institutions; and balances in taxable and tax-exempt retail money market mutual funds (money funds with minimum initial investments of less than \$50,000), excluding IRAs and Keogh accounts.

M3 is M2 plus large-denomination time deposits at all depository institutions other than those due to money stock issuers; balances in institution-only money market mutual funds (money funds with minimum initial investments of \$50,000 or more); wholesale RP liabilities (overnight and term) issued by all depository institutions, net of money fund holdings; and Eurodollars (overnight and term) held by U.S. residents at all banking offices in Canada and the United Kingdom and at foreign branches of U.S. banks worldwide, net of money fund holdings. For further details, see the Federal Reserve's H.6 Statistical Release.

M1 fell 1¼ percent in 1997. As has been true for the past four years, the growth of this aggregate was depressed by the adoption by banks of retail sweep programs, whereby balances in transactions accounts, which are subject to reserve requirements, are “swept” into savings accounts, which are not. Sweep programs benefit depositories by reducing their required reserves, which earn no interest. At the same time, they do not restrict depositors’ access to their funds for transactions purposes, because the funds are swept back into transactions accounts when needed. The initiation of programs that sweep funds out of NOW accounts—in 1997 the most common form of retail sweep programs—appears to be slowing, but sweeps of household demand deposits have picked up, and the estimated total amount by which sweep account balances increased in 1997 was similar to that in 1996. Adjusted for the initial reduction in transactions accounts resulting from the introduction of new sweep programs, M1 expanded 6 percent in 1997, a little above its sweep-adjusted growth in 1996.

The drop in transactions accounts caused required reserves to fall 7¼ percent in 1997. Despite this decline, the monetary base grew 6 percent, boosted by a hefty advance in currency. Currency again benefited from foreign demand, as overseas shipments continued at the elevated levels seen in recent years. Moreover, domestic demand for currency expanded sharply in response to the strong domestic spending.

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

unavoidable daily mismatches between reserves made available through open market operations and desired reserves typically have been fairly small, and their effect on the federal funds rate has been muted. However, banks also hold reserve balances at the Federal Reserve to avoid overdrafts after making payments for themselves and their customers. This component of the demand for reserves is difficult to predict, varies considerably from day to day, and must be fully satisfied each day. As required reserves have declined, the demand for balances at the Federal Reserve has become increasingly dominated by these more changeable daily payment-related needs. Nonetheless, federal funds volatility did not increase noticeably in 1997. In part this was because the Federal Reserve intervened more frequently than in the past with open market operations of overnight maturity in order to better match the supply of and demand for reserves each day. In addition, banks made greater use of the discount window, increasing the supply of reserves when the market was excessively tight. Significant further declines in reserve balances, however, do risk increased federal funds rate volatility, potentially complicating the money market operations of the Federal Reserve and of the private sector. One possible solution to this problem is to pay banks interest on their required reserve balances, reducing their incentive to avoid holding such balances.

Interest Rates and Equity Prices

Interest rates on intermediate- and long-term Treasury securities moved lower, on balance, in 1997. Yields rose early in the year as market participants became concerned that strength in aggregate demand would further tighten resource

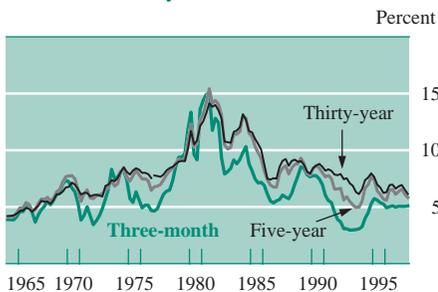
utilization margins and increase inflation unless the Federal Reserve took countervailing action. Over the late spring and summer, however, as growth moderated some and inflation remained subdued, these concerns abated significantly, and longer-term interest rates declined. Further reductions came in the latter part of the year as economic problems mounted in Asia. On balance, between the end of 1996 and the end of 1997, the yields on ten-year and thirty-year Treasury bonds fell about 70 basis points. At year-end, rates were approaching their levels of the late 1960s and early 1970s, when the buildup of inflation expectations was in its early stages.

Survey measures of expectations for longer-horizon inflation generally did move lower in 1997, but by less than the drop in nominal yields. As a result, estimates of the real longer-term interest rate calculated by subtracting these measures of expected inflation from nominal yields indicate a slight decline in real rates over the year. In contrast, yields on the inflation-indexed ten-year Treasury note rose about a quarter percentage point between mid-March (when market participants seem to have become more comfortable with the new security) and the end of the year. The market for the

indexed securities is sufficiently small that their yields can fluctuate temporarily as a result of moderate shifts in supply or demand. Indeed, much of the rise in the indexed yield came late in the year, when, in an uncertain global economic environment, investors' heightened desire for liquidity may have made nominal securities relatively more attractive.

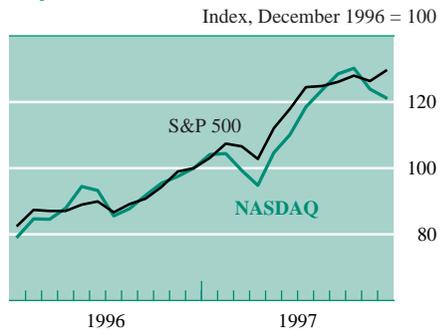
With real longer-term interest rates remaining low and corporate profits growing strongly, equities had another good year in 1997, and major stock indexes rose 20 percent to 30 percent. Although stocks rose early in the year, they fell with the upturn in interest rates in February. As interest rates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

Selected Treasury Rates



NOTE. The twenty-year Treasury bond rate is shown until the first issuance of the thirty-year Treasury bond, in February 1977. The data are quarterly.

Major Stock Price Indexes



NOTE. The data are monthly.

stock prices remained volatile but displayed little trend.

Despite the strong performance of earnings in 1997 and the slower rise of stock prices in the second half of the year, valuations seemed to reflect a combination of expectations of quite rapid future earnings growth and a historically small risk premium on equities. The gap between the market's forward-looking earnings-price ratio and the real interest rate, measured by the ten-year Treasury rate less a survey measure of inflation expectations, was at the smallest sustained level in 1997 in the eighteen-year period for which these data are available. Declines in this gap generally imply either that expected real earnings growth has increased or that the risk premium over the real rate investors use when valuing those earnings has fallen, or both. Survey estimates of stock analysts' expectations of long-term nominal earnings growth were, in fact, the highest observed in the fifteen years for which these data are available. Because inflation has trended down over the past fifteen years, the implicit forecast of the growth in real earnings departs even further from past forecasts. However, even with this forecast of real earnings growth, the level of equity valuation suggested that investors were also requiring a lower risk premium on equities than has generally been the case in the past, a hypothesis supported by the low risk premiums evident in corporate bond yields in 1997. ■

International Developments in 1997

In 1997 economic growth accelerated in the major foreign industrial countries, with the exception of Japan, where growth slowed sharply under fiscal tightening imposed in an atmosphere of already depressed confidence in the economy and distress in the banking system. Unemployment remained near its record high level in Japan and stayed high or rose in continental Europe despite a pickup in economic growth. Budget deficits declined in several European countries, partly under the influence of measures inspired by the Maastricht Treaty objective for 1997,¹ and the budget moved into surplus in Canada. Improving budget balances and steady or falling inflation—which in 1997 was less than 2 percent on average in the foreign G-10 countries—helped move long-term interest rates significantly lower abroad.²

Economic growth in most Asian developing countries slowed in 1997, with widespread financial turmoil in the area depressing activity in the latter part of the year. The pace of economic activity also generally moderated in Latin America, except in Mexico and Venezuela, where growth was more robust. Output expanded slightly in Russia after declining for six straight years; most of the other republics of the former Soviet

Union also showed signs of growth. The countries of central and eastern Europe continued to experience generally moderate growth. Economic activity in Africa expanded, but more slowly than during the spurt of the previous year, and activity in the Middle East, which had been showing signs of acceleration, stagnated again in 1997.

The U.S. trade deficit in goods and services in 1997, at \$114 billion, was little different from that in the preceding year. Both exports and imports expanded vigorously, especially during the first half of the year. Exports slowed later in the year, even before the effects of deteriorating economic and financial conditions in Asia began to be felt.

The current account deficit widened in 1997, to \$166 billion from \$148 billion in 1996, as a result of rising net payments on the large, negative U.S. investment position. A record net accumulation of assets in the United States by private foreigners exceeded the level of net capital inflows needed to balance the current account deficit in 1997. Foreign official assets in the United States also increased, but only slightly, in sharp contrast to the massive inflows of the previous two years.

The exchange value of the dollar rose over 1997 in terms of all major foreign currencies except the U.K. pound. The dollar moved up sharply against the currencies of most continental European countries and Japan, where economic activity was moderate or even slow relative to that in the United States. The dollar also appreciated dramatically in terms of the currencies of several major Asian countries, particularly in the second half of the year, when these

1. According to the Maastricht Treaty, only those countries that had a general government deficit of 3 percent of gross domestic product or less in 1997 may participate in the European Monetary Union upon its scheduled commencement at the start of 1999.

2. The G-10 (Group of Ten) countries are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

economies were disrupted by financial turmoil.

Foreign Economies

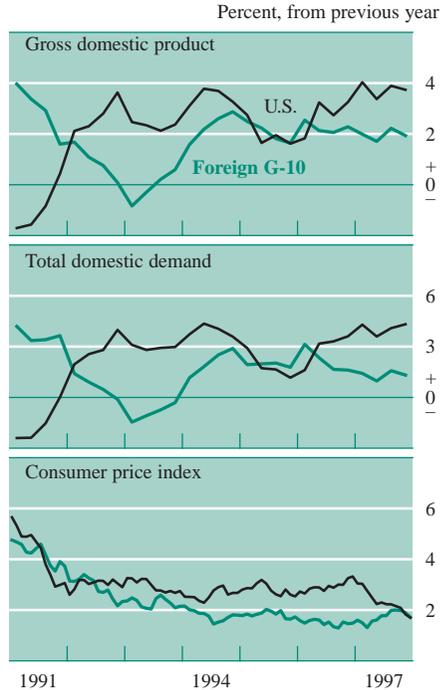
In Germany and France, economic growth was slow early in 1997 but picked up as the year progressed. Growth continued to be led by net exports, although domestic demand did accelerate in both countries from its sluggish pace in 1996. In Italy, by contrast, net exports were depressed by the lingering effects of the lira's appreciation relative to the dollar and other major currencies in 1996, somewhat dampening otherwise solid growth. The stronger lira had reflected, in part, improved prospects for Italy's inclusion in the first round of European Monetary Union.

The shortfall of actual output from estimated potential narrowed slightly in the major countries of continental Europe, but the improvement had little effect on stubborn unemployment. Reductions in employment subsidies in the eastern states of Germany raised the unemployment rate there. In Italy, where a sizable output gap remained, the slack in the economy contributed to a significant decline in inflation for a second straight year; prices rose about 1½ percent, the smallest increase since the late 1960s. Inflation in Germany and France was also below 2 percent.

Efforts to curtail spending in order to reduce the general government budget deficit achieved notable success in Italy. Germany and France also undertook several measures to narrow their deficits, including spending cuts and temporary tax increases. These moves were motivated by the desire of the major countries to participate in European Monetary Union from its commencement, scheduled for January 1999.

Economic growth remained robust in the United Kingdom through most of the year, largely because the service sector expanded at a rapid pace; growth in manufacturing was weak. By mid-year, output likely exceeded the level regarded as sustainable. The official unemployment rate fell sharply to 5 percent, its lowest point in nearly two decades. Some of the decline was related to changes in the system of unemployment benefits. An appreciation in sterling relative to other major currencies reduced import prices,

Changes in GDP, Demand, and Prices



NOTE. Data for the foreign G-10 countries are from national sources. The data are weighted by the countries' 1987-89 GDP as valued after adjusting for differences in the purchasing power of their currencies; GDP and domestic demand are in constant prices.

Data for the United States are from the Departments of Commerce and Labor. GDP and domestic demand are derived from chained (1992) dollars.

For GDP and domestic demand, the data are quarterly; for consumer prices, the data are monthly.

but underlying retail price inflation remained somewhat above the official target of 2½ percent, as retailers appeared to increase their profit margins in the face of strong demand. In these circumstances, the Monetary Policy Committee of the newly independent Bank of England began to tighten monetary conditions.

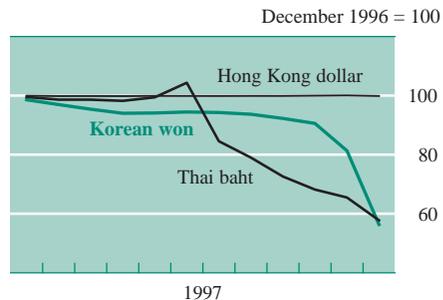
In Canada, both consumption and business investment moved significantly higher in 1997, spurred by the monetary easing of the previous year. These expenditures overcame a sharp drop in net exports to narrow the output gap substantially and push the unemployment rate below 9 percent. With some slack left in the economy, however, inflation fell from the midpoint of the Bank of Canada's target range of 1 percent to 3 percent to just below the bottom of the range. Nonetheless, short-term interest rates were raised sharply in the second half of the year, largely in response to the depreciation of the Canadian dollar. With Canada a major commodity exporter, the currency was hurt by the expectation that global demand for commodities would be adversely affected by developments in Asia. The achievement of a budget surplus in Canada reflected sharp spending reductions over the past four years as well as a surge in tax receipts from a booming economy and a rising stock market.

Japan's economic activity picked up early in the year in anticipation of the April 1 increase in the consumption tax but fell in the second quarter after the tax came into effect. Economic and financial performance later in the year was impeded by concerns that problems in other Asian economies would spill over, adversely affecting trade and bank solvency. As a result of these difficulties, domestic demand declined during 1997, with consumption and investment particularly weak. The only positive

force on growth was exerted by exports, spurred by the lagged effect of the yen's depreciation over the past two years. Japan's weak economy produced a widening output gap, and unemployment remained near its postwar high of 3½ percent. Inflation rose—from zero in 1996 to 2 percent in 1997—but only because of the consumption tax increase.

Economic growth elsewhere in Asia slowed in 1997, largely because of financial turmoil in the region in the second half of the year. Thailand was the first to be affected, but severe disruptions in financial markets soon spread to other countries, notably Indonesia and South Korea. These developments appeared to be triggered by a crisis of confidence in the medium-term prospects for these economies given a cluster of factors: substantial external deficits in some of the economies, exchange rates that generally appeared to be overvalued, weak financial systems, and government policy responses to the initial disruptions that were widely viewed as inadequate. Pressures persisted despite the provision of financial assistance to several countries under programs supported by the International Monetary Fund, and the need for structural reforms became apparent.

Exchange Value of Selected Asian Currencies versus the Dollar



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

South Korea and the major economies of Southeast Asia—Thailand, Malaysia, Indonesia, and the Philippines—all experienced abrupt and deep currency depreciation, a collapse in equity prices, and a sharp increase in interest rates. As a result, activity subsided throughout the region and actually declined in the fourth quarter in several of these countries. For 1997 as a whole, only Thailand’s economy contracted, but growth rates were down sharply in the other countries. Weaker growth and depreciated currencies in the affected countries caused their external balances to start swinging sharply toward surplus late in the year. The sharp currency depreciations also boosted inflation rates.

The spread of financial turmoil also affected China and the economies of Hong Kong and Taiwan, although not as virulently as elsewhere. The peg of the Hong Kong currency to the U.S. dollar was maintained, and the Chinese authorities did not change the value of the yuan. In Taiwan, the authorities allowed the currency to depreciate somewhat early in the crisis after briefly attempting to defend the peg to the dollar. Growth rates in these economies slowed only moderately on balance from the rapid pace of the previous year. In China, surging exports contributed to the largest trade surplus in the country’s history.

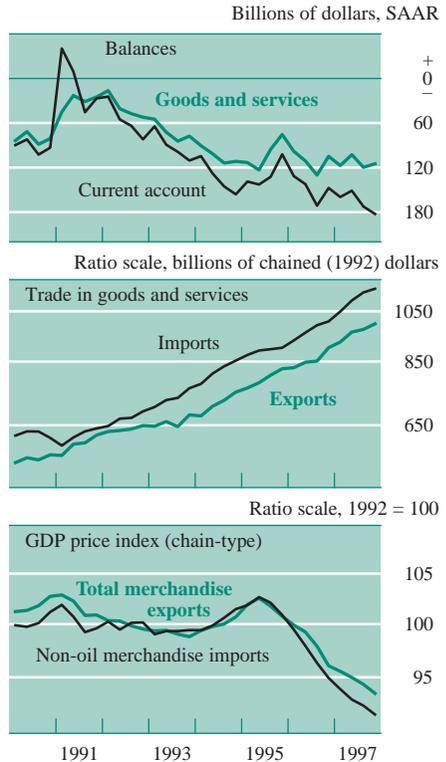
Growth generally moderated in Latin America, except in Venezuela, where a strong recovery from the downturn of the previous year began. Late in the year, many Latin American economies experienced spillover effects from the financial crisis in Asia. Hardest hit was Brazil, where interest rates had to be raised sharply to defend the crawling currency peg, leading to an abrupt slowing of activity in the final quarter of the year. Overall, conditions in Mexico

remained relatively favorable: Growth, though easing from the very rapid pace of the preceding year, continued to be robust, inflation declined further, and the trade balance remained in surplus.

U.S. International Transactions

The vigorous growth of the U.S. economy in 1997 spurred another year of strong expansion in real imports of goods and services. A surge in imports early in the year subsided only slightly in later months, resulting in an inflow about 14 percent greater than in 1996; imports had also expanded briskly in the earlier year, at a rate of about 12 per-

U.S. International Trade



NOTE. The data are from the Department of Commerce; they are quarterly and seasonally adjusted. Data for trade are at annual rates.

U.S. International Transactions

Billions of dollars, seasonally adjusted

Transaction	Year		Quarter				
			1996		1997		
	1996	1997 ^p	Q4	Q1	Q2	Q3	Q4 ^p
Goods and services, net	-111	-114	-26	-29	-26	-30	-29
Exports	849	932	220	224	235	235	238
Merchandise	612	678	158	162	171	170	175
Services	237	253	62	62	63	64	64
Imports	960	1,045	246	253	260	265	267
Merchandise	803	877	206	212	218	222	224
Services	157	168	40	41	42	42	43
Investment income, net	3	-14	1	-2	-3	-4	-5
Direct investment, net	67	68	19	17	18	17	16
Portfolio investment, net	-64	-82	-18	-19	-21	-21	-21
Unilateral transfers, private and government, net	-40	-39	-12	-9	-9	-9	-12
Current account balance	-148	-166	-37	-40	-38	-43	-46
Private capital flows, net (outflows, -)	67	246	8	21	58	51	117
Bank-related capital, net (outflows, -)	-88	-9	-28	-45	*	-21	56
U.S. net purchases (-) of foreign securities	-108	-79	-30	-15	-22	-39	-4
Foreign net purchases (+) of U.S. securities	289	352	100	87	97	97	72
Treasury securities	156	163	68	48	45	36	34
Corporate and other non-Treasury bonds	121	122	31	29	30	37	27
Corporate stocks	13	67	1	10	22	23	12
Direct investment flows, net (outflows, -)	-11	-12	-13	4	-10	3	-8
U.S. direct investment abroad	-88	-119	-31	-27	-37	-23	-33
Foreign direct investment in United States	77	108	18	31	27	26	25
Foreign holdings of U.S. currency	17	25	8	3	5	7	10
Other corporate capital flows, net	-32	-32	-29	-14	-12	4	-10
Foreign official assets in United States (increase, +)	122	18	33	29	-5	22	-27
U.S. official reserve assets, net (increase, -)	7	-1	*	4	*	-1	-5
U.S. government foreign credits and other claims, net	-1	*	*	*	*	*	*
Total discrepancy	-47	-97	-3	-14	-14	-29	-40
Seasonal adjustment discrepancy	0	0	3	7	-1	-8	3
Statistical discrepancy	-47	-97	-6	-21	-13	-21	-43

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

* In absolute value, greater than zero and less than \$500 million.

^p Preliminary.

SOURCE. Department of Commerce, Bureau of Economic Analysis.

cent. Also encouraging imports was another round of falling prices for goods other than oil, importantly influenced by the strong dollar. The most pronounced increases in imports were in capital goods, consumer goods, and automotive products.

Exports also exhibited strong growth in 1997, particularly during the first half of the year. Real exports of goods and services rose 10 percent after increasing 9 percent the preceding year. Exports accelerated despite the appreciation of the dollar because of the pickup in

economic activity in many U.S. trading partners. Growth of U.S. exports to Latin America and Canada was particularly strong, and exports to western Europe also increased at a healthy pace.

With imports expanding at a somewhat faster pace than exports, the already sizable U.S. trade deficit widened a bit further in 1997, from \$111 billion to \$114 billion. Because payments of investment income by U.S. residents to foreigners exceeded the reverse flow, the current account deficit increased by a larger amount. That

payments of investment income exceeded receipts—for the first time in this century—reflects the large deterioration in the country's net international investment position that has accompanied persistent current account deficits over the past decade and a half.

Both foreign ownership of assets in the United States and U.S. ownership of assets abroad increased substantially in 1997, as they have for several years. Worldwide, asset holders have become increasingly willing to expand their portfolios across borders. The gathering financial storm in Asia led, particularly in the last quarter of the year, to significant and opposite net shifts in the holdings of assets in the United States by foreign authorities and private foreigners.

Foreign official assets in the United States rose somewhat in the first nine months of 1997 but declined sharply late in the year; the net inflow for the year was only \$18 billion, compared with \$122 billion the year before. The net outflow in the fourth quarter was concentrated among Asian countries and a few developing countries elsewhere that were experiencing exchange-market pressures.

The increase in 1997 in the holdings of U.S. securities by private foreigners surpassed previous annual increases. Net purchases of U.S. stocks by private foreigners were particularly strong, a record \$67 billion. Net purchases of U.S. Treasury securities by private foreign parties remained robust; more than \$30 billion net were purchased in October alone, when developments in Asia increased the attractiveness of holdings in the United States. (Later in the year, some Asian investors liquidated their holdings to obtain needed funds.) Net purchases of U.S. corporate and other bonds also stayed high. In addition to these inflows, foreign direct investment

in the United States amounted to a record \$108 billion, largely the consequence of an ongoing trend of mergers and acquisitions between U.S. and foreign companies.

U.S. direct investment abroad reached a record high of \$119 billion in 1997. U.S. net purchases of foreign securities were \$76 billion in the first three quarters of 1997, a little below the pace for 1996, but net purchases in this category fell sharply in the fourth quarter, probably reflecting wider perception of increased risk as a result of the financial market turmoil in Asia. Banks in the United States reported a large increase in net claims on foreigners in the first quarter, but much of this outflow was reversed later in the year.

Recorded net outflows of capital exceeded the current account deficit by a substantial margin in 1997 for the second year running. This negative statistical discrepancy indicates that net payments in the current account or net outflows in the capital account have gone unrecorded. Although the U.S. international accounts rarely sum to zero in practice, the size of the discrepancy and its shift from a positive to a negative number recently are puzzling.

Foreign Exchange Developments

The dollar gained 13½ percent to 15 percent against the mark and other continental European currencies tightly linked to the mark (measured as the change between the average for December 1996 and that for December 1997). This increase was consistent with strong U.S. economic growth and more moderate growth in continental Europe. Uncertainties related to the prospective formation of European Monetary Union may also have played a role. The mark appreciated somewhat in terms of the dollar during the late summer and fall as

the Bundesbank raised interest rates. When conditions in Germany subsequently made it seem less likely that the Bundesbank would tighten further, the mark weakened again.

The dollar moved little in terms of the U.K. pound. Sterling was boosted relative to other European currencies by a strong economy and the Bank of England's moves to tighten monetary policy. Versus the Canadian dollar, the U.S. currency firmed nearly 5 percent, chiefly toward the end of the year. The Asian financial crisis dampened prospects for worldwide economic growth, putting downward pressure on prices for primary commodities, an important part of Canada's economy. Its currency declined even in the face of significant monetary policy tightening by the Bank of Canada.

Versus the yen, the dollar rose nearly 14 percent on balance. Early in the year, concerns about the resilience of Japan's banking system in the face of proposed financial deregulation weakened the yen. The scheduled increase in taxes on consumption in April also undermined prospects for sustained economic growth. When domestic demand initially seemed to weather the tax increase and net exports also burgeoned, the yen appre-

ciated briefly, but later evidence that growth had stalled after the tax increase undermined the currency again. Downward pressure intensified when Japan's weakened financial system and sluggish economy were exposed to further stress from economic and financial collapse in several key Asian countries.

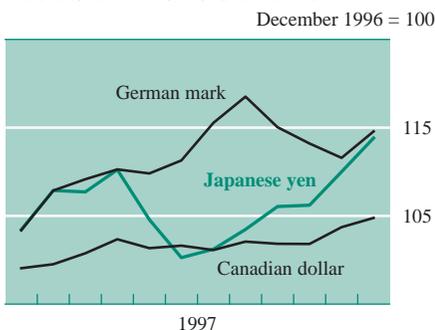
The dollar appreciated substantially in terms of the currencies of most East Asian economies during the second half of 1997. Because a large portion of the external debt of these countries was denominated in foreign currencies and had short maturities, the devaluations greatly hobbled the ability of borrowers to roll over their liabilities. The Mexican peso, which had firmed vis-à-vis the dollar earlier in the year, also came under pressure as investors feared that difficulties in Asia would spread to Latin America. On balance, the dollar appreciated 3½ percent in terms of the peso in 1997.

Foreign Exchange Operations

U.S. authorities did not intervene in foreign exchange markets in 1997. Reported net sales of dollars by major foreign central banks were \$10 billion in 1997, in contrast to net purchases of \$46 billion in 1996.

At the end of the year, the Federal Reserve held the equivalent of \$17,046 million, valued at current exchange rates, in marks and yen. With the dollar's appreciation versus both currencies in 1997, the cumulative gains on System foreign currency holdings declined \$2,593 million, to \$358 million. In the absence of transactions in foreign currencies, the System did not realize any gains or losses. ■

Exchange Value of the Dollar versus Selected G-10 Currencies



NOTE. Foreign currency units per dollar. The data are monthly.

Monetary Policy Reports to the Congress

In this chapter are reports submitted to the Congress on February 26 and July 22, 1997, pursuant to the Full Employment and Balanced Growth Act of 1978.

Report on February 26, 1997

Monetary Policy and the Economic Outlook

The economy performed impressively this past year, and the members of the Board of Governors and the Reserve Bank presidents anticipate that 1997 will bring further appreciable economic expansion with relatively low inflation. In 1996, solid advances in the real expenditures of households and businesses led to sizable gains in output. Employment rose briskly, and the unemployment rate edged down to its lowest level of the current expansion. Consumer price inflation increased owing to the likely temporary effects of firmness in food and energy markets, but some broader price measures showed inflation holding steady or even declining. With the economy strengthening, intermediate- and long-term interest rates rose on net, but credit continued to be amply available to businesses and most households, and equity prices soared.

Several factors helped to restrain price increases this past year in the face of high levels of resource utilization. With workers still concerned to some degree about job security, acceleration in hourly compensation was not so pronounced as in comparable periods in the past; wage increases picked up rela-

tively moderately, and further success in controlling health care costs helped to temper the rise in benefits. Moreover, significant declines in the prices of U.S. imports, owing to low inflation abroad and appreciation of the dollar on foreign exchange markets, tended to hold down domestic prices. Damped inflation expectations probably contributed as well to the favorable price performance: A lengthening run of years during which inflation has been in a more moderate range, together with an understanding of the Federal Reserve's commitment to maintaining progress toward price stability, may have discouraged aggressive pricing behavior. Business firms continued to rely on cost control and gains in productivity, rather than on price increases, as the primary channels for achieving profit growth.

Still, the Federal Open Market Committee (FOMC) recognized the danger that pressures emanating from the tight labor market might trigger an acceleration of prices, which could eventually undermine the ongoing economic expansion. Consequently, although conditions last year were not deemed to warrant immediate policy action, the Committee's policy directives starting in mid-1996 reflected a perception that the most likely direction of any policy action would be toward greater restraint in the provision of reserves to the banking system. Forestalling a disruptive buildup of inflationary pressures in the near term and moving toward price stability over time remain central to the System's mission of promoting maximum sustainable growth of employment and production.

Monetary Policy, Financial Markets, and the Economy in 1996

The FOMC eased the stance of monetary policy twice around the beginning of last year—in December 1995 and in January—lowering the federal funds rate $\frac{1}{2}$ percentage point in total, to $5\frac{1}{4}$ percent. These actions were taken to offset the effect on the level of the real federal funds rate of declines in inflation and inflation expectations in the second half of 1995 and thereby to help ensure the resumption of moderate economic growth after the marked slowdown and inventory correction in late 1995. By the spring, economic growth had become more vigorous than either the Committee or financial markets had foreseen. In response, intermediate- and longer-term interest rates as of mid-May were up around a full percentage point from the two-year lows reached early in the year. In combination with some softening of economic activity abroad and declines in interest rates in major foreign industrial countries, these developments contributed to a further appreciation of the dollar, building on the rise that had started in mid-1995. The Committee anticipated that the increase in the cost of credit, along with the higher exchange value of the dollar, would be sufficient to foster a downshift in economic expansion to a more sustainable pace and contain price pressures; thus, it left its policy stance unchanged at its spring meetings.

By early summer, however, the continued momentum in demand and pressures on labor resources that were being reflected in faster growth in wages were seen as posing a threat of increased inflation. Core inflation remained moderate, but in light of the heightened risk that it would turn upward, the Committee in its early July directive to the Manager of the Open Market Account indi-

cated its view that near-term economic developments were more likely to lead to a tightening of policy than to an easing. Labor markets continued to be taut over the balance of the year, and this bias toward restraint was included in directives adopted at all of the Committee's remaining meetings in 1996.

After having peaked during mid-summer, interest rates moved down on balance through the fall, as expansion of consumer spending and economic activity in general appeared to be moderating and markets saw less likelihood of a need for Federal Reserve firming action. Equity prices fell back for a time during the summer, reversing some of the substantial increase registered over the first half of the year, but by autumn they had reached new highs. Interest rates and dollar exchange rates turned back up late in the year when signs of rapid growth and more intense use of the economy's resources re-emerged. Since year-end, interest rates have changed little, on net. The foreign exchange value of the dollar has posted further gains, in part reflecting greater-than-expected weakness in Europe and renewed pessimism about economic and financial prospects in Japan. Equity prices have registered new highs since the start of the year. As of mid-February, intermediate- and long-term interest rates were up about $\frac{1}{2}$ to $\frac{3}{4}$ percentage point, on balance, since early 1996, and the value of the dollar was up around 9 percent against an average of other Group of Ten currencies.

For the nonfinancial business sector, the effect of the higher intermediate- and long-term interest rates on the overall cost of funds last year was offset to some degree by an easing of lending terms at banks and a narrowing of yield spreads on corporate bonds over Treasuries, as well as by declines in the cost of capital in the equity market. Encour-

aged, perhaps, by the prospects of sustained economic expansion and low inflation, banks, market lenders, and equity investors displayed a strong appetite for business obligations and seemed willing to require less compensation for the possible risks entailed. Some households, by contrast, faced a tightening of standards and terms with respect to credit card debt and some other types of consumer debt last year, as banks reacted to a rising volume of delinquencies and charge-offs on these instruments. However, credit availability under home equity lines increased, particularly from finance companies but also from banks. Overall debt growth slowed slightly but remained near the midpoint of its 3 percent to 7 percent monitoring range. The growth rates of M2 and M3 edged up last year and, as was anticipated in the monetary policy reports to the Congress last February and July, both aggregates ended 1996 near or above the upper end of their growth ranges. Again last year, the growth of M2 relative to nominal income and interest rates was generally in line with historical relationships, in contrast to its behavior during the early years of the decade.

Economic Projections for 1997

With the economy free of serious imbalances, prospects appear favorable for further growth of activity and expansion of job opportunities in the coming year, although resource constraints seem likely to keep the pace of growth below that of 1996. The central tendency of the growth forecasts of gross domestic product put forth by the members of the Board of Governors and the Reserve Bank presidents is from 2 percent to 2¼ percent, measured as the change in real output between the final quarter of 1996 and the final quarter of 1997. Output growth of this magnitude is expected to result in little change in the civilian unemployment rate, which is projected to be between 5¼ percent and 5½ percent in the fourth quarter of this year. These forecasts of GDP growth and unemployment are similar to those of the Administration. The central tendency of the policymakers' forecasts of the consumer price index for 1997 spans the relatively narrow interval of 2¾ percent to 3 percent, with the lower bound near the inflation forecast of the Administration.

Economic Projections for 1997

Percent

Indicator	Federal Reserve governors and Reserve Bank presidents		Administration
	Range	Central tendency	
<i>Change, fourth quarter to fourth quarter¹</i>			
Nominal GDP	4¼–5¼	4½–4¾	4.6
Real GDP ²	2–2½	2–2¼	2.0
Consumer price index ³	2¾–3½	2¾–3	2.6
<i>Average level, fourth quarter</i>			
Civilian unemployment rate	5¼–5½	5¼–5½	5.4

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

2. Chain-weighted.

3. All urban consumers.

Consumer spending, which accounts for about two-thirds of total GDP, should be supported in coming quarters by further gains in income and the substantial increase in household net worth that has occurred over the past two years; debt problems, although rising of late, do not seem to be so widespread as to threaten the ongoing expansion of household expenditures in the aggregate. In the business sector, balance sheets are strong, profits have been rising, and efforts to bolster efficiency through the use of technologically advanced equipment are continuing at an intense pace. In the commercial real estate market, the supply-demand balance has shifted in many locales to a point at which interest in office building projects has picked up noticeably. These conditions, together with the ready access to a wide variety of sources of finance that businesses currently are enjoying, should keep investment spending on an upward trajectory. Foreign demand for U.S. products should continue to rise with growth of the world economy, even in the wake of the significant appreciation of the dollar since the first half of 1995; however, imports also seem likely to remain on a clear upward trend, given the prospects for continued expansion of the U.S. economy. Government expenditures for consumption and investment probably will follow recent trends, with further cutbacks in real outlays at the federal level and moderate increases in the combined purchases of state and local governments.

Although the risk of increased inflation pressures is significant, especially in view of the tightness of the labor market and the strength in activity that has been evident recently, Federal Reserve policymakers expect this year's rise in the consumer price index to be somewhat smaller than that of 1996.

The major reason for expecting a smaller CPI increase this year is a more favorable outlook for food and energy prices. Prices of farm products have dropped back from the highs of last summer, and, barring further weather problems, this year's rise in food prices at retail should be considerably smaller than that of 1996. Oil prices have recently declined and seem likely to ease further in coming months as world production and consumption come back into better balance; this price relief is important not only because of the direct effects on the price of gasoline and other consumer energy items but also because petroleum is a major element in the cost of producing and distributing many other goods. By contrast to the favorable outlook for food and energy prices, some risk exists that core inflation could turn up during the coming year. The minimum wage will be moving up further in 1997, compounding whatever cost pressures might be in train as a result of labor market tightness, and the degree to which businesses can continue to absorb stepped-up increases in labor costs without raising prices more rapidly is not certain.

As noted in the July 1996 monetary policy report, the CPI forecasts of the governors and Reserve Bank presidents incorporate allowances for the technical improvements to this index that have been made by the Bureau of Labor Statistics. These technical changes are estimated to have trimmed the reported rate of CPI inflation slightly in each of the past two years, and additional changes will be affecting the rise in the index in 1997. In view of the remaining difficulties of accurately measuring price change in a highly complex and rapidly changing economy, alternative price indexes will continue to be given substantial weight, along with the CPI, in monitoring progress toward the long-

run goal of price stability. Some of the broad measures of inflation derived from the GDP accounts slowed in 1996; the Committee is concerned that, even if the CPI decelerates as expected in 1997, other indexes—with different scope and weights—may pick up in reflection of the pressures on productive resources.

Money and Debt Ranges for 1997

Again in 1997, the Committee has set ranges for M2 and M3 that would encompass monetary growth expected to be consistent with approximate price stability and a sustainable rate of real economic growth, assuming that the behavior of velocity is in line with historical norms. These ranges are unchanged from those for 1996: 1 percent to 5 percent for M2 and 2 percent to 6 percent for M3.

As has been the case for several years, the 1997 ranges for M2 and M3 were set against a backdrop of uncertainty about the stability and predictability of their velocities. A long-run pattern of reasonably stable velocity behavior broke down in the early 1990s when the public's holdings of monetary assets were depressed by several factors: the contraction of the thrift industry; a tightening of credit supplies and deleveraging by businesses and households; an extremely wide spread between short- and intermediate-term interest

rates that heightened the attractiveness of capital market instruments relative to bank deposits; and the expanding availability and growing acceptance of stock and bond mutual funds as household investments.

With the waning of all but the last of these influences, movements in velocity have become more predictable over the past couple of years. This recent evidence of stability, however, covers only a relatively brief period, and its durability remains uncertain. In these circumstances, the Committee has opted to continue treating the ranges as benchmarks for the trends of money growth consistent with price stability rather than as short-run targets for policy. Meanwhile, the actual behavior of the monetary measures will be monitored for such information as it may convey about underlying economic developments.

The central tendency of the Committee's expectations for nominal GDP growth in 1997 is slightly below that registered in 1996. Thus, if velocity behaves as it did last year, M2 and M3 might decelerate a bit but even so would again expand around the upper ends of their growth ranges. Debt of the nonfinancial sectors is anticipated to increase this year at around the pace of last year, remaining near the midpoint of its unchanged 3 to 7 percent range.

Economic and Financial Developments in 1996 and Early 1997

The economy turned in a remarkably favorable performance this past year. Preliminary estimates indicate that real GDP rose more than 3 percent over the four quarters of 1996, one of the larger gains of the past several years and appreciably more than the FOMC was expecting a year ago. Although intermediate- and long-term interest

Ranges for Growth of Monetary and Debt Aggregates

Percent			
Aggregate	1995	1996	1997
M2	1-5	1-5	1-5
M3	2-6	2-6	2-6
Debt	3-7	3-7	3-7

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

rates moved up, credit remained readily available to most borrowers, and equity prices rose substantially. Expansion of the debt of nonfinancial sectors continued at about the 5 percent rate it has maintained over the past several years, and growth of the stock of money picked up a little to its most rapid pace this decade. These financial developments provided support for strong advances in the real expenditures of households and businesses, and the growth of exports held up well in the face of an appreciating dollar. Tightness of the labor market led to a moderate pickup in wage increases in 1996. However, acceleration of prices was confined largely to the food and energy sectors; prices for other consumer products decelerated, as did prices paid by businesses for capital goods and materials. Economic data for early 1997 show the unemployment rate holding in a low range with the inflation trend still subdued.

Economic Developments

The Household Sector

After having risen less than 2 percent in 1995, real personal consumption expenditures moved up 2³/₄ percent in 1996. Although debt problems arose with greater frequency this past year, households benefited from healthy increases in real income and another year of sizable gains in wealth. Consumers were relatively optimistic about prospects for the economy at the start of 1996, and they became more so as the year progressed.

Real outlays for consumer durables rose more than 5 percent in 1996 after a gain of only 1¹/₄ percent during 1995. As has been true for many years, real expenditures on computers and elec-

tronic equipment outpaced the growth of other household outlays by a wide margin in 1996. Sizable increases were also reported for most other types of consumer durables. However, real expenditures on vehicles changed little on net over the year, as gains achieved during the first half were reversed after midyear. Late in 1996, sales of light vehicles may have been constrained to some degree by supply shortages that arose during strikes in the United States and Canada; early in 1997, vehicle sales strengthened. Consumer purchases of nondurables rose 1³/₄ percent in 1996 after having increased 1 percent during 1995. Spending for services rose 2¹/₂ percent last year, about the same as the average gain in previous years of the expansion.

After-tax personal income increased 5 percent in nominal terms over the four quarters of last year. Wages and salaries rose briskly, and the income of farm proprietors surged. Other types of income generally exhibited moderate gains. Given the low level of price inflation, the rise in nominal income translated into another significant advance in real disposable income—about 2³/₄ percent over the year.

As in 1995, strong cross-currents continued to shape individual households' willingness—and ability—to spend from current income. Huge increases in stock market wealth provided some households the wherewithal to boost spending at a pace considerably faster than the growth of disposable income. But a number of households were likely held back by the need to divert income to the servicing of debt, and according to some survey evidence, households have become more concerned about saving for retirement. Responding to these influences, the annual average of the personal saving rate was up slightly from that of 1995; however, it remained

relatively low compared with its longer-run average.

Residential investment expenditures posted a gain of 4 percent in real terms over the four quarters of 1996, more than reversing a small decline in the previous year. Demand for single-family housing was especially strong. Although interest rates on longer-term fixed-rate mortgage loans moved up considerably in 1996, a substantial number of homebuyers sidestepped at least the initial costs by using adjustable-rate loans that were available at lower rates. The effects of the rate increases on the single-family market were cushioned by other influences as well, most notably the growth of employment and income. Even for fixed-rate loans, mortgage financing costs held at a level that, by historical standards, was low relative to household incomes. All told, sales of new homes surged to the highest annual total of the current expansion, and sales of existing homes established a historical high. New construction of single-family dwellings also rose but not so dramatically as sales, as builders apparently chose to work off some of their inventories of unsold units, which had climbed in 1995. Mild sluggishness in starts toward the end of 1996—which was probably exacerbated by poor weather in December—was followed by more upbeat indicators of new construction in January of this year.

Construction of multifamily units maintained a path of recovery from the extreme lows of the early 1990s, moving up about 13 percent in terms of annual totals. The number of multifamily units started—about 315,000—was double the number started in 1993, when construction of these units was at a low. However, compared with previous peaks, the 1996 total was less impressive—starts were twice as high in some years of the 1970s and 1980s.

Although market conditions for multifamily properties varied considerably from city to city in 1996, the national average vacancy rate for multifamily rental units remained relatively high, and demographic influences were probably less supportive of multifamily housing than they were a decade or so ago. Also, manufactured houses have provided an increased number of families with an alternative to rental apartments in recent years.

The Business Sector

Business fixed investment recorded a fifth consecutive year of strong expansion in 1996, rising about 9 percent according to the initial estimate. As in other recent years, investment was driven by rising profits, favorable trends in the cost of capital, and the ongoing efforts of businesses to boost efficiency. Although much of the investment spending was to replace depreciated equipment, the net addition to the aggregate capital stock appears to have been substantial. The rate of rise in the stock has picked up over the past two or three years after subpar growth through the latter half of the 1980s and first few years of the 1990s; the resulting rise in the level of capital per worker should enhance labor productivity and potential output.

Equipment outlays moved up almost 9½ percent in real terms in 1996. Business purchases of office and computing equipment once again rose much faster than the outlays for other types of equipment. Computer purchases were propelled by many of the same forces that have been at work in other recent years—most particularly, the expansion of networks and the availability of new models of computers embodying substantially improved computing power at highly attractive prices. Outlays for

communications equipment also rose quite rapidly in 1996. Gains for other types of equipment were generally more modest.

Investment in nonresidential structures also rose substantially over the four quarters of 1996, posting the largest advance in several years. Business spending on structures went through an extended contraction in the latter part of the 1980s and early 1990s, and until recently the subsequent recovery has been relatively slow. That the 1996 gain in nonresidential investment would be so large was not evident until late in the year, when incoming data began to trace out sizable increases in new construction for many types of buildings. Investment in office buildings scored an especially large gain over the year, amid widespread reports of firming market conditions and reduced vacancy rates, and real outlays for other commercial structures moved up for a fifth consecutive year. Financing appears to be in ample supply for commercial construction, and according to reports from the District Reserve Banks, speculative office building projects—that is, those without pre-committed tenants—are becoming more common.

Inventory investment was relatively subdued in 1996. The stock of nonfarm business inventories rose less than 2 percent over the four quarters of the year, the smallest increase since 1992. Businesses had been moving toward a reduced rate of stockpiling over much of 1995, and the rate of accumulation came almost to a halt in early 1996, when stocks of motor vehicles plummeted in conjunction with a strike at two plants that manufacture auto parts. Thereafter, inventory developments were relatively uneventful. Stocks of vehicles changed little on net over the final three quarters of the year, and accumulation of inventories by other nonfarm businesses was

moderate on average. Stocks at year-end generally appeared to be at comfortable levels relative to recent trends in sales.

Business profits turned in another strong performance in 1996. Economic profits of all U.S. corporations rose at an annual rate of more than 10 percent from the final quarter of 1995 to the third quarter of 1996. Profits earned by foreign subsidiaries of U.S. corporations fluctuated from quarter to quarter but remained at high levels, and returns from domestic operations rose substantially, for both financial and nonfinancial firms. Domestic profits of nonfinancial corporations amounted to 10.7 percent of the nominal value of these firms' output in the third quarter, the highest reading of the current expansion.

The Government Sector

Real federal expenditures on consumption and gross investment—the part of federal spending that is included in GDP—rose about 2½ percent, on net, from the fourth quarter of 1995 to the fourth quarter of 1996, but the rise was mostly an artifact of late-1995 real purchases having been pushed to especially low levels by government shutdowns. The underlying trend of federal consumption and investment expenditures probably is better represented by the 2½ percent annual rate of decline from the fourth quarter of 1994 to the final quarter of 1996. Reductions have been apparent over the past two years both in real defense purchases and in real nondefense purchases.

Federal expenditures in the unified budget increased about 3 percent in nominal terms in fiscal 1996 after having increased 3¾ percent in fiscal 1995. Slower growth was recorded across many budgetary categories this past year, and outright declines were reported in some. Combined expenditures on

health, social insurance, and income security—items that account for more than half of all federal outlays—moved up 4½ percent, the smallest increase this decade. Defense spending was down about 2¼ percent in nominal terms, and net interest outlays rose much less rapidly than in fiscal 1995. Measured relative to the size of nominal GDP, total outlays in the most recent fiscal year were the smallest since 1979. Legislative restraint has led to cuts in a number of discretionary programs in recent years, and the expanding economy has relieved pressure on those outlays that tend to vary inversely with the strength of activity.

Federal receipts increased about 7½ percent in fiscal 1996, the third year in which growth of receipts outpaced growth of nominal GDP by a significant margin. Receipts from individual income taxes climbed more than 11 percent in the most recent fiscal year, in conjunction with healthy increases in households' taxable earnings from capital and labor. Taxes on corporate profits also continued to rise rapidly, more or less in step with the growth of business earnings. The rapid growth of receipts, coupled with the restrained growth of expenditures, brought the unified budget deficit down to \$107 billion in fiscal 1996 from almost \$165 billion in fiscal 1995. The deficit as a share of nominal GDP was 1.4 percent, the smallest in more than twenty years.

The aggregate consumption and investment expenditures of state and local governments rose 2¼ percent in real terms over 1996. This gain was about the same as those of the two previous years. Outlays for services, which consist mainly of employee compensation and account for more than two-thirds of all state and local purchases, rose roughly 1¼ percent in real terms last year. Investment expenditures,

which make up the next biggest portion of state and local purchases, rose about 4½ percent in real terms. In the aggregate, the budget picture for state and local governments was relatively stable in 1996, as the surplus of nominal receipts over nominal current expenditures changed little from the positive readings of other recent years.

The External Sector

The nominal trade deficit for goods and services widened to \$115 billion in 1996 from \$105 billion the previous year. For the first three quarters of the year, the current account deficit totaled \$165 billion at an annual rate, somewhat greater than the \$150 billion deficit recorded in 1995.

The quantity of imports of goods and services rose strongly over the four quarters of 1996—about 8½ percent according to the preliminary estimate—after having expanded only 4¼ percent the previous year. The pickup in U.S. real output growth boosted the demand for imported goods, as did the declines in the prices of non-oil imports. Sizable increases in import volume were widespread among most major merchandise trade categories, with the notable exceptions of oil and semiconductors.

Very strong export growth in the fourth quarter of 1996 raised the yearly gain in the quantity of exports of goods and services to 7½ percent. Growth in the economies of our major trading partners was only moderate on average but was somewhat faster than in 1995. As a consequence, growth of exports was similar to the 1995 rate despite the appreciation of the dollar. Over the past year, most of the rise in the value of merchandise exports went to Canada and Latin America. Exports to Western Europe and Asia were only marginally higher than they were a year earlier.

In most of the major industrial countries abroad, real economic activity accelerated last year from a relatively weak performance in 1995. In the United Kingdom, real output growth firmed through the year, as growth in consumption spending rebounded from its low 1995 rate. In Germany and France, real GDP growth strengthened but was still too low to prevent a further rise in the unemployment rate in both countries. In Italy, output growth slowed as the rebound in the lira from its previous depreciation sharply reduced the growth of exports and depressed investment spending. For most continental European countries, further fiscal restraint is planned this year as governments hoping to participate in the third stage of European Monetary Union strive to meet the Maastricht Treaty's 1997 reference standard of a budget deficit no larger than 3 percent of GDP. In Japan, fiscal stimulus spurred economic expansion early last year; subsequently, slower private consumption, reduced inventory accumulation, and decreased government investment spending reduced output growth. In contrast, Canada's real output growth rose over 1996 as inventory adjustment was completed during the first half of the year and as exports strengthened.

Except in the United Kingdom, inflation pressures in the foreign industrial countries continued to decline or remained subdued during 1996. Consumer prices in Japan were flat. Consumer price inflation fell sharply in Italy and remained below 2 percent in Germany and France. In the United Kingdom, consumer prices excluding mortgage interest payments accelerated to an annual rate of more than 3 percent.

The Mexican economy continued on a course of recovery that returned GDP to its pre-crisis level in the fourth quarter of 1996. Increases in income and

a strengthening of the price-adjusted value of the peso contributed to a reduction in the Mexican merchandise trade surplus over 1996. Argentina and Brazil also continued to recover from recessions. In Chile, real GDP growth moderated from the very high rate recorded in 1995 to about 6 percent in 1996. In Venezuela, windfall oil revenues softened the decline in real GDP in 1996 and improved the prospects for 1997.

In our major trading partners in Asia other than Japan, real output growth generally slowed from its 1995 pace, despite a pickup in many countries toward year-end in response to more accommodative monetary policies and a partial recovery in export markets. In China, the slowdown of growth to about 10 percent last year from the 12 percent to 14 percent annual rates experienced during 1992-94 reflected a substantial deceleration in investment spending, owing to China's efforts to reduce inflation by tightening central bank credit to state-owned enterprises and by restricting investment.

Consumer price inflation in Mexico was about 28 percent in 1996, significantly lower than the 1995 inflation rate of more than 50 percent. Venezuela's inflation rate in 1996 exceeded 100 percent, but inflation in most other Latin American countries was at levels well under 10 percent. Inflation rates generally remained low in Asia.

The Labor Market

The number of jobs on nonfarm payrolls rose more than 2½ million from December 1995 to December 1996, an increase of about 2¼ percent. Employment gains were substantial in each quarter last year, and the labor market report for January of this year showed a further sizable expansion of payrolls.

Employment in the private service-producing sector, in which nearly two-thirds of all nonfarm workers are employed, increased about 3 percent during 1996. Moderate employment gains were posted in retail trade, transportation, and finance, and sizable gains in hiring continued in some other service-producing industries, such as data processing, computer services, and engineering and management. Job growth at suppliers of personnel—a category that includes temporary help agencies—was about 6½ percent, a touch faster than in 1995 but much slower than it had been over 1992–94; with the tightening of labor markets in the past couple of years, longer-lasting commitments in hiring may have come back into greater favor among some employers.

Employment changes among producers of goods were mixed in 1996. In construction, employment climbed about 5½ percent, to a new high that was almost 4 percent above the peak of the last business expansion. In manufacturing, increases in factory jobs through the latter part of 1996 were not sufficient to reverse declines that had taken place earlier in the year. On net, last year's loss of factory jobs amounted to about ½ percent, a shade less than the average rate of decline since 1979, the year in which manufacturing employment peaked. Manufacturers of durable goods boosted employment slightly last year, but many producers of nondurables implemented further job cuts. As in many other recent years, reductions in factory employment were accompanied by strong gains in worker productivity. Consequently, increases in output were sizable—the rise in the Federal Reserve's index of manufacturing production cumulated to 4¼ percent over the year.

Growth of output per hour in the nonfarm business sector as a whole picked up in 1996, rising about 1¼ percent over the year according to preliminary data. However, coming after a three-year period in which output per hour changed little, this rise left the average rate of productivity growth in the 1990s a bit below that of the 1980s and well below the average gains achieved in the first three decades after World War II. The sustained sluggishness in measured productivity growth this decade is difficult to explain, as it has occurred during a period when high levels of investment in new capital and extensive restructuring of business operations should have been boosting the efficiency of workers. Of course, measurement problems could be distorting the data. As a summary measure that relates aggregate output to aggregate input of labor, the nonfarm productivity index is affected by whatever deficiencies might be present either in adding up the nominal expenditures for goods and services in the economy or adjusting those expenditures for price change. A considerable amount of recent research suggests that growth of output and productivity is in fact understated, but whether the degree of understatement has been increasing over time is less clear.

In contrast to the experience of most other recent years, this past year's rise in employment was accompanied by a sustained pickup in the labor force participation rate. The rise in participation boosted the labor supply and helped to relieve pressures on the labor market. Nonetheless, hiring during 1996 was sufficient to reduce the civilian unemployment rate from a December 1995 rate of 5.6 percent to a December 1996 rate of 5.3 percent. In January of this year, the rate remained low, at 5.4 percent.

Tightness of the labor market appears to have exerted some upward pressure on the cost of labor in 1996, even as some workers continued to express anxiety about job security. The employment cost index (ECI) for the private nonfarm sector of the economy showed compensation per hour moving up 3.1 percent over the year. The index had risen 2.6 percent in 1995. The step-up in hourly pay increases was to some extent the result of a hike in the minimum wage that took place at the start of October. More generally, however, businesses probably had to boost hourly compensation either to attract workers or to retain them at a time when alternative employment opportunities were perceived to be more widely available.

As in 1995, increases in hourly compensation in 1996 came more as wage and salary increases than as increases in fringe benefits. According to the ECI, the rise in wage rates for workers in the nonfarm sector amounted to nearly 3½ percent this past year after a rise of 2¾ percent in 1995. By contrast, the ECI measure of the hourly cost of benefits rose only 2 percent, slightly less than it did in 1995 and much less than it rose on average over the past decade. Increases in the cost of benefits have been held down in recent years by reduced inflation for medical services and by the actions that many firms have taken to shift employees into managed care arrangements and to require them to assume a greater portion of the cost of health insurance and other medical benefits.

Prices

The consumer price index rose more rapidly than in 1995, but the step-up was concentrated in the food and energy sectors—areas in which prices were affected by supply limitations that

seemed likely to be of temporary duration. The CPI excluding food and energy—often called the “core” CPI—rose just a touch more than 2½ percent after having increased 3 percent during 1995. Both the total CPI and the core CPI have been affected in the past two years by technical improvements implemented by the Bureau of Labor Statistics that are aimed at obtaining more accurate readings of price change; the rise in the CPI in 1996 would have been somewhat greater if procedures used through 1994 had not been altered.

Other price indexes generally rose less rapidly than the CPI. Like the overall CPI, the chain-type price index for personal consumption expenditures (PCE) accelerated somewhat in 1996, but its rate of rise, shown in the accompanying table, was significantly lower than that of the CPI. The two measures of consumer prices differ to some degree in their weights and methods of aggregation. They also differ somewhat in their selection of price data, with the PCE measure relying on alternative data in some areas in which the accuracy of the CPI has been questioned. The chain type price index for gross domestic purchases, which takes account of the

Alternative Measures of Price Change

Percent

Price measure	1995	1996
<i>Fixed-weight</i>		
Consumer price index	2.7	3.2
Excluding food and energy ...	3.0	2.6
<i>Chain-type</i>		
Personal consumption expenditures	2.1	2.5
Excluding food and energy ...	2.3	2.0
Gross domestic purchases	2.3	2.2
Gross domestic product	2.5	2.1
<i>Deflator</i>		
Gross domestic product	2.5	1.8

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

prices paid by businesses and governments as well as those paid by consumers, moved up $2\frac{1}{4}$ percent during 1996, about the same as the percentage rise during 1995. By contrast, price measures associated with GDP decelerated in 1996 to thirty-year lows of around 2 percent or less. Conceptually, the GDP measures are indicative of price changes for goods and services that are produced domestically rather than price changes for goods and services purchased domestically—foreign trade accounting for the difference.

The 1996 outcomes for all these measures reflected an economy in which inflation pressures were muted. Sharp declines in non-oil import prices during the year lowered input costs for many domestic firms and likely caused other firms to restrain their product prices for fear of losing market share to foreign competitors. Also important, in all likelihood, were the favorable imprints that several years of moderate and relatively stable rates of inflation have left on inflation expectations. Despite the uptick in hourly compensation and adverse developments in the food and energy sectors, survey data showed little change in consumers' expectations of inflation, and private forecasters' views of the prospects for prices held steady. Businesses commonly described the situation as one in which competitive pressures were intense and the "leverage" for raising prices simply was not present.

Food and energy prices were the exceptions. In the food sector, steep increases in grain prices in 1995 and the first few months of 1996 caused production adjustments among livestock farmers and substantial price increases for some livestock products. Later in the year, grain prices fell back, but livestock production could not recover in time to prevent significant price advances for

some retail foods. Consumer prices for pork, poultry, and dairy products registered their largest increases in several years. Retail beef prices also rose but only moderately: Expansion of the cattle herd in previous years had laid the groundwork for a high flow of product to consumers, and herd reductions that occurred in 1996 augmented that flow. Elsewhere in the food sector, acceleration was reported in the price index for food away from home—a category that has a weight of almost 40 percent in the CPI for food; the rise in the minimum wage appears to have been an important factor in the acceleration. All told, the 1996 rise in CPI food prices amounted to $4\frac{1}{4}$ percent, the largest increase since 1990.

The energy sector was the other major part of the economy in which significant inflation pressures were evident this past year. Crude oil prices, which had started firming in the latter part of 1995, continued on an upward course through much of 1996, rising more than 30 percent in total. Stocks of crude oil and petroleum products were tight during the year, even after allowing for an apparent downward trend in firms' desired inventories. Inventory building was forestalled by production disruptions at refineries, a string of weather problems here and abroad that boosted fuel requirements for heating or cooling, and a reluctance of firms to take on inventories that seemed likely to fall in value once renewed supplies from Iraq became available. Natural gas, too, was in tight supply at times, and its price surged. With retail prices of gasoline, fuel oil, and natural gas all moving up substantially, the CPI for energy rose about $7\frac{1}{2}$ percent over the four quarters of 1996, the largest increase since the Gulf War.

The CPI for goods other than food and energy rose 1 percent during 1996,

one of the smallest increases of recent decades. As in 1995, price increases for new vehicles were moderate last year, and prices of used cars turned down after several years of sizable advances. Prices of apparel and house furnishings also fell; these prices, as well as the prices of vehicles, may have been heavily affected by the softness of import prices. Moderate increases were the rule among most other categories of goods in the CPI. In the producer price index, prices of capital equipment rose less than ½ percent over 1996; computer prices continued to plunge, and the prices of other types of equipment rose moderately, on balance. Materials prices were weak: Prices of intermediate materials excluding food and energy declined about 1¼ percent from the fourth quarter of 1995 to the final quarter of 1996, and the producer price index for crude materials excluding food and energy dropped more than 6½ percent over that period. Productive capacity was adequate among domestic producers of materials, and supplies of many materials were readily available at competitive prices on the world market.

The CPI for non-energy services increased 3¼ percent in 1996. The rise was somewhat smaller than the increases of most other recent years. Prices of medical services decelerated for a sixth consecutive year, and increases in the cost of shelter were held down by another year of moderate advances in residential rent and owners' equivalent rent. Large increases were evident only in scattered categories: Airfares posted a large increase, and educational costs, maintaining a long-established trend, continued to rise quite rapidly relative to prices in general.

Financial Developments

Debt

Growth of the debt of nonfinancial sectors slowed slightly last year, to 5¼ percent. The growth of household sector debt dropped from 8¼ percent to 7½ percent, a deceleration accounted for entirely by a sharp slowing of consumer credit. The expansion of business borrowing was held below its 1995 pace by an increase in internally generated funds, but at 5¼ percent, it was faster than in any other year since 1989. Its strength reflected robust spending, extremely favorable credit conditions, and financing needs associated with a high level of mergers and acquisitions. Federal government debt grew 3¾ percent, the lowest rate in more than two decades. The debt outstanding of the state and local sectors was unchanged.

The Household Sector. Consumer credit grew 8¼ percent last year, just a bit over half the pace of the preceding two years. The sharp retrenchment likely reflected the burdens associated with a substantial accumulation of outstanding consumer debt over recent years as well as some tightening of lending terms and standards by commercial banks, particularly with respect to credit cards.

The slowing in consumer credit growth also was associated with a shift toward increased use of home equity loans. These loans were marketed vigorously, particularly by finance companies, in part as a vehicle for consolidating credit card and other outstanding consumer debt. Some of the growth in home equity loans reflected moves by finance companies and banks into the "subprime" market—

lending either to higher-risk customers or on terms entailing unusually high loan-to-value ratios, or both. The push to expand home equity lending last year offset to some degree the effect of tighter lending standards and terms on credit cards and other forms of consumer credit.

The shift toward home equity loans, along with a strong housing market, led to a pickup in mortgage debt growth last year to a rate of 7½ percent, the largest advance since 1990. Mortgage borrowing for home purchases was restrained surprisingly little by the increase in interest rates over the first half of the year. As noted previously, many borrowers were able to put off, at least for a time, much of the impact of the increase in rates by shifting to adjustable-rate mortgages, the rates on which rose much less last year than those on fixed-rate mortgages.

Although the growth of household sector debt fell off a bit from the pace of recent years, it still exceeded that of disposable income. With loan rates up on average for mortgages and down only a little on consumer loans, debt-service burdens continued to rise last year, and some households experienced difficulties servicing certain kinds of debt. Delinquency rates on banks' consumer loans, particularly credit card loans, posted a second year of considerable increase, although they remained below levels in the early 1990s. At finance companies that are subsidiaries of auto-makers, auto loan delinquency rates rose to very high levels; but this rise apparently resulted in large part from a business strategy to compete in the vehicle market by easing lending standards. Auto loan delinquency rates at commercial banks also rose but remained well within historical ranges. Delinquency

rates on residential mortgages remained low.

In the segment of the finance company market that deals in subprime auto loans, some problems emerged last month. A small firm in this market defaulted on its commercial paper after it restated earlier earnings at lower levels, and another firm filed for bankruptcy. Although the share prices of these and other firms primarily engaged in sub-prime lending declined along with their earnings outlook, this sector constitutes a very small part of the overall auto loan market, and the implications for the availability of credit to the household sector overall appear slight.

Charge-off rates on consumer loans rose at banks in 1996 to around the peak levels of the last recession in 1990–91. According to Federal Reserve surveys of senior loan officers, banks had anticipated some deterioration in the quality of their consumer loan portfolios last year, but they were surprised by its extent. These surveys also showed that banks considered the rate of charge-offs last year to be high relative to the level of delinquencies and that the credit-scoring models most banks use to evaluate consumer lending decisions have tended to be too optimistic. An important reason for the high level of charge-offs and the apparent shortcomings of the credit-scoring models was a 30 percent increase in personal bankruptcies. This surge stemmed in part from changes in the bankruptcy code that became effective at the beginning of last year against a backdrop of an apparently reduced stigma associated with this method of dealing with financial problems. Banks responded to the deterioration in their consumer loan portfolios by tightening standards and terms, especially

on credit cards. In contrast, banks eased terms and conditions on home equity loans.

Despite the rise in delinquencies on consumer debt, household balance sheets appear healthy overall, as growth of household assets over the past two years has more than kept pace with the growth of debt. Although year-end balance sheet figures are not yet complete, the net worth of households appears to have risen approximately \$5 trillion from the end of 1994 to the end of 1996, an amount that is equal to almost a full year's personal disposable income. Roughly two-thirds of that gain has been accounted for by the surge in the prices of corporate shares, which has lifted the value of a wide range of household investments, not only directly held stocks but also assets held in other forms such as pension plans. The ratio of household net worth to personal disposable income continued to climb this past year, moving to its highest level in recent decades.

The Business Sector. Although many interest rates rose last year, businesses continued to find credit readily available and at favorable terms. This accommodation likely resulted in part from the strong financial condition of this sector, reflected in minimal delinquency rates on bank loans to businesses and very low default rates on corporate bonds, including those of low-rated issuers. With securitization of household debt instruments proceeding apace and with high levels of capital, banks appeared to have ample room on their balance sheets for business loans. This situation encouraged the development of a highly competitive lending environment in which banks further eased a variety of credit terms, such as covenants and markups over base rates. In capital markets, interest rate spreads of private debt

instruments over Treasuries narrowed, particularly in the case of high-yield bonds. Surveys by the National Federation of Independent Business revealed a rising tendency of small businesses to borrow over 1996, with credit availability reported to be in a range more favorable than at any time in the current economic expansion.

On a gross basis, a pickup in bond issuance by nonfinancial firms last year was accounted for mainly by speculative-grade offerings, likely in part a reaction to the improved pricing. In the fourth quarter, however, investment-grade issuance was substantial, responding to the decline in interest rates that began in late summer. Commercial paper declined in the final months of the year, primarily because of paydowns from bond proceeds, but bank lending to businesses was strong, owing in some part to robust merger activity. Despite a marked increase in gross stock issuance—with strong gains both for initial public offerings and for seasoned offerings—equity continued to be retired on net last year, as merger activity remained brisk and businesses used ample cash resources to repurchase their outstanding shares.

The Government Sector. The growth of federal debt was held down in 1996 by legislative constraints on spending and by the boost to tax receipts from both the stronger economy and a booming stock market. Two years of contraction of state and local government debt ended last year. The declines had occurred as issues that were pre-refunded earlier in the decade, when interest rates were unusually favorable, matured or became eligible to be called. Pre-refunded debt continued to be called last year, albeit at a reduced pace, but this decline was just offset by gross issuance, which picked up.

Depository Intermediation. The expansion of depository credit slowed last year, entirely reflecting a slower advance in bank credit. Growth at thrift institutions picked up, benefiting from strong demand for residential mortgages and improved capital positions. Growth of commercial bank loans moderated, as loans to businesses and, especially, consumers decelerated from elevated rates of growth in 1995. Bank portfolio expansion also appears to have been damped somewhat by a faster pace of asset securitization, likely spurred by receptive capital markets. For example, real estate loan growth at banks was a subdued 4 percent last year, despite a robust housing market and a pickup in commercial real estate. At the same time, outstanding securities backed by mortgage pools expanded at a \$179 billion annual rate in the first three quarters of last year, well above the pace of 1995. Commercial banks are a major source of securitized mortgages. The outstanding amount of consumer credit that had been securitized by banks also rose at a brisk pace last year, although not so rapidly as in 1995. As a result of the slowing of bank credit, the share of last year's advance in nonfederal debt that ended up on the books of depositories fell to about 38 percent, down from around 44 percent in the preceding two years.

The balance sheets and operating results of depositories remained strong in 1996. Bank profits through the third quarter were at historically high levels for the fourth consecutive year, reflecting the maintenance of relatively wide interest rate margins, further loan growth, and substantial fee income related to sales of mutual funds as well as to securitization and other off-balance-sheet activities. As of the third quarter, almost 99 percent of commercial bank assets were held at banks

classified as "well capitalized." Underlying thrift profits were also stronger last year. However, profits at thrift institutions and at banks with deposits insured by the Savings Association Insurance Fund (SAIF) were held down temporarily by a special assessment on deposits to recapitalize SAIF. (Some bank deposits are SAIF-insured because of mergers with thrift institutions or acquisitions of them.)

The Monetary Aggregates

Despite the slowing of depository credit, growth of the broader monetary aggregates strengthened last year: M3 expanded 7 percent, up 1 percentage

Growth of Money and Debt

Percent

Period	M1	M2	M3	Domestic non-financial debt
<i>Annual</i> ¹				
1980	7.5	8.7	9.6	9.5
1981	5.4	9.0	12.4	10.2
	2.5 ²			
1982	8.8	8.8	9.7	9.9
1983	10.3	11.8	9.5	11.9
1984	5.4	8.1	10.8	14.5
1985	12.0	8.6	7.7	14.2
1986	15.5	9.1	9.0	13.2
1987	6.3	4.2	5.8	10.0
1988	4.3	5.7	6.3	9.0
1989 .....	.5	5.2	4.0	7.9
1990	4.1	4.1	1.8	6.9
1991	7.9	3.1	1.2	4.6
1992	14.4	1.8	.6	4.7
1993	10.6	1.3	1.1	5.1
1994	2.5	.6	1.7	5.2
1995	-1.6	4.0	6.2	5.5
1996	-4.6	4.6	6.9	5.3
<i>Quarterly (annual rate)</i> ³				
1996:Q1	-3.5	5.3	6.6	5.0
Q2	-1.4	4.5	6.3	5.7
Q3	-6.5	3.4	5.4	5.3
Q4	-7.4	5.0	8.5	4.9

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

2. Adjusted for shifts to NOW accounts in 1981.

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

point from 1995 and also 1 percentage point above the upper end of its 2 percent to 6 percent annual range. M2 grew 4½ percent, up ½ percentage point and in the upper portion of its 1 percent to 5 percent range. As noted above, the ranges for monetary growth last year had been chosen to be consistent with approximate price stability and a sustainable rate of real economic growth, rather than as indicators of the range of money growth rates likely to prevail under expected economic conditions.

The acceleration of M3 was caused partly by a shift in the way banks financed their credit—specifically, substituting issuance of large time deposits for borrowings from offices abroad. Both foreign and domestically chartered banks paid down net borrowing from foreign head offices and branches last year. For domestic banks, this paydown may have been related to the reduction to zero of insurance assessments on deposits, beginning with the last quarter of 1995. In addition, the greater growth of M3 relative to that of M2 reflected the need to fund particularly strong loan growth at U.S. branches and agencies of foreign banks, which do not offer the retail accounts that dominate deposits in M2.

Growth of both M2 and M3 was supported again last year by continuing robust advances in money market mutual funds (MMMFs). Because the yields on these funds are based on the average return earned on their assets, they lag changes in yields on new market instruments; thus, the funds tend to attract additional inflows when market rates are falling. Accordingly, MMMFs advanced most rapidly in the early part of last year, when the monetary easings of December and January pulled down short-term rates, and also later in the year, when short-term rates were again

declining. However, these instruments expanded briskly even in the third quarter, when short-term rates were rising, suggesting that part of the attractiveness of MMMFs is the convenience they offer those investors engaged in moving funds in and out of stock and bond mutual funds, which expanded at a record pace last year. In addition, institution-only funds seem to be having considerable success in marketing cash management programs that capture excess cash of corporations and municipalities. Likely reflecting the attractiveness of money market and capital market mutual funds last year, deposits in M2 actually showed little growth in 1996. Retail deposit growth also may have been damped by a lack of aggressive pricing of deposits on the part of banks, as demand for their loans slipped and they apparently found it cheaper to finance a larger share of loan originations through securitizations and large time deposits.

The behavior of M2 relative to income last year, as summarized by its income velocity, again bore a fairly systematic relationship to M2's opportunity cost—the return on M2 assets relative to yields available on alternative instruments. The relationship of velocity to opportunity costs was reasonably stable historically, but it broke down in the early 1990s, a period characterized by extensive restructuring of balance sheets by households, businesses, and banks. In the process, M2 velocity rose substantially and, apparently, permanently. Since 1993, velocity no longer appears to be shifting higher, and M2 velocity and opportunity costs are moving together about as they did before 1990. However, the recent period of relative stability in this relationship has been too short for the Federal Reserve to place increased reliance on M2 as a guide to policy at this time.

M1 contracted 4½ percent last year, as the pace at which new arrangements were established to sweep reservable retail transactions deposits to nonreservable nontransaction accounts accelerated. The initial amounts removed from transaction accounts by sweep arrangements established last year amounted to \$116 billion, compared with \$45 billion in 1995. M1 continued to be supported by currency growth last year, when foreign demands, which were depressed earlier in the year partly in anticipation of the new \$100 bill, picked up in the second half. Adjusted for the initial amounts removed from transaction accounts by sweep arrangements, M1 grew 5¼ percent last year. The sweeping of transaction deposits contributed to a contraction of almost 12 percent in required reserves—twice the rate of decline of the previous year. The monetary base decelerated only a little, however, as growth of its major component, currency, was little changed between 1995 and 1996.

Continued declines in the levels of required reserves have the potential to impinge on the Federal Reserve's ability to exert close day-to-day control over the federal funds rate—the overnight rate on reserves traded among depository institutions. Depositories hold balances at Reserve Banks to meet daily clearing needs in addition to satisfying statutory reserve requirements. At low enough levels, reserve balances may provide inadequate protection against adverse clearings, and banks' attempts to avoid overdrafts could generate highly variable daily demands for balances at the Federal Reserve and a volatile federal funds rate. To date, however, no serious problems have emerged, in part because the substantial drop in depositories' required reserve balances attributable to sweeps has been partially

offset by increases in their holdings of required clearing balances—an arrangement whereby depositories pay for services provided by the Federal Reserve through the holding of specified amounts in reserve account balances. In addition, advances in banks' techniques of monitoring balances at the Federal Reserve and gauging their clearing needs have enabled them to operate efficiently and smoothly at relatively low levels of balances. Sweeps have had an effect on Federal Reserve earnings and the amounts it remits to the Treasury. The decline in reserve balances of about \$12 billion owing to sweeps must be matched by an accompanying lower level of Treasury securities on the books of Reserve Banks. The Federal Reserve continues to monitor sweep activity closely.

Interest Rates, Equity Prices, and Exchange Rates

Interest Rates. Declines in interest rates during the second half of last year on evidence that economic growth had moderated only partially reversed the increases over the first half. Reflecting the surprising strength in economic activity last year, longer-term Treasury rates rose on balance on the order of ½ percentage point over the year, and intermediate rates were up somewhat more. Spreads between most private rates and Treasuries narrowed markedly last year, reflecting the high quality of business balance sheets. Municipal rates moved up comparatively little over the first half of 1996, as earlier relative increases in these yields associated with discussions of fundamental tax reform were reversed when the likelihood of such changes to the tax code diminished. Movements in interest rates over the year appeared to be basically in their real component, as inflation expecta-

tions were little changed, according to surveys.

Equity Prices. The substantial rise in equity prices last year was only a bit below that registered in 1995. However, in contrast to 1995, when bond rates declined substantially, the equity gains last year came despite the net rise in bond rates. Corporate earnings were robust last year, but their advance fell short of share price increases, and price-earnings ratios rose to unusually high levels; dividend-price ratios were even more out of line with historical experience. Market participants appear to be anticipating further robust earnings growth, and they also seem to be requiring much less compensation for the extra risk of holding equities compared to, say, Treasury bonds. Such evaluations may be based on a perceived environment of persisting low inflation and balanced economic growth that would lower the odds of disruptions to economic activity. Other asset prices were generally subdued. Commodity prices were flat to down. Commercial real estate prices, although no longer falling, rose at little more than the rate of inflation. Residential real estate prices increased moderately.

Exchange Rates. The foreign exchange value of the dollar in terms of the currencies of the other G-10 countries rose about 4 percent during 1996. When measured in terms of the currencies of a broader group of U.S. trading partners and adjusted for differences in consumer price inflation, the appreciation of the dollar last year was also about 4 percent. Much of the rise in the exchange value of the dollar occurred during the first half of the year. Indications of greater-than-expected underlying strength in the U.S. economy and signs of weakness in some European

economies in the first two quarters reinforced market expectations that U.S. monetary policy was less likely to be eased than was policy in the other industrial countries. These expectations boosted U.S. long-term interest rates relative to those abroad and contributed to upward pressure on the dollar. The dollar fluctuated somewhat from June through December but on balance changed little. Over the course of 1996, the dollar appreciated 12 percent in terms of the yen and $7\frac{3}{4}$ percent in terms of the mark. During the first weeks of 1997, the dollar's average value against the G-10 currencies has again moved up, appreciating about 7 percent since the end of December, as economic data have suggested additional strength in the U.S. economy and have raised questions about the vigor of economic expansions in several foreign industrial countries.

On average, yields on ten-year government securities in the major foreign industrial countries fell about 80 basis points last year, with most of the decline coming in the second half. In Italy, long-term rates declined much more, about 375 basis points, in response to low growth in real output, substantial progress in lowering inflation, and sizable, credible measures to reduce the government deficit. In contrast, long-term rates in the United Kingdom rose slightly as the economy strengthened. Rates in Japan rose early in the year as the economy spurted, but subsequent indicators of a weakening expansion caused rates to turn back down; over the year, they declined about 40 basis points on net. Long-term rates abroad have moved down slightly further so far this year. Short-term market rates in the foreign industrial countries on average declined about 120 basis points during 1996. Except in Japan, official central bank lending rates were lowered in the

foreign G-10 countries last year, contributing to the decline in market rates.

Equity prices in most industrial countries rose strongly last year. The major exception was Japan, where prices on balance fell slightly. The general decline in long-term interest rates abroad and moves toward monetary ease were among the factors contributing to the upward movement in stock prices.

The dollar appreciated in nominal terms about 2½ percent on balance against the Mexican peso during 1996, with much of that appreciation coming over a few weeks in October. After having fluctuated in a narrow range for most of the year, the Mexican peso depreciated in terms of the dollar when market participants became concerned about the loss of competitiveness of Mexican exports during the year and about the partial nature of the government's planned privatization of the petrochemical industry. Peso interest rates rose in October and November, but have since more than retraced that increase as the peso has stabilized. In January, Mexican officials repaid all remaining outstanding obligations to the Exchange Stabilization Fund of the U.S. Treasury, completing repayment to the United States of all borrowings that were made following the peso crisis in late 1994; a partial early repayment was made to the International Monetary Fund as well.

In the first three quarters of 1996, large increases were reported in both foreign ownership of assets in the United States and U.S. ownership of assets abroad. Over the same period, foreign official assets in the United States increased almost \$90 billion. Part of this increase was associated with exchange market intervention by the Japanese authorities to counter a brief strengthening of the exchange value of the yen early in the year, but a larger part reflected the repurchase of reserves

by several European countries whose currencies strengthened against the mark. About half reflected increases in reserves of newly industrializing countries.

Private foreigners also added substantially to their assets in the United States in the first three quarters of 1996. Net purchases of U.S. Treasury securities by private foreigners amounted to \$85 billion through September, and net purchases of corporate and government agency bonds were equally large. Foreign direct investment in the United States surged to a record \$71 billion in the first three quarters, reflecting numerous mergers and acquisitions of U.S. companies by foreigners.

U.S. private investors also added rapidly to their holdings of foreign assets in the first three quarters of 1996. In contrast to foreign investors in the United States, U.S. portfolio investors favored foreign stocks over bonds. Net purchases in Japan were particularly large in the first half of the year. In addition, U.S. direct investment abroad remained strong, reflecting acquisitions and continued privatizations of foreign firms.

Report on July 22, 1997

Monetary Policy and the Economic Outlook

The economy continued to perform exceptionally well in the first half of 1997. Real output grew briskly, while inflation ebbed. Sizable further increases in payrolls pushed the unemployment rate below 5 percent for the first time in nearly twenty-five years. Although growth in real gross domestic product appears to have slowed in the spring, this slackening came on the heels of a dramatic surge in the opening months

of the year; all indications are that the expansion remains well intact. The members of the Board of Governors and the Reserve Bank presidents anticipate that the economy will grow at a moderate pace in the second half of this year and in 1998 and that inflation will remain low. Conditions in financial markets are supportive of continued growth: Longer-term interest rates are in the lower portion of the range observed in this decade, the stock market has registered all-time highs, and credit remains readily available to private borrowers.

Since the February report on monetary policy, Federal Reserve policymakers have revised upward their expectations for growth of real activity in 1997 and trimmed their forecasts of inflation. This combination of revisions highlights the extraordinarily positive conditions still prevailing more than six years into the current economic expansion. In part, the recent confluence of higher-than-expected output and lower inflation has reflected the favorable influences on prices of retreating oil prices and a strong dollar. But it may also be attributable to more durable changes in our economy, notably a greater flexibility and competitiveness in labor and product markets and more rapid, technology-driven gains in efficiency. In essence, the economy may be experiencing an upward shift in its longer-range output potential.

To the extent that aggregate supply is expanding more rapidly, monetary policy can accommodate extra growth in demand without fostering increased inflationary pressures. In late March, however, the Federal Open Market Committee (FOMC) concluded that there was a significant risk that aggregate demand would grow faster in the coming quarters than available supply, which, with utilization already at a very high level, would place the economy's

resources under increasing strain. If such unsustainable growth persisted, the resulting inflationary imbalances would eventually undermine the health of the expansion—the all too frequent pattern of past business cycles. To protect against the possibility of such an outcome, the Committee tightened policy slightly. With the softening of demand in the spring, the Committee was able to maintain a steady posture in the money market while closely monitoring economic developments. The ongoing objective of monetary policy is to help the nation achieve maximum sustainable economic growth and the highest average living standards. The Federal Reserve recognizes that it can best accomplish this objective by keeping inflation in check, because an environment of price stability is most conducive to sound, long-term planning by households and businesses.

Monetary Policy, Financial Markets, and the Economy over the First Half of 1997

The rapid economic growth observed in the closing months of 1996 continued in the first quarter of this year, with real gross domestic product advancing almost 6 percent at an annual rate. Consumer spending surged, fueled by a significant increase in income, upbeat consumer attitudes, and the effects of the huge run-up in equity prices over the past couple of years on household net worth. Business fixed investment was strong, and companies restocked inventories that had become thin as sales soared. The advance in real output provided support for considerable new hiring; rising pay and greater job availability drew additional people into the workforce, lifting the labor force participation rate to a new high during the first quarter of the year. The underlying trend

in consumer price inflation was still subdued. Inflation pressures were held in check by smaller food price increases, declining prices for non-oil imports, the marked expansion of industrial capacity in recent years, and continuing efforts by businesses to boost efficiency.

At their meeting in late March, FOMC members expected that the growth of economic activity would ease in the coming months, but they were uncertain about the likely extent of that slowing. Although the first-quarter burst in production had owed importantly to a number of temporary factors, many of the fundamentals underlying consumer and business demand remained quite positive. The Committee was concerned about the risk that if outsized gains in real output continued, pressures on costs and prices would emerge that could eventually undermine the expansion. Therefore, to help foster more sustainable trends in output and guard against potential inflationary imbalances, the Committee firmed policy slightly by raising the expected federal funds rate from around 5¼ percent to around 5½ percent.

The unsustainably strong pace of economic growth in the first quarter weighed on financial markets. Interest rates rose substantially, even before the System's action, despite favorable news on inflation. Because the policy tightening was widely anticipated, rates were little affected by the announcement, but they moved up a little more in the following weeks as incoming data suggested persistent strength in economic activity. Equity prices rose early in the first quarter and then declined, changing relatively little on net. The trade-weighted value of the dollar in terms of the other G-10 currencies increased about 7 percent in the first quarter, reflecting the unexpectedly strong economic growth in the United States and

market uncertainty about economic performance abroad.

As the second quarter progressed, it became increasingly evident that economic activity had indeed decelerated. The expansion of consumer spending eased considerably, while business fixed investment remained strong. Employment continued to climb rapidly, pushing the unemployment rate down below 5 percent on average in the second quarter—the lowest level since the early 1970s. Despite high levels of employment and production through the first half of the year, there were few signs that inflation was deviating significantly from recent trends. Although overall consumer price inflation dipped in the second quarter as energy prices declined, consumer prices excluding food and energy increased at about the same pace in the first half of the year as in 1996.

Continued favorable price movements and the slowing of economic growth suggested to financial market participants that inflation might remain damped without a further tightening of financial conditions, and this belief prompted a substantial drop in interest rates from late April to mid-July, reversing the earlier advance. With resource utilization still at very high levels, and with economic and financial conditions conducive to robust increases in spending, the FOMC at its May meeting continued to view the risks as skewed toward the re-emergence of inflationary pressures. But the moderation in aggregate demand and uncertainty about the relationship between utilization rates and inflation led the Committee to leave reserve conditions unchanged in May and again in July. The drop in market interest rates in the second quarter may also have been encouraged by favorable news about this year's federal budget deficit and by the agreement between

the President and the Congress to balance the budget in fiscal year 2002. Spurred by lower rates and greater optimism about the long-term outlook for earnings, the stock market surged in the second quarter and into July. The value of the dollar rose somewhat further in foreign exchange markets, on balance, an increase more than accounted for by an appreciation against continental European currencies.

During the first half of the year, credit remained available on favorable terms to most households and businesses. High delinquency rates for consumer loans encouraged many banks to tighten standards, but consumer loan rates generally stayed fairly low relative to benchmark Treasury rates, and consumer credit continued to grow faster than income and only a little below the pace of 1996. Home mortgage debt advanced at a moderate rate, with home equity loans expanding especially rapidly in the spring. Businesses continued to have access to ample external funding both directly in capital markets and through financial intermediaries. The spreads between yields on corporate bonds and Treasury securities stayed low or fell further, and, relative to market rates, bank business loan rates held near the lower end of the range seen in the current expansion.

Total domestic nonfinancial debt expanded more slowly in the first half of 1997 than in 1996, mainly because of a reduced pace of federal borrowing. Trends in the monetary aggregates during the first half of 1997 were similar to those in 1996, with M2 near the upper end of the range set by the FOMC and M3 somewhat above its range. This outcome was in line with FOMC expectations, because the ranges had been set to be consistent with conditions of price stability, and inflation, while damped, remained above this level. The behavior

of M2 in the first part of the year was again reasonably well explained by changes in nominal GDP and interest rates.

Economic Projections for 1997 and 1998

After growing swiftly on balance over the first half of the year, economic activity is expected to expand more moderately in the second half of 1997 and in 1998. For this year, the central tendency of the GDP growth forecasts put forth by members of the Board of Governors and the Reserve Bank presidents is 3 percent to 3¼ percent, measured as the change in real output between the final quarter of 1996 and the final quar-

Economic Projections for 1997 and 1998

Percent

Indicator	Federal Reserve governors and Reserve Bank presidents	
	Range	Central tendency
1997		
<i>Change, fourth quarter to fourth quarter¹</i>		
Nominal GDP	5-6	5-5½
Real GDP	3-3½	3-3¼
Consumer price index ²	2-2¾	2¼-2½
<i>Average level in the fourth quarter</i>		
Civilian unemployment rate	4¾-5¼	4¾-5
1998		
<i>Change, fourth quarter to fourth quarter¹</i>		
Nominal GDP	4¼-5¾	4½-5
Real GDP	2-3	2-2½
Consumer price index ²	2½-3	2½-3
<i>Average level in the fourth quarter</i>		
Civilian unemployment rate	4½-5¼	4¾-5

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

2. All urban consumers.

ter of 1997. For 1998, most of the forecasts anticipate growth of real GDP within a range of 2 percent to 2½ percent. With this pace of continued economic expansion over the next six quarters, the central tendency of forecasts for the civilian unemployment rate remains a little under 5 percent through 1998, about the average for the second quarter of this year.

Economic activity appears to have entered the second half with considerable positive momentum. Households have experienced hefty gains in employment, income, and wealth, and their optimism about the future is quite high. These factors seem likely to outweigh any drag on consumer demand that might be associated with the debt-servicing problems that some households have experienced. Lower mortgage rates are buttressing demand for homes. In the business sector, healthy balance sheets and profits and a moderate cost of external funds, along with a continuing desire to install new technology, are providing support and impetus for investment in equipment. Meanwhile, investment in structures should follow last year's strong performance with further increases, because of declining vacancy rates in some sectors and ready access to financing.

Notwithstanding the economy's positive momentum, growth is expected to be more moderate in the next year and a half than in the first half of 1997. In part, this deceleration is likely to reflect the influence on demand of the substantial buildup of stocks of household durables and business plant and equipment thus far in the expansion. As well, the pace of inventory investment will need to slacken considerably relative to that observed in the first part of this year, lest stock-to-sales ratios become uncomfortably high. In the external sector, the strength of the dollar on exchange

markets since last year could damp export sales and encourage U.S. firms and households to purchase foreign-produced goods and services.

Federal Reserve policymakers believe that this year's rise in the CPI will be smaller than that of 1996, mostly because of favorable developments in the food and, especially, energy sectors. After last year's run-up, crude oil prices have dropped back significantly, pulling down the prices of petroleum products. Food price increases also have been subdued this year, as the decline in grain prices that began in the middle of last year has been working its way through to the retail level. Looking ahead to next year, the governors and Reserve Bank presidents expect larger increases in the CPI, with a central tendency from 2½ percent to 3 percent. Food and energy prices are not expected to repeat this year's salutary performance, and non-oil import prices may be less of a restraining influence than in 1997, absent a continued uptrend in the dollar. Moreover, there is a risk that high levels of resource utilization could begin putting upward pressure on business costs.

As noted in past monetary policy reports, the CPI forecasts of Federal Reserve policymakers incorporate the technical improvements that the Bureau of Labor Statistics is making to the CPI in 1997 and 1998. A series of technical changes is estimated to have trimmed reported rates of CPI inflation slightly in recent years, and the additional changes will affect the index this year and next. In light of the challenges of accurately measuring price changes in a complex and dynamic economy, the governors and Reserve Bank presidents will continue placing substantial weight on other price indexes, along with the CPI, in gauging progress toward the long-run goal of price stability.

The Administration has not yet released an update of the economic projections contained in the February *Economic Report of the President*. The earlier Administration forecasts were broadly similar to those in the Federal Reserve's February report, with Administration forecasts for growth and inflation within or near the range anticipated by Federal Reserve policymakers in February. Because of developments in the economy since that time, the central tendency of forecasts for real GDP growth put forth by the members of the Board of Governors and the Reserve Bank presidents has moved higher, while their forecasts for the CPI have moved down.

Money and Debt Ranges for 1997 and 1998

At its meeting earlier this month, the Committee reaffirmed the ranges for 1997 growth of money and debt that it had established in February: 1 percent to 5 percent for M2, 2 percent to 6 percent for M3, and 3 percent to 7 percent for the debt of the domestic nonfinancial sectors. The Committee also set provisional ranges for 1998 at the same levels as for 1997.

In choosing the ranges for M2 and M3, the Committee recognized the continuing uncertainty about the future

behavior of the velocities of the two aggregates. For several decades until the 1990s, these aggregates exhibited fairly stable trends relative to nominal spending, and variations in M2 growth around its trend were reasonably closely related to changes in the spread between market rates and yields on the assets in M2. These relationships were disrupted in the first part of this decade. Between 1991 and early 1994, the velocities of M2 and M3 climbed well above the levels that were predicted by past experience, as households shifted substantial amounts out of lower-yielding deposits into higher-yielding stock and bond mutual funds, and as banks and thrift institutions sharply curtailed their lending to focus on rebuilding capital. Since mid-1994, the velocities have been moving more nearly in line with their historical patterns with respect to changes in opportunity costs—albeit at higher levels. This recent period of renewed stability is still brief, however, and has occurred at a time of relatively stable financial and economic conditions, leaving open the important question of whether the stability would be sustained in the future under a wider variety of circumstances.

In light of this uncertainty, the Committee again decided to view the ranges as benchmarks for monetary growth rates that would be consistent with approximate price stability and historical velocity relationships. If velocities change little over the next year and a half, Committee members' expectations of nominal GDP growth in 1997 and 1998 imply that M2 and M3 will likely finish around the upper boundaries of their respective ranges each year. The debt of the domestic nonfinancial sectors is expected to remain near the middle of its range this year and next. The Committee will continue to monitor the behavior of the monetary aggregates

Ranges for Growth of Monetary and Debt Aggregates

Percent

Aggregate	1996	1997	Provisional for 1998
M2	1-5	1-5	1-5
M3	2-6	2-6	2-6
Debt	3-7	3-7	3-7

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

and domestic nonfinancial debt—as well as a wide range of other data—for information about economic and financial developments.

Economic and Financial Developments in 1997

The economy has continued to perform exceptionally well this year. Real gross domestic product surged almost 6 percent at an annual rate in the first quarter of 1997, and available data point to a healthy, though smaller, increase in the second quarter. Financial conditions remained supportive of spending. Despite a modest tightening of money market conditions by the System, most interest rates were little changed or declined a bit on net during the first half of the year, and equity prices surged ahead. With relatively few exceptions, credit remained readily available from both intermediaries and financial markets on generally favorable terms. The rapid increases in output led to a further tightening of labor markets in the first six months of 1997, and labor costs accelerated a little from the pace of a year earlier. Price inflation has been subdued, held down in part by declines in energy prices, smaller increases in food prices, and lower prices for non-oil imports that have followed in the wake of the appreciation of the dollar. In addition, intense competition, adequate plant capacity, and ongoing efficiency gains have helped to restrain inflation pressures in the face of rising wages.

The Household Sector

Spending, Income, and Saving

After posting a sizable increase in 1996, real personal consumption expenditures jumped 5½ percent at an annual rate in the first quarter of 1997. Although the

advance in spending slowed thereafter—partly because of unusually cool weather in late spring—underlying fundamentals for the household sector remain favorable to further solid gains; notably, real incomes have continued to rise, and many consumers have benefited from sizable gains in wealth. With this good news in hand, consumers have become extraordinarily upbeat about the economy's prospects. Indexes of consumer sentiment—such as those compiled by the Survey Research Center at the University of Michigan and the Conference Board—have soared to some of the highest readings since the 1960s. Despite this generally healthy picture, some households still face difficulties meeting debt obligations, and delinquency rates for consumer loans have remained at high levels.

Real outlays for consumer durables surged 18¾ percent (annual rate) in the first quarter of this year but apparently slowed considerably in the second quarter. After changing little, on net, last year, consumer purchases of motor vehicles increased rapidly early in the year, a result of sound fundamentals, a bounce-back from the strike-depressed fourth quarter, and enlarged incentives offered by automakers. In the second quarter, sales were once again held down noticeably by strike-related supply constraints, as well as by some payback from the elevated first-quarter pace. Smoothing through the ups and downs, the underlying pace of demand in the first half of the year likely remained reasonably close to the 15 million unit rate that has prevailed since the second half of 1995. Purchases of durable goods other than motor vehicles also took off in the first quarter; computers and other electronic equipment were an area of notable strength, as households took advantage of rapidly falling prices to acquire the latest technology. According to avail-

able monthly data, purchases of durables other than motor vehicles and electronic equipment moderated in the second quarter. Although a pause in the growth of spending is not surprising after the strong first quarter, unusually cool spring weather, leading to the postponement of purchases of some seasonal items, may also have contributed to the moderation.

Growth of real spending for nondurables also appears to have slowed considerably from a strong first-quarter pace. Within services, weather conditions held down growth of real outlays for energy services in the first quarter and boosted them in the second. Growth of real outlays for other services—typically the steadiest component of consumption—picked up at the end of 1996 and appears to have stayed ahead of last year's $2\frac{1}{2}$ percent pace in the first half of 1997.

Consumer spending continued to draw support from healthy advances in income this year, as gains in wages and salaries boosted personal disposable income. These gains translated into a 4 percent annual rate advance in real disposable income in the first quarter, after a significant $2\frac{3}{4}$ percent advance last year. Although month-to-month movements were affected by unevenness in the timing of tax payments, the underlying trend in real disposable income remained strong into the second quarter.

On top of rising incomes, further increases in net worth—primarily related to the soaring stock market—have given many households the financial wherewithal to spend. In light of the very large gains in wealth, the impetus to consumption appears to have been smaller than might have been anticipated on the basis of historical relationships, suggesting that other factors may be offsetting the effect of higher

net worth. One such factor could be a greater focus on retirement savings, particularly among the large cohort of the population reaching middle age. Concerns about the adequacy of saving for retirement have likely been heightened by increased public discussion of the financial problems of social security and federal health programs. In addition, debt problems may be restraining the spending of some households.

Residential Investment

The underlying pace of housing activity has remained at a high level this year, even though some indicators suggest that activity has edged off a bit from last year's pace. In the single-family sector, housing starts through June averaged 1.14 million units at an annual rate, a shade below the pace of starts in 1996. Although starts dipped in the second quarter, the decline was from a first-quarter level that, doubtless, was boosted by mild weather. Mortgage rates have zigzagged moderately this year; the average level has differed little from that in 1996. With mortgage rates low and income growth strong, a relatively large proportion of families has been able to afford the monthly cost of purchasing a home. Home sales have remained strong, helping to keep inventories of unsold new units relatively lean—a favorable factor for prospective building activity. Other indicators of demand remain quite positive. According to the latest survey by the National Association of Homebuilders, builders' ratings of new home sales strengthened in recent months to the highest level since last August. Moreover, consumers' assessments of conditions for homebuying, as reported by the Survey Research Center at the University of Michigan, remained very favorable into July. In addition, the volume of

applications for mortgages to purchase homes has moved up recently to a high level.

The pace of multifamily starts has been well maintained. These starts averaged close to 320,000 units at an annual rate from January to June, a little above last year's figure for starts. Even so, the pace of multifamily construction remains well below peaks in the 1970s and 1980s, partly because of changes in the nation's demographic composition as the bulge of renters in the 1980s has moved on to home ownership. Another factor that has restrained multifamily construction is the growing popularity of manufactured housing ("mobile homes"), which provides an alternative to rental housing for some households. In particular, the price of a typical manufactured unit is considerably less than that of a new single-family house, making manufactured homes especially attractive to first-time buyers and to people purchasing second houses or retirement homes. Shipments of these homes trended up through last fall and then flattened out at a relatively high level.

Household Finance

Household balance sheets strengthened in the aggregate during the first half of 1997, but debt-payment problems continued at a high level in several market segments. Indebtedness grew less rapidly than it had in 1996, and further gains in equity markets pushed up the ratio of household net worth to disposable personal income to its highest mark in recent decades. Consumer credit increased at a 6¼ percent annual rate between December 1996 and May 1997, compared with 8¼ percent in 1996. The growth of mortgage debt was somewhat slower in the first quarter than in 1996 and, according to avail-

able indicators, probably stayed at roughly the same rate during the second quarter.

The estimated ratio of required payments of loan principal and interest to disposable personal income remained high in the first quarter, after climbing rapidly between early 1994 and early 1996 and rising more slowly in the second half of last year. This measure of the debt-service burden of households has nearly returned to the peak reached toward the end of the last business cycle expansion. Adding estimated payments on auto leases to households' scheduled monthly debt payments boosts the ratio a little more than 1 percentage point and places it just above its previous peak.

Indicators of households' ability to service their debt have been mixed. The delinquency rate for mortgage loans past due sixty days or more is at its lowest level in two decades, but delinquency rates for consumer loans are relatively high. According to data from the Report of Condition and Income filed by banks (the Call Report), the delinquency rate for credit card loans was roughly unchanged in the first quarter of 1997, remaining at its highest value since late 1992, when the economy was in the midst of a sluggish recovery and the unemployment rate was more than 2 percentage points higher than today. For auto loans at the finance companies affiliated with the major manufacturers, the delinquency rate rose again in the first quarter, continuing the steady run-up in this measure over the past three years.

Anecdotal evidence suggests that the recent increases in consumer credit delinquency rates had been partly anticipated by lenders, reflecting the normal seasoning of loans as well as banks' efforts to stimulate borrowing by making credit more broadly available and automakers' attempts to stimulate sales

using the same approach. During the past several years, lenders have aggressively sought business from people who might not have been granted credit previously, in part because of lenders' confidence in new "credit scoring" models that statistically evaluate an individual's creditworthiness. Despite these new tools, banks evidently have been surprised by the extent of the deterioration of their consumer loans and have tightened lending standards as a result. Nearly half the banks responding to the Federal Reserve's May survey on bank lending practices had imposed more stringent standards for new credit card accounts over the preceding three months, with a smaller fraction reining in other consumer loans. About one-third more of the responding banks expected charge-off rates on consumer loans to increase further over the remainder of the year than expected charge-off rates to decrease; many of those expecting an increase cited consumers' growing willingness to declare bankruptcy. Rising delinquency rates have also put pressure on firms specializing in subprime auto loans, with some reporting reduced profits and acute liquidity problems.

According to the most recently available data, personal bankruptcies surged again in the first quarter of the year after rising 30 percent in 1996. The rapid increases of late are partly related to the same increase in financial stress evident in the delinquency statistics, but they may also be tied to more widespread use of bankruptcy as a means of dealing with such stress. Changes in federal bankruptcy law effective at the start of 1995 increased the value of assets that may be protected from liquidation, and there may also be a secular trend toward less stigma being associated with declaring bankruptcy.

The Business Sector

Investment Expenditures

Following a fifth year of sizable increases in 1996, real business fixed investment rose at an annual rate of 11 percent in the first quarter. The underlying determinants of investment spending remain solid: strong business sales, sizable increases in cash flow, and a favorable cost of capital, especially for high-tech equipment. To be sure, a significant portion of this investment has been required to update and replace depreciated plant and equipment; nevertheless, the current pace of investment implies an appreciable expansion of the capital stock.

Real outlays for producers' durable equipment jumped at an annual rate of 12 $\frac{3}{4}$ percent in the first quarter of this year after rising 9 $\frac{3}{4}$ percent last year. As in recent years, purchases of computers and other information processing equipment contributed importantly to this gain. The computer sector has been propelled by declining prices of new and more powerful products and by a drive in the business sector to improve efficiency with these latest technological developments. Real purchases of communications equipment also have been robust, boosted by rapidly growing demand for wireless phone services and Internet connections as well as by upgrades to telephone switching and transmission equipment in anticipation of eventual deregulation of local phone markets. In addition, purchases of aircraft by domestic airlines moved higher on net in 1995 and 1996 and—on the basis of orders and production plans of aircraft makers—are expected to rise considerably further this year. For the second quarter, data on orders and shipments of nondefense capital goods in April and May imply that healthy

increases in equipment investment have continued.

Real business spending for nonresidential structures posted another sizable increase in the first quarter after advancing a hefty 9 percent in 1996. Although the latest data suggest a slowing of the pace of advance in the second quarter, the economic factors underlying this sector point to continued increases. Vacancy rates have been falling and rents have been improving. Financing for commercial construction reportedly is in abundant supply, especially with substantial amounts of capital flowing to real estate investment trusts (REITs).

Trends in construction continue to differ among sectors. Increases in office construction were especially robust in recent quarters, as vacancy rates fell for both downtown and suburban properties. With office-based employment expanding, this sector has continued to recover from the severe slump of the late 1980s and early 1990s; even so, the level of construction activity is barely more than half that of the mid-1980s. Construction of other commercial buildings has increased steadily during the past five years, and the gain in the first quarter of this year was sizable. Since the current expansion began, the non-office commercial sector has provided a large contribution to overall construction spending. Industrial construction dropped back in the first quarter after jumping at the end of last year; the trend for this sector has been relatively flat on balance in recent years.

During 1996, investment in real non-farm business inventories was modest compared with the growth of sales, and the year ended with lean inventories in many sectors. In the first quarter of this year, businesses moved to rebuild stocks, and inventory investment picked up substantially. Outside of motor vehi-

cles, stocks rose in the first quarter, with particularly sizable increases coming from a continued ramp-up in production of aircraft and from a restocking of petroleum products during a period when prices eased. Nevertheless, with extraordinarily strong sales, inventory-sales ratios still moved down further in the major sectors. Available monthly data suggest that vigorous inventory investment outside of motor vehicles continued through mid-spring, as firms responded to strength in current and prospective sales. For motor vehicles, inventories moved up some in the first quarter of this year, after strike-related reductions in the fourth quarter. In the second quarter, the monthly pattern of motor vehicles stocks was bounced around somewhat by strikes; cutting through the noise, inventories of light vehicles still appear to be in balance.

Corporate Profits and Business Finance

The continued rapid advance of business investment this year has been financed through both strong cash flow and substantial borrowing at relatively favorable terms. Economic profits (book profits after inventory valuation and capital consumption adjustments) in the first quarter were $7\frac{3}{4}$ percent higher than a year earlier. For the nonfinancial sector, domestic profits were more than 9 percent higher, reaching their highest share of those firms' domestic output in the current expansion. Despite abundant profits, the financing gap for these companies—the excess of capital expenditures (including inventory investment) over internally generated funds—has widened somewhat since the middle of 1996. To fund that gap, and the ongoing net retirement of equity shares, non-financial corporations increased their debt $6\frac{1}{2}$ percent at an annual rate in the

first quarter, compared with 5¼ percent during 1996.

External funding has remained readily available to businesses on favorable terms. The spreads between yields on investment-grade bonds and yields on Treasury securities have stayed low since the beginning of the year, while the spreads on high-yield bonds have declined further to historically narrow levels. Price-earnings ratios are high, implying a low cost of equity financing. Further, banks remain accommodative lenders to businesses. According to the Federal Reserve's most recent survey of business lending, the spreads between loan rates and market rates have held about steady for borrowers of all sizes, with rate spreads for large loans near the lower end of the range seen over the past decade. Moreover, surveys by the National Federation of Independent Business indicate that small businesses have not had difficulty obtaining credit.

The plentiful supply of credit probably stems from several factors. Most banks are well positioned to lend: Their profits are strong, rates of return on equity and on assets are high, and capital is ample. In addition, continued substantial inflows into stock and high-yield bond mutual funds suggest that investors may now perceive less risk in these areas or may be more willing to accept risk. In fact, businesses generally are in very good financial condition, with the estimated ratio of operating cash flow to interest expense for the median nonfinancial corporation remaining quite high in the first part of the year. Moreover, delinquency rates for business loans at banks have stayed extremely low, as has the default rate on speculative-grade debt.

The increase in the pace of business borrowing in the first half of 1997 was widespread across sources of finance. Nonfinancial corporations stepped up

their borrowing from banks. The outstanding commercial paper of these corporations also increased on net from December through June, after declining a little in 1996. Meanwhile, these businesses' net issuance of long-term bonds in the first half of the year exceeded last year's pace, with speculative-grade offerings accounting for the highest share of gross issuance on record.

At the same time, the pace of gross equity issuance by nonfinancial corporations dropped considerably in the first half of this year. In particular, the market for initial public offerings has been cooler than in 1996, despite some pickup of late; new issues have been priced below the intended range more often than above it, and first-day trading returns have been relatively low. Net equity issuance has been deeply negative again this year, as gross issuance has been more than offset by retirements through share repurchases and mergers. The bulk of merger activity in the 1980s involved share retirements financed by borrowing, but the recent surge—which largely involves friendly intra-industry mergers—has been financed about equally through borrowing and stock swaps. Structuring deals as stock swaps can reduce shareholders' tax liabilities and enable the combined firm to use a more advantageous method of financial accounting. The dollar value of nonfinancial mergers in which the target firm was worth more than a billion dollars set a record in 1996, and merger activity appears to be on a very strong track this year as well.

The Government Sector

Federal

The federal budget deficit has come down considerably in recent years and

should register another substantial decline this fiscal year. Over the first eight months of fiscal year 1997—the period October through May—the deficit in the unified budget was \$65 billion, down \$43 billion from the comparable period of fiscal 1996. The recent reduction in the deficit primarily reflected extremely rapid growth of receipts for the second year in a row, although a continuation of subdued growth in outlays also contributed to the improvement. Given recent developments, the budget deficit as a share of nominal GDP this fiscal year is likely to be at its lowest level since 1974.

Federal receipts were almost 8½ percent higher in the first eight months of fiscal year 1997 than in the year-earlier period and apparently are on track to outpace the growth of nominal GDP for the fifth year in a row. Individual income tax payments have risen sharply this fiscal year—on top of a hefty increase last year—reflecting strong increases in households' taxable labor and capital income; preliminary data from the Daily Treasury Statement indicate that individual income tax revenues remained strong in June. Moreover, corporate tax payments posted another sizable advance through May of this fiscal year.

Federal outlays during the first eight months of the fiscal year rose 3½ percent in nominal terms from the comparable period last year. Although this increase is up from the restrained rate of growth in fiscal 1996—which was held down by the government shutdown—spending growth remained subdued across most categories. Outlays for income security programs rose modestly in the first eight months of the fiscal year, partly as a result of the continued strong economy, and spending on the major health programs grew somewhat more slowly than their average pace in

recent years. Although still restrained, outlays for defense have ticked up this fiscal year after trending down for several years.

As for the part of federal spending that is included directly in GDP, real federal expenditures on consumption and gross investment declined 3¼ percent in the first quarter of 1997, a shade more than the average rate of decline in recent years. An increase in real non-defense spending was more than offset by a decline in real defense outlays.

The substantial drop in the unified budget deficit reduced federal borrowing in the first half of 1997 compared with the first half of 1996. The Treasury responded to the smaller-than-expected borrowing need by reducing sales of bills; this traditional strategy of allowing borrowing swings to be absorbed primarily by variation in bill issuance enables the Treasury to have predictable coupon auctions and to issue sufficient quantities of coupon securities to maintain their liquidity. The result this past spring was an unusually large net redemption of bills, which pushed yields on short-term bills down relative to yields on other Treasury securities and on short-term private paper.

The issuance of inflation-indexed securities at several maturities has been a major innovation in federal debt management this year. The Treasury sold indexed ten-year notes in January and April and added five-year notes earlier this month. A small number of agency and other borrowers issued their own inflation-indexed debt immediately after the first Treasury auction, and the Chicago Board of Trade recently introduced futures and options contracts based on inflation-indexed securities. As one would expect at this stage, however, the market for indexed debt has not yet fully matured: Trading volume as a share of the outstanding amount is much smaller

than for nominal debt, and a market for stripped securities has yet to emerge.

State and Local

The fiscal condition of state and local governments has remained positive over the past year, as the surplus of receipts over current expenditures has been stable at a relatively high level. Strong growth in sales and incomes has led to robust growth in revenues, despite numerous small tax cuts, and many states have held the line on spending in the past several years. Additionally, the welfare reform legislation passed in August 1996, while presenting long-term challenges to state and local governments, actually has eased fiscal pressures in recent quarters: Block grants to states are based largely on 1992–94 grant levels, but caseloads more recently have been falling. Overall, at the state level, accumulated surpluses—current surpluses plus those from past years—were on track to end fiscal year 1997 at a healthy level, according to a survey by the National Association of State Budget Officers taken shortly before the end of most states' fiscal years.

Real expenditures for consumption and gross investment by state and local governments increased moderately in the first quarter of this year, about the same as the pace of advance in the past two years. For construction, the average level of real outlays during the first five months of the year was a little higher than in the fourth quarter. Hiring by state and local governments over the first half of the year was somewhat above last year's pace, with most of the increase at the local level.

The pace of gross issuance of state and local debt was roughly the same in the first half of the year as in 1996. Net issuance turned up noticeably, however, as retirements of debt that had

been pre-refunded in the early 1990s waned.

The External Sector

Trade and the Current Account

The nominal deficit on trade in goods and services was \$116 billion at an annual rate in the first quarter, somewhat larger than the \$105 billion in the fourth quarter of last year. The current account deficit of \$164 billion (annual rate) in the first quarter exceeded the \$148 billion deficit for 1996 as a whole because of the widening of the trade deficit and further declines in net investment income. In April and May, the trade deficit was slightly narrower than in the first quarter.

The quantity of U.S. imports of goods and services surged in the first quarter at an annual rate of about 20 percent. Continued strength in the pace of U.S. economic activity largely accounted for the rapid growth, but a rebound in automotive imports from Canada from their strike-depressed fourth-quarter level boosted imports as well. Preliminary data for April and May suggest that strong real import growth continued. Non-oil import prices fell through the second quarter, extending the generally downward trend that began in mid-1995.

The quantity of U.S. exports of goods and services expanded at an annual rate a bit above 10 percent in the first quarter, about the same rapid pace as during the second half of last year. Growth of output in our major trading partners, particularly the industrial countries, helped to sustain the growth of exports, as did increased deliveries of civilian aircraft. Exports to western Europe and to Canada grew strongly, while those to the Asian developing countries declined somewhat. Preliminary data for April and May suggest that real exports rose moderately.

Capital Flows

Large gross capital inflows and outflows continued during the first quarter of 1997, reflecting the continued trend toward globalization of financial and product markets. Both foreign direct investment in the United States and U.S. direct investment abroad were very strong, swelled by mergers and acquisitions.

Private foreign net purchases of U.S. securities amounted to \$85 billion in the first quarter, down somewhat from the very high figure in the previous quarter but still above the record pace for 1996 as a whole. Net purchases of U.S. Treasury securities were particularly robust. Private foreigners also showed increased interest in the U.S. stock market in the first quarter of 1997. U.S. net purchases of foreign securities amounted to \$15 billion in the first quarter, down from the strong pace of 1996. Private foreigners continued to add to their holdings of U.S. paper currency in the first quarter, but at a rate substantially below earlier peaks.

Foreign official assets in the United States, which rose a record \$122 billion in 1996, increased another \$28 billion in the first quarter of 1997. Apart from the oil-producing countries, which benefited from high oil prices, significant increases in holdings were associated with efforts by some emerging-market countries to temper the impact of large private capital inflows on their economies. Information for April and May suggests that official inflows have abated.

Foreign Economies

Economic activity in the major foreign industrial countries has generally strengthened so far this year from the pace in the second half of last year.

In Japan, real GDP accelerated to a 6½ percent annual growth rate in the first quarter, boosted by extremely strong growth of consumer spending ahead of an increase in the consumption tax on April 1. Activity appears to have fallen in the second quarter, but continued improvement in business sentiment suggests that the current weakness is only temporary. In Canada, growth of real output increased to 3½ percent at an annual rate in the first quarter. Final domestic demand more than accounted for this expansion, as business investment, consumption, and residential construction all provided significant contributions. Indicators suggest that output growth remained healthy in the second quarter.

Economic activity has remained vigorous so far this year in the United Kingdom and appears to have strengthened in Germany and France. In the first quarter, U.K. real GDP grew at an annual rate of 3½ percent as domestic demand, particularly investment, accelerated from its already strong pace in the fourth quarter. Strong household consumption spending supported demand in the second quarter. Weak demand for exports, associated with the appreciation of the pound since mid-1996, and some tightening of monetary conditions should moderate growth in the current quarter. In Germany, economic expansion revived in the first quarter and appears to have firmed in the second quarter. After growing very little in the fourth quarter of last year, German real GDP rose at an annual rate of 1¾ percent in the first quarter, led by government consumption, equipment investment, and exports. Manufacturing orders and indicators of business sentiment suggest additional gains in the second quarter. French real GDP grew only three-quarters percent at an annual rate in the first quarter, as declines in

investment offset strong export growth, but data on manufacturing output and consumption suggest a pickup in activity during the second quarter.

In most major Latin American countries, real output growth remained vigorous. In Mexico, real economic expansion slowed some in the first quarter from its very rapid pace in the second half of last year but remained robust. The industrial sector continued to be the source of strength, while the service sector lagged. A pickup in import growth has resulted in a narrowing of the trade surplus; through May, the trade balance of \$1¼ billion was about half the size it was in the same period last year. In Argentina, continued healthy economic growth in the first quarter has brought real GDP back to its level before the recession induced by the Mexican crisis of 1995. In Brazil, real output declined in the first quarter after three quarters of strong expansion.

Economic growth in our major Asian trading partners other than Japan slowed a bit on average in the first quarter but appears to have rebounded in the second quarter. Nationwide labor strikes in Korea affected many of the country's key export industries and were partly responsible for weakness in first-quarter output and a ballooning of the current account deficit. Data for April and May show recovery in industrial production, and the trade balance improved in the second quarter. Real output growth in Taiwan remains strong so far this year, though not quite so vigorous as during the second half of 1996. In China, real GDP continues to expand at an annual rate of nearly 10 percent, about the same brisk pace as last year.

Despite the pickup in growth, considerable excess capacity remains in the major foreign industrial countries. As a consequence, inflation has generally remained quiescent. The increase in

the Japanese consumption tax lifted the twelve-month change in the consumer price index to about 1½ percent, but elevation of the inflation rate should be temporary. CPI inflation remains less than 2 percent in Germany, France, Canada, and Italy. Only in the United Kingdom, where output growth has resulted in tight labor markets and consumer prices are rising at an annual rate of more than 2½ percent, are inflation pressures currently a concern.

In most major countries in Latin America, inflation either is falling or is already low. Mexican inflation continues to improve: The monthly inflation rate was below 1 percent in May and June, the lowest monthly rates since the 1994 devaluation. In Argentina, consumer prices were essentially flat through the second quarter after almost no increase last year. Brazilian inflation has declined to historically low rates. In contrast, Venezuelan inflation, though it has come down from its 1996 rate of more than 100 percent per year, remains near 50 percent. Consumer price inflation remains generally low in Asia, including in China, where it fell to less than 3 percent in the twelve months through May.

The Labor Market

Payroll employment continued to expand solidly during the first half of 1997. The growth in nonfarm payrolls averaged about 230,000 per month; this figure may overstate slightly the underlying rate of employment growth in the first half because technical factors boosted payroll figures in April. The strength in labor demand drew additional people into the job market, raising the labor force participation rate to historical highs during the first half. Nevertheless, the civilian unemployment rate

moved down to 4.9 percent, on average, in the second quarter.

Employment gains in the private service-producing sector, in which nearly two-thirds of all nonfarm workers are employed, accounted for much of the expansion in payrolls through June of this year. Within this sector, higher employment in services, transportation, and retail trade contributed importantly to the gain. After advancing substantially for several years, payrolls in the personnel supply industry—a category that includes temporary help agencies—actually turned down in the second quarter; anecdotal reports suggest that some temporary help firms are having difficulty finding workers, especially for highly skilled and technical positions.

Employment gains were also posted in the goods-producing sector. In the construction industry, payrolls increased substantially between December and June. Factory employment moved somewhat higher in the first part of the year after declining a little during 1996, and manufacturing overtime hours remained at a high level. Producers of durable goods increased employment further between December and June, while makers of nondurable goods continued to reduce payrolls. Since the end of 1994, factory employment and total hours worked in manufacturing have changed little. Even so, manufacturers have boosted output considerably over this period, primarily through ongoing improvements in worker productivity.

Although productivity for the broader nonfarm business sector rose substantially in the first quarter, it was just 1 percent above its value a year earlier. Moreover, output per hour changed little from the end of 1992 to the last quarter of 1995. The average rate of measured productivity growth in the 1990s is still somewhat below that of the 1980s and

is even further below the average gains realized in the twenty-five years after World War II. The slower reported productivity growth during this expansion could partly reflect measurement problems. Productivity is the ratio of real output to hours worked, and official productivity indexes rely on a measure of real output based on expenditures. In theory, a matching measure of real output should be derivable by summing labor and capital inputs on the “income side” of the national accounts. However, the income-side measure of real output has increased considerably faster than the expenditure-side measure in recent years, raising the possibility that productivity growth has been somewhat better than reported in the official indexes.

Measurement difficulties may also affect estimates of the longer-term trajectory of productivity growth. In particular, if inflation were overstated by official measures—as a considerable amount of recent research suggests it is—then real output growth would be understated. This understatement would arise because too much inflation would be removed from nominal output growth in the calculation of real output growth. Indeed, productivity growth for nonfinancial corporations—a sector for which output growth arguably is measured more accurately than in broader sectors—has been more rapid than for nonfarm business overall. In particular, productivity for nonfinancial corporations increased at an average annual pace of about 1½ percent between 1990 and 1996, while productivity in the nonfarm business sector rose a little less than 1 percent per year over the same period. This difference—which implies very weak measured productivity growth outside of the nonfinancial corporate sector—raises the possibility that overall productivity

growth is stronger than indicated by official indexes for nonfarm business.¹ Of course, a critical—and still unanswered—question is the extent to which any understatement of productivity growth has become larger over time. If productivity growth were more rapid than indicated by official statistics, then the economy's capacity to produce goods and services would be increasing faster than indicated by current official statistics. But if the amount of mismeasurement has not increased over time, then the economy's productive capacity also increased more rapidly in earlier years than shown by published measures. In this case, the official statistics on productivity growth—though perhaps understated—would not give a misleading impression about changes in productivity trends.

After changing little, on net, since the late 1980s, the labor force participation rate turned up early last year; it reached a record high 67.3 percent in March of this year and remained at an elevated 67.1 percent in the second quarter. Better employment opportunities have drawn additional people into the workforce. Although the recent welfare reform legislation probably has not yet had a large effect on aggregate labor force dynamics, it may generate an additional, albeit small, boost to labor force participation rates over the next few years. Since the beginning of 1996, the increases in the labor force associated with a higher participation rate have eased pressures on labor markets, as additional workers have stepped in to satisfy continuing strong demand for labor. Nevertheless, hiring was

sufficiently brisk during the first half of this year to pull the unemployment rate down about one-quarter percentage point between December and June.

Just as the low unemployment rate points to tightness in labor markets, anecdotal reports from many regions and industries mention the difficulties firms are having hiring workers, especially workers with specialized skills. With this tightness, labor compensation costs have accelerated slightly. Although hourly labor costs, as measured by the employment cost index (ECI), increased only 2.5 percent at an annual rate during the first three months of this year, they were up 3.0 percent over the twelve months ending in March, compared with 2.7 percent over the preceding twelve months. These increases are smaller than might have been expected on the basis of historical relationships, perhaps partly reflecting persistent worker concerns about job security. In addition, modest increases in employer-paid benefits have partly offset faster increases in wages and salaries in the past couple of years. With smaller increases in health care costs than earlier in the decade, shifts of employees into managed care plans, and requirements that employees assume a greater share of health care costs, employer costs for health-related benefits have been well contained. However, growth in employer health care costs may be in the process of bottoming out, as reports of rising premiums for health insurance have become more common. Moreover, the wages and salaries component of the ECI has continued to accelerate, rising 3.4 percent during the twelve months ending in March 1997, about one-quarter percentage point faster than during the previous twelve months and roughly half a percentage point faster than in 1994 and 1995.

1. More detail is provided in a paper by Lawrence Slifman and Carol Corrado, "Decomposition of Productivity and Unit Costs," Board of Governors of the Federal Reserve System, November 18, 1996.

Prices

The underlying trend of price inflation has remained favorable this year. In particular, the CPI excluding food and energy—often referred to as the “core” CPI—increased at an annual rate of 2½ percent over the first two quarters of the year, about the same pace as in 1996. The overall CPI registered a smaller increase than the core CPI during the first half of this year. Both the overall CPI and the core CPI have been affected by a series of technical changes implemented by the Bureau of Labor Statistics over the past two and one-half years to obtain a more accurate measure of price changes. If not for these changes, increases in the CPI since 1994 would be marginally larger.

Other measures of prices also suggest that favorable inflation trends continued into 1997. Measured from the first quarter of last year to the first quarter of this year, the chain price index for personal consumption expenditures excluding food and energy rose 2 percent, the same as in the four-quarter period a year earlier.² Similarly, the chain price index for overall GDP—which covers prices of all goods and services produced in the United States—and the chain measure for gross domestic purchases—which covers prices of all goods purchased in the United States—increased the same amount over the year ending in the first quarter of 1997 as during the previous four quarters.

All of these price measures indicate that inflation remains muted, despite

2. The price measure for personal consumption expenditures (PCE) is closely related to the CPI because components of the CPI are key inputs in the construction of the PCE price measure. Nevertheless, the PCE price measure has the advantage that by using chain weighting rather than fixed weights it avoids some of the substitution bias that affects the CPI.

high levels of resource utilization. Several factors have contributed to the recent favorable performance of price inflation. Energy prices have declined this year. Non-oil import prices also have fallen significantly, reducing input costs for some domestic companies and likely restraining the prices charged by domestic businesses that compete with foreign producers. Besides being restrained by some price competition from imported materials and supplies, prices of manufactured goods at earlier stages of processing have been held in check by an expansion of industrial capacity that has been rapid enough to restrain increases in utilization rates over the past year. Also, to the extent that firms have succeeded in their efforts to realize large efficiency gains and reduce unit costs, upward pressure on prices may be reduced. Finally, an extended period of relatively low and steady inflation has reinforced a belief among households and businesses that the trend of inflation should remain muted, and consequently helped to hold down inflation expectations.

Developments in the food and energy sectors were favorable to consumers in the first half of 1997. Consumer energy

Alternative Measures of Price Change

Percent

Price measure	1995:Q1 to 1996:Q1	1996:Q1 to 1997:Q1
<i>Fixed-weight</i>		
Consumer price index	2.7	2.9
Excluding food and energy ...	2.9	2.5
<i>Chain-type</i>		
Personal consumption expenditures	2.0	2.5
Excluding food and energy ...	2.0	2.0
Gross domestic purchases	2.2	2.2
Gross domestic product	2.2	2.2
<i>Deflator</i>		
Gross domestic product	2.1	1.8

NOTE. Changes are based on quarterly averages.

prices declined in the first half of the year as the price of crude oil dropped back following last year's run-up. In 1996, the price of crude oil was boosted by refinery disruptions, uncertainty about the timing of Iraqi oil sales, and unusual weather patterns that increased energy demand for heating and cooling. As these factors receded this year, crude oil prices fell. Although the downward trend was interrupted by some transitory spikes in prices—as in May when tensions in the Middle East flared up—the price of crude is now roughly back to the range that prevailed before last year's run-up. Since December, gasoline prices have tumbled more than 16 percent at an annual rate, and heating oil prices have fallen significantly. Natural gas prices also fell as stocks, which had dwindled over the winter, were replenished. Reflecting the declines in fuel prices, the CPI for energy fell about 9 percent at an annual rate between December 1996 and June 1997.

Consumer food prices increased at an annual rate of only about 1 percent in the first half of the year. Although coffee prices jumped, the prices of many other food items were flat or edged lower. Most notably, declines in grain prices that began in mid-1996 have been working their way to the retail level and have held down prices for a variety of grain-dependent foods, such as beef, poultry, and dairy products. Prices of foods that depend more heavily on labor costs have been rising modestly this year.

Consumer prices for goods other than food and energy rose a restrained three-quarters percent at an annual rate between December and June of this year, a touch below last year's pace. Declining prices for non-oil imports helped contain prices of goods in the CPI in the first half of the year, in part by constraining U.S. businesses in competition with importers. For example,

prices of new and used passenger cars declined in the first six months of the year, and prices of light trucks were essentially flat. Also, prices of house furnishings were about unchanged, on balance, in the first half of the year, although apparel prices moved up after declining in recent years.

The CPI for non-energy services rose about 3 percent at an annual rate between December and June, a touch below last year's pace. After rising markedly last year, airfares declined, on net, in the first half of this year. Fares fell substantially early in the year when the excise tax on tickets expired, and even with the reimposition of the tax in March, ticket prices were still lower in June than in December. Increases in prices of medical services also continued to slow somewhat this year.³ In addition, the CPI for auto finance fell in May and June as automakers sweetened incentives. In contrast, price increases in the first half of the year picked up in some other areas; shelter prices rose a bit more rapidly than last year, as did tuition and prices for personal care services.

Credit and the Monetary Aggregates

Credit and Depository Intermediation

The total debt of domestic nonfinancial sectors increased at an annual rate of about 4¾ percent from the fourth quarter of 1996 through May of this year, placing the aggregate near the middle of the range for 1997 established by the

3. In January 1997, the Bureau of Labor Statistics introduced a new measure of the prices of hospital services—which account for roughly one-third of the CPI for medical services—and this new measure should, over time, provide a more accurate gauge of price movements in this area.

FOMC. This pace is more than half a percentage point below that for 1996, reflecting significantly slower growth of borrowing by the federal government. The total debt of the other sectors has risen at a roughly constant pace over the past few years, even though the growth rate of nominal output has been increasing.

Credit on the books of depository institutions rose more rapidly than total debt in the first half of 1997, indicating that their share of total debt outstanding increased. Credit growth at thrift institutions eased late last year and early this year after increasing moderately in the first three quarters of 1996. However, commercial bank credit grew at a brisk pace in the first half of the year, with both securities and loans increasing more rapidly than they did last year.

Growth of Money and Debt

Percent

Period	M1	M2	M3	Domestic non-financial debt
<i>Annual</i> ¹				
1987	6.3	4.2	5.8	10.0
1988	4.3	5.7	6.3	9.0
1989 .....	.5	5.2	4.0	7.9
1990	4.1	4.1	1.8	6.9
1991	7.9	3.1	1.2	4.6
1992	14.4	1.8	.6	4.7
1993	10.6	1.3	1.1	5.2
1994	2.5	.6	1.7	5.2
1995	-1.6	4.0	6.2	5.5
1996	-4.6	4.7	6.8	5.4
<i>Quarterly (annual rate)</i> ²				
1997:Q1	-7	6.1	8.2	4.5
Q2	-5.4	4.3	6.8	n.a.
<i>Year-to-date</i> ³				
1997	-2.6	4.9	7.1	4.8

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

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

3. From average for fourth quarter of 1996 to average for June (May in the case of domestic nonfinancial debt).

n.a. Not available.

Real estate lending at banks rose about 9 percent at an annual rate between the fourth quarter of 1996 and June of this year, compared with 4 percent in 1996. In contrast, outstanding home mortgages at thrift institutions grew little in the first part of the year after a large run-up in 1996. Home equity credit lines from banks expanded especially rapidly in the spring, as some banks promoted these loans as a substitute for consumer loans. The growth of consumer loans at banks (including loans that were securitized as well as loans still on banks' books) fell from about 11 percent in 1996 to 3¼ percent at an annual rate between the fourth quarter of 1996 and June of this year.

The Monetary Aggregates

Growth of the monetary aggregates during the first half of 1997 was similar to growth in 1996. Between the fourth quarter of last year and June, M2 expanded at an annual rate of almost 5 percent; as the Committee had anticipated, the aggregate was running close to the upper bound of its growth cone, which had been chosen to be consistent with price stability. The behavior of M2 over this period can be reasonably well explained by changes in nominal GDP and interest rates, using historical velocity relationships. In the first quarter, the velocity of M2 (defined as the ratio of nominal GDP to M2) increased a little more than might have been anticipated from its recent relationship to the opportunity cost of holding M2—the interest earnings forgone by owning M2 assets rather than market instruments such as Treasury bills. M2 may have been held down a bit by savers' preferences for equity market funds, for which inflows were quite strong. Growth of M2 was much slower in the second quarter than in the first quarter

(4¼ percent compared with 6 percent at an annual rate), consistent with the slowing of the economy and almost unchanged M2 opportunity cost. The monthly pattern of M2 growth in the second quarter was heavily influenced by unusually high individual non-withheld tax payments. M2 surged in April, as households apparently accumulated additional liquid balances in order to make the larger tax payments, and was about unchanged on a seasonally adjusted basis in May as payments cleared and balances returned to normal.

The correspondence between changes in M2 velocity and in opportunity cost during recent years may represent a return to the roughly stable relationship observed for several decades until 1990—albeit at a higher level of velocity. The relationship was disturbed in the early 1990s by households' apparent decisions to shift funds out of lower-yielding deposits into higher-yielding stock and bond mutual funds. On one hand, the "credit crunch" at banks and the resolution of troubled thrifts curbed the eagerness of these institutions to attract retail deposits, holding down the rates of return offered on brokered deposits and similar accounts relative to the average deposit rates used in constructing measures of opportunity cost. At the same time, the appeal of longer-term assets was enhanced temporarily by the steeply sloped yield curve and more permanently by the greater variety and lower cost of mutual fund products available to investors. More recently, robust inflows into stock funds apparently have substituted to only a limited extent for holdings of M2 assets, and M2 velocity and opportunity cost have again been moving roughly together since mid-1994, although velocity has continued to drift up slightly. However, the period

of renewed stability in the behavior of M2—three years—is still fairly short, and whether the stability will persist is unclear. Variations in opportunity cost and income growth during this period have been rather small, leaving considerable doubt about how M2 would respond to more significant changes in the financial and economic environment.

M3 rose about 7 percent at an annual rate between the fourth quarter of 1996 and June of this year. This pace is a little faster than last year's and again left M3 above the upper end of its growth cone, which, like the growth cone for M2, was set to be consistent with price stability. Large time deposits, which are not included in M2, continued to increase much more rapidly than other deposits. Banks have been funding their asset growth disproportionately through wholesale deposits, leaving interest rates on retail deposits further below market rates than they have been historically. Growth of institution-only money market funds eased just a little from last year's torrid pace, as the role of these funds in corporate cash management continued to increase.

M1 contracted at a 2½ percent annual rate between the fourth quarter of 1996 and June of this year. Growth of this aggregate was again depressed by the spread of so-called sweep programs, whereby balances in transactions accounts, which are subject to reserve requirements, are "swept" into savings accounts, which are not. Sweep programs benefit depositories by reducing their required holdings of reserves, which earn no interest. At the same time, they do not restrict depositors' access to their funds for transactions purposes, because the funds are swept back into transactions accounts when needed. Until late last year, most retail

sweep programs were limited to NOW accounts, but demand-deposit sweeps have expanded markedly since then. Adjusted for the estimated total of balances swept owing to the introduction of new sweep programs, M1 expanded at a 4¾ percent annual rate between the fourth quarter of 1996 and June 1997, a little below its sweep-adjusted growth rate in 1996.

The drop in the amount of deposits held in transactions accounts in the first half of 1997 caused required reserves to fall about 10 percent at an annual rate, close to the rate of decline last year. Nonetheless, the monetary base has expanded at a moderate pace so far in 1997, because the runoff in required reserves has been more than offset—as it was also last year—by an increase in the demand for currency. Currency growth has been a little higher this year than last, as the effects of strong domestic spending more than offset a slight drop in net shipments of U.S. currency abroad in the first four months of the year.

Further reductions in required reserves have the potential to diminish the Federal Reserve's ability to control the federal funds rate closely on a day-to-day basis. Traditionally, the daily demand for balances at the Federal Reserve largely reflected banks' needs for required reserves, which are fairly predictable. As a result, the Federal Reserve has generally been able to supply the quantity of balances that satisfies this demand at the intended funds rate. Moreover, reserve requirements are specified in terms of an average level of balances over a two-week period, so if the funds rate on a particular day moves above the level expected to prevail on ensuing days, banks can trim their balances and thereby relieve some of the upward pressure on the funds rate. If

required reserves were to fall quite low, the demand for balances would become more linked to banks' desire to avoid overnight overdrafts when conducting transactions through their accounts at Reserve Banks. Demand from this source is more variable than is requirement-related demand, and it also cannot be substituted across days; both factors would tend, all else equal, to increase the volatility of the federal funds rate.

The decline in required reserves over the past several years has not created serious problems in the federal funds market, but funds-rate volatility has risen a little, and the risk of much greater volatility would increase if required reserves were to fall substantially further. One factor mitigating an increase in funds-rate volatility has been an increase in required clearing balances. These balances, which banks can precommit to hold on a two-week average basis, earn credits that banks use to pay for Federal Reserve priced services. Like required reserve balances, required clearing balances are predictable by the Federal Reserve and can be substituted across days within the two-week maintenance period. Funds-rate volatility has also been damped by banks' improved management of their balances at Reserve Banks, which in part reflects the improved real-time access to account information now provided by the Federal Reserve. Whether these factors could continue to restrain funds-rate volatility if required reserve balances were to become much smaller is as yet unclear. Also unclear is whether a moderate increase in funds-rate volatility would have any serious adverse consequences for interest rates farther out on the yield curve or for the macroeconomy. The Federal Reserve continues to monitor the situation closely.

Interest Rates, Equity Prices, and Exchange Rates

Interest Rates

Interest rates on Treasury securities were little changed or declined a bit, on balance, between the end of 1996 and mid-July. Yields rose substantially in the first quarter as evidence mounted that the robust economic activity observed in the closing months of 1996 had continued into 1997. By the time of the March FOMC meeting, most participants in financial markets were anticipating some tightening of monetary policy, and rates moved little when the increase in the intended federal funds rate was announced. Beginning in late April, key data pointed to continued low inflation and a slowing of economic growth in the second quarter, and interest rates retraced their earlier advance.

The yield on the inflation-indexed ten-year Treasury note was little changed between mid-April and mid-July, suggesting that at least part of the roughly 60-basis-point drop in the nominal ten-year yield over that period reflected a reduction in expected inflation or in uncertainty about future inflation, or both. Yet, relative movements in these two yields should be interpreted carefully, as the market's experience in trading indexed debt is relatively brief, making its prices potentially vulnerable to small shifts in market sentiment. Moreover, the Treasury announced this spring a reduction in the frequency of nominal ten-year note auctions, perhaps putting downward pressure on their nominal yields, and some investors may have paid renewed attention to upcoming technical adjustments to the CPI, which will reduce measured inflation. Survey-based measures of expected inflation showed little change in the second quarter.

The interest rate on the three-month Treasury bill was held down in recent months by the reduced supply of bills associated with the smaller federal deficit. Between mid-March and mid-July, the spread between the federal funds rate and the three-month yield averaged about 15 basis points above the average spread in 1996. Interest rates on private short-term instruments increased a little in the second quarter after the small System tightening in March.

Equity Prices

Equity markets have advanced dramatically again this year. Through mid-July, most broad measures of U.S. stock prices had climbed between 20 percent and 25 percent since year-end. Stocks began the year strongly, with the major indexes reaching then-record levels in late January or February. Significant selloffs ensued, partly occasioned by the backup in interest rates, and by early April the NASDAQ index was well below its year-end mark and the S&P 500 composite index was barely above its. Equity prices began rebounding in late April, however, soon pushing these indexes to new highs. Stock prices have been somewhat more volatile this year than last.

The run-up in stock prices in the spring was bolstered by unexpectedly strong corporate profits for the first quarter. Still, the ratio of prices in the S&P 500 to consensus estimates of earnings over the coming twelve months has risen further from levels that were already unusually high. Changes in this ratio have often been inversely related to changes in long-term Treasury yields, but this year's stock price gains were not matched by a significant net decline in interest rates. As a result, the yield on ten-year Treasury notes now exceeds the ratio of twelve-month-ahead earnings to

prices by the largest amount since 1991, when earnings were depressed by the economic slowdown. One important factor behind the increase in stock prices this year appears to be a further rise in analysts' reported expectations of earnings growth over the next three to five years. The average of these expectations has risen fairly steadily since early 1995 and currently stands at a level not seen since the steep recession of the early 1980s, when earnings were expected to bounce back from levels that were quite low.

Exchange Rates

The weighted average foreign exchange value of the dollar in terms of the other G-10 currencies rose sharply in the first quarter from its level in December and has moved up somewhat further since then. On balance, the nominal dollar is more than 10 percent above its level at the end of December. A broader measure of the dollar that includes currencies from additional U.S. trading partners and adjusts for changes in relative consumer prices shows appreciation of about 7 percent. After rising nearly 10 percent in terms of the Japanese yen to a recent peak in late April, the dollar retreated; it is currently about unchanged from its value in terms of yen at the end of December. In contrast, the dollar has risen about 17 percent in terms of the German mark since the end of last year.

Early in the year, data showing continued strengthening of U.S. economic activity surprised market participants, raised their expectations of some tightening of U.S. monetary policy, and contributed to upward pressure on the dollar. In light of the FOMC action in late March and the tendency for subsequent economic indicators to suggest a slowing of the growth of U.S. real output,

pressure for dollar appreciation abated. While robust economic activity in the United States generated a rise in U.S. long-term interest rates through April, market uncertainty about the strength of output growth in several foreign industrial countries led to little change, on balance, in average long-term (ten-year) rates in other G-10 countries. Since then, U.S. rates have returned to near year-end levels, while rates abroad have moved down. Accordingly, the long-term interest differential, on balance, has shifted further in favor of dollar assets since December, consistent with the net appreciation of the dollar this year.

Despite indications of further recovery of output in Japan, the dollar rose against the yen early in the year as planned fiscal policy in Japan appeared to be more restrictive than had been expected, and Japanese long-term interest rates declined in response. Statements by G-7 officials at their meeting in Berlin in February and on subsequent occasions suggested some concern that the dollar's strength and the yen's weakness not become excessive. The dollar moved back down in terms of the yen in May and has since fluctuated narrowly. The yen has been supported by data showing a widening of Japanese external surpluses and by a partial retracing by Japanese long-term rates of their earlier decline, as indicators have suggested that the fiscal measures may not be as contractionary as previously expected.

The dollar also rose sharply early in the year in terms of the German mark and other continental European currencies. Market participants have been disappointed that the pace of economic activity has not strengthened further in continental European countries. In addition, uncertainties about the prospects for European Monetary Union, including the possibility of delay and the question of which countries will be in the

first group proceeding to Stage Three, have resulted in fluctuations in the mark and, on balance, appear to have strengthened the dollar. German long-term interest rates have declined somewhat on balance this year.

Short-term market interest rates in most of the major foreign industrial countries have changed little on average since the end of last year. Rates in the United Kingdom have risen somewhat as the new government increased the official lending rate one-quarter percentage point in May and the Bank of England raised it by the same amount in June and again in July. Short-term rates in Italy and Switzerland have eased. Stock prices have risen sharply so far this year in the major foreign industrial countries, particularly in continental Europe.

The dollar has changed little on balance in terms of the Mexican peso since December, as improved investor sentiment toward Mexico, reflected in narrowing yield spreads between Mexican and U.S. dollar-denominated bonds, has supported the peso. The trend in Mexican inflation has declined this year; nevertheless, the excess of Mexican inflation over U.S. inflation implies about a 7 percent real appreciation of the peso since December.

Since mid-May, financial pressures in Thailand, which caused authorities there to raise interest rates and have led to depreciation of the currency, have spilled over to influence financial markets in some of our Asian trading partners, particularly the Philippines and Malaysia. Interest rates in both of these countries rose sharply. Philippine officials relaxed their informal peg of the peso in terms of the dollar, and the currency declined significantly; the Malaysian ringgit and Indonesian rupiah have also depreciated. ■

Part 2

*Records, Operations,
and Organization*

Record of Policy Actions of the Board of Governors

Regulation B Equal Credit Opportunity

September 9, 1997—Amendments

The Board amended Regulation B to create a legal privilege for self-tests conducted voluntarily by creditors, effective January 30, 1998.

Votes for this action: Messrs. Greenspan and Kelley, Ms. Phillips, and Mr. Meyer. Absent and not voting: Ms. Rivlin.^{1,2}

The Board revised Regulation B to implement amendments to the Equal Credit Opportunity Act as part of the Economic Growth and Regulatory Paperwork Reduction Act of 1996. That act created a legal privilege for information produced by creditors through voluntary self-tests they conduct to determine the level or effectiveness of their compliance with the Equal Credit Opportunity Act, provided that appropriate corrective action is taken to address any possible violations they discover. The Department of Housing and Urban Development issued a substantially similar regulation under the Fair Housing Act. The Board announced its revised regulation on December 11, 1997.

1. Throughout this chapter, note 1 indicates that two vacancies existed on the Board when the action was taken.

2. In voting records throughout this chapter, Board members, except the Chairman and Vice Chair, are listed by seniority.

Regulation C Home Mortgage Disclosure

January 16, 1997—Amendment

The Board approved an interim amendment to Regulation C to increase the exemption threshold for depository institutions, effective January 1, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Messrs. Kelley and Lindsey, Mses. Phillips and Yellen, and Mr. Meyer.

The Economic Growth and Regulatory Paperwork Reduction Act of 1996 amended the Home Mortgage Disclosure Act to increase the asset-exemption threshold that determines which depository institutions are exempt from the act. The new asset-exemption threshold is based on the percentage by which the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPIW) for 1996 exceeded the index for 1975. On the basis of the CPIW for December 1996, the Board approved a threshold of \$28 million. The Board also requested comment on the interim amendment.

May 19, 1997—Amendments

The Board amended Regulation C to increase the asset-exemption threshold for depository institutions, ease disclosure requirements, and extend data collection authority, effective July 1, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

The revisions implement amendments to the Home Mortgage Disclosure Act included in the Economic Growth and Regulatory Paperwork Reduction Act of 1996. The action makes final an interim amendment adopted in January 1997 that set the asset-exemption threshold for depository institutions at \$28 million. The amendments also establish an alternative method by which institutions may provide disclosure statements in metropolitan areas in which they have branch offices and extend data collection authority under the Paperwork Reduction Act for another three years.

Regulation D **Reserve Requirements** **of Depository Institutions**

October 26, 1997—Amendments

The Board amended Regulation D to allow U.S. branches and agencies of foreign banks and Edge Act and agreement corporations to choose whether to aggregate reserve balances on a nationwide basis with a single pass-through correspondent or to continue to maintain reserve balances on a same-state/same-District basis, effective January 1, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

To make interstate banking and branching easier, the Federal Reserve Banks began in January 1998 to implement a new account structure that provides a single Federal Reserve account for each domestic depository institution and enables the Federal Reserve Banks to establish a single debtor-creditor relationship with each chartered entity. The amendments allow foreign banks and Edge Act and agreement corporations to choose whether to aggregate required

reserve balances nationally or locally. The revisions also update and clarify the pass-through rules in Regulation D for all institutions.

November 7, 1997—Amendments

The Board amended Regulation D to decrease the amount of transaction balances to which the lower reserve requirement applies.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, and Ms. Phillips. Absent and not voting: Mr. Meyer.¹

Under the Monetary Control Act of 1980, depository institutions, Edge Act corporations, agreement corporations, and U.S. agencies and branches of foreign banks are subject to reserve requirements set by the Board. The act directs the Board to adjust annually the amount subject to the lower reserve requirement to reflect changes in transaction balances nationwide. Recent declines in transaction balances warranted a decrease to \$47.3 million, and the Board amended Regulation D accordingly.

The Garn-St Germain Depository Institutions Act of 1982 establishes a zero percent reserve requirement on the first \$2 million of an institution's reservable liabilities. The act also provides for annual adjustments to that exemption amount based on deposit growth nationwide. Recent growth in deposits warranted an increase to \$4.7 million, and the Board amended Regulation D accordingly.

For institutions reporting weekly, the amendments are effective with the reserve computation period beginning December 30, 1997, and the corresponding reserve maintenance period beginning January 1, 1998. For institutions reporting quarterly, the amendments are

effective with the reserve computation period beginning December 16, 1997, and the corresponding reserve maintenance period beginning January 15, 1998.

To reduce the reporting burden on small institutions, depository institutions with total deposits below specified levels are required to report their deposits and reservable liabilities quarterly or less frequently. To reflect increases in the growth rate of total deposits at all depository institutions, the Board increased the deposit cutoff levels used in determining the frequency and detail of deposit reporting to \$78.9 million for nonexempt depository institutions and to \$50.7 million for exempt depository institutions, beginning in September 1998.

Regulation D Reserve Requirements of Depository Institutions

Regulation I Issue and Cancellation of Capital Stock of Federal Reserve Banks

Rules Regarding Delegation of Authority

June 3, 1997—Amendments

The Board amended Regulations D and I to define the location of a depository institution for purposes of Federal Reserve membership and reserve account maintenance, effective October 1, 1997.

Votes for this action: Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer. Absent and not voting: Mr. Greenspan.¹

The Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 eliminated many barriers to interstate

banking, and the number of depository institutions with branches in more than one Federal Reserve District is expected to increase. The amendments clarify the Federal Reserve District in which a depository institution is eligible for Federal Reserve membership and the location of a depository institution's reserve account. The Board also delegated to the Secretary of the Board the authority to make a determination of location under Regulation D or Regulation I if (1) the relevant Federal Reserve Banks and the institution agree on the specific Reserve Bank in which the institution should hold stock or with which the institution should maintain a reserve account and (2) the location agreed upon does not raise any significant policy issues.

Regulation E Electronic Fund Transfers

August 8, 1997—Amendments

The Board amended Regulation E to exempt certain needs-tested electronic benefit transfer programs established or administered by state or local government agencies from requirements of the Electronic Fund Transfer Act and Regulation E, effective September 15, 1997.

Votes for this action: Messrs. Greenspan and Kelley, Ms. Phillips, and Mr. Meyer. Absent and not voting: Ms. Rivlin.¹

Electronic benefit transfer programs generally involve the issuance of access cards and personal identification numbers to recipients of government benefits so that they can obtain their benefits through automated teller machines and point-of-sale terminals. The amendments implement a provision of the Electronic Fund Transfer Act contained in the Personal Responsibility and Work Opportunity Reconciliation Act of 1996

that exempted certain electronic benefit transfer programs from coverage under the Electronic Fund Transfer Act.

Regulation G

Securities Credit by Persons other than Banks, Brokers, or Dealers

Regulation T

Credit by Brokers and Dealers

Regulation U

Credit by Banks for the Purpose of Purchasing or Carrying Margin Stocks

Regulation X

Borrowers of Securities Credit

December 18, 1997—Amendments

The Board amended Regulations G, T, U, and X to reduce regulatory distinctions between broker-dealers, banks, and other lenders and to implement changes to the Board's securities credit regulations, effective April 1, 1998.

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

The Board adopted the amendments to simplify the regulations and reduce burden as part of its periodic regulatory review and to implement changes to the Board's statutory authority contained in the National Securities Markets Improvement Act of 1996, which deregulated lending to certain broker-dealers. The amendments also provide for merging Regulation G into Regulation U, thereby eliminating Regulation G. The Board also will discontinue publication of its quarterly list of over-the-counter market stocks that are subject to its margin regulations for broker-dealers, effective January 1, 1999, and for other lenders, effective April 1,

1998. Compliance with the amendments to Regulation T is optional until July 1, 1998.

Regulation H

Membership of State Banking Institutions in the Federal Reserve System

February 24, 1997—Amendments

The Board adopted amendments to provisions of Regulation H related to recordkeeping and confirmation of certain securities transactions effected by state member banks, effective April 1, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

The amendments update recordkeeping and confirmation requirements to conform them with rules of the Securities Exchange Commission and the Department of the Treasury and with principles of safe and sound banking.

Regulation H

Membership of State Banking Institutions in the Federal Reserve System

Regulation K

International Banking Operations

March 11, 1997—Amendments

The Board amended Regulations H and K to establish rules concerning government securities sales practices by depository institutions, effective July 1, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

The rules, which were also adopted by the other federal banking agencies,

minimize regulatory burden to the extent feasible while providing consistent treatment for customers of bank and non-bank dealers and brokers in government securities.

August 22, 1997—Amendments

The Board amended Regulations H and K to implement the prohibition in section 109 of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 against establishing interstate branches primarily for the purpose of deposit production, effective October 10, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

As required by section 109 of the act, the Board, along with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, adopted uniform amendments to their regulations that prohibit any bank from establishing or acquiring, under the authority of the act, a branch or branches outside of its home state primarily for the purpose of deposit production. The amendments also provide guidelines for determining whether such a bank is reasonably helping to meet the credit needs of the communities served by its interstate branches.

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

Regulation Y Bank Holding Companies and Change in Bank Control

December 17, 1997—Interim Rule

The Board approved an interim amend-

ment to Regulations H and Y to reduce regulatory burden in risk-based capital guidelines that apply to banking organizations with significant trading activities, effective December 31, 1997.

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

The Board, along with the other federal banking agencies, amended the risk-based capital standards for market risk applicable to certain banks and bank holding companies with significant trading activities. The amendment eliminates the requirement that the total capital charge for specific risk must equal at least 50 percent of the standard capital charge for specific risk when an institution measures specific market risk using its internal model. The rule implements a revision to the Basle Accord and reduces regulatory burden for institutions with qualifying internal models because they will no longer be required to calculate a standard specific-risk capital charge.

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

August 26, 1997—Amendment

The Board amended Regulation J to establish a policy under which each depository institution will have a single Federal Reserve account relationship, effective January 2, 1998.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, and Ms. Phillips. Absent and not voting: Mr. Meyer.¹

The Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994

eliminated many barriers to interstate banking, and the number of depository institutions operating branches in more than one Federal Reserve District is expected to increase. The amendment allows a depository institution to send checks to any Reserve Bank for collection, but all of its check-collection transactions through the Federal Reserve System will be reflected in a single account held at its Administrative Reserve Bank, regardless of where the institution has its branches. This account structure will establish a single debtor-creditor relationship between each institution and a Federal Reserve Bank and will make account management more efficient for banks having interstate branches.

Regulation M **Consumer Leasing**

March 26, 1997—Amendments

The Board amended Regulation M to implement legislation, revise certain disclosures, and make technical corrections, effective April 1, 1997, with compliance optional until October 1, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

The amendments incorporate statutory changes that streamline lease advertising disclosures, revise the requirement to disclose certain costs due at the signing of the lease to parallel the statutory change to a similar advertising provision, and make several technical corrections.

September 25, 1997—Amendments

The Board delayed the date for mandatory compliance with revisions to Regu-

lation M that apply to automobile leasing from October 1, 1997, to January 1, 1998.

Votes for this action: Messrs. Greenspan and Kelley, Ms. Phillips, and Mr. Meyer. Absent and not voting: Ms. Rivlin.¹

On October 7, 1996, the Board had published revisions to Regulation M to take effect on October 1, 1997. Those revisions established a new disclosure scheme to improve consumer understanding of automobile-leasing transactions. The new scheme required the preparation of new forms and the reprogramming of computer software. The Board had been asked by representatives of the automobile leasing industry to delay the effective date of the new rules, to allow more time for installation of the software programs necessary to produce computer-generated disclosure statements.

Regulation O **Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks**

March 11, 1997—Amendment

The Board amended Regulation O to exclude from coverage certain extensions of credit by a bank to an executive officer or a director of an affiliate, effective April 1, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

The amendment excludes from the requirements of Regulation O extensions of credit by a bank to an executive officer or a director of an affiliate, provided that the executive officer or director is not engaged in major policymaking functions of the lending bank and

that the affiliate does not account for more than 10 percent of the consolidated assets of the bank's parent holding company. The amendment also simplifies the procedure for a bank to implement this exclusion by resolution or bylaw.

Regulation Q Prohibition against Payment of Interest on Demand Deposits

May 6, 1997—Interpretation

The Board revised an interpretation of Regulation Q to provide an exception to the current limitations on premiums given on demand deposit accounts, effective May 15, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

The Board revised an interpretation to provide an additional exception to the limitations on premiums that may be paid on demand deposit accounts. The revised interpretation permits the payment of premiums to depositors without any limit, provided the premiums are not related to or dependent on the balance in a demand deposit account and the duration of the account balance.

Regulation Y Bank Holding Companies and Change in Bank Control

February 19, 1997—Amendments

The Board amended Regulation Y to eliminate unnecessary regulatory burden and paperwork and to improve efficiency, effective April 21, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

The amendments include a streamlined and expedited review process for bank and nonbanking proposals by well-run bank holding companies, a reorganized and expanded list of permissible nonbanking activities, elimination of outmoded or superseded restrictions on nonbanking activities, revisions to tying restrictions, revisions to provisions implementing the Change in Bank Control Act, and other changes to improve the competitiveness of bank holding companies by eliminating unnecessary regulatory burden and modernizing the regulation. The Board also adopted a number of measures intended to broaden and improve public notice of bank acquisition proposals and to ensure that applications and notices are quickly available to the public.

August 21, 1997—Amendments

The Board amended the prudential limitations applicable to bank holding companies engaged in securities underwriting and dealing activities through section 20 subsidiaries, effective October 31, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

The Board, in its decisions under the Bank Holding Company Act and section 20 of the Glass-Steagall Act, had established prudential limitations (firewalls) that permit a nonbank subsidiary of a bank holding company to underwrite and deal in securities. The amendments eliminate limitations that have proved to be unduly burdensome or unnecessary in light of other laws or regulations and consolidate the remaining limitations in a series of eight operating standards.

Regulation Z **Truth in Lending**

November 19, 1997—Amendment

The Board amended the disclosure requirements for variable-rate loans in Regulation Z, which implements the Truth in Lending Act, to give creditors flexibility in providing disclosures about variable-rate loans, effective November 21, 1997.

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

The revision implements an amendment to the Truth in Lending Act contained in the Economic Growth and Regulatory Paperwork Reduction Act of 1996 and applies to variable-rate loans that have terms of more than one year and are secured by the borrower's principal dwelling. Under the amendment, for any variable-rate mortgage transaction, instead of a fifteen-year historical table, creditors may give borrowers a statement that their periodic payments may increase or decrease substantially and a maximum interest rate and corresponding payment based on a \$10,000 loan.

Compliance with the amendment initially was optional until December 22, 1997. On December 2, 1997, the Board extended the date for optional compliance until October 1, 1998.

Regulation CC **Availability of Funds and** **Collection of Checks**

February 26, 1997—Amendments

The Board adopted clarifying and technical amendments to Regulation CC, effective April 28, 1997.

Votes for this action: Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.
Absent and not voting: Mr. Greenspan.¹

Many of the amendments clarify the requirements of the regulation. Others reduce the compliance burden for depository institutions by, for example, allowing more flexibility in the way institutions must provide certain notices and disclosures to their customers.

Rules Regarding Delegation **of Authority**

March 11, 1997—Amendment

The Board amended its Rules Regarding Delegation of Authority to delegate to an individual Board member the authority to extend the time period for Board action on certain applications, effective March 22, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

The Board delegated to the chairman of its Committee on Supervisory and Regulatory Affairs its authority, under the Economic Growth and Regulatory Paperwork Reduction Act of 1996, to extend the 180-day period for final Board action on applications by foreign banks to establish a branch or agency or to acquire ownership or control of a commercial lending company.

Rules Regarding Availability **of Information**

October 1, 1997—Amendments

The Board approved amendments to subparts A and B of its Rules Regarding Availability of Information to provide for expedited processing of requests for

records and multitrack processing of requests, effective November 19, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

The Board's Rules Regarding Availability of Information implement the Freedom of Information Act and set forth the procedures for providing access to Board information under the act and in other circumstances. The Board adopted the amendments to comply with the Electronic Freedom of Information Act Amendments of 1996, which require agencies to provide for expedited processing of requests for records and permit agencies to provide for fast-track processing of certain requests. The Board also updated its rules to comply with statutes that have been enacted since the latest revisions in 1988. Revisions to subpart C of the rules are still under consideration.

Policy Statements and Other Actions

March 13, 1997—Volume-Based Fee Structures

The Board approved guidelines for the use of volume-based fee structures for Reserve Bank payment services, effective March 25, 1997, and reduced automated clearinghouse fees, effective May 1, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

The Board adopted guidelines for the Reserve Banks' use of volume-based fee structures for their electronic payment services and products and for continuation of volume-based fees for certain electronic check products. The Board

also approved volume-based fees for the origination of automated clearinghouse transactions and a reduction in the fee for the receipt of transactions.

November 6, 1997—Policy Statement on Payments System Risk

The Board modified its procedures for measuring daylight overdrafts to accommodate an earlier afternoon presentment deadline for checks drawn on local Federal Reserve Banks, effective November 14, 1997.

Votes for this action: Mr. Greenspan, Ms. Rivlin, Mr. Kelley, Ms. Phillips, and Mr. Meyer.¹

The Board revised its procedures to establish a uniform Systemwide presentment deadline for federal funds checks of 3:00 p.m. local time. Federal funds checks presented after that deadline will be credited to depository institutions' accounts on the next business day at 8:30 a.m. eastern time.

1997 Discount Rates

During 1997 the basic discount rate was left unchanged at 5 percent. Over the course of the year, however, there were numerous changes in the rates charged by the Federal Reserve Banks for seasonal and extended credit. The rates for both types of credit are set on the basis of market-related formulas, and these rates exceeded the basic discount rate by varying amounts during the year.

Basic Discount Rate

The Board's decisions about the basic discount rate are made against the background of the policy actions of the Federal Open Market Committee (FOMC) and related economic and financial

developments. These developments are covered more fully in part 1 of this REPORT and in the minutes of the FOMC meetings during 1997 that also appear in this REPORT.

Economic activity continued to expand at a rapid pace during the early months of 1997 after strengthening markedly in the latter part of 1996. The sharp uptrend in economic activity was associated with substantial growth in employment and slightly faster increases in average hourly earnings. At the same time, however, the underlying trend in consumer price inflation remained subdued. In view of these developments, most of the Reserve Banks continued to favor leaving the basic discount rate unchanged at 5 percent, its level since it was lowered $\frac{1}{4}$ percentage point in January 1996. By mid-March, however, four Reserve Banks were proposing a $\frac{1}{4}$ percentage point increase in view of their growing concerns about the prospects for inflation. The Board took no action on these pending requests but agreed on the need to monitor the economy for signs of developing inflationary pressures.

On March 25, the FOMC unanimously approved a small increase in the federal funds rate to an average of about $5\frac{1}{2}$ percent. This action took into account the persistence of rapid growth in economic activity, which, in the context of already high levels of resource use, was seen as progressively increasing the risk of rising inflation. In the circumstances, the slight firming of monetary policy was viewed as a prudent step that, by fostering an environment conducive to lower inflation, afforded greater assurance of prolonging the current economic expansion. In light of this preemptive action and subsequent signs that the economic expansion might be slowing to a more sustainable pace, some Reserve Banks withdrew

their requests for an increase in the basic discount rate, and by early July no Reserve Banks were proposing a higher rate.

Over the summer and fall, the growth of economic activity remained relatively brisk, although it was well below its pace during the opening months of the year. Price inflation continued to be subdued during this period despite indications of some pickup in the rise of labor compensation. No requests were made by any of the Banks to raise the basic rate during the summer months, but in early October one Bank proposed a $\frac{1}{4}$ percentage point increase, and late in the year a second Bank requested an increase of the same amount. The two Banks expressed concern about what they regarded as an overly accommodative monetary policy at a time when the persisting strength of domestic demand seemed to be increasing pressures on resources and augmenting the risks of higher inflation. The Board decided, however, that the discount rate should not be changed. Price inflation had remained quite limited and, indeed, appeared by some measures to be declining. Moreover, the financial turmoil in Southeast Asia, which intensified during the closing months of the year, could be expected to have a dampening effect on the economic expansion and inflation in the year ahead. Accordingly, although higher price inflation clearly remained a risk, the Board agreed with most of the Reserve Banks that near-term uncertainties warranted a cautious, wait-and-see policy posture.

Structure of Discount Rates

The basic rate is the rate normally charged on loans to depository institutions for short-term adjustment credit, while flexible, market-related rates generally are charged on seasonal and

extended credit. These flexible rates are calculated periodically in accordance with formulas that are approved by the Board.

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

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

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

At the end of 1997 the structure of discount rates was as follows: a basic rate of 5 percent for short-term adjustment credit, a rate of 5.65 percent for seasonal credit, and a rate of 6.15 percent for extended credit. During 1997 the rate for seasonal credit ranged from 5.25 percent to 5.70 percent, and the rate for extended credit ranged from 5.75 percent to 6.20 percent.

Board Votes

Under the Federal Reserve Act, the boards of directors of the Federal Reserve Banks must establish rates on loans to depository institutions at least every fourteen days and must submit the rates to the Board of Governors for review and determination. The Reserve Banks are also required to submit requests to renew the formulas for calculating the flexible rates on seasonal and extended credit. All votes on discount rates by the Board of Governors during 1997 were unanimous. ■

Minutes of Federal Open Market Committee Meetings

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

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

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

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to

execute transactions for the System Open Market Account. In the area of domestic open market activities, the Federal Reserve Bank of New York operates under two sets of instructions from the Federal Open Market Committee: an Authorization for Domestic Open Market Operations and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Committee operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations. These policy instruments are shown below in the form in which they were in effect at the beginning of 1997. Changes in the instruments during the year are reported in the minutes for the individual meetings.

Authorization for Domestic Open Market Operations

In Effect January 1, 1997

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

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

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

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

(c) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers acceptances of the types authorized for purchase under 1(b) above, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after

applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

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

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

Domestic Policy Directive

In Effect January 1, 1997¹

The information reviewed at this meeting suggests that economic activity has continued to expand at a moderate pace. Private nonfarm payroll employment increased appreciably further in November, although the civilian unemployment rate edged up to 5.4 percent. Industrial production rose sharply in November, in part because of a rebound in motor vehicle assemblies that had been depressed earlier by work stoppages. Consumer spending has posted appreciable gains over recent months after a summer lull. Housing starts rebounded in November after declining in September and October. Business fixed investment appears to be growing moderately after a sharp rise in the third quarter. The nominal deficit on U.S. trade in goods and services widened substantially in the third quarter from its rate in the second quarter. Increases in labor compensation have trended up this year, and consumer price inflation also has picked up owing to larger increases in food and energy prices.

Short-term market interest rates have registered mixed changes since the Committee meeting on November 13, 1996, while long-term yields have risen slightly. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies has risen slightly over the intermeeting period.

Growth of M2 picked up in November, while expansion of M3 moderated somewhat from its brisk pace in October. For the year through November, M2 is estimated to have grown at a rate in the upper half of the Committee's annual range, and M3 at a rate a little above the top of its range. Total domestic nonfinancial debt has expanded moderately on balance over recent months and has remained in the middle portion of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in July reaffirmed the ranges it had established in January for growth of M2 and M3

of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1995 to the fourth quarter of 1996. The monitoring range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1997, the Committee agreed on a tentative basis to set the same ranges as in 1996 for growth of the monetary aggregates and debt, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with relatively strong expansion in M2 and M3 over coming months.

Authorization for Foreign Currency Operations

In Effect January 1, 1997

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

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

1. Adopted by the Committee at its meeting on December 17, 1996.

ments, and with other international financial institutions:

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

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

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

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

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

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

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

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

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

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

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

7. The Chairman is authorized:

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

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

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

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

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

Foreign Currency Directive

In Effect January 1, 1997

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

2. To achieve this end the System shall:

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

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

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

3. Transactions may also be undertaken:

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

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

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

4. System foreign currency operations shall be conducted:

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

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

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

Procedural Instructions with Respect to Foreign Currency Operations

In Effect January 1, 1997

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

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

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

B. Any operation that would result in a change on any day in the System's net posi-

tion in a single foreign currency exceeding \$150 million, or \$300 million when the operation is associated with repayment of swap drawings.

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

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

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

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

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

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

Meeting Held on February 4–5, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, February 4, 1997, at 2:30 p.m. and continued on Wednesday, February 5, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broadus
Mr. Guynn
Mr. Kelley
Mr. Meyer
Mr. Moskow
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and
Ms. Minehan, Alternate Members
of the Federal Open Market
Committee

Messrs. Boehne, McTeer, and Stern,
Presidents of the Federal Reserve
Banks of Philadelphia, Dallas,
and Minneapolis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel²
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Beebe, Eisenbeis, Goodfriend,
Hunter, Lindsey, Mishkin,
Promisel, Siegman, Slifman, and
Stockton, Associate Economists

Mr. Fisher, Manager, System Open
Market Account

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

Mr. Winn, Assistant to the Board,
Office of Board Members, Board
of Governors

Messrs. Madigan and Simpson,
Associate Directors, Divisions of
Monetary Affairs and Research
and Statistics respectively, Board
of Governors

Ms. Johnson,³ Assistant Director,
Division of International Finance,
Board of Governors

Messrs. Brady³ and Reifschneider,³
Section Chiefs, Divisions of
Monetary Affairs and Research
and Statistics respectively, Board
of Governors

Messrs. Brayton³ and Rosine,³ Senior
Economists, Division of Research
and Statistics, Board of Governors

Ms. Garrett, Economist, Division of
Monetary Affairs, Board of
Governors

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

Ms. Browne, Messrs. Dewald, Hakkio,
Lang, Rosenblum, and Sniderman,
Senior Vice Presidents, Federal
Reserve Banks of Boston,
St. Louis, Kansas City,
Philadelphia, Dallas, and
Cleveland respectively

Mr. Miller and Ms. Perelmuter,
Vice Presidents, Federal Reserve
Banks of Minneapolis and
New York respectively

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 1997, and ending December 31, 1997, had been received and that the named individuals had executed their oaths of office.

The elected members and alternate members were as follows:

William J. McDonough, President of the Federal Reserve Bank of New York, with Ernest T. Patrikis, First Vice President of the Federal Reserve Bank of New York, as alternate;

2. Attended Tuesday session only.

3. Attended portions of meeting relating to the Committee's review of the economic outlook and establishment of its monetary and debt ranges for 1997.

J. Alfred Broaddus, Jr., President of the Federal Reserve Bank of Richmond, with Cathy E. Minehan, President of the Federal Reserve Bank of Boston, as alternate;

Michael H. Moskow, President of the Federal Reserve Bank of Chicago, with Jerry L. Jordan, President of the Federal Reserve Bank of Cleveland, as alternate;

Jack Guynn, President of the Federal Reserve Bank of Atlanta, with Thomas C. Melzer, President of the Federal Reserve Bank of St. Louis, as alternate;

Robert T. Parry, President of the Federal Reserve Bank of San Francisco, with Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City, as alternate.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first meeting of the Committee after December 31, 1997, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee:

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

Jack H. Beebe, Robert A. Eisenbeis, Marvin S. Goodfriend, William C. Hunter, David E. Lindsey, Frederic S. Mishkin, Larry J. Promisel, Charles J. Siegman, Lawrence Slifman, and

David J. Stockton, Associate
Economists

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first meeting of the Committee after December 31, 1997.

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

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

By unanimous vote, the Authorization for Domestic Open Market Operations shown below was reaffirmed.

Authorization for Domestic Open Market Operations

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

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replace-

ment; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than \$8.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

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

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

such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

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

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

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

Authorization for Foreign Currency Operations

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market

Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

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

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

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

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

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

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up

to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

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

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

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

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

designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

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

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

7. The Chairman is authorized:

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

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

C. From time to time, to transmit appropriate reports and information to the

National Advisory Council on International Monetary and Financial Policies.

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

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

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

Foreign Currency Directive

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

2. To achieve this end the System shall:

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

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

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

3. Transactions may also be undertaken:

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

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

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

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the U.S. Treasury;

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

C. In a manner consistent with the obligations of the United States in the Inter-

national Monetary Fund regarding exchange arrangements under the IMF Article IV.

Mr. Broaddus dissented in the votes on the Authorization and the Directive because they provide the foundation for foreign exchange market intervention. He believed that the Federal Reserve's participation in foreign exchange market intervention compromises its ability to conduct monetary policy effectively. Because sterilized intervention cannot have sustained effects in the absence of conforming monetary policy actions, Federal Reserve participation in foreign exchange operations in his view risks one of two undesirable outcomes. First, the independence of monetary policy is jeopardized if the System adjusts its policy actions to support short-term foreign exchange objectives set by the U.S. Treasury. Alternatively, the credibility of monetary policy is damaged if the System does not follow interventions with compatible policy actions, the interventions consequently fail to achieve their objectives, and the System is associated in the mind of the public with the failed operations.

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

Procedural Instructions with Respect to Foreign Currency Operations

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

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

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

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

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

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

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

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

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

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

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

By unanimous vote, the Committee reduced from \$20 billion to \$5 billion the amount of eligible foreign currencies that the System was prepared to

“warehouse” for the U.S. Treasury and the Exchange Stabilization Fund (ESF). Warehousing involves spot purchases of foreign currencies from the U.S. Treasury or the ESF and simultaneous forward sales of the same currencies to the U.S. Treasury or the ESF at the then-current forward market rates. The effect of warehousing is to supplement the U.S. dollar resources of the U.S. Treasury and the ESF for financing the purchase of foreign currencies and related international operations. The agreement had been enlarged from \$5 billion to \$20 billion in early 1995 to facilitate U.S. participation in the Multilateral Program to Restore Financial Stability in Mexico. No use of the warehousing facility had been made by the U.S. Treasury or the ESF during this period, and in light of Mexico’s repayment to the U.S. Treasury of all the financing provided under the Program and the termination of that Program, the Committee agreed that the size of the warehousing arrangement should revert to \$5 billion.

The Report of Examination of the System Open Market Account, conducted by the Board’s Division of Reserve Bank Operations and Payment Systems as of the close of business on October 31, 1996, was accepted.

By unanimous vote, the Program for Security of FOMC Information was amended to update the document with regard to certain security classifications, access to FOMC information, and attendance at FOMC meetings.

On January 23, 1997, the continuing rules and other standing instructions of the Committee were distributed with the advice that, in accordance with procedures approved by the Committee, they were being called to the Committee’s attention before the February 4–5 organization meeting to give members an opportunity to raise any questions they might have concerning them. Members

were asked to indicate if they wished to have any of the documents in question placed on the agenda for consideration at this meeting, and no requests for consideration were received.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on December 17, 1996, were approved. The Committee also discussed its long-standing practice of releasing the minutes a few days after the meeting at which they were approved, usually on the following Friday. The members agreed with a proposal to advance the normal release to Thursday to facilitate the dissemination and public understanding of these decisions.

The Manager of the System Open Market Account reported on developments in foreign exchange markets since the meeting on December 17, 1996. There were no transactions in foreign currencies for System account during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period December 18, 1996, through February 4, 1997. By unanimous vote, the Committee ratified these transactions.

The Manager advised the Committee that the anticipated pattern of reserve needs was such that he might want to add considerably to the System’s outright holdings of U.S. government securities over the coming intermeeting period. By unanimous vote, the Committee amended paragraph 1(a) of the Authorization for Domestic Open Market Operations to raise the limit on intermeeting changes in such holdings from \$8 billion to \$12 billion for the period ending with the close of business on the date of the next meeting, March 25, 1997.

The Committee then turned to a discussion of the economic and financial outlook, the ranges for the growth of money and debt in 1997, and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the growth of the economy had strengthened markedly in the fourth quarter of 1996. To a large extent the gain in final demand during the quarter reflected a surge in exports, but consumer spending also increased substantially after having risen at a much reduced pace in the third quarter. Despite some slowing in the growth of business fixed investment and some easing in housing activity, the overall economy had expanded briskly as reflected in data on production and employment. The tightness in labor markets had persisted and was evidenced by some continued acceleration in labor compensation in the fourth quarter. There was no discernible change in the underlying trend in price inflation, although a spurt in energy prices had resulted in faster increases in overall consumer and producer prices than in the third quarter.

Private payroll employment rose appreciably further in December after having recorded sizable increases over October and November. The gains remained widespread among employment categories and continued to be led by large advances in the services and trade industries. Aggregate hours of private production workers and the average workweek edged higher in the fourth quarter. The civilian unemployment rate was unchanged in December at 5.3 per-

cent, its average level for the second half of the year.

Industrial production increased sharply in November and December. The gains in December were widely distributed across manufacturing industries but were held down by a steep decline in the output of utilities after a surge in November. The production of aircraft and parts extended a strong uptrend. The utilization of total manufacturing capacity rose considerably further in December, to a level slightly above its long-term average.

Consumer spending registered a sizable increase over the fourth quarter after having grown little during the summer. In December total nominal retail sales rose considerably following a small decline in November. The December increases were spread across all major categories except for some further decline in sales of building materials and supplies. The most recent data on services expenditures pointed to moderate advances in October and November. Surveys indicated that consumer confidence had remained elevated in late 1996 and early 1997.

Housing starts fell appreciably in December, evidently reflecting unusually adverse weather conditions in several parts of the country, and were down somewhat for the fourth quarter as a whole. The declines were concentrated in single-family units. Permits for new home construction were little changed in December but edged lower for the fourth quarter as a whole. Available data indicated a somewhat slower pace of sales of new and existing homes in the fourth quarter.

Growth of business fixed investment moderated considerably in the fourth quarter after having advanced sharply in the previous quarter. The slowdown reflected a small decline in spending on producer durable equipment that was

more than offset by an apparent surge in outlays for nonresidential structures. Growth in spending on office, computing, and communications equipment slowed somewhat from the third-quarter pace but remained on a steep uptrend. Business investment in transportation equipment was weak in the fourth quarter, as sales of heavy trucks fell further and work stoppages at a major manufacturer prompted cuts in fleet auto sales in October and November.

Business inventory investment picked up somewhat on average in October and November, with most of the increase occurring in manufacturing. Trade inventories increased moderately on balance over the two-month period. Reflecting considerable strength in shipments and sales, however, inventory–sales ratios for most industries and trade groupings edged lower from their third-quarter levels.

The nominal deficit on U.S. trade in goods and services narrowed considerably in October and November from its rate in the third quarter. Nearly all the improvement was accounted for by a very large increase in exports of goods and services. The rise was spread among all major trade categories except automotive products. Economic activity in the major foreign industrial countries appeared to have continued to expand at a moderate rate on average in the fourth quarter. Available indicators suggested relatively strong economic performances in Japan, Canada, and the United Kingdom and slower growth in the major continental European countries. Further expansion was reported for several large Latin American and some Asian economies.

Recent data pointed to little change in underlying inflation trends. Overall consumer prices had continued under upward pressure in November and December, boosted by large advances

in energy prices. Excluding food and energy items, consumer prices rose modestly over the two months and increased less over the twelve months ending in December than over the previous twelve months. At the producer level, a similar pattern prevailed in prices of finished goods, and there was no evidence of increased price pressures at earlier stages of production. Worker compensation as measured by the employment cost index (ECI) and average hourly earnings of production and nonsupervisory workers rose considerably further during the closing months of 1996. For the year, both measures were up appreciably more than in 1995, though much of the acceleration in the ECI occurred in the first half of the year.

At its meeting on December 17, 1996, the Committee issued a directive that called for maintaining the existing degree of pressure on reserve positions. The directive included a bias toward the possible firming of reserve conditions to reflect a consensus among the members that the risks remained biased toward higher inflation and that the next policy move was more likely to be toward some tightening than toward easing. In this regard, the directive stated that in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with some slowing of the growth of M2 and M3 over coming months.

Open market operations during the intermeeting period continued to be directed toward maintaining the existing degree of pressure on reserve positions.

The federal funds rate rose briefly in response to year-end pressures, but it otherwise tended to remain close to the 5¼ percent level expected with an unchanged policy stance. Other short-term interest rates generally were unchanged to slightly higher over the intermeeting period. Rates on intermediate- and long-term securities edged higher on balance in reaction to incoming data on economic activity that were on the firm side of market expectations; the increases in such rates appeared to be tempered, however, by favorable market reactions to new data on wages and prices. The generally positive news on economic growth and inflation along with favorable reports on earnings appeared to reinforce the optimism of equity market investors, and major indexes of stock prices increased markedly further over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose substantially over the intermeeting period. The rise, which was most pronounced against the Japanese yen and continental European currencies, appeared to reflect market perceptions of unexpectedly strong economic growth in the United States and a risk of faltering growth in the other countries. The dollar appreciated less against sterling and declined somewhat against the Canadian dollar in apparent response to expectations of relative strength in the economies of those countries.

After having grown at a considerably faster rate in the fourth quarter, M2 and M3 apparently increased at a more moderate but still brisk pace in January. The expansion of both aggregates likely was boosted by strong income growth, and the relatively rapid expansion of M3 reflected heavy bank reliance on the managed liabilities in M3 to fund robust

loan growth. From the fourth quarter of 1995 to the fourth quarter of 1996, M2 was estimated to have grown at a rate near the upper end of the Committee's annual range and M3 at a rate appreciably above the top of its range. Total domestic nonfinancial debt had expanded moderately on balance over recent months and was estimated to have grown last year at a rate near the midpoint of its range.

The staff forecast prepared for this meeting suggested that the expansion would be sustained at a rate a bit above the economy's estimated growth potential. The increase in consumer spending was projected to moderate somewhat from its pace in the fourth quarter to a rate generally in line with the expected rise in disposable income. Homebuilding was forecast to decline somewhat but to stabilize at a relatively high level in the context of continued income growth and the generally favorable cash flow affordability of home ownership. Business spending on equipment and structures was projected to expand less rapidly in light of some anticipated slowing in the growth of sales and profits. Fiscal policy and the external sector were expected to exert small restraining influences on economic activity over the year ahead. With resource utilization high and rising, consumer price inflation, as measured by the CPI excluding the relatively volatile food and energy components of the index, was forecast to increase slightly this year in the context of some further pickup in the growth of labor compensation that would include another legislated rise in the federal minimum wage.

In the Committee's discussion of current and prospective economic developments, members commented that the robust performance of the economy in the fourth quarter partly reflected some sources of strength, notably a surge in

exports, that were evidently temporary, and they anticipated substantial moderation in the pace of the expansion over the period ahead. The outlook was subject to considerable uncertainty, but as they assessed the numerous factors bearing on prospective developments, the members generally concluded as they had at previous meetings that further growth in aggregate demand at a rate averaging near or a bit above the economy's potential remained a reasonable expectation. Many observed, however, that the risks to such an outlook appeared to be tilted to the upside. The strength of the expansion in the fourth quarter, and in fact over 1996 as a whole, had heightened concerns that the economy had considerable forward momentum at a time when it was already operating at a level, especially with regard to labor resources, that could tend to generate rising inflationary pressures. Indeed, in the view of at least some members, growth of aggregate demand in line with increases in potential output posed a risk of rising price inflation because the recent relatively favorable price performance was seen in this view as reflecting at least in part the behavior of special factors that could dissipate over the projection horizon.

In keeping with the practice at meetings when the Committee establishes its long-run ranges for the growth of money and debt aggregates, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members had provided individual projections of the growth in real and nominal GDP, the rate of unemployment, and the rate of inflation for the year 1997. The forecasts of the rate of expansion in real GDP had a central tendency of 2 to 2¼ percent and a full range of 2 to 2½ percent. The projections of the civilian unemployment rate associated with these growth expectations were all in a

range of 5¼ to 5½ percent for the fourth quarter of the year. With regard to nominal GDP growth in 1997, the forecasts were mainly in a range of 4¼ to 4¾ percent, with an overall range of 4¼ to 5¼ percent. Nearly all the members anticipated a small decline in the rate of inflation in 1997, as measured by the consumer price index, from that recorded in 1996. Specifically, the projections converged on rates of 2¾ to 3 percent and a full range of 2¾ to 3½ percent in 1997. These forecasts took account of expected developments in the food and energy sectors and further technical improvements in the index by the Bureau of Labor Statistics, both of which were expected to trim the reported rate. The projections were based on individual views concerning what would be an appropriate policy over the projection horizon to further progress toward the Committee's goals.

In their review of developments in key sectors of the economy, members observed that the available data and anecdotal information indicated considerable strength in consumer spending in recent months, and they referred to a number of underlying factors that should help to sustain at least moderate further growth in such spending. The latter included the solid expansion in employment and incomes, the increased financial wealth of many consumers, and the high level of consumer confidence as indicated by recent surveys. However, members also cited some factors that would tend to restrain the growth in consumer spending. Among these factors were the effects of the high level of consumer debt and rising repayment problems on both the willingness of households to borrow and of financial intermediaries to lend, the likely absence of pent-up demands after an extended period of expansion, and the possibility of a setback in the stock

market. It was difficult to evaluate how these differing factors would on balance affect consumer spending, but the members concluded that the consumer sector was likely to provide important support for sustained economic expansion.

The growth in business capital spending was expected to moderate somewhat in 1997 in association with slower growth in sales, profits, and cash flows. It also seemed likely after several years of robust investment expenditures that many business firms now had high levels of up-to-date capital stock relative to planned production. Members referred, however, to a number of favorable factors that should continue to support at least moderate further growth in business investment, including the attractive pricing of and ongoing rapid technological improvements in computer and communications equipment and the wide availability of equity and debt financing on favorable terms to business firms. Members also reported that commercial building activity had improved in many areas. Some noted a tendency to underestimate the strength of overall business investment in recent years, including the stimulus provided by efforts to improve productivity in highly competitive markets.

While indicators of housing activity had been somewhat erratic over the past several months, members sensed a somewhat softer tone on balance in this sector of the economy. This assessment was supported by anecdotal observations in several regions across the country. Against the background of the increase that had occurred earlier in mortgage financing costs and forecasts of some slowing in the growth of jobs and incomes, the housing sector was likely to weaken slightly over the coming year, but some members commented that surprises on the upside of current

forecasts, as in 1996, could not be ruled out.

Fiscal policy and foreign trade also were seen as likely to exert some modest restraint on overall economic activity. Federal purchases of goods and services still appeared to be on a declining trend. Although fiscal policy negotiations were likely to be difficult and their outcome was uncertain, members felt that there was some basis for anticipating the enactment of further legislation this year to help bring the federal budget into eventual balance. The large increase in exports in the fourth quarter clearly was associated with temporary developments, and net exports were expected to weaken this year, reflecting both some reversal of recent developments and the earlier appreciation of the dollar. Some members reported that business contacts had already communicated concerns about increased competitive pressures from imports because of the rise in the foreign exchange value of the dollar.

Members commented that inflation had remained remarkably subdued, but they expressed considerable concern about the risks of rising inflation in the context of high levels of resource use. They referred in particular to statistical indications, supported by anecdotal reports from around the nation, of very tight conditions in labor markets and some upward pressures on wages. Thus far, the rise in compensation had been held down by diminishing increases in worker benefit costs, and productivity gains also appeared to have had a favorable effect on unit labor costs. In addition, the increases in wages themselves had continued to be restrained by apparent worker concerns about job security. To date, there was no evidence that pressures stemming from tight labor markets had been passed through to a measurable extent to higher prices.

While the absence of increasing price inflation was a welcome development, members were concerned that the break with historical patterns might not persist. If labor markets remained under pressure, nominal compensation costs were likely to pick up at some point as one-time savings in worker benefit costs ran out and as workers became less willing to trade off lower wages for increased security; such a development would foster increases in labor costs that ultimately would feed through to higher prices. The members did not anticipate a sudden surge in inflation, but many expressed concern about the possibility of a gradual upcreep in coming quarters that might become more considerable later. They generally expected a small decline in overall price inflation this year, reflecting favorable developments in food and energy and, for the CPI, further technical improvements by the Bureau of Labor Statistics; however, they believed that the risks to their forecasts were in the direction of greater inflation, and several noted in particular that projected declines in energy prices might not materialize as soon or to the extent assumed in many forecasts.

In keeping with the requirements of the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act), the Committee reviewed the ranges for growth of the monetary and debt aggregates in 1997 that it had established on a tentative basis at its meeting in July 1996. Those ranges included expansion of 1 to 5 percent for M2 and 2 to 6 percent for M3, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The monitoring range for growth of total domestic nonfinancial debt was provisionally set at 3 to 7 percent for 1997. The tentative ranges for 1997 were unchanged from the actual ranges adopted for 1995 (in July of that year for M3) and 1996.

In reviewing the tentative ranges, the members took note of a staff projection indicating that M2 and M3 likely would grow in 1997 at rates close to the upper limit of those ranges, given the Committee's expectations for the performance of the economy and prices and assuming no major changes in interest rates. The staff analysis anticipated that the velocities of the broad monetary aggregates would continue to behave in the relatively stable and predictable manner that had re-emerged in the last few years and that was closer to historical norms than had been the case in the early 1990s.

The greater measure of predictability in velocity recently was an encouraging development, but in view of the substantial changes in financial markets and the increased availability of investment alternatives it would be premature to assume that the pattern would necessarily continue going forward. Given the substantial uncertainty still attached to projections of money growth consistent with the Committee's basic objectives for monetary policy, the members agreed that there was no firm basis for changing the tentative ranges set in July 1996. Adopting higher ranges, which would be more closely centered on money growth thought likely to be consistent with the Committee's expectations for economic activity and prices, could be misinterpreted as indicating that the Committee had become much more confident of the predictability of velocity and was placing greater emphasis on M2 and M3 as gauges of the thrust of monetary policy. One member, while agreeing with this assessment, emphasized that a continuation of a stable and predictable pattern of velocity behavior would raise the question as to whether the Committee should return to setting ranges consistent with its expectations for economic developments. Nonetheless, from a longer-run

perspective, the tentative ranges readily encompass rates of growth of M2 and M3 that, if velocity were to behave in line with historical experience, could be expected to be associated with approximate price stability and a sustainable rate of real economic growth. In that regard, they continue to serve the useful purpose of benchmarking money growth consistent with the Committee's long-run goal of price stability.

At the conclusion of its discussion, the Committee voted to approve without change the tentative ranges for 1997 that it had established in July of last year. In keeping with its usual procedures under the Humphrey-Hawkins Act, the Committee would review its ranges at mid-year, or sooner if interim conditions warranted, in light of the growth and velocity behavior of the aggregates and ongoing economic and financial developments. Accordingly, the following statement of longer-run policy for 1997 was approved for inclusion in the domestic policy directive:

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

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Votes against this action: None. Absent and not voting: Mr. Lindsey and Ms. Yellen.

In the Committee's discussion of policy for the intermeeting period ahead, all the members favored or could support a proposal to maintain an unchanged policy stance; the members also strongly supported the retention of a bias toward restraint. An unchanged policy seemed appropriate with inflation still quiescent, with few signs of emerging price pressures, with growth in economic activity seen as likely to moderate appreciably from the unexpectedly strong and unsustainable pace of the fourth quarter, and with considerable uncertainty about future inflationary developments. However, the members emphasized that the extent of the slowdown in economic expansion was unclear and that the persisting, or even greater, tightness of labor markets, coupled with potentially faster growth in worker benefits and diminishing worker insecurity, could put added upward pressure on labor costs and induce some increase in price inflation over time. Even so, most members thought that inflation likely would remain contained for some period ahead and that any strengthening in inflation pressures probably would be gradual, allowing the Committee to respond in a timely manner. Several also commented that a tightening policy action was not generally anticipated in financial markets, and a move at this time could have exaggerated repercussions. A few members emphasized, however, that the recent surge in economic activity had raised the probability that the level of economic output was now above the economy's long-run potential, and without a significant slowing in economic growth, inflationary pressures were more likely to increase over the forecast horizon. While an immediate tightening of policy would help to forestall such a buildup of pressures, the members agreed that current uncertainties about the outlook for both the rate of expan-

sion and inflation warranted a continuing "wait and see" policy stance, or at least made such a policy acceptable at this juncture.

In their discussion of possible adjustments to policy during the intermeeting period, the members recognized that an asymmetric directive tilted toward tightening was consistent with their general view that the risks were now more clearly in the direction of an upward trend in inflation. They agreed that the current environment called for careful monitoring of new developments and for prompt action by the Committee to counter any tendency for price inflation to rise and for higher inflation expectations to become embedded in financial markets and economic decisionmaking more generally. Indeed, in the interest of fostering a continuation of sustainable growth of the economy, it would be desirable to tighten before any sign of actual higher inflation were to become evident.

At the conclusion of the Committee's discussion, all the members indicated that they supported a directive that called for maintaining the existing degree of pressure on reserve positions and that retained a bias toward the possible firming of reserve conditions during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

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

The information reviewed at this meeting suggests that the economic expansion strengthened markedly in the fourth quarter. Private nonfarm payroll employment increased appreciably further in December after sizable gains over October and November. The civilian unemployment rate remained at 5.3 percent in December. Industrial production rose sharply in November and December. Consumer spending posted a large increase in the fourth quarter after a summer lull. Housing activity moderated somewhat over the closing months of the year. Growth in business fixed investment slowed substantially in the fourth quarter after a sharp rise in the third quarter. The nominal deficit on U.S. trade in goods and services narrowed considerably in October and November from its rate in the third quarter. Advances in labor compensation trended up in 1996, but price inflation generally diminished apart from enlarged increases in food and energy prices.

Most market interest rates have changed little or risen slightly since the Committee meeting on December 17, 1996. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies has increased substantially over the intermeeting period.

Growth of M2 and M3 strengthened considerably in the fourth quarter and appeared to have continued at a fairly brisk, though diminished, pace in January. From the fourth quarter of 1995 to the fourth quarter of 1996, M2 is estimated to have grown near the upper end of the Committee's annual range and M3 well above the top of its range. Total domestic nonfinancial debt has expanded moderately on balance over recent months and is estimated to have grown last year near the midpoint of its range.

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

and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The monitoring range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Gynn, Kelley, Meyer, Moskow, Parry, Ms. Phillips and Rivlin. Votes against this action: None. Absent and not voting: Mr. Lindsey and Ms. Yellen.

It was agreed that the next meeting of the Committee would be held on Tuesday, March 25, 1997.

The meeting adjourned at 11:35 a.m.

Donald L. Kohn
Secretary

Meeting Held on March 25, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, March 25, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Gynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and
Ms. Minehan, Alternate Members
of the Federal Open Market
Committee

Messrs. Boehne, McTeer, and Stern,
Presidents of the Federal Reserve
Banks of Philadelphia, Dallas, and
Minneapolis respectively

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

Messrs. Eisenbeis, Goodfriend, Hunter,
Lindsey, Mishkin, Siegman, and
Stockton, Associate Economists

Mr. Fisher, Manager, System Open
Market Account

Mr. Winn, Assistant to the Board,
Office of Board Members, Board
of Governors

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

Messrs. Madigan and Simpson,
Associate Directors, Divisions of
Monetary Affairs and Research
and Statistics respectively, Board
of Governors

Mr. Hooper, Assistant Director,
Division of International Finance,
Board of Governors

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

Messrs. Dewald, Hakkio, Lang, Rolnick, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, Philadelphia, Minneapolis, and Dallas respectively

Messrs. Altig, Bentley, Judd, and Kopcke, Vice Presidents, Federal Reserve Banks of Cleveland, New York, San Francisco, and Boston respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on February 4–5, 1997, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no System open market transactions in foreign currencies during the period since the meeting on February 4–5, 1997, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in U.S. government securities and federal agency obligations during the period February 5, 1997, through March 24, 1997. By unanimous vote, the Committee ratified these transactions.

The Manager advised the Committee that he continued to anticipate a pattern of reserve needs that might require another unusually large addition to the System's outright holdings of U.S. government securities during the relatively long intermeeting period ahead. The limit on increases in outright holdings between meetings had been raised to \$12 billion at the February meeting, and the Manager requested that the higher limit be retained for the upcoming period. By unanimous vote, the Committee amended paragraph 1(a) of the Authorization for Domestic Open Mar-

ket Operations to raise the limit on intermeeting changes in such holdings from \$8 billion to \$12 billion for the period ending with the close of business on the date of the next meeting, May 20, 1997.

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

The information reviewed at this meeting suggested that the economy had continued to expand at a relatively robust pace in early 1997 after having strengthened markedly in the fourth quarter of 1996. Much of the more recent growth reflected further acceleration in consumer spending, but business capital expenditures, housing activity, and an upturn in inventory investment also had contributed to the recent increase in total expenditures. By contrast, available data pointed to a sharp drop in net exports after a surge in the fourth quarter. To meet the strong aggregate demand, employment had recorded another large advance in early 1997 and industrial production had risen somewhat further. The underlying trend in consumer price inflation had remained subdued, but the increase in average hourly earnings had continued to edge higher early this year.

Private nonfarm payroll employment rose substantially further in January and February. The gains continued to be led by sizable advances in the services and trade industries. Employment in construction increased considerably over the two months, largely because of

unseasonably warm weather across much of the country in February that led to an earlier-than-usual pickup in building activity. Aggregate hours of private production workers, which were also affected by changing weather conditions, were up appreciably on balance over the two months, and the average workweek increased considerably, reaching a new recent high in February. The civilian unemployment rate, at 5.3 percent in February, was unchanged from its average level in the second half of 1996.

Industrial production rose appreciably in February after having declined slightly in January. The February advance resulted from a surge in the manufacturing of durable goods that was only partly offset by a plunge in the output of utilities associated with unseasonably mild weather in that month. The utilization of total manufacturing capacity was unchanged on balance over the two months at a level slightly above its long-term average.

Consumer spending strengthened considerably further in early 1997 after having registered a sizable increase over the fourth quarter. Nominal retail sales rose sharply in January and February. The gains over the two months were concentrated in sales of durable goods, including motor vehicles and building materials. Spending on services rose strongly in January (latest data) but may have moderated in February when milder-than-normal weather held down heating costs. Recent surveys indicated that consumer confidence had risen to the highest levels in many years.

Housing construction rose sharply in February after two months of relatively depressed activity. On balance, various indicators of housing activity had been mixed over the past several months and did not suggest any clear trend in spending for new housing.

Recent trends in orders and shipments pointed to a sizable further rise in outlays for producers' durable equipment in early 1997, largely reflecting continued rapid growth in purchases of computers and some further increase in spending for communications equipment. Expenditures for other types of equipment remained little changed. In the nonresidential construction sector, trends in contracts suggested some further spending gains in most market segments after strong advances in the fourth quarter. Manufacturing and trade inventories rose somewhat in January, roughly offsetting small declines over the previous two months. With sales and shipments rising rapidly in January, inventory-sales ratios for a wide range of industries dropped further from already low levels.

The nominal deficit on U.S. trade in goods and services widened substantially in January from its temporarily depressed rate in the fourth quarter. Nearly all the deterioration in the trade balance reflected a sharp rise in imports; that increase was largely the result of a rebound in automotive shipments from Canada, which had been temporarily reduced by a strike. Recent information on economic activity in the G-7 countries suggested continued expansion at a moderate rate on average in early 1997, but rates of expansion had continued to diverge among those economies. Growth in output still appeared to be relatively strong in Japan, Canada, and the United Kingdom, while much weaker economic performances were indicated for the major continental European countries. The economies of the major developing countries in Latin America and eastern Asia apparently continued to expand in late 1996.

Data for January and February were consistent with the continuation of a subdued trend in underlying price infla-

tion. Overall consumer price inflation moderated somewhat over the two months from its pace in the fourth quarter; smaller increases in energy prices were an important factor in the slowdown, but prices of consumer items other than food and energy also advanced at a slower rate over the first two months of the year. For the twelve months ending in February, consumer prices excluding food and energy rose somewhat less than they had over the preceding twelve months; a development contributing importantly to the deceleration was a smaller rise in non-oil import prices associated with the appreciation of the dollar. At the producer level, overall prices of finished goods declined somewhat in January and February, reflecting an appreciable drop in the food and energy components. For the twelve months ending in February, the increase in the overall index of finished goods prices was little changed from that over the preceding twelve months, but excluding food and energy prices, which had registered sizable advances in 1996, the rise was considerably smaller over the latest twelve-month period. At early stages of processing, however, some producer prices had moved up in recent months. Average hourly earnings of production and nonsupervisory workers posted small further increases in January and February but were up appreciably more over the twelve months ending in February than over the preceding twelve months.

At its meeting on February 4–5, 1997, the Committee issued a directive that called for maintaining the existing degree of pressure on reserve positions. The directive included a bias toward the possible firming of reserve conditions, reflecting a consensus among the members that the risks were clearly in the direction of an upward trend in inflation

and that the next policy move was more likely to be toward some tightening than toward easing. In this regard, the directive stated that in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with some slowing of the growth of M2 and M3 over coming months.

Over the period since the February meeting, open market operations were directed toward maintaining the existing degree of pressure on reserve positions. Federal funds continued to trade mainly at rates close to the 5¼ percent level expected with an unchanged policy stance, though the rate did at times fall below that level in conjunction with unanticipated shortfalls in demands for excess reserves. Most other market interest rates rose somewhat over the intermeeting period in apparent response to indications of stronger-than-expected economic activity, perceptions that the Federal Reserve had become more concerned about a possible buildup in inflation pressures, and perhaps disappointment over the prospects for legislation to reduce the federal budget deficit. In these circumstances, expectations built that monetary policy would be tightened. The rise in most market interest rates was accompanied by slight declines in a number of major indexes of stock market prices, although stock prices in some industries posted more pronounced declines.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose

further over the intermeeting period. The dollar's appreciation appeared to reflect spreading perceptions of a relatively strong U.S. expansion and associated increases in U.S. interest rates compared with those abroad. The dollar's rise was most pronounced against the continental European currencies.

Growth of M2 moderated somewhat in January and February from a brisk pace in late 1996, while expansion of M3 remained rapid in both months. Data for the first part of March suggested diminished growth of both aggregates. The appreciable further expansion of these broad aggregates thus far this year probably continued to reflect elevated income growth, and the relative strength of M3 was associated to an important extent with heavy bank reliance on large-denomination time deposits to fund robust asset growth. M3 also continued to be boosted by the rapid growth of money market mutual funds. The expansion of total domestic nonfinancial debt appeared to have slowed in the early part of the year in conjunction with reduced borrowing by both federal and state governments, which were drawing down cash balances.

The staff forecast prepared for this meeting suggested that the expansion in economic activity would slow in coming quarters to a pace somewhat above that of the economy's estimated potential and would moderate a bit further in 1998. Growth in consumer spending was expected to decline appreciably from its recent pace but to remain fairly brisk over the quarters ahead, supported by further projected gains in employment and incomes. Expansion in business spending on equipment and structures also was projected to moderate, but to a still relatively high rate, in association with smaller increases in sales and profits. Housing construction was forecast to drift lower over coming

quarters, partly reflecting the rise that already had occurred in mortgage interest rates. The staff continued to anticipate that fiscal policy and the external sector would exert mildly restraining effects on economic activity over the year ahead. With resource utilization high and labor compensation rising, core consumer price inflation was forecast to increase slightly over the year ahead.

In the Committee's discussion of current and prospective economic developments, members referred to the widespread statistical and anecdotal evidence that the surprising strength in economic activity over the closing months of 1996 was persisting in 1997. Some observed that it was difficult to detect signs of weakness or imbalances in domestic sectors of the economy. While the members believed that some slowing in the expansion was inevitable, they felt that substantial uncertainty surrounded the timing and extent of such slowing in the quarters ahead. Continued growth near, or even somewhat below, the recent pace would raise resource utilization rates further from their already high levels. Although labor markets already were tight, inflation had remained relatively subdued, and there were no signs in price data that it was picking up. However, the risks of a rise in inflation down the road had increased appreciably as a result of the strength of aggregate demand and the increase in pressures on resources that likely would accompany it absent a firming in financial conditions.

In their discussion of the outlook for spending in key sectors of the economy, members emphasized the strength of consumer spending in recent months. They noted that anecdotal reports from numerous parts of the country and surveys indicating very high levels of consumer confidence tended to confirm statistical evidence of an ebullient con-

sumer sector. While the recent surge in consumer demand probably was supported mainly by rapid growth in employment and labor income, it seemed possible that consumers also were responding increasingly to the run-up in household net worth stemming from the earlier buoyant performance of the stock market. The effects of rising financial wealth on consumer spending were difficult to isolate, and they were undoubtedly restrained by efforts to accumulate savings for future expenditures such as college expenses and retirement. Moreover, the constraints on spending imposed by the high debt burdens of many households tended to exert at least a partly offsetting influence on overall consumer spending. On balance, however, the members believed that the consumer sector was likely to provide major ongoing support to the expansion, though the increases in consumer spending probably would diminish in the context of more restrained growth in jobs and incomes. A number of members expressed the view, however, that the risks to such a forecast were in the direction of more robust consumer spending.

Business fixed investment, which had remained on a steep uptrend for an extended period, also was expected to provide continuing though moderating stimulus to the overall economic expansion. Growth in expenditures for business equipment was forecast to decline from the extraordinary pace of recent years, despite continuing brisk demand for computers and communications equipment. With regard to the outlook for nonresidential building activity, anecdotal reports from several regions pointed to a further pickup in commercial construction associated with declining vacancy rates, rising property values and rents, and readily available financing. Indeed, reports from a few areas

indicated the emergence of speculative building activity. On the other hand, in some regions, signs of slowing nonresidential construction were reported.

Housing construction activity had fluctuated in recent months, largely in response to changing weather conditions, but such construction appeared to be little changed on balance. Recent anecdotal reports pointed to improving housing markets in several regions and to some easing in a few. Looking ahead, the members generally anticipated that housing activity would be maintained at a relatively high level, perhaps slightly below that prevailing on average in recent quarters, barring unanticipated developments in the broader economy or in financial markets. Although the rise that had occurred in mortgage interest rates was a somewhat inhibiting influence on the prospects for housing, favorable factors noted during the meeting included the ongoing effects of the large gains in stock market wealth, sizable increases in employment and incomes, and a still relatively favorable cash-flow affordability of home ownership.

The persisting efforts by business firms to economize on their inventories had reduced the latter to quite low levels in relation to sales. In the circumstances, current inventory levels were viewed as an upside risk to the expansion that could be triggered by unexpected strength in final demand. Absent an upside surprise in demand, inventories might be expected to remain a slightly positive factor in the economic outlook; and if growth in final demand were to moderate more than anticipated, the currently lean inventories could be viewed as minimizing the risks of accumulating weakness in the near term.

The outlook for fiscal policy remained one of modest restraint; on the basis of existing legislation, reductions were

anticipated in constant-dollar purchases of goods and services by the federal government in fiscal years 1997 and 1998. A key element in the potential impact of fiscal policy was the uncertain outcome of the current effort to eliminate the federal deficit over time. Although success in that effort probably would have little effect on the government's budget position over the next few years, it likely would have some beneficial repercussions on business and consumer confidence and possibly also on financial markets. Financial markets would be especially positively affected by an agreement to reduce significantly the growth of entitlements, which would damp government spending and deficits over the longer run.

The unwinding in the early months of 1997 of special factors that had boosted net exports in the fourth quarter of 1996 was offsetting some of the effects on production of the persisting strength in domestic demand. Beyond the near term, the appreciated value of the dollar was expected to hold down net exports, restraining overall demand and growth. Some members observed in this regard that the deterioration in net exports might be substantial. While such an outcome would help to moderate inflationary pressures on domestic resources in coming quarters, it also would exacerbate the longer-term problem of very large foreign trade and current account deficits.

In their review of developments bearing on the outlook for inflation, members commented that the risks now seemed to be tilted more clearly toward higher inflation. They acknowledged that it was difficult to find indications of rising inflation in broad measures of consumer or GDP-related prices; indeed, such measures still could be viewed as consistent with a slightly declining trend in price inflation. Even so, prospects for

a substantial period of economic expansion at a rate that exceeded the estimated growth of potential had generated increasing concerns of rising inflationary pressures in an economy that already was operating at high levels of resource utilization. Members observed in this regard that while there was little evidence of growing demand pressures on capital resources, the tightness in labor markets appeared to be intensifying. Indications of such a development included not only widespread anecdotal reports but a variety of data such as initial claims, insured unemployment, and help-wanted advertising. The rise in labor force participation to a high percentage of the working age population had helped to keep the unemployment rate from falling, but the unexpected increase in participation was itself suggesting tight conditions that were inducing marginal workers into the job market.

The data on worker compensation were somewhat mixed, but they suggested some acceleration on balance. Members noted that the damping effects of some temporary factors on labor costs could well begin to wane soon, if they had not already begun to do so. These included the possibility that job security concerns might be diminishing after an extended period of rapid job growth and low unemployment. The downward trend in medical cost increases might be in the process of shifting to a flat, if not a rising, gradient according to informed observers. Moreover, as the rise in labor force participation depleted the pool of available workers, less productive workers would tend to be hired, with adverse effects on productivity and costs. The members recognized that even though aggregate demand pressures seemed to be pressing increasingly on available producer resources, it was not possible to forecast with confidence when the

period of favorable price behavior would end. Even so, it was clear that inflationary developments in the economy had become a matter of more urgent concern for monetary policy.

In light of this concern, in the Committee's discussion of policy for the intermeeting period ahead, the members supported or could accept a proposal to adjust policy toward a slightly less accommodative stance and to move to symmetry in the directive. They noted that continued relatively rapid growth of economic activity in the first quarter suggested greater persisting strength in demand than they had anticipated. With resource use already at high levels, further rapid growth risked greater pressures on resources and rising inflation. Although inflation remained remarkably subdued and any increase in inflationary pressures likely would tend to emerge only slowly, the strength in demand had developed against the backdrop of financial conditions that, broadly considered, were not substantially different from those now prevailing. In this situation, they saw a clear need for a preemptive policy action that would head off any pickup of inflation, and it was noted that a shift to a tighter policy stance would seem to pose little risk to the expansion. Indeed, by countering any tendency for inflation to rise and for higher inflation expectations to become embedded in financial markets and economic decisionmaking more generally, such action would help head off a more abrupt economic slowing, or even a downturn, and thereby would help sustain the expansion and preserve the firm labor markets and their associated benefits.

A few members argued that a more substantial tightening was needed at this juncture to provide a better calibrated response to the persisting strength of the economy and the related risk of inten-

sifying inflationary pressures. In their view, a more vigorous action would lessen the need for tightening in the future and also would foster a financial setting that would be more conducive to sustained expansion. Other members acknowledged that a smaller policy move would have less effect in curbing inflationary pressures, but they felt that a cautious approach to policy was desirable at a time when the outlook for economic activity and inflation remained subject to substantial uncertainties. Some noted that a shift in policy direction, as the Committee was about to undertake, often can have exaggerated effects in financial markets, making it difficult to judge how much additional restraint, if any, might be needed.

In their discussion of possible adjustments to policy during the intermeeting period, a majority of the members favored a symmetric directive. While additional policy tightening might be needed at some point, it did not appear very likely that developments during the intermeeting period would require a further policy move. Some added that inflation remained quiescent and the near-term onset of an appreciable slowing of the expansion to a rate more in line with the economy's potential could not be ruled out. Accordingly, they felt that the directive should not establish a presumption about further near-term policy tightening. Other members believed that growth of the economy was not likely to slow enough to alleviate excess demands for resources and that additional tightening would be needed sooner rather than later to moderate inflationary pressures and prolong the expansion. In their view, the outlook called for vigilance and the maintenance of an asymmetric directive with a bias toward tightening, but they could accept a symmetric directive with careful moni-

toring of new developments for any signs of the need for prompt action.

At the conclusion of the Committee's discussion, all the members indicated that they supported or could accept a directive that called for a slight increase in the degree of pressure on reserve positions and that did not include a presumption about adjustments to policy during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that slightly greater reserve restraint or slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

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

The information reviewed at this meeting suggests that relatively strong economic growth has continued in the first quarter. Private nonfarm payroll employment increased substantially further in January and February, and the civilian unemployment rate, at 5.3 percent in February, was unchanged from its level in the second half of 1996. Industrial production rose moderately on balance in January and February. Nominal retail sales increased sharply further over January and February after a considerable advance in the fourth quarter. Housing activity strengthened markedly over January and February, though much of the rise probably related to unusually favorable weather. Recent data on orders and contracts point to a further sizable gain in business fixed investment in the first quarter. The nominal deficit on U.S. trade in goods and

services widened substantially in January from its temporarily depressed rate in the fourth quarter. Underlying price inflation has remained subdued.

Most market interest rates have risen somewhat since the Committee meeting on February 4–5, 1997. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies increased further over the intermeeting period.

Growth of M2 moderated somewhat in January and February from a brisk pace over the fourth quarter while the expansion of M3 remained relatively robust; data for the first part of March pointed to diminished growth in both aggregates. Total domestic nonfinancial debt has expanded moderately on balance over recent months.

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

In the implementation of policy for the immediate future, the Committee seeks to increase slightly the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, slightly greater reserve restraint or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Ms. Phillips and Rivlin. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 20, 1997.

The meeting adjourned at 12:20 p.m.

Donald L. Kohn
Secretary

After the meeting, the following press release was issued:

The Federal Open Market Committee decided today to tighten money market conditions slightly, expecting the federal funds rate to rise $\frac{1}{4}$ percentage point to around $5\frac{1}{2}$ percent.

This action was taken in light of persisting strength in demand, which is progressively increasing the risk of inflationary imbalances developing in the economy that would eventually undermine the long expansion.

In these circumstances, the slight firming of monetary conditions is viewed as a prudent step that affords greater assurance of prolonging the current economic expansion by sustaining the existing low inflation environment through the rest of this year and next. The experience of the last several years has reinforced the conviction that low inflation is essential to realizing the economy's fullest growth potential.

No change was made in the Federal Reserve discount rate, which remains at 5 percent.

Meeting Held on May 20, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 20, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broadus
Mr. Gynn
Mr. Kelley
Mr. Moskow
Mr. Meyer

Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and
Ms. Minehan, Alternate Members
of the Federal Open Market
Committee

Messrs. Boehne, McTeer, and Stern,
Presidents of the Federal Reserve
Banks of Philadelphia, Dallas, and
Minneapolis respectively

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

Messrs. Beebe, Eisenbeis, Goodfriend,
Hunter, Lindsey, Mishkin,
Promisel, Siegman, Slifman, and
Stockton, Associate Economists

Mr. Fisher, Manager, System Open
Market Account

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

Messrs. Madigan and Simpson,
Associate Directors, Divisions of
Monetary Affairs and Research
and Statistics respectively, Board
of Governors

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

Mr. Conrad, First Vice President,
Federal Reserve Bank of Chicago
Messrs. Dewald, Hakkio, Ms. Krieger,
Messrs. Lang, Rosenblum, and
Sniderman, Senior Vice
Presidents, Federal Reserve
Banks of St. Louis, Kansas City,
New York, Philadelphia, Dallas,
and Cleveland respectively

Messrs. Cox, Rosengren, and Weber,
Vice Presidents, Federal Reserve
Banks of Dallas, Boston, and
Minneapolis respectively

By unanimous vote, the Federal Open Market Committee approved the minutes of its meeting on March 25, 1997.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. The Desk did not conduct any transactions in foreign currencies for System Account during the period since the latest meeting on March 25, 1997, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period March 25, 1997, through May 19, 1997. By unanimous vote, the Committee ratified these transactions.

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

The information reviewed at this meeting suggested that the expansion of economic activity had slowed after having surged in late 1996 and earlier this year. Consumer spending appeared to be increasing at a considerably slower pace after the spurt in the first quarter, while business fixed investment remained on a strong uptrend, and the demand for housing seemed to be well maintained. Growth of labor demand had moderated somewhat from the rapid pace at the beginning of the year, but labor markets remained tight and worker compensation appeared to be accelerating gradually. Despite the upward drift in labor

costs, underlying price inflation was still subdued.

Private nonfarm payroll employment rose at a considerably reduced pace over March and April, and the average workweek dropped from an unusually high rate in February and March to a more normal level in April. The services industries recorded further large gains in employment in March and April, but the number of jobs in manufacturing contracted in April and construction employment declined in both March and April. The civilian unemployment rate fell appreciably in April to 4.9 percent, and the labor force participation rate edged down from the record high reached in March.

Industrial production was unchanged in April after having recorded sizable increases in March and other recent months; declines in mining and manufacturing were offset by a large rise in utility output. The drop in manufacturing production reflected a sharp decline in the output of motor vehicles and parts that was largely related to the lagged effects of strike activity in recent months. The output of manufactured goods other than motor vehicles and parts rose moderately in April: the production of business equipment posted another solid gain while the output of consumer goods and construction supplies was unchanged. The rate of utilization of manufacturing capacity fell in April, reflecting the decline in motor vehicle output, but it remained relatively high.

Nominal retail sales were unchanged in March and declined in April after having increased rapidly in earlier months. Weaker sales of motor vehicles contributed to the overall sluggishness of retail activity in March and April, but spending on many other categories of goods, both durable and nondurable, also was down over the two-month period after having previously grown

strongly. Expenditures on services advanced further through March (latest available data) even though unseasonably mild weather held down outlays for heating. While retail sales had slowed recently, the latest surveys indicated that consumer sentiment had risen further from an already markedly high level.

Housing activity in March and April was in line with that in other recent months. Single-family housing starts were unchanged in April after having declined in March. Starts for the two-month period were only a little below the average for 1996, and sales of new homes remained at a very high level in March (latest data). Multifamily starts rose considerably in April and on average over March and April were a little above the elevated level in the fourth quarter.

Business fixed investment expanded briskly in the first quarter. Outlays for producers' durable equipment rebounded after fourth-quarter weakness, and spending for nonresidential structures posted another substantial advance. Available indicators pointed to further sizable gains in spending on both equipment and structures. Business inventory investment was up considerably in the first quarter after having increased a relatively small amount in the fourth quarter; however, inventory-sales ratios for most industry and trade groupings remained at very low levels.

The nominal deficit on U.S. trade in goods and services widened substantially on balance over January and February from the temporarily depressed rate in the fourth quarter of last year and was about the same as the rate in the third quarter. A surge in imports reflected a rebound in the importation of automotive products from the strike-reduced level of the fourth quarter, further expansion in purchases of imported

computers, and an upturn in imports of semiconductors after four quarters of declines. By contrast, exports of goods and services rose only slightly in the January-February period; exports of automotive products were up sharply, but sizable increases in exports of chemicals, computers, and semiconductors were largely offset by declines in other nonautomotive trade categories. Recent economic information on the foreign G-7 countries, including some preliminary indicators for the second quarter, suggested that the growth of output had strengthened somewhat on average in these countries. Activity in continental Europe, though still weak, was improving, while the economies of Canada, Japan, and the United Kingdom remained strong. Economic activity continued to expand rapidly on average in the major developing countries in the first quarter.

Recent data indicated that price inflation remained moderate despite a gradual acceleration of labor costs. Increases in consumer prices were held down in March and April by sizable declines in energy prices and a small net reduction in food prices. Consumer prices for items other than food and energy advanced at a moderate rate over the two months, and over the twelve months ended in April they increased the same amount as in the previous twelve months. Producer prices fell in both March and April, reflecting large declines in energy prices. Excluding food and energy, producer prices edged lower in April after having risen a sizable amount in March. Core producer prices increased considerably less over the twelve months ended in April than over the previous twelve months. At earlier stages of production, producer prices registered declines both in recent months and for the twelve months ended in April. An upward creep in the growth

of labor costs was apparent in data on the hourly compensation of private industry workers; although the rise in the first three months of 1997 was smaller than the increase in the fourth quarter, the advance over the twelve months ended in March was larger than that over the previous twelve months. A similar but more pronounced pattern was evident in data on average hourly earnings for production or nonsupervisory workers.

At its meeting on March 25, 1997, the Committee issued a directive that called for a slight increase in the degree of pressure on reserve positions; the firming of policy was taken in light of continued rapid growth of aggregate demand in the first quarter and the attendant greater risk of heightened pressures on resources and an upturn in inflation. Although further policy tightening might be needed at some point, the Committee did not believe that developments during the intermeeting period were likely to require an adjustment, and thus the directive did not include a presumption about adjustments to policy during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

Open market operations immediately after the meeting on March 25 were directed toward implementing the slightly firmer reserve conditions desired by the Committee and then maintaining those conditions over the remainder of the intermeeting period. The federal funds rate averaged close to the higher intended level of 5½ percent. Open market operations were complicated during the period by extraordinarily large federal tax payments in April, which substantially increased the volume of open market purchases

needed to offset the reserve drains associated with those tax payments.

Market interest rates generally posted small mixed changes over the intermeeting period. Most private short-term rates increased only a little in response to the March policy action, which had been largely anticipated by market participants. Intermediate- and long-term yields rose over the early part of the intermeeting period, responding mostly to incoming data suggesting that growth in aggregate demand and output remained strong; these increases were subsequently more than reversed, however, as later information indicated that economic growth was moderating and price inflation remained subdued and on news of an agreement to balance the federal budget. Major indexes of stock market prices fluctuated substantially over the period but they rose considerably on balance.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined on balance over the intermeeting period. The movements of the dollar during the period roughly corresponded to the fluctuations in intermediate- and long-term U.S. interest rates; the dollar advanced strongly in April on growing expectations of a further firming of U.S. monetary policy but more than retraced that gain in May as the likelihood of further tightening waned. The dollar's weakness in May also seemed to reflect growing attention to the prospects for official intervention to restrain the dollar's rise, notably against the Japanese yen and the German mark.

The growth of M2 and M3 remained brisk over March and April. Much of M2's strength during this period resulted from a temporary buildup by households of balances in savings accounts and money market mutual funds to cover unusually large tax payments. The

rapid growth of M3 was associated not only with the bulge in M2 but also with stepped-up issuance of large time deposits to fund the expansion of bank credit. For the year through April, both aggregates expanded at rates appreciably above the upper bounds of their respective ranges for the year. The growth of total domestic nonfinancial debt had moderated over recent months as a result of reductions in federal government borrowing.

The staff forecast prepared for this meeting suggested that the economy would expand in the second half of the year at a rate a little above that of its estimated potential and then would increase at a slower and more sustainable rate in 1998. Growth of consumer spending, supported by high levels of household wealth and further projected gains in employment and income, was expected to remain fairly brisk over the forecast horizon. Business spending on equipment and structures was anticipated to continue to outpace the overall expansion of the economy, though the differential would tend to narrow over time in conjunction with the gradual diminution of increases in sales and profits that was expected to be associated with moderating economic growth. Housing construction was projected to drift lower over coming quarters, partly in conjunction with the rise in mortgage interest rates that already had occurred but also in response to the smaller increases expected in household income. The staff continued to anticipate that fiscal policy and the external sector would exert mild restraint on the expansion of economic activity. With resource utilization high and labor compensation gradually accelerating, core consumer price inflation was forecast to drift slightly higher.

In the Committee's discussion, the members agreed that the information for

recent months pointed on balance to a marked slowing in the expansion of economic activity from a very rapid pace in late 1996 and earlier this year. The extent of the reduced growth in the current quarter and the prospects for subsequent quarters were subject to substantial uncertainty, but the members generally felt that the economy retained considerable underlying strength. In the circumstances and assuming no changes from current financial conditions, the individual members saw likely prospects for expansion over the forecast horizon at a pace close to, or a little above, the estimated growth of the economy's long-run potential. Many noted, however, that high levels of consumer and business confidence and supportive financial conditions among other factors suggested the possibility that growth could turn out to be even faster. With the utilization of productive resources, notably labor, already at particularly high levels in relation to the economy's potential, an outcome no stronger than current forecasts could well have adverse implications for inflation. Nonetheless, the members also noted that the rise in compensation increases had been damped and that there continued to be few indications of accelerating price inflation in the statistical and anecdotal information available at this time; such developments underlined persisting uncertainties about behavior in labor markets and the level and growth of the economy's sustainable potential.

In their review of developments in key sectors of the economy, members referred to favorable underlying factors in the outlook for consumer spending. These included solid growth in consumer incomes, large increases in financial wealth, and currently high levels of consumer confidence. While more moderate growth in consumer spending for durable goods seemed likely after

an extended period of robust expansion, these favorable factors suggested that the risks of a different outcome were tilted in the direction of faster-than-projected expansion. On the negative side, large consumer debts were still viewed as likely to constitute an inhibiting influence on consumer expenditures, and many banking institutions had tightened lending terms and conditions at least for their more marginal consumer borrowers. On balance, growth in consumer expenditures at a somewhat reduced pace approximating that of the expected expansion of disposable incomes appeared to be a reasonable prospect, though one that was subject to considerable uncertainty.

Spending for business fixed investment seemed to have retained a good deal of momentum even after the large increases in such expenditures in recent years. Clearly, businesses regarded such investments as highly profitable, and they appeared to be leading to gains in productivity that in turn were helping to offset rising compensation and to maintain profit margins in highly competitive markets. In the circumstances, it appeared unlikely that growth in capital outlays would moderate appreciably for some time. A number of members also referred to the increasing strength in nonresidential construction, notably that of commercial structures, in several parts of the nation. Some referred in particular to planned or actual construction of new office buildings in various locales; such activity was being stimulated by declining vacancy rates, rising rents, and a ready availability of financing. Likewise, a surge in tourism in a number of areas had resulted in a scarcity of hotel rooms and was spurring hotel construction in some major cities. Anecdotal reports of nonresidential building activity undertaken on a speculative basis had increased, but a building

boom reminiscent of the 1980s did not appear to be under way.

Concerning the outlook for housing, members referred to forecasts of a mild downtrend in residential construction associated with the increases that had occurred in mortgage interest rates. To date, however, there were few indications of any weakening. Indeed, housing construction had been relatively robust in the early months of the year, though the strength probably was largely accounted for by unusually favorable weather conditions and may have borrowed from building activity later in the year. On balance, as evidenced by anecdotal reports from some areas, various factors including ongoing growth in employment and incomes, the availability of financing on still generally favorable terms, and the associated affordability of housing for many homeowners seemed likely to provide continued support for this sector of the economy for some period of time.

A surge in nonfarm business inventory investment accounted for a substantial portion of the acceleration in output in the first quarter, and an anticipated moderation in the accumulation of inventories was an important element in forecasts of greatly reduced economic growth in the current quarter. In keeping with business practices aimed at achieving or maintaining lean inventory-sales ratios, inventory investment was projected to continue at a relatively subdued pace in coming quarters. A number of members expressed the view, however, that stockbuilding represented an upside risk in the economic outlook, at least in the nearer term. While there were some indications of efforts to pare inventories in recent months, generally optimistic business sentiment and currently trim inventories in most industries might well foster efforts to accumulate stocks at a relatively rapid

pace, especially if more-buoyant-than-anticipated sales were to stimulate a precautionary demand for inventories as had occurred in 1994.

With regard to the outlook for inflation, members observed that increases in prices had remained subdued despite the rapid expansion in economic activity in recent quarters and the associated increase in pressures on already highly utilized resources. The appreciation of the dollar undoubtedly had helped to damp domestic inflation this year, and reported increases in consumer prices also had been held down to a marginal extent by an ongoing series of technical adjustments to the consumer price index. These were only partial explanations, however, and the members found it very difficult to account for the surprisingly benign behavior of inflation in an economy that had been operating at a level approximating full employment—indeed, possibly somewhat above sustainable full employment in labor markets in the view of a number of members, especially taking into consideration the recent further decline in the unemployment rate. On the basis of historical patterns, any overshooting of full employment would be expected to generate rising inflation over time. Although increases in labor compensation had been trending higher, these pressures were muted and had not shown through to prices.

Members focused on the possible role of faster-than-reported increases in productivity as a key explanation for the benign behavior of inflation in current circumstances. Business firms had continued to report robust profit margins in a period when competitive pressures generally prevented them from raising their prices, or raising them sufficiently, to pass on the increases that they were experiencing in worker compensation. Standard statistical measures that

pointed to relatively limited increases in productivity seemed inconsistent with strong profits as well as with anecdotal reports of sizable gains associated with widespread business restructuring activities and large additions of high-technology equipment to an increasingly efficient capital stock. The ongoing development and spreading adoption of automated equipment along with the increasing skills and other infrastructure needed to use it effectively appeared to be creating growing efficiencies or synergies that were markedly enhancing productivity and enabling firms to hold the line on prices and maintain high profit margins.

While these were welcome developments, members continued to express concern that, perhaps sooner rather than later, growing pressures on productive resources would be reflected in some upturn in overall inflation. Although most measures of labor compensation had been relatively favorable recently, such measures had been displaying a clear uptrend over a somewhat longer period, and it seemed likely that, if this trend continued, labor cost developments would at some point be reflected more fully in core measures of prices. Members commented that the timing and extent of any upturn in price inflation would depend on growth of overall demand in the economy, but they also believed that expansion of demand in line with their current expectations could induce a somewhat less favorable inflation experience during coming quarters. However, recent developments had underscored the fact that historical experience was not a fully reliable guide to the prospective behavior of prices; accordingly, the inflation outlook remained subject to considerable uncertainty.

In the Committee's discussion of policy for the intermeeting period ahead,

all but one of the members indicated that they could support a proposal to maintain an unchanged policy stance, although some also expressed a preference for some tightening at this meeting. Those who endorsed a steady policy at this time agreed that some tightening might well be needed later to contain potentially rising inflation. For now, however, economic growth seemed to be slowing to a more sustainable pace, and the uncertainties surrounding the extent of the slowing and the outlook for inflation pointed to the desirability of a cautious approach to any policy tightening, especially given the persisting absence of a rising inflation trend in current measures of prices. A number of members also observed that real interest rates were not unusually low. Thus, the present stance of monetary policy probably was not very far out of alignment with what likely would prove to be a desirable degree of restraint, thereby lessening any risk of large and persisting imbalances that a delay in implementing further restraint might incur.

Members who preferred some tightening, at least in the near term if not necessarily at this meeting, noted that the Committee needed to weigh the risks of having to implement a small degree of restraint now versus considerably more later if inflation were allowed to build momentum. Monetary policy exerts its effects with a considerable lag, and a small but relatively prompt tightening action would provide some further insurance against an intensification of inflation. Such an outcome could be seen as more likely now, given the increased tightness in labor markets and the possibility that relatively strong growth would put added pressures on resources. Some of these members commented that the risk of a retarding effect on the economy from a small move at this time was quite limited in light of the

apparently solid momentum of the economic expansion. Indeed, the strength of investment demand, the ready availability of financing, and possible favorable productivity gains argued that real rates of interest would need to be higher than historical norms to balance aggregate demand and supply. The risk of slightly lower economic growth needed to be compared with what they viewed as the greater risk of losing ground to inflation and thereby inhibiting the Committee's ability to reach its ultimate goal of price stability, a goal that all the members viewed as necessary to achieve maximum sustainable economic growth over time. Given the quiescence of inflation and the uncertainties surrounding its outlook, however, all but one of these members could accept a wait-and-see policy stance for now.

With regard to possible adjustments to policy during the intermeeting period, all the members supported a shift from the symmetric directive that had been adopted in conjunction with the policy tightening action at the March meeting to an asymmetric directive tilted toward tightening. While such a bias did not necessarily imply an intention to tighten policy during the weeks immediately ahead, it was consistent with the members' view that the risks were in the direction of a potential need for some tightening in monetary policy to counter rising inflationary pressures, and that they might be required to make such a decision in the not-too-distant future.

At the conclusion of the Committee's discussion, all but one member indicated that they supported a directive that called for maintaining the existing degree of pressure on reserve positions and that included a bias toward the possible firming of reserve conditions during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability

and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate growth of M2 and M3 over coming months.

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

The information reviewed at this meeting suggests that growth in economic activity has slowed after surging in late 1996 and earlier this year. Private nonfarm payroll employment increased at a considerably reduced pace over March and April, but the civilian unemployment rate fell appreciably to 4.9 percent in April. Industrial production was flat in April following sizable gains over previous months. Nominal retail sales were unchanged in March and declined in April after a considerable advance in earlier months. Housing activity in March and April was little changed from other recent months. Available indicators point to further sizable gains in business fixed investment. The nominal deficit on U.S. trade in goods and services widened substantially in January–February from its temporarily depressed rate in the fourth quarter. Underlying price inflation has remained subdued.

Market interest rates generally have posted small mixed changes since the Committee meeting on March 25, 1997; share prices in equity markets have risen considerably. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined on balance over the intermeeting period.

Growth of M2 and M3 was brisk over March and April, boosted by a buildup in household balances to cover unusually large tax payments. For the year through April,

both aggregates expanded at rates appreciably above the upper bounds of their respective ranges for the year. Growth in total domestic nonfinancial debt has moderated over recent months, reflecting reductions in federal government borrowing.

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

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Guynn, Kelley, Meyer, Moskow, Parry, Ms. Phillips and Rivlin.
Vote against this action: Mr. Broadus.

Mr. Broadus dissented because he believed that the strength of investment demand, due possibly to an increase in the trend growth rate of productivity, required somewhat higher real interest rates to prevent inflationary pressures from developing. He was concerned that, with the economy already operating at a high level and labor markets apparently very tight, any increase in

such pressures might be costly to reverse and might reduce the credibility of the Committee's longer-run strategy of promoting maximum sustainable growth by fostering price level stability. He also believed that the risk to the economy of a moderate further tightening was small given the apparent momentum of aggregate economic activity.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, July 1–2, 1997.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary

Meeting Held on July 1–2, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, July 1, 1997, at 2:30 p.m. and continued on Wednesday, July 2, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and
Ms. Minehan, Alternate Members
of the Federal Open Market
Committee

Messrs. Boehne, McTeer, and Stern,
Presidents of the Federal Reserve
Banks of Philadelphia, Dallas,
and Minneapolis respectively

Mr. Kohn, Secretary and Economist

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

Messrs. Beebe, Goodfriend, Hunter,
Lindsey, Mishkin, Promisel,
Siegman, Slifman, and Stockton,
Associate Economists

Mr. Fisher, Manager, System Open
Market Account

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

Messrs. Madigan and Simpson,
Associate Directors, Divisions of
Monetary Affairs and Research
and Statistics respectively, Board
of Governors

Ms. Johnson, Assistant Director,
Division of International Finance,
Board of Governors

Messrs. Reifschneider⁴ and Small,⁴
Section Chiefs, Divisions of
Research and Statistics and
Monetary Affairs respectively,
Board of Governors

Mr. Sichel, Senior Economist, Division
of Research and Statistics, Board
of Governors

Mr. Elmendorf,⁴ and Ms. Garrett,
Economists, Division of Monetary
Affairs, Board of Governors

Mr. Lebow,⁵ and Ms. Lindner,⁵
Economists, Division of Research
and Statistics, Board of Governors

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

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

5. Attended portion of meeting relating to price measurement issues for monetary policy.

Ms. Holcomb, First Vice President,
Federal Reserve Bank of Dallas

Ms. Browne, Messrs. Dewald, Hakkio,
Kos, Lang, Rolnick, Rosenblum,
and Sniderman, Senior Vice
Presidents, Federal Reserve Banks
of Boston, St. Louis, Kansas City,
New York, Philadelphia,
Minneapolis, Dallas, and
Cleveland respectively

Ms. Rosenbaum, Vice President,
Federal Reserve Bank of Atlanta

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on May 20, 1997, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange markets since the meeting on May 20, 1997. There were no System open market transactions in foreign currencies during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period May 20, 1997, through June 30, 1997. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic outlook, the ranges for the growth of money and debt in 1997 and 1998, and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the economic

expansion slowed substantially in the second quarter after having surged in late 1996 and earlier this year. Consumer spending decelerated considerably, but business spending on durable equipment increased substantially further and housing demand appeared to have been well maintained. Employment growth moderated recently, while industrial production continued to rise appreciably. Price inflation remained subdued despite high rates of resource utilization, notably that of labor.

Private nonfarm payroll employment rose at a reduced pace in May after having registered sizable advances over the first four months of the year. Job growth remained brisk in the services sector despite a further drop in employment at temporary help agencies that might have reflected constraints on the availability of workers for hire. Although employment in construction recovered in May from the weather-depressed level in April, the underlying growth in such jobs seemed to have slowed. Employment in manufacturing changed little over April and May after having increased moderately in the first quarter. The average workweek for production or nonsupervisory workers was unchanged in May but was slightly below the average for the first quarter. The civilian unemployment rate fell slightly further to 4.8 percent in May.

Industrial production continued to grow briskly in May. Manufacturing output recorded a substantial gain and mining production rose considerably; however, cooler-than-average weather led to a drop in utility output. Much of the rise in manufacturing reflected a rebound in the production of motor vehicles and parts from strike-depressed levels in April and strength in the output of business equipment, construction supplies, and materials. With output generally keeping pace with the rapid

expansion of factory capacity, the rate of utilization of manufacturing capacity remained at a relatively high level.

Personal consumption expenditures, in real terms, rose substantially in May after having changed little on balance over the preceding three months. Spending on services remained on a solid uptrend in May, while aggregate purchases of goods turned up after three months of lackluster spending on nondurable goods and motor vehicles. The unusual weather patterns of late winter and early spring apparently had a depressing effect on consumer expenditures, especially for seasonal items; however, the combination of strong job gains, buoyant sentiment, and increased household net worth pointed to a possible resumption of more robust spending by consumers.

Housing activity appeared to have been generally well maintained in recent months. Although housing starts were down somewhat in May from the relatively elevated average rate for the first four months of the year, this slowing might have been, at least in part, the result of unusually mild winter weather that enabled an early start on spring building activity. The latest information on home sales suggested continued firm demand for single-family housing: Sales of existing homes rose in May and were among the highest monthly totals on record, and sales of new homes in April (latest data available) were down only a little from the brisk pace of earlier months in the year.

Available information suggested further sizable gains in business fixed investment. Shipments of nondefense capital goods edged higher in May after having posted large increases in earlier months of the year. Shipments of computers had been particularly strong this year in conjunction with rapidly falling prices, but shipments of other categories

of capital goods also had been robust on balance. Recent data on orders pointed to further brisk growth in coming months. Nonresidential construction activity appeared to have eased recently, with construction-put-in-place slipping in March and April from the elevated pace of the first two months of the year. However, other information suggested that the downturn might be shortlived: Vacancy rates for office space had been declining, prices for commercial real estate had been edging up, and recent data on contracts suggested that building activity would improve in coming months.

Business inventory investment picked up sharply in April from the slow pace in March but, overall, stocks remained at a low level in relation to sales. In manufacturing, much of the increase in stocks occurred in capital goods industries in which production was expanding briskly. In the wholesale sector, a substantial decline in stocks in April more than offset a sizable increase in March, and the aggregate stock-sales ratio for the sector fell further over the March-April period. Retail inventories rose considerably in April, with notable increases in stocks of apparel and general merchandise. In a departure from the general downtrend of recent months, inventory-sales ratios for most types of retail establishments were up appreciably in April.

The nominal deficit on U.S. trade in goods and services narrowed somewhat in April from a downward-revised average rate in the first quarter. The value of exports in April rose substantially from the first-quarter level, led by increases in exports of machinery and aircraft. The value of imports also rose but less than that of exports; imports were up in most trade categories except petroleum products. Recent information suggested that, on average, economic activity in the

major foreign industrial countries continued to grow at a moderate rate in the second quarter. Growth remained robust in Canada and the United Kingdom and was improving in Germany, France, and Italy. Economic activity appeared to have flattened temporarily in Japan after an increase in the consumption tax in April.

Price inflation remained subdued. For a third straight month, consumer prices recorded only a slight increase in May. Favorable developments in food and energy continued to hold down the overall rise and accounted for a much smaller advance in the index of prices of all consumer items over the twelve months ended in May than over the previous twelve months. The decline in core CPI inflation over the same time period was much less, though this measure of inflation also remained relatively restrained. At the producer level, prices of finished goods other than food and energy fell further in May and were little changed over the year ended that month. At earlier stages of processing, producer prices for intermediate materials other than food and energy changed little over the year ended in May, and producer prices at the crude level advanced only slightly. The tight conditions prevailing in labor markets were associated with a somewhat larger increase in average hourly earnings in the twelve months ended in May than in the year-earlier period.

At its meeting on May 20, 1997, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions. Because the members saw the potential need for some tightening in monetary policy to counter rising inflationary pressures, perhaps in the relatively near term, the directive included a bias toward the possible firming of reserve conditions during the intermeeting

period. The reserve conditions associated with this directive were expected to be consistent with moderate growth of M2 and M3 over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining the existing degree of pressure on reserve positions, and the federal funds rate averaged close to the intended level of 5½ percent. Most other market interest rates declined somewhat on balance during the period. Market participants apparently concluded that the likelihood of further policy tightening had decreased substantially in light of incoming data that suggested slowing growth of final demand and continued subdued inflation. Share prices in equity markets rose considerably further.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies was up on balance over the intermeeting period; the advance occurred despite a smaller decline on average in long-term interest rates abroad than in the United States. The dollar rose appreciably against the German mark and most other continental European currencies amid growing market concerns that there would be broad participation in the European Monetary Union despite the fact that the major European countries would not be able to comply strictly with the Maastricht fiscal standards and related expectations that the euro would be a weak currency. In contrast, the dollar fell against the Japanese yen and the British pound; the yen moved up as markets focused more closely on recent and prospective increases in Japan's current account surplus, and the pound strengthened in anticipation of further policy tightening by the Bank of England.

Expansion of M2 and M3 slowed sharply in May in association with a swing in household balances related

to large tax payments; growth of M2 rebounded in June, but M3 accelerated less. For the year through June, M2 increased at a rate near the upper bound of its range for the year. Rapid growth of M3 over the first half of the year, partly in conjunction with robust expansion of bank credit, placed growth of this aggregate somewhat above the upper bound of its range. The rate of increase in total domestic nonfinancial debt had been a little higher in recent months; for the year to date, this aggregate had grown at a rate near the middle of its range.

The staff forecast prepared for this meeting suggested that the economy would expand at a pace somewhat above that of its estimated potential in the second half of the year but would slow to a rate of increase more in line with that of potential in 1998. Growth of consumer spending, supported by high levels of household wealth and further projected gains in employment and income, was expected to be relatively brisk for some time. Business spending on equipment and structures was anticipated to continue outpacing the overall expansion of the economy, though the differential would tend to narrow in association with the gradual diminution of increases in sales and profits that was expected to occur in the context of moderating economic growth. Housing construction was projected to drift lower over the forecast period. The staff anticipated that fiscal policy and the external sector would exert mild restraint on the expansion of economic activity. With labor compensation gradually accelerating in the context of high resource utilization, core consumer price inflation was forecast to drift slightly higher.

In the Committee's discussion of current and prospective economic developments, members commented on the continuing exceptional performance of the

economy, including widespread indications of strength in business activity and subdued inflation. After a surge in late 1996 and earlier this year, the rate of expansion had moderated considerably in recent months, and the members generally expected economic activity to settle into a pattern of growth over the next six quarters that would approximate the economy's estimated output potential. A major factor in that outlook was their expectation of some deceleration in demands for consumer durables and business plant and equipment in light of the substantial buildup of such assets that already had taken place in recent years. However, given the underlying strength of the expansion, favorable financial conditions, and the absence of major imbalances in the economy, the risks of a different outcome were judged to be in the direction of somewhat faster growth than currently projected. The outlook for inflation was subject to particular uncertainty. Despite an economy that had been operating for a considerable period at rates of resource utilization that were very close to, and by some estimates somewhat above, sustainable levels, inflation had remained relatively low and indeed had declined on the basis of some broad measures of prices. Such an outcome was very much welcome, but the reasons for it were not completely understood and appeared to include some factors that might exert only temporary restraint on price increases. Consequently, continuing pressures on resources associated with economic growth in line with the members' current forecasts could well be reflected in rising inflation over time.

In keeping with the practice at meetings when the Committee sets its long-run ranges for the money and debt aggregates, the members of the Committee and the Federal Reserve Bank presi-

dents not currently serving as members provided individual projections of the growth in real and nominal GDP, the rate of unemployment, and the rate of inflation for the years 1997 and 1998. The forecasts of the rate of expansion in real GDP for 1997 as a whole had a central tendency of 3 to 3¼ percent and for 1998 were centered on a range of 2 to 2½ percent. With regard to the growth of nominal GDP, most of the forecasts were in ranges of 5 to 5½ percent for 1997 and 4½ to 5 percent for 1998. The civilian rate of unemployment associated with these forecasts had a central tendency of 4¾ to 5 percent in the fourth quarters of both years. Projections of the rate of inflation, as measured by the consumer price index, pointed to a sizable moderation this year from the rate in 1996 and a partially offsetting rise in 1998, with prices of food and energy accounting for much of the swing. Specifically, the projections converged on CPI inflation rates of 2¼ to 2½ percent in 1997 and 2½ to 3 percent in 1998.

In their review of the outlook for economic activity in major sectors of the economy, members referred to the generally sluggish pace of retail sales in recent months. It was noted, however, that the slowdown was perhaps in part an adjustment to very strong growth of sales in previous months, and some members commented on anecdotal indications of some pickup in recent weeks. More importantly, underlying trends and fundamentals pointed to prospective growth in consumer expenditures at a pace that was likely to continue to provide key support for further moderate expansion in overall economic activity. In particular, jobs and incomes had continued to post sizable gains; further large increases in stock market prices had raised wealth-to-income ratios sharply; and consumer optimism had risen to

new highs. On the other hand, the accumulation of consumer durables that had occurred over the course of the current cyclical advance was likely to exert a retarding influence on the rise in consumer spending. Other somewhat restraining factors included the prospect of some softening in housing demand and related purchases of household goods and the already heavy debt repayment burdens of many consumers. Some members also noted that a possible correction from the currently elevated levels of stock market prices could have adverse effects on consumer sentiment and purchasing power. On balance, growth in personal consumer expenditures was seen as likely to approximate the moderate rate of increase projected in overall domestic demand.

The members viewed the prospects for further growth in business fixed investment as another important supportive factor in the outlook for sustained economic expansion. Current indicators pointed to the continuation of very rapid growth in such spending over the near term, but some moderation was likely over the course of coming quarters in conjunction with the projected slowing in the increase of overall demand and the very large buildup in the stock of capital that already had occurred in recent years. Even so, investment spending was likely to be relatively robust over the projection horizon in the context of continuing incentives to hold down production costs in highly competitive markets and to take advantage of falling prices and wider applications for certain types of new equipment, notably computer-related equipment. The ready availability of both debt and equity finance on favorable terms, an upbeat outlook for sales in many industries, and generally high profit levels were other positive factors. The outlook for nonresi-

dential construction activity also seemed to be relatively favorable. Members referred to declining vacancy rates and rising rents for commercial structures in many parts of the country and noted that construction contracts for new office buildings and hotels recently had turned up on a nationwide basis after a pause earlier this year. In sum, the growth in business fixed investment seemed likely to continue to outpace that of overall demand in coming quarters.

Some restraint on aggregate demand would come from other sectors of the economy—notably government spending, net exports, housing, and perhaps business inventories. None of these factors seemed likely to exert a substantially negative effect, but in total they were expected to help keep the pace of the expansion close to the estimated rate of increase in the economy's potential over coming quarters.

During the course of the Committee's discussion, many of the members commented on the persistence of an impressively benign inflation performance despite widespread indications of very high, and by some measures increasing, levels of capacity use. Indeed, most broad measures of prices pointed to subdued or even declining inflation, and it was difficult to find evidence of rising inflation pressures in "pipeline" price data or the wage structure. The members anticipated that inflation as measured by the consumer price index would decrease appreciably over 1997 as a result of favorable developments in the food and especially the energy sectors of the economy and declining import prices associated with the previous appreciation of the dollar. These positive influences would wane over time, however, and consumer prices were likely to rise at a somewhat faster pace in 1998.

The members agreed that the risks to their price forecasts were in the direction of higher inflation, given already high levels of capacity use and their expectations of appreciable further economic growth. Nonetheless, the relatively low inflation experienced despite a lengthy period of fully employed resources suggested that the timing of a potential upturn in inflation—indeed whether inflation would in fact pick up—could not be predicted with any degree of confidence on the basis of past historical patterns. The reasons for the persistence of a relatively benign inflation performance in the current expansion were not fully understood. They included some temporary factors such as the effect of the rise in the dollar on import prices and the restraint on health care costs. More fundamentally, they presumably also involved the favorable effects on production costs of widespread business restructurings and the large volume of investment in more productive technology in recent years, the impact of both factors on the job security concerns of workers and their willingness to accept reduced increases in compensation, and the effects of an intense degree of competition among domestic and foreign producers in U.S. markets. With regard to the possibility that more robust productivity increases would be holding down production costs, it was noted that a surge in economic activity, such as had occurred in late 1996 and early 1997, tended to be accompanied by above-trend gains in productivity. A slower pace of economic growth in the second quarter and beyond might provide an opportunity to assess whether productivity increases were on a clear uptrend and could help to explain the favorable behavior of prices over an extended period. In any event, it was too early to reach any firm conclusion on this issue or the broader question of

whether or when a rise in inflation might materialize under anticipated economic conditions.

The members also discussed a staff study of the relative performance of various price indexes as measures of inflation. Members noted that most broad measures of inflation moved together over extended periods of time, but they did not always do so over short intervals. Differences in construction, coverage, and other factors meant that none of the individual measures was clearly superior in assessing general inflation trends, and several members commented that all measures needed to be monitored.

In keeping with the requirements of the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act), the Committee at this meeting reviewed the ranges for growth of the monetary and debt aggregates that it had established in February for 1997, and it decided on tentative ranges for those aggregates for 1998. The current ranges set in February for the period from the fourth quarter of 1996 to the fourth quarter of 1997 were unchanged from the ranges for 1996 and included expansion of 1 to 5 percent for M2 and 2 to 6 percent for M3. An unchanged range of 3 to 7 percent also was set in January for growth of total domestic nonfinancial debt in 1997.

All the members favored retaining the current ranges for this year and extending them on a provisional basis to 1998. They anticipated that growth of M2 probably would continue at rates in the upper part of its current range in both years and that of M3 at rates approximating or even slightly above the upper bound of its range, given the Committee's expectations for the performance of the economy and prices. The current ranges were not expected to be guides to money growth under anticipated con-

ditions in the period ahead, but instead could be viewed as anchors or benchmarks for money growth that would be associated with approximate price stability and sustained economic growth, assuming behavior of velocity in line with historical experience. Accordingly, a reaffirmation of those ranges would underscore the Committee's commitment to a policy of achieving price stability over time, and in the view of at least some members, higher ranges could raise questions in this regard.

Over the past few years, in contrast to earlier in the 1990s, the behavior of the broad aggregates, especially that of M2, in relation to nominal GDP and short-term interest rates had displayed a pattern that was in line with historical norms before the 1990s. The members viewed this as an encouraging development in that it raised the possibility of giving more weight at some point to the performance of these aggregates as useful indicators in formulating monetary policy. However, the period of more predictable M2 and M3 behavior was still relatively brief, and such behavior had occurred at a time of generally settled conditions in financial markets and the overall economy. The prospective performance of these aggregates in periods of rapid changes in financial and economic conditions was still an open question, and in light of the uncertainties that were involved the members concluded that it would be premature to place increased reliance on them in the conduct of policy. Accordingly, the Committee decided that despite projected growth of M2 and M3 at rates in the vicinity of the upper limits of the current ranges, prevailing uncertainties made it desirable to retain those ranges as benchmarks for the achievement of price stability rather than to establish higher ranges that seemed more likely to capture expected outcomes. In the circum-

stances, any tendency for growth of the monetary aggregates to move outside the Committee's ranges would not in itself call for a policy adjustment but would continue to be interpreted in the context of a broad range of business and financial developments bearing on the prospective performance of the overall economy.

The Committee members were unanimously in favor of retaining the current range of 3 to 7 percent for growth of total domestic nonfinancial debt in 1997 and extending that range on a provisional basis to 1998. They took account of a staff projection indicating that growth of the debt aggregate was likely to slow somewhat from its pace in 1995 and 1996, reflecting a small reduction in the expansion of federal government debt. According to the staff projection, growth in the debt measure would be near the midpoint of the existing range over the period through 1998.

At the conclusion of this discussion, the Committee voted to reaffirm the ranges for growth of M2, M3, and total domestic nonfinancial debt that it had established in February for 1997. For the year 1998, the Committee approved provisional ranges for the three aggregates that were unchanged from the 1997 ranges. In keeping with its usual procedure under the Humphrey-Hawkins Act, the Committee would review its preliminary ranges for 1998 early next year, or sooner if interim conditions warranted, in light of their growth and velocity behavior and ongoing economic and financial developments. Accordingly, the Committee voted to incorporate the following statement regarding the 1997 and 1998 ranges in its domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sus-

tainable growth in output. In furtherance of these objectives, the Committee reaffirmed at this meeting the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1998, the Committee agreed on tentative ranges for monetary growth, measured from the fourth quarter of 1997 to the fourth quarter of 1998, of 1 to 5 percent for M2 and 2 to 6 percent for M3. The Committee provisionally set the associated range for growth of total domestic nonfinancial debt at 3 to 7 percent for 1998. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Gynn, Kelley, Meyer, Moskow, Parry, Ms. Phillips and Rivlin. Votes against this action: None.

In the Committee's discussion of policy for the intermeeting period ahead, all the members favored or could support a proposal to maintain an unchanged policy stance, and they strongly supported the retention of a bias toward restraint. An unchanged policy seemed appropriate with inflation still quiescent and business activity projected to settle into a pattern of moderate growth broadly consistent with the economy's long-run output potential. While the members assessed risks surrounding such a forecast as decidedly tilted to the upside, the slowing of the expansion should keep resource utilization from rising substantially further, and this outlook together with the absence of significant early signs of rising inflationary pressures suggested the desirability of a cautious "wait and see" policy stance at this point. In the current uncertain environment, this would afford the Committee an opportunity to gauge the momentum

of the expansion and the related degree of pressure on resources and prices. The risks of waiting appeared to be limited, given that the evidence at hand did not point to a step-up in inflation despite low unemployment and that the current stance of monetary policy did not seem to be overly accommodative, at least on the basis of some measures such as the level of real short-term interest rates. In these circumstances, any tendency for price pressures to mount was likely to emerge only gradually and to be reversible through a relatively limited policy adjustment. Some members commented, however, that in the absence of unanticipated weakness in the economy, some tightening of policy was likely to be needed in the relatively near future, and one expressed the view that a tightening action at this meeting seemed desirable to forestall or limit the risks of intensifying inflationary pressures. However, waiting was an acceptable alternative given the favorable economic news and the persisting uncertainties surrounding the relationship of output to prices.

In their discussion of possible adjustments to policy during the intermeeting period, all the members indicated that they wanted to retain the existing asymmetry toward restraint adopted at the May meeting. An asymmetric directive was consistent with their view that the risks clearly were in the direction of excessive demand pressures in the economy and an associated upward trend in inflation. Such a bias in the directive also would serve the purpose of signaling the Committee's ongoing commitment to curb inflation in the interest of fostering maximum sustainable economic growth and employment. The members agreed that the current environment called for careful monitoring of developments and for prompt action by the Committee if needed to counter rising inflation. Indeed, in the interest of

fostering a continuation of sustainable growth of the economy, it would be desirable to tighten on the basis of early signs of potentially intensifying inflation and before higher inflation actually materialized.

At the conclusion of the Committee's discussion, all the members indicated that they could support a directive that called for maintaining the existing degree of pressure on reserve positions and that retained a bias toward the possible firming of reserve conditions during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate expansion in M2 and M3 over coming months.

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

The information reviewed at this meeting suggests that the economic expansion slowed substantially in the second quarter after surging in late 1996 and earlier this year. Private nonfarm payroll employment increased at a reduced pace in May, but the civilian unemployment rate fell slightly further to 4.8 percent. Industrial production registered another sizable gain in May. Personal consumption expenditures, in real terms, rose substantially in May after having changed little over the preceding three months. Housing activity appears to have been well maintained in recent months. Available indicators point to further sizable gains in business fixed invest-

ment. The nominal deficit on U.S. trade in goods and services narrowed somewhat in April from its downward-revised average rate in the first quarter. Price inflation has remained subdued.

Market interest rates generally have declined somewhat since the day before the Committee meeting on May 20, 1997; share prices in equity markets have risen considerably further. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies was up slightly on balance over the intermeeting period.

Growth of M2 and M3 fluctuated sharply from April to May in association with a swing in household balances related to large tax payments; on balance, both aggregates expanded at a moderate pace over the two months, and available data pointed to further moderate growth in June. For the year through June, M2 expanded at a rate near the upper bound of its range for the year and M3 at a rate somewhat above the upper bound of its range. Total domestic nonfinancial debt has continued to expand in recent months and is near the middle of its range.

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

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on

reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Ms. Phillips and Rivlin. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 19, 1997.

The meeting adjourned at 11:55 a.m. on July 2.

Donald L. Kohn
Secretary

Meeting Held on August 19, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 19, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and
Ms. Minehan, Alternate Members
of the Federal Open Market
Committee

Messrs. Boehne, McTeer, and Stern,
Presidents of the Federal Reserve
Banks of Philadelphia, Dallas, and
Minneapolis respectively

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

Messrs. Beebe, Cecchetti, Goodfriend,
Eisenbeis, Lindsey, Promisel,
Siegman, Slifman, and Stockton,
Associate Economists

Mr. Fisher, Manager, System Open
Market Account

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

Messrs. Madigan and Simpson,
Associate Directors, Divisions of
Monetary Affairs and Research
and Statistics respectively, Board
of Governors

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

Ms. Strand, First Vice President,
Federal Reserve Bank of
Minneapolis

Messrs. Lang, Rolnick, Rosenblum,
and Sniderman, Senior Vice
Presidents, Federal Reserve Banks
of Philadelphia, Minneapolis,
Dallas, and Cleveland respectively

Messrs. Gavin, Kahn, and
Ms. Perelmuter, Vice Presidents,
Federal Reserve Banks of
St. Louis, Kansas City, and
New York respectively

Ms. Little and Mr. Sullivan, Assistant
Vice Presidents, Federal Reserve
Banks of Boston and Chicago
respectively

By unanimous vote, the minutes of
the meeting of the Federal Open Market
Committee held on July 1–2, 1997, were
approved.

By unanimous vote, the Committee
elected Mr. Stephen G. Cecchetti of the
Federal Reserve Bank of New York as
Associate Economist to serve until the
election of his successor at the first
meeting of the Committee after Decem-
ber 31, 1997. It was understood that
in the event of the discontinuance of
his official connection with the Fed-
eral Reserve Bank of New York, he
would cease to have any official con-
nection with the Federal Open Market
Committee.

The Manager of the System Open
Market Account reported on develop-
ments in foreign exchange markets since
the meeting in early July. There were
no System open market transactions in
foreign currencies during this period,
and thus no vote was required of the
Committee.

The Manager also reported on devel-
opments in domestic financial markets
and on System open market transactions
in government securities and federal
agency obligations during the period
July 2, 1997, through August 18, 1997.
By unanimous vote, the Committee rati-
fied these transactions.

The Committee then turned to a dis-
cussion of the economic outlook and the
implementation of monetary policy over
the intermeeting period ahead. A sum-
mary of the economic and financial
information available at the time of the
meeting and of the Committee's dis-
cussion is provided below, followed by
the domestic policy directive that was
approved by the Committee and issued
to the Federal Reserve Bank of
New York.

The information reviewed at this
meeting suggested that economic activ-
ity was expanding moderately. Growth

in consumer spending had picked up after having slowed sharply in early spring, business purchases of durable equipment were still on a strong upward trend, and housing demand seemed to have been well maintained. The overall rise in production had been held down recently by supply disruptions in the motor vehicles industry, but employment had continued to expand at a strong pace and the unemployment rate was at a low level. Increases in labor compensation had remained moderate even though labor markets were tight, and price inflation was still subdued.

Private nonfarm payroll employment rose sharply in July after a June increase that was below the average for earlier months of the year. The step-up in job growth in July reflected substantially larger job gains in business services, retail trade, and the finance, insurance, and real estate industries. A small decline in manufacturing jobs roughly offset slightly higher employment in construction. The civilian unemployment rate, at 4.8 percent in July, matched its low for the current economic expansion.

Industrial production increased relatively slowly in July after having advanced at a fairly brisk pace over the first half of the year. The July slowdown reflected a temporary drop in motor vehicle assemblies partly associated with work stoppages at a major automotive manufacturer. Outside the motor vehicles sector, the output of business equipment and consumer durable goods rose strongly while the production of consumer nondurables weakened further. Factory capacity increased a little more than production in July, and the utilization of total manufacturing capacity slipped to its lowest level since last autumn.

Retail sales rose briskly in June and July after having changed little over the

preceding three months. Sales at automotive dealers rebounded in June and July following substantial weakness in earlier months, and expenditures at nondurable goods stores also strengthened. By contrast, sales at non-automotive durable goods outlets were unchanged over June and July. The pickup in consumer spending occurred against a backdrop of further strong gains in incomes and household net worth. In addition, credit was readily available to most consumers, although lenders continued to tighten terms for marginal borrowers. Total private housing starts were unchanged in July after having rebounded in June from a May decline. Data on home sales in recent months continued to suggest that demand for single-family housing was still relatively buoyant.

Real business fixed investment increased substantially further in the second quarter, reflecting a broad-based surge in spending on producers' durable equipment. Real outlays for office and computing equipment continued to grow rapidly as prices of personal computers and networking equipment remained on a steep downtrend. Spending for communications equipment grew at a slower pace in the second quarter, but recent orders for such equipment pointed to larger increases in the current quarter. Nonresidential construction activity was sluggish in the second quarter. While available information on construction contracts suggested little improvement in building activity in coming months, prices for commercial real estate had risen slightly and vacancy rates had declined.

Nonfarm business inventories increased rapidly in the second quarter, but there were few signs of inventory imbalances. In June, the pace of inventory investment in manufacturing slowed from the rapid average rate for

April and May, and the inventory–shipments ratio for the sector was at a very low level. In wholesale trade, stocks rose sharply in June after little net change over the two previous months. Despite the June increase, the stock–sales ratio was at the middle of its relatively narrow range of the past year. At the retail level, the rise in inventories in June retraced only part of the May decline; the inventory–sales ratio for the sector also was near the middle of its range for the last year.

The nominal deficit on U.S. trade in goods and services was slightly smaller on balance over April and May than the downward-revised average rate in the first quarter. Measured against their first-quarter levels, the value of exported goods and services grew more than the value of imports over the April–May period. The largest increases in exports were in machinery and aircraft and parts, while the biggest gains in imports were in consumer goods, computers, and capital goods other than computers. The available information suggested that in recent months economic activity had expanded further in all the major foreign industrial countries except Japan. Growth continued to be robust in Canada and the United Kingdom and apparently remained moderate in France and Germany. Economic activity in Japan had slowed after a rise in that country’s consumption tax in April.

Consumer price inflation picked up slightly in July from the slow pace in each of the previous four months; a small decline in energy prices offset a further increase in food prices. The index for items other than food and energy rose in July at the same low rate recorded for both the first six months of 1997 and the twelve months ended in July. At the producer level, prices of finished goods edged down for a seventh consecutive month, reflecting a fur-

ther drop in food prices. Prices of finished goods other than food and energy were unchanged over the twelve months ended in July. At earlier stages of production, producer prices for core intermediate materials rose slightly over the year ended in July and prices of core crude materials increased by a larger amount over the same period. Growth in hourly compensation of private industry workers picked up somewhat in the second quarter, but the rise in compensation over the year ended in June matched the advance over the comparable year-earlier period. Average hourly earnings of production and non-supervisory workers were unchanged in July, and the rise in such earnings over the twelve months ended in July also was the same as in the year-earlier period.

At its meeting on July 1–2, 1997, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions. Because the Committee continued to see a potential need for some tightening of monetary policy to counter rising inflationary pressures, the directive included a bias toward a possible firming of reserve conditions during the intermeeting period. The reserve market conditions associated with this directive were expected to be consistent with moderate growth of M2 and M3 over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining the existing degree of pressure on reserve positions, and the average federal funds rate for the period was at the Committee’s intended level of 5½ percent. Most other market interest rates declined further on balance over the period in an atmosphere of greater volatility in financial markets. The net decline in market rates seemed to have reflected a judgment by market

participants that the outlook for inflation had improved slightly on balance and that the likelihood of any tightening of monetary policy in coming months had receded a little further. Share prices in equity markets increased on balance over the period.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose significantly on balance over the intermeeting period. The appreciation of the dollar was uneven against the currencies of the major foreign industrial countries. The dollar's substantial increase against the German mark and other continental European countries reflected both the continuing favorable developments in the U.S. economy and persisting market concerns that difficulties faced by the major European countries would lead to policies that might detract from strength in the euro. The dollar rose only slightly against the yen. That currency came under downward pressure in reaction to incoming data suggesting a somewhat-greater-than-expected falloff in demand following the recent increase in the consumption tax, but the release of the June current account surplus late in the intermeeting period rekindled market concerns about Japanese external balances and led to some appreciation of the yen.

M2 expanded at a moderate pace over June and July after having fluctuated sharply in April and May as a result of tax-related flows. Data for early August suggested a somewhat faster rate of M2 growth in association with heavier inflows to retail money funds; the latter might have been related to heightened demand for liquidity as a result of recently higher volatility in bond and equity markets. For the year through July, M2 expanded at a rate near the upper bound of its range. M3 also fluctuated sharply over April and May and grew at a relatively moderate rate in

June. M3 surged in July, however, as heavy volumes of large time deposits were issued by U.S. branches of foreign banks to pay down borrowings from their overseas offices and by domestic banks to counter the runoff of government deposit accounts; the latter two sources of funds are not included in M3. For the year through July, M3 expanded at a rate appreciably above the upper bound of its range. Total domestic non-financial debt had continued to expand in recent months at a rate near the middle of its range.

The staff forecast prepared for this meeting suggested that the expansion of the economy would be damped in the second half of the year by a slowing of inventory accumulation from the unsustainably brisk pace in the first half of the year. In 1998, the economy would expand at a pace in line with the growth of its estimated potential. Growth of consumer spending, supported by high levels of household wealth and projected further gains in employment and income, was expected to be relatively brisk over the forecast horizon. Business spending on equipment and structures was anticipated to continue to outpace the overall expansion of the economy, though the differential would tend to narrow over time in association with the gradual diminution of increases in sales and profits that was expected in conjunction with moderating economic growth. Housing construction was projected to drift lower over the forecast horizon. The staff anticipated that the external sector would exert some mild restraint on the expansion of economic activity. With labor compensation gradually accelerating in the context of higher resource utilization, core consumer price inflation was forecast to drift slightly higher.

The Committee's discussion of current and prospective economic develop-

ments highlighted statistical and anecdotal evidence of a solid economic performance, including indications of a rebound in final demand after a lull during the spring and the persistence of relatively subdued, and by some measures declining, inflation. Growth in consumer spending had slowed sharply, and a surge in inventory accumulation had accounted for much of the expansion of economic activity in the second quarter. Looking ahead, the members did not believe that recent developments had altered the prospect that the economy would settle into a pattern of moderate growth approximating its potential. Such a forecast was subject to considerable uncertainty, and several members observed that the risks appeared to be mostly in the direction of stronger growth in demand. With regard to the outlook for inflation, widespread evidence of very tight labor markets was associated with scattered indications that the rise in labor compensation might be accelerating, but overall labor costs had remained relatively damped and price inflation restrained. Gains in productivity and muted increases in nonlabor costs probably also were contributing to holding producer costs under good control. Nonetheless, the members remained concerned about the risks of rising inflation, especially if somewhat-faster-than-projected growth in economic activity were to occur and add to pressures on resources in an economy that already seemed to be operating close to, or perhaps even above, its sustainable potential.

The uncertain prospects for inventory investment were a dominant factor in the outlook for economic activity over the nearer term. The accumulation of inventories had been unusually high in the second quarter according to the available evidence. There was no broad sense of an undesired buildup, but the

rate of inventory investment would have to be reined in if an overhang were to be averted. A concern in this regard was that the apparent upturn in final demand, particularly if it proved to be somewhat stronger than currently expected, and related business optimism about sales prospects might well result in a further buildup of inventories at a relatively rapid rate. While such a development was not viewed as the most likely outcome and, indeed, less-than-projected strength in the inventory sector could not be ruled out, relatively rapid inventory accumulation in the context of persisting above-trend growth in final demand would generate additional pressure on resources and heighten the risks of accelerating inflation.

With regard to the prospects for final demand in key sectors of the economy, members noted that the appreciable rebound in consumer spending followed a weak second quarter, and some moderation in the growth of such spending was likely later this year and in 1998. Even so, favorable prospects for employment and incomes and the large gains that had occurred in financial wealth suggested that consumer expenditures were likely to be well maintained over the projection horizon. The high level of consumer confidence reported by consumer surveys was another supporting factor in this favorable outlook,

In the area of business fixed investment, a strong upward trend in outlays for new equipment was thought likely to persist, notably in the computer-related and the telecommunications industries. Anecdotal reports also pointed to appreciable strength in commercial construction activity, including office structures, hotels, and warehouses in various parts of the country. Indeed, in some areas construction activity was said to be limited only by shortages of qualified labor.

Positive factors in the outlook for business investment included the persistence of a high level of profits, an accommodative financial climate, and the rapid obsolescence of high-tech equipment. There were, nonetheless, indications of some moderation in commercial construction activity in a number of areas, including reports of developing overcapacity of retail space in shopping centers. Spending for basic industrial equipment also was likely to soften, given moderating growth in overall final demand in line with current forecasts.

Housing activity continued to display considerable vigor in many parts of the nation as evidenced by available statistics and anecdotal reports. The affordability of housing and the very large increases that had occurred in stock market wealth clearly were supportive factors. Concurrently, however, there were indications of slowing in residential building activity in several areas. On balance, some moderation in housing construction appeared likely over the projection horizon in keeping with longer-term population and other trends affecting such construction.

In the Committee's discussion of the prospects for inflation, members commented that a number of factors could be cited to explain the persistence of relatively subdued inflation this year despite high levels of resource use. Among those factors were the appreciation of the dollar and its effects on prices of imports and competing domestic products, a significant decline in world oil prices, the relatively sluggish performance of many foreign economies that had tended to moderate prices of products traded in world markets, and relatively large grain harvests in the United States that had curbed pressures on food prices. However, the underlying reasons for the favorable price trends were not entirely clear. Labor costs were still ris-

ing appreciably less than would have been expected on the basis of past experience under similarly tight labor market conditions. Explanations tended to focus on the concerns about job security felt by many workers, the muted rise in the costs of worker benefits, notably for health care, and the increased use of innovative and highly targeted methods of compensation. With regard to the market pricing of goods, businesses tended to cite highly competitive conditions across the nation that made it very difficult to raise prices and gave impetus to efforts to improve productivity. Indeed, the available evidence suggested that the profits of business concerns generally had continued to increase in the second quarter, implying that productivity had been rising at a pace that exceeded published estimates by a significant margin.

Even though inflation had not accelerated, some signs were beginning to emerge that wages and other labor costs might be experiencing increasing pressure. These included some limited evidence that job security concerns might be diminishing and multiplying anecdotal reports of a less benign outlook for health care costs. Some members commented that the outcome of the recent labor negotiations involving a very large package delivery firm might well be a harbinger of more militant labor negotiating attitudes. Against this background, members expressed concern that a further increase in labor utilization rates could put substantial upward pressures on wages that eventually would work their way through to prices.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal to maintain an unchanged policy stance. Underlying economic conditions and the outlook for economic activity and inflation had changed little in recent months.

The most likely outcome of the current policy stance was growth near potential and some pickup in inflation as the effects of special factors holding it down abated. For the present, monetary policy appeared to be appropriately positioned to foster the Committee's objectives of resisting an intensification of inflationary pressures while supporting a fully employed economy. The level of real short-term interest rates was relatively high by historical standards and provided some assurance that the current stance of policy would not accommodate a significant increase in underlying inflationary pressures. Nonetheless, the members remained concerned about the outlook for inflation. Although some decline in inflation could not be ruled out, persistence of the current degree of tightness in labor markets, consistent with the economy growing at a pace near its potential, could at some point begin to put more pressure on costs and prices, and growth somewhat above potential, which some members saw as a distinct possibility, would be even more likely to produce that result. While there were no current indications that inflation might be accelerating and no policy move was called for at this time, the members saw a need for continuing vigilance. As at earlier meetings, a number of them expressed the view that an anticipatory policy move to counter intensifying inflationary pressures likely would be needed at some point.

In the Committee's discussion of possible adjustments to policy during the intermeeting period, members agreed that the retention of an asymmetric directive toward tightening was consistent with their view that the risks remained biased toward a rise in inflation. Accordingly, while they did not attach a high probability to the prospect that the incoming information would warrant a tightening move during the

intermeeting period, they continued to view the next policy move as more likely to be in the direction of some firming than toward easing.

The members reviewed proposals for rewording the operational paragraph of the directive for the purpose of updating and clarifying the description of the Committee's instructions to the Manager of the System Open Market Account and to conform the directive wording with current public announcement practices regarding the Committee's policy decisions. In particular, the directive would in the future include specific reference to the federal funds rate that the Committee judged to be consistent with the stance of monetary policy. The Committee also modified the present sentence relating to the intermeeting bias in the directive to recognize that changes in the stance of policy are now expressed in terms of the federal funds rate. These changes were not intended to alter the substance of the directive or the Committee's operating procedures.

At the conclusion of the Committee's discussion, all the members expressed their support of a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent. All the members also agreed on the desirability of retaining a bias in the directive toward the possible firming of reserve conditions and a higher federal funds rate during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the inter-

meeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate expansion in M2 and M3 over coming months.

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

The information reviewed at this meeting suggests that economic activity is expanding at a moderate pace. In labor markets, hiring remained robust at midyear, and the civilian unemployment rate, at 4.8 percent in July, matched its low for the current economic expansion. Industrial production increased relatively slowly in July, owing in part to a temporary drop in motor vehicle assemblies. Retail sales rose briskly in June and July after having changed little over the preceding three months. Housing starts rebounded in June and July after having weakened in May. Business fixed investment increased substantially further in the second quarter and available indicators point to further sizable gains in the current quarter. The nominal deficit on U.S. trade in goods and services narrowed slightly on balance over April and May from its downward-revised average rate in the first quarter. Price inflation has remained subdued and increases in labor compensation have been moderate.

Market interest rates generally have declined somewhat further since the start of the Committee meeting on July 1–2, 1997. Share prices in equity markets have increased on balance. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose significantly on balance over the intermeeting period.

After fluctuating sharply from April to May, growth of M2 was at a moderate pace over June and July and that of M3 picked up to a relatively rapid rate. For the year through July, M2 expanded at a rate near the upper bound of its range for the year and M3 at a rate appreciably above the upper bound of its range. Total domestic nonfinancial debt has continued to expand in recent months at a rate near the middle of its range.

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

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

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Ms. Phillips and Rivlin. Votes against this action: None.

Rules Regarding Availability of Information

By notation vote completed on August 20, 1997, the Committee approved for public comment a revision of its Rules Regarding the Availability of Information. The purpose of the revision is to bring the rules into conformance with the Electronic Freedom of Information

Act of 1996 (EFOIA), which amends the Freedom of Information Act (FOIA). The revision does not incorporate any substantive changes in the rules other than to conform them to the requirements of EFOIA and to update and clarify the Committee's procedures for processing FOIA requests. After review of the comments that are received from the public, the Committee will issue the rules in final form on or before October 2, 1997.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 30, 1997.

The meeting adjourned at 12:40 p.m.

Donald L. Kohn
Secretary

Meeting Held on September 30, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 30, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and
Ms. Minehan, Alternate Members
of the Federal Open Market
Committee

Messrs. Boehne, McTeer, and Stern,
Presidents of the Federal
Reserve Banks of Philadelphia,
Dallas, and Minneapolis
respectively

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

Messrs. Cecchetti, Goodfriend,
Eisenbeis, Hunter, Lindsey,
Promisel, Siegman, Slifman,
and Stockton, Associate
Economists

Mr. Fisher, Manager, System Open
Market Account

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

Messrs. Madigan and Simpson,
Associate Directors, Divisions of
Monetary Affairs and Research
and Statistics respectively, Board
of Governors

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

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

Mr. Varvel, First Vice President,
Federal Reserve Bank of
Richmond

Ms. Browne, Messrs. Dewald, Hakkio,
Ms. Krieger, Messrs. Lang,
Rolnick, Rosenblum, and
Sniderman, Senior Vice
Presidents, Federal Reserve Banks
of Boston, St. Louis, Kansas City,
New York, Philadelphia,
Minneapolis, Dallas, and
Cleveland respectively

Mr. Judd, Vice President, Federal
Reserve Bank of San Francisco

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 19, 1997, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange and international financial markets in the period since the previous meeting on August 19, 1997. There were no open market transactions in foreign currencies for System account since that meeting, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period August 19, 1997, through September 29, 1997. By unanimous vote, the Committee ratified these transactions.

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

The information reviewed at this meeting suggested that economic activity had expanded briskly further in the third quarter. The expansion was paced by robust growth in consumer spending and substantial further increases in business investment expenditures. Housing demand seemed to have been well maintained over the summer. Employment and production had risen considerably further since midyear. Despite widespread indications of tight labor markets, increases in labor compensation had been moderate in

recent months, and price inflation had remained subdued.

Private nonfarm payroll employment rose substantially over July and August despite the retarding effects of a work stoppage at a major package shipping firm. Aggregate weekly hours of production or nonsupervisory workers were considerably above their second-quarter average over the two months. The civilian unemployment rate, at 4.9 percent in August, was marginally above its low for the current economic expansion.

Industrial production increased considerably in July and August, extending a relatively brisk advance over the first half of the year. The output of business equipment rose strongly over the two months, with sizable gains in all major categories, and the output of consumer nondurables turned up after having displayed some weakness in earlier months of the year. The production of consumer durables also increased on balance over the two months. After having risen somewhat in other recent months, the utilization of total manufacturing capacity was up appreciably in August, reaching its highest level since the spring of 1995.

Retail sales were up substantially over the summer after having edged lower during the spring. The upturn in recent months included a rebound in sales at automotive dealers following some weakness in earlier months. Sales at non-auto durable and at nondurable goods stores also strengthened after having declined on balance during the second quarter. The pickup in consumer spending occurred against a backdrop of further strong gains in incomes and household net worth that, according to recent surveys, had fostered high levels of consumer confidence. In addition, credit continued to be readily available to most consumers. Total private housing starts and building permits declined

in August to levels somewhat below their averages in earlier months of the year, but data on overall home sales and builder ratings of new home sales continued to suggest that demand for single-family housing was still relatively buoyant.

Real business fixed investment had remained on a steep uptrend since mid-year, with exceptional ongoing demand for computers and communications equipment and relatively robust demand in other categories of business equipment as well. Nonresidential construction activity appeared to have rebounded somewhat in late spring and early summer after having declined moderately earlier in the year. While new construction contracts displayed little trend, favorable conditions for nonresidential construction were suggested by low vacancy rates, rising prices for commercial real estate, and a widespread availability of financing.

The accumulation of nonfarm business inventories slowed substantially in July (latest data) from its average pace in the second quarter. Inventory investment in manufacturing was only a bit below its pace in the second quarter, but the inventory–shipments ratio for the sector remained at a very low level. In wholesale trade, stocks fell after a sharp buildup in June, and the stock–sales ratio for this sector was at the middle of its relatively low range for the past year. At the retail level, a rise in inventories in July about matched that in June and the inventory–sales ratio for the sector also was near the middle of its range for the past year.

The nominal deficit on U.S. trade in goods and services widened substantially in July, reflecting both a decline in exports and a rise in imports. The lower exports of goods and services were associated with decreases in most trade categories and left total exports slightly

below their relatively high level of the second quarter. The July increase in imports also was spread among nearly all trade categories and brought total imports of goods and services to a level somewhat above the average for the second quarter. The available information suggested that economic activity expanded further in recent months in all the major foreign industrial countries except Japan. Growth remained relatively robust in Canada and the United Kingdom, and activity apparently picked up in France and Germany after having been sluggish early in the year. Economic activity in Japan declined appreciably in the second quarter, and more recent information provided little clear evidence of subsequent strength.

Price inflation had remained subdued. Consumer price inflation picked up slightly in July and August from a slow rate of increase in each of the previous four months; reduced but still appreciable increases in food prices contributed to the larger advance in both months, and a sizable rise in energy prices lifted the index in August. At the producer level, the price index for finished goods rose moderately in August after having fallen for seven consecutive months; the August rise largely reflected a jump in energy prices. Over the twelve months ended in August, consumer prices were up considerably less than in the previous twelve months, while producer prices of finished goods were down slightly after having increased moderately in the previous twelve months. The behavior of these broad measures of inflation excluding the effects of food and energy prices also was favorable over the year ended in August, albeit slightly less so. Average hourly earnings of production and nonsupervisory workers picked up in August from a much reduced pace in July; the rise in such earnings over the

twelve months ended in July was slightly above that in the previous twelve months.

At its meeting on August 19, 1997, the Committee adopted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate averaging about 5½ percent. The directive included a bias toward the possible firming of reserve conditions and a somewhat higher federal funds rate to reflect a consensus among the members that the economic risks remained biased toward higher inflation. Although the members did not see a high probability that likely developments would warrant a tightening of policy during the intermeeting interval, they continued to anticipate that the next policy move was more likely to be in the direction of some firming than toward some easing. The reserve market conditions associated with this directive were expected to be consistent with some slowing in the growth of M2 and M3 to more moderate rates over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining the existing degree of pressure on reserve positions, and the federal funds rate averaged just slightly above the Committee's intended level of 5½ percent. Most other interest rates in short-term markets were little changed over the period. Rates on longer-term obligations were down somewhat on balance, apparently reflecting a reassessment of the outlook for inflation by some market participants in the light of unexpectedly low inflation and other statistics released during the latter part of the period. The downward movement in long-term interest rates resulted in some further flattening of the slope of the yield curve and appeared consistent with an interpretation that market participants saw little likelihood of any

tightening of monetary policy in coming months. Share prices in equity markets continued to display considerable volatility but increased appreciably further on balance over the intermeeting interval.

In foreign exchange markets, the dollar experienced mixed changes in relation to major foreign currencies, largely reflecting diverging economic developments abroad. On balance, the dollar's trade-weighted value in terms of the other G-10 currencies declined somewhat over the intermeeting period. The dollar was down considerably against the mark as data suggesting a pickup in German economic activity and inflation led to market speculation concerning a possible increase in short-term German interest rates. The dollar also registered sizable declines over the period against a number of other European currencies. On the other hand, the dollar rose appreciably in relation to the Japanese yen, which came under selling pressure against the background of continuing sluggish economic conditions in Japan, persistent problems in its financial system, and concerns about the potential effect on Japan of the recent depreciations of Southeast Asian currencies. The dollar also strengthened somewhat in terms of the British pound, in part as a result of some indications that economic activity in the United Kingdom was not as strong as expected and the sizable declines that had occurred recently in that nation's long-term interest rates.

M2 expanded at a rapid pace in August and continued to grow at a still robust though diminished rate in September according to the limited data available for that month. The strength of M2 and also that of M3 was related at least in part to changes in the allocation of financial assets and liabilities rather than to the growth in spending; in particular, the volatility in the stock market

evidently fostered a redirection of funds to M2 assets, among others, and included heavy inflows to the money market funds component of M2. For the year through August, M2 rose at a rate somewhat above the upper bound of the Committee's range. M3 grew at an exceptionally rapid rate over the summer months, with only few signs of moderation in September according to the partial data available for that month. Apart from the strength in its M2 components, the increase in this aggregate reflected bank substitution of large time deposits for foreign borrowings to finance credit growth and also reflected substantial inflows to institution-only money funds. For the year through August, M3 expanded at a rate well above the upper bound of its range. Total domestic nonfinancial debt continued to increase at a relatively moderate rate in recent months.

The staff forecast prepared for this meeting suggested that the economy would expand at a pace significantly above that anticipated earlier for the second half of the year and the early part of 1998, but economic growth was likely to moderate appreciably to a more sustainable rate later. In the near term, business fixed investment appeared to be providing surprisingly strong impetus to income growth, and rising levels of wealth were stimulating robust consumer demand. With sales so strong, the downward adjustment in inventory investment that had been anticipated in the previous staff forecast seemed likely to occur more gradually. The projected strength in aggregate demand appeared likely to intensify pressures on resources and lead to some pickup in inflation. Less accommodative financial market conditions were anticipated to damp these tendencies over time.

In the Committee's discussion of current and prospective economic develop-

ments, members commented on the continued remarkable performance of the economy. Strength in consumer spending and further acceleration in capital investment sparked faster-than-expected growth in the third quarter, and relatively brisk economic expansion seemed to be in prospect for a period ahead in the context of very positive business and consumer sentiment, strong demands for capital goods, and favorable financial conditions. The rate of expansion might subsequently be expected to slow as stocks of business capital and consumer durable goods built up relative to sales and incomes, inventory investment moderated somewhat, and the recent strength of the dollar began to exert a drag on exports. It was an open question, however, as to whether these influences would be sufficient to slow the growth of demands for goods and services to a more sustainable pace, and many members suggested that the risks to the forecast were on the side of increases in final demands that would press more intensely against the available resources. Despite high levels of resource utilization, inflation and inflationary expectations had remained subdued to date, reflecting to some extent special influences like the rise in the foreign exchange value of the dollar. Moreover, sizable gains in productivity combined with moderate increases in wages and salaries seemed to have contributed to keeping unit labor costs and prices under control. However, the growing tightness in labor markets in many parts of the country was being accompanied by some signs of rising pressures on labor compensation, including the use of special bonuses and other innovative compensation initiatives that are not included in the usual statistical measures of labor costs. In the circumstances, members saw a risk of added wage and price inflation if

economic activity did not slow to a more sustainable pace consistent at a minimum with no further appreciable increase in labor utilization rates.

With regard to the prospects for final demand in key sectors, members took note of the rebound in consumer expenditures after a sluggish second quarter. Solid gains in employment, incomes, and household net worth were seen as sustaining further robust expansion in consumer spending. In addition, members anticipated that continued further rapid expansion in investment expenditures by business firms for equipment and structures would provide strong underlying support for the economic expansion. High rates of return on investments in equipment, particularly for computers and communications equipment where prices were falling rapidly, coupled with ready financing from both internal cash flows and external sources were inducing firms to undertake large investment programs. Such investments would expand capacity, improve productivity, and lower costs of production. Anecdotal reports suggested a mixed picture in nonresidential real estate markets. In much of the country, commercial and office vacancies were declining from already low levels and lease rates were rising. Shortages of construction workers were said to be holding back construction in some areas, but in other parts of the country there were indications of some moderation in construction activity and of emerging overcapacity in some markets. The ready availability of financing was a supportive factor in the outlook for nonresidential construction.

A gradual decline in housing activity was expected to exert only mild restraint on the increase of economic activity. Solid job and income growth, the high level of household wealth, and the low cash flow burden of homeownership

would continue to provide good support for housing demand. In this regard, recent statistical and anecdotal information indicated that home sales were holding up well across the country, although higher-priced homes appeared to be selling relatively slowly in some areas.

In the Committee's discussion of the prospects for inflation, members discussed the relative absence of price pressures in an environment of increasingly tight labor markets across the country and rising levels of manufacturing capacity utilization. In labor markets, costs were increasing much less than would have been expected on the basis of previous experience under similarly tight conditions. Among the possible explanations for this outcome were persisting concerns about job security; the muted rise in worker benefits, notably health care; and the increasing use by employers of more flexible and innovative means to attract and retain workers that were in high demand. Moreover, it was suggested that, at least in manufacturing, productivity had risen unusually rapidly of late, allowing corporations to hold the line on prices despite increases in labor costs. While the underlying reasons for the favorable inflation trends were not entirely clear, the members noted that, in addition to subdued increases in labor costs, the appreciation of the dollar and the relatively sluggish performance of many foreign industrial economies seemed to be contributing to the better-than-expected inflation performance by holding down prices in world commodity markets and prices of imported goods more generally. These developments also added to competitive pressures on businesses, which together with customer resistance were making it very difficult for firms to raise prices to reflect their higher costs.

The members commented that while few signs of rising price inflation had surfaced, the widespread tautness of labor markets and the emergence of scattered indications of increased pressure on wages and other labor costs were cause for concern. Anecdotal reports suggested that increases in health care costs were likely to turn up, and there were indications that fears about job security might be diminishing and that workers were becoming less reluctant to leave their jobs before finding better ones. In addition, businesses were reporting increasing difficulty in hiring and retaining qualified workers. Growth in labor demand had been outpacing sustainable increases in labor supply; these reports suggested that the risk of an acceleration in labor compensation was rising.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal to maintain an unchanged policy stance, but several also indicated that economic developments could well require a tightening of policy in the relatively near future. Members observed in this regard that some factors that had contributed to a currently subdued rate of inflation, notably the appreciation of the dollar, damped wage demands, and relatively limited increases in the cost of health benefits, were not likely to continue to exert the same restraining influence. Moreover, final demands had been unexpectedly strong, with economic activity and the associated demand for labor expanding at an unsustainable pace for some time, and it was unclear whether without policy action overall demands would moderate sufficiently to avoid increasing pressures on resources. In the circumstances, the risks to the economy appeared to be strongly tilted toward rising inflation whose emergence would in turn threaten the sus-

tainability of the expansion. Several members emphasized in this regard that a tightening move could be most effective if it were implemented preemptively, before inflation had time to gather upward momentum and become embedded in financial asset prices and in business and consumer decision-making.

There were, nonetheless, a number of reasons for delaying a tightening of policy. The behavior of inflation had been unexpectedly benign for an extended period of time for reasons that were not fully understood. Forecasts of an upturn in inflation were therefore subject to a considerable degree of uncertainty, and the expansion of economic activity could still slow to a noninflationary pace. Members also commented that a policy tightening was not anticipated at this time and such an action might therefore have unintended adverse effects on financial markets. Members recognized that from the standpoint of the level of real short-term interest rates, monetary policy could already be deemed to be fairly restrictive. Several noted, however, that credit from a wide variety of lenders appeared to be amply available in financial markets on favorable terms, perhaps overly so in present circumstances, and some also noted that the strength in the broad measures of money in recent months suggested that policy was not restraining liquidity or financial conditions more generally. In the course of the Committee's discussion of these diverging considerations, a consensus emerged for maintaining a steady policy course at this time, but members also expressed the need for a heightened degree of vigilance as they continued to assess ongoing developments for signs that inflation might intensify in the future.

In their discussion of possible adjustments to policy during the intermeeting

period, all the members indicated that they wanted to retain in the operating paragraph of the directive the existing asymmetry toward restraint that was initially adopted at the May meeting. Such a directive was consistent with their view that the risks continued to be biased toward rising inflation and indeed with the view of most members that those risks might have increased. Accordingly, while the probability that the incoming information would warrant a tightening move during the intermeeting period might not be high, the members continued to view the next policy move as more likely to be in the direction of some firming than toward easing.

At the conclusion of the Committee's discussion, all the members supported a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent. All the members also agreed on the desirability of retaining a bias in the directive toward the possible firming of reserve conditions and a higher federal funds rate during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the expansion in M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until

instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that growth of economic activity remains brisk. In labor markets, hiring continued robust over the summer months and the civilian unemployment rate, at 4.9 percent in August, remained near its low for the current economic expansion. Industrial production increased considerably further in July and August. Retail sales have risen sharply over recent months after a pause during the spring. Housing starts declined in July and August, but home sales have been strong. Business fixed investment has increased substantially further since midyear and available indicators point to further sizable gains in coming months. After narrowing somewhat in the second quarter, the nominal deficit on U.S. trade in goods and services widened substantially in July. Inventory investment in July was well below the average pace in prior months of 1997. Price inflation has remained subdued and increases in labor compensation have been moderate in recent months.

Most market interest rates are about unchanged on balance since the day before the Committee meeting on August 19, 1997. Share prices in equity markets have increased considerably over the period, with some stock price indexes reaching new highs. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined somewhat on balance over the intermeeting period.

Growth of M2 appears to have moderated somewhat in September from a very rapid pace in August, while expansion of M3 remained very strong in both months. For the year through August, M2 expanded at a rate somewhat above the upper bound of its range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt has continued to expand in recent months at a pace near the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that

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

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

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Wednesday, November 12, 1997.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary

Meeting Held on November 12, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, November 12, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and
Ms. Minehan, Alternate Members
of the Federal Open Market
Committee

Messrs. Boehne, McTeer, and Stern,
Presidents of the Federal Reserve
Banks of Philadelphia, Dallas, and
Minneapolis respectively

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

Messrs. Cecchetti, Goodfriend,
Eisenbeis, Lindsey, Promisel,
Slifman, and Stockton, Associate
Economists

Mr. Fisher, Manager, System Open
Market Account

Messrs. Madigan and Simpson,
Associate Directors, Divisions of
Monetary Affairs and Research
and Statistics respectively,
Board of Governors

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

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

Ms. Pianalto and Mr. Rives, First
Vice Presidents, Federal Reserve
Banks of Cleveland and St. Louis
respectively

Messrs. Dewald, Hakkio, Rolnick,
and Sniderman, Senior Vice
Presidents, Federal Reserve Banks
of St. Louis, Kansas City,
Minneapolis, and Cleveland
respectively

Messrs. Bentley, Meyer, and
Rosengren, Vice Presidents,
Federal Reserve Banks of
New York, Philadelphia, and
Boston respectively

Ms. Gonczy and Mr. Koenig, Assistant
Vice Presidents, Federal Reserve
Banks of Chicago and Dallas
respectively

Mr. Trehan, Research Officer, Federal
Reserve Bank of San Francisco

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on September 30, 1997, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange and international financial markets in the period since the previous meeting on Septem-

ber 30, 1997. There were no System open market transactions in foreign currencies during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period September 30, 1997, through November 11, 1997. By unanimous vote, the Committee ratified these transactions.

By unanimous vote, paragraph 1.A of the Authorization for Domestic Open Market Operations was amended to raise from \$8 billion to \$12 billion the dollar limit on intermeeting changes in System Account holdings of U.S. government and federal agency securities for the intermeeting period through December 16, 1997. The Manager advised the Committee that, as was usually the case at this time of year, the anticipated pattern of reserve needs was such that he might want to add considerably to the System's outright holdings of U.S. government securities over the coming intermeeting period. By unanimous notation vote, the Committee subsequently approved a further increase in the intermeeting leeway to \$17 billion. The increase, effective December 8, was made on the recommendation of the Manager who saw the need for substantially more outright purchases of Treasury obligations than anticipated earlier, largely in light of much greater than projected growth in currency.

With Mr. Broadus dissenting, the Committee authorized the renewal for an additional one-year period of the System's reciprocal currency ("swap") arrangements with foreign central banks and the Bank for International Settlements. The amounts and current maturity dates of the arrangements approved for renewal are shown in the table that follows:

Foreign bank	Amount of arrangement (millions of dollars equivalent)	Term (months)	Maturity date
Austrian National Bank	250	12	12/04/97
Bank of England	3,000	↑	12/04/97
Bank of Japan	5,000		12/04/97
Bank of Norway	250		12/04/97
Bank of Sweden	300		12/04/97
Swiss National Bank	4,000		12/04/97
Bank for International Settlements:			
Swiss francs	600		12/04/97
Other authorized European currencies	1,250		12/04/97
Bank of Mexico	3,000		12/12/97
Bank of Canada	2,000		12/15/97
National Bank of Belgium	1,000		12/18/97
National Bank of Denmark	250		12/28/97
Bank of France	2,000		12/28/97
German Federal Bank	6,000		12/28/97
Bank of Italy	3,000		12/28/97
Netherlands Bank	500	12	12/28/97

Mr. Broaddus dissented because he believed that the Federal Reserve's participation in foreign exchange market intervention compromises its ability to conduct monetary policy effectively. Because sterilized intervention cannot have sustained effects in the absence of conforming monetary policy actions, Federal Reserve participation in foreign exchange operations risks one of two undesirable outcomes. First, the independence of monetary policy is jeopardized if the System adjusts its policy actions to support short-term foreign exchange objectives set by the Treasury. Alternatively, the credibility of monetary policy is damaged if the System does not follow interventions with compatible policy actions, the interventions consequently fail to achieve their objectives, and the System is associated in the mind of the public with the failed operations. In these circumstances, he did not

view renewal of the existing swap lines as desirable because they are used primarily to facilitate market intervention.

The Committee then turned to a discussion of the economic outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at the meeting suggested that economic activity continued to grow rapidly in recent months. The further advance reflected a surge in business fixed investment and consumer spending, while housing demand remained at a high level. Significant slowing in exports and inventory investment provided only a partial offset to the strength. Accordingly, production and employment recorded further large gains. Price inflation remained subdued despite tight labor markets and a pickup in the pace of labor compensation.

Nonfarm payroll employment rose substantially further in October. Manufacturing payrolls recorded their largest rise in the current economic expansion, and aggregate weekly hours worked increased significantly; most of the gain in payrolls occurred at durable goods establishments. Hiring remained robust in the service-producing sector, led by sizable increases at computer services and engineering and management services firms. The civilian unemployment rate fell to 4.7 percent in October, its low for the current expansion.

Industrial production registered a large advance in the third quarter and apparently remained strong in October. A third-quarter surge in the manufacture of durable goods, notably of motor vehicles, aircraft, and information processing equipment, more than offset weak expansion in the output of nondurable goods and a decline in mining activity. Although the step-up in manufacturing production boosted further the rate of utilization of manufacturing capacity,

the latter was somewhat below its most recent peak in January 1995.

Retail sales posted a sharp rise in the third quarter, though growth in sales of both durable and nondurable goods moderated during the quarter. Consumer spending on services also continued to increase at a relatively brisk pace. Growth in such spending was underpinned by continuing substantial gains in incomes, the cumulative increase in household net worth over the past several years, and the ready availability of credit to most consumers. Housing demand remained strong in the third quarter in association with moderate interest rates and very positive consumer assessments of homebuying conditions. Sales of both new and existing homes increased a bit, and housing starts were little changed in the third quarter from the high level recorded during the first half of the year.

Business fixed investment increased at an unusually rapid rate in the third quarter. The rise in outlays was spread across all categories of producers' durable equipment, but the largest gains were in office, computing, and communications equipment. Available data on new orders pointed to further broad-based and robust expansion in equipment spending in coming months. Nonresidential construction grew at a moderate pace in the latest quarter despite a decline in September. Available information suggested that construction would trend upward at a modest rate in coming months.

Business inventory investment appeared to have moderated substantially in the third quarter from the rapid rate of the previous quarter, and on balance stocks were at relatively low levels in relation to sales. In manufacturing, stocks rose somewhat further in September, but the inventory-to-shipments ratio for the sector declined to the low end

of its range for the past twelve months. Wholesale inventories posted another sizable advance in September; the inventory-sales ratio for this sector was just above the high end of its range for the past year. Retail stocks fell in August (latest available data), more than reversing their July increase. The inventory-sales ratio for the sector also was at the low end of its range for the past year.

The nominal deficit on U.S. trade in goods and services widened substantially on balance over July and August from its rate in the second quarter. Exports of goods and services changed little on net in the July-August period, but imports rose considerably; the largest increases in imports were for aircraft and automotive products, though sizable gains also were recorded for computers, semiconductors, and industrial supplies. Available indicators of economic activity in the third quarter pointed to robust expansion in all the major foreign industrial countries except Japan, where activity rebounded only moderately from a sharp second-quarter decline. Although timely data were sparse, the economies of many Asian countries probably were weakening as their exchange rates came under pressure, problems in their financial sectors were revealed, and their monetary and fiscal policies moved toward restraint.

Consumer price inflation remained subdued in September. The increase in both overall consumer prices and the prices of consumer items other than food and energy was modest. For the twelve months ended in September, prices of consumer items other than food and energy increased by a considerably smaller amount than in the year-earlier period. At the producer level, the September rise in prices was the largest monthly increment since January 1991; nonetheless, the overall index was unchanged over the past twelve months

after a sizable rise over the previous twelve-month period. The core index also decelerated on a year-over-year basis. The rate of increase in the hourly compensation of private industry workers was unchanged in the third quarter, but the advance over the past four quarters was somewhat larger than that for the previous four. Growth in average hourly earnings picked up in September and October, perhaps partly reflecting the effects of an increase in the federal minimum wage.

At its meeting on September 30, 1997, the Committee adopted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate averaging around 5½ percent. The Committee retained a tilt in the directive toward a possible firming of reserve conditions during the intermeeting period, reflecting its view that the risks continued to be skewed toward rising inflation. Reserve market conditions associated with this directive were expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining reserve conditions consistent with the Committee's intended level of around 5½ percent for the federal funds rate, and the rate averaged close to that level over the period. Other financial markets became quite volatile from time to time. Share prices in equity markets fluctuated widely in occasionally turbulent trading activity and were down somewhat on balance over the period; equity markets in other countries, notably in Asia, also were volatile, and very large declines were recorded in some of those markets. Against this background, U.S. short-term interest rates registered small mixed changes over the period since the

September 30 meeting, while Treasury bond yields declined somewhat on balance. Unexpectedly strong incoming data on U.S. producer prices, employment, and wages tended to exert upward pressures on bond yields on some days, but these were more than offset by investor desires for safety and quality, the continuing moderation in consumer inflation, and the perception engendered by international financial developments that inflation pressures were likely to remain subdued.

The dollar also was affected by the spreading financial turmoil in developing countries, appreciating significantly over the intermeeting period against the currencies of a number of Asian and Latin American countries. Much of the increase was counterbalanced, however, by a sizable decline in the dollar's trade-weighted value in terms of the currencies of the other G-10 countries. The dollar's decline against the German mark and other European currencies partly reflected diminished market expectations of potential tightening in the United States and a snugging of monetary conditions by the Bundesbank and other continental European central banks. Further progress in resolving uncertainties surrounding the European Monetary Union also may have contributed to the rise in European currencies. The dollar appreciated slightly on balance against the Japanese yen.

Growth of M2 and M3 apparently moderated further in October, though the expansion of these aggregates remained brisk. A sharp slowing of inflows to money market mutual funds accounted for much of the deceleration of M2, and an easing in the pace of issuance of large time deposits, evidently reflecting a smaller rise in bank credit, also contributed to a modest reduction in M3 growth. For the year through October, M2 expanded at a rate

that was at the upper bound of the Committee's range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt increased in recent months at a rate somewhat below the middle of its range.

The staff forecast prepared for this meeting suggested that the economy would continue to expand for a time at a pace considerably above its potential, but growth was expected to moderate to a more sustainable rate later. Further rapid increases in business investment would provide strong impetus to income growth in the near term, and the rise in household wealth so far in 1997 would stimulate robust consumer demand going forward. The projected strength of domestic demand would be offset to some extent by a considerable weakening in the growth of exports in response to the lagged effects of the earlier appreciation of the dollar and sharp anticipated reductions in the economic growth of Asian and other developing countries.

In the Committee's discussion of current and prospective economic developments, members focused on widespread indications of a continued solid advance in economic activity, spurred by strength in all major sectors of the domestic economy, and the persistence of subdued increases in prices. The current momentum of the expansion, together with broadly supportive financial conditions and favorable business and consumer sentiment, suggested that economic growth was likely to be well maintained, especially over the nearer term. As a consequence, the members agreed that there remained a clear risk of additional pressures on already tight resources and ultimately on prices that could well need to be curbed by tighter monetary policy. But the members also focused on two important influences that were injecting new uncertainties into this outlook. Turmoil in Asian financial

markets and economies would tend to damp output and prices in the United States. To date, it appeared that the effects on the U.S. economy would be quite limited, but the ultimate extent of the adjustment in Asia was unknown, as was its spillover to global financial markets and to the economies of nations that were important U.S. trading partners. The second influence was the apparently sharp increase in productivity in the second and third quarters. This was an encouraging development, although it was too early to judge the persistence of the uptrend in productivity growth and the extent to which it might reduce the additional price pressures that would be generated in the event of an extended period of further robust economic expansion.

Strength in consumer spending had provided an important underpinning for robust economic expansion, and substantial growth was likely to persist, sustained by increases in employment and incomes, high levels of confidence, and the cumulative effects of very large gains in stock market wealth over the past several years. The outlook for capital spending also remained quite favorable because the factors that were contributing to the ongoing surge in such spending—its potential for lowering production costs in highly competitive markets and the ready availability of finance on attractive terms—were likely to persist. While private domestic demand most likely would continue to display considerable strength, both consumption and investment were somewhat vulnerable to developments in financial markets, perhaps arising from further difficulties in Asia. Increased uncertainty about asset values could engender greater caution on spending, and of course a substantial decline in equity values would reduce household wealth and raise the cost of

equity capital. Some members also commented that additional appreciation of the dollar, perhaps in association with possible further turbulence in Asia and weakness in foreign economies, would have adverse implications for net exports, which already were seen as a somewhat negative factor in the economic outlook. At the same time, a stronger dollar would have a positive effect on domestic inflation over the projection horizon.

In the course of their discussion, the members gave considerable emphasis to recent developments in labor markets. Statistical indicators of rising levels of employment, low and falling rates of unemployment, and a diminishing supply of new workers were reinforced by anecdotal evidence of tight labor markets throughout the nation. The demand for many types of workers exceeded the supply in many regions, and a number of members reported that growth of economic activity in various parts of the country was being held back by the scarcity of labor. While labor compensation had accelerated, the pickup was moderate in light of the taut conditions in labor markets and some of it reflected the legislated rise in the minimum wage. Nonetheless, members cited numerous examples of efforts to attract or retain workers in especially scarce supply through a variety of bonus payments and other incentives that were not included in standard measures of labor compensation.

The effects on costs and prices of somewhat faster increases in compensation evidently were being muted by what appeared to have been a sharp advance in productivity growth in the past two quarters. The acceleration in productivity seemed to be related in part to the surge in capital spending, which had been stimulated by the ability of new equipment to enhance efficiency

and hold down costs, suggesting that productivity might be on a higher trend for a time. But it also could be attributed to some extent to the strengthening in economic output; such strengthening often is associated with a pickup in productivity as producers react initially to the upturn in demand by stretching available labor further. If the pace of the economic expansion were to moderate in line with current expectations, the growth in productivity also could be expected to slow, but to an uncertain extent.

The trend in productivity gains was a key factor in the outlook for unit costs and ultimately for price inflation. As had been true for an extended period, inflation had remained relatively subdued in comparison with past experience under broadly similar economic conditions. The reasons for the relative quiescence of inflation were not fully understood, but they undoubtedly included a number of special factors beyond higher productivity such as a lagged response to earlier appreciation of the dollar and unusually damped increases in the cost of health benefits. As they had at previous meetings, members suggested that these favorable influences were likely to erode over the year ahead. A number of members again cited reports of increases in health insurance premiums next year and subsequently. More fundamentally, it was difficult to predict whether anticipated increases in labor compensation would be fully offset by productivity gains in coming quarters and whether, in turn, competitive market conditions would allow firms to raise prices to compensate for any increases in their costs. On balance, the members felt that the risks remained in the direction of rising price inflation though the extent and timing of that outcome were subject to considerable debate.

In the Committee's discussion of policy for the intermeeting period ahead, all but one member endorsed a proposal to maintain an unchanged policy stance, and all agreed that the risks remained tilted toward rising inflation. While developments in Southeast Asia were not expected to have much effect on the U.S. economy, global financial markets had not yet settled down and further adverse developments could have greater-than-anticipated spillover effects on the ongoing expansion. In this environment, with markets still skittish, a tightening of U.S. monetary policy risked an oversized reaction. Some members also emphasized that the relatively favorable trends in productivity, costs, and prices continued to raise questions about the strength and timing of any pickup in inflation. Other members stressed that the unsustainable pace of domestic demand and rising resource utilization seemed to call for a near-term tightening of policy. Some of these members noted that overall financial conditions remained quite supportive despite the recent market turmoil and high real short-term interest rates. Credit from a wide variety of lenders appeared to be amply available on favorable terms, perhaps overly so in present circumstances. Nonetheless, all but one of the members believed that in light of the uncertainties about the economic outlook, an immediate policy tightening was not needed in the absence of firmer indications that inflationary pressures might be emerging. In the view of one member, however, aggregate final demand was so strong that, with economic activity and the associated demand for labor having expanded at an unsustainable pace for some time, one could be reasonably confident that inflation would most likely pick up in the absence of policy action.

In their discussion of possible adjustments to policy during the intermeeting period, the members indicated that they wanted to retain in the operating paragraph of the directive the existing asymmetry toward restraint that was initially adopted at the May meeting. Such a directive was consistent with their view that the risks continued to be biased toward rising inflation. Accordingly, the members continued to view the next policy move as more likely to be in the direction of some firming than toward easing.

At the conclusion of the Committee's discussion, all but one member supported a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent and that retained a bias toward the possible firming of reserve conditions and a higher federal funds rate during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate growth in M2 and M3 over coming months.

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

The information reviewed at this meeting suggests that economic activity continued

to grow rapidly in recent months. In labor markets, hiring has remained robust and the civilian unemployment rate fell to 4.7 percent in October, its low for the current economic expansion. Industrial production increased very rapidly in the third quarter, and appears to have remained strong in October. Retail sales also rose sharply in the third quarter, though at a moderating pace as the summer progressed. Housing starts, while fluctuating from month to month, were little changed on balance in the third quarter. Business fixed investment posted unusually strong increases in the latest quarter, and available indicators point to further sizable gains in coming months. The nominal deficit on U.S. trade in goods and services widened substantially on average in July and August from its rate in the second quarter. Price inflation has remained subdued despite some increase in the pace of advance in labor compensation.

Short-term interest rates have registered small mixed changes since the day before the Committee meeting on September 30, 1997, while bond yields have fallen somewhat. Share prices in U.S. equity markets have fluctuated widely in turbulent trading activity and are down on balance over the period; equity markets in other countries, notably in Asia, have been volatile as well and some have registered very large declines. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined somewhat on balance over the intermeeting period. The dollar appreciated significantly, however, in terms of the currencies of a number of Asian and Latin American countries.

Growth of M2 and M3 appears to have moderated further in October from the unusually brisk rates of August. For the year through October, M2 expanded at the upper bound of its range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt has expanded in recent months at a pace somewhat below the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in July reaffirmed the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respec-

tively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1998, the Committee agreed on a tentative basis to set the same ranges as in 1997 for growth of the monetary aggregates and debt, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

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

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Guynn, Kelley, Meyer, Moskow, Parry, Ms. Phillips and Rivlin. Vote against this action: Mr. Broaddus.

Mr. Broaddus dissented because he believed that a modest tightening of policy would be prudent in view of the recent strength in aggregate demand for goods and services; such demand appeared to be growing considerably more rapidly than the sustainable rate at which it could be supplied without an increase in inflation. While he recognized that a tightening at this meeting presented risks in view of recent financial and economic developments in East Asia, he believed these risks were outweighed by the risk that policy would have to be tightened more aggressively if action were delayed, demand

remained robust, and the recent apparent reduction in inflationary expectations were reversed. The negative impact on economic activity in such circumstances would be markedly greater than if a more modest action were taken at this meeting.

Rules Regarding Availability of Information

By notation vote the Committee unanimously approved in final form certain revisions to its Rules Regarding the Availability of Information. The final rules take account of comments received from the public on the Committee's proposed revisions to the rules that were published earlier in the Federal Register. The purpose of the revisions is to bring the rules into conformity with the Electronic Freedom of Information Act of 1996, which amends the Freedom of Information Act. The new rules take effect on December 17, 1997.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 16, 1997.

The meeting adjourned at 1:10 p.m.

Donald L. Kohn
Secretary

Meeting Held on December 16, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, December 16, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich

Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, and
Ms. Minehan, Alternate Members
of the Federal Open Market
Committee

Messrs. Boehne, McTeer, and Stern,
Presidents of the Federal Reserve
Banks of Philadelphia, Dallas, and
Minneapolis respectively

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

Messrs. Beebe, Cecchetti, Eisenbeis,
Goodfriend, Lindsey, Promisel,
Siegman, Slifman, and Stockton,
Associate Economists

Mr. Fisher, Manager, System Open
Market Account

Mr. Winn, Assistant to the Board,
Office of Board Members, Board
of Governors

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

Messrs. Madigan and Simpson,
Associate Directors, Divisions of
Monetary Affairs and Research
and Statistics respectively, Board
of Governors

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

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

Messrs. Connolly and Rives, First Vice Presidents, Federal Reserve Banks of Boston and St. Louis respectively

Mses. Browne, Krieger, Messrs. Dewald, Hakkio, Lang, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Boston, New York, St. Louis, Kansas City, Philadelphia, and Dallas respectively

Mr. Miller, Vice President, Federal Reserve Bank of Minneapolis

Messrs. Bryan and Evans, Assistant Vice Presidents, Federal Reserve Banks of Cleveland and Chicago respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 12, 1997, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange and international financial markets in the period since the previous meeting on November 12, 1997. There were no open market transactions in foreign currencies for System Account during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period November 12, 1997, through December 15, 1997. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting suggested that economic activity had continued to grow at a rapid pace

in recent months. The further advance reflected moderating but still sizable increases in business fixed investment and consumer spending and an upturn in business inventory accumulation. Housing demand remained at a high level, and deepening trade deficits provided only a partial offset to the strength in domestic spending. Against this background, employment and production posted further large gains. Price inflation remained subdued despite tight labor markets and some pickup in the rate of wage increases.

Nonfarm payroll employment rose sharply further in October and November. The increases in payrolls were widespread across sectors, and in November they included notably large gains in the service-producing industries. Manufacturing employment also rose considerably further in November, and aggregate weekly hours of production or nonsupervisory workers registered a particularly large advance in that month. The civilian unemployment rate fell to 4.6 percent in November, its low for the current expansion.

Industrial production continued to advance at a brisk pace in October and November. The November increase was widespread across market groups. It featured particularly strong growth in the production of durable goods, including a surge in the output of motor vehicles and parts. Partly offsetting the strength in the manufacturing sector in November was a decline in mining activity and in utilities output after two months of robust expansion. The large rise in production boosted the rate of utilization of manufacturing capacity to its highest level in more than two years.

Growth in consumer spending had moderated in recent months from a very brisk pace during the summer. Retail sales were unchanged on balance over October and November after having

increased rapidly in the third quarter. The flat sales for the two months reflected some softening in the durable goods category, notably at automotive dealers, and relatively slow growth in the nondurable goods sector. Consumer spending on services appeared to have remained relatively robust in October. According to recent surveys, consumer sentiment continued at an extraordinarily ebullient level in the context of further strong gains in jobs and incomes, the cumulative effect of large increases in household net worth, and the ready availability of financing for most consumers.

Available information suggested that business capital expenditures had moderated in recent months from the exceptionally strong increases of the second and third quarters. Shipments of office and computing equipment fell in nominal terms in October, while shipments of communications equipment were about unchanged after having posted strong gains earlier in the year. Shipments of nondefense capital goods other than aircraft and high tech equipment also declined in October. Spending on non-residential structures had softened a bit in recent months.

In the housing sector, demand had continued to display appreciable strength in recent months in association with relatively moderate mortgage rates and very positive consumer assessments of homebuying conditions. In October, the latest month for which data were available, sales of new homes were well maintained, and sales of existing homes rose. Housing starts increased somewhat in October and November from the already high level reached earlier in the year.

After having picked up considerably in September, the pace of business inventory investment in October remained above that recorded earlier in the sum-

mer. The rise in stocks at the manufacturing level was at a somewhat faster pace in October than in September, but the buildup in inventories at the wholesale level, and especially at the retail level, moderated in October. On balance, inventories remained at quite low levels in relation to shipments and sales.

The nominal deficit on U.S. trade in goods and services was significantly larger in the third quarter than in the second. Exports of goods and services rose only marginally in the third quarter, as increases in machinery, industrial supplies, and service receipts were nearly offset by sharp declines in exports of aircraft and gold. Imports of goods and services rose appreciably in the third quarter; the increases were in most major trade categories and included strong further advances in the quantity of oil imports. Economic growth in most major foreign industrial countries was relatively vigorous in the third quarter, and preliminary indicators for the fourth quarter suggested continued above-trend expansion. However, growth since mid-year appeared to have recovered only modestly in Japan from a sharp second-quarter decline. The ongoing financial turmoil affecting a number of Asian economies had led to a significant slowdown in economic activity in the region. Available data also suggested a favorable economic performance in major Latin American countries in the third quarter.

Consumer price inflation had remained at a low level in recent months, reflecting a variety of influences including a favorable labor cost environment, falling import prices, small increases in energy prices, and declining inflation expectations. For the twelve months ended in November, overall consumer prices and consumer prices excluding food and energy items increased appreciably less than in the year-earlier

period. At the producer level, prices for finished goods edged lower in November and the index was down somewhat on balance over the past year, reflecting declines in the food and energy components. The rate of increase in average hourly earnings had picked up in recent months, apparently reflecting the effects of an increase in the federal minimum wage and some bidding up of wages in a tight labor market.

At its meeting on November 12, 1997, the Committee adopted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate averaging around 5½ percent. In the directive the Committee retained a tilt toward a possible firming of reserve conditions during the intermeeting period. Such a bias was seen as consistent with the members' views that the risks continued to be skewed toward rising inflation and that the next policy move was more likely to be in the direction of some firming than toward easing. Reserve market conditions associated with this directive were expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

Open market operations throughout the intermeeting period were directed toward maintaining reserve conditions consistent with the intended average of around 5½ percent for the federal funds rate, and the average effective rate over the period was close to that rate level. In other domestic financial markets, short-term interest rates registered small mixed changes since the day before the Committee meeting on November 12, 1997, while bond yields fell somewhat. Share prices in U.S. equity markets recorded mixed changes over the period. Domestic financial markets became somewhat less volatile over the period, though further turmoil in a number

of foreign markets fostered a sense of unease that was reflected in relatively wide yield spreads and, on occasion, in trading activity and price movements. Equity markets in other countries, notably in Asia, remained volatile.

In foreign exchange markets, the value of the dollar rose over the intermeeting period in terms of both the trade-weighted index of the other G-10 currencies and the currencies of a number of Asian countries. The dollar's appreciation against the German mark and other Western European currencies appeared to reflect market perceptions that the prospects for monetary tightening had ebbed in those countries in light of the persistence of subdued inflation and indications that the continuing financial turmoil in Asian and other emerging economies was likely to have a retarding effect on the economies of the industrial countries. The dollar's appreciation relative to the yen appeared to reflect rising concerns about the Japanese economy in the wake of continuing financial difficulties in Japan and spillover effects from events elsewhere in Asia. The dollar strengthened further in this period against most of the other East Asian currencies, notably against the Korean won.

Growth in the broad monetary aggregates picked up to relatively rapid rates in November. Strength in currency and a surge in liquid deposits boosted the expansion of M2, while that of M3 was amplified by a step-up in RP borrowing to help finance more rapid growth in bank credit. For the year through November, M2 expanded at a rate that was slightly above the upper bound of the Committee's annual range and M3 at a rate substantially above the upper bound of its range. The increase in total domestic nonfinancial debt for the year to date was at a pace somewhat below the middle of the Committee's range.

The staff forecast prepared for this meeting suggested somewhat greater moderation in economic expansion than had been projected earlier and slightly less pressure on wages and prices. A number of factors were expected to contribute to the slowing of aggregate demand and reduced pressure on resources. These included: a slackening in world economic expansion that, in conjunction with the appreciation of the dollar, would substantially restrain U.S. exports; some moderation of the growth in household and business investment; and a diminution in the desired rate of inventory accumulation.

In the Committee's discussion of current and prospective economic developments, members commented on indications that growth in economic activity had remained solid and that inflation had continued to be surprisingly low. While wages appeared to be increasingly subject to upward pressure, productivity had picked up in recent quarters, and the persisting strength in profits suggested that unit labor costs were not accelerating noticeably. The evidently higher pace of productivity growth was very encouraging, though it was still difficult to assess how long this favorable performance might last and the extent to which it might ease the price pressures that could emerge if the economic expansion did not moderate as members anticipated. Domestic demand for goods and services had been quite strong and was likely to remain reasonably robust. However, the effects of the persisting turmoil in Asian financial markets were likely to moderate the pace of expansion, though the extent of this effect was difficult to judge. The ongoing turbulence since the last Committee meeting, which included further noticeable increases in the dollar against the currencies of affected countries, likely would have a somewhat greater

damping effect on output and prices in the United States than previously had been anticipated. Exports to many Asian countries, and possibly to other U.S. trading partners whose economies might be adversely affected by the spillover effects of developments in Asia, would be reduced, and declines in import prices would ease inflation pressures. However, the ultimate extent of the adjustment in Asian economies remained unknown, and more substantial downward pressure on the economies of the United States and its trading partners could not be ruled out.

With regard to the prospects for final demand in key sectors, the members noted that the appreciation of the dollar against a wide range of currencies, along with the prospective slackening in world economic expansion associated with the Asian turmoil, could be expected to exert a considerable damping effect on U.S. exports over the next several quarters. In addition, increased uncertainty about financial asset values, possibly related in part to further difficulties in Asia, could lead to greater caution in spending, while a substantial decline in equity values, should it occur, would have a more pronounced effect by reducing household wealth and raising the cost of equity capital. However, a number of members suggested that consumer spending might hold up relatively well if the effects of the Asian crisis on the U.S. economy were not markedly deeper or more prolonged than currently expected. To date, anecdotal reports indicated only scattered signs of weaker export demand, primarily some slackening in orders for and shipments of selected commodities such as agricultural goods and lumber and wood products, and there were few indications of reduced demand for manufactured goods. At the same time, business contacts were optimistic about holiday

sales, tourism was booming in some parts of the country, and spending for services had been brisk. In the circumstances, continuing gains in wages and employment, the prevailing high levels of confidence, the cumulative effects of very large increases in household wealth in recent years, and the intense competition among retailers for the consumer's attention could promote substantial further growth in consumer expenditures. The same factors, along with the favorable cash flow affordability of home ownership, were maintaining housing demand at a relatively high level.

The outlook for business fixed investment remained favorable. In the near term, the low cost of capital, the ready availability of finance on attractive terms, and the potential for reducing production costs in highly competitive markets were providing strong support for capital spending. Moreover, shrinking vacancy rates and rising lease rates were fostering a rapid increase in the number of large commercial building projects, notably office buildings, that were planned or under way in many areas of the country. Even so, the growth of business capital spending was expected to slow from the unusually rapid pace of recent quarters in response to the projected smaller increases in sales and profits arising from moderating economic growth. In addition, business firms were expected to trim the pace of their inventory accumulation to keep stocks at desired levels relative to sales.

In their comments on recent developments in labor markets, the members emphasized the very limited supply of new workers and the extraordinary tightness prevailing in markets throughout the nation. Several reported that the scarcity of available workers was limiting the growth of economic activity in some parts of the country and that

some employers were trying out novel approaches aimed at enticing people not currently seeking a job to enter the work force. While wage increases remained moderate on balance, larger increases were gradually becoming more pervasive as labor markets tightened. Moreover, employers were continuing their efforts to attract or retain workers that were in particularly scarce supply by means of a variety of bonus payments and other incentives that were not included in standard measures of labor compensation. There also were reports of offers of expanded benefits and, in some instances, the granting of very large wage increases to highly skilled technical personnel.

In the course of their discussion, many members remarked on the absence of inflationary price pressures during a period when economic activity had risen briskly and labor markets had grown steadily tighter. The muted effect of higher labor compensation on unit labor costs and prices reflected sharp advances in productivity partly associated with the rapid expansion of the stock of capital; the latter had been stimulated, most probably, by the desire to enhance efficiency and thus hold down costs. In addition, the earlier appreciation of the dollar and the unusually damped increases in the cost of health benefits in recent years had helped to limit the rise in compensation.

As members had noted at previous meetings, these favorable influences were likely to erode over time. Anecdotal reports indicated that health insurance premiums were beginning to trend higher, and the dollar would not rise indefinitely. More fundamentally, persistent tightness in labor markets risked a continuing uptrend in labor compensation increases that, at some point, could not be fully offset by productivity gains. Under those circumstances, competitive

market conditions would allow firms to raise prices to compensate for increases in their costs. However, for some period ahead, developments associated with the turmoil in Asia along with the partly related appreciation of the dollar would tend to intensify import competition and damp the prices of goods.

In the Committee's discussion of policy for the intermeeting period ahead, nearly all the members favored a proposal to maintain an unchanged policy stance. In their discussion, members emphasized that price inflation had remained subdued, indeed with some key price measures indicating declining inflation, despite the persistence of robust economic growth and high levels of resource use, notably in labor markets. They expressed concern, however, that multiplying indications of faster wage increases might presage rising price inflation at some point. Weighing against the risks of higher inflation was the financial turmoil that had intensified in Southeast Asia during October and more recently in Korea. The effects of those developments on the U.S. economy were quite limited thus far, but the members expected some damping of economic expansion and price increases in the quarters ahead, and they did not rule out a potentially strong impact in the event of an even deeper crisis in Asia, or one that spread to other countries. Nonetheless, many members commented that, with domestic demand still quite strong and the economy possibly producing beyond its potential, they viewed the risks on balance as pointing to rising price inflation and the next policy move as likely to be in the direction of some tightening. However, most members agreed that the need for such a policy adjustment did not appear to be imminent and that prevailing near-term uncertainties warranted a cautious wait-and-see policy posture. One member,

while acknowledging the downside risks to the expansion associated with potential developments in Asia, still was persuaded that the economy probably would continue to expand at an unsustainable pace and that monetary policy should be tightened promptly to avert a further buildup of pressures in already strained labor markets, associated increases in labor costs, and at some point an inevitable rise in price inflation.

Other considerations cited by some members in favor of an unchanged policy included the possibility that, because a policy tightening move was not expected at this juncture, even a modest firming action might well have outsized effects in financial markets, especially the foreign exchange markets. Current conditions in domestic financial markets clearly remained supportive of spending, but it also was noted that the real federal funds rate was relatively high and that growth in the broad measures of money was expected to moderate over coming months after a period of robust expansion. The members agreed that the crosscurrents that were generating the present uncertainties in the outlook for economic activity and inflation made a flexible approach to monetary policy particularly desirable at this juncture.

Views were somewhat more divided with regard to the instruction in the directive relating to the possible adjustment of policy during the intermeeting period. A majority of the members indicated a preference for a shift to a symmetrical directive even though many continued to anticipate that the next policy move was likely to be in a tightening direction. They noted that while the probability of any policy change in the near term was very low, uncertainties in the outlook had increased, and they could not rule out the possibility that the next change might be in the direction

of some easing if, contrary to current expectations, the turmoil in Asia were to intensify to the extent that it seemed likely to exert very substantial effects on the U.S. economy. A symmetric directive would position the Committee to respond flexibly in either direction to unanticipated developments in the period ahead. Other members expressed a slight preference for retaining a directive that was tilted toward tightening. In their view, such a directive would continue to underscore their concern that, at current and prospective levels of resource utilization, rising inflation was the most serious risk to the economy and that the Committee remained committed to fostering progress toward a stable price environment that in turn would heighten the prospects for sustained economic expansion and full employment.

At the conclusion of the Committee's discussion, all but one member endorsed a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent and that did not include a presumption about the likely direction of any adjustment to policy during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a slightly higher or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System

Account in accordance with the following domestic policy directive:

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

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

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

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in July reaffirmed the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The range

for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1998, the Committee agreed on a tentative basis to set the same ranges as in 1997 for growth of the monetary aggregates and debt, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

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

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Vote against this action: Mr. Broaddus.

Mr. Broaddus dissented because he continued to believe that a modest tightening of policy would be prudent in light of the apparent persisting strength in aggregate demand for goods and services. He recognized the case for holding policy steady given recent developments in East Asian economies and financial markets; he believed, however, that a slight firming at this meeting would provide valuable insurance against the risk that demand growth might remain above a sustainable trend and require a sharper policy response later. He thought further that the potential benefits of this insurance outweighed the risk that such an action would have a significant negative impact

on U.S. economic activity. He also believed that signaling a greater willingness to tolerate modest policy adjustments in response to emerging developments would foster more flexible movements in longer-term financial markets and specifically enable longer-term interest rates to play their traditional role as automatic stabilizers for the economy more effectively.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, February 3–4, 1998.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary

Consumer and Community Affairs

In 1997 the Board's activities in the consumer protection area centered on making disclosures about transactions more helpful to consumers and focused particularly on automobile leases and real estate mortgages. The Board developed a major consumer education campaign related to the disclosures that consumers receive under its consumer leasing regulations. The initiative had participation from more than thirty agencies and organizations, resulting in the publication of an educational brochure on how to make informed leasing choices and the creation of a public Web site.

In the area of mortgage transactions, the Board joined with the U.S. Department of Housing and Urban Development (HUD) to review the disclosures currently given to consumers under the Truth in Lending Act and the Real Estate Settlement Procedures Act, seeking ways to make the disclosures more useful. The agencies determined that regulatory change alone would not achieve the desired improvements called for by the Congress and turned their attention to legislative changes to reform the current disclosure scheme.

The Board acted on bank and bank holding company applications that involved Community Reinvestment Act (CRA) protests, adverse CRA ratings, and issues of fair lending and noncompliance with consumer protection regulations. Several applications involving major bank mergers elicited both strong support and strong opposition from members of the public; all were protested on CRA grounds. After extensive analysis, the Board approved all these applications, finding in each case that

convenience and needs factors were consistent with approval.

For CRA examinations of state member banks, the Board in 1997 focused on working with the other financial regulatory agencies to foster consistency in the application of examination procedures and on analyzing the data collected by large banks on small business and small farm loans and community development lending. For large institutions, revised CRA regulations became fully effective on July 1, 1997, so that all such institutions are now examined under the revised regulation and no longer have the option to be examined under the previous regulation.

In the fair lending area, in addition to pursuing corrective measures on its own, the Board referred several discrimination cases involving state member banks to the Department of Justice, including a case of alleged redlining in brokered loans. The Board referred other cases raising claims of alleged mortgage discrimination to HUD for investigation. The Board also published final rules governing "self tests" that allow lenders to keep findings from any self-tests they conduct confidential under a legal privilege; the rules are parallel to rules issued by HUD under the Fair Housing Act. The Board continued to improve the System's process for fair lending examinations, using enhanced statistical techniques to test large institutions for compliance.

Acting on behalf of the Federal Financial Institutions Examination Council (FFIEC) and HUD, the Board prepared Home Mortgage Disclosure Act statements for individual lenders and aggregate reports for metropolitan

areas, meeting the statutory target for delivery. From the data, the Board noted that denial rates continued to show disparities among racial and ethnic groups and that although the number of loans to black applicants increased in 1996 as it had in previous years, the rate of growth decreased.

These matters are discussed below, along with other actions by the Board in the areas of consumer protection and community affairs.

Leasing Education and Regulatory Changes

Regulation M, which implements the Consumer Leasing Act, requires lessors to give consumers uniform disclosures of the costs and terms of a lease before the lease becomes legally binding. In September 1996, the Board adopted a revised Regulation M following a multi-year review under its Regulatory Planning and Review program. Through the review the Board identified ways to simplify the regulation to carry out more effectively the congressional intent of consumer protection. The review also led to the modernization of the rules, to address changes that have taken place in consumer leasing since 1976, the year the Consumer Leasing Act was enacted. The revisions included new disclosures, primarily for motor vehicle leasing, to improve consumers' understanding of lease transactions. The Board determined that these revisions were especially necessary given that about one-third of all passenger cars now delivered to consumers are leased rather than purchased and financed.

Throughout 1997, the Board worked to develop an educational program to ensure that consumers could take maximum advantage of the new disclosures about lease transactions. It organized a broad-based coalition of more than

thirty agencies and organizations from the private and public sectors, including automobile manufacturers and dealers, leasing trade associations, consumer advocacy groups, Reserve Banks, the Federal Trade Commission, and state attorneys general.

This leasing education team developed "core messages" about leasing—key information that consumers need to make informed choices:

- Leasing is different from buying
- Consumers need to consider the costs at the beginning of, during, and at the end of the lease
- Consumers need to compare lease offers and negotiate some terms
- Consumers need to know their rights and responsibilities in lease transactions.

These core messages were incorporated into a new brochure, *Keys to Vehicle Leasing—A Consumer Guide*, which was released at a press conference in December. One million copies of the brochure were printed and are being distributed by the Federal Reserve and the other organizations that participated in its preparation.

The information in the brochure is also available on the Board's public Web site, and copies can be printed from there (<http://www.bog.frb.fed.us/pubs/leasing>). The Web site includes a glossary of leasing terms and provides links to the sites of some members of the leasing education team. In December alone, the Web site recorded almost 20,000 visits.¹

1. The Board's Web site provides a wide array of other information, including educational brochures on home mortgages, guidance for filing complaints, the consumer compliance handbook, and credit card information. It also provides links to the Web sites of the FFIEC and the other financial regulatory agencies. For CRA, the agency sites provide data on CRA ratings, reports,

In March the Board amended Regulation M to implement changes to the Consumer Leasing Act enacted in 1996. The changes primarily streamline the advertising disclosures as specified in the act; they also revise the rules for disclosure of up-front costs in lease agreements to parallel the advertising rules and include several other technical changes.

The revised leasing rules adopted in 1996 made it necessary for leasing companies and automobile dealerships to develop new leasing forms and to reprogram the computer software used to produce the lease disclosures. The new rules (and the commentary interpreting them) were to become mandatory on October 1, 1997. In September 1997, the Board delayed the mandatory effective date for compliance to January 1, 1998, to give the nation's more than 22,500 new-car dealerships more time to install and test the computer software used to produce the disclosures.

TILA and RESPA Rules

During 1997 the Board and HUD studied ways to improve the disclosures about home mortgage transactions given to consumers under the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA). In 1996 the Congress required the two agencies to simplify and improve the disclosures if possible and to create a single format for use in complying with both laws. In December 1996, the agencies jointly published an advance notice of proposed rulemaking, seeking comment on regulatory and legislative changes that might achieve those goals.

Following a review of the comments and an analysis conducted by the Board and HUD, the Board in March 1997 published a finding that, to achieve the goals set forth in the amendments, legislative rather than regulatory changes would be necessary. The Board invited public comment on possible statutory changes to TILA and received numerous letters from individual consumers. Consumers' primary concern was that disclosures about mortgage costs be given earlier in the process than they are now, so that they can use the disclosures to comparison shop before applying for a loan from a particular lender. Consumers also want the cost disclosures to be as accurate as possible, so that they will not face unexpected charges at loan closing, when they no longer have the flexibility to seek other financing.

In July, the Board and HUD testified before the Senate Banking Committee on ways to improve the disclosures and outlined their plans to develop legislative recommendations. Also in July, the Board and HUD held a public forum to hear views on major issues raised by reform efforts. The participants, who included consumer advocates, officials of state agencies, and trade associations representing lenders, mortgage brokers, and providers of settlement services, discussed the goals of TILA and RESPA and considered whether significant improvement can be made to the existing statutes or whether more comprehensive reform is needed. They talked about whether lenders should guarantee rates and other costs at the time of application. They also discussed preliminary findings from survey data on consumer credit shopping presented by the Board indicating that although many consumers rely on the annual percentage rate—the APR—when selecting a loan, few understand the measure's mathematical significance.

and examination schedules; at year-end, work was under way to create a centralized interagency database of CRA ratings.

At year-end, the Board and HUD were preparing a report and recommendations on disclosures about home mortgage transactions, targeted for delivery to the Congress in 1998.

Other Regulatory Matters

Regulation B (Equal Credit Opportunity)

During 1997 the Board and HUD developed rules to govern “self tests” under the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. (The two agencies were directed by amendments to the statutes to issue “substantially similar” rules.) In December 1996 the Board published a proposal to allow a creditor that voluntarily conducts a self-test of its operations to keep the results confidential under a legal “privilege.” The privilege serves as an incentive to do self-testing by ensuring that any evidence of discrimination produced by a self-test conducted voluntarily will not be used against the creditor, provided the creditor takes appropriate corrective measures for any discrimination that is found.

The primary issue addressed in the rulemaking process was whether to define “self test” narrowly or broadly; the Board used a narrow definition in the proposal but solicited public comment on a broader definition.

The Board’s final rule, published in December 1997, adopted the narrow definition. It defines a self-test as any program, practice, or study designed and used specifically to determine the extent or effectiveness of a creditor’s compliance with the ECOA by creating data or other factual information that is not available and cannot be derived from loan or application files or other records related to credit transactions. It applies

to the practice of using fictitious applicants for credit (“testers”) but does not apply to creditor reviews and evaluations of loan and application files. (HUD published a similar rule to revise regulations implementing the Fair Housing Act.)

Regulation C (Home Mortgage Disclosure)

The Congress in 1996 raised the asset threshold for coverage of depository institutions under the Home Mortgage Disclosure Act (HMDA) from \$10 million, setting a standard based on the consumer price index for urban wage earners and clerical workers (the CPIW); it left unchanged the asset measure for nondepository institutions. To implement this amendment, the Board in January 1997 published an interim rule making an initial adjustment to the asset threshold—to \$28 million—on the basis of the change in the CPIW between 1975 and year-end 1996. The Board made the rule final in May. It will make future changes using the annual average of the CPIW for the twelve-month period ending in November, a schedule that will allow publication by December of any change in the threshold for the coming year.

The rule made final in May also establishes, pursuant to statutory changes, an alternative way for institutions to make HMDA disclosure statements available for public inspection. An institution must make a complete copy of its disclosure statement available to the public at its home office. For branch offices located in other metropolitan areas, it previously had to make disclosures available at one office in each area within ten calendar days; now it has the option of posting a notice informing the public that disclosures will be provided

on request (and indicating the address to which requests should be sent).

In December, the Board adjusted the asset threshold to \$29 million for data collection in 1998.

Regulation E (Electronic Fund Transfers)

In January 1997, the Board published a proposal to revise Regulation E to implement amendments to the Electronic Fund Transfer Act (EFTA) included in the Personal Responsibility and Work Opportunity Reconciliation Act of 1996. The amendments exempt from coverage “needs tested” electronic benefit transfer (EBT) programs established by or administered by state or local governments, including those for the disbursement of food stamps and cash assistance to needy families.

Federally administered programs—as well as pension and other employment-related EBT programs established by state or local governments—remain subject to Regulation E’s special rules for government programs. Compliance with these special rules, which the Board adopted in 1994, became mandatory on March 1, 1997.

In March the Board submitted to the Congress, as required by the Economic Growth and Regulatory Paperwork Reduction Act of 1996, a report on the possible costs and consumer benefits resulting from application of the EFTA to electronic stored-value products. The report considered several alternative approaches, including allowing competition in the market to determine which consumer protections are provided for a given electronic stored-value product. Among the sources of information used for the analysis were comments submitted to the Board in response to its 1996 proposal to extend the disclosure provi-

sions of Regulation E to some electronic stored-value products.

The report noted that even minimal regulation (such as requiring only initial disclosures) could affect the development of electronic stored-value products if the incremental costs of complying with the regulation were large or if they differed from one product to the next. Because experience with electronic stored-value products to date is limited, the report concluded that it would be difficult to predict whether the benefits to consumers from any particular regulatory provision would outweigh the corresponding costs of compliance. The report did not endorse or recommend any specific course of action at this time.

Regulation Z (Truth in Lending)

In January the Board published proposed revisions to Regulation Z to carry out changes to the Truth in Lending Act enacted by the Congress in 1996. The amendments apply to variable-rate loans having a term of more than one year that are secured by the consumer’s principal dwelling. Previously, creditors had to give a fifteen-year historical example of index values related to the interest rate. Now they have the option of providing a statement that the periodic payment may increase or decrease substantially, together with the disclosure of a maximum interest rate and a corresponding payment based on a \$10,000 loan amount. The Board adopted a final rule in November.

In June the Board held public hearings in Los Angeles, Atlanta, and Washington, D.C., to determine how well the Home Ownership Equity Protection Act (HOEPA) is working. The HOEPA provisions of Truth in Lending apply to loans secured by the homeowner’s prin-

cial dwelling if the interest rate or closing costs exceed certain levels. The law seeks to protect against abusive mortgage lending practices that target the elderly and the unsophisticated. The act requires credit disclosures, beyond those normally given, three days before a homeowner becomes obligated on a loan.

The Board heard a wide range of views. Lenders criticized the complexity of HOEPA's coverage tests and suggested simplifying the rules about which fees count toward the closing costs threshold (and raising the rate and fee thresholds to keep the same level of coverage). They also expressed concern about having to give new disclosures to correct even a small error, because doing so triggers a new three-day waiting period before funds can be disbursed. Consumer advocates asked for a more effective enforcement tool to address continuing abuses and also favored a prohibition on practices that they say place homes at risk of foreclosure, such as loans to borrowers who have high debt-to-income ratios and repeated refinancings (loan flipping) that add fees on top of fees.

Although the June hearings were devoted primarily to home equity lending, the Board also used them to explore other issues that it must consider in the future, including issues related to how Truth in Lending's finance charge disclosure could more accurately reflect the cost of consumer credit.

Actions under the Fair Credit Reporting Act

In March the Board submitted to the Congress a report concerning the availability and use of sensitive identifying information about consumers, such as their social security numbers. The report, required by amendments to the

Fair Credit Reporting Act adopted in 1996, addresses the potential use of such information to commit financial fraud and the corresponding risk of loss to insured depository institutions.

The Board found that information about consumers is widely available from both government and commercial sources and that few legal constraints limit its collection, use, or dissemination. Some of the information is sensitive and can be used to facilitate unlawful activities, such as "identity theft" involving the illegal use of personal data to commit financial fraud. Losses from identity theft do not seem to present a significant risk to insured depository institutions at this time. Nonetheless, the report notes, this type of fraud is a growing risk to consumers and financial institutions, and relatively easy access to personal information may increase the risk. The report suggests steps that consumers and financial institutions could take to reduce the likelihood of fraud, but it makes no recommendations for legislative or administrative action.

In July the Board published for comment proposed amendments to the model forms in Regulation B related to consumer rights under the Fair Credit Reporting Act. The proposal relates to the disclosures that consumers must be given when they are denied credit on the basis of information obtained from a consumer reporting agency or from an affiliate of the creditor. Final action was pending at year-end.

Interpretations

In February the Board revised the official staff commentary to Regulation Z (Truth in Lending). The update gives guidance about new tolerances for the disclosure of finance charges and other matters in connection with home-secured installment loans.

In March the Board revised the official staff commentary to Regulation M (Consumer Leasing). The update offers guidance for compliance with Regulation M as revised by the Board in September 1996.

HMDA Data and Lending Patterns

The Home Mortgage Disclosure Act requires that mortgage lenders covered by the act collect and make public certain data about their home purchase, home improvement, and refinancing loan transactions. Depository institutions generally are covered if they were located in metropolitan areas and had assets above a certain threshold at the preceding year-end; mortgage companies are covered if they were located in or made loans in metropolitan areas and had assets of more than \$10 million at the preceding year-end (when combined with the assets of any parent company), and are also covered, regardless of asset size, if they originated 100 or more home purchase loans in the preceding year.² In 1997, 8,367 depository institutions and affiliated mortgage companies and 961 independent mortgage companies reported HMDA data for calendar year 1996.

Lenders covered by HMDA submit information about the geographic location of the properties related to their loans and applications, the disposition of loan applications, and, in most cases, the race or national origin, income, and sex of applicants and borrowers. The Federal Reserve Board processes the data and produces disclosure statements

on behalf of HUD and the member agencies of the Federal Financial Institutions Examination Council.³

The FFIEC prepares individual disclosure statements for lenders that reported data—one statement for each metropolitan area in which a lender had offices and reported loan activity. The 42,936 statements produced from the 1996 data cover 14.8 million loans and applications; the 32 percent increase in loans and applications over 1995 is largely attributable to a sharp increase in refinancing activity.⁴ In July, each institution made its disclosure statements public; and in August, reports containing aggregate data for all lenders in a given metropolitan area were made available at central depositories in the nation's 332 metropolitan areas.

Lending institutions tend to specialize in different types of home loans. In 1996, depository institutions continued to be the predominant source of home improvement loans and loans for multi-family residences. Mortgage companies accounted for about 52 percent of the conventional home purchase loans reported under HMDA and about 80 percent of the government-backed home purchase loans.

Mortgage originators and institutions in the secondary market for mortgages, such as Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation), offer a variety of conventional home loan programs, often in concert with private mortgage

3. The member agencies of the FFIEC are the Board, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

4. A summary of the 1996 HMDA data appears in a series of special tables in the *Federal Reserve Bulletin*, vol. 83, no. 9 (September 1997), pp. A68–A75.

2. Through 1996, the asset threshold for depository institutions was \$10 million. In September 1996, the Congress amended HMDA to raise the asset threshold according to changes in the CPIW. See "Other Regulatory Matters" above.

insurers, to benefit low-income and minority households and neighborhoods. In recent years, these institutions have expanded their program offerings, which may account for the continuing increase in loans to these homebuyers. From 1993 to 1996 the number of conventional home purchase loans to low-income borrowers increased 37 percent, compared with 23 percent for high-income borrowers.

The Federal Housing Administration (FHA) also has adopted measures to enhance borrowing opportunities for low-income households; at the same time, it has worked to make FHA loans more competitive. The agency has lowered its insurance premiums, increased flexibility in its underwriting standards, and raised the maximum size of the loans that it will back. Between 1993 and 1996 the number of government-backed home purchase loans (predominantly FHA-insured) increased 19 percent for low-income borrowers, compared with 5 percent for high-income borrowers.

Lending Patterns

Home purchase lending to minority homebuyers has increased markedly in recent years: From 1993 to 1996 the number of home purchase loans extended to black applicants increased 53 percent, to Hispanic applicants 56 percent, and to Asian applicants 15 percent—compared with 14 percent for white applicants. However, the growth of lending to blacks slowed in 1996 and was less than the national average. The slower growth may have been due in part to the relatively weaker housing markets in that year in states that have relatively large black populations, principally some states in the mid-Atlantic region and a number of southern states.

The 1996 HMDA data continue to show higher rates of credit denial for conventional home purchase loans for black and Hispanic applicants than for Asian and white applicants, even within the same income brackets. Overall denial rates for conventional home purchase loans were 49 percent for black applicants, 34 percent for Hispanic applicants, 14 percent for Asian applicants, and 24 percent for white applicants. All these rates were higher than in 1993, 1994, and 1995.⁵

The increase in denial rates over time stems in part from changes in the home lending market. First, the number of applications submitted to “subprime” lenders and to institutions that extend loans for the purchase of manufactured homes has increased substantially. These lenders’ denial rates are quite high (about 55 percent on average, compared with about 13 percent for other lenders), and their increasing share of all applications for conventional home purchase loans (25 percent in 1996 compared with 11 percent in 1993) results in higher overall denial rates. Second, applications by low-income households constitute an increasing share of all applications. Because low-income households tend to have relatively high denial rates, overall denial rates also tend to rise. Finally, the incidence of multiple applications has increased over time. Applicants who submit applications to more than one prospective lender have high denial rates, and their growth in the pool of all applicants also tends to raise overall denial rates.

The data collected under HMDA do not include the wide range of financial and property-related factors that lenders consider in evaluating loan

5. For details, see the Special Tables section in the September issue of the *Federal Reserve Bulletin* for 1995 and subsequent years.

applicants. Thus, the HMDA data alone do not provide an adequate basis for determining whether a particular lender is discriminating unlawfully. But because they can be supplemented by other information available to lenders' supervisory agencies, the data are an important tool in the enforcement of fair lending laws.

Use of Data by Other Agencies

Lenders who sell their loans in the secondary market are required under HMDA to identify the category of purchaser (for example, Fannie Mae or Freddie Mac). The information helps make it possible to assess the relative performance of institutions in serving the credit needs of lower-income and minority homebuyers.⁶

In its oversight of the housing activities of government-sponsored entities, HUD uses the HMDA data to help assess the efforts of Fannie Mae and Freddie Mac to support mortgages for low- and moderate-income families and mortgages on properties in targeted communities. The data also serve as one component of the fair lending reviews conducted by HUD and the Department of Justice. In addition, the data assist HUD, the Department of Justice, and state and local agencies in responding to allegations of lending discrimination filed by loan applicants and borrowers and assist in the agencies' targeting of lenders for further inquiry.

6. See, for example, the discussion of which institutions bear the credit risk of mortgages extended to lower-income and minority homebuyers in Glenn B. Canner, Wayne Passmore, and Brian J. Surette, "Distribution of Credit Risk among Providers of Mortgages to Lower-Income and Minority Homebuyers," *Federal Reserve Bulletin*, vol. 82 (December 1996), pp. 1077-1102.

Private Mortgage Insurance

The FFIEC, on behalf of the nation's eight active private mortgage insurance (PMI) companies, compiles information on applications for private mortgage insurance similar to the information on home mortgage lending collected under HMDA. Lenders typically require private mortgage insurance for conventional mortgages that involve small down payments.

Working through their national trade association, the Mortgage Insurance Companies of America, the PMI companies submit their data to the FFIEC on a voluntary basis. The FFIEC prepares disclosure statements for each company and aggregate reports for metropolitan areas. These reports are available for public review at the central depositories at which the HMDA data are available.⁷

Fair Lending

Under the Equal Credit Opportunity Act, the Board is required to refer to the Department of Justice any violations that it has reason to believe constitute a "pattern or practice" of unlawful discrimination. The Board made four such referrals during 1997. Two of the cases involved discrimination on the basis of marital status, and a third, discrimination on the basis of age. The three matters were returned to the Board for enforcement.

The fourth case, which was still under consideration by the Department of Justice at the close of 1997, involved a determination that a lender had apparently engaged in discriminatory "redlining" in residential loans, in violation of

7. A summary of the 1996 PMI data appears in a series of special tables in the *Federal Reserve Bulletin*, vol. 83, no. 9 (September 1997), pp. A76-A79.

both the ECOA and the Fair Housing Act. The alleged redlining occurred when the lender, which brokered loans for another institution, honored the practice of that institution to refrain from taking applications from persons residing in designated urban areas. The Board's examination had demonstrated that those urban areas had significantly higher percentages of minority residents than the remainder of the institution's market area and that the lender appeared to have no nondiscriminatory explanation for adhering to the institution's redlining policy.

Community Development

The Federal Reserve System, through its Community Affairs programs at the Board and the Reserve Banks, engages in ongoing outreach, informational, and educational activities to help financial institutions and the public understand and address financial services issues affecting low- and moderate-income persons.

In 1997, six Reserve Banks—Boston, New York, Cleveland, St. Louis, Chicago, and San Francisco—reached the final stages of their Residential Mortgage projects following a two-year initiative in selected cities to help identify and address barriers to equal access to credit in the homebuying process. In earlier stages, the Reserve Banks had brought together community representatives and key industry participants in the homebuying process to discuss problems that affect minority and lower-income homebuyers and to forge solutions. Task groups reported their findings during 1997. Implementation of their recommendations by community and industry groups, separately and in joint efforts, is expected to improve equal access to credit over the long term in the cities studied.

Although community development, reinvestment, and fair lending continued to be central to Community Affairs educational and technical assistance activities, 1997 was marked by a broader approach to the economic issues confronting low- and moderate-income communities. The New York Reserve Bank, for example, sponsored a conference on welfare reform and its implications for lower-income communities. The Minneapolis Reserve Bank helped organize focus groups to discuss the possible effects of increased use of electronic banking services on low- and moderate-income residents.

The development and sponsorship of educational activities remained a major undertaking of the Federal Reserve's Community Affairs programs in 1997. Overall, the Reserve Banks sponsored or cosponsored 233 conferences, seminars, and informational meetings on community development, reinvestment, and fair lending topics. The programs were attended by more than 11,600 bankers, bank examiners, and representatives of small businesses and community and consumer groups. Additionally, staff members from the Board and the Reserve Banks made more than 275 presentations at conferences, seminars, and meetings sponsored by banking, governmental, business, and community organizations.

Programs in 1997 reflected a growing concern with issues related to small business finance and economic development. The Cleveland Reserve Bank, working with the U.S. Small Business Administration and the National Council for Smaller Enterprises, spearheaded an "Access to Capital" initiative for the Cleveland area. The initiative will bring together business leaders to review the credit process, identify possible barriers faced by small firms, and make recommendations for improving these firms'

access to financing. The Boston and San Francisco Reserve Banks sponsored conferences and workshops on the financing and technical assistance needs of women-owned businesses. The Dallas Reserve Bank sponsored a symposium on financing for very small firms—"microenterprises"—and the Boston Reserve Bank helped create a training curriculum on microenterprise development.

Economic development in rural areas and on Indian reservations was the focus of educational forums at several Reserve Banks. The Chicago Reserve Bank sponsored a conference on rural community economic development, and the Minneapolis Reserve Bank sponsored a workshop on women's access to credit and capital in rural areas and on Indian reservations. The Kansas City and Minneapolis Reserve Banks worked with the Montana-Wyoming Tribal Leaders Council and the University of Montana Law School to cosponsor a conference on building tribal infrastructure to support economic prosperity.

In 1997 the Community Affairs programs developed or expanded a variety of publications and other informational resources directed at bankers, small businesses, and community organizations. The Minneapolis Reserve Bank published a revised and expanded second edition of *Principles and Practices for Community Development Lending*, and the Richmond Reserve Bank published a special *Marketwise Report* on "Community-Based Development." The Reserve Banks published a combined total of thirteen different community affairs newsletters dealing with various aspects of community and economic development, reinvestment, and fair lending. The combined circulation of these newsletters in 1997 grew to more than 73,000, including bankers, small-business owners, representatives

of community-based development and consumer groups, and housing, community, and economic development officials.

Outreach and technical assistance to banks—and to community representatives interested in bank involvement in reinvestment and community development initiatives—continued to play a major role in Community Affairs programs in 1997. Members of the Community Affairs staffs at the Board and the Reserve Banks conducted more than 1,600 outreach meetings with representatives of financial institutions and local communities to explore community credit needs and issues related to the provision of financial services.

In conjunction with their outreach efforts, several Reserve Banks develop, for selected communities, profiles that identify key community and economic development needs and describe some organizations that can serve as resources. These profiles are made available to banks and to community and business organizations, and they often help stimulate collaborative approaches to community reinvestment. During 1997, the New York Reserve Bank published profiles for Westchester County in New York and for Bergen and Passaic Counties in New Jersey, and the Chicago Reserve Bank published a profile for the metropolitan area of Saginaw-Bay City-Midland in Michigan.

The St. Louis Reserve Bank developed a profile for the Springfield, Missouri, metropolitan area and worked with the Dallas Reserve Bank on a profile of the Texarkana metropolitan area. The Richmond Reserve Bank developed a profile of the tricounty area surrounding Petersburg, Virginia.

The San Francisco Reserve Bank developed profiles for the states of Utah, Idaho, and Washington and the cities of Portland, San Diego, Los Angeles,

Sacramento, San Francisco, San Jose, Las Vegas, and Phoenix. Each profile, about sixty pages long, gives an overview of the economic and demographic characteristics of the area and includes a directory of community and government organizations, programs of interest to bankers, and lending, service, and investment opportunities for financial institutions.

The Atlanta Reserve Bank completed work on a community contacts database designed to facilitate accessibility and greater use of outreach information. The database has been adopted for use by several other Reserve Banks, and the database design has been adopted by the FFIEC to facilitate interagency sharing of community contact information for use in assessments of CRA performance.

In 1997, the Board helped organize the first formal interagency meeting of Community Affairs representatives of the federal supervisory agencies. Participants exchanged information on their agencies' community affairs programs, discussed community development and reinvestment issues, and explored ways in which the agencies might coordinate their activities.

Community Affairs programs continued in 1997 to provide support as the Federal Reserve carried out its supervisory responsibilities. Board and Reserve Bank staff members helped to review proposals regarding community development investment by banks and bank holding companies and to analyze HMDA and CRA data on small-business lending for use in community affairs research and publications; and in conducting CRA examinations, Reserve Bank examiners increasingly made use of community contacts and other information provided by Community Affairs staff members.

Finally, Board and Reserve Bank staff members provided considerable support to members of the Board of Governors and to Reserve Bank presidents, who in 1997 gave increased attention to community development, reinvestment, fair lending, and consumer credit issues. Members of the Board made speeches at conferences and meetings of community, consumer, and civil rights groups and toured lower-income neighborhoods and community development projects in Reserve Bank cities. A member of the Board continued to serve on the board of directors of the Neighborhood Reinvestment Corporation. Activity by the Subcommittee on Community Affairs of the System's Conference of Presidents also increased.

Economic Effects of the Electronic Fund Transfer Act

In keeping with statutory requirements, the Board monitors the effects of the Electronic Fund Transfer Act on the compliance costs and consumer benefits related to electronic fund transfer services. In 1997 the economic effects of the act generally increased because of continued growth in the use of EFT services, although an exemption for certain electronic benefit transfer programs reduced costs for state and local governments.

As revised in 1997, Regulation E exempts "needs tested" EBT programs established or administered by state or local governments. The exemption reduces the cost of providing benefits electronically and eliminates uncertainty about potential losses associated with Regulation E's liability rules. Thus, it will likely encourage the states to develop EBT programs. Without Regulation E, the protections previously afforded benefit recipients, especially

protections against unauthorized use, may be diminished somewhat. However, electronic delivery will likely provide benefit recipients greater security than the paper-based delivery systems previously used.

During the 1990s, the proportion of U.S. households using EFT services has grown at an annual rate of about 2 percent. About 85 percent of households now have one or more EFT features on their accounts at financial institutions.

Automated teller machines remain the most widely used EFT service. Nearly two-thirds of all U.S. households currently have ATM cards, and most of the nation's depository institutions offer consumers access to ATMs. Access to ATMs has been enhanced by the operation of shared networks; almost all ATM terminals are part of one or more shared networks. Over the past year, the number of ATM transactions increased about 3 percent, from 890.3 million per month in 1996 to 915.0 million per month in 1997. Over the same period, the number of installed ATMs rose 19 percent, to 165,000.

Direct deposit is another widely used EFT service. More than half of all households in the United States receive direct deposit of funds into their accounts. Direct deposit is particularly widespread in the public sector, accounting for more than half of social security payments and two-thirds of federal salary and retirement payments. It is less common in the private sector but has grown substantially in recent years. Taking into account both public and private payments, the proportion of households receiving direct deposits has grown about 5 percent a year during the 1990s.

Nearly a third of households now have debit cards, which consumers use at the point of sale to debit their transaction accounts. Point-of-sale systems still

account for a small share of electronic transactions, but their use continued to grow rapidly in 1997. Over the past year, the number of point-of-sale transactions rose 26 percent, to 120.2 million per month from 95.5 million per month in 1996, and the number of point-of-sale terminals rose 49 percent, to 1.3 million.

The incremental costs associated with the EFTA are difficult to quantify because no one knows how industry practices would have evolved in the absence of statutory requirements. The benefits of the law are also difficult to measure because they cannot be isolated from consumer protections that would have been provided in the absence of regulation.

The available evidence suggests no serious consumer problems with electronic transactions at this time. In 1997, about 94 percent of depository institutions examined by federal banking agencies were in full compliance with Regulation E. Violations primarily involved failure to provide all the required consumer disclosures. Consumer complaints and inquiries filed with the System are another source of information about potential problems. In 1997, 114 of the complaints processed involved electronic transactions; of the 52 that involved state member banks, none involved a violation of the EFTA or Regulation E. The 62 complaints that did not involve state member banks were forwarded to other agencies for resolution.

Compliance Examinations

Since 1977 the Federal Reserve System has maintained a consumer compliance examination program to ensure that state member banks and foreign banking organizations subject to Federal Reserve examination comply with federal laws

governing consumer protections in financial services.

The Oversight Section of the Board's Division of Consumer and Community Affairs coordinates compliance examinations, which are conducted by the consumer affairs examination units of the twelve Reserve Banks. The section reviews a sample of the examinations for effectiveness, adherence to System policy, and uniformity of approach.

During the 1997 reporting period (July 1, 1996, through June 30, 1997), the Federal Reserve conducted 839 examinations for compliance with consumer protection laws: 599 of state member banks and 240 of foreign banking organizations.⁸

Examiner training in the areas of consumer compliance, fair lending, and the Community Reinvestment Act is an important aspect of the Federal Reserve's compliance program. New Reserve Bank examiners attend a two-week basic consumer compliance school, and examiners with six to twelve months of field experience attend a two-week advanced consumer compliance school, a two-week fair lending school, and a one-week course in CRA examination techniques. During the 1997 reporting period, the System conducted three basic consumer compliance schools for a total of fifty-nine participants, two advanced consumer compliance schools for thirty-two participants, three fair lending schools for fifty-three

participants, and three courses in CRA examination techniques for sixty-six participants.

The Reserve Banks supplement examiner training through departmental meetings and special training sessions. In addition, examiners from the Reserve Banks routinely participate in special projects that give them an opportunity to widen their perspective through working with other System examiners and Board staff.

During 1997, the Board and the FDIC entered into a memorandum of understanding to jointly develop an examiner-workstation module to provide automated assistance in three areas of compliance examinations: loans, deposit operations, and home mortgage disclosures. The goals of this joint effort are to increase consistency in examinations, to reduce the time examiners spend on site, and to provide tools that decrease the time examiners spend entering data needed for examinations.

The FFIEC is the interagency coordinating body charged with developing uniform examination principles, standards, and report forms. In 1997, the member agencies of the FFIEC jointly revised examination procedures to reflect changes in consumer protection laws and regulations, including the Flood Disaster Protection Act, the Truth in Lending Act, the Fair Debt Collection Practices Act, the Real Estate Settlement Procedures Act, and the Electronic Fund Transfer Act.

In addition, the FFIEC worked to promote consistency in examinations among the agencies responsible for implementing the CRA. Examiners from the Board, the FDIC, the OCC, and the OTS reviewed the examination process for small institutions, and the agencies implemented some of their recommendations for revising examination procedures and the public evaluation format.

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

To foster consistency in the application of the examination procedures for large institutions, the agencies held three interagency training sessions under the auspices of the FFIEC. The agencies are also reviewing the implementation of the procedures for examining institutions under the lending, investment, and service tests by reviewing the written performance evaluations and conducting interagency examinations of eight large institutions. They expect to provide examiner training on the basis of their findings and to provide interpretive guidance on issues identified through the project.

The FFIEC expanded its CRA Web site to make information on CRA more readily available to the public. The site now includes the CRA regulation; an interagency question-and-answer document; examination procedures; interpretive letters; CRA data collected from large institutions; and links to each member agency's CRA Web site for information on CRA ratings, examination schedules, and performance evaluations.

Community Reinvestment Act

The Federal Reserve assesses the CRA performance of state member banks during regular compliance examinations and takes the CRA record (as well as other factors) into account when acting on applications from state member banks and from bank holding companies.

The Federal Reserve System has a three-faceted program for fostering and enforcing better bank performance under the CRA:

- Examining institutions to assess compliance
- Disseminating information on community development techniques to

bankers and the public through community affairs offices at the Reserve Banks

- Performing CRA analyses in connection with applications from banks and bank holding companies.

During the 1997 reporting period (July 1, 1996–June 30, 1997), the Federal Reserve conducted 586 CRA examinations. Of the banks examined, 152 were rated “outstanding” in meeting community credit needs, 423 were rated “satisfactory,” 10 were rated “needs to improve,” and 1 was rated as being in “substantial noncompliance.”

Regulation BB, as revised in 1995, provides for different evaluation methods depending on an institution's size, structure, and operations. The performance standards for small banks became effective on January 1, 1996. Also as of that date, institutions could choose whether (1) to submit a strategic plan to serve as a basis for their evaluations, (2) to be evaluated under the lending, investment, and service tests if they were large institutions, or (3) to request to be designated wholesale or limited purpose institutions and be examined under the regulation's community development test. Using the lending, service, and investment tests for large retail institutions was mandatory after July 1, 1997, meaning that they could no longer be evaluated under the earlier regulation. Of the 586 CRA examinations conducted by the Federal Reserve during the reporting period, 460 used the new assessment method for small banks; 86 used the assessment-factor method of the earlier regulation; 39 used the lending, investment, and service tests; and 1 used the community development test. During the 1997 reporting period, the Board also approved one bank's strategic plan and approved four banks'

requests to be designated wholesale institutions.

Agency Reports on Compliance with Consumer Regulations

The Board is required to report annually on compliance with the regulations that implement the Equal Credit Opportunity Act, the Electronic Fund Transfer Act, the Consumer Leasing Act, the Truth in Lending Act, and the Expedited Funds Availability Act and with the prohibition in Regulation AA against unfair and deceptive practices. For purposes of this report, the Board assembles data from the Reserve Banks and collects data from the four other financial regulatory agencies (the FDIC, the OCC, the OTS, and the NCUA) and from other federal supervisory agencies.⁹ The extent of compliance with these regulations varied widely in 1997, but, overall, compliance was better than in 1996. The following sections summarize compliance data for July 1, 1996, through June 30, 1997 (referred to here as the 1997 reporting period, or simply 1997).

Equal Credit Opportunity Act (Regulation B)

The five financial regulatory agencies reported that 80 percent of the institutions examined during the 1997 reporting period were in full compliance with Regulation B, compared with 78 percent for the 1996 reporting period. Of the institutions not in full compliance, 71 percent had one to five violations (the lowest frequency category). The most frequent violations involved the

failure to take one or more of the following actions:

- Provide a written notice of adverse action containing a statement of the action taken, the name and address of the creditor, an ECOA notice, and the name and address of the federal agency that enforces compliance
- For monitoring purposes, collect information about the race or national origin, sex, marital status, and age of applicants seeking credit primarily for the purchase or refinancing of a principal residence
- Notify an applicant of the action taken within the time frames specified in the regulation
- Give a statement of reasons for adverse action that is specific and indicates the principal reasons for the credit denial or other adverse action
- Take a written credit application for the purchase or refinancing of a principal residence
- Retain proper records of credit transactions.

The OTS issued three formal enforcement actions addressing violations of Regulation B, and the FDIC issued two formal enforcement actions addressing violations of consumer protection regulations, including Regulation B.

In 1997, the Federal Trade Commission (FTC) obtained consent decrees against two consumer finance companies for violations of the ECOA. In one case, the decree addressed allegations that the finance company discriminated against applicants on the basis of age and the fact that their income derived from public assistance. In the other case, the finance company failed to provide applicants who were denied credit a written notice of adverse action. The FTC is continuing its work with other government agencies and with creditor

9. The financial regulatory agencies use different methods to compile data on compliance, which are presented here in terms of percentages of financial institutions supervised or examined. Consequently, the data support only general conclusions.

and consumer organizations to increase awareness of, and compliance with, the ECOA.

The other agencies that enforce the ECOA—the Farm Credit Administration (FCA), the Department of Transportation, the Securities and Exchange Commission (SEC), the Small Business Administration, and the Grain Inspection, Packers and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise. The FCA's examination and enforcement activities revealed certain violations of the ECOA, most of them due to creditors' failure to collect monitoring information and to comply with rules regarding adverse action notices; however, no formal actions were initiated. The SEC reported that no violations of Regulation B were detected during examinations of registered broker-dealers conducted by self-regulatory organizations, the agency's principal method of reviewing for compliance.

Electronic Fund Transfer Act (Regulation E)

The five financial regulatory agencies reported that approximately 94 percent of the institutions examined during the 1997 reporting period were in compliance with Regulation E, the same percentage as in 1996. Financial institutions most frequently failed to comply with the following provisions:

- Provide, at least once each calendar year, a notice of the procedures for resolving alleged errors
- After receiving notice of an error, investigate the alleged error promptly, determine whether an error was actually made, and transmit the results of the investigation and determination to the consumer within ten business days

- Provide an adequate initial disclosure at the time a consumer contracts for an EFT service or before the first transfer is made
- Provide customers with a periodic statement of all required information at least quarterly, or monthly if EFT activity occurred.

The OTS issued one formal enforcement action addressing violations of Regulation E during the 1997 reporting period. The FTC issued a final decision and order that was incorporated into a consent decree, settling charges against a telemarketing company for failing to obtain written authorization from consumers for preauthorized transfers. In addition, the FTC accepted for public comment consent agreements in three cases alleging violations of the EFTA; the cases involved free trial offers that resulted in unexpected charges for many consumers. The FDIC issued two formal enforcement actions addressing violations of consumer protection regulations, including Regulation E.

The SEC reported that no violations of Regulation E were detected during examinations of registered broker-dealers conducted by self-regulatory organizations.

Consumer Leasing Act (Regulation M)

The five financial regulatory agencies reported substantial compliance with Regulation M for the 1997 reporting period. As in 1996, more than 99 percent of the institutions examined were in full compliance with the regulation. The few violations involved failure to adhere to specific disclosure requirements.

In 1997 the FTC issued five final decisions and orders against major automobile manufacturers to address violations of the Consumer Leasing Act

(CLA) and the Truth in Lending Act (TILA). The orders settled charges that the five companies had violated the CLA in lease promotions that featured low monthly payments or low amounts down in large, bold print but hid additional costs and sometimes contradictory information in “mouse print” that was difficult or impossible to read. The complaints in these cases also charged the companies with violating the CLA by failing to clearly and conspicuously disclose various lease costs and terms as required.

In two other cases, the FTC issued final decisions and orders against automobile dealerships for deceptive credit and lease agreements in violation of the CLA and TILA. The FTC also issued for public comment consent agreements with two major automobile manufacturers, and with five dealerships and their chief executive officers in the St. Louis area, for violations of the CLA and TILA involving misrepresentation and hiding or failing to disclose adequately the terms of advertised automobile lease deals.

In 1997 the FTC continued its education efforts among consumers and businesses and published a new brochure for businesses giving information about the advertising requirements of revised Regulation M.

Truth in Lending Act (Regulation Z)

The five financial regulatory agencies reported that 75 percent of the institutions examined during the 1997 reporting period were in full compliance with Regulation Z, compared with 70 percent in 1996. The Board reported a decrease in compliance, the FDIC and the OTS reported an increase, and the OCC and the NCUA reported an unchanged level of compliance. The five agencies indi-

cated that of the institutions not in compliance, 62 percent were in the lowest-frequency category (one to five violations), compared with 63 percent in 1996.

The violations of Regulation Z most often observed were failure to accurately disclose the finance charge, payment schedule, annual percentage rate, and amount financed and failure to provide a disclosure reflecting the terms of the legal obligation between the parties.

The OTS issued five formal enforcement actions addressing violations of Regulation Z, and the FDIC issued two formal enforcement actions addressing violations of consumer protection regulations, including Regulation Z.

A total of 261 institutions supervised by the Board, the FDIC, or the OTS were required, under the Interagency Enforcement Policy on Regulation Z, to refund \$2.6 million to consumers in 1997 because of improper disclosures.

The Department of Transportation continued during 1997 to prosecute a cease-and-desist consent order issued in 1993 against a travel agency and a charter operator. The complaint alleged that the two organizations had violated Regulation Z by routinely failing to send credit statements for refund requests to credit card issuers within seven days of receiving fully documented credit refund requests from customers. A motion for a summary judgment is pending before an administrative law judge.

The FTC during the year issued two final decisions and orders in cases alleging deceptive disclosures and understated credit terms, including the annual percentage rate, in violation of Regulation Z and TILA. Another final decision and order included civil penalties and consumer redress for alleged violations of a prior FTC order relating to failure to include mandatory credit insurance

and other costs in credit disclosures to consumers. The agency also issued seven final decisions and orders and accepted for public comment consent agreements in seven other cases involving lease and credit advertising. These cases alleged deceptive lease and credit advertising, in violation of the CLA or TILA—specifically, failure to clearly and conspicuously or accurately provide required lease or credit advertising disclosures.

During the year the FTC also continued its consumer and business education efforts through training seminars in several regions of the country.

Expedited Funds Availability Act (Regulation CC)

The five financial regulatory agencies reported that 87 percent of institutions examined during the 1997 reporting period were in full compliance with Regulation CC, the same percentage as in 1996. Of the institutions not in full compliance, 66 percent had one to five violations (the lowest-frequency category). Institutions most frequently failed to comply with the following provisions:

- Follow special procedures for large deposits
- Adequately train employees and provide procedures to ensure compliance
- For deposits not subject to next-day availability, provide immediate availability to \$100
- Make funds from certain checks, both local and nonlocal, available for withdrawal within the times prescribed by the regulation
- Provide disclosures of the institution's availability policy.

The OTS issued two formal enforcement actions addressing violations of Regulation CC, and the FDIC issued

two formal enforcement actions addressing violations of consumer protection regulations, including Regulation CC.

Unfair and Deceptive Acts or Practices (Regulation AA)

The three financial regulatory agencies with responsibility for enforcing Regulation AA's Credit Practices Rule reported that 97 percent of the institutions examined during the 1997 reporting period were in full compliance with the regulation. The most frequent violation was failure to provide a clear, conspicuous disclosure regarding a cosigner's liability. No formal enforcement actions for violations of Regulation AA were issued during the period.

Applications

In February, the Board adopted amendments to Regulation Y (Bank Holding Companies and Change in Bank Control) that streamlined the applications process for mergers and acquisitions. Bank acquisition proposals from well-capitalized and well-managed bank holding companies having "satisfactory" or better CRA examination records are now eligible for consideration using an expedited review process. Also, comments submitted after the close of the public comment period are no longer routinely considered by the System.

In 1997 the Federal Reserve System acted on twenty-four bank and bank holding company applications that involved CRA protests and six that involved adverse CRA ratings. The System reviewed another twenty applications involving fair lending and other issues related to compliance with con-

sumer protection laws.¹⁰ Among the applications processed were several related to major bank acquisitions that were protested on CRA grounds. The Board approved these applications, finding in each case that convenience and needs considerations, including CRA performance records, were consistent with approval, as described below.

In February, the Board approved the application by Marine Midland Bank (Buffalo) to merge with First Federal Savings and Loan of Rochester (Rochester). Commenters expressed concern that the closing of certain branches operated by the two companies would adversely affect low- and moderate-income neighborhoods. In its order approving the application, the Board directed Marine Midland to submit its plan for branch closures, consolidations, and relocations to the New York Reserve Bank. For each branch being closed in a low- or moderate-income or predominantly minority census tract, Marine Midland will indicate how it plans to help meet the convenience and needs of the affected community. Marine Midland will also notify the Reserve Bank of any changes to the plan for a period of two years or until the Reserve Bank conducts its next CRA performance examination.

In April, the Board approved the application of Banc One Corporation (Columbus), at that time the nation's tenth largest banking organization, to acquire Liberty Bancorp, Inc. (Oklahoma City). The order noted that each of Banc One's thirty subsidiary banks had received "outstanding" or "satis-

factory" ratings at their most recent CRA examinations. The Board also considered certain preliminary information developed in the course of its supervision of Banc One that raised questions about fair lending oversight, procedures, and practices at Banc One Mortgage Corporation, a nonbank subsidiary of the bank holding company. In its order, the Board noted that the Federal Reserve was conducting an examination of Banc One Mortgage Corporation to resolve these issues and to ensure compliance with the law. If the examination were to reveal a problem, the Board has the supervisory authority to require the bank holding company and the nonbank subsidiary to address the deficiencies.

In October, the Board approved the application by First Union Corporation (Charlotte), the nation's sixth largest banking organization, to acquire Signet Banking Corporation (Richmond). The two organizations competed directly in Virginia, Maryland, and the District of Columbia, and some commenters expressed concern that branch closings resulting from the merger would disproportionately disadvantage communities with predominantly low- and moderate-income and minority residents. In light of these concerns, the Board reviewed preliminary, confidential information from First Union on branches slated for closure as well as the company's branch closure policy. The Board also reviewed the OCC's most recent publicly available CRA performance evaluations for First Union's subsidiary banks; these reports indicated that the banks have satisfactory records of opening and closing branches and that they provide reasonable access to services for all segments of their communities. In addition, the Board reviewed data on First Union's lending record in its communities and in low- and moderate-income

10. Two applications were withdrawn in 1997—one involving an adverse CRA rating and the other, a fair lending issue. The System also reviewed comments submitted in three other cases (not reflected in the above figures) that were deemed to be more in the nature of individual consumer complaints than protests.

areas. The Board concluded that convenience and needs considerations, including CRA performance records, were consistent with approval.

In December, the Board approved the application by NationsBank Corporation (Charlotte), the nation's fifth largest banking organization, to acquire Barnett Banks, Inc. (Jacksonville). The two organizations competed directly in a large number of banking markets in Florida, as well as in a few markets in Georgia. Several commenters expressed concern that branch closures resulting from the merger would adversely affect senior citizens and low- and moderate-income neighborhoods and would result in a reduction in community development and home mortgage lending. In its order approving the application, the Board noted that it had considered NationsBank's record of opening and closing branches in other acquisitions, in particular, its acquisition of Boatmen's Bancshares, Inc. (St. Louis), in December 1996. In that case the Board found that, to date, NationsBank had followed its branch closure policy by assessing the effect of closings in low- and moderate-income areas. Given the

extensive overlap of the two organizations' branches in Florida markets, the Board directed NationsBank, as part of any subsequent application to acquire a depository institution, to report to the Federal Reserve its branch closures in Florida and Georgia during the two-year period following its acquisition of Barnett.

Consumer Complaints

The Federal Reserve investigates complaints against state member banks and forwards to the appropriate enforcement agencies complaints involving other creditors and businesses (see accompanying table). The Federal Reserve also monitors and analyzes complaints about unregulated practices.

Complaints about State Member Banks

The Federal Reserve received 3,318 complaints about financial institutions in 1997: 2,673 by mail, 634 by telephone, and 11 in person. Fewer than half of the complaints (1,524) were against state member banks; of these,

Consumer Complaints to the Federal Reserve System Regarding State Member Banks and Other Institutions, by Subject, 1997

Subject	State member banks	Other institutions	Total
Regulation B (Equal Credit Opportunity)	69	39	108
Regulation E (Electronic Fund Transfers)	62	52	114
Regulation Z (Truth in Lending)	194	299	493
Regulation BB (Community Reinvestment)	1	3	4
Regulation CC (Expedited Funds Availability)	30	31	61
Regulation DD (Truth in Savings)	50	44	94
Fair Credit Reporting Act	56	113	169
Fair Debt Collection Practices Act	13	18	31
Flood insurance	2	1	3
Regulations G, T, U and X	0	1	1
Real Estate Settlement Procedures Act	0	13	13
Unregulated practices ¹	1,047	1,180	2,227
Total	1,524	1,794	3,318

1. Complaints against these institutions were referred to the appropriate enforcement agencies.

almost two-thirds involved unregulated practices. Of the complaints against state member banks, about 61 percent concerned lending: 5 percent alleged discrimination on a prohibited basis; and 56 percent raised a variety of issues, most of them involving lending practices, including credit denial on a basis not prohibited by law (such as credit history or length of residence) and miscellaneous other practices (such as release or use of credit information). Another 25 percent of the complaints against state member banks involved disputes about interest on deposits and general deposit account practices; the remaining 14 percent concerned disputes about electronic fund transfers, trust services, and other miscellaneous bank practices (see accompanying table).

The System also received 2,209 inquiries about consumer credit and banking policies and practices. In responding to these inquiries, the Board and the Reserve Banks give specific

explanations of laws, regulations, and banking practices and provide relevant printed materials on consumer issues.

Unregulated Practices

Under section 18(f) of the Federal Trade Commission Act, the Board monitors complaints about banking practices not subject to existing regulations and focuses on complaints involving practices that may be unfair or deceptive. Of the 2,227 complaints about unregulated practices, the top five categories related to credit cards: miscellaneous problems involving credit cards (135), interest rates and terms (127), customer service problems (93), pre-approved solicitations (78), and penalty charges on accounts (69). The specific complaints about credit cards represented by these categories concerned such matters as failure to close accounts as requested, increased interest rates on accounts, changed credit terms on pre-approved

Consumer Complaints Received by the Federal Reserve System, by Type and Function, 1997

Complaint	Complaints against state member banks					
	Total		Not investigated		Investigated	
	Number	Percent	Unable to obtain sufficient information	Explanation of law provided to consumer	Bank legally correct	
					No reimbursement or other accommodation	Goodwill reimbursement or other accommodation
Loans						
Discrimination alleged						
Real estate loans	11	1	0	0	1	1
Credit cards	26	2	1	5	12	1
Other loans	32	2	1	2	13	1
Discrimination not alleged						
Real estate loans	70	5	2	4	28	14
Credit cards	617	40	11	57	184	168
Other loans	172	11	6	27	64	30
Deposits	379	25	14	31	162	52
Electronic fund transfers	52	3	2	2	18	14
Trust services	12	1	1	1	3	2
Other	153	10	13	27	43	23
Total	1,524	100	51	156	528	306

accounts, and penalty charges such as over-limit fees.

Each of these five complaint categories accounts for a small portion (4 percent or less) of all consumer complaints received by the System. All other complaint categories involving unregulated practices registered fewer than fifty complaints in 1997.

Complaint Referrals to HUD

In 1997, in accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies, the Federal Reserve referred to HUD five complaints about state member banks alleging violations of the Fair Housing Act. Investigations completed for two of the five complaints (and five others that were pending at year-end 1996) revealed no evidence of unlawful discrimination; the other three were pending at year-end.

During 1997 HUD referred four complaints involving state member banks to the Federal Reserve. By year-end the Federal Reserve had completed investigations into two of the four complaints; the investigations revealed no evidence of unlawful discrimination.

Complaint Program Activities

In 1997 the Consumer Complaints Section at the Board continued work on implementing a comprehensive system designed to replace and consolidate the complaint program's analysis tools. Along with other management tools, the Board's new system for collecting complaint data—Complaint Analysis Evaluation System and Reports (CAESAR)—provides the capability to automatically generate response letters to individual complaints; analyze the type of discrimination complaints received by the Federal Reserve; and analyze data to deter-

Consumer Complaints Received—Continued

Complaints against state member banks					Pending, December 31	Referred to other agencies	Total complaints
Investigated							
Customer error	Bank error	Factual or contractual dispute— resolvable only by courts	Possible bank violation— bank took corrective action	Matter in litigation			
0	0	0	0	0	9	10	21
0	2	0	0	0	5	6	32
0	1	1	0	0	13	23	55
0	13	3	0	2	4	245	315
18	79	18	6	0	76	488	1,105
4	13	4	1	4	19	274	446
6	50	12	1	4	47	427	806
0	10	0	0	0	6	62	114
0	1	2	0	0	2	15	27
1	26	2	0	2	16	244	397
29	195	42	8	12	197	1,794	3,318

mine patterns and trends. As part of this initiative, the Board is converting the mainframe-based Consumer Complaint and Inquiry Tracking System and querying systems to the PC-based CAESAR; implementation throughout the Federal Reserve is expected by early 1999.

In 1997, individual staff members from the Reserve Banks' consumer complaint sections continued to work at the Board for several weeks at a time to gain familiarity with operations in Washington. Nine Reserve Banks participated in the program.

Consumer Policies

The Consumer Policies program explores alternatives to regulation for protecting consumers in retail financial services and brings research information to bear more directly on policymaking. During 1997, Consumer Policies staff members provided research analysis for reports on finance charges, home equity lines of credit, characteristics of households without bank accounts, and the TILA-RESPA streamlining initiative. The Consumer Policies Section and the Consumer Complaints Section worked to improve the analysis of data from the Consumer Satisfaction Questionnaire, which is distributed to consumers who lodge complaints about state member banks. This analysis assesses the level of consumers' satisfaction with the handling of their complaints, as a measure of the complaint program's performance, and is used to identify possible improvements.

The Consumer Policies program also conducted a major educational initiative that targeted automobile leasing disclosures and complemented the implementation of the revised Regulation M. The educational program, discussed earlier in the section "Leasing Education and Regulatory Changes," included prepara-

tion of a new brochure and creation of a public Web site.

Consumer Advisory Council

The Consumer Advisory Council convened in April, July, and October to advise the Board on matters concerning laws that the Board administers and other issues related to consumer financial services. The council's thirty members come from consumer and community organizations, financial and academic institutions, and state governments. Council meetings are open to the public.

The streamlining of the Truth in Lending Act and the Real Estate Settlement Procedures Act was a major topic during 1997. In April, the council's consumer credit committee reported broad agreement for providing meaningful disclosures as early as possible and for combining disclosures and eliminating duplication. Several possibilities were discussed: a "lender pay all" approach for disclosing the amount the borrower needs at loan closing, with the lender assuming the risk for any higher costs; a consolidated disclosure approach covering both TILA and RESPA, with the disclosure delivered before formal application so that consumers can comparison shop; and rolling all loan costs into a finance charge that is disclosed as an annual percentage rate. Council members also talked about enforcement strategies, education for homebuyers, and the need to reduce paperwork not required by either TILA or RESPA.

In October, the council considered concepts related to rate disclosures: improving the current annual percentage rate (APR) disclosure (which is the percentage equivalent of the finance charge) by incorporating some costs that are currently not included in the finance charge; replacing the APR with a disclo-

sure of the note rate and total of all closing costs; and consolidating all costs paid at closing into a single dollar figure and converting that figure into a “premium rate” to facilitate comparison shopping. Council members had differing views on the APR. Some believed that it is not useful, pointing to findings of a Michigan Research Center survey that consumers do not really understand the APR. An APR that does not work well now, they said, will not be improved by adding other cost items. Others disagreed. They noted that consumers in the Michigan survey frequently mentioned the APR as a shopping tool. They also observed that the APR was initially developed because no other rate proved to be an effective or accurate way of describing the cost of credit to consumers.

The council also discussed issues related to the HOEPA provisions of Truth in Lending, which seek to protect homeowners against abusive mortgage lending practices. Some members continued to believe that it may be too early to measure the success of a law that has been in place for only two years. But they also noted that it was evident from the testimony presented at the Board’s hearings in June 1997 that HOEPA has not stopped all fraudulent activity in the high-cost mortgage area. Some suggested that if HOEPA could be changed to prevent fraudulent activity, it should be changed now, but they expressed doubt about finding effective means to eliminate abusive practices such as the entry of inflated income on applications completed by the lender for the borrower. Some members suggested substantive restrictions—such as requiring refunds on “points” charged on the earlier loan or prohibiting new closing costs—for HOEPA loans refinanced by the lender within, say, one year. Members also posed the idea of extending the

ban on balloon payments, which currently applies only to loans for terms of less than five years.

Community development and reinvestment was a topic at all three council meetings in 1997. In April, members discussed the effects of bank mergers and acquisitions on local communities. Some members see mergers as giving the resulting institution greater flexibility, increased capacity to take risks, and a more focused ability to work with and provide technical assistance to groups in local communities. Others believe that larger institutions sometimes lack the flexibility to meet local needs because their programs focus on the statewide potential, and they worry that consolidation reduces access to loan officers and key decisionmakers, who may be located out of state.

At the April meeting the council discussed proposed interagency regulations that would prohibit a bank from establishing branches outside its home state primarily for deposit production and focused on how the loan-to-deposit ratio for the host state should be determined. Council members suggested using a statewide test, in light of the difficulty of determining which branch deposits are local. The council also discussed the service and investment tests under the revised CRA rules and the need for institutions to publish specific goals (such as goals for small business loans or low-income housing) when they issue strategic plans for public comment.

At the July and October meetings, the council’s discussion of the CRA rules addressed such matters as whether financial institutions should receive CRA credit under the service test for providing free or low-cost checking accounts to facilitate the government’s electronic delivery of federal payments; the application of the service and investment tests in regard to the perfor-

mance of large banks, as reflected in CRA public evaluations by the Federal Reserve; and the clarification of terms—such as *innovation, complexity, size, and impact on the community*—used to define the weight given to “qualified investments” and to successful, long-term investments made previously and still outstanding.

In October, the council discussed findings from newly released data on small business, small farm, and community development lending collected and reported under the revised CRA regulations by large commercial banks and savings associations. In light of certain limitations of these data, the council urged that the Board continue to explore methodologies for further analysis and for measuring loan demand in local communities, to provide a context for the lending reported. The council also suggested that the Board consider partnership projects that focus on improving small business lending, modeled on the Federal Reserve’s mortgage partnership projects, which have identified obstacles in mortgage lending and strategies for removing them. In addition, council members suggested that banks disclose, on a voluntary basis, information about their community development loans, such as the kinds and locations of projects, as the single number currently disclosed is not helpful.

During 1997 a working group of the council considered the effects of appraisals on community development lending. In July, members discussed some of the negative consequences when a property is undervalued by an appraiser unfamiliar with the community or a particular community development initiative: The insurer may not want to insure the loan, or the lender may decide not to close the deal. If the low valuation becomes a “comparable value” for other properties, property

values in a community are very quickly driven down. Discriminatory practices, such as an appraisal that bases the valuation on a foreclosure sale miles from the property instead of market values around the block, can add to problems. In rural areas, the variability of property types, uses, and size further complicates appraisals. In the case of a property’s “over-improvement,” the difficulty of finding valuations on comparable properties in the local market adds to the difficulty for a developer and a bank seeking to finance a community development project; either the developer invests more in equity or the bank underwrites a loan with a higher loan-to-value ratio (causing concern for the bank’s regulator).

In October, the council heard recommendations from the working group on such matters as training and licensing of appraisers; providing incentives for banks to direct resources to the appraisal process; educating consumers and appraisers about the importance of accurate, unbiased appraisals; and the need for further research into the appraisal process.

The council considered a wide array of other topics during the year, including

- Options for delivering disclosures electronically under a variety of federal regulations
- The federal mandate to convert most federal payments to electronic deposit, and whether special rules are needed under the Board’s Regulation E for new accounts offered to about 10 million recipients who have no banking relationship
- The circumstances under which financial institutions ought to receive credit in the assessment of their performance under the CRA rule’s service test
- The Board’s reports to the Congress on stored-value products and on the

public availability of identifying information about consumers, such as social security numbers

- A Board-initiated study, headed by the Board's Vice Chair, of the Federal Reserve's role in the payments system.

Testimony and Legislative Recommendations

In July, the Board testified before the Senate Banking Committee on ways to improve the disclosures required for home mortgage loans under TILA and to unify them with the disclosures required under RESPA. The Board's testimony discussed how the two statutes regulate home mortgage lending, described the Board's and HUD's efforts to simplify and streamline the information given to consumers, and outlined the agencies' plans to develop legislative recommendations.

In September, the Board testified before the Subcommittee on Financial Institutions and Consumer Credit of the House Banking Committee on debit cards that can be used without security codes, requiring only a signature. (These cards are often referred to as check cards or off-line debit cards.) Some observers have expressed concern that consumers may not be aware of the risk of unauthorized use associated with these products.

The Board noted its inclination, given that the industry has voluntarily acted to limit consumer liability in many instances to \$50 or less, to see how well these voluntary efforts work before recommending that the Congress amend the Electronic Fund Transfer Act. It is also in everyone's interest, the Board said, to ensure that consumers understand the risks associated with these cards and are able to make an informed choice about whether to assume the risk.

The subcommittee hearing also addressed a legislative proposal to bar creditors from mailing unsolicited loan checks to consumers. The Board suggested a better course would be to let the market work without the interference of new laws. The Truth in Lending Act requires that full disclosure of credit terms be included in any mailing so that consumers can make informed decisions about whether to accept the loans; the primary concern with unsolicited loan checks is not disclosure, but the potential for theft and fraud by persons other than the intended recipient.

Recommendations of Other Agencies

Each year the Board asks for recommendations from the other federal supervisory agencies for amending the financial services laws or the implementing regulations.

The FDIC suggested addressing solicitation and marketing practices related to credit cards, through legislative or regulatory change, to permit enforcement agencies to more adequately supervise trade practices. It noted some practices that may technically comply with the law but that in the opinion of many consumers constitute deceptive marketing. It also endorsed efforts by the Board and HUD to streamline TILA-RESPA requirements to facilitate comparison shopping for consumers before they submit an application for credit.

The OCC recommended that the Congress review current consumer disclosures, which may unnecessarily burden banks and insufficiently benefit consumers, and that it consider disclosures that are less burdensome to depository institutions and more useful to consumers. The FTC expressed its support for updating and clarifying the requirements

of Regulation B and Regulation Z, scheduled for review soon under the Board's Regulatory Planning and Review program. ■

Litigation

During 1997 the Board of Governors was a party in twenty-three lawsuits or appeals filed that year and was a party in fifteen other cases pending from previous years, for a total of thirty-eight cases. In 1996 the Board had been a party in a total of twenty-nine lawsuits. Three of the twenty-three lawsuits filed in 1997 raised questions under the Bank Holding Company Act. As of December 31, 1997, twenty-one cases were pending.

Bank Holding Company Act— Review of Board Actions

Eliopulos v. Board of Governors, No. 97-1442 (D.C. Circuit, filed July 17, 1997), was a petition for review of a Board order dated June 23, 1997, approving the application of First Bank System, Inc., Minneapolis, Minnesota, to acquire U.S. Bancorp, Portland, Oregon, and thereby acquire U.S. Bancorp's banking and nonbanking subsidiaries (83 *Federal Reserve Bulletin* 689). On November 10, 1997, the court granted the Board's motion to dismiss the petition.

Greeff v. Board of Governors, No. 97-1976 (4th Circuit, filed June 17, 1997), is a petition for review of a Board order dated May 19, 1997, approving the application of Allied Irish Banks, plc, Dublin, Ireland, and First Maryland Bancorp, Baltimore, Maryland, to acquire Dauphin Deposit Corporation, Harrisburg, Pennsylvania, and thereby acquire Dauphin's banking and nonbanking subsidiaries (83 *Federal Reserve Bulletin* 607).

In *Inner City Press/Community on the Move v. Board of Governors*, No. 97-

1394 (D.C. Circuit, filed June 12, 1997), petitioners sought review of a Board order dated May 14, 1997, approving the application of Banc One Corporation, Inc., Columbus, Ohio, to merge with First USA, Inc., Dallas, Texas (83 *Federal Reserve Bulletin* 602). Petitioners' motion for a stay pending appeal was denied on June 27, 1997. On December 12, 1997, the court granted the Board's motion to dismiss the petition (130 F.3d 1088).

In *The New Mexico Alliance v. Board of Governors*, No. 96-9552 (10th Circuit, filed December 24, 1996), petitioners seek review of a Board order dated December 16, 1996, approving the acquisition by NationsBank Corporation and NB Holdings Corporation, both of Charlotte, North Carolina, of Boatmen's Bancshares, Inc., St. Louis, Missouri (83 *Federal Reserve Bulletin* 148).

First Baird Bancshares, Inc. v. Board of Governors, No. 96-1426 (D.C. Circuit, filed November 18, 1996), was a petition for review of a Board order dated November 6, 1996, approving applications of First Commercial Corporation, Little Rock, Arkansas; Arvest Bank Group, Inc., Bentonville, Arkansas; and TRH Bank Group, Inc., Norman, Oklahoma, to acquire all the shares of The Oklahoma National Bank of Duncan, Duncan, Oklahoma (83 *Federal Reserve Bulletin* 41). On November 20, 1996, the court denied petitioners' motion for a stay. The case was dismissed by agreement of the parties on January 2, 1997.

The Southeast Raleigh Community Development Corporation v. Board of Governors, No. 96-1054 (D.C. Circuit, filed February 16, 1996), was a petition

for review of a Board order dated January 17, 1996, approving the merger of First Citizens BancShares, Inc., Raleigh, North Carolina, with Allied Bank Capital, Inc., Sanford, North Carolina (82 *Federal Reserve Bulletin* 232). Petitioners' motion for a stay was denied on March 5, 1996. On January 2, 1997, the case was dismissed on petitioners' motion.

Inner City Press/Community on the Move v. Board of Governors, No. 96-4008 (2d Circuit, filed January 19, 1996), was a petition for review of a Board order dated January 5, 1996 (82 *Federal Reserve Bulletin* 239), approving the merger of Chemical Banking Corporation and The Chase Manhattan Corporation, both of New York, New York. On March 26, 1996, the court denied petitioners' motion for a stay. On July 2, 1997, the court dismissed the petition (118 F.3d 905).

Lee v. Board of Governors, No. 95-4134 (2d Circuit, filed August 22, 1995), was a petition for review of two Board orders dated July 24, 1995, approving certain steps of a corporate reorganization of U.S. Trust Corporation, New York, New York, and the acquisition of U.S. Trust by The Chase Manhattan Corporation, New York, New York (81 *Federal Reserve Bulletin* 893). The case, which was consolidated with *Inner City Press v. Board of Governors*, No. 96-4008, was dismissed on July 2, 1997 (118 F.3d 905).

Money Station, Inc. v. Board of Governors, No. 95-1182 (D.C. Circuit, filed March 30, 1995), was a petition for review of a Board order dated March 1, 1995, approving notices by Banc One Corporation, Columbus, Ohio; CoreStates Financial Corp., Philadelphia, Pennsylvania; PNC Bank Corp., Pittsburgh, Pennsylvania; and KeyCorp, Cleveland, Ohio, to acquire certain data processing assets of National City Cor-

poration, Cleveland, Ohio, through a joint venture (81 *Federal Reserve Bulletin* 491). On April 23, 1996, a panel of the court of appeals granted the petition for review and vacated the Board's order. The full court subsequently granted the Board's request for rehearing en banc and vacated the panel's judgment (94 F.3d 658). The case was dismissed on the parties' joint motion on January 7, 1997.

Litigation under the Financial Institutions Supervisory Act

Leuthe v. Office of Financial Institution Adjudication, No. 97-1826 (3d Circuit, filed October 22, 1997), is an appeal of a district court dismissal (977 F. Supp. 537 (E.D. Pa. 1997)) of an action against the Board and other federal banking agencies challenging the constitutionality of the Office of Financial Institution Adjudication.

Towe v. Board of Governors, No. 97-71143 (9th Circuit, filed September 15, 1997), is a petition for review of a Board order dated August 18, 1997 (83 *Federal Reserve Bulletin* 849), prohibiting Edward Towe and Thomas E. Towe from further participation in the banking industry.

In *Banking Consultants of America v. Board of Governors*, No. 97-2791 (W.D. Tenn., filed September 2, 1997), plaintiffs seek to enjoin an investigation by the Board, the Office of the Comptroller of the Currency, and the Department of Labor.

In *Vickery v. Board of Governors*, No. 97-1344 (D.C. Circuit, filed May 9, 1997), petitioner seeks review of a Board order dated April 14, 1997, prohibiting Charles R. Vickery, Jr., from further participation in the banking industry (83 *Federal Reserve Bulletin* 535).

Pharaon v. Board of Governors, No. 97-1114 (D.C. Circuit, filed February 28, 1997), is a petition for review of a Board order dated January 31, 1997, imposing civil money penalties and an order of prohibition against Ghaith R. Pharaon for violations of the Bank Holding Company Act (83 *Federal Reserve Bulletin* 347).

Snyder v. Board of Governors, No. 96-1403 (D.C. Circuit, filed October 23, 1996), was a petition for review of a Board order dated September 11, 1996, prohibiting petitioners from further participation in the banking industry (82 *Federal Reserve Bulletin* 1067). On May 8, 1997, the court dismissed the petition, and on July 31, 1997, the court denied petitioners' motion for rehearing and rehearing en banc.

In *Clifford v. Board of Governors*, No. 96-1342 (D.C. Circuit, filed September 17, 1996), petitioners sought review of a Board order dated August 21, 1996, denying petitioners' motion to dismiss an enforcement action against them. On May 6, 1997, the court granted the Board's motion to dismiss the petition.

Long v. Board of Governors, No. 96-9526 (10th Circuit, filed July 31, 1996), was a petition for review of a Board order dated July 2, 1996, assessing a civil money penalty and imposing a cease and desist order for violations of the Bank Holding Company Act (82 *Federal Reserve Bulletin* 871). On June 30, 1997, the court affirmed the Board's order (117 F.3d 1145).

In *Interamericas Investments, Ltd. v. Board of Governors*, No. 96-60326 (5th Circuit, filed May 8, 1996), petitioners sought review of a Board order dated April 9, 1996, imposing civil money penalties and a cease and desist order against them (82 *Federal Reserve Bulletin* 609). Petitioners' motion to stay the order pending judicial review

was denied on August 20, 1996. On April 16, 1997, the court affirmed the Board's order (111 F.3d 376).

In *Board of Governors v. Interamericas Investments, Ltd.*, No. H-95-565 (S.D. Texas, filed February 24, 1995), the Board sought to freeze certain assets of a company pending the administrative adjudication of a civil money penalty assessment by the Board. On March 1, 1995, the court issued a stipulated order requiring the company to deposit \$1 million into the registry of the court. On June 24, 1997, the action was dismissed following the payment to the Board of the assets at issue.

In *Board of Governors v. Pharaon*, No. 91-CIV-6250 (S.D. New York, filed September 17, 1991), the Board sought to freeze the assets of an individual pending the administrative adjudication of a civil money penalty assessment by the Board. On September 17, 1991, the court issued an order temporarily restraining the transfer or disposition of the individual's assets. The order has been extended by agreement.

Other Actions

Goldman v. Department of the Treasury, No. 1-97-CV-3798 (N.D. Georgia, filed December 23, 1997), is a declaratory judgment action challenging Federal Reserve notes as lawful money.

Kerr v. Department of the Treasury, No. CV-S-97-01877-DWH (S.D. Nevada, filed December 22, 1997), is a challenge to income taxation and Federal Reserve notes.

Allen v. Indiana Western Mortgage Corp., No. 97-7744 RJK (C.D. California, filed November 12, 1997), is a customer dispute with a bank.

Patrick v. United States, No. 97-75564 (E.D. Michigan, filed November 7, 1997), and *Patrick v. United*

States, No. 97-75017 (E.D. Michigan, filed September 30, 1997), are actions for damages arising out of tax disputes.

Artis v. Greenspan, No. 97-5235 (D.C. Circuit, filed September 19, 1997), is an appeal of a district court order dismissing a class complaint alleging race discrimination in employment. A related employment discrimination case, *Artis v. Greenspan*, No. 97-5234 (D.C. Circuit, filed September 19, 1997), is an appeal of the dismissal of an individual discrimination claim.

In *Branch v. Board of Governors*, No. 97-5229 (D.C. Circuit, filed September 12, 1997), the plaintiff appeals a district court order denying his motion to compel production of pre-decisional supervisory documents and testimony sought in connection with an action by Bank of New England Corporation's trustee in bankruptcy against the Federal Deposit Insurance Corporation. On November 10, 1997, the court denied appellant's request for expedited consideration of the appeal.

Wilkins v. Reno, No. 97-2275 (4th Circuit, filed September 12, 1997), was an appeal of a district court's dismissal of a complaint concerning a customer dispute with a bank. On December 9, 1997, the court of appeals affirmed the district court's dismissal.

Clarkson v. Greenspan, No. 97-CV-2035 (D. District of Columbia, filed September 5, 1997), is a Freedom of Information Act case.

Bettersworth v. Board of Governors, No. 97-CA-624 (W.D. Texas, filed August 21, 1997), is a complaint under the Privacy Act.

Wilkins v. Warren, No. 97-CV-590 (E.D. Virginia, filed August 4, 1997), is a customer dispute with a bank.

Maunsell v. Greenspan, No. 97-6131 (2d Circuit, filed May 22, 1997), is an appeal of a district court's dismissal of an action for compensatory and punitive

damages for alleged violations of civil rights by a federal savings bank.

Research Triangle Institute v. Board of Governors, No. 97-1282 (4th Circuit, filed February 24, 1997), was an appeal of a district court's dismissal of a contract claim (962 F. Supp. 61 (M.D.N.C. 1997)). On December 29, 1997, the court of appeals affirmed the district court's dismissal of the action (13 F.3d 985).

Jones v. Board of Governors, No. CV97-0198 (W.D. Louisiana, filed January 30, 1997), was a complaint alleging violations of the Fair Housing Act. On November 13, 1997, the court granted the Board's motion to dismiss the action.

American Bankers Insurance Group, Inc. v. Board of Governors, No. 96-CV-2383-EGS (D. District of Columbia, filed October 16, 1996), is an action seeking declaratory and injunctive relief invalidating a new regulation issued by the Board under the Truth in Lending Act relating to treatment of fees for debt cancellation agreements (12 C.F.R. section 226.4(d)(3)). On October 18, 1996, the district court denied plaintiffs' motion for a temporary restraining order.

Kuntz v. Board of Governors, No. 96-1079 (D.C. Circuit, filed March 7, 1996), was a petition for review of a Board order, issued under the Federal Reserve Act and the Bank Merger Act, approving the application of The Fifth Third Bank, Cincinnati, Ohio, and The Fifth Third Bank of Columbus, Columbus, Ohio, to acquire certain assets and assume certain liabilities of twenty-five branches of NBD Bank, Columbus, Ohio (82 *Federal Reserve Bulletin* 366). The court dismissed the petition on February 13, 1997.

Kuntz v. Board of Governors, No. 95-1485 (D.C. Circuit, filed September 21, 1995), was a petition for review of a

Board order issued under the Federal Reserve Act and the Bank Merger Act approving the application of the Fifth Third Bank, Cincinnati, Ohio, to acquire certain assets and assume certain liabilities of twelve branches of PNC Bank, Ohio, N.A., Cincinnati, Ohio, and to establish certain branches (81 *Federal Reserve Bulletin* 976). On February 13, 1997, the court dismissed the petition. ■

Legislation Enacted

Among the legislation enacted during 1997, the Riegle–Neal Amendments Act, the Treasury appropriation for fiscal year 1998, the Depository Institutions Disaster Relief Act, the 50 States Commemorative Coin Program Act, and an act authorizing the sale of the Culpeper facility of the Federal Reserve Bank of Richmond to the Architect of the Capitol directly affect the Federal Reserve System or the institutions it regulates.

Riegle–Neal Amendments Act

In 1994, the Congress enacted the Riegle–Neal Interstate Banking and Branching Act (Riegle–Neal Act) to establish a framework that would govern interstate branching. The Riegle–Neal Act permits banks to establish interstate branches through mergers with other banks, except in states that affirmatively chose, on or before June 1, 1997, not to permit interstate branching within their borders.

The Riegle–Neal Amendments Act (Pub. L. 105–24, 111 Stat. 238) (the act) provides that an insured state-chartered bank that establishes a branch in a host state may conduct any “activity” at the branch that is permissible under the laws of the bank’s home state, so long as the “activity” is permissible for a bank chartered by the host state or for an out-of-state national bank branch located in the host state. For example, the activities of a branch of a New Jersey state-chartered bank located in New York (host state) would be governed by New Jersey state banking law (home state law) so long as the activities are permissible under New York state

law or are permissible for out-of-state national bank branches located in New York. The act also provides that the laws of the host state, including laws regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches, apply to any out-of-state, state-chartered bank branch located in a host state to the same extent that the host state’s laws apply to an out-of-state, national bank branch located in the host state. To the extent that the host state’s laws do not apply to the out-of-state branch, the home state’s laws apply to the branch.

Before it was amended, the Riegle–Neal Act provided that an out-of-state bank that establishes a branch in a host state could not conduct any activity at that branch that was not permissible for a bank chartered by the host state and that the host state’s laws applied to the out-of-state branch to the same extent that they applied to a branch of a bank chartered by the host state.

Treasury Appropriation for Fiscal Year 1998

The Treasury appropriation for fiscal year 1998 (Pub. L. 105–61, 111 Stat. 1272) authorizes a permanent indefinite appropriation to reimburse Federal Reserve Banks for fiscal agency services rendered to the Treasury Department.

Depository Institutions Disaster Relief Act

The Depository Institutions Disaster Relief Act (Pub. L. 105–18, 111 Stat. 211) (the act) granted the Board of

Governors the power, for a period of 240 days after June 12, 1997, to make exceptions to the Truth in Lending Act (TILA) and the Expedited Funds Availability Act (EFAA) for transactions within a geographic area that the President determined, on or after February 28, 1997, to be a major disaster area as a result of the 1997 flooding of the Red River of the North, the Minnesota River, and the tributaries of these rivers. The Board had the power to grant exceptions from TILA and EFAA if it determined that an exception could alleviate hardships to the public resulting from the disaster and that the benefits of the relief outweighed the possible adverse effects of granting the exception. The Board was required to publish in the *Federal Register* a description of each exception and a statement of its benefits, including an explanation of how the benefits outweighed the possible adverse effects. Exceptions had to expire no later than September 1, 1998.

The act also granted the Board authority to allow an insured depository institution, in calculating compliance with the leverage limits prescribed under section 38 of the Federal Deposit Insurance Act (FDI Act), to subtract from the institution's total assets an amount not exceeding the qualifying amount attributable to insurance proceeds. The Board could grant such an exception if the following conditions were met: (1) the depository institution had its principal place of business within, and 60 percent of its total deposits were from persons located within, an area designated as a major disaster area as a result of the 1997 flooding of the Red River of the North, the Minnesota River, and the tributaries of these rivers; (2) the depository institution was adequately capitalized before the disaster; (3) the depository institution had an acceptable plan for managing the increase in its total

assets and deposits; and (4) the subtraction was consistent with the purposes of section 38 of the FDI Act. Exceptions to section 38 of the FDI Act had to expire no later than February 28, 1999.

The act also allowed the Board to exercise its authority with respect to depository institutions whose principal place of business is within, or with respect to transactions or activities within, an area designated as a major disaster area as a result of the 1997 flooding of the Red River of the North, the Minnesota River, and the tributaries of these rivers without complying with certain provisions of the Administrative Procedures Act or with provisions of any other law that requires a notice or opportunity for a hearing or that sets time limits for agency action. It also allowed the Board to waive publication requirements for establishing branches. The Board was required to publish in the *Federal Register* a description of each action taken as well as an explanation of the need for the action. The act also granted the Board authority to waive the application of the appraisal standards prescribed by title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 for transactions involving real property located within the disaster area.

50 States Commemorative Coin Program Act

The 50 States Commemorative Coin Program Act (Pub. L. 105-125, 111 Stat. 2534) (the act) grants the Treasury, among other powers, the authority to create a new \$1 coin once the supply of Susan B. Anthony \$1 coins is depleted. The new coin must (1) be golden in color, have a distinctive edge, with tactile and visual features making it readily discernible, (2) be minted and fabricated in the United States, and (3) have metal-

lic anticounterfeiting properties similar to those of U.S. clad coinage in circulation as of December 1, 1997. The act directs the Treasury to adopt a marketing program to promote use of the new coins, to conduct a marketing study, and to report its progress to the Congress.

Sale of the Culpeper Facility of the Federal Reserve Bank of Richmond

A recent act (Pub. L. 105-144, 111 Stat. 2667) authorized the sale of the Culpeper facility of the Federal Reserve Bank of Richmond to the Architect of the Capitol, on behalf of the United States government. Three parcels totaling approximately forty-one acres, located in Culpeper County, Virginia, and the improvements thereunder will be transferred in the sale. Title will be transferred to the United State government, and the Federal Reserve will not be reimbursed for the property. ■

Banking Supervision and Regulation

The condition of the U.S. banking system remained robust during 1997: The industry reported further gains in asset quality, continued record earnings, and the highest equity-to-asset ratios in more than fifty years. Only one (small) insured commercial bank failed, and the assets of problem banks, at \$3.5 billion, continued to decline from already low levels. As a result, the U.S. banking industry appears to be among the strongest and most innovative of the major industrial countries and well positioned to meet the nation's financial needs.

This dramatic progress from the industry's stressed condition at the beginning of the decade is evidence of the underlying strength and resilience of the U.S. banking system and its ability to adapt to and, to a large extent, direct evolving practices in world financial markets. These practices, the expanded application of technology in the design and management of financial products, and the structural changes that are occurring within the U.S. and world financial systems present challenges and opportunities not only to many U.S. banks but also to the Federal Reserve in its role as a financial supervisor and regulator.

Changes in the nature and pace of bank activities have been most significant among the largest banking organizations, for which the growth of trading and derivatives activities has been profound. These events and the growing complexity of many activities have required that the Federal Reserve, in its supervisory role, place more emphasis on the management and internal control process within banks and less emphasis on independent transaction-testing. That

requirement, in turn, has fueled a need for more prior planning for examinations, increased training of examiners, and additional guidance on sound practices for both bankers and bank examiners. It has also made it necessary for the Federal Reserve to improve its own information systems, to allocate resources more productively, and to make better use of available technology in all aspects of its supervisory process.

In recent years the Federal Reserve has used the opportunity presented by the relatively trouble free domestic banking system to develop and promote sound risk-management practices throughout the industry, both domestically and abroad; to develop more efficient techniques for supervision; and, when prudent, to reduce the level of regulatory intrusion into the activities of U.S. banks and bank holding companies. Such efforts account for many of the Board's accomplishments in bank supervision and regulation during 1997. These accomplishments include support of international efforts to strengthen and coordinate the supervision of internationally active banks; reduction of regulatory restrictions on the activities of section 20 affiliates of bank holding companies; streamlining of the application process for many banks and bank holding companies; significant advances in the use of automation during bank examinations; and many other initiatives, discussed below.

More recently, in response to potential industry exposure associated with the century date change, the Federal Reserve has initiated an extensive supervision program that has included the issuance of several policy statements,

the conduct of comprehensive examinations, and an outreach program. Working closely with other federal and state banking regulators, the Federal Reserve has been focusing significant attention on banking industry preparedness regarding automated systems and their ability to calculate date-dependent information after the century date change. The outreach program has included numerous public statements and conferences intended to provide guidance to the industry on this significant matter. Further, the Federal Reserve is examining all banks subject to its supervision authority by June 30, 1998, for year 2000 readiness.

Adverse economic developments in Asian countries during the year directed attention to bank exposures in that part of the world as well as to emerging markets more generally. Consistent with the System's risk-focused approach for supervising large, internationally active banking organizations, the Federal Reserve's supervisory process during 1997 placed emphasis on evaluating the impact of these developments on U.S. banks that are active in the Asian markets, and on the U.S. operations of banks that are based there. In this connection, it is noteworthy that U.S. banking organizations continue to report historically high levels of capital and reserves.

Scope of Responsibilities for Supervision and Regulation

The Federal Reserve is the federal supervisor and regulator of all U.S. bank holding companies and of state-chartered commercial banks that are members of the Federal Reserve System. In overseeing these organizations, the Federal Reserve primarily seeks to promote their safe and sound operation and their compliance with laws and regulations, including the Bank Secrecy

Act and consumer and civil rights laws.¹ The Federal Reserve also examines the following specialized activities of these institutions: information systems, fiduciary activities, mutual fund activities, government securities dealing and brokering, municipal securities dealing, securities clearing, and securities underwriting and dealing through special subsidiaries. The Federal Reserve also has responsibility for the supervision of (1) all Edge Act corporations and agreement corporations, (2) the international operations of state member banks and U.S. bank holding companies, and (3) the operations of foreign banking companies in the United States.²

The Federal Reserve exercises important regulatory influence over the entry into, and the structure of, the U.S. banking system through its administration of the Bank Holding Company Act, the Bank Merger Act for state member banks, the Change in Bank Control Act for bank holding companies and state member banks, and the International Banking Act. Also, the Federal Reserve is responsible for imposing margin requirements on securities transactions.

1. The Board's Division of Consumer and Community Affairs is responsible for coordinating the Federal Reserve's supervisory activities with regard to the compliance of banking organizations with consumer and civil rights laws. To carry out this responsibility, the Federal Reserve specifically trains a number of its bank examiners to evaluate institutions with regard to such compliance. The chapter of this REPORT covering consumer and community affairs describes these regulatory responsibilities. Compliance with other statutes and regulations, which is treated in this chapter, is the responsibility of the Board's Division of Banking Supervision and Regulation and the Reserve Banks, whose examiners also check for safety and soundness.

2. Edge Act corporations are chartered by the Federal Reserve, and agreement corporations are chartered by the states, to provide all segments of the U.S. economy with a means of financing international trade, especially exports.

In carrying out these responsibilities, the Federal Reserve coordinates its supervisory activities with other federal and state regulatory agencies and with the bank regulatory agencies of other nations.

Supervision for Safety and Soundness

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

Examinations and Inspections

The Federal Reserve conducts *examinations* of state member banks, branches and agencies of foreign banks, Edge Act corporations, and agreement corporations. Many elements reviewed at bank holding companies and their nonbank subsidiaries differ from bank examinations; therefore, the Federal Reserve conducts *inspections* of holding companies and their subsidiaries. Pre-examination planning and on-site review of operations are integral parts of ensuring the safety and soundness of financial institutions. Regardless of whether it is an examination or an inspection, the review entails (1) an assessment of the quality of the processes in place to identify, measure, monitor, and control risk exposures, (2) an appraisal of the quality of the institution's assets, (3) an evaluation of management, including an assessment of internal policies, procedures, controls, and operations, (4) an assessment of the key financial factors of capital, earnings, liquidity, and sensitivity to market risk, and (5) a review for compliance with applicable laws and regulations.

State Member Banks

At the end of 1997, 992 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented about 10.9 percent of all insured U.S. commercial banks and held about 25 percent of all insured commercial bank assets in the United States.

The guidelines for Federal Reserve examinations of state member banks are fully consistent with section 10 of the Federal Deposit Insurance Act, as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and by the Riegle Community Development and Regulatory Improvement Act of 1994. A full-scope, on-site examination is required at least once during each twelve-month period for most of these depository institutions; certain well-capitalized and well-managed institutions with assets of less than \$250 million may be examined every eighteen months.

During 1997, the Federal Reserve Banks conducted 552 examinations of state member banks (some of them jointly with the state agencies), and state banking departments conducted 346 independent examinations of state member banks.

Bank Holding Companies

At year-end 1997, the number of U.S. bank holding companies totaled 6,102. These organizations controlled about 7,015 insured commercial banks and held approximately 93.8 percent of all insured commercial bank assets.

Federal Reserve guidelines call for annual inspections of large bank holding companies and smaller companies that have significant nonbank assets. Certain small, noncomplex companies—

those that have less than \$1 billion in consolidated assets, do not have debt outstanding to the public, and do not engage in significant nonbank activities—are subject to a special supervisory program that became effective in 1997. The program permits a more flexible approach to supervising those entities in a risk-focused environment and is designed to improve the overall effectiveness and efficiency of the Federal Reserve's bank supervisory efforts. Each such holding company is subject to off-site review once during each supervisory cycle, which corresponds to the mandated examination cycle for the company's lead bank.

In judging the financial condition of subsidiary banks, Federal Reserve examiners consult the examination reports of the federal and state banking authorities that have primary responsibility for the supervision of these banks, thereby minimizing duplication of effort and reducing the burden on banking organizations. In 1997, the Federal Reserve inspected 1,682 bank holding companies. Altogether, Federal Reserve examiners conducted 1,782 bank holding company inspections, 137 of which were conducted off-site, and state examiners conducted 98 independent inspections.

Enforcement Actions, Civil Money Penalties, and Suspicious Activity Reporting

In 1997, the Federal Reserve Banks recommended, and members of the Board's staff initiated and worked on, 105 enforcement cases involving 207 separate actions, such as cease and desist orders, written agreements, removal and prohibition orders, and civil money pen-

alties. Of these, 35 cases involving 67 actions were completed by year-end.

Of particular note was an action taken by the Board of Governors with regard to the illegal activities of the Bank of Credit and Commerce International (BCCI). After a factual hearing before an administrative law judge, the Board of Governors assessed a civil money penalty of \$37 million against Ghaiht R. Pharaon for his participation in BCCI's illegal acquisition of the failed Independence Bank of Encino, California.

In other significant matters, the Board of Governors assessed civil money penalties totaling \$30 million, including a fine of \$5 million, along with an order to disgorge profit of \$17.32 million, against a foreign bank for allegedly failing to file complete and accurate applications and reports in connection with its purchase and ownership of a U.S. bank; a fine of \$5 million against a foreign bank and its U.S. branch for misconduct related to the alleged misuse of confidential supervisory information, the making of allegedly false statements to bank supervisory officials, and the alleged obstruction of a formal investigation by bank supervisory officials; and a fine of \$2.5 million against a foreign bank and its U.S. branch for allegedly engaging in unsafe and unsound practices and violations of laws and regulations.

All final enforcement orders issued by the Board of Governors and all written agreements executed by the Federal Reserve Banks in 1997 are available to the public. In 1997, they became available on the Board's public Web site.

In addition to formal enforcement actions, the Federal Reserve Banks in 1997 completed 83 informal enforcement actions, such as memorandums of understanding and resolutions from boards of directors.

Specialized Examinations

The Federal Reserve conducts specialized examinations of banking organizations in the areas of information technology, fiduciary activities, government securities dealing and brokering, municipal securities dealing, securities clearing, and securities underwriting and dealing through so-called section 20 subsidiaries of bank holding companies. The Federal Reserve also reviews state member banks and bank holding companies that act as transfer agents.

Information Technology

Under the Interagency EDP Examination Program, the Federal Reserve examines the information technology activities of state member banks, U.S. branches and agencies of foreign banks, Edge Act and agreement corporations, and independent data centers that provide electronic data processing services to these institutions. On-site examinations are essential to ensure the safe and sound operation of financial institutions, at which computer operations may pose significant exposures. During 1997, the Federal Reserve conducted 420 examinations that focused on the safety and soundness of information technology and electronic data processing systems. The Federal Reserve was also the lead agency on 3 examinations of large, multiregional data processing servicers examined in cooperation with the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). In addition, Federal Reserve examiners initiated targeted reviews of banking organizations to assess their progress in preparing for the century date change.

Fiduciary Activities

The Federal Reserve has supervisory responsibility for institutions that together hold more than \$9.2 trillion of discretionary and nondiscretionary assets in various fiduciary capacities. This group of institutions comprises 297 state-chartered member banks and trust companies, 86 nonmember trust companies that are subsidiaries of bank holding companies, and 17 entities that are either branches or agencies of foreign banking organizations or Edge corporation subsidiaries of domestic banking institutions.

On-site examinations are essential to ensure the safety and soundness of financial institutions that have fiduciary operations. These examinations include (1) an evaluation of management, policies, audit and control procedures, and risk management, (2) an assessment of the quality of trust assets, (3) an assessment of earnings, (4) a review for conflicts of interest, and (5) a review for compliance with laws, regulations, and general fiduciary principles. During 1997, Federal Reserve examiners conducted 255 on-site trust examinations of state member banks and trust companies, branches and agencies of foreign banking organizations, or Edge corporation subsidiaries of domestic banking institutions.

Government Securities Dealers and Brokers

The Federal Reserve is responsible for examining the government securities dealing and brokering of state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with Department of the Treasury regulations. Thirty-eight state member banks and nine state branches of foreign banks have notified the Board

that they are government securities dealers or brokers not exempt from Treasury's regulations. During 1997, the Federal Reserve conducted 21 examinations of broker-dealer activities in government securities at state member banks and foreign banks.

Municipal Securities Dealers and Clearing Agencies

Under the Securities Act Amendments of 1975, the Board of Governors is responsible for the supervision of state member banks and bank holding companies that act as municipal securities dealers or as clearing agencies. The Board supervises thirty-seven banks that act as municipal securities dealers and three clearing agencies that act as custodians of securities involved in transactions settled by booking entry. In 1997, the Federal Reserve examined all three clearing agencies and twenty of the banks that act as municipal securities dealers.

Securities Subsidiaries of Bank Holding Companies

Section 20 of the Banking Act of 1933 (the Glass-Steagall Act) prohibits the affiliation of a member bank with a company that is "engaged principally" in underwriting or dealing in securities. The Board of Governors in 1987 approved proposals by banking organizations to underwrite and deal on a limited basis in specified classes of "bank ineligible" securities (that is, commercial paper, municipal revenue bonds, conventional residential mortgage-related securities, and securitized consumer loans) in a manner consistent with section 20 of the Glass-Steagall Act and the Bank Holding Company Act. At that time, the Board limited revenues from these newly approved activities to no more than 5 percent of total revenues for

each section 20 securities subsidiary. In September 1989 the limit was increased to 10 percent.

In January 1989, the Board approved applications by bank holding companies to underwrite and deal in corporate and sovereign debt and equity securities, subject, in each case, to reviews of managerial and operational infrastructure and other conditions and requirements, or firewalls, specified by the Board. In approving this broader range of activities, the Board also adopted firewalls more restrictive than those contained in its 1987 approval order.

Significant changes concerning the revenue limit and firewalls governing the activities of section 20 subsidiaries were implemented in 1997. On the basis of its experience supervising these section 20 subsidiaries as well as developments in the securities markets since the revenue test was adopted, the Board permitted, effective March 1997, section 20 firms to derive up to 25 percent of total revenues from underwriting and dealing in ineligible securities. In August 1997, the Board completed a review of firewalls, as required by the Riegle Community Development and Regulatory Improvement Act of 1994, for the purpose of eliminating unnecessary regulatory burden and enabling section 20 subsidiaries to operate in an efficient, effective manner. As a result of its review, the Board eliminated certain restrictions that have proved to be unduly burdensome or unnecessary in light of other laws and regulations. The remaining restrictions have been consolidated into a series of operating standards that are fully consistent with safe and sound operations.

At year-end 1997, forty-five bank holding companies held section 20 subsidiaries authorized to underwrite and deal in ineligible securities. Of these, twenty-eight could underwrite any debt

or equity security, two could underwrite any debt security, and fifteen could underwrite only the limited types of debt securities approved by the Board in 1987. The Federal Reserve follows specialized inspection procedures to review the operations of these securities subsidiaries; it conducted forty-one such inspections in 1997.

Transfer Agents

Federal Reserve examiners also conduct examinations of state member banks and bank holding companies that are registered transfer agents. Among other things, transfer agents countersign and monitor the issuance of securities, register the transfer of securities, and exchange or convert securities. During 1997, Federal Reserve examiners conducted on-site examinations at 59 of the 160 banks and bank holding companies registered as transfer agents with the Board.

Surveillance and Risk Assessment

The Federal Reserve monitors the financial condition and performance of individual banking organizations and of the banking system as a whole to identify areas of supervisory concern. The monitoring is accomplished, in part, through the use of automated screening systems. Surveillance screens address a number of aspects of banking performance, including capitalization, asset growth, loan quality, loan concentrations, liquidity, and capital markets activities. Information from these screens assists in allocating examination resources to institutions experiencing, or vulnerable to, deterioration and is also used in the examination-planning process. Among the automated screening systems used to monitor bank performance are two econometric models that use quarterly

Call Report data to estimate an examination rating for each bank and to identify banks having the potential to become critically undercapitalized over the subsequent two years.

During 1997, the Federal Reserve continued to refine its Systemwide surveillance programs, implementing parent-company-only screens that address bank holding company performance on an unconsolidated basis and adding nonbank screens to monitor the effect of nonbank activities on the strength of parent bank holding companies. In addition, changes were made to the capital markets monitoring screens to address credit derivatives activities and the adoption of the market risk capital rule. Development of a surveillance program for small shell bank holding companies was also begun, to assist with implementation of the Risk-Focused Supervision Policy for Small Shell Bank Holding Companies adopted by the Board in November.

To assist supervisory staff in evaluating individual bank holding companies, the Federal Reserve produces quarterly Bank Holding Company Performance Reports (BHCPRs), which provide detailed financial information on the condition and performance of individual bank holding companies. During the year, information on derivatives activities contained in BHCPRs was significantly revised to provide more data on the use of derivative instruments. The Federal Reserve also produces several statistical and analytical reports on the structure and condition of the banking industry for use in supervising banks and bank holding companies. During 1997, development of an Aggregate Loan Quality Analysis Report was completed. This report supplements loan concentration surveillance screens by providing additional detail on the quality of assets at institutions reporting con-

centrations in loans of various types. In addition, electronic access to National Information Center (NIC) data on banks, bank holding companies, and surveillance screen results is provided to supervisory staff through the Performance Report Information and Surveillance Monitoring system (PRISM).

The Federal Reserve actively works with the other federal banking authorities to enhance surveillance tools through its representation on the Federal Financial Institutions Examination Council Task Force on Surveillance Systems.

International Activities

The Federal Reserve plays a critical role in the supervision and regulation of the international activities of U.S. banking organizations and the U.S. activities of foreign banking organizations. It supervises foreign branches of member banks; overseas investments by member banks, Edge Act corporations and agreement corporations, and bank holding companies; and investments by bank holding companies in export trading companies. The Federal Reserve also supervises the U.S. activities of foreign banking organizations, including U.S. branches, agencies, and representative offices, U.S. bank subsidiaries, and commercial lending company subsidiaries and nonbanking subsidiaries.

Foreign Office Operations of U.S. Banking Organizations

The Federal Reserve examines the international operations of state member banks, Edge Act corporations, and bank holding companies, principally at the U.S. head offices of these organizations, where the ultimate responsibility for their foreign offices lies. In 1997 the

Federal Reserve conducted examinations of 12 foreign branches of state member banks and 114 foreign subsidiaries of Edge Act corporations and bank holding companies. All of the examinations abroad were conducted with the cooperation of the supervisory authorities of the countries in which they took place; when appropriate, the examinations were coordinated with the Office of the Comptroller of the Currency. Also, examiners made eight visits to the overseas offices of U.S. banks to obtain financial and operating information and, in some instances, to evaluate their compliance with corrective measures or to test-check their adherence to safe and sound banking practices.

Foreign Branches of Member Banks

At the end of 1997, 89 member banks were operating 786 branches in foreign countries and overseas areas of the United States; 59 national banks were operating 599 of these branches, and 30 state member banks were operating the remaining 187 branches. In addition, 19 nonmember banks were operating 29 branches in foreign countries and overseas areas of the United States.

Edge Act and Agreement Corporations

Edge Act corporations are international banking organizations chartered by the Board to provide all segments of the U.S. economy with a means of financing international business, especially exports. Agreement corporations are state-chartered or federally chartered companies that enter into agreements with the Board not to exercise any power that is impermissible for an Edge Act corporation.

Under sections 25 and 25(A) of the Federal Reserve Act, Edge Act and

agreement corporations may engage in international banking and foreign financial transactions. These corporations, which in most cases are subsidiaries of member banks, may (1) conduct a deposit and loan business in states other than that of the parent provided that the business is strictly related to international transactions and (2) make foreign investments that are broader than those of member banks because they can invest in foreign financial organizations, such as finance companies and leasing companies, as well as in foreign banks.

At year-end 1997, there were eighty-four Edge Act and agreement corporations with thirty domestic branches. During the year, the Federal Reserve examined all of these corporations.

U.S. Activities of Foreign Banks

The Federal Reserve has broad authority to supervise and regulate the U.S. activities of foreign banks that engage in banking and related activities in the United States through branches, agencies, representative offices, commercial lending companies, Edge Act corporations, banks, and certain nonbank companies. Foreign banks continue to be significant participants in the U.S. banking system. As of year-end 1997, 278 foreign banks from 59 countries operated 412 state-licensed branches and agencies (of which 23 were insured by the FDIC) as well as 64 branches licensed by the OCC (of which 6 had FDIC insurance). These foreign banks also directly owned 16 Edge Act corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 87 U.S. commercial banks. Altogether, these U.S. offices of foreign banks at the end of 1997 controlled approximately

20 percent of U.S. banking assets. These foreign banks also operated 148 representative offices; an additional 97 foreign banks operated in the United States solely through a representative office.

The Federal Reserve has acted to ensure that all state-licensed and federally licensed branches and agencies are examined on-site at least once during each twelve-month period either by the Federal Reserve or by a state or other federal regulator. The Federal Reserve conducted or participated with state and federal regulatory authorities in 446 examinations during 1997.

Joint Program for Supervising the U.S. Operations of Foreign Banking Organizations

In 1995 the Federal Reserve, in cooperation with the other federal and state banking supervisory agencies, formally adopted a joint program for supervising the U.S. operations of foreign banking organizations (FBOs). The program has two major parts. One part focuses on the examination process for those FBOs that have multiple U.S. operations and is intended to improve coordination among the various U.S. supervisory agencies.

The other part of the program is a review of the financial and operational profile of each FBO to assess its general ability to support its U.S. operations and to determine what risks, if any, the FBO poses through its U.S. operations. Together, these two processes provide critical information to the U.S. supervisors in a logical, uniform, and timely manner. During 1997 the Federal Reserve continued to implement program goals through coordination with other supervisory agencies and the development of financial and risk assessments of foreign banking organizations and their U.S. operations.

Technical Assistance

In 1997 the System provided staff for technical assistance missions and training sessions on bank supervisory matters to a number of central banks in countries of the former Soviet Union, Eastern Europe, Asia, the Caribbean, and Latin America.

Supervisory Policy

The Federal Reserve in 1997 issued for public comment an interim rule and several proposals to amend its capital adequacy guidelines. It also issued a proposal to amend its real estate appraisal rule for bank holding companies and their nonbank subsidiaries. During the year, the Federal Reserve continued to revise its supervisory process to enhance the effectiveness of examinations and inspections as well as to address changes in the banking industry. As part of these efforts, the Federal Reserve and the Federal Deposit Insurance Corporation jointly formalized and implemented a risk-focused supervision framework for the examination of community banks. The Federal Reserve also introduced a parallel framework for the risk-focused supervision of large, complex banking organizations.

Capital Adequacy Guidelines

The risk-based capital requirements, adopted by the Federal Reserve in 1989, implement the international risk-based capital standards that were developed by the Basle Committee on Banking Regulation and Supervisory Practices (Basle Supervisors Committee) and endorsed by the Group of Ten (G-10) countries in July 1988. The standards include a framework for calculating risk-adjusted assets and for assigning assets and off-

balance-sheet items to broad categories primarily on the basis of credit risk. In addition, some institutions must measure their market risk exposure and include that measure in their risk-based capital calculation. Banking organizations are expected to maintain capital equal to at least 8 percent of their risk-adjusted assets.

To supplement the risk-based capital standards, the Federal Reserve in 1990 issued leverage guidelines setting forth minimum ratios of capital to total assets to be used in the assessment of an institution's capital adequacy. During 1997, the Board of Governors approved for public comment an interim rule and several proposals to amend its capital adequacy guidelines.

Market Risk/Specific Risk

On December 30, 1997, the Board, together with the FDIC and the OCC, issued an interim rule, effective at year-end 1997, along with a request for public comment, that amended their respective risk-based capital guidelines for market risk applicable to certain institutions having significant trading activities. The rule permits institutions to use qualifying internal models to determine their capital requirements in relation to specific risk (an element of market risk) without comparing the requirements generated by their internal models with the so-called standardized specific-risk capital requirement. The rule implements a revision to the Basle Accord that permits such treatment for institutions whose internal models adequately measure specific risk.

Recourse

On November 5, 1997, the Federal Reserve, together with the OCC, FDIC, and OTS, issued a proposal to revise the risk-based capital standards to address

the regulatory capital treatment of recourse obligations and direct credit substitutes that expose banks, bank holding companies, and thrift institutions to credit risk. The proposed rules would use credit ratings to match the risk-based capital assessment more closely to an institution's relative risk of loss in certain asset securitizations.

Unrealized Gains on Certain Equity Securities

On October 23, 1997, the agencies issued a joint proposal to amend the risk-based capital standards for banks, bank holding companies, and thrift institutions with regard to the treatment of certain unrealized revaluation gains on certain equity securities. Under the proposal, institutions would be permitted to include in tier 2 capital up to 45 percent of their unrealized gains on certain available-for-sale equity securities.

Servicing Assets

On August 4, 1997, the agencies issued a proposal to amend their risk-based and tier 1 leverage capital guidelines for banks, bank holding companies, and thrift institutions to address the accounting treatment of servicing assets on both mortgage assets and financial assets other than mortgages. The proposal reflects changes in accounting standards for servicing assets made in Statement of Financial Accounting Standard (FAS) No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. FAS 125 extended the accounting treatment for mortgage servicing to servicing on all financial assets. The proposed amendment would raise the capital limitations on the sum of all mortgage servicing assets and purchased credit card rela-

tionships from 50 percent of tier 1 capital to 100 percent of tier 1 capital. The amendment would also allow the deduction of servicing assets on financial assets other than mortgages from tier 1 capital.

Leverage Capital Ratios

On October 27, 1997, the agencies issued for public comment a proposal addressing their leverage standards. Under the proposal, institutions rated a composite 1 under the Uniform Financial Institutions Rating System would be subject to a minimum 3.0 percent leverage ratio, and all other institutions would be subject to a minimum 4.0 percent leverage ratio. This change would simplify and streamline the leverage standards and make the agencies' rules uniform.

Technical Modifications

In October 1997, the agencies issued a proposal to amend their capital adequacy guidelines to eliminate differences among the agencies. The proposed amendments pertain to the risk-based capital treatment of presold one-to four-family residential properties, second liens on one- to four-family residential properties, and investments in mutual funds. The amendment would permit a 50 percent risk weight for construction loans on all presold one- to four-family residential properties. All first and second liens would be treated separately, with qualifying first liens risk-weighted at 50 percent and non-qualifying first liens and all second liens risk-weighted at 100 percent. At their option, institutions would be permitted to assign mutual fund investments on a pro rata basis among the risk categories according to the investment limits in the mutual fund prospectus.

Real Estate Appraisal Regulation

In 1990, in accordance with title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, the Board, along with the other federal banking agencies, adopted appraisal regulations for real estate-related transactions within their jurisdiction and exempted certain transactions from the regulations. In 1994 the agencies amended several existing exemptions and added several new exemptions. On December 5, 1997, the Board issued a proposal to amend its real estate appraisal regulation for bank holding companies and their nonbank subsidiaries. The proposed amendment would permit a bank holding company or its nonbank subsidiary having the authority to underwrite or deal in mortgage-backed securities to do so without demonstrating that the loans underlying the securities are supported by appraisals that at origination met the Board's appraisal regulation. The Board proposed this amendment to address concerns raised by bank holding companies regarding the inability of their nonbank subsidiaries to actively participate in the commercial mortgage-backed securities market because of the Board's appraisal requirements. A final amendment is expected in early 1998.

Risk-Focused Supervision

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

Risk-Focused Supervision of Banks

In October 1997, the Federal Reserve formally implemented two risk-focused supervision programs for banks, one for large, complex banking organizations and the other for community banks. Both programs rely on an understanding of the institution, the performance of risk assessments, the development of a supervisory plan, and examination procedures tailored to the institution's risk profile.

Large, complex banks. For large, complex organizations, the supervision program emphasizes the need for ongoing supervision, through increased planning and off-site monitoring, and for coordination of supervisory activities with an organization's multiple regulators, to improve efficiency and avoid duplication. The program also emphasizes a review of functional activities or business lines, rather than just legal entities, because large organizations generally are structured according to business functions and manage many important financial and operational activities centrally. As part of this approach, the program endorses the concept of conducting, when appropriate, a series of targeted examinations during a given supervisory cycle, each focusing on a single function or business line.

Community banks. The supervisory framework for community banks was developed jointly by the Federal Reserve and the FDIC in close consultation with state bank supervisors. The program sets forth guidelines for planning and scoping examinations to focus on the areas of highest risk to the bank and encourages the performance of as many supervisory activities as possible off-site. It also describes general procedures for examining each of the major

areas of a bank's risk-bearing activities. The procedures are set forth in modules that are structured in a decision-tree format. This format allows an examiner to draw conclusions about a particular activity after completing a core analysis, which in most cases would require only a few procedures. If the core analysis indicates that a more in-depth review and more testing are needed to draw a conclusion about a particular activity, the examiner would perform an expanded analysis. To aid in conducting risk-focused examinations, an automated program has been developed that allows examiners to document their work for each module on their laptop computers. The program, which also provides electronic access to the FDIC and Federal Reserve examination manuals, is designed to operate on all computers currently used by FDIC, Federal Reserve, and state bank supervisors.

Risk-Focused Supervision of Small Shell Bank Holding Companies

In November 1997, the Board adopted a risk-focused supervision program for small shell bank holding companies that tailors supervisory activities to an assessment of each company's reported condition and activities and the condition of its subsidiary banks. Under the program, Reserve Banks are expected to perform a risk assessment of each small shell bank holding company at least once during each supervisory cycle, which depends on the examination frequency for the holding company's lead bank. If the preliminary assessment identifies no unusual supervisory issues or concerns, no special follow-up with the company is necessary. However, if it supports the assignment of a supervisory rating (that is, a BOPEC rating) of 3 or worse or a management rating of less than satisfactory, a full-scope,

on-site inspection is expected to be performed. Newly formed companies will still be subject to a full-scope, on-site inspection within the first twelve to eighteen months of operation.

Examination-Frequency Guidelines

In February 1997, the Board and the other banking agencies revised their examination-frequency guidelines to address provisions in the Riegle Community Development and Regulatory Improvement Act of 1994 and the Economic Growth and Regulatory Paperwork Reduction Act of 1996. As a result of the revision, certain banks having assets of less than \$250 million will be subject to an eighteen-month examination cycle rather than a twelve-month cycle. To qualify for less-frequent examination, a bank must be rated composite 2 or better, must be well capitalized and well managed, must not be subject to a formal enforcement action, and must not have experienced a change of control during the preceding twelve months.

Risk-Management Guidance

In June 1997, in response to an amendment to the Basle Accord on capital requirements for exposure to general market risk, the Federal Reserve issued guidance on the risk-based capital treatment of credit derivatives held in trading accounts. Banking organizations are expected to hold risk-based capital to compensate for exposure to counterparty credit risk, general market risk, and specific risk in credit derivative transactions.

In July 1997, the Board issued guidance on the risk management and capital adequacy of secondary-market credit activities such as loan syndications, loan sales and participations, credit

derivatives, and asset securitizations and the provision of credit and liquidity enhancements to transactions in these areas. The guidance identifies some of the significant risks involved in several of the more common types of secondary-market credit activities. It also describes sound practices and special considerations that supervisors should take into account when assessing a banking organization's systems for managing risks arising from these activities.

Derivatives Accounting and Disclosures

During 1997 the Federal Reserve provided comments on the Financial Accounting Standards Board's (FASB) proposed standard Accounting for Derivative and Similar Financial Instruments and for Hedging Activities. Although the Federal Reserve supports the FASB's objective of promoting greater transparency in financial statements, the Board's comment letters expressed concerns that the FASB approach would not improve the transparency of financial reporting and would likely constrain prudent risk-management practices that make use of derivatives. The Federal Reserve offered the FASB suggestions for improving the transparency of financial reporting for derivatives and all other financial instruments. In conjunction with the Basle Committee on Banking Supervision, similar comments were provided to the International Accounting Standards Committee (IASC) regarding its accounting proposal for financial instruments.

Industry groups and regulators continued during 1997 to monitor the quality of bank disclosures of derivatives activities, with the goal of making these activities more transparent to the public

and to regulatory authorities. In November, the Basle Supervisors Committee and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) issued a third joint report on the public disclosure of trading and derivatives activities of banks and securities firms worldwide. The report provides an overview and analysis of the disclosures about trading and derivatives activities presented in the 1996 annual reports of a sample of the largest internationally active banks and securities firms in the G-10 countries, and notes improvements since 1993.³ The analysis was built in part on a framework used by the Federal Reserve in analyzing the trading and derivatives disclosures of major U.S. banking organizations. It revealed that a number of firms in the sample have continued to make general improvements, such as the expansion of value-at-risk disclosures, as well as significant voluntary innovations in their annual report disclosures. Despite these encouraging advances, however, some institutions have continued to disclose little about their trading and derivatives activities. The report also contains recommendations made by the Basle Committee and IOSCO in 1995 for further improvements in disclosures of qualitative and quantitative information about institutions' involvement in trading and derivatives activities, including their risk exposures and risk-management policies, and the effect of these activities on earnings.

Bank Internal Audit Functions

In December 1997, the Board and the other federal banking regulators issued a joint policy statement that describes

3. The total sample consisted of seventy-nine global institutions holding more than \$83 trillion in derivative instruments (notional amounts).

sound practices for managing the internal audit function of banking organizations and includes a major section on internal audit outsourcing. The statement reiterates that directors and senior managers are responsible for ensuring that the system of internal control is adequate for the nature and scope of the organization's business. It provides examiners with guidance for assessing the quality and effectiveness of an organization's internal audit function. It also provides guidance on sound practices for internal audit outsourcing arrangements and on independence issues when an accountant plans to serve as the banking organization's external auditor and as its internal-audit outsourcing vendor.

Information Technology

As described in previous sections, during 1997 the Federal Reserve formalized risk-based supervision programs for large, complex banking organizations and for community banking organizations. The Division of Banking Supervision and Regulation views the support of these programs as its most critical objective in deploying information technology. The risk-based programs require that (1) the division maintain a current risk profile of large, complex organizations subject to Federal Reserve supervision for the purpose of determining the appropriate supervisory strategy for ensuring safe and sound operations and (2) examination exercises for all organizations focus on areas of highest risk and be conducted in a manner that both leverages to the greatest extent possible upon existing management information systems and eliminates duplication of effort among regulators and bankers. During the year, the division made significant progress in the use of information technology to support these pro-

grams and implemented a process for focusing future development efforts on risk-based supervision. Several of these initiatives are discussed below.

National Information Center and National Examination Database

The National Information Center (NIC) is a Federal Reserve System database maintained at the Board of Governors and made available to staff members at the Board, the Reserve Banks, and other federal and state banking agencies. The NIC contains information about the organizational structure of all depository institutions, nonbanks, bank holding companies, and foreign banking organizations operating in the United States. It also contains financial information such as Call Report data and Uniform Performance reports for depository institutions, and FR-Y financial reports and Uniform Performance reports for bank holding companies. In addition, the NIC contains supervisory information resulting from examinations and inspections and enables end users to perform financial analysis on institutions.

During 1997, work continued on software to improve NIC's usefulness through the use of distributed technologies. The National Examination Data (NED) software system was implemented in December. The system allows staff members to retrieve and update supervisory and financial information on depository institutions and bank holding companies. Development of the NED system, which was begun in 1995 to take advantage of the Federal Reserve System's intranet and to improve the functionality of the NIC through the use of client/server technology, will greatly facilitate the examination process, bank surveillance, and supervisory analysis. Implementation of similar technological

improvements to support other areas of the NIC began in 1996 and will continue, in several phases, through 1999. In addition, much progress was made in 1997 toward providing public access to nonconfidential NIC information. In January, a public Internet page was made available to provide access to many of the structure and financial reports contained in the NIC. The page is reached through the FFIEC home page and through a link on the Board of Governor's home page.

In 1998 and beyond, the Federal Reserve will make the NED system available to state banking agencies and will explore ways to use internet technologies to expand the availability of NIC data in general.

Foreign Banking Organization Desktop (FBO Desktop)

FBO Desktop is an automated system developed by the Federal Reserve to assist in the supervision of U.S. branches and agencies of foreign banking organizations. The system makes possible the sharing throughout the Federal Reserve System of information used in the supervision of foreign banking organizations, including information on foreign financial systems, foreign accounting standards, and analysis of the financial performance of foreign banking organizations having U.S. operations. The Federal Reserve plans in May 1998 to implement a similar system for large domestic banking organizations that includes more types of information. Also in 1998, access to these two systems will be extended to state and federal banking regulators.

Examination-Related Initiatives

In 1997, the Division of Banking Supervision and Regulation took several steps

to improve the use of automation in the conduct of examinations, notably through joint efforts with the FDIC and state bank supervisors. One step was development of the Examination Laptop Visual Information System (ELVIS). ELVIS leads examiners through a decision matrix to focus on high-risk activities and helps ensure consistency among examiners in the use of risk-focused procedures. Because it automatically documents the examination process, the system also provides cost savings.

Also during the year, the division agreed with the FDIC and state supervisors to use a common, automated tool for analyzing loans. Use of an automated loan-analysis tool saves considerable examination resources by expediting the selection of loans to be reviewed, eliminating the need to transcribe certain information available electronically at the bank, and facilitating greater portfolio analysis. The division also agreed with the FDIC and state supervisors on a system for accessing data to be used in conducting examinations and preparing examination reports. A production version of the system is expected to be ready in late 1998.

Staff Training

The Supervisory Education Program trains staff members having supervisory or regulatory responsibilities at the Reserve Banks, at the Board of Governors, and at state banking departments; students from supervisory counterparts in foreign countries attend the training sessions on a space-available basis. The program provides training at the basic, intermediate, and advanced levels for the four disciplines of bank supervision: bank examinations, bank holding company inspections, surveillance and monitoring, and applications analysis.

Classes are conducted in Washington, D.C., or at regional locations and may be held jointly with regulators of other financial institutions. The program is designed to increase the student's knowledge of the entire supervisory and regulatory process and thereby provide a higher degree of cross-training among staff members.

The System also participates in training offered by the Federal Financial Institutions Examination Council (FFIEC) and by certain other regulatory agencies. The System's involvement includes developing and implementing basic and advanced training in various emerging issues as well as in such specialized areas as trust activities, international

banking, information technology, municipal securities dealer activities, capital markets, payment systems risk, white collar crime, and real estate lending. In addition, the System co-hosts the World Bank Seminar for students from developing countries.

The Federal Reserve conducted a variety of schools and seminars in 1997, and staff members participated in several courses offered by or cosponsored with other agencies, as shown in the accompanying table.

In 1997 the Federal Reserve trained 4,199 students in System schools, 1,085 in schools sponsored by the FFIEC, and 84 in other schools, for a total of 5,368, including 256 representatives from for-

Number of Sessions of Training Programs for Banking Supervision and Regulation, 1997

Program	Total	Regional
<i>Schools or seminars conducted by the Federal Reserve</i>		
<i>Core schools</i>		
Introduction to examinations	8	6
Financial institution analysis	10	7
Bank management	7	3
Effective writing for banking supervision staff	19	19
Management skills	12	11
Conducting meetings with management	19	19
<i>Other schools</i>		
Loan analysis	6	5
Real estate lending seminar	5	3
Specialized lending seminar	3	...
Senior forum for current banking and regulatory issues	5	4
Banking applications	1	...
Bank holding company inspections	6	5
Basic entry-level trust	1	...
Advanced trust	1	...
Consumer compliance examinations I	2	...
Consumer compliance examinations II	3	...
CRA examination techniques	3	...
Fair lending	3	...
Information systems and emerging technology risk management ...	17	16
Information systems continuing education	2	...
Intermediate information systems examination	1	...
Capital markets seminars	16	12
Section 20 securities seminar	4	2
Internal controls	8	5
Seminar for senior supervisors of foreign central banks ¹	1	...
<i>Other agencies conducting courses²</i>		
Federal Financial Institutions Examination Council	55	7
Office of the Comptroller of the Currency	3	...
Federal Bureau of Investigation ³	1	1

NOTE. ... Not applicable.

1. Conducted jointly with the World Bank.
2. Open to Federal Reserve employees.

3. Co-sponsored by the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Office of the Comptroller of the Currency.

eign central banks. A total of 26,608 student days of training were provided, comparable to the amount of training provided in recent years.

The Federal Reserve System also gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program 773 state examiners were trained: 458 in Federal Reserve courses, 302 in FFIEC programs, and 13 in other courses.

Every staff member seeking an examiner's commission is required to pass a core proficiency examination, which includes a core content area and a specialty area of the student's choice—safety and soundness, consumer affairs, trust, or information technology (formerly information systems). In 1997, 131 students took the examination (see table).

Late in the year, the System initiated revisions to the core training program that leads to the commissioning of assistant examiners. The project was undertaken to give assistant examiners a greater understanding of risk-focused examination concepts, the components of sound internal controls, the importance of management information systems, the concept of risk as it applies to banking, and the key supervisory issues related to integrated supervision. The changes will be implemented over 1998 and 1999.

Federal Financial Institutions Examination Council

Year 2000

The Federal Reserve is working closely with the other federal banking agencies to address the banking industry's readiness for the year 2000. The supervisory program focuses on the industry's efforts to ensure that automated systems will be able to correctly calculate date-dependent information after the century date change. The program has included the issuance of several policy statements, the development of a uniform set of examination procedures, and an outreach program that has provided numerous opportunities for banks and bank supervisors to discuss the issues. Year 2000 supervisory initiatives are continuing to intensify and have been of great interest to the industry, bank supervisors, and the Congress.

The banking agencies, through the FFIEC, issued two policy statements to all banks in 1997—"Year 2000 Project Management Awareness" on May 5 and "Safety and Soundness Guidelines Concerning the Year 2000 Business Risk" on December 17. The May statement included a set of uniform examination procedures that is being used in the Year 2000 examination of all banks subject to Federal Reserve supervision by mid-1998.

Status of Students Registered for the Core Proficiency Examination, 1997

Student status	Core	Specialty area			
		Safety and soundness	Consumer	Trust	Information technology
In queue, year-end 1996	33	26	4	1	0
Test taken, 1997	131	82	42	5	6
Passed	114	69	33	5	2
Failed	17	13	9	0	4
In queue, year-end 1997	23	13	9	0	1

NOTE. Students choose a test in one specialty area to accompany the core examination.

As part of its outreach activities, the Federal Reserve in June 1997 produced a ten-minute video entitled "Year 2000 Executive Awareness," which is intended for viewing by bank boards of directors and senior management. Governor Edward W. Kelley, Jr., introduces the video and emphasizes that the Year 2000 challenge is a business matter and not exclusively a technology problem, thus warranting the attention of boards of directors and senior officers.

In an effort to intensify international involvement by foreign bank supervisors, the Federal Reserve and other U.S. bank supervisors worked closely with the Bank for International Settlements's Committee on Banking Supervision to prepare a paper on the Year 2000 situation that was distributed in September 1997 to banks and bank supervisors in more than one hundred countries. The committee encouraged BIS member countries to make preparation for the year 2000 a priority to ensure that banks everywhere are ready for the century date change.

The Federal Reserve's supervisory activities and internal preparations have been of significant interest to both the House and the Senate Banking Committees as well as to the General Accounting Office. Staff members have been asked to provide quarterly written and oral briefings to both houses of Congress beginning with the third quarter of 1997 and continuing through the century date change.

Revisions to the Call Report

During 1997 the FFIEC implemented changes to the bank Reports of Condition and Income (Call Reports) to adopt generally accepted accounting principles (GAAP) as the reporting basis in all areas of the Call Reports, effective with

the March 1997 report. This change brought the accounting principles used in bank regulatory reports into conformity with those used in bank holding company FR-Y reports, savings association Thrift Financial Reports, and general-purpose financial statements. The FFIEC also revised the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002), effective with the March 1997 report, and the Foreign Branch Report of Condition (FFIEC 030), effective with the September 1997 report, to adopt GAAP and certain other disclosures to maintain consistency with the bank Call Reports.

In October, the Federal Reserve and the other federal banking agencies proposed minor revisions to the bank Call Reports to improve the agencies' ability to monitor bank compliance with certain regulations and to facilitate bank supervision. The revisions would, with the March 1998 report, add items to monitor compliance with the risk-based capital standards for market risk exposures and low-level recourse transactions less frequently as part of the FFIEC's continuing efforts to reduce unnecessary regulatory burden and to streamline regulatory reports. The proposal would also eliminate several detailed items on bank trading portfolios and collect certain deposit information.

Besides implementing or proposing changes to Call Report content, the FFIEC in 1997 phased out the direct filing of Call Reports in paper form and implemented an electronic filing requirement. The FFIEC also revised the four versions of the Call Report instructions into a single set of instructions and made the report forms available on the Internet. These changes are consistent with the objectives of section 307 of the Riegle Community Development and Regulatory Improvement Act of

1994, which requires that the agencies work together to develop a single form for the filing of core information by banks, savings associations, and bank holding companies; to simplify instructions for such reports; and to develop a system under which such reports can be filed electronically.

Regulation of the U.S. Banking Structure

The Board administers the Bank Holding Company Act, the Bank Merger Act, the Change in Bank Control Act, and the International Banking Act for bank holding companies, member banks, and foreign banking organizations. In doing so, the Federal Reserve acts on a variety of proposals that directly or indirectly affect the structure of U.S. banking at the local, regional, and national levels; the international operations of domestic banking organizations; and the U.S. banking operations of foreign banks.

Bank Holding Company Act

Under the Bank Holding Company Act, a company must obtain the Federal Reserve's approval before forming a bank holding company by acquiring control of one or more banks in the United States. Once formed, a bank holding company must receive the Federal Reserve's approval before acquiring additional banks or nonbanking companies. The act permits well-run bank holding companies that satisfy specific criteria to commence certain nonbanking activities on a *de novo* basis without prior Board approval and establishes an expedited prior notice procedure for other activities and for small acquisitions.

In reviewing an application or notice filed by a bank holding company

for prior Board approval, the Federal Reserve considers several factors, including the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, and the applicant's ability to make available to the Board information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor.

In 1997, the Federal Reserve approved 358 proposals by foreign or domestic companies to become bank holding companies; approved 108 proposals by existing bank holding companies to merge with other bank holding companies; approved 283 proposals by existing bank holding companies to acquire or retain banks; approved 398 requests by existing bank holding companies to acquire nonbank firms engaged in activities closely related to banking; and approved 90 other bank holding company applications or notices and denied 1. Data on these and all other decisions are shown in the accompanying table.

Bank Merger Act

The Bank Merger Act requires that all proposed mergers of insured depository institutions be acted on by the appropriate federal banking agency. If the institution surviving the merger is a state member bank, the Federal Reserve has primary jurisdiction. Before acting on a proposed merger, the Federal Reserve considers factors relating to the financial

and managerial resources of the applicant, the future prospects of the existing and combined institutions, the convenience and needs of the community to be served, and the competitive effects of the proposal. It also considers the views of certain other agencies regarding the competitive factors involved in the transaction.

During 1997 the Federal Reserve approved 156 merger applications. As required by law, each merger is described in this REPORT (in table 16 of the "Statistical Tables" chapter).

When the FDIC, the OCC, or the OTS has jurisdiction over a merger, the Federal Reserve is asked to comment on the competitive factors to ensure comparable enforcement of the antitrust provisions of the Bank Merger Act. The Federal Reserve and those agencies have adopted standard terminology for assessing competitive factors in merger cases to ensure consistency in administering the act. The Federal Reserve submitted 994 reports on competitive fac-

tors to the other federal banking agencies in 1997.

Change in Bank Control Act

The Change in Bank Control Act requires persons seeking control of a U.S. bank or bank holding company to obtain approval from the appropriate federal banking agency before completing the transaction. Under the act, the Federal Reserve is responsible for reviewing changes in control of state member banks and of bank holding companies. In doing so, the Federal Reserve reviews the financial position, competence, experience, and integrity of the acquiring person; considers the effect on the financial condition of the bank or bank holding company to be acquired; determines the effect on competition in any relevant market; assesses the completeness of information submitted by the acquiring person; and considers whether the proposal would have an

Decisions by the Federal Reserve, Domestic and International Applications, 1997

Proposal	Direct action by the Board of Governors			Action under authority delegated by the Board of Governors					Total
				Director of the Division of Banking Supervision and Regulation		Office of the Secretary	Federal Reserve Banks		
	Approved	Denied	Permitted	Approved	Denied	Approved	Approved	Permitted	
Formation of holding company	12	0	0	0	0	1	261	84	358
Merger of holding company	12	0	0	0	0	16	61	19	108
Acquisition of bank ..	25	0	0	0	0	22	155	81	283
Acquisition of nonbank	0	0	124	0	0	44	0	230	398
Merger of bank	23	0	0	0	0	17	116	0	156
Change in control	6	0	0	0	0	4	0	174	184
Establishment of a branch, agency, or representative office by a foreign bank	18	0	1	0	0	0	1	0	20
Other	363	1	58	19	0	169	1,395	129	2,134
Total	459	1	183	19	0	273	1,989	717	3,641

adverse effect on the federal deposit insurance funds.

The appropriate federal banking agencies are required to publish notice of each proposed change in control and to invite public comment, particularly from persons located in the markets served by the institution to be acquired. The agencies are also required to assess the qualification of each person seeking control. In early 1997, following discussions with the FDIC, the OCC, and the OTS, the Board adopted significant changes to the portion of Regulation Y that implements the Change in Bank Control Act. The modifications represent an attempt to reduce unnecessary regulatory burden and to harmonize the scope and procedural requirements of the Federal Reserve with those of the other federal banking agencies. As discussed in the later section "Recent Regulatory Changes," these revisions were part of a broader effort by the Board to improve Regulation Y.

In 1997 the Federal Reserve acted on 184 proposed changes in control of state member banks and bank holding companies.

International Banking Act

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

In reviewing proposals, the Board generally considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. It may also take into account whether the home country supervisor has consented to the establishment of the U.S. office;

the financial resources of the foreign bank and its existing U.S. operations; the managerial resources of the foreign bank; whether the home country supervisor shares information regarding the operations of the foreign bank with other supervisory authorities; whether the foreign bank has provided adequate assurances that information concerning its operations and activities will be made available to the Board, if deemed necessary to determine and enforce compliance with applicable law; and the record of the foreign bank with respect to compliance with U.S. law.⁴

In 1997, the Federal Reserve approved applications by fourteen foreign banks from twelve foreign countries to establish branches, agencies, and representative offices in the United States.

Public Notice of Federal Reserve Decisions

Each decision by the Federal Reserve that involves a bank holding company, a bank merger, a change in control, or the establishment of a new U.S. banking presence by a foreign bank is effected by an order or an announcement. Orders state the decision, the essential facts of the application or notice, and the basis for the decision; announcements state only the decision. All orders and announcements are made public immediately; they are subsequently reported in the Board's weekly H.2 statistical release and in the monthly *Federal Reserve Bulletin*. The H.2 release also contains announcements of applications and notices received by the Federal Reserve but not yet acted on. In 1997, the H.2 release became available on the Board's public Web site.

4. The Board may also consider the needs of the community, the foreign bank's history of operation, and its relative size in its home country.

Timely Processing of Applications

The Federal Reserve maintains target dates and procedures for the processing of applications. The setting of target dates promotes efficiency at the Board and the Reserve Banks and reduces the burden on applicants. The time allowed for a decision ranges from thirty to sixty days, depending on the type of application or notice. In 1997, 98 percent of decisions met this standard.

Delegation of Applications

Historically, the Board of Governors has delegated certain regulatory functions—including the authority to approve, but not to deny, certain types of applications—to the Reserve Banks, to the Director of the Board's Division of Banking Supervision and Regulation, and to the Secretary of the Board. The delegation of responsibility for applications permits staff members at the Board and the Reserve Banks to work more efficiently by removing routine cases from the Board of Governors's agenda. In 1997, 82 percent of the applications processed were acted on under delegated authority.

Recent Regulatory Changes

In February 1997, the Board approved significant revisions to Regulation Y, which implements the Bank Holding Company Act, the Change in Bank Control Act, and certain related statutes. The revisions were intended to improve the competitiveness of bank holding companies by eliminating unnecessary regulatory burden and operating restrictions and by streamlining the application and notice process. As part of the final regulation, the Board implemented a streamlined and expedited review process for bank and nonbank proposals by well-

run bank holding companies. The Board also reorganized and expanded the list of generally permissible activities of bank holding companies and updated or eliminated many of the restrictions under which bank holding companies conduct business. The final regulation also adopted a number of measures designed to broaden and improve public notice of acquisition proposals.

In December 1997, the Board requested comment on proposed comprehensive revisions to Regulation K, which governs international banking operations. The proposed revisions are intended to improve the international competitiveness of U.S. banking organizations by expanding permissible activities abroad and reducing regulatory burden associated with the conduct of such activities, and to reduce regulatory burden on foreign banks operating in the United States by streamlining the application and notice process.

Banking and Nonbanking Proposals

During 1997, the Board approved several merger proposals involving some of the largest banking organizations in the United States. As in previous cases, these proposals generated many comments from the public, particularly with respect to Community Reinvestment Act, fair lending, and competitive issues. The Board also continued to process numerous banking proposals involving mutual holding companies.

Beginning in the second half of 1996, the Board adopted a series of changes in the restrictions applicable to the operations of section 20 subsidiaries. As a result of these changes, the Federal Reserve System in 1997 received significantly more proposals involving the establishment and expansion of section 20 subsidiaries by bank holding companies. By year-end 1997, the Board

had approved a variety of proposals by both foreign and domestic banking organizations to acquire full-service securities brokerage and investment firms. The number of section 20 subsidiary proposals from smaller banking organizations also increased.

In the course of acting on other nonbanking proposals by foreign and domestic bank holding companies, the Board continued to expand the scope of permissible data processing activities to facilitate electronic banking. It also permitted several banking organizations to acquire or retain certain operations engaged in a broad range of mutual fund activities.

Overseas Investments by U.S. Banking Organizations

U.S. banking organizations, with the authorization of the Board, may engage in a broad range of activities overseas. Most foreign investments may be made under general consent procedures that involve only after-the-fact notification to the Board; significant investments must be reviewed by the Board in advance. In 1997 the Board approved twenty-three proposals by U.S. banking organizations to make significant investments overseas.

The Board also has authority to act on proposals involving Edge Act and agreement corporations, which are established by banking organizations to provide a means of engaging in international business. In 1997 the Board approved two proposals to increase the investment by a member bank in its Edge corporation subsidiaries above 10 percent of the member bank's capital and surplus. These proposals were novel in that until September 1996, U.S. banks were prohibited from investing more than 10 percent of their capital and surplus in Edge and agreement corporations. At that

time, legislation was adopted that allows member banks to invest up to 20 percent of their capital and surplus with the prior approval of the Board. During 1997, the Board also approved two applications to establish new agreement corporations.

Applications by Member Banks

State member banks must obtain Board approval to establish domestic branches, and member banks (including national banks) must obtain Board approval to establish foreign branches. In considering proposals for domestic branches, the Board reviews the scope of the functions and the character of the business to be conducted. In reviewing proposals for foreign branches, the Board considers, among other things, the condition of the bank and the bank's experience in international business. Once a member bank has received authority to open a branch in a particular foreign country, the member bank may open additional branches in that country without prior Board approval. In 1997 the Federal Reserve acted on merger and new branch proposals related to 1,681 domestic branches and granted prior approval for the establishment of 10 foreign branches.

Stock Repurchases by Bank Holding Companies

A bank holding company may purchase its own shares from its shareholders. When the company borrows money to buy the shares, the transaction increases its debt and decreases its equity. Relatively larger purchases may undermine the financial condition of a bank holding company and its bank subsidiaries. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's capital guidelines. In 1997 the Federal Reserve reviewed thirty-

seven proposed stock repurchases by bank holding companies, all of which were acted upon under delegated authority by either the Reserve Banks or the Secretary of the Board.

Enforcement of Other Laws and Regulations

Financial Disclosure by State Member Banks

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including financial reports and proxy statements. By statute, the Board's financial disclosure rules must be substantially similar to those of the Securities and Exchange Commission. At the end of 1997, twenty-eight state member banks, most of them small or medium sized, were registered with the Board under the Securities Exchange Act.

Bank Secrecy Act

The Currency and Foreign Transactions Reporting Act (the Bank Secrecy Act) was originally designed as a means of creating and maintaining records of various financial transactions that otherwise would not be identifiable in efforts to trace the proceeds of illegal activities. In recent years, the Bank Secrecy Act has been regarded as a primary tool in the fight against money laundering. The records that must be reported and maintained by financial institutions provide law enforcement authorities, as well as bank regulators, with data useful in detecting and preventing unlawful activity. The Federal Reserve, through its examination process and other off-site measures, monitors compliance with the Bank Secrecy Act by the institutions it supervises.

In 1997 the Federal Reserve issued revised and expanded procedures for its examinations for compliance with the Bank Secrecy Act that include new interagency anti-money-laundering examination procedures, as required by the provisions of section 404 of the Riegle Community Development and Regulatory Improvement Act of 1994. The enhancements include procedures that address compliance with anti-money-laundering rules, procedures to determine whether suspicious activities are being monitored and reported, procedures to assess training programs for all relevant staff in the areas of Bank Secrecy Act compliance and anti-money-laundering controls, and procedures that require bank examiners to address a banking organization's compliance with several regulations related to anti-money-laundering recently issued by the Department of the Treasury.

The Federal Reserve continued in 1997 to provide expertise and guidance to the Bank Secrecy Act Advisory Group, a committee established at the Department of the Treasury by congressional mandate to seek measures to reduce unnecessary Bank Secrecy Act burdens and to increase the utility of Bank Secrecy Act data to regulators. Also, through the Special Investigations Section of the Division of Banking Supervision and Regulation, the Federal Reserve has assisted in the investigation of money laundering activities and has provided anti-money-laundering training to designated staff members at each Reserve Bank as well as for law enforcement agencies and the banking sector. The Federal Reserve has also participated extensively in the Financial Action Task Force, which in 1997 provided anti-money-laundering training to numerous foreign governments and central banking authorities.

Loans to Executive Officers

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

Federal Reserve Membership

At the end of 1997, 3,543 banks were members of the Federal Reserve System. At that time, member banks were operating 45,037 branches and accounted for 39 percent of all commercial banks in the United States and for 73 percent of all commercial banking offices.

Loans by State Member Banks to their Executive Officers, 1996 and 1997

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
<i>1996</i>			
October 1–December 31	705	27,555,000	0.0–19.8
<i>1997</i>			
January 1–March 31	735	31,815,000	0.0–18.0
April 1–June 30	786	36,167,000	0.0–19.5
July 1–September 30	743	37,229,000	0.0–18.0

SOURCE. Call Reports.



Regulatory Simplification

In 1978 the Board of Governors established a regulatory review program to help minimize the burden of regulation on banking organizations. The objectives of the program are to ensure that the economic consequences of regulation for small business are considered, to afford interested parties the opportunity to participate in designing regulations and comment on them, and to ensure that regulations are written in simple, clear language. Board staff members continually review regulations for their adherence to these objectives and for their consistency with the provisions of the Regulatory Flexibility Act.

Comprehensive Reviews

In 1997 the Board continued the review process mandated by the Regulatory Flexibility Act and by section 303 of the more recent Riegle Community Development and Regulatory Improvement Act. As a result of this process, it adopted revised versions of Regulation T, Regulation U, and Regulation Y. It also eliminated Regulation G (effective in 1998) by revising Regulation U to cover lenders formerly covered by Regulation G. In addition, the Board proposed revising several other major regulations and combining some regulations, thereby reducing the total number of regulations.

Regulatory Revisions Adopted

Regulations G, T, U, and X Securities Credit Transactions

In 1995 and 1996, the Board proposed revisions to Regulations G, T, and U as

part of its comprehensive review of its margin regulations. In 1996, the Board also proposed amendments to the regulations to reflect statutory changes to the Board's margin authority contained in the National Securities Markets Improvement Act of 1996. In December 1997, the Board adopted amendments based on comments on the three proposals. The amendments revise Regulation U, which formerly covered only commercial banks, to also cover lenders formerly subject to Regulation G (lenders other than banks, brokers, and dealers). They also reduce regulatory distinctions between broker-dealers, banks, and other lenders and generally liberalize the treatment of securities credit transactions.

Amendments to Promote Uniformity among Lenders and Reduce Inconsistencies

The Board's margin authority is found in the Securities Exchange Act of 1934 (SEA). The SEA prohibits the Board from regulating extensions of securities credit by banks as comprehensively as it regulates extensions of securities credit by brokers and dealers. In the 1930s, the Board adopted Regulation T to cover brokers and dealers and Regulation U to cover commercial banks. In 1968, it adopted Regulation G to cover lenders other than banks, brokers, and dealers. Regulation G was generally more restrictive than Regulation U. As the Board gained experience with "Regulation G lenders," it amended Regulation G to make it more and more similar to Regulation U. At the beginning of the comprehensive review of Regulations G

and U, the primary difference between the regulations was based on section 8(a) of the SEA, which distinguished between bank and nonbank lenders with respect to loans to broker-dealers. Section 8(a) of the SEA was repealed by Congress in 1996, leading the Board to propose combining Regulations G and U. In 1997, the Board announced the extension of Regulation U to cover lenders subject to Regulation G and the elimination of Regulation G, effective April 1, 1998.

Regulation U contains several exemptions from the regular margin requirements for loans made to broker-dealers. The combining of Regulations G and U will result in these exemptions applying to lenders formerly subject to Regulation G. Although the Board amended Regulation T in 1983 to include some of these exemptions, others remained available only in Regulation U. In 1997 the Board announced that all exemptions for loans to brokers and dealers in Regulation U will be extended to Regulation T, so that broker-dealers seeking exempt credit will be able to borrow from all lenders on the same basis.

A significant difference between the coverage of Regulation T and the coverage of Regulations G and U is the treatment of transactions involving nonequity securities. The Board's margin authority under the SEA does not extend to extensions of credit by banks against nonequity securities, and the scope of Regulations G and U has consequently been limited to extensions of credit against equity securities. In contrast, Regulation T covers extensions of credit against both debt and equity securities. To reduce the disparity between broker-dealers and other lenders with respect to extensions of credit against debt securities, the Board eliminated the numerical margin requirement for marginable non-

equity securities under Regulation T in 1968 and replaced it with the concept of "good faith margin." Good faith margin is the amount of margin that a broker-dealer, exercising sound credit judgment, would customarily require for a specified security position; it is established without regard to the customer's other assets or securities portions held in connection with unrelated transactions. Although broker-dealers are not required to obtain a specified percentage of margin for the purchase of debt securities, Regulation T still contains rules for debt transactions not found in Regulations G and U. For example, under Regulation T, margin for debt securities must be collected within a specified time period, and a broker-dealer is required to liquidate a customer's securities if the customer does not pay for margin within the required time. In addition, Regulation T does not permit the purchase of a nonequity security to be financed on an unsecured basis or against collateral other than securities. None of these provisions are found in Regulations G and U. In 1996, the Board proposed to further deregulate transactions involving nonequity securities by allowing good faith margin for all nonequity securities and by creating a new account for such transactions that does not have the payment period and the sell-out restrictions applicable to equity security transactions. In addition, the Board proposed to modify the definition of good faith margin to allow broker-dealers to consider the creditworthiness of the borrower as well as the value of the collateral. The proposal was adopted in 1997. It allows the purchase of debt securities by unsecured credit and largely deregulates broker-dealer credit to the debt markets to provide broker-dealers greater parity with banks and other lenders whose credit to the debt markets has not been regulated.

Another significant difference between Regulation T and Regulations G and U is their treatment of nonmargin equity securities. Under Regulation T, nonmargin equity securities have no loan value, meaning that the customer must pay for them in full. Under Regulations G and U, nonmargin equity securities used in connection with a covered transaction have "good faith loan value." In 1996, the Board proposed to expand the definition of "margin security" in Regulation T. After reviewing comments, the Board modified its proposal and in 1997 announced that all securities listed in the NASDAQ Stock Market will become margin securities on January 1, 1999. This amendment reduces the number of nonmargin equity securities under Regulation T, thereby increasing the number of securities eligible for credit at all lenders.

Another amendment to promote uniformity among lenders announced by the Board in 1997 was the exclusion of money market mutual funds from the definition of "margin stock" in Regulation U. The exclusion has the effect of allowing banks and other lenders to extend "good faith" credit against these securities, as has been allowed under Regulation T since July 1996. The Board also amended the regulations to reduce internal inconsistencies. For example, Regulation U prohibited the extension of credit against exchange-traded options while allowing all other exchange-traded equity securities to be purchased with 50 percent margin. In 1997, the Board amended Regulation U to provide a uniform margin requirement of 50 percent for all exchange-traded equities, including options. The Board also reduced the inconsistencies in the section of Regulation T that covers the borrowing and lending of securities so as to provide uniform treatment of all foreign securities and to permit

broker-dealers to borrow securities in anticipation of any situation permissible under the regulation.

Amendments to Improve Efficiency and Reduce Unnecessary Costs

The Board has always relied on the listing standards of the national securities exchanges in defining what constitutes a "margin stock" or "margin security" under its margin regulations. Since 1968, however, the Board has made an individualized determination regarding the margin status of many over-the-counter (OTC) stocks and has published a list of marginable stocks, known as the OTC list, on a periodic basis (currently four times a year). Preparation of the list is an expense both to the Board and to the issuers of OTC securities surveyed by the Board. Moreover, publication of a stock's name on the OTC list lags its qualification as an OTC security under the Board's criteria by more than four months. In 1997, the Board announced changes to the definitions of "margin security" in Regulation T and "margin stock" in Regulation U that will result in elimination of the Board's quarterly OTC list by relying on the listing standards of the NASDAQ Stock Market. The changes will allow lenders to extend credit against OTC stocks on the basis of their current trading status without having to wait for the Board to publish its OTC list.

The Board also publishes a list of foreign margin stocks for purposes of Regulation T. Stocks appear on the foreign list after meeting Board criteria or appearing on the Financial Times/Standard & Poor's World Actuaries Indices (FT/S&P list). The latter group of stocks are included because the Securities and Exchange Commission considers them to have a "ready market"

for purposes of broker–dealer capital requirements; the Board amended Regulation T in 1996 to allow margin status for foreign stocks with a “ready market.” Stocks added to the FT/S&P list are not marginable until they appear on the Board’s quarterly foreign list. In 1997, the Board announced that it will no longer require that a foreign stock with a “ready market” appear on its foreign list to be considered a “margin security” under Regulation T. This change will allow broker–dealers to extend credit against foreign securities as soon as they are deemed to have a “ready market” without waiting for the Board to verify that status by publishing the names of the securities on its foreign list.

In 1995 the Board solicited comment on the mixed collateral provision in Regulation U, which applies to regulated loans that are secured in part by margin stock and in part by other collateral. The Board noted that this provision makes collateral management extremely difficult and appears to be unnecessarily burdensome to effectuate the statutory scheme of margin regulation. In 1997, the Board announced elimination of the separation requirement in the mixed collateral provision. Regulation U lenders will still be required to determine that the combined loan value of collateral is sufficient to support the credit outstanding.

Amendments to Eliminate Outmoded and Duplicative Requirements

As part of its comprehensive review of Regulations G and U, the Board in 1997 announced the deletion of six Board interpretations because they were obsolete or duplicative of regulatory language added after the interpretation was

issued. In 1997 the Board recognized the 1996 congressional repeal of section 8(a) of the SEA by deleting the provisions in Regulations G, T, and U that had been adopted to implement section 8(a). The Board also determined that the collateral requirements for the borrowing and lending of securities under Regulation T were unnecessary to effectuate the purposes of Regulation T and therefore duplicative of the SEC’s customer protection rules in this area and of the securities self-regulatory organizations’ responsibility for overseeing the safety and soundness of member broker–dealers.

Amendment to Reduce Regulatory Burden

Regulation T requires broker–dealers to keep records of customer transactions by recording them in a margin account or other special-purpose account. In general, the requirements for one account may not be met by considering items in another account. As part of its comprehensive review of Regulation T, the Board announced in 1997 that it was reducing the number of Regulation T accounts from nine to five. The remaining account structure recognizes the distinction between cash and margin transactions for customers; it incorporates a new account for nonequity securities transactions and includes a separate account for transactions between broker–dealers.

Regulation Y **Bank Holding Companies**

In 1996 the Board conducted an extensive review of Regulation Y and issued a proposal for public comment (dis-

cussed in last year's REPORT). In April 1997, the Board announced the adoption of revisions to the regulation based on the proposal. The revisions streamline and expedite the process for reviewing bank and nonbank applications submitted by well-run bank holding companies; reorganize and expand the regulatory list of nonbanking activities and remove a number of restrictions on the nonbanking activities of bank holding companies that would not apply to insured banks engaged in the same activities; amend the tying restrictions, including the restrictions on bank holding companies and their nonbank subsidiaries; and make other changes to eliminate unnecessary regulatory burden and to streamline and modernize Regulation Y.

Effective in October, the Board modified the prudential limitations established in its decisions under the Bank Holding Company Act and section 20 of the Glass-Steagall Act permitting nonbank subsidiaries of bank holding companies to underwrite and deal in securities. It eliminated restrictions that have proved unduly burdensome or unnecessary in light of other laws or regulations and consolidated the remaining restrictions in a series of eight operating standards. The Board concluded that the narrower set of restrictions is consistent with safety and soundness, should increase customer service options, and should improve operating efficiencies at section 20 subsidiaries. The new operating standards cover capital requirements for bank holding companies and section 20 subsidiaries, internal controls, interlock restrictions, customer disclosures, credit for clearing purposes, funding of securities purchases, reporting requirements, and the application of sections 23A and 23B of the Federal Reserve Act to foreign banks.

Regulatory Revisions Proposed

Regulations H and P Membership in the Federal Reserve System, and Bank Protection Act

The Board proposed in March 1997 to amend subpart A of Regulation H, regarding the general provisions for membership in the Federal Reserve System, and subpart E of Regulation H, regarding interpretations. The Board also proposed to incorporate Regulation P into Regulation H. In general, the proposed amendments reorganize, clarify, and reduce the burden of compliance with subpart A. They delete application procedures no longer in effect, reflect the requirements of the Community Reinvestment Act in branch applications, provide for expedited procedures in connection with certain membership and branch applications, and eliminate provisions that no longer have a significant effect. The proposal also eliminates a number of interpretations in Regulation H.

Regulation P implements the requirements of the Bank Protection Act of 1968. The proposal to subsume Regulation P in the revised subpart A of Regulation H would not substantively amend the terms of Regulation P. The proposal to combine the regulations is designed to simplify compliance for state member banks by consolidating the regulatory requirements applying to state member banks into one regulation.

Regulation I Issue and Cancellation of Federal Reserve Bank Stock

In March the Board proposed amending Regulation I to reduce regulatory burden and to update requirements. The proposed amendments simplify, mod-

ernize, and condense the regulation and reflect the replacement of share certificates by a book-entry system. They also codify Board and staff interpretations. Finally, the proposed amendments delete references to specific forms, many of which are obsolete because they no longer exist or no longer have the same identification numbers.

Regulation K **International Banking Operations**

After a lengthy review, the Board in December 1997 proposed several revisions to Regulation K. Some of the revisions are intended to improve the international competitiveness of U.S. banking organizations by expanding the number of activities that they may engage in abroad and reducing the regulatory burden associated with the conduct of such activities; other revisions are intended to reduce the regulatory burden on foreign banks operating in the United States by streamlining the application and notice process. The proposed revisions include expansion of the authority of U.S. banking organizations to engage in equity securities underwriting and dealing outside the United States; relaxation of limits on the ability of U.S. banking organizations to make venture capital investments in nonbank organizations outside the United States; a streamlined and expedited review process for U.S. banking organizations to branch abroad, and for foreign banking organizations to establish offices in the United States; expedited review of proposals by well-run U.S. banking organizations to make investments abroad; increased flexibility in the standard for determining whether a foreign banking organization would qualify for certain nonbanking exemptions from the Bank Holding Act; and implementation of statutory changes with respect to

increased investments by U.S. banks in Edge Act corporation subsidiaries and to the interstate operations of foreign banks operating in the United States.

Other Regulatory Proposals

In November 1997, the Board proposed amendments to Regulation D for monetary policy purposes that are intended to reduce regulatory burden.

Regulation D **Reserve Requirements of Depository Institutions**

The Board proposed amendments to move from the existing system of contemporaneous reserve maintenance for institutions that are weekly reporters to a system under which reserves are maintained on a lagged basis. Under the lagged system, the reserve maintenance period for weekly reporters would begin thirty days after the beginning of a reserve computation period. Under the current system, the reserve maintenance period begins only two days after the beginning of a computation period. The longer time between computation and maintenance of reserves should facilitate compliance by weekly reporting institutions and improve the Board's ability to estimate the need for reserves on a timely basis. ■

Federal Reserve Banks

Two major interests of the Federal Reserve Banks during 1997 were the Federal Reserve's role in the payments mechanism and continued preparation for the century date change. Other important activities were preparation of revised accounting procedures related to interstate branching and implementation of new procedures for the provision of fiscal agency and depository services for the federal government.

Major Initiatives

Payment Services

The System's Committee on the Federal Reserve in the Payments Mechanism during 1997 reviewed the payment services provided by the Federal Reserve to depository institutions and began preparing its report. Created by Chairman Greenspan in October 1996 in recognition of the rapid changes in the financial services and technology sectors, the committee had as one of its goals determining the extent to which the Federal Reserve should be involved in providing check collection and automated clearinghouse (ACH) services and future generations of payment services. Board of Governors Vice Chair Alice M. Rivlin chaired the committee; members were Governor Edward W. Kelley, Jr., William J. McDonough, president of the Federal Reserve Bank of New York, and Thomas C. Melzer, president of the Federal Reserve Bank of St. Louis.

The committee focused its discussions and analyses of critical payment systems issues by developing five hypothetical scenarios for the future role of

the Federal Reserve in retail payment services. The scenarios ranged from exiting the check and ACH services altogether to playing a more active role, in collaboration with other providers, in moving more rapidly toward electronic payment services. The scenarios were not designed to be actual policy options, but were intended to serve as catalysts for debate both within the Federal Reserve and among payment system participants. The committee held forums around the country so that representatives of depository institutions, clearinghouses, other payment service providers, consumers, businesses, and academics could express their views on the various possible future directions. Federal Reserve staff analyzed the likely impact of each of the alternatives on payment systems of the future, with emphasis on efficiency, access by depository institutions of various sizes, and whether different roles of the Federal Reserve would accelerate or retard the movement to electronic forms of payment.

The committee came to two general conclusions: (1) The Federal Reserve should remain a provider of both check collection and ACH services, with the explicit goal of enhancing the efficiency, effectiveness, and convenience of both systems while ensuring access by all depository institutions; and (2) The Federal Reserve should play a more active role, working closely and collaboratively with providers and users of payment systems, both to enhance the efficiency of check and ACH services and to help evolve strategies for moving to the next generation of payment instru-

ments. In reaching these conclusions, the committee recognized that fostering private-sector competition is vital in improving the efficiency of payment systems and in developing new payment instruments.

Year 2000 Readiness

The Federal Reserve continued in 1997 to focus on its readiness for the century date change to ensure that the Reserve Banks continue to provide reliable services to the nation's banking system and financial markets. When it began consolidating its mainframe data processing operations late in 1992, the Federal Reserve started to address the possibility that automated systems would not function properly at the turn of the century. As a result, new centralized applications critical to the Federal Reserve's mission, such as Fedwire funds transfer, Fedwire securities transfer, and ACH, were designed to operate properly into the next century. All changes to Reserve Bank computer programs, testing of systems, and acceptance testing by Federal Reserve users of those systems are scheduled to be completed by year-end 1998. In addition, critical financial-services systems that interface with depository institutions will be year 2000 ready by mid-1998; this schedule will permit approximately eighteen months for customer testing.

Also during the year, the Reserve Banks initiated a comprehensive program to raise public awareness of the potential year 2000 problem and to advise depository institutions of the Federal Reserve's plans and schedules. The Reserve Banks also participated in domestic and international forums to help foster awareness of year 2000 issues and to share experiences, ideas, and best practices.

Interstate Branching

As a result of the Riegle-Neal Interstate Banking and Branching Act of 1994, which became effective in June 1997, banking organizations that formerly maintained separately chartered institutions in different states may now convert those institutions into branches of a single chartered bank. With fewer chartered institutions, at the end of 1997, Reserve Banks held 9,368 accounts, compared with 9,753 at year-end 1996, a decrease of 4.0 percent.

To accommodate banking organizations having an interstate structure, the Reserve Banks established an account structure, effective January 2, 1998, that provides, for each chartered institution, a single (master) account at one Reserve Bank, in which all credits and debits arising from financial transactions with the Federal Reserve are settled. Institutions may maintain subaccounts to keep separate several different types of financial transaction information—for example, by geographic region or operational function. The Reserve Banks modified their accounting software to permit institutions to view intraday activity in the master account and any subaccounts separately or combined. This new structure and associated accounting tools permit interstate banking organizations to centralize all their financial information or to segregate information according to their needs.

The Board of Governors in 1997 amended some Federal Reserve regulations to facilitate the transition to the single Federal Reserve account structure. Specifically, the Board amended Regulation J to allow an institution to send checks for collection to any Reserve Bank and to settle for checks through its single account. It also revised Regulations D and I to define

an institution's location for purposes of Federal Reserve membership and account location. It further amended Regulation D to allow pass-through correspondents to hold all their respondent balances in their single Federal Reserve account, regardless of the location of the respondent; this change allows U.S. branches and agencies of foreign banks, and also Edge Act and agreement corporations, to adopt a single account structure by combining the reserve balances of multiple offices into a single pass-through correspondent account.

Fees for Electronic Payment Services

In March 1997, the Board adopted guidelines for the Reserve Banks in establishing fees for their electronic payment services on the basis of volume. The Board also approved the continuation of volume-based fees for certain electronic check products, pending completion of an analysis of whether those fees meet the new guidelines. In May, the Reserve Banks implemented volume-based fees for the ACH service.

Fiscal Agency and Depository Services

Reserve Banks worked during the year to implement a policy, adopted in late 1996, to clarify the Reserve Banks' unique statutory relationship with the Treasury and other federal government entities. The Reserve Banks provide fiscal agency and depository services for the U.S. government; the policy, among other things, establishes uniform and consistent practices for accounting, reporting, and billing for the full costs of providing these services.

Developments in Federal Reserve Priced Services

The Monetary Control Act of 1980 requires that the Federal Reserve set fees for providing "priced services" to depository institutions that, over the long run, recover all the direct and indirect costs of providing the services as well as the imputed costs, such as the income taxes that would have been paid and the pretax return on equity that would have been earned had the services been provided by a private firm. The imputed costs are collectively referred to as the private sector adjustment factor (PSAF).¹ Over the past ten years, the Federal Reserve System has recovered 100.4 percent of its priced services costs, including the PSAF.

Overall, fees charged in 1997 for priced services were lowered approximately 3.7 percent from 1996 levels.² The fees for electronic payment services were lowered significantly, in large part because of the efficiencies associated with the transition to a consolidated automation environment and with the centralization of electronic payment processing applications.

Revenue from priced services in 1997 was \$789.1 million, other income related to priced services was \$29.7 million, and costs related to priced services were \$721.5 million. As a result, net

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

2. Based on a chained Fisher Ideal price index not adjusted for quality changes.

revenue was \$97.3 million, for a recovery rate of 101.5 percent of costs, including the PSAF. Revenue from priced services in 1996 was \$26.6 million more than total costs, resulting in a recovery rate of 103.4 percent, including the PSAF.³

Check Collection

In 1997, total Reserve Bank operating expenses and imputed costs for commercial check services were \$581.2 million, compared with \$570.7 million in 1996. Revenue from check operations totaled \$598.4 million, and other income amounted to \$23.2 million, resulting in income before income taxes of \$40.4 million. The Reserve Banks handled 15.9 billion checks, an increase

of 3.0 percent over 1996 (see table). The volume of fine-sort check deposits, which are presorted by the depositing bank according to paying bank, increased 0.7 percent in 1997, compared with an 11.9 percent decline in 1996. The volume of checks deposited that required processing by Reserve Banks rose 3.4 percent.

To increase the efficiency of the check-collection system, the Reserve Banks continued to expand the use of electronics in check processing. During 1997, the Reserve Banks electronically presented approximately 2.2 billion checks, or 14.1 percent of all checks presented to paying banks, an increase of about 56 percent over the 1996 level. Both the number of checks presented electronically and the number of checks truncated grew in 1997.

The Reserve Banks also continued in 1997 to offer more products involving the capture and storage of digital images to support paying banks' use of electronic check products. With the New York and Richmond Districts' introduction of image products during the year, at least one office in each Federal Reserve District except the First offered image products in 1997; the Boston Reserve Bank plans to offer image products in early 1998.

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

Activity in Federal Reserve Priced Services, 1997, 1996, and 1995

Thousands of items

Service	1997	1996	1995	Percentage change	
				1996-97	1995-96
Commercial checks	15,949,152	15,486,833	15,465,209	3.0	.1
Funds transfers	91,800	84,871	77,742	8.2	9.2
Securities transfers	4,136	4,125	3,689	.3	11.8
Commercial ACH	2,602,892	2,372,108	2,046,086	9.7	15.9
Noncash collection	887	1,069	838	-17.1	27.6
Cash transportation	2	36	61	-93.9	-41.0

NOTE. Components may not yield percentages shown because of rounding. Activity in *commercial checks* is the total number of commercial checks collected, including processed and fine-sort items; in *funds transfers* and securities transfers, the number of transactions originated

on line and off line; in *ACH*, the total number of commercial items processed; in *noncash collection*, the number of items on which fees are assessed; in *cash transportation*, the number of registered mail shipments and FRB-arranged armored carrier stops.

In October 1997, the Boston Reserve Bank closed its Regional Check Processing Center at Lewiston, Maine, and consolidated its check-processing operations at the Boston office. In addition, the Interdistrict Transportation System moved one of its five airport hubs from Cleveland to Cincinnati, Ohio, enabling Reserve Banks to set later deposit deadlines and to improve funds availability for many depositors.

Fedwire Funds Transfer and Net Settlement

Reserve Bank operating expenses and imputed costs for Fedwire funds transfer and net settlement services totaled \$79.9 million in 1997, compared with \$71.1 million in 1996. Revenue from these operations totaled \$94.6 million, and other income amounted to \$3.2 million, resulting in income before income taxes of nearly \$18.0 million.

Funds Transfer

The number of Fedwire funds transfers originated by depository institutions increased 8.2 percent in 1997, to 91.8 million, of which 89.5 million were value (monetary) transfers and 2.4 million were nonvalue messages. The increase in volume was due largely to increased mutual fund activity and aggressive marketing of cash management services by depository institutions, and to a lesser extent to increased mortgage activity and securities-related settlement payments.

Fees charged for Fedwire transfers were lowered 10 percent in 1997, from \$0.50 to \$0.45 per basic transfer. As a result, depository institutions paid approximately \$9.2 million less for funds transfers in 1997 than in 1996. The reduction generally reflects increased efficiencies resulting from the

centralization of Fedwire funds transfer processing.

By year-end 1997, all on-line institutions (those with an electronic connection to the Federal Reserve) had adopted a new, expanded-message Fedwire funds transfer format. The new format (1) reduces manual intervention in the transfer process, (2) eliminates the need to truncate payment-related information when forwarding payment orders that were received via other large-value transfer systems through Fedwire, and (3) allows additional information about the originator and beneficiary of a transfer to be included in the transfer message, as required by the Bank Secrecy Act rules adopted by the Department of the Treasury.

On December 8, the Fedwire funds transfer service began opening at 12:30 a.m. eastern time, thereby expanding the Fedwire funds transfer service day to eighteen hours from the previous ten hours. The longer day is useful to the private sector in reducing settlement risk in foreign exchange markets; it also eliminates an operational barrier to potentially important innovations in privately provided payment and settlement services.

Net Settlement

The Federal Reserve provides net settlement services to approximately 170 local private-sector clearing and settlement arrangements and to seven nationwide arrangements.⁴ These

4. Two of the national arrangements, the Clearing House Interbank Payments System (CHIPS) and the Participants Trust Company (PTC), process and net large-dollar transactions, CHIPS for interbank funds transfers and PTC for the settlement of mortgage-backed securities transactions. Two of the other national arrangements, VisaNet ACH and the New York ACH, process and net small-dollar ACH transactions. The other three

(Footnote continues on next page.)

arrangements enable participants to settle their net positions either via Fedwire funds transfers using special settlement accounts at Reserve Banks or via accounting entries, which are posted to participants' Reserve Bank accounts.

In 1997, the Federal Reserve Board requested comment on a proposal that would enhance the Reserve Banks' current net settlement services. Under the proposed changes, the Reserve Banks would offer a fully automated net settlement service to participants in clearing arrangements. The service would provide finality of settlement at least once on the settlement date, rather than next-day finality.

Fedwire Book-Entry Securities

Reserve Bank operating expenses and imputed costs for book-entry securities transfer services totaled \$15.5 million in 1997, compared with \$16.2 million in 1996. Revenue from book-entry securities operations totaled \$16.6 million, and other income amounted to \$0.6 million, resulting in income before income taxes of \$1.7 million. The Reserve Banks processed 4.1 million transfers of government agency securities on the Fedwire book-entry securities transfer system during the year, an increase of 0.3 percent over the 1996 level.⁵ Fees charged

national arrangements—the National Clearing House Association, the Interdistrict Check Exchange and Settlement Service, and the National Check Exchange—clear and net check transactions. Most local clearing arrangements are check clearinghouses.

5. The revenues, expenses, and volumes reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and international institutions such as the World Bank. The Fedwire book-entry securities service also provides custody, transfer, and settlement services for U.S. Treasury securities. The Reserve Banks act as fiscal agents of the United States when they transfer and

for book-entry securities transfers did not change from 1996 to 1997.

Seven Reserve Banks converted their Fedwire securities transfer applications to the Federal Reserve's new centralized application known as the National Book-Entry System (NBES), joining the four Reserve Banks that converted to NBES in 1996. The NBES offers several benefits, including (1) an expanded account structure designed to accommodate the different needs of Federal Reserve customers and U.S. government agencies, (2) modular, centralized application software designed to facilitate a more rapid response to changing industry needs, (3) improved, standardized contingency and disaster recovery capabilities, and (4) processing efficiencies such as uniform operating hours in all Districts. The conversion process will be complete when the Federal Reserve Bank of New York converts to NBES in early 1998.

Automated Clearinghouse

Reserve Bank operating expenses and imputed costs for commercial ACH services totaled \$52.3 million in 1997, compared with \$63.7 million in 1996. Revenue from ACH operations totaled \$70.3 million, and other income amounted to \$2.4 million, resulting in income before income taxes of \$20.4 million. The Reserve Banks processed 2.6 billion commercial ACH transactions during the year, an increase of 9.7 percent over 1996 volume.

The year 1997 was the first full year that all Reserve Banks operated with the new centralized automated system known as Fed ACH. The ongoing reduction in ACH operating costs in 1997

safekeep Treasury securities, and the Treasury assesses fees on depository institutions for some of these services. For more details, see the section "Fiscal Agency Services" later in this chapter.

reflects the savings realized from centralization. Consolidation of operations also made it possible to offer several new features to depository institutions, including additional file delivery options and automated trace and research capabilities.

In May, the Reserve Banks implemented volume-based fees for ACH transactions. The use of volume-based fees, an extension of the multipart fees already in use, increases the potential to improve the payment system's efficiency by permitting the Reserve Banks to address the differences in demand for services by high-volume customers (2,500 items or more per file) and low-volume customers (fewer than 2,500 items per file) through the fees charged for those services. As a result of volume-based pricing, the cost to depository institutions to originate ACH transactions declined an average of 17 percent and the cost to institutions to receive ACH transactions declined 10 percent. In October, the Reserve Banks extended the regular billing deposit deadline for ACH items, which reduced the number of customers subject to premium fees.

Noncash Collection

Reserve Bank operating expenses and imputed costs for noncash collection services totaled \$3.2 million in 1997, compared with \$4.9 million in 1996. Revenue from noncash operations totaled \$4.3 million, and other income amounted to \$0.2 million, resulting in income before income taxes of \$1.3 million. The Reserve Banks processed 887,000 noncash collection items (coupons and bonds), a decrease of 17.1 percent from 1996.

Until late in the year, two Federal Reserve sites processed noncash items—the Cleveland Reserve Bank and

the Jacksonville Branch of the Atlanta Reserve Bank. In the fourth quarter of 1997, all noncash processing was centralized at the Jacksonville Branch.

Cash Services

Because the provision of high-quality currency and coin is a basic responsibility of the Federal Reserve, the Reserve Banks charge fees only for certain special cash services. These services include providing wrapped coin, non-standard currency packages, and more-frequent-than-standard access to cash services.

The Cleveland District and the Helena Branch of the Minneapolis Reserve Bank provide wrapped coin as a priced service. In 1997, the Detroit Branch of the Chicago Reserve Bank and the Helena Branch provided currency in nonstandard packages, and the Minneapolis and San Francisco Districts and the Detroit Branch offered access to cash services more frequently than that provided under the Federal Reserve's standard access policy. When the uniform cash access policy is implemented in May 1998, income from fees for non-standard cash access will be treated as a recovery of expense rather than as priced-service revenue. The new policy will provide flexibility by permitting depository institutions to obtain cash services from any Reserve Bank office.

Depository institutions pay the cost of transporting cash to and from Reserve Banks. In the past, many of the Reserve Banks arranged transportation to move cash to and from depository institutions in their Districts. During the third quarter of 1997, the last Federal Reserve office to provide that service stopped arranging armored carrier cash transportation when the Helena Branch canceled its armored carrier contract for the delivery of cash. Seven Districts still

provide cash transportation by registered mail.

Reserve Bank operating expenses and imputed costs for special cash services totaled \$4.5 million in 1997, compared with \$5.2 million in 1996. Revenue from cash operations totaled \$4.9 million, and other income amounted to \$0.2 million, resulting in income before income taxes of \$0.6 million.

Float

Federal Reserve float decreased in 1997 to a daily average of \$282.0 million, from a daily average of \$413.4 million in 1996. The Federal Reserve recovers the cost of float associated with priced services as part of the fees for those services.

Developments in Currency and Coin

The Federal Reserve continued in 1997 to work closely with the Treasury to deter the counterfeiting of U.S. currency. The Series 1996 currency design program continued with the introduction of the new \$50 note in October. The Series 1996 \$100 note, introduced in March 1996, continued to gain acceptance and accounted for more than half of the \$100 notes in circulation by the end of 1997. Work on the Series 1996 \$20 note continued; distribution is scheduled for fall 1998.

The Federal Reserve's cost to print new currency in 1997 was \$356 million. The Treasury's Bureau of Engraving and Printing produced 9.5 billion notes in 1997; 15 percent of the notes produced were of the Series 1996 new design, 45 percent were \$1 notes, and the remaining 40 percent were \$5, \$10, and \$20 notes.

The Federal Reserve supplies currency and coin to approximately 9,500

depository institutions throughout the United States; these institutions supply currency and coin to other depository institutions and to the public. The value of currency and coin in circulation increased 6.9 percent in 1997 and exceeded \$482 billion by year-end. During the year, the Federal Reserve received more than 25.3 billion Federal Reserve notes in deposits from depository institutions and sent more than 25.8 billion Federal Reserve notes to depository institutions. The Federal Reserve finished converting its currency-processing operations to Giesecke and Devrient's Banknote Processing System (BPS) 3000, an electronic, high-speed currency processing, destruction, and accounting system. At the end of 1997, the 128 BPS 3000 machines installed at Reserve Banks were processing approximately 97 million notes each business day. Reserve Bank operating expenses for processing and storing currency and coin, including priced cash services, totaled \$283 million for the year.

In late 1997, the

Developments in Fiscal Agency and Government Depository Services

The Federal Reserve Act provides that when required by the Secretary of the Treasury, Reserve Banks will act as fiscal agents and depositories of the United States. As fiscal agents, Reserve Banks provide services for the Department of the Treasury related to the federal debt,

such as issuing, transferring or reissuing, exchanging, and redeeming marketable Treasury securities and savings bonds and processing secondary market transfers initiated by depository institutions. As depositories, Reserve Banks collect and disburse funds on behalf of the federal government. The Reserve Banks also provide fiscal agency services on behalf of several domestic and international government agencies.

The total cost of providing fiscal agency and depository services for the Treasury in 1997 amounted to \$255.4 million, compared with \$265.2 million in 1996 (see table). The cost of providing services to other government agencies was \$48.6 million, compared with \$49.8 million in 1996.

Significant Reserve Bank resources were devoted in 1997 to the General Accounting Office (GAO) audit of U.S.

government consolidated financial statements. As part of the audit, the GAO reviewed principal Federal Reserve operations and automated applications that process Treasury transactions.

During the year, the Reserve Banks and the Treasury jointly conducted studies to identify the best ways to provide services to the Treasury over the next five years. The business areas studied were Treasury Direct, Treasury tax and loan, collateral, savings bonds, and Treasury auctions.

Fiscal Agency Services

The Reserve Banks handle marketable Treasury securities and savings bonds and monitor the collateral pledged by depository institutions to the federal government.

Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 1997, 1996, and 1995

Thousands of dollars

Agency and service	1997	1996	1995
DEPARTMENT OF THE TREASURY			
<i>Bureau of the Public Debt</i>			
Savings bonds	70,340.4	78,765.8	80,934.6
Treasury Direct	35,440.4	26,788.8	30,117.4
Commercial book entry	26,809.4	27,099.0	27,705.9
Marketable Treasury issues	14,855.4	22,349.9	22,830.3
Definitive securities and Treasury coupons	3,618.9	3,498.5	3,860.6
Total	151,064.5	158,502.0	165,448.8
<i>Financial Management Service</i>			
Treasury tax and loan and Treasury general account	35,265.9	38,828.2	35,749.3
Government check processing	26,548.0	22,604.1	24,347.4
Automated clearinghouse	14,477.3	20,557.0	22,238.0
Government agency deposits	2,795.3	3,366.1	3,823.5
Fedwire funds transfers	422.0	455.3	357.9
Other services	20,994.2	17,346.3	16,376.7
Total	100,502.7	103,157.1	102,892.8
<i>Other</i>			
Total	3,840.0	3,554.6	4,017.5
Total, Treasury	255,407.2	265,213.6	272,359.1
OTHER FEDERAL AGENCIES			
Securities services	17,042.1	18,788.8	18,547.2
Food coupons	25,495.7	25,287.6	24,251.4
Postal money orders	6,108.7	5,722.9	5,467.8
Total, other agencies	48,646.5	49,799.3	48,266.4
Total	304,053.7	315,012.9	320,625.5

Marketable Treasury Securities

Reserve Bank operating expenses for activities related to marketable Treasury securities (Treasury Direct, commercial book entry, Treasury issues, and definitive securities and coupons) totaled \$80.7 million in 1997, a 1.2 percent increase over 1996.

Reserve Banks processed more than 411,000 commercial tenders for government securities in Treasury auctions, 7.6 percent fewer than in 1996.

The Reserve Banks operate two book-entry securities systems for the custody and transfer of Treasury securities—the Fedwire system and Treasury Direct. Almost all book-entry Treasury securities, 97.6 percent of the total par value outstanding at year-end 1997, were maintained on Fedwire; the remainder were maintained on Treasury Direct.

The Reserve Banks in 1997 processed 8.8 million Fedwire transfers of Treasury securities, a 1.9 percent decline from 1996. They also processed 23.9 million interest and principal payments for Treasury and government agency securities, a 10.8 percent increase over 1996.

Treasury Direct, operated by the Philadelphia Reserve Bank, is a system of book-entry securities accounts for institutions and individuals planning to hold their Treasury securities to maturity. The Treasury Direct system holds more than 1.9 million accounts. During 1997, the Reserve Banks processed nearly 433,000 tenders for Treasury Direct customers seeking to purchase Treasury securities at Treasury auctions and handled 1.7 million reinvestment requests; the volume of tenders was 3.9 percent lower than in 1996, and the volume of reinvestment requests was 13.2 percent lower. The Philadelphia Reserve Bank issued 6.9 million pay-

ments for discounts, interest, and redemption proceeds; 2.8 million payments for savings bonds; and more than 51,000 interest payments for definitive Treasury issues.

In 1997, the Federal Reserve worked with the Treasury's Bureau of the Public Debt to make several changes that benefit Treasury Direct investors. First, the Treasury Direct account statement was redesigned for clarity. Second, the "Buy Direct" program was introduced; it permits certain Treasury Direct investors to pay for Treasury securities by means of an ACH debit to their bank account on the security's issue date rather than by a personal or certified check submitted in advance. Third, the "Reinvest Direct" program was begun; it permits investors to schedule their reinvestments electronically using a touch-tone telephone. Finally, the Chicago Reserve Bank introduced the "Sell Direct" program; for a fee, the Bank will liquidate Treasury securities on the secondary market for Treasury Direct investors; in the last four months of the year, the Bank sold more than 4,000 securities worth \$132.3 million at the request of Treasury Direct investors.

Savings Bonds

Reserve Bank operating expenses for savings bond activities totaled \$70.3 million in 1997, a decrease of 10.8 percent from 1996. The Reserve Banks printed and mailed 51.4 million savings bonds on behalf of the Treasury's Bureau of the Public Debt, a 6.8 percent decline from 1996. They processed 39 million original-issue transactions. They also processed approximately 674,000 redemption, reissue, and exchange transactions, a 1.5 percent increase over 1996. In addition, the Reserve Banks responded to 1.7 million service calls from owners of

savings bonds, approximately the same number as in 1996.

Savings bond operations are conducted at five Reserve Bank offices:

All five offices process savings bond transactions, but only the offices print and mail savings bonds.

Other Initiatives

The St. Louis Reserve Bank in 1997 completed development and installation of Cash Track for the Treasury's Financial Management Service. By consolidating information about receipts and payments processed on behalf of the Treasury, Cash Track makes it easier for the Treasury to forecast its cash needs. The average daily flow reported by Cash Track is \$13.4 billion. At year-end, the Treasury was running parallel systems and expected to implement Cash Track fully in 1998.

The Federal Reserve also worked with the Financial Management Service to implement the Treasury Offset Program, which electronically compares information about delinquent debts owed the U.S. government with information about payments being issued by the government. If a match occurs, the Treasury applies a portion of the payment to the delinquent debt. The Federal Reserve Bank of San Francisco developed the software with which the Treasury maintained an interim delinquent debtor database for matching against payments and provided support to the Treasury in its efforts to develop software for longer-term use.

Depository Services

The Reserve Banks maintain the Treasury's funds account, accept deposits of federal taxes, pay checks drawn on the

Treasury's account, and make electronic payments on behalf of the Treasury.

Federal Tax Payments

Reserve Bank operating expenses related to federal tax payment activities in 1997 totaled \$35.3 million. The Reserve Banks processed approximately 334,000 paper and 5.7 million electronic advices of credit from depository institutions handling tax payments for businesses and individuals. (Advices of credit are notices from depository institutions to the Federal Reserve and the Treasury summarizing taxes collected on a given day.) The number of paper advices of credit declined 61.7 percent from 1996 to 1997, and the number of tax payments submitted electronically increased 5.8 percent. The Reserve Banks also received a small number of tax payments directly. Depository institutions that receive tax payments may place the funds in a Treasury tax and loan (TT&L) account or remit the funds to a Reserve Bank. The Minneapolis Reserve Bank operates an automated system through which businesses pay taxes that are due on the same day the tax liability is determined. These electronic tax payments, a part of the Treasury's Electronic Federal Tax Payment System, are invested in depository institutions' TT&L balances via the Federal Reserve's TT&L mechanism. In 1997, this electronic tax application processed approximately 56,000 tax payments from 5.3 million taxpayers totaling \$70.8 billion.

Payments Processed for the Treasury

Reserve Bank operating expenses related to government payment operations (check processing, ACH, agency deposits, and funds transfers) totaled \$44.2 million in 1997. The Treasury continued to encourage electronic pay-

ments. For example, ACH transactions processed for the Treasury (social security, pension, salary, and vendor payments) totaled 677 million, an increase of 8.4 percent over 1996. All recurring Treasury Direct payments and most definitive securities interest payments are made via the ACH.

The Treasury also continues to reduce the number of payments made by check. The Reserve Banks processed 378 million paper government checks in 1997, a decrease of 13.3 percent from 1996. They also issued 1.6 million fiscal agency checks, a decrease of 19.1 percent from 1996. Fiscal agency checks were used primarily to pay semiannual interest on registered, definitive Treasury notes and bonds and Series H and HH savings bonds; they were also used to pay the principal of matured securities and coupons and to make discount payments to first-time purchasers of government securities through Treasury Direct.

In 1997, the Reserve Banks began to capture and store digital images of U.S. government checks for the Treasury's Financial Management Service; full implementation of the system is expected in 1998. Digital imaging will improve the Treasury's check reconciliation and claims processing by eliminating manual research and by reducing the time needed to make information on paid Treasury checks available for research and inquiry.

Services Provided to Other Entities

When required to do so by the Secretary of the Treasury or when required or permitted to do so by federal statute, the Reserve Banks provide fiscal agency and depository services to other domestic and international agencies. Depending on the authority under which the services are provided, the Reserve

Banks may (1) maintain book-entry accounts of government agency securities and handle their transfer, (2) provide custody for the stock of unissued, definitive securities, (3) maintain and update balances of outstanding book-entry and definitive securities for issuers, (4) perform various other securities-servicing activities, and (5) maintain funds accounts for some government agencies.

One such service is the provision of food coupon services for the U.S. Department of Agriculture. Reserve Bank operating expenses for food coupon services in 1997 totaled \$25.5 million, 0.8 percent higher than in 1996. The Reserve Banks redeemed 2.9 billion food coupons, a decrease of 21.5 percent from 1996. The volume of paper food coupons redeemed by the Reserve Banks is expected to continue to decline each year as a result of the Department of Agriculture's program to provide benefits electronically.

Information Technology

In 1997, Federal Reserve Automation Services (FRAS) continued to consolidate the Federal Reserve System's data processing and data communications systems, managed the three consolidated data centers, and continued to explore new technologies for improved communications strategies.⁶ By the end of 1997, most Reserve Bank applications except check processing had been converted to the shared processing environment; mainframe computers dedicated to check processing remained in ten Districts.

At year-end, the Federal Reserve supported approximately 12,450 Fedline connections (electronic links between

6.

small depository institutions and Reserve Banks) and 580 computer interface connections, enabling depository institutions to access Federal Reserve services and to report information; depository institutions that transmit large numbers of transactions to Reserve Banks use more sophisticated computer interface connections over dedicated leased circuits. In 1997, FRAS continued its ongoing efforts to explore alternative, more efficient electronic services, such as web-based technology.

During 1997, the Reserve Banks completed FEDNET, the new Federal Reserve telecommunications network. FEDNET offers a consistent level of service to all points in the System, as well as improved reliability, security, and disaster recovery capabilities.

Financial Examinations of Federal Reserve Banks

Section 21 of the Federal Reserve Act requires that the Board of Governors order an examination of each Reserve Bank at least once a year. The Board has assigned this responsibility to its Division of Reserve Bank Operations and Payment Systems. Every year since 1995, the division has engaged a public accounting firm to audit the combined financial statement of the Reserve Banks. In addition, in 1997 the public accounting firm audited the individual year-end financial statement of each of the twelve Reserve Banks; the firm relied, in part, on the division's 1997 reviews of the major operating areas of the twelve Reserve Banks for these audits.

In addition, the division rendered an opinion on the management control system at each Reserve Bank, using a format consistent with the integrated framework of the Committee of Spon-

soring Organizations (COSO) of the Treadway Commission. Following COSO's four control objectives, the examinations concentrated on (1) efficiency and effectiveness of operations, (2) accuracy of financial data, (3) compliance with applicable laws and regulations, and (4) safeguarding of assets. The Reserve Banks have also adopted the COSO framework as it applies to the accuracy of financial reporting, for implementation in 1998. To prepare for implementation, three Reserve Banks in 1997 conducted pilot self-assessments of their internal control systems for financial reporting.

As in past years, the division in 1997 assessed compliance with policies established by the Federal Open Market Committee (FOMC) by examining the accounts and holdings of the System Open Market Account at the Federal Reserve Bank of New York and the foreign currency operations conducted by that Reserve Bank. In addition, at year-end a public accounting firm certified the schedule of participated asset and liability accounts and the related schedule of participated income accounts.

Income and Expenses

The accompanying table summarizes the income, expenses, and distributions of net earnings of the Federal Reserve Banks for 1997 and 1996.

Income in 1997 was \$26,917 million, compared with \$25,164 million in 1996. Total expenses were \$2,151 million (\$1,618 million in operating expenses, \$359 million in earnings credits granted to depository institutions, and \$174 million in assessments for expenditures by the Board of Governors). The cost of new currency (including printing, shipping, and other expenses) was \$364 million. Revenue from priced services was \$789 million. Unreimbursed expenses

for services provided to the Treasury and other government entities amounted to \$35 million.⁷

The profit and loss account showed a net loss of \$2,577 million. The loss was due primarily to realized and unrealized losses on assets denominated in foreign currencies that were revalued to reflect current market exchange rates. Statutory dividends paid to member banks totaled \$300 million, \$44 million more than in 1996; the rise reflects an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Reserve Banks.

Payments to the Treasury in the form of interest on Federal Reserve notes totaled \$20,659 million in 1997, up from \$20,083 million in 1996; the payments equal net income after the deduction of dividends paid and of the amount neces-

sary to bring the surplus of the Reserve Banks to the level of capital paid-in. In addition, the Federal Reserve in 1997 made a lump-sum payment of \$107 million to the U.S. Treasury from the surplus account of the Reserve Banks, as required by statute, compared with \$106 million in 1996.

In the “Statistical Tables” chapter of this REPORT, table 6 details the income and expenses of each Federal Reserve Bank for 1997, and table 7 shows a condensed statement for each Bank for 1914–97. A detailed account of the assessments and expenditures of the Board of Governors appears in the following chapter, “Board of Governors Financial Statements.”

Holdings of Securities and Loans

The Reserve Banks’ average daily holdings of securities and loans during 1997 amounted to \$417,805 million, an increase of \$27,537 million over 1996 (see table). Holdings of U.S. government securities increased \$27,466 mil-

7. The Reserve Banks bill the Treasury and other government entities for the cost of certain services, and the portions of the bills that are not paid are reported as unreimbursed expenses.

Income, Expenses, and Distribution of Net Earnings of Federal Reserve Banks, 1997 and 1996

Millions of dollars

Item	1997	1996
Current income	26,917	25,164
Current expenses	1,976	1,948
Operating expenses ¹	1,618	1,639
Earnings credits granted	359	309
Current net income	24,941	23,216
Net additions to (deductions from, -) current net income	-2,577	-1,639
Cost of unreimbursed services to Treasury	35	38
Assessments by the Board of Governors	539	565
For expenditures of Board	174	163
For cost of currency	364	403
Net income before payments to Treasury	21,790	20,975
Dividends paid	300	256
Transferred to surplus	832	635
Payments to Treasury ²	20,659	20,083

NOTE. In this and the following table, components may not sum to totals because of rounding.

1. Includes a net periodic credit for pension costs of \$200.0 million in 1997 and \$139.5 million in 1996.

2. Interest on Federal Reserve notes.

Securities and Loans of Federal Reserve Banks, 1995–97

Millions of dollars except as noted

Item and year	Total	U.S. government securities ¹	Loans ²
<i>Average daily holdings³</i>			
1995	376,069	375,867	202
1996	390,268	390,063	206
1997	417,805	417,529	277
<i>Earnings</i>			
1995	23,837	23,826	11
1996	23,895	23,884	11
1997	25,714	25,699	15
<i>Average interest rate (percent)</i>			
1995	6.34	6.34	5.62
1996	6.12	6.12	5.27
1997	6.15	6.16	5.27

1. Includes federal agency obligations.

2. Does not include indebtedness assumed by the Federal Deposit Insurance Corporation.

3. Based on holdings at opening of business.

lion, and holdings of loans increased \$71 million.

The average rate of interest earned on Reserve Banks' holdings of government securities rose to 6.16 percent, from 6.12 percent in 1996. The average rate of interest earned on loans remained constant at 5.27 percent.

Volume of Operations

Table 9 in the "Statistical Tables" chapter shows the volume of operations in the principal departments of the Federal Reserve Banks for the years 1994 through 1997.

Federal Reserve Bank Premises

During 1997, construction was completed on the new headquarters building for the Minneapolis Reserve Bank; relocation of staff and operations was completed in October. The expansion and renovation of the headquarters building of the Cleveland Reserve Bank continued during the year, as did design work for the Atlanta Reserve Bank's new headquarters building and its new Birmingham Branch building.

Multiyear renovation programs continued for the New York Reserve Bank's headquarters building and the Oklahoma City, Seattle, Portland, and Salt Lake City Branches. The Board approved the New York Reserve Bank's request to lease space in a nearby office building in New York City and to make necessary leasehold improvements to the facility.

The Atlanta Reserve Bank sold its headquarters building, and the Minneapolis Reserve Bank sold its former headquarters building before relocating to its new building. ■

Board of Governors Financial Statements

The financial statements of the Board for 1997 and 1996 were audited by Price Waterhouse, independent public accountants.

Price Waterhouse



REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Governors of the
Federal Reserve System

We have audited the accompanying balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 1997 and 1996, and the related statements of revenues and expenses and fund balance and of cash flows for the years then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Board as of December 31, 1997 and 1996, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 16, 1998 on our consideration of the Board's internal controls and a report dated March 16, 1998 on its compliance with laws and regulations.

Price Waterhouse LLP

March 16, 1998
Arlington, Virginia

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
BALANCE SHEET

ASSETS	As of December 31,	
	1997	1996
CURRENT ASSETS		
Cash	\$ 23,364,834	\$ 15,712,258
Accounts receivable	1,071,278	2,561,975
Transfers receivable—surplus Federal Reserve Bank earnings (Note 1)	652,913,560	659,862,602
Prepaid expenses and other assets	992,096	2,247,391
Total current assets	678,341,768	680,384,226
PROPERTY, BUILDINGS, AND EQUIPMENT, NET (Note 4)	64,220,105	61,110,184
Total assets	\$742,561,873	\$741,494,410
LIABILITIES AND FUND BALANCE		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	\$ 9,797,829	\$ 10,435,545
Accrued payroll and related taxes	7,609,781	6,804,678
Transfers payable—surplus Federal Reserve Bank earnings (Note 1)	652,913,560	659,862,602
Accrued annual leave	7,477,187	6,966,327
Capital lease payable (current portion)	98,772	0
Unearned revenues and other liabilities	2,016,190	2,263,338
Total current liabilities	679,913,319	686,332,490
CAPITAL LEASE PAYABLE (non-current portion)	516,228	0
ACCUMULATED RETIREMENT BENEFIT OBLIGATION (Note 2)	740,497	466,056
ACCUMULATED POSTRETIREMENT BENEFIT OBLIGATION (Note 3)	20,193,034	18,171,722
ACCUMULATED POSTEMPLOYMENT BENEFIT OBLIGATION (Note 3)	1,769,646	1,409,343
FUND BALANCE	39,429,149	35,114,799
Total liabilities and fund balance	\$742,561,873	\$741,494,410

The accompanying notes are an integral part of these statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
STATEMENT OF REVENUES AND EXPENSES
AND FUND BALANCE

	For the years ended December 31,	
	1997	1996
BOARD OPERATING REVENUES		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures.....	\$ 174,406,600	\$ 162,642,400
Other revenues (Note 5).....	9,460,475	9,789,141
Total operating revenues	183,867,075	172,431,541
BOARD OPERATING EXPENSES		
Salaries	108,870,919	106,353,644
Retirement and insurance contributions.....	19,835,377	18,417,943
Contractual services and professional fees	10,735,745	11,159,490
Depreciation and net losses on disposals.....	9,306,428	8,626,785
Travel	4,680,031	4,942,020
Equipment and facilities rental.....	4,291,093	4,356,715
Postage and supplies	4,261,161	4,263,382
Utilities	4,172,795	4,189,203
Software	4,130,603	3,907,874
Repairs and maintenance	2,895,097	3,417,539
Printing and binding	2,707,738	2,665,188
Other expenses (Note 5).....	3,665,738	4,354,734
Total operating expenses	179,552,725	176,654,517
BOARD OPERATING REVENUES OVER (UNDER) EXPENSES	4,314,350	(4,222,976)
ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES		
Assessments levied on Federal Reserve Banks for currency costs	363,738,623	403,232,215
Expenses for currency printing, issuance, retirement, and shipping	363,738,623	403,232,215
CURRENCY ASSESSMENTS OVER (UNDER) EXPENSES	0	0
TOTAL REVENUE OVER (UNDER) EXPENSES	4,314,350	(4,222,976)
FUND BALANCE, Beginning of year.....	35,114,799	39,337,775
TRANSFERS TO THE U.S. TREASURY		
Transfers and accrued transfers from surplus Federal Reserve Bank earnings (Note 1)	20,765,972,296	5,623,716,034
Transfers and accrued transfers to the U.S. Treasury (Note 1)	(20,765,972,296)	(5,623,716,034)
FUND BALANCE, End of year.....	\$ 39,429,149	\$ 35,114,799

The accompanying notes are an integral part of these statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
STATEMENT OF CASH FLOWS

Increase (Decrease) in Cash

	For the years ended December 31,	
	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES		
Board operating revenues over (under) expenses	\$ 4,314,350	\$ (4,222,976)
Adjustments to reconcile operating revenue over (under) expenses to net cash provided by operating activities:		
Depreciation and net losses on disposals	9,306,428	8,626,785
Decrease (increase) in transfers receivable—surplus Federal Reserve Bank earnings	6,949,042	(659,862,602)
Increase in accumulated postretirement benefits	2,021,312	1,097,134
Increase in accumulated retirement benefits	274,441	466,056
Increase in accumulated postemployment benefits	360,303	315,943
Decrease (increase) in accounts receivable, prepaid expenses, and other assets	2,745,993	(1,684,189)
Increase in accrued annual leave	510,860	365,323
(Decrease) increase in accounts payable and accrued liabilities	(637,716)	2,855,174
(Decrease) increase in transfers payable—surplus Federal Reserve Bank earnings	(6,949,042)	659,862,602
Increase in payroll payable and related taxes	805,103	1,936,181
(Decrease) increase in unearned revenues and other liabilities	(247,148)	78,456
Net cash provided by operating activities	19,453,926	9,833,887
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from disposals of furniture and equipment	18,301	70,500
Capital expenditures	(11,819,651)	(10,334,324)
Net cash used in investing activities	(11,801,350)	(10,263,824)
NET INCREASE (DECREASE) IN CASH	7,652,576	(429,937)
CASH BALANCE, Beginning of year	15,712,258	16,142,195
CASH BALANCE, End of year	\$23,364,834	\$ 15,712,258
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Capital lease obligations incurred	\$ 615,000	\$ 0

The accompanying notes are an integral part of these statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOTES TO FINANCIAL STATEMENTS

(1) SIGNIFICANT ACCOUNTING POLICIES

Board Operating Revenues and Expenses—Assessments made on the Federal Reserve Banks for Board operating expenses and capital expenditures are calculated based on expected cash needs. These assessments, other operating revenues, and operating expenses are recorded on the accrual basis of accounting.

Issuance and Redemption of Federal Reserve Notes—The Board incurs expenses and assesses the Federal Reserve Banks for the costs of printing, issuing, shipping, and retiring Federal Reserve Notes. These assessments and expenses are separately reported in the statements of revenues and expenses because they are not Board operating transactions.

Property, Buildings and Equipment—The Board's property, buildings and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 4 to 10 years for furniture and equipment and from 10 to 50 years for building equipment and structures. Upon the sale or other disposition of a depreciable asset, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is recognized.

Federal Reserve Bank Surplus Earnings—The Omnibus Budget Reconciliation Act of 1993 requires that surplus Federal Reserve Bank earnings be transferred from the Banks to the Board and then to the U.S. Treasury for the period October 1, 1996, to September 30, 1998. Prior to this time the Federal Reserve Banks made their transfers directly to the Treasury. The Board accounts for these transfers when earned and due, which may result in transfers receivable and payable as of the balance sheet date.

Estimates—The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period.

Reclassifications—Certain 1996 disclosures have been reclassified to conform with the 1997 presentation, the effect of which is immaterial.

(2) RETIREMENT BENEFITS

Substantially all of the Board's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). The System Plan is a multiemployer plan that covers employees of the Federal Reserve Banks, the Board, and the Plan Administrative Office. Employees of the Board who entered on duty prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who entered on duty after 1983 are covered by a non-

contributory defined benefits program under the System Plan. Contributions to the System Plan are actuarially determined and funded by participating employers at amounts prescribed by the System Plan's administrator. Based on actuarial calculations, it was determined that employer funding contributions were not required for the years 1997 and 1996, and the Board was not assessed a contribution for these years. Excess Plan assets will continue to fund future years' contributions. The Board is not accountable for the assets of this plan.

A relatively small number of Board employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). The Board matches employee contributions to these plans. These defined benefits plans are administered by the Office of Personnel Management. The Board's contributions to these plans totaled \$98,000 and \$201,500 in 1997 and 1996 respectively. The Board has no liability for future payments to retirees under these programs, and it is not accountable for the assets of the plans.

Effective January 1, 1996, Board employees covered under the System Plan are also covered under a Benefits Equalization Plan (BEP). Benefits paid under the BEP are limited to those benefits that cannot be paid from the System Plan because of limitations imposed by Sections 401(a)(17), 415(b), and 415(e) of the Internal Revenue Code of 1986. Pension costs attributed to the BEP reduce the pension costs of the System Plan. The net periodic pension cost for the BEP for 1997 and 1996 included the following components:

	1997	1996
Service cost (benefits attributed to employee services during the year)	\$133,331	\$260,868
Interest cost on projected benefit obligation	81,060	102,594
Amortization of unrecognized net liability	102,594	102,594
Amortization of unrecognized prior service cost	(13,490)	0
Amortization of unrecognized net (gain)/loss	(29,054)	0
Net periodic pension cost	<u>\$274,441</u>	<u>\$466,056</u>

Although these pension costs are recorded using the accrual basis of accounting in accordance with Statement of Financial Accounting Standards No. 87, Employers' Accounting for Pensions (FAS 87), the Board's current policy is to fund the cost of these benefits on a pay-as-you-go basis.

The net periodic pension cost was determined using a 7.25 percent discount rate and average compensation growth of 5 percent.

The FAS 87 accumulated benefit obligation at December 31, 1997, comprises:

	<u>1997</u>	<u>1996</u>
Accumulated benefit obligation		
Vested	\$ 329,000	\$ 218,000
Nonvested	20,000	21,000
Total	<u>\$ 349,000</u>	<u>\$ 239,000</u>
Plan assets at fair value	\$ 0	0
Less: Actuarial present value of projected benefit obligation	<u>(527,980)</u>	<u>(1,589,924)</u>
Projected benefit obligation in excess of plan assets	(527,980)	(1,589,924)
Less: Unrecognized net transition obligation ...	1,260,447	1,363,041
Unrecognized prior service cost ..	(996,371)	(190,000)
Unrecognized net (gain)/loss ...	<u>(476,593)</u>	<u>(49,173)</u>
Unfunded pension cost ..	<u>\$ (740,497)</u>	<u>\$ (466,056)</u>

The liability as of December 31, 1997, was determined using a 7.25 percent discount rate and average compensation growth of 5 percent. The Board has elected to amortize the unrecognized prior service cost over 14.3 years.

(3) OTHER BENEFIT PLANS

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan. Under the Thrift Plan, members may contribute up to a fixed percentage of their salary. Board contributions are based upon a fixed percentage of each member's basic contribution and were \$4,771,700 in 1997 and \$4,644,100 in 1996.

The Board also provides certain defined benefit health and life insurance for its active employees and retirees under federal and Board-sponsored programs. The net periodic postretirement benefit cost for 1997 and 1996 included the following components:

	<u>1997</u>	<u>1996</u>
Service cost (benefits attributed to employee services during the year)	\$ 154,474	\$ 195,016
Interest cost on accumulated postretirement benefit obligation	1,474,782	1,461,103
Amortization of gains and losses	112,493	372,253
Curtailement effect	<u>1,174,489</u>	<u>0</u>
Net periodic postretirement benefit cost	<u>\$2,916,238</u>	<u>\$2,028,372</u>

Although postretirement benefits are recorded using the accrual basis of accounting in accordance with FAS 106, the Board's current policy is to fund the cost of these benefits on a pay-as-you-go basis.

The FAS 106 accumulated postretirement benefit obligation at December 31, 1997 and 1996, comprises:

	<u>1997</u>	<u>1996</u>
Retirees	\$16,959,528	\$14,393,309
Fully eligible active plan participants	3,574,930	3,512,825
Other active plan participants	<u>2,439,440</u>	<u>3,422,992</u>
	22,973,898	21,329,126
Unrecognized net loss	<u>(2,780,864)</u>	<u>(3,157,404)</u>
Liability for accumulated postretirement benefit obligation	<u>\$20,193,034</u>	<u>\$18,171,722</u>

The liability for the accumulated postretirement benefit obligation and the net periodic benefit cost were determined using a 7.25 percent discount rate. Unrecognized losses of \$2,780,864 result from changes in the discount rate used to measure the liabilities. Under FAS 106, the Board may have to record some of these unrecognized losses in operations in future years. The assumed health care cost trend rate for measuring the increase in costs from 1997 to 1998 was 9.5 percent. These rates were assumed to gradually decline to an ultimate rate of 5.0 percent in the year 2005 for the purpose of calculating the December 31, 1997, accumulated postretirement benefit obligation. The effect of a 1 percent increase in the assumed health care cost trend rate would increase the accumulated postretirement benefit obligation by \$1,777,007 at December 31, 1997, and the net periodic benefit cost by \$172,488 for the year. The assumed salary trend rate for measuring the increase in postretirement benefits related to life insurance was an average of 5 percent.

The above accumulated postretirement benefit obligation is related to the Board sponsored health benefits and life insurance programs. During 1997, a special retirement program was offered to employees who were eligible to retire by May 31, 1998. This resulted in a curtailment loss of \$1,174,489 during the year, comprising \$1,044,096 for 62 employees covered by the Board-sponsored health benefits plan and \$130,393 for 78 employees covered by the Board-sponsored life insurance plan. The Board has no liability for future payments to employees who continue coverage under the federally sponsored programs upon retiring. Contributions for active employees participating in federally sponsored programs totaled \$3,667,300 and \$3,553,400 in 1997 and 1996 respectively.

The Board provides certain postemployment benefits to eligible employees after employment but before retirement. Effective January 1, 1994, the Board adopted Statement of Financial Accounting Standards No. 112, Employers' Accounting for Postemployment Benefits (FAS 112), which requires that employers providing postemployment benefits to their employees accrue the cost of such benefits. Prior to January 1994, postemployment benefit expenses were recognized on a pay-as-you-go basis.

(4) PROPERTY, BUILDINGS AND EQUIPMENT

The following is a summary of the components of the Board's fixed assets, at cost, net of accumulated depreciation.

	As of December 31,	
	1997	1996
Land and improvements ...	\$ 1,301,314	\$ 1,301,314
Buildings	65,611,228	65,343,600
Furniture and equipment	63,486,071	55,102,012
	<u>130,398,613</u>	<u>121,746,926</u>
Less accumulated depreciation	(66,178,508)	(60,636,742)
Total property, buildings and equipment	<u>\$ 64,220,105</u>	<u>\$ 61,110,184</u>

Furniture and equipment and accumulated depreciation as of December 31, 1997, includes \$615,000, and \$0, respectively for capitalized leases, which were acquired during 1997.

(5) OTHER REVENUES AND OTHER EXPENSES

The following are summaries of the components of Other Revenues and Other Expenses.

	For the years ended December 31,	
	1997	1996
Other Revenues		
Data processing revenue	\$5,184,075	\$4,612,476
National Information Center	2,156,191	1,974,295
Subscription revenue	1,394,394	1,583,193
Reimbursable services to other agencies .	399,426	424,940
Miscellaneous	<u>326,389</u>	<u>1,194,237</u>
Total Other Revenues	<u>\$9,460,475</u>	<u>\$9,789,141</u>
Other Expenses		
Tuition, registration, and membership fees	\$1,118,683	\$1,290,090
Cafeteria operations, net	794,019	870,429
Subsidies and contributions ...	653,207	646,194
Miscellaneous	<u>1,099,833</u>	<u>1,548,021</u>
Total Other Expenses	<u>\$3,665,742</u>	<u>\$4,354,734</u>

(6) COMMITMENTS

The Board has entered into several operating leases to secure office, training, and warehouse space for periods ranging from one to nine years. Minimum future commitments under those leases having an initial or remaining noncancelable lease term in excess of one year at December 31, 1997, are as follows:

1998	\$ 3,689,825
1999	3,707,625
2000	3,965,158
2001	3,948,759
after 2001	<u>13,215,854</u>
	<u>\$28,527,221</u>

Rental expenses under the operating leases were \$3,960,400 and \$3,930,700 in 1997 and 1996 respectively.

(7) FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

The Board is one of the five member agencies of the Federal Financial Institutions Examination Council (the "Council"). During 1997 and 1996, the Board paid \$228,200 and \$224,600 respectively in assessments for operating expenses of the Council. These amounts are included in subsidies and contributions for 1997 and 1996. During 1997 and 1996, the Board paid \$157,800 and \$127,100 respectively for office space subleased from the Council. ■

Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 1997 and 1996

Millions of dollars

Item	1997	1996 ¹
<i>Short-term assets (Note 1)</i>		
Imputed reserve requirements		
on clearing balances	658.0	658.3
Investment in marketable securities ...	5,922.0	5,924.7
Receivables	72.8	69.0
Materials and supplies	2.8	3.0
Prepaid expenses	9.0	23.0
Items in process of collection	<u>3,742.3</u>	<u>7,548.4</u>
Total short-term assets	10,406.8	14,226.4
<i>Long-term assets (Note 2)</i>		
Premises	389.2	394.6
Furniture and equipment	137.4	148.4
Leases and leasehold improvements ..	31.8	29.5
Prepaid pension costs	<u>350.2</u>	<u>287.4</u>
Total long-term assets	<u>908.5</u>	<u>859.9</u>
Total assets	11,315.3	15,086.3
<i>Short-term liabilities</i>		
Clearing balances and balances		
arising from early credit		
of uncollected items	7,114.8	12,366.3
Deferred-availability items	3,207.5	1,765.1
Short-term debt	<u>84.5</u>	<u>95.0</u>
Total short-term liabilities	10,406.8	14,226.4
<i>Long-term liabilities</i>		
Obligations under capital leases .....	.7	2.3
Long-term debt	188.8	189.3
Postretirement/postemployment		
benefits obligation	<u>205.0</u>	<u>191.8</u>
Total long-term liabilities	<u>394.5</u>	<u>383.4</u>
Total liabilities	10,801.3	14,609.8
Equity	<u>514.0</u>	<u>476.5</u>
Total liabilities and equity (Note 3) ..	11,315.3	15,086.3

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

The priced services financial statements consist of these tables and the accompanying notes.

1. Some of these data have been revised.

Pro Forma Income Statement for Federal Reserve Priced Services, 1997 and 1996

Millions of dollars

Item	1997	1996
Revenue from services provided		
to depository institutions (Note 4)	789.1	787.2
Operating expenses (Note 5)	<u>672.6</u>	<u>666.0</u>
Income from operations	116.4	121.2
Imputed costs (Note 6)		
Interest on float	14.6	21.9
Interest on debt	17.5	17.3
Sales taxes	9.8	11.6
FDIC insurance	<u>6.9</u>	<u>0.0</u>
Income from operations after imputed costs	67.6	70.4
Other income and expenses (Note 7)		
Investment income	367.7	315.8
Earnings credits	<u>-338.0</u>	<u>-287.1</u>
Income before income taxes	97.3	99.1
Imputed income taxes (Note 8)	<u>31.2</u>	<u>29.6</u>
Net income (Note 9)	<u>66.1</u>	<u>69.5</u>
MEMO: Targeted return on equity (Note 10)	54.3	42.9

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

The priced services financial statements consist of these tables and the accompanying notes.

Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 1997

Millions of dollars

Item	Total	Com- mercial check collection	Funds transfer and net settlement	Book- entry securities	Com- mercial ACH	Noncash collection	Cash services
Revenue from operations	789.1	598.4	94.6	16.6	70.3	4.3	4.9
Operating expenses (Note 5)	<u>672.6</u>	<u>540.3</u>	<u>76.1</u>	<u>14.8</u>	<u>49.3</u>	<u>2.9</u>	<u>4.3</u>
Income from operations	116.4	58.1	18.6	1.8	21.0	1.4	.6
Imputed costs (Note 6)	<u>48.9</u>	<u>40.9</u>	<u>3.8</u>	<u>.7</u>	<u>3.0</u>	<u>.3</u>	<u>.2</u>
Income from operations after imputed costs	67.6	17.1	14.8	1.1	18.0	1.1	.4
Other income and expenses, net (Note 7)	<u>29.7</u>	<u>23.2</u>	<u>3.2</u>	<u>.6</u>	<u>2.4</u>	<u>.2</u>	<u>.2</u>
Income before income taxes	97.3	40.4	18.0	1.7	20.4	1.3	.6

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

The priced services financial statements consist of these tables and the accompanying notes.

FEDERAL RESERVE BANKS

NOTES TO FINANCIAL STATEMENTS FOR PRICED SERVICES

(1) SHORT-TERM ASSETS

The imputed reserve requirement on clearing balances held at Reserve Banks by depository institutions reflects a treatment comparable to that of compensating balances held at correspondent banks by respondent institutions. The reserve requirement imposed on respondent balances must be held as vault cash or as non-earning balances maintained at a Reserve Bank; thus, a portion of priced services clearing balances held with the Federal Reserve is shown as required reserves on the asset side of the balance sheet. The remainder of clearing balances is assumed to be invested in three-month Treasury bills, shown as investment in marketable securities.

Receivables are (1) amounts due the Reserve Banks for priced services and (2) the share of suspense-account and difference-account balances related to priced services.

Materials and supplies are the inventory value of short-term assets.

Prepaid expenses include salary advances and travel advances for priced-service personnel.

Items in process of collection is gross Federal Reserve cash items in process of collection (CIPC) stated on a basis comparable to that of a commercial bank. It reflects adjustments for intra-System items that would otherwise be double-counted on a consolidated Federal Reserve balance sheet; adjustments for items associated with non-priced items, such as those collected for government agencies; and adjustments for items associated with providing fixed availability or credit before items are received and processed. Among the costs to be recovered under the Monetary Control Act is the cost of float, or net CIPC during the period (the difference between gross CIPC and deferred-availability items, which is the portion of gross CIPC that involves a financing cost), valued at the federal funds rate.

(2) LONG-TERM ASSETS

Consists of long-term assets used solely in priced services, the priced-services portion of long-term assets shared with nonpriced services, and an estimate of the assets of the Board of Governors used in the development of priced services. Effective Jan. 1, 1987, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). Accordingly, the Reserve Banks recognized credits to expenses of \$62.8 million in 1997 and \$45.3 million in 1996 and corresponding increases in this asset account.

(3) LIABILITIES AND EQUITY

Under the matched-book capital structure for assets that are not "self-financing," short-term assets are financed with short-term debt. Long-term assets are financed with long-term debt and equity in a proportion equal to the ratio of long-term debt to equity for the fifty largest bank holding companies, which are used in the model for the private-sector adjustment factor (PSAF). The PSAF consists of the taxes that would have been paid and the return on capital that would have been provided had priced services been furnished by a private-sector firm. Other

short-term liabilities include clearing balances maintained at Reserve Banks and deposit balances arising from float. Other long-term liabilities consist of accrued postemployment and postretirement benefits costs and obligations on capital leases.

(4) REVENUE

Revenue represents charges to depository institutions for priced services and is realized from each institution through one of two methods: direct charges to an institution's account or charges against its accumulated earnings credits.

(5) OPERATING EXPENSES

Operating expenses consist of the direct, indirect, and other general administrative expenses of the Reserve Banks for priced services plus the expenses for staff members of the Board of Governors working directly on the development of priced services. The expenses for Board staff members were \$2.9 million in 1997 and \$2.8 million in 1996. The credit to expenses under SFAS 87 (see note 2) is reflected in operating expenses.

The income statement by service reflects revenue, operating expenses, and imputed costs except for income taxes. Total operating expense does not equal the sum of operating expenses for each service because of the effect of SFAS 87. Although the portion of the SFAS 87 credit related to the current year is allocated to individual services, the amortization of the initial effect of implementation is reflected only at the System level.

(6) IMPUTED COSTS

Imputed costs consist of interest on float, interest on debt, sales taxes, and the FDIC assessment. Interest on float is derived from the value of float to be recovered, either explicitly or through per-item fees, during the period. Float costs include costs for checks, book-entry securities, noncash collection, ACH, and funds transfers.

Interest is imputed on the debt assumed necessary to finance priced-service assets. The sales taxes and FDIC assessment that the Federal Reserve would have paid had it been a private-sector firm are among the components of the PSAF (see note 3).

Float costs are based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses less shipping expenses for each service to the total expenses for all services less the total shipping expenses for all services.

The following list shows the daily average recovery of float by the Reserve Banks for 1997 in millions of dollars:

Total float	545.5
Unrecovered float	16.7
Float subject to recovery	528.8
Sources of recovery of float	
Income on clearing balances	52.9
As-of adjustments	263.5
Direct charges	103.9
Per-item fees	108.5

Unrecovered float includes float generated by services to government agencies and by other central bank services. Float recovered through income on clearing balances is the result of the increase in investable clearing balances; the increase is produced by a deduction for float for cash items in process of collection, which reduces imputed reserve requirements. The income on clearing balances reduces the float to be recovered through other means. As-of adjustments and direct charges are mid-week closing float and interterritory check float, which may be recovered from depositing institutions through adjustments to the institution's reserve or clearing balance or by valuing the float at the federal funds rate and billing the institution directly. Float recovered through per-item fees is valued at the federal funds rate and has been added to the cost base subject to recovery in 1997.

lion for 1996. The Reserve Banks plan to recover these amounts, along with a finance charge, by the end of the year 2001. After-tax return on equity has not been allocated by service because it relates to the organization as a whole.

(7) OTHER INCOME AND EXPENSES

Consists of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances represents the average coupon-equivalent yield on three-month Treasury bills applied to the *total* clearing balance maintained, adjusted for the effect of reserve requirements on clearing balances. Expenses for earnings credits granted to depository institutions on their clearing balances are derived by applying the average federal funds rate to the *required* portion of the clearing balances, adjusted for the net effect of reserve requirements on clearing balances.

Because clearing balances relate directly to the Federal Reserve's offering of priced services, the income and cost associated with these balances are allocated to each service based on each service's ratio of income to total income.

(8) INCOME TAXES

Imputed income taxes are calculated at the effective tax rate derived from the PSAF model (see note 3). Taxes have not been allocated by service because they relate to the organization as a whole.

(9) ADJUSTMENTS TO NET INCOME FOR PRICE SETTING

In setting fees, certain costs are excluded in accordance with the System's overage and shortfalls policy and its automation consolidation policy. Accordingly, to compare the financial results reported in this table with the projections used to set prices, adjust net income as follows (amounts shown are net of tax):

	<u>1997</u>	<u>1996</u>
Net income	66.1	69.5
Amortization of the initial effect of implementing SFAS 87	-10.2	-10.5
Deferred costs of automation consolidation	-8.5	-6.3
Adjusted net income	47.4	52.7

(10) RETURN ON EQUITY

The after-tax rate of return on equity that the Federal Reserve would have earned had it been a private business firm, as derived from the PSAF model (see note 3). This amount is adjusted to reflect the recovery of \$8.5 million of automation consolidation costs for 1997 and \$6.3 mil-

Statistical Tables

1. Detailed Statement of Condition of All Federal Reserve Banks Combined, December 31, 1997 and 1996

Millions of dollars

Item	1997	1996
ASSETS		
Gold certificate account	11,047	11,048
Special drawing rights certificate account	9,200	9,718
Coin	460	591
<i>Loans and securities</i>		
Loans to depository institutions	2,035	85
Federal agency obligations		
Bought outright	685	2,225
Held under repurchase agreement	2,652	1,612
U.S. Treasury securities		
Bought outright		
Bills	197,123	190,647
Notes	174,206	150,922
Bonds	59,407	49,339
Total bought outright	430,736	390,907
Held under repurchase agreement	21,188	19,971
Total U.S. Treasury securities	451,924	410,878
Total loans and securities	457,295	414,800
<i>Items in process of collection</i>		
Transit items	6,982	11,741
Other items in process of collection	<u>1,395</u>	<u>1,387</u>
Total items in process of collection	8,378	13,128
<i>Bank premises</i>		
Land	194	192
Buildings (including vaults)	1,100	934
Building machinery and equipment	255	241
Construction account	<u>61</u>	<u>194</u>
Total bank premises	1,610	1,562
Less: Depreciation allowance	<u>338</u>	<u>329</u>
Bank premises, net	1,272	1,233
<i>Other assets</i>		
Furniture and equipment	1,258	1,230
Less: Depreciation allowance	<u>749</u>	<u>707</u>
Total furniture and equipment, net	510	524
Denominated in foreign currencies ¹	17,046	19,264
Interest accrued	4,386	3,891
Premium on securities	7,194	6,004
Overdrafts	33	6
Prepaid expenses	1,239	991
Suspense account	22	3
Real estate acquired for banking-house purposes ..	6	10
Other	<u>333</u>	<u>299</u>
Total other assets	30,768	30,992
Total assets	<u>518,420</u>	<u>481,510</u>

1.—Continued

Item	1997	1996
LIABILITIES		
<i>Federal Reserve notes</i>		
Outstanding (issued to Federal Reserve Banks) ..	549,600	526,826
Less: Held by Federal Reserve Banks ..	<u>92,131</u>	<u>100,304</u>
Total Federal Reserve notes, net	457,469	426,522
<i>Deposits</i>		
Depository institutions	30,838	24,524
U.S. Treasury, general account	5,444	7,742
Foreign, official accounts	457	167
<i>Other deposits</i>		
Officers' and certified checks	18	26
International organizations	100	108
Other ²	<u>779</u>	<u>759</u>
Total other deposits	897	893
Deferred credit items	7,817	7,831
<i>Other liabilities</i>		
Discount on securities	3,899	3,844
Sundry items payable	119	103
Suspense account	8	4
All other	<u>819</u>	<u>783</u>
Total other liabilities	4,845	4,734
Total liabilities	<u>507,767</u>	<u>472,413</u>
CAPITAL ACCOUNTS		
Capital paid in	5,433	4,602
Surplus	5,220	4,496
Other capital accounts ³	0	0
Total liabilities and capital accounts ..	<u>518,420</u>	<u>481,510</u>

NOTE. Amounts in boldface type indicate items in the Board's weekly statement of condition of the Federal Reserve Banks.

Components may not sum to totals because of rounding.

1. Of this amount, \$8,117.2 million in 1997 and \$8,291.8 million in 1996 were invested in securities issued by foreign governments, and the balance was

invested with foreign central banks and the Bank for International Settlements.

2. In closing out the other capital accounts at year-end, the Reserve Bank earnings that are payable to the Treasury are included in this account pending payment.

3. During the year, includes undistributed net income, which is closed out on December 31.

2. Statement of Condition of Each Federal Reserve Bank, December 31, 1997 and 1996

Millions of dollars

Item	Total		Boston	
	1997	1996	1997	1996
ASSETS				
Gold certificate account	11,047	11,048	624	661
Special drawing rights certificate account	9,200	9,718	530	636
Coin	460	591	23	13
<i>Loans</i>				
To depository institutions	2,035	85	21	0
Other	0	0	0	0
Acceptances held under repurchase agreements	0	0	0	0
<i>Federal agency obligations</i>				
Bought outright	685	2,225	42	131
Held under repurchase agreements	2,652	1,612	0	0
<i>U.S. Treasury securities</i>				
Bought outright ¹	430,736	390,907	26,259	23,000
Held under repurchase agreements	21,188	19,971	0	0
Total loans and securities	457,295	414,800	26,322	23,131
Items in process of collection	8,378	13,128	441	706
Bank premises	1,272	1,233	94	95
<i>Other assets</i>				
Denominated in foreign currencies ²	17,046	19,264	637	830
All other	13,722	11,729	697	534
Interdistrict Settlement Account	0	0	-3,621	1,024
Total assets	518,420	481,510	25,746	27,629
LIABILITIES				
Federal Reserve notes	457,469	426,522	22,984	25,417
<i>Deposits</i>				
Depository institutions	30,838	24,524	1,544	1,048
U.S. Treasury, general account	5,444	7,742	0	0
Foreign, official accounts	457	167	5	6
Other	897	893	2	38
Total deposits	37,636	33,326	1,551	1,092
Deferred credit items	7,817	7,831	412	511
Other liabilities and accrued dividends ³	4,845	4,734	283	268
Total liabilities	507,767	472,413	25,231	27,289
CAPITAL ACCOUNTS				
Capital paid in	5,433	4,602	262	172
Surplus	5,220	4,496	254	168
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	518,420	481,510	25,746	27,629
FEDERAL RESERVE NOTE STATEMENT				
Federal Reserve notes outstanding (issued to Bank)	549,600	526,826	27,943	30,331
Less: Held by Federal Reserve Bank	92,131	100,304	4,959	4,914
Federal Reserve notes, net	457,469	426,522	22,984	25,417
<i>Collateral for Federal Reserve notes</i>				
Gold certificate account	11,047	11,048	...	...
Special drawing rights certificate account	9,200	9,718	...	...
Other eligible assets	0	0	...	...
U.S. Treasury and federal agency securities	437,222	405,756	...	...
Total collateral	457,469	426,522	...	...

For notes see end of table.

2. Statement of Condition of Each Federal Reserve Bank, December 31, 1997 and 1996—Continued

Millions of dollars

Item	Atlanta		Chicago	
	1997	1996	1997	1996
ASSETS				
Gold certificate account.....	723	769	1,069	1,140
Special drawing rights certificate account.....	602	745	900	979
Coin.....	45	81	52	70
<i>Loans</i>				
To depository institutions.....	163	0	13	18
Other.....	0	0	0	0
Acceptances held under repurchase agreements.....	0	0	0	0
<i>Federal agency obligations</i>				
Bought outright.....	46	148	73	241
Held under repurchase agreements.....	0	0	0	0
<i>U.S. Treasury securities</i>				
Bought outright ¹	28,743	26,087	45,944	42,364
Held under repurchase agreements.....	0	0	0	0
Total loans and securities.....	28,952	26,236	46,031	42,623
Items in process of collection.....	1,287	1,556	773	1,537
Bank premises.....	78	80	108	110
<i>Other assets</i>				
Denominated in foreign currencies ²	1,574	1,890	1,989	2,296
All other.....	764	631	1,222	1,006
Interdistrict Settlement Account.....	793	-511	-5,705	157
Total assets.....	34,818	31,477	46,438	49,919
LIABILITIES				
Federal Reserve notes.....	30,390	27,511	40,531	44,858
<i>Deposits</i>				
Depository institutions.....	2,081	1,708	3,570	2,574
U.S. Treasury, general account.....	0	0	0	0
Foreign, official accounts.....	13	14	17	17
Other.....	99	54	125	120
Total deposits.....	2,193	1,775	3,712	2,712
Deferred credit items.....	1,210	1,033	679	808
Other liabilities and accrued dividends ³	328	318	487	479
Total liabilities.....	34,121	30,637	45,409	48,857
CAPITAL ACCOUNTS				
Capital paid in.....	359	425	527	537
Surplus.....	338	415	502	524
Other capital accounts.....	0	0	0	0
Total liabilities and capital accounts.....	34,818	31,477	46,438	49,919
FEDERAL RESERVE NOTE STATEMENT				
Federal Reserve notes outstanding (issued to Bank).....	38,413	34,458	47,119	51,546
Less: Held by Federal Reserve Bank.....	8,023	6,947	6,589	6,688
Federal Reserve notes, net.....	30,390	27,511	40,531	44,858

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

1. Includes securities loaned—fully guaranteed by U.S. Treasury securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale–purchase transactions.

2. Valued monthly at market exchange rates.

3. Includes exchange-translation account reflecting the monthly revaluation at market exchange rates of foreign-exchange commitments.

2.—Continued

St. Louis		Minneapolis		Kansas City		Dallas		San Francisco	
1997	1996	1997	1996	1997	1996	1997	1996	1997	1996
401	474	147	168	286	321	459	433	1,420	1,067
340	419	123	144	247	280	367	399	1,241	957
15	29	20	19	36	56	37	49	68	74
4	29	5	7	13	7	0	1	335	15
0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0
27	104	10	34	20	70	25	80	86	188
0	0	0	0	0	0	0	0	0	0
17,156	18,312	5,999	5,896	12,299	12,244	15,643	13,998	54,194	33,108
0	0	0	0	0	0	0	0	0	0
17,186	18,445	6,014	5,936	12,332	12,321	15,668	14,078	54,615	33,312
93	666	701	639	440	843	359	1,284	2,210	1,873
31	31	132	111	55	56	150	155	159	160
424	476	395	481	647	737	951	1,197	3,270	2,631
439	411	191	151	331	293	420	344	1,411	780
-534	-2,694	-1,205	-453	880	-650	5,259	218	-1,658	23,441
18,396	18,257	6,517	7,195	15,253	14,258	23,670	18,156	62,737	64,295
16,422	16,769	4,792	5,503	13,541	12,435	20,007	15,340	54,617	56,905
1,244	718	629	721	761	817	2,479	1,730	3,677	3,612
0	0	0	0	0	0	0	0	0	0
4	4	3	4	5	5	8	9	28	20
29	32	5	8	63	21	13	18	59	51
1,276	754	637	732	830	844	2,501	1,757	3,763	3,683
252	292	610	653	473	463	424	374	1,893	1,575
197	216	96	96	164	171	184	178	539	388
18,147	18,031	6,135	6,985	15,007	13,912	23,116	17,649	60,812	62,551
127	114	194	107	127	175	283	257	980	880
122	112	189	104	119	171	271	250	945	865
0	0	0	0	0	0	0	0	0	0
18,396	18,257	6,517	7,195	15,253	14,258	23,670	18,156	62,737	64,295
18,568	19,480	6,480	7,027	15,339	14,148	26,054	21,005	72,179	71,088
2,145	2,711	1,689	1,524	1,798	1,713	6,047	5,666	17,562	14,182
16,422	16,769	4,792	5,503	13,541	12,435	20,007	15,340	54,617	56,905

3. Federal Reserve Open Market Transactions, 1997

Millions of dollars

Type of security and transaction	Jan.	Feb.	Mar.	Apr.
U.S. TREASURY SECURITIES				
<i>Outright transactions (excluding matched transactions)</i>				
Treasury bills				
Gross purchases	0	0	0	4,006
Gross sales	0	0	0	0
Exchanges	40,346	33,997	31,720	33,160
New bills	40,346	33,647	31,720	33,160
Redemptions	0	0	0	0
Others within 1 year				
Gross purchases	0	818	0	0
Gross sales	0	0	0	0
Maturity shift	2,481	5,086	3,143	2,006
Exchanges	-550	-2,864	-1,534	-2,100
Redemptions	607	0	0	376
1 to 5 years				
Gross purchases	0	1,125	2,861	1,924
Gross sales	0	0	0	0
Maturity shift	-2,481	-4,926	-3,143	-2,006
Exchanges	550	1,874	1,534	1,700
5 to 10 years				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Maturity shift	0	1,236	0	0
Exchanges	0	890	0	400
More than 10 years				
Gross purchases	0	0	1,117	0
Gross sales	0	0	0	0
Maturity shift	0	-1,396	0	0
Exchanges	0	450	0	0
All maturities				
Gross purchases	0	1,943	3,978	5,930
Gross sales	0	0	0	0
Redemptions	607	0	0	376
<i>Matched transactions</i>				
Gross purchases	285,667	250,867	288,373	303,056
Gross sales	283,240	254,741	288,073	301,177
<i>Repurchase agreements</i>				
Gross purchases	74,422	48,805	60,425	102,578
Gross sales	86,673	45,747	60,718	62,685
Net change in U.S. Treasury securities	-10,430	1,127	3,984	47,326
FEDERAL AGENCY OBLIGATIONS				
<i>Outright transactions</i>				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Redemptions	187	27	17	24
<i>Repurchase agreements</i>				
Gross purchases	17,668	9,795	14,300	10,178
Gross sales	17,995	9,454	14,830	10,285
Net change in agency obligations	-514	314	-547	-131
Total net change in System Open Market Account	-10,944	1,441	3,437	47,195

NOTE. Sales, redemptions, and negative figures reduce holdings of the System Open Market Account; all other figures increase such holdings. Components may not sum to totals because of rounding.

3.—Continued

May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
0	596	0	0	0	0	0	4,545	9,147
0	0	0	0	0	0	0	0	0
47,456	33,022	35,948	35,666	28,328	39,313	33,485	26,905	419,347
47,456	33,022	35,948	35,666	28,328	39,313	33,485	26,905	418,997
0	0	0	0	0	0	0	0	0
383	494	0	0	644	0	1,462	1,947	5,748
0	0	0	0	0	0	0	0	0
5,666	1,476	4,359	7,487	1,596	3,193	5,231	1,748	43,473
-4,229	-2,250	-1,087	-2,780	-2,382	-1,267	-4,126	-2,329	-27,499
0	0	598	0	0	416	0	0	0
1,102	2,797	0	0	2,697	0	3,323	4,471	20,299
0	0	0	0	0	0	0	0	0
-4,685	-1,476	-4,359	-5,247	-1,596	-3,193	-4,883	-1,748	-39,744
2,479	2,250	1,087	1,170	2,382	1,267	1,651	2,329	20,274
734	499	0	0	0	770	485	613	3,101
0	0	0	0	0	0	0	0	0
-981	0	0	-2,240	0	0	31	0	-1,954
1,750	0	0	880	0	0	1,295	0	5,215
988	906	0	0	0	648	954	1,214	5,827
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	-379	0	-1,775
0	0	0	730	0	0	1,180	0	2,360
3,206	5,292	0	0	3,341	1,418	6,224	12,790	44,122
0	0	0	0	0	0	0	0	0
0	0	598	0	0	416	0	0	1,996
287,229	293,506	307,101	317,008	311,153	316,425	272,474	353,726	3,588,905
287,826	293,008	309,578	315,439	312,083	318,485	269,586	355,668	3,586,584
46,552	55,073	44,087	54,561	77,109	75,323	73,618	97,932	810,485
89,477	47,070	53,217	50,340	74,960	78,157	73,064	87,160	809,268
-40,316	13,793	-12,205	5,790	4,560	-3,893	9,666	21,620	41,022
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
0	474	287	179	105	215	26	0	1,540
7,954	8,401	10,437	13,131	9,796	15,639	23,054	20,056	160,409
7,096	9,131	10,811	11,252	11,196	15,157	20,976	21,186	159,369
858	-1,204	-661	1,700	-1,505	267	2,052	-1,130	-500
-39,458	12,589	-12,866	7,490	3,055	-3,626	11,718	20,490	40,522

4. Federal Reserve Bank Holdings of U.S. Treasury and Federal Agency Securities, December 31, 1995–97

Millions of dollars

Description	December 31			Change	
	1997	1996	1995	1996 to 1997	1995 to 1996
U.S. TREASURY SECURITIES					
Held outright ¹	447,762	405,613	390,534	42,149	15,079
<i>By remaining maturity</i>					
<i>Bills</i>					
1–91 days	112,892	106,063	101,564	6,829	4,499
92 days to 1 year	101,257	99,289	93,888	1,968	5,401
<i>Notes and bonds</i>					
1 year or less	49,370	29,045	41,419	20,325	–12,374
More than 1 year through 5 years	95,028	95,608	90,031	–580	5,577
More than 5 years through 10 years	40,907	33,782	31,469	7,125	2,313
More than 10 years	48,308	41,826	36,921	6,482	4,905
<i>By type</i>					
Bills	214,149	205,353	195,451	8,796	9,902
Notes	174,206	150,922	151,013	23,284	–91
Bonds	59,407	49,339	44,069	10,068	5,270
Repurchase agreements	21,188	19,971	12,762	1,217	7,209
MSPs, foreign accounts	17,027	14,706	12,336	2,321	2,370
MSPs, in the market	0	0	0	0	0
FEDERAL AGENCY SECURITIES					
Held outright ¹	685	2,225	2,634	–1,540	–409
<i>By remaining maturity</i>					
1 year or less	252	1,223	1,241	–971	–18
More than 1 year through 5 years	153	520	841	–367	–321
More than 5 years through 10 years	255	457	527	–202	–70
More than 10 years	25	25	25	0	0
<i>By issuer</i>					
Federal Farm Credit Banks	10	912	912	–902	0
Federal Home Loan Banks	57	115	230	–58	–115
Federal Land Banks	0	17	66	–17	–49
Federal National Mortgage Association	618	1,181	1,425	–563	–244
Repurchase agreements	2,652	1,612	1,025	1,040	587

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

1. Excludes the effects of temporary transactions—repurchase agreements and matched sale–purchase agreements (MSPs).

5. Number and Annual Salaries of Officers and Employees of Federal Reserve Banks, December 31, 1997

Federal Reserve Bank (including Branches)	President	Other officers		Employees			Total	
	Salary (dollars)	Number	Salaries (dollars)	Number		Salaries (dollars)	Number	Salaries (dollars)
				Full-time	Part-time			
Boston	192,900	58	6,349,450	1,039	159	47,957,251	1,257	54,499,601
New York	247,100	239	31,801,892	3,561	77	165,589,803	3,878	197,638,795
Philadelphia	219,300	55	5,986,400	1,118	66	43,343,736	1,240	49,549,436
Cleveland	196,700	46	4,871,100	1,238	67	43,944,303	1,352	49,012,103
Richmond	193,900	76	7,483,800	1,862	155	66,495,814	2,094	74,173,514
Atlanta	207,950	81	8,033,535	2,241	54	75,219,153	2,377	83,460,638
Chicago	218,600	92	9,707,227	1,966	61	81,666,507	2,120	91,592,334
St. Louis	225,100	60	5,537,600	1,062	73	37,131,767	1,196	42,894,467
Minneapolis	206,300	48	5,023,350	1,073	102	39,964,829	1,224	45,194,479
Kansas City	192,400	55	5,360,400	1,379	54	49,452,754	1,489	55,005,554
Dallas	193,700	56	5,635,500	1,375	52	51,274,259	1,484	57,103,459
San Francisco	273,900	95	11,005,400	2,270	80	100,939,143	2,446	112,218,443
Federal Reserve Automation Service	0	24	2,767,200	518	7	28,027,052	549	30,794,252
Total	2,567,850	985	109,562,854	20,702	1,007	831,006,371	22,706	943,137,075

6. Income and Expenses of Federal Reserve Banks, 1997

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
CURRENT INCOME					
Loans	14,584	480	1,909	135	395
U.S. Treasury and federal agency securities	25,698,971	1,519,193	9,013,874	878,282	1,667,701
Foreign currencies	375,386	14,182	86,691	22,007	23,901
Priced services	789,092	68,359	98,372	40,299	50,119
Other	39,180	827	28,509	1,575	361
Total	26,917,213	1,603,041	9,229,356	942,297	1,742,477
CURRENT EXPENSES					
Salaries and other personnel expenses	1,029,650	58,871	221,353	51,763	54,070
Retirement and other benefits ..	269,708	16,344	62,917	13,323	14,679
Net periodic pension costs ¹	-200,083	26	-200,404	29	16
Fees	41,066	2,038	7,255	760	3,053
Travel	44,344	1,958	6,741	2,033	2,512
Software expenses	57,267	2,298	11,300	1,682	1,760
Postage and other shipping costs	79,363	38,616	6,106	1,409	2,056
Communications	10,577	405	2,275	391	702
Materials and supplies	53,890	2,645	10,094	3,170	2,989
<i>Building expenses</i>					
Taxes on real estate	31,233	4,004	4,105	1,662	2,798
Property depreciation	56,635	4,297	9,872	2,476	3,673
Utilities	31,488	2,599	7,067	2,688	1,696
Rent	38,880	849	15,883	259	2,493
Other	26,108	558	5,738	1,380	567
<i>Equipment</i>					
Purchases	8,893	345	1,936	774	241
Rentals	33,382	105	2,336	267	216
Depreciation	137,435	5,005	21,859	5,229	6,202
Repairs and maintenance	82,287	4,329	12,626	3,538	4,581
Earnings-credit costs	358,896	22,880	60,336	26,072	25,295
Other	66,629	3,950	21,227	1,831	3,255
Shared costs, net ²	0	-1,793	15,279	12,101	13,170
Recoveries	-54,723	-9,689	-8,168	-3,301	-922
Expenses capitalized ³	-2,762	-230	0	-288	-322
Total	2,200,164	160,408	297,729	129,246	144,779
Reimbursements	-223,710	-7,490	-47,040	-19,767	-23,547
Net expenses	1,976,453	152,917	250,689	109,479	121,232

For notes see end of table.

6.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
500	396	2,153	2,071	3,948	1,590	136	872
2,308,544	1,679,290	2,696,166	1,051,531	358,570	737,993	910,319	2,877,507
26,049	34,813	43,869	9,325	8,738	14,264	21,115	70,428
62,270	98,419	94,794	37,750	46,557	53,675	53,194	85,283
560	1,474	1,150	333	626	155	272	3,338
2,397,923	1,814,392	2,838,134	1,101,012	418,440	807,677	985,037	3,037,429
113,029	88,213	102,807	46,304	49,757	61,597	60,981	120,906
28,623	24,872	24,649	13,513	12,899	15,006	17,312	25,569
13	39	32	13	20	20	14	98
11,765	1,492	2,442	2,246	1,340	669	892	7,114
5,080	4,544	4,486	2,462	2,728	2,756	2,949	6,096
24,411	3,146	2,772	2,040	1,729	1,277	1,374	3,478
3,391	4,932	4,472	2,238	3,909	4,219	2,381	5,634
1,156	889	932	525	738	876	844	845
6,412	6,269	5,234	2,870	2,125	3,303	3,393	5,386
2,157	1,583	3,961	328	5,296	679	1,989	2,672
5,900	4,051	6,022	2,804	1,549	3,804	5,188	6,999
3,005	1,923	2,505	1,511	1,556	1,375	2,184	3,381
10,409	5,008	1,449	480	886	387	338	438
2,866	2,507	5,930	850	843	748	1,765	2,356
1,519	1,024	618	265	257	404	558	952
28,210	646	735	147	262	102	93	262
55,588	9,242	8,676	3,116	3,787	4,202	5,360	9,171
18,701	9,210	8,068	3,036	2,854	2,705	3,657	8,982
37,598	31,698	50,454	16,378	6,364	14,199	25,972	41,649
4,923	6,217	5,989	3,627	2,153	3,419	3,391	6,648
-137,766	14,484	20,829	12,002	8,824	18,127	14,024	10,718
-15,324	-2,701	-4,502	-1,013	-597	-565	-4,625	-3,318
-166	-528	-225	-119	-343	-373	-81	-86
211,499	218,762	258,336	115,622	108,940	138,937	149,954	265,952
-25,586	-10,818	-17,196	-10,960	-15,816	-18,635	-7,201	-19,655
185,913	207,943	241,140	104,662	93,125	120,303	142,754	246,297

6. Income and Expenses of Federal Reserve Banks, 1997—Continued

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
PROFIT AND LOSS					
Current net income	24,940,759	1,450,123	8,978,667	832,818	1,621,245
<i>Additions to and deductions from (-) current net income⁴</i>					
Profits on sales of U.S.					
Treasury and federal agency securities					
	13,153	799	4,309	446	898
Other additions	2,801	30	6	0	3
Total additions	15,954	830	4,315	446	901
Losses on foreign exchange transactions					
	-2,592,718	-96,832	-591,244	-154,267	-164,746
Other deductions	-88	-2	-18	-2	-2
Total deductions	-2,592,806	-96,834	-591,263	-154,269	-164,747
Net addition to or deductions from (-) current net income	-2,576,852	-96,004	-586,948	-153,823	-163,846
Cost of unreimbursed Treasury services	34,718	1,241	2,264	2,423	1,470
<i>Assessments by Board</i>					
Board expenditures ⁵	174,407	6,540	39,315	10,278	10,837
Cost of currency	364,454	21,723	119,098	11,816	25,508
Net income before payment to U.S. Treasury	21,790,329	1,324,616	8,231,043	654,478	1,419,584
Dividends paid	299,652	11,405	65,286	16,987	19,320
Payments to U.S. Treasury (interest on Federal Reserve notes)					
	0	0	0	0	0
Statutory transfer	20,658,972	1,223,253	8,109,194	626,418	1,343,641
Surplus transfer	-107,000	-4,003	-24,447	-6,352	-6,801
Transferred to surplus	831,705	89,958	56,563	11,073	56,623
Surplus, January 1	4,495,745	167,603	1,023,159	268,111	285,579
Surplus, December 31	5,220,449	253,558	1,055,274	272,832	335,400

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

1. Reflects the effect of Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). The System Retirement Plan for employees is recorded on behalf of the System on the books of the Federal Reserve Bank of New York, resulting in a reduction in expenses of \$200,813 thousand. The Retirement Benefits Equalization Plan is recorded by each Federal Reserve Bank.

2. Includes distribution of costs for projects performed by one Reserve Bank for the benefit of one or more other Reserve Banks.

3. Includes expenses for labor and materials temporarily capitalized and charged to activities when the products are consumed.

4. Includes reimbursement from the U.S. Treasury for uncut sheets of Federal Reserve notes, gains and losses on the sale of Reserve Bank buildings, counterfeit currency that is not charged back to the depositing institution, and stale Reserve Bank checks that are written off.

5. For additional details, see the preceding chapter, "Board of Governors Financial Statements."

6.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
2,212,010	1,606,449	2,596,994	996,350	325,315	687,374	842,283	2,791,132
1,238	878	1,405	532	184	379	477	1,608
15	2,449	12	0	277	1	5	1
1,253	3,327	1,417	532	462	380	482	1,610
-179,047	-239,317	-302,502	-64,439	-60,000	-98,463	-144,589	-497,272
-15	-3	-11	-7	-4	-8	-9	-7
-179,062	-239,320	-302,513	-64,446	-60,004	-98,471	-144,598	-497,280
-177,809	-235,993	-301,096	-63,914	-59,542	-98,092	-144,115	-495,670
5,636	1,818	4,325	2,068	3,127	2,405	2,683	5,259
14,815	14,955	20,070	4,206	4,421	6,206	9,579	33,187
33,096	23,517	38,330	14,334	4,704	10,626	13,110	48,593
1,980,655	1,330,166	2,233,173	911,828	253,521	570,045	672,796	2,208,424
34,077	23,140	31,693	6,800	9,337	9,014	15,905	56,688
0	0	0	0	0	0	0	0
1,431,350	1,373,317	2,211,352	892,486	157,002	608,850	630,418	2,051,693
-7,395	-9,884	-12,487	-2,659	-2,478	-4,064	-5,975	-20,454
515,228	-66,290	-9,871	12,542	87,183	-47,819	26,473	100,043
310,232	414,670	524,405	111,745	103,945	170,720	250,379	865,197
818,065	338,496	502,046	121,628	188,649	118,837	270,877	944,786

7. Income and Expenses of Federal Reserve Banks, 1914-97

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (-) ¹	Assessments by Board of Governors	
				Board expenditures	Costs of currency
<i>All Banks</i>					
1914-15	2,173	2,018	6	302	...
1916	5,218	2,082	-193	192	...
1917	16,128	4,922	-1,387	238	...
1918	67,584	10,577	-3,909	383	...
1919	102,381	18,745	-4,673	595	...
1920	181,297	27,549	-3,744	710	...
1921	122,866	33,722	-6,315	741	...
1922	50,499	28,837	-4,442	723	...
1923	50,709	29,062	-8,233	703	...
1924	38,340	27,768	-6,191	663	...
1925	41,801	26,819	-4,823	709	...
1926	47,600	24,914	-3,638	722	1,714
1927	43,024	24,894	-2,457	779	1,845
1928	64,053	25,401	-5,026	698	806
1929	70,955	25,810	-4,862	782	3,099
1930	36,424	25,358	-93	810	2,176
1931	29,701	24,843	311	719	1,479
1932	50,019	24,457	-1,413	729	1,106
1933	49,487	25,918	-12,307	800	2,505
1934	48,903	26,844	-4,430	1,372	1,026
1935	42,752	28,695	-1,737	1,406	1,477
1936	37,901	26,016	486	1,680	2,178
1937	41,233	25,295	-1,631	1,748	1,757
1938	36,261	25,557	2,232	1,725	1,630
1939	38,501	25,669	2,390	1,621	1,356
1940	43,538	25,951	11,488	1,704	1,511
1941	41,380	28,536	721	1,840	2,588
1942	52,663	32,051	-1,568	1,746	4,826
1943	69,306	35,794	23,768	2,416	5,336
1944	104,392	39,659	3,222	2,296	7,220
1945	142,210	41,666	-830	2,341	4,710
1946	150,385	50,493	-626	2,260	4,482
1947	158,656	58,191	1,973	2,640	4,562
1948	304,161	64,280	-34,318	3,244	5,186
1949	316,537	67,931	-12,122	3,243	6,304
1950	275,839	69,822	36,294	3,434	7,316
1951	394,656	83,793	-2,128	4,095	7,581
1952	456,060	92,051	1,584	4,122	8,521
1953	513,037	98,493	-1,059	4,100	10,922
1954	438,486	99,068	-134	4,175	6,490
1955	412,488	101,159	-265	4,194	4,707
1956	595,649	110,240	-23	5,340	5,603
1957	763,348	117,932	-7,141	7,508	6,374
1958	742,068	125,831	124	5,917	5,973
1959	886,226	131,848	98,247	6,471	6,384
1960	1,103,385	139,894	13,875	6,534	7,455
1961	941,648	148,254	3,482	6,265	6,756
1962	1,048,508	161,451	-56	6,655	8,030
1963	1,151,120	169,638	615	7,573	10,063
1964	1,343,747	171,511	726	8,655	17,230
1965	1,559,484	172,111	1,022	8,576	23,603
1966	1,908,500	178,212	996	9,022	20,167
1967	2,190,404	190,561	2,094	10,770	18,790
1968	2,764,446	207,678	8,520	14,198	20,474
1969	3,373,361	237,828	-558	15,020	22,126

For notes see end of table.

7.—Continued

Dividends paid	Payments to U.S. Treasury		Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Statutory transfers ²	Interest on Federal Reserve notes		
217	...	...	...	...
1,743	...	...	...	...
6,804	1,134	...	...	1,134
5,541	...	...	...	48,334
5,012	2,704	...	...	70,652
5,654	60,725	...	...	82,916
6,120	59,974	...	...	15,993
6,307	10,851	...	...	-660
6,553	3,613	...	...	2,546
6,682	114	...	...	-3,078
6,916	59	...	...	2,474
7,329	818	...	...	8,464
7,755	250	...	...	5,044
8,458	2,585	...	...	21,079
9,584	4,283	...	...	22,536
10,269	17	...	...	-2,298
10,030	...	...	...	-7,058
9,282	2,011	...	...	11,021
8,874	...	...	...	-917
8,782	...	...	-60	6,510
8,505	298	...	28	607
7,830	227	...	103	353
7,941	177	...	67	2,616
8,019	120	...	-419	1,862
8,110	25	...	-426	4,534
8,215	82	...	-54	17,617
8,430	141	...	-4	571
8,669	198	...	50	3,554
8,911	245	...	135	40,327
9,500	327	...	201	48,410
10,183	248	...	262	81,970
10,962	67	...	28	81,467
11,523	36	75,284	87	8,366
11,920	...	166,690	...	18,523
12,329	...	193,146	...	21,462
13,083	...	196,629	...	21,849
13,865	...	254,874	...	28,321
14,682	...	291,935	...	46,334
15,558	...	342,568	...	40,337
16,442	...	276,289	...	35,888
17,712	...	251,741	...	32,710
18,905	...	401,556	...	53,983
20,081	...	542,708	...	61,604
21,197	...	524,059	...	59,215
22,722	...	910,650	...	-93,601
23,948	...	896,816	...	42,613
25,570	...	687,393	...	70,892
27,412	...	799,366	...	45,538
28,912	...	879,685	...	55,864
30,782	...	1,582,119	...	-465,823
32,352	...	1,296,810	...	27,054
33,696	...	1,649,455	...	18,944
35,027	...	1,907,498	...	29,851
36,959	...	2,463,629	...	30,027
39,237	...	3,019,161	...	39,432

7. Income and Expenses of Federal Reserve Banks, 1914-97—Continued

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (-) ¹	Assessments by Board of Governors	
				Board expenditures	Costs of currency
1970.....	3,877,218	276,572	11,442	21,228	23,574
1971.....	3,723,370	319,608	94,266	32,634	24,943
1972.....	3,792,335	347,917	-49,616	35,234	31,455
1973.....	5,016,769	416,879	-80,653	44,412	33,826
1974.....	6,280,091	476,235	-78,487	41,117	30,190
1975.....	6,257,937	514,359	-202,370	33,577	37,130
1976.....	6,623,220	558,129	7,311	41,828	48,819
1977.....	6,891,317	568,851	-177,033	47,366	55,008
1978.....	8,455,309	592,558	-633,123	53,322	60,059
1979.....	10,310,148	625,168	-151,148	50,530	68,391
1980.....	12,802,319	718,033	-115,386	62,231	73,124
1981.....	15,508,350	814,190	-372,879	63,163	82,924
1982.....	16,517,385	926,034	-68,833	61,813	98,441
1983.....	16,068,362	1,023,678	-400,366	71,551	152,135
1984.....	18,068,821	1,102,444	-412,943	82,116	162,606
1985.....	18,131,983	1,127,744	1,301,624	77,378	173,739
1986.....	17,464,528	1,156,868	1,975,893	97,338	180,780
1987.....	17,633,012	1,146,911	1,796,594	81,870	170,675
1988.....	19,526,431	1,205,960	-516,910	84,411	164,245
1989.....	22,249,276	1,332,161	1,254,613	89,580	175,044
1990.....	23,476,604	1,349,726	2,099,328	103,752	193,007
1991.....	22,553,002	1,429,322	405,729	109,631	261,316
1992.....	20,235,028	1,474,531	-987,788	128,955	295,401
1993.....	18,914,251	1,657,800	-230,268	140,466	355,947
1994.....	20,910,742	1,795,328	2,363,862	146,866	368,187
1995.....	25,395,148	1,818,416	857,788	161,348	370,203
1996.....	25,164,303	1,947,861	-1,676,716	162,642	402,517
1997.....	26,917,213	1,976,453	-2,611,570	174,407	364,454
Total, 1914-97.....	444,326,051	32,523,434	3,474,202	2,488,662	4,753,587
<i>Aggregate for each Bank, 1914-97</i>					
Boston.....	24,017,634	2,183,100	90,732	92,064	280,959
New York.....	143,400,992	5,616,082 ⁴	1,222,234	657,442	1,486,522
Philadelphia.....	17,057,720	1,797,441	49,413	116,496	190,350
Cleveland.....	28,769,688	2,039,232	134,992	173,053	298,052
Richmond.....	35,431,346	2,796,667	168,188	152,440	418,383
Atlanta.....	20,497,504	3,022,109	300,425	208,712	265,542
Chicago.....	58,777,829	4,187,289	434,357	324,832	595,521
St. Louis.....	15,426,913	1,649,321	51,834	69,433	182,239
Minneapolis.....	8,188,820	1,521,072	92,686	70,524	83,885
Kansas City.....	17,597,697	2,078,129	108,207	100,228	191,063
Dallas.....	22,374,862	2,052,356	362,996	166,541	230,784
San Francisco.....	52,785,046	3,580,635	458,139	356,897	530,287
Total.....	444,326,051	32,523,434	3,474,202	2,488,662	4,753,587

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

1. For 1987 and subsequent years, includes the cost of services provided to the Treasury by Federal Reserve Banks for which reimbursement was not received.

2. Represents transfers made as a franchise tax from 1917 to 1932; transfers made under section 13b of the Federal Reserve Act from 1935 to 1947; and transfers made under section 7 of the Federal Reserve Act for 1996 and 1997.

3. The \$5,562,121 thousand transferred to surplus was reduced by direct charges of \$500 thousand for charge-off

on Bank premises (1927), \$139,300 thousand for contributions to capital of the Federal Deposit Insurance Corporation (1934), \$4 thousand net upon elimination of section 13b surplus (1958), and \$106,000 thousand (1996) and \$107,000 thousand (1997) transferred to the Treasury as statutorily required; and was increased by transfer of \$11,131 thousand from reserves for contingencies (1955), leaving a balance of \$5,220,449 thousand on December 31, 1997.

4. This amount is reduced \$1,117,482 thousand, which is related to the System Retirement Plan. See note 1, table 6.

7.—Continued

Dividends paid	Payments to U.S. Treasury		Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Statutory transfers ²	Interest on Federal Reserve notes		
41,137	...	3,493,571	...	32,580
43,488	...	3,356,560	...	40,403
46,184	...	3,231,268	...	50,661
49,140	...	4,340,680	...	51,178
52,580	...	5,549,999	...	51,483
54,610	...	5,382,064	...	33,828
57,351	...	5,870,463	...	53,940
60,182	...	5,937,148	...	45,728
63,280	...	7,005,779	...	47,268
67,194	...	9,278,576	...	69,141
70,355	...	11,706,370	...	56,821
74,574	...	14,023,723	...	76,897
79,352	...	15,204,591	...	78,320
85,152	...	14,228,816	...	106,663
92,620	...	16,054,095	...	161,996
103,029	...	17,796,464	...	155,253
109,588	...	17,803,895	...	91,954
117,499	...	17,738,880	...	173,771
125,616	...	17,364,319	...	64,971
129,885	...	21,646,417	...	130,802
140,758	...	23,608,398	...	180,292
152,553	...	20,777,552	...	228,356
171,763	...	16,774,477	...	402,114
195,422	...	15,986,765	...	347,583
212,090	...	20,470,011	...	282,122
230,527	...	23,389,367	...	283,075
255,884	5,517,716	14,565,624	...	635,343
299,652	20,658,972	0	...	831,705
3,948,566	26,328,016	372,195,871	-4	5,562,121³
157,144	1,558,701	19,564,040	135	272,222
1,059,330	10,547,740	124,111,328	-433	1,145,215
197,631	777,704	13,728,622	291	298,598
286,824	1,658,804	24,086,374	-10	362,351
244,986	1,889,932	29,258,068	-72	839,130
313,412	1,707,668	14,916,441	5	364,041
506,983	2,818,689	50,236,364	12	542,495
111,722	1,166,038	12,167,994	-27	132,025
110,068	224,564	6,073,680	65	197,649
155,409	770,467	14,279,520	-9	131,097
251,646	780,250	18,968,511	55	287,716
553,412	2,427,458	44,804,931	-17	989,583
3,948,566	26,328,016	372,195,871	-4	5,562,121

8. Acquisition Costs and Net Book Value of Premises of Federal Reserve Banks and Branches, December 31, 1997

Thousands of dollars

Federal Reserve Bank or Branch	Acquisition costs				Net book value	Other real estate ³
	Land	Buildings (including vaults) ¹	Building machinery and equipment	Total ²		
BOSTON	22,074	97,863	7,441	127,377	93,906	...
NEW YORK	20,330	133,536	44,703	198,569	151,031	...
Buffalo	888	4,072	3,017	7,976	4,896	...
PHILADELPHIA	2,380	60,976	7,672	71,028	50,587	...
CLEVELAND	2,715	96,700	16,690	116,105	104,816	...
Cincinnati	2,247	15,158	8,373	25,777	11,683	...
Pittsburgh	1,658	12,904	5,953	20,515	15,567	...
RICHMOND	6,261	61,059	22,098	89,418	70,583	5,708
Baltimore	6,478	27,101	4,569	38,148	26,927	...
Charlotte	3,130	27,477	4,750	35,356	28,802	...
ATLANTA ⁴	23,524	5,115	0	28,639	28,638	...
Birmingham	5,861	1,890	1,749	9,501	6,994	...
Jacksonville	1,730	17,226	2,859	21,815	17,309	48
Miami	3,823	13,556	2,728	20,108	14,120	...
Nashville	612	2,558	2,386	5,555	2,884	...
New Orleans	3,497	5,850	2,827	12,174	8,225	...
CHICAGO	5,030	117,615	13,974	136,619	99,367	...
Detroit	798	5,591	3,610	9,999	8,190	...
ST. LOUIS	700	18,797	6,001	25,498	17,412	...
Little Rock	1,148	3,701	1,110	5,960	4,708	...
Louisville	700	3,634	1,503	5,837	4,077	...
Memphis	1,136	4,360	2,755	8,250	5,186	...
MINNEAPOLIS	8,049	101,634	13,160	122,842	121,920	...
Helena	1,955	9,335	766	12,056	10,567	...
KANSAS CITY	2,048	18,173	8,264	28,486	18,507	...
Denver	3,188	6,134	3,455	12,777	8,319	...
Oklahoma City	646	11,454	2,881	14,981	12,326	...
Omaha	6,535	10,987	1,401	18,923	15,410	...
DALLAS	28,512	102,692	18,601	149,806	133,611	...
El Paso	262	2,865	908	4,035	3,266	...
Houston	2,205	4,749	1,688	8,643	6,768	...
San Antonio	482	5,279	2,686	8,448	6,360	...
SAN FRANCISCO	15,600	71,813	18,321	105,734	76,755	...
Los Angeles	3,892	52,417	9,210	65,519	50,847	...
Portland	2,754	9,659	2,144	14,557	12,951	...
Salt Lake City	495	7,195	2,360	10,050	8,064	...
Seattle	325	10,090	2,727	13,142	10,415	...
Total	193,670	1,161,212	255,343	1,610,225	1,271,996	5,757

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

1. Includes expenditures for construction at some offices, pending allocation to appropriate accounts.

2. Excludes charge-offs of \$17,699 thousand before 1952.

3. Covers acquisitions for banking-house purposes and Bank premises formerly occupied and being held pending sale.

4. The Atlanta Bank sold its building and its building machinery and equipment in 1997. The Bank is leasing back the building pending completion of a new facility.

9. Operations in Principal Departments of Federal Reserve Banks, 1994–97

Operation	1997	1996	1995	1994
<i>Millions of pieces (except as noted)</i>				
Loans (thousands)	7	6	6	8
Currency received and counted	24,510	23,436	22,594	20,166
Currency verified and destroyed	7,769	8,686	8,911	7,244
Coin received and counted	9,603	8,654	7,578	6,950
Checks handled				
U.S. government checks	378	436	460	470
Postal money orders	204	206	203	200
All other	15,949	15,487	15,465	16,479
Government securities transfers ¹	13	13	13	13
Transfer of funds	90	83	76	72
Automated clearinghouse transactions ²				
Commercial	2,603	2,372	2,046	1,737
Government	677	625	599	574
Food stamps redeemed	2,854	3,637	3,954	4,229
<i>Millions of dollars</i>				
Loans	39,863	25,350	22,854	22,853
Currency received and counted	399,080	375,399	345,318	277,685
Currency verified and destroyed	123,359	148,394	113,828	76,620
Coin received and counted	1,212	1,175	1,112	1,045
Checks handled				
U.S. government checks	401,989	462,647	490,299	504,479
Postal money orders	26,464	25,831	24,835	23,764
All other	12,169,087	11,584,276	11,567,820	12,079,107
Government securities transfers ¹	174,949,330	160,637,460	149,764,431	144,702,226
Transfer of funds	288,419,808	249,140,021	222,954,083	211,201,540
Automated clearinghouse transactions ²				
Commercial	9,128,779	8,287,711	7,817,323	7,094,246
Government	1,581,552	1,250,472	1,117,452	948,984
Food stamps redeemed	15,054	18,669	20,862	21,867

1. Beginning with the 1994 *Annual Report*, "Government securities transfers" replaced the previous time series that included "Issues, redemptions, and exchanges of U.S. Treasury and federal agency securities." This change was made to enable consistent time series report-

ing for the fiscal area, for which complex definitional changes have occurred over the reported years.

2. Beginning in 1997, the reported ACH volumes no longer include non-value items.

10. Federal Reserve Bank Interest Rates on Loans to Depository Institutions, December 31, 1997

Reserve Bank	Adjustment credit ¹	Seasonal credit ²	Extended credit ³	
			First thirty days of borrowing	After thirty days of borrowing
All Federal Reserve Banks	5.00	5.65	5.00	6.15

1. Adjustment credit is available on a short-term basis to help depository institutions meet temporary needs for funds that cannot be met through reasonable alternative sources. Adjustment credit is usually provided at the basic discount rate, but under certain circumstances a special rate or rates above the basic discount rate may be applied. See section 201.3(a) of Regulation A.

2. Seasonal credit is available to help smaller depository institutions meet regular, seasonal needs for funds that cannot be met through special industry lenders and that arise from a combination of expected patterns of movement in their deposits and loans. The discount rate on seasonal credit takes into account rates on market sources of funds and ordinarily is reestablished on the first business day of each two-week reserve maintenance period; however, it is never lower than the discount rate applicable to adjustment credit. See section 201.3(b) of Regulation A.

3. Extended credit is available to depository institutions, if similar assistance is not reasonably available from other sources, when exceptional circumstances or practices involve only a particular institution or when an institution is experiencing difficulties adjusting to changing market conditions over a longer period of time. See section 201.3(c) of Regulation A.

Extended-credit loans outstanding more than thirty days ordinarily will be charged a flexible rate somewhat above rates on market sources of funds; however, the rate will always be at least 50 basis points above the discount rate applicable to adjustment credit. The flexible rate is reestablished on the first business day of each two-week reserve maintenance period. At the discretion of the Federal Reserve Bank, the flexible rate may be charged on extended-credit loans that are outstanding less than thirty days.

11. Reserve Requirements of Depository Institutions, December 31, 1997

Type of deposit	Requirements	
	Percentage of deposits	Effective date
<i>Net transaction accounts</i> ¹		
\$0 million–\$47.8 million ²	3	1-1-98
More than \$47.8 million ³	10	1-1-98
Nonpersonal time deposits ⁴	0	12-27-90
Eurocurrency liabilities ⁵	0	12-27-90

NOTE. Required reserves must be held in the form of deposits with Federal Reserve Banks or vault cash. Nonmember institutions may maintain reserve balances with a Federal Reserve Bank indirectly, on a pass-through basis, with certain approved institutions. For previous reserve requirements, see earlier editions of the *Annual Report* or the *Federal Reserve Bulletin*. Under the Monetary Control Act of 1980, depository institutions include commercial banks, mutual savings banks, savings and loan associations, credit unions, agencies and branches of foreign banks, and Edge Act corporations.

1. Transaction accounts include all deposits against which the account holder is permitted to make withdrawals by negotiable or transferable instruments, payment orders of withdrawal, or telephone or preauthorized transfers for the purpose of making payments to third persons or others. However, accounts subject to the rules that permit no more than six preauthorized, automatic, or other transfers per month (of which no more than three may be by check, draft, debit card, or similar order payable directly to third parties) are savings deposits, not transaction accounts.

2. The Monetary Control Act of 1980 requires that the amount of transaction accounts against which the 3 percent reserve requirement applies be modified annually by 80 percent of the percentage change in transaction accounts held by all depository institutions, determined as of June 30 each year. Effective with the reserve maintenance period beginning January 1, 1998, for depository institutions that report weekly, and with the reserve maintenance period beginning January 15, 1998, for institutions that report quarterly, the amount was decreased from \$49.3 million to \$47.8 million.

Under the Garn–St Germain Depository Institutions Act of 1982, the Board adjusts the amount of reservable

liabilities subject to a zero percent reserve requirement each year for the succeeding calendar year by 80 percent of the percentage increase in the total reservable liabilities of all depository institutions, measured on an annual basis as of June 30. No corresponding adjustment is made in the event of a decrease. The exemption applies only to accounts that would be subject to a 3 percent reserve requirement. Effective with the reserve maintenance period beginning January 1, 1998, for depository institutions that report weekly, and with the period beginning January 15, 1998, for institutions that report quarterly, the exemption was raised from \$4.4 million to \$4.7 million.

3. The reserve requirement was reduced from 12 percent to 10 percent on April 2, 1992, for institutions that report weekly, and on April 16, 1992, for institutions that report quarterly.

4. For institutions that report weekly, the reserve requirement on nonpersonal time deposits with an original maturity of less than 1½ years was reduced from 3 percent to 1½ percent for the maintenance period that began December 13, 1990, and to zero for the maintenance period that began December 27, 1990. For institutions that report quarterly, the reserve requirement on nonpersonal time deposits with an original maturity of less than 1½ years was reduced from 3 percent to zero on January 17, 1991.

The reserve requirement on nonpersonal time deposits with an original maturity of 1½ years or more has been zero since October 6, 1983.

5. The reserve requirement on Eurocurrency liabilities was reduced from 3 percent to zero in the same manner and on the same dates as the reserve requirement on nonpersonal time deposits with an original maturity of less than 1½ years (see note 4).

12. Initial Margin Requirements under Regulations T, U, G, and X

Percent of market value

Effective date	Margin stocks	Convertible bonds	Short sales, T only ¹
1934, Oct. 1	25-45	...	...
1936, Feb. 1	25-55	...	...
Apr. 1	55	...	...
1937, Nov. 1	40	...	50
1945, Feb. 5	50	...	50
July 5	75	...	75
1946, Jan. 21	100	...	100
1947, Feb. 21	75	...	75
1949, Mar. 3	50	...	50
1951, Jan. 17	75	...	75
1953, Feb. 20	50	...	50
1955, Jan. 4	60	...	60
Apr. 23	70	...	70
1958, Jan. 16	50	...	50
Aug. 5	70	...	70
Oct. 16	90	...	90
1960, July 28	70	...	70
1962, July 10	50	...	50
1963, Nov. 6	70	...	70
1968, Mar. 11	70	50	70
June 8	80	60	80
1970, May 6	65	50	65
1971, Dec. 6	55	50	55
1972, Nov. 24	65	50	65
1974, Jan. 3	50	50	50

NOTE. These regulations, adopted by the Board of Governors pursuant to the Securities Exchange Act of 1934, limit the amount of credit to purchase and carry "margin securities" (as defined in the regulations) when such value is collateralized by securities. Margin requirements on securities are the difference between the market value (100 percent) and the maximum loan value of collateral as prescribed by the Board. Regulation T was adopted effective October 15, 1934; Regulation U, effective May 1, 1936; Regulation G, effective March 11, 1968; and Regulation X, effective November 1, 1971.

On January 1, 1977, the Board of Governors for the first time established in Regulation T the initial margin

required for writing options on securities, setting it at 30 percent of the current market value of the stock underlying the option. On September 30, 1985, the Board changed the required margin on individual stock options, allowing it to be the same as the option maintenance margin required by the appropriate exchange or self-regulatory organization; such maintenance margin rules must be approved by the Securities and Exchange Commission.

1. From October 1, 1934, to October 31, 1937, the requirement was the margin "customarily required" by the brokers and dealers.

13. Principal Assets and Liabilities and Number of Insured Commercial Banks in the United States, by Class of Bank, June 30, 1997 and 1996

Millions of dollars, except as noted

Item	Total	Member banks			Nonmember banks
		Total	National	State	
1997					
ASSETS					
Loans and investments	3,412,288	2,616,982	1,974,445	642,536	795,307
Gross loans	2,593,208	2,018,481	1,567,741	450,740	574,727
Net loans	2,589,450	2,016,325	1,565,973	450,352	573,125
Investments	819,080	598,501	406,705	191,796	220,580
U.S. Treasury and federal agency securities	298,280	190,202	130,366	59,837	108,078
Other	520,800	408,298	276,339	131,959	112,502
Cash assets, total	242,325	200,589	148,152	52,437	41,736
LIABILITIES					
Deposits, total	2,769,594	2,094,630	1,573,413	521,217	674,964
Interbank	49,463	42,445	31,929	10,516	7,017
Other transaction	725,105	557,081	415,078	142,003	168,024
Other nontransaction	2,163,105	1,598,717	1,204,788	393,928	564,388
Equity capital	402,005	315,374	231,752	83,622	86,630
Number of banks	9,259	3,632	2,646	986	5,627
1996 ^r					
ASSETS					
Loans and investments	3,208,537	827,250	1,833,815	547,472	827,250
Gross loans	2,398,633	589,707	1,434,639	374,287	589,707
Net loans	2,394,569	587,924	1,432,835	373,810	587,924
Investments	809,904	237,543	399,176	173,185	237,543
U.S. Treasury and federal agency securities	310,423	116,790	136,589	57,044	116,790
Other	499,481	120,753	262,586	116,141	120,753
Cash assets, total	208,992	42,293	131,457	35,243	42,293
LIABILITIES					
Deposits, total	2,601,770	695,640	1,486,541	419,588	695,640
Interbank	41,738	6,654	26,990	8,093	6,654
Other transaction	724,573	181,001	423,587	119,986	181,001
Other nontransaction	2,039,109	582,040	1,136,828	320,241	582,040
Equity capital	365,064	90,097	207,372	67,594	90,097
Number of banks	9,651	3,774	2,753	1,021	5,877

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

r. Some data have been revised.

14. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items—Year-End 1918–97, and Month-End 1997

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding								Gold stock ⁶	Special drawing rights certificate account	Treasury currency outstanding ⁷
	U.S. Treasury and federal agency securities			Loans	Float ³	All other ⁴	Other Federal Reserve assets ⁵	Total			
	Total	Bought outright ¹	Held under repurchase agreement ²								
1918.....	239	239	0	1,766	199	294	0	2,498	2,873	...	1,795
1919.....	300	300	0	2,215	201	575	0	3,292	2,707	...	1,707
1920.....	287	287	0	2,687	119	262	0	3,355	2,639	...	1,709
1921.....	234	234	0	1,144	40	146	0	1,563	3,373	...	1,842
1922.....	436	436	0	618	78	273	0	1,405	3,642	...	1,958
1923.....	134	80	54	723	27	355	0	1,238	3,957	...	2,009
1924.....	540	536	4	320	52	390	0	1,302	4,212	...	2,025
1925.....	375	367	8	643	63	378	0	1,459	4,112	...	1,977
1926.....	315	312	3	637	45	384	0	1,381	4,205	...	1,991
1927.....	617	560	57	582	63	393	0	1,655	4,092	...	2,006
1928.....	228	197	31	1,056	24	500	0	1,809	3,854	...	2,012
1929.....	511	488	23	632	34	405	0	1,583	3,997	...	2,022
1930.....	739	686	43	251	21	372	0	1,373	4,306	...	2,027
1931.....	817	775	42	638	20	378	0	1,853	4,173	...	2,035
1932.....	1,855	1,851	4	235	14	41	0	2,145	4,226	...	2,204
1933.....	2,437	2,435	2	98	15	137	0	2,688	4,036	...	2,303
1934.....	2,430	2,430	0	7	5	21	0	2,463	8,238	...	2,511
1935.....	2,431	2,430	1	5	12	38	0	2,486	10,125	...	2,476
1936.....	2,430	2,430	0	3	39	28	0	2,500	11,258	...	2,532
1937.....	2,564	2,564	0	10	19	19	0	2,612	12,760	...	2,637
1938.....	2,564	2,564	0	4	17	16	0	2,601	14,512	...	2,798
1939.....	2,484	2,484	0	7	91	11	0	2,593	17,644	...	2,963
1940.....	2,184	2,184	0	3	80	8	0	2,274	21,995	...	3,087
1941.....	2,254	2,254	0	3	94	10	0	2,361	22,737	...	3,247
1942.....	6,189	6,189	0	6	471	14	0	6,679	22,726	...	3,648
1943.....	11,543	11,543	0	5	681	10	0	12,239	21,938	...	4,094
1944.....	18,846	18,846	0	80	815	4	0	19,745	20,619	...	4,131
1945.....	24,252	24,252	0	249	578	2	0	15,091	20,065	...	4,339
1946.....	23,350	23,350	0	163	580	1	0	24,093	20,529	...	4,562
1947.....	22,559	22,559	0	85	535	1	0	23,181	22,754	...	4,562
1948.....	23,333	23,333	0	223	541	1	0	24,097	24,244	...	4,589
1949.....	18,885	18,885	0	78	534	2	0	19,499	24,427	...	4,598
1950.....	20,778	20,725	53	67	1,368	3	0	22,216	22,706	...	4,636
1951.....	23,801	23,605	196	19	1,184	5	0	25,009	22,695	...	4,709
1952.....	24,697	24,034	663	156	967	4	0	25,825	23,187	...	4,812
1953.....	25,916	25,318	598	28	935	2	0	26,880	22,030	...	4,894
1954.....	24,932	24,888	44	143	808	1	0	25,885	21,713	...	4,985
1955.....	24,785	24,391	394	108	1,585	29	0	26,507	21,690	...	5,008
1956.....	24,915	24,610	305	50	1,665	70	0	26,699	21,949	...	5,066
1957.....	24,238	23,719	519	55	1,424	66	0	25,784	22,781	...	5,146
1958.....	26,347	26,252	95	64	1,296	49	0	27,755	20,534	...	5,234
1959.....	26,648	26,607	41	458	1,590	75	0	28,771	19,456	...	5,311
1960.....	27,384	26,984	400	33	1,847	74	0	29,338	17,767	...	5,398
1961.....	28,881	30,478	159	130	2,300	51	0	31,362	16,889	...	5,585
1962.....	30,820	28,722	342	38	2,903	110	0	33,871	15,978	...	5,567
1963.....	33,593	33,582	11	63	2,600	162	0	36,418	15,513	...	5,578
1964.....	37,044	36,506	538	186	2,606	94	0	39,930	15,388	...	5,405

For notes see end of table.

14.—Continued

Factors absorbing reserve funds											
Cur- rency in cir- cu- la- tion	Trea- sury cash hold- ings ⁸	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve ac- counts ⁵	Re- quired clear- ing bal- ances	Other Federal Reserve lia- bilities and capital ⁵	Member bank reserves ⁹			
		Trea- sury	For- eign	Other				With Federal Reserve Banks	Cur- rency and coin ¹⁰	Re- quired ¹¹	Ex- cess ¹¹
4,951	288	51	96	25	118	0	0	1,636	0	1,585	51
5,091	385	51	73	28	208	0	0	1,890	0	1,822	68
5,325	218	57	5	18	298	0	0	1,781	0	0	0
4,403	214	96	12	15	285	0	0	1,753	0	1,654	99
4,530	225	11	3	26	276	0	0	1,934	0	0	0
4,757	213	38	4	19	275	0	0	1,898	0	1,884	14
4,760	211	51	19	20	258	0	0	2,220	0	2,161	59
4,817	203	16	8	21	272	0	0	2,212	0	2,256	-44
4,808	201	17	46	19	293	0	0	2,194	0	2,250	-56
4,716	208	18	5	21	301	0	0	2,487	0	2,424	63
4,686	202	23	6	21	348	0	0	2,389	0	2,430	-41
4,578	216	29	6	24	393	0	0	2,355	0	2,428	-73
4,603	211	19	6	22	375	0	0	2,471	0	2,375	96
5,360	222	54	79	31	354	0	0	1,961	0	1,994	-33
5,388	272	8	19	24	355	0	0	2,509	0	1,933	576
5,519	284	3	4	128	360	0	0	2,729	0	1,870	859
5,536	3,029	121	20	169	241	0	0	4,096	0	2,282	1,814
5,882	2,566	544	29	226	253	0	0	5,587	0	2,743	2,844
6,543	2,376	244	99	160	261	0	0	6,606	0	4,622	1,984
6,550	3,619	142	172	235	263	0	0	7,027	0	5,815	1,212
6,856	2,706	923	199	242	260	0	0	8,724	0	5,519	3,205
7,598	2,409	634	397	256	251	0	0	11,653	0	6,444	5,209
8,732	2,213	368	1,133	599	284	0	0	4,026	0	7,411	6,615
11,160	2,215	867	774	586	291	0	0	12,450	0	9,365	3,085
15,410	2,193	799	793	485	256	0	0	13,117	0	11,129	1,988
20,499	2,303	579	1,360	356	339	0	0	12,886	0	11,650	1,236
25,307	2,375	440	1,204	394	402	0	0	14,373	0	12,748	1,625
28,515	2,287	977	862	446	495	0	0	15,915	0	14,457	1,458
28,952	2,272	393	508	314	607	0	0	16,139	0	15,577	562
28,868	1,336	870	392	569	563	0	0	17,899	0	16,400	1,499
28,224	1,325	1,123	642	547	590	0	0	20,479	0	19,277	1,202
27,600	1,312	821	767	750	106	0	0	16,568	0	15,550	1,018
27,741	1,293	668	895	565	714	0	0	17,681	0	16,509	1,172
29,206	1,270	247	526	363	746	0	0	20,056	0	19,667	389
30,433	1,270	389	550	455	777	0	0	19,950	0	20,520	-570
30,781	761	346	423	493	839	0	0	20,160	0	19,397	763
30,509	796	563	490	441	907	0	0	18,876	0	18,618	258
31,158	767	394	402	554	925	0	0	19,005	0	18,903	102
31,790	775	441	322	426	901	0	0	19,059	0	19,089	-30
31,834	761	481	356	246	998	0	0	19,034	0	19,091	-57
32,193	683	358	272	391	1,122	0	0	18,504	0	18,574	-70
32,591	391	504	345	694	841	0	0	18,174	310	18,619	-135
32,869	377	485	217	533	941	0	0	17,081	2,544	18,988	637
33,918	422	465	279	320	1,044	0	0	17,387	2,544	18,988	96
35,338	380	597	247	393	1,007	0	0	17,454	3,262	20,071	645
37,692	361	880	171	291	1,065	0	0	17,049	4,099	20,677	471
39,619	612	820	229	321	1,036	0	0	18,086	4,151	21,663	574

14. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items—Year-End 1918–97 and Month-End 1997—Continued

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding							Gold stock ⁶	Special drawing rights certificate account	Treasury currency outstanding ⁷	
	U.S. Treasury and federal agency securities			Loans	Float ³	All other ⁴	Other Federal Reserve assets ⁵				Total
	Total	Bought outright ¹	Held under repurchase agreement ²								
1965.....	40,768	40,478	290	137	2,248	187	0	43,340	13,733	...	5,575
1966.....	44,316	43,655	661	173	2,495	193	0	47,177	13,159	...	6,317
1967.....	49,150	48,980	170	141	2,576	164	0	52,031	11,982	...	6,784
1968.....	52,937	52,937	0	186	3,443	58	0	56,624	10,367	...	6,795
1969.....	57,154	7,154 ⁵	0	183	3,440	64	2,743	64,584	10,367	...	6,852
1970.....	62,142	62,142	0	335	4,261	57	1,123	67,918	10,732	400	7,147
1971.....	70,804	69,481	1,323	39	4,343	261	1,068	76,515	10,132	400	7,710
1972.....	71,230	71,119	111	1,981	3,974	106	1,260	78,551	10,410	400	8,313
1973.....	80,495	80,395	100	1,258	3,099	68	1,152	86,072	11,567	400	8,716
1974.....	85,714	84,760	954	299	2,001	999	3,195	92,208	11,652	400	9,253
1975.....	94,124	92,789	1,335	211	3,688	1,126	3,312	102,461	11,599	500	10,218
1976.....	104,093	100,062	4,031	25	2,601	991	3,182	110,892	11,598	1,200	10,810
1977.....	111,274	108,922	2,352	265	3,810	954	2,442	118,745	11,718	1,250	11,331
1978.....	118,591	117,374	1,217	1,174	6,432	587	4,543	131,327	11,671	1,300	11,831
1979.....	126,167	124,507	1,660	1,454	6,767	704	5,613	140,705	11,172	1,800	13,083
1980.....	130,592	128,038	2,554	1,809	4,467	776	8,739	146,383	11,160	2,518	13,427
1981.....	140,348	136,863	3,485	1,601	1,762	195	9,230	153,136	11,151	3,318	13,687
1982.....	148,837	144,544	4,293	717	2,735	1,480	9,890	163,659	11,148	4,618	13,786
1983.....	160,795	159,203	1,592	918	1,605	418	8,728	172,464	11,121	4,618	15,732
1984.....	169,627	167,612	2,015	3,577	833	0	12,347	186,384	11,096	4,618	16,418
1985.....	191,248	186,025	5,223	3,060	988	0	15,302	210,598	11,090	4,718	17,075
1986.....	221,459	205,454	16,005	1,565	1,261	0	17,475	241,760	11,084	5,018	17,567
1987.....	231,420	226,459	4,961	3,815	811	0	15,837	251,883	11,078	5,018	18,177
1988.....	247,489	240,628	6,861	2,170	1,286	0	18,803	269,748	11,060	5,018	18,799
1989.....	235,417	233,300	2,117	481	1,093	0	39,631	276,622	11,059	8,518	19,628
1990.....	259,786	241,432	18,354	190	2,566	0	39,880	302,421	11,058	10,018	20,404
1991.....	288,429	272,531	15,898	218	1,026	0	34,524	324,197	11,059	10,018	21,017
1992.....	308,518	300,424	8,094	675	3,350	0	30,278	342,820	11,056	8,018	21,452
1993.....	349,865	336,653	13,212	94	963	0	33,394	384,316	11,053	8,018	22,101
1994.....	378,746	368,156	10,590	223	740	0	33,441	413,150	11,051	8,018	22,912
1995.....	394,693	380,831	13,862	136	231	0	33,483	428,543	11,050	10,168	23,951
1996.....	414,715	393,132	21,583	85	5,297	0	32,222	452,319	11,048	9,718	24,798
1997.....	455,260	431,420	23,840	2,035	561	0	32,044	489,901	11,047	9,200	25,644

14.—Continued

Factors absorbing reserve funds											
Cur- rency in cir- cu- lation	Trea- sury cash hold- ings ⁸	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve ac- counts ⁵	Re- quired clear- ing bal- ances	Other Federal Reserve lia- bilities and capital ⁵	Member bank reserves ⁹			
		Trea- sury	For- eign	Other				With Federal Reserve Banks	Cur- rency and coin ¹⁰	Re- quired ¹¹	Ex- cess ^{11,12}
42,056	760	668	150	355	211	0	0	18,447	4,163	22,848	-238
44,663	1,176	416	174	588	-147	0	0	19,779	4,310	24,321	-232
47,226	1,344	1,123	135	563	-773	0	0	21,092	4,631	25,905	-182
50,961	695	703	216	747	-1,353	0	0	21,818	4,921	27,439	-700
53,950	596	1,312	134	807	0	0	1,919	22,085	5,187	28,173	-901
57,903	431	1,156	148	1,233	0	0	1,986	24,150	5,423	30,033	-460
61,068	460	2,020	294	999	0	0	2,131	27,788	5,743	32,496	1,035
66,516	345	1,855	325	840	0	0	2,143	25,647	6,216	32,044	98 ¹²
72,497	317	2,542	251	1,419 ¹³	0	0	2,669	27,060	6,781	35,268	-1,360
79,743	185	2,113	418	1,275 ¹³	0	0	2,935	25,843	7,370	37,011	-3,798
86,547	483	7,285	353	1,090	0	0	2,968	26,052	8,036	35,197	-1,103 ¹⁴
93,717	460	10,393	352	1,357	0	0	3,063	25,158	8,628	35,461	-1,535
103,811	392	7,114	379	1,187	0	0	3,292	26,870	9,421	37,615	-1,265
114,645	240	4,196	368	1,256	0	0	4,275	31,152	10,538	42,694	-893
125,600	494	4,075	429	1,412	0	0	4,957	29,792	11,429	44,217	-2,835
136,829	441	3,062	411	617	0	0	4,671	27,456	13,654	40,558	675
144,774	443	4,301	505	781	0	117	5,261	25,111	15,576	42,145	-1,442
154,908	429	5,033	328	1,033	0	436	4,990	26,053	16,666	41,391	1,328
171,935	479	3,661	191	851	0	1,013	5,392	20,413	17,821	39,179	-945
183,796	513	5,316	253	867	0	1,126	5,952	20,693			
197,488	550	9,351	480	1,041	0	1,490	5,940	27,141			
211,995	447	7,588	287	917	0	1,812	6,088	46,295			
230,205	454	5,313	244	1,027	0	1,687	7,129	40,097			
247,649	395	8,656	347	548	0	1,605	7,683	37,742			
260,456	450	6,217	589	1,298	0	1,618	8,486	36,713	n.a.	n.a.	n.a.
286,965	561	8,960	369	242	0	1,963	8,147	36,695			
307,759	636	17,697	968	1,706	0	3,945	8,113	25,467			
334,706	508	7,492	206	372	0	5,897	7,984	26,181			
365,299	377	14,809	386	397	0	6,332	9,292	28,614			
403,762	335	7,161	250	876	0	4,239	11,959	26,550			
424,192	270	5,979	386	932	0	5,171	12,342	24,441			
450,660	249	7,742	167	892	0	6,601	13,829	17,922			
482,428	225	5,444	457	900	0	6,667	15,500	24,171			

14. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items—Year-End 1918–97, and Month-End 1997—Continued

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding							Gold stock ⁶	Special drawing rights certificate account	Treasury currency outstanding ⁷	
	U.S. Treasury and federal agency securities			Loans	Float ³	All other ⁴	Other Federal Reserve assets ⁵				Total
	Total	Bought outright ¹	Held under repurchase agreement ²								
1997											
Jan. ...	402,771	393,766	9,005	30	363	0	30,971	434,135	11,048	9,400	25,047
Feb. ...	405,213	392,809	12,404	36	601	0	29,365	435,215	11,051	9,400	25,111
Mar. ...	408,651	397,070	11,581	3,998	381	0	30,275	443,305	11,050	9,200	25,173
Apr. ...	455,850	404,483	51,367	156	432	0	33,263	489,702	11,051	9,200	25,231
May ...	416,394	407,094	9,300	571	227	0	30,050	447,242	11,051	9,200	25,284
June ...	428,984	412,411	16,573	1,894	592	0	32,517	463,987	11,050	9,200	25,335
July ...	416,117	409,048	7,069	411	222	0	31,437	448,188	11,051	9,200	25,376
Aug. ...	423,609	410,440	13,169	468	-34	0	29,886	453,929	11,050	9,200	25,414
Sept. ...	426,665	412,747	13,918	313	738	0	31,682	459,398	11,050	9,200	25,462
Oct. ...	423,043	411,477	11,566	175	14	0	32,946	456,178	11,050	9,200	25,532
Nov. ...	434,765	420,567	14,198	90	395	0	30,993	466,244	11,051	9,200	25,588
Dec. ...	455,260	431,420	23,840	2,035	561	0	32,044	489,901	11,047	9,200	25,644

NOTE. For a description of figures and discussion of their significance, see *Banking and Monetary Statistics, 1941–1970* (Board of Governors of the Federal Reserve System, 1976), pp. 507–23. Components may not sum to totals because of rounding.

... Not applicable.

n.a. Not available.

1. Beginning in 1969, includes securities loaned—fully guaranteed by U.S. government securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale-purchase transactions.

2. Beginning December 1, 1966, includes federal agency obligations held under repurchase agreements and beginning September 29, 1971, includes federal agency issues bought outright.

3. Beginning in 1960, figures reflect a minor change in concept; see *Federal Reserve Bulletin*, vol. 47 (February 1961), p. 164.

4. Principally acceptances and, until August 21, 1959, industrial loans, authority for which expired on that date.

5. For the period before April 16, 1969, includes the total of Federal Reserve capital paid in, surplus, other

capital accounts, and other liabilities and accrued dividends, less the sum of bank premises and other assets, and is reported as “Other Federal Reserve accounts”; thereafter, “Other Federal Reserve assets” and “Other Federal Reserve liabilities and capital” are shown separately.

6. Before January 30, 1934, includes gold held in Federal Reserve Banks and in circulation.

7. Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are fractional and dollar coins. For details see “Currency and Coin in Circulation,” *Treasury Bulletin*.

8. Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

9. Beginning in November 1979, includes reserves of member banks, Edge Act corporations, and U.S. agencies and branches of foreign banks. Beginning on November 13, 1980, includes reserves of all depository institutions.

Beginning in 1984, data on “Currency and coin” and “Required” and “Excess” reserves changed from daily to biweekly basis.

14.—Continued

Factors absorbing reserve funds											
Cur- rency in cir- cu- la- tion	Trea- sury cash hold- ings ⁸	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve ac- counts ⁵	Re- quired clear- ing bal- ances	Other Federal Reserve lia- bilities and capital ⁵	Member bank reserves ⁹			
		Trea- sury	For- eign	Other				With Federal Reserve Banks	Cur- rency and coin ¹⁰	Re- quired ¹¹	Ex- cess ^{11,12}
438,394	249	6,770	167	359	0	6,764	13,384	13,543	↑	↑	↑
441,655	280	5,258	229	345	0	6,815	14,135	12,061			
444,544	313	5,945	916	350	0	6,756	14,816	15,089			
446,632	309	52,215	169	348	0	6,918	14,977	13,616			
451,141	330	5,174	177	325	0	6,887	16,037	12,705			
453,624	343	16,368	178	321	0	6,952	15,517	16,267			
455,074	311	5,014	175	325	0	6,893	14,785	11,239	n.a.	n.a.	n.a.
459,479	278	4,700	169	327	0	6,757	16,144	11,740			
458,262	255	7,692	188	386	0	6,738	16,536	15,053			
461,542	237	4,616	190	337	0	6,787	16,328	11,922			
471,216	234	5,127	167	509	0	6,711	15,559	12,560	↓	↓	↓
482,428	225	5,444	457	900	0	6,667	15,500	24,171			

10. Between December 1, 1959, and November 23, 1960, part was allowed as reserves; thereafter all was allowed.

11. Estimated through 1958. Before 1929, data were available only on call dates (in 1920 and 1922 the call date was December 29). Beginning on September 12, 1968, the amount is based on close-of-business figures for the reserve period two weeks before the report date.

12. Beginning with week ending November 15, 1972, includes \$450 million of reserve deficiencies on which Federal Reserve Banks are allowed to waive penalties for a transition period in connection with bank adaptation to Regulation J as amended, effective November 9, 1972. Allowable deficiencies are as follows (beginning with first statement week of quarter, in millions): 1973—Q1, \$279; Q2, \$172; Q3, \$112; Q4, \$84; 1974—Q1, \$67; Q2, \$58. The transition period ended with the second quarter of 1974.

13. For the period before July 1973, includes certain deposits of domestic nonmember banks and foreign-owned banking institutions held with member banks and redeposited in full with Federal Reserve Banks in connection with voluntary participation by nonmember institutions in the Federal Reserve System program of credit restraint.

As of December 12, 1974, the amount of voluntary nonmember bank and foreign-agency and branch deposits at Federal Reserve Banks that are associated with marginal reserves are no longer reported. However, two amounts are reported: (1) deposits voluntarily held as reserves by agencies and branches of foreign banks operating in the United States and (2) Eurodollar liabilities.

14. Adjusted to include waivers of penalties for reserve deficiencies, in accordance with change in Board policy effective November 19, 1975.

15. Banking Offices, and Banks Affiliated with Bank Holding Companies in the United States, December 31, 1996 and 1997

Type of office	Total	Commercial banks ¹					State-chartered savings banks
		Total	Member			Nonmember	
			Total	National	State		
All banking offices							
BANKS							
Number, Dec. 31, 1996 ..	9,993	9,487	3,698	2,684	1,014	5,789	506
<i>Changes during 1997</i>							
New banks	224	207	77	61	16	130	17
Banks converted into branches	-587	-565	-297	-215	-82	-268	-22
Ceased banking operation ²	-47	-33	-11	-8	-3	-22	-14
Other ³	0	7	76	29	47	-69	-7
Net change	-410	-384	-155	-133	-22	-229	-26
Number, Dec. 31, 1997 ..	9,583	9,103	3,543	2,551	992	5,560	480
BRANCHES AND ADDITIONAL OFFICES							
Number, Dec. 31, 1996 ..	62,644	59,139	40,828	31,211	9,617	18,311	3,505
<i>Changes during 1997</i>							
New branches	3,348	3,122	2,294	1,771	523	828	226
Branches converted from banks	587	575	336	241	95	239	12
Discontinued ²	-1,784	-1,636	-1,238	-941	-297	-398	-148
Other ³	0	434	2,817	2,878	-61	-2,383	-434
Net change	2,151	2,495	4,209	3,949	260	-1,714	-344
Number, Dec. 31, 1997 ..	64,795	61,634	45,037	35,160	9,877	16,597	3,161
Banks affiliated with bank holding companies							
BANKS							
Number, Dec. 31, 1996 ..	7,366	7,241	2,981	2,161	820	4,260	125
<i>Changes during 1997</i>							
BHC-affiliated new banks	323	306	125	92	33	181	17
Banks converted into branches	-514	-501	-268	-194	-74	-233	-13
Ceased banking operation ²	-41	-34	-14	-11	-3	-20	-7
Other ³	0	3	65	29	36	-62	-3
Net change	-232	-226	-92	-84	-8	-134	-6
Number, Dec. 31, 1997 ..	7,134	7,015	2,889	2,077	812	4,126	119

1. For purposes of this table, banks are entities that are defined as banks in the Bank Holding Company Act as amended and implemented in Federal Reserve Regulation Y. Generally, a bank is any institution that accepts demand deposits and is engaged in the business of making commercial loans or any institution that is

defined as an insured bank in section 3(h) of the FDIC Act. Covers entities in the United States and its territories and possessions (affiliated insular areas).

2. Institutions that no longer meet the Regulation Y definition of bank.

3. Interclass changes and sales of branches.

16. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities
Approved by the Board of Governors, 1997

Bank of the West, El Paso, Texas to acquire assets and liabilities of one branch of Nations-Bank of Texas, N.A., Dallas, Texas

SUMMARY REPORT BY THE ATTORNEY GENERAL (1-16-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-3-96)

The applicant has assets of \$273 million; the target has assets of \$55 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Marine Midland Bank, Buffalo, New York to merge with First Federal Savings and Loan Association of Rochester, Rochester, New York

SUMMARY REPORT BY THE ATTORNEY GENERAL (12-2-96)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-3-97)

The applicant has assets of \$22 billion; the target has assets of \$7 billion. The parties operate in the same markets. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Humboldt Bank, Eureka, California to acquire assets and liabilities of the Garberville branch of California Federal Bank, F.S.B., San Francisco, California

SUMMARY REPORT BY THE ATTORNEY GENERAL (1-30-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-12-96)

The applicant has assets of \$208 million; the target has assets of \$26 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Tri-City Bank and Trust Company, Blountville, Tennessee to acquire assets and liabilities of the Kingsport, Tennessee branch of Greene County Bank, Greeneville, Tennessee

SUMMARY REPORT BY THE ATTORNEY GENERAL (3-10-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-20-97)

The applicant has assets of \$299 million; the target has assets of \$2 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Santa Barbara Bank and Trust Company, Santa Barbara, California to merge with First Valley Bank, Lompoc, California

SUMMARY REPORT BY THE ATTORNEY GENERAL (2-13-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (2-26-97)

The applicant has assets of \$1.2 billion; the target has assets of \$131 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Community Bank & Trust Company, Neosho, Missouri to merge with The Diamond Bank, Diamond, Missouri

SUMMARY REPORT BY THE ATTORNEY GENERAL (3-10-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (3-12-97)

The applicant has assets of \$177 million; the target has assets of \$19 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

First United Bank, Boca Raton, Florida to merge with Island National Bank and Trust Company, Palm Beach, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (2-13-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (3-19-97)

16. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities
Approved by the Board of Governors, 1997—Continued

The applicant has assets of \$557 million; the target has assets of \$131 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Republic Security Bank, West Palm Beach, Florida to merge with Family Bank, Hallandale, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (3-10-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (4-2-97)

The applicant has assets of \$326 million; the target has assets of \$231 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

U.S. Bank of Utah, Salt Lake City, Utah to merge with Sun Capital Bank, Saint George, Utah

SUMMARY REPORT BY THE ATTORNEY GENERAL (3-27-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (4-3-97)

The applicant has assets of \$812 million; the target has assets of \$73 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Minden Bank & Trust Company, Minden, Louisiana to merge with First Federal Savings Bank, Shreveport, Louisiana

SUMMARY REPORT BY THE ATTORNEY GENERAL (4-10-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (4-29-97)

The applicant has assets of \$250 million; the target has assets of \$36 million. The parties operate in the same markets. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Johnstown Bank & Trust Company, Johnstown, Pennsylvania to acquire assets and liabilities of three branches of National City Bank of Pennsylvania, Pittsburgh, Pennsylvania

SUMMARY REPORT BY THE ATTORNEY GENERAL (5-1-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (5-9-97)

The applicant has assets of \$866 million; the targets have assets of \$72 million. The parties operate in the same markets. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Security Savings Bank, Gowrie, Iowa to acquire assets and liabilities of the Boxholm, Iowa, branch of Boone Bank & Trust Company, Boone, Iowa

SUMMARY REPORT BY THE ATTORNEY GENERAL (4-10-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (5-14-97)

The applicant has assets of \$30 million; the target has assets of \$4 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Huron Community Bank, East Tawas, Michigan to acquire assets and liabilities of the Au Gres branch of Citizens Bank, Flint, Michigan

SUMMARY REPORT BY THE ATTORNEY GENERAL (5-1-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (5-16-97)

The applicant has assets of \$84 million; the target has assets of \$6 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama to merge with Great Southern Bank, West Palm Beach, Florida

16.—Continued

SUMMARY REPORT BY THE ATTORNEY GENERAL (5-13-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (5-21-97)

The applicant has assets of \$5 billion; the target has assets of \$119 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama to merge with First Commerce Bank of Polk County, Winter Haven, Florida**SUMMARY REPORT BY THE ATTORNEY GENERAL (5-13-97)**

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (5-21-97)

The applicant has assets of \$5 billion; the target has assets of \$106 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Consolidated Bank and Trust Company, Richmond, Virginia to acquire assets and liabilities of three branches of First Union National Bank of Virginia, Roanoke, Virginia**SUMMARY REPORT BY THE ATTORNEY GENERAL (4-10-97)**

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (5-22-97)

The applicant has assets of \$95 million; the targets have assets of \$27 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Banco Popular de Puerto Rico, Hato Rey, Puerto Rico to merge with Roig Commercial Bank, Humacao, Puerto Rico**SUMMARY REPORT BY THE ATTORNEY GENERAL (3-27-97)**

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (5-27-97)

The applicant has assets of \$14 billion; the target has assets of \$888 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Gulf Bank, Gulf Shores, Alabama to merge with First Bank of Baldwin County, Robertsedale, Alabama**SUMMARY REPORT BY THE ATTORNEY GENERAL (5-13-97)**

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (5-29-97)

The applicant has assets of \$40 million; the target has assets of \$35 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Summit Bank, Hackensack, New Jersey to merge with Collective Bank, Egg Harbor City, New Jersey**SUMMARY REPORT BY THE ATTORNEY GENERAL (5-13-97)**

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (5-29-97)

The applicant has assets of \$21 billion; the target has assets of \$6 billion. The parties operate in the same markets. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

First Security Bank of Nevada, Las Vegas, Nevada to merge with American Bank of Commerce, Las Vegas, Nevada**SUMMARY REPORT BY THE ATTORNEY GENERAL (5-23-97)**

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (5-30-97)

The applicant has assets of \$467 million; the target has assets of \$318 million. The parties operate in the same market. The banking factors and consid-

16. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1997—Continued

erations relating to the convenience and needs of the community are consistent with approval.

Fifth Third Bank, Cincinnati, Ohio to merge with Suburban FSB, Cincinnati, Ohio

SUMMARY REPORT BY THE ATTORNEY GENERAL (5-23-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-12-97)

The applicant has assets of \$10 billion; the target has assets of \$219 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

1st United Bank, Boca Raton, Florida to merge with Seaboard Savings Bank, F.S.B., Stuart, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (5-23-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-17-97)

The applicant has assets of \$716 million; the target has assets of \$75 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

United Bank, Arlington, Virginia to merge with Patriot National Bank, Reston, Virginia

SUMMARY REPORT BY THE ATTORNEY GENERAL (5-23-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-20-97)

The applicant has assets of \$122 million; the target has assets of \$189 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Marshall & Ilsley Bank, Milwaukee, Wisconsin to merge with Security Bank SSB, Milwaukee, Wisconsin

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-17-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (6-30-97)

The applicant has assets of \$5 billion; the target has assets of \$4 billion. The parties operate in the same markets. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Triangle Bank, Raleigh, North Carolina to acquire assets and liabilities of eight branches of United Carolina Bank, Whiteville, North Carolina and two branches of Branch Banking and Trust Company, Winston-Salem, North Carolina

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-2-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-1-97)

The applicant has assets of \$1 billion; the targets have assets of \$215 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

First Community Bank of Southwest Virginia, Inc., Tazewell, Virginia to acquire assets and liabilities of the Clintwood, Virginia, branch of First Virginia Bank-Mountain Empire, Damascus, Virginia; the Pound, Virginia, branch of Premier Bank-Central, N.A., Honaker, Virginia; and the Fort Chiswell, Virginia, branch of Premier Bank-South, N.A., Wytheville, Virginia

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-2-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-9-97)

The applicant has assets of \$53 million; the targets have assets of \$46 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Centura Bank, Rocky Mount, North Carolina to acquire assets and liabilities of nine branches

16.—Continued

of United Carolina Bank, Whiteville, North Carolina, and five branches of Branch Banking and Trust Company, Winston-Salem, North Carolina

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-2-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-10-97)

The applicant has assets of \$6 billion; the targets have assets of \$200 million. The parties operate in the same markets. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Vectra Bank, Denver, Colorado to merge with Professional Bank, Denver, Colorado

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-17-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-16-97)

The applicant has assets of \$580 million; the target has assets of \$85 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Fifth Third Bank Cincinnati, Cincinnati, Ohio to acquire assets and liabilities of five branches of Great Lakes National Bank, Hamilton, Ohio

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-17-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-31-97)

The applicant has assets of \$10 billion; the targets have assets of \$17 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Fifth Third Bank Columbus, Columbus, Ohio to acquire assets and liabilities of three branches of Great Lakes National Bank, Hamilton, Ohio

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-17-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-31-97)

The applicant has assets of \$1 billion; the targets have assets of \$752,000. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Provident Bank of Florida, Apollo Beach, Florida to merge with Enterprise National Bank of Sarasota, Sarasota, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-17-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (7-31-97)

The applicant has assets of \$49 million; the target has assets of \$163 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama to merge with First Independence Bank of Florida, Fort Myers, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (8-5-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (8-6-97)

The applicant has assets of \$6 billion; the target has assets of \$74 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Resource Bank, Virginia Beach, Virginia to merge with Eastern American Bank, F.S.B., Herndon, Virginia

SUMMARY REPORT BY THE ATTORNEY GENERAL (8-5-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (8-7-97)

The applicant has assets of \$115 million; the target has assets of \$87 million. The parties do not operate in the same market. The banking factors

16. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1997—Continued

and considerations relating to the convenience and needs of the community are consistent with approval.

Community Bank & Trust Company, Neosho, Missouri to merge with Citizens State Bank, Galena, Missouri

SUMMARY REPORT BY THE ATTORNEY GENERAL (8-5-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (8-12-97)

The applicant has assets of \$202 million; the target has assets of \$18 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama to merge with Dadeland Bank, Miami, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (8-25-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (8-20-97)

The applicant has assets of \$4 billion; the target has assets of \$134 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Santa Barbara Bank and Trust, Santa Barbara, California to merge with Citizens State Bank of Santa Paula, Santa Paula, California

SUMMARY REPORT BY THE ATTORNEY GENERAL (7-17-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (8-21-97)

The applicant has assets of \$1 billion; the target has assets of \$86 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

LeSueur State Bank, LeSueur, Minnesota to acquire assets and liabilities of the Cloquet,

Minnesota, branch of TCF National Bank, Minneapolis, Minnesota

SUMMARY REPORT BY THE ATTORNEY GENERAL (8-25-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (8-28-97)

The applicant has assets of \$28 million; the target has assets of \$14 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

First Community Bank, Inc., Buckhannon, West Virginia to acquire assets and liabilities of the Man, West Virginia, branch of The Huntington National Bank, Columbus, Ohio

SUMMARY REPORT BY THE ATTORNEY GENERAL (9-9-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (9-4-97)

The applicant has assets of \$341 million; the target has assets of \$51 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Citizens Commercial Bank & Trust Company, Celina, Ohio to acquire assets and liabilities of eleven branches of KeyBank, N.A., Cleveland, Ohio

SUMMARY REPORT BY THE ATTORNEY GENERAL (9-9-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (9-8-97)

The applicant has assets of \$215 million; the targets have assets of \$364 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Crestar Bank, Richmond, Virginia to merge with American National Savings Bank, F.S.B., Baltimore, Maryland

16.—Continued

SUMMARY REPORT BY THE ATTORNEY GENERAL (9-9-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (9-8-97)

The applicant has assets of \$22 billion; the target has assets of \$509 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

F&M Bank—Portage County, Stevens Point, Wisconsin to acquire assets and liabilities of the Antigo branch of Security Bank, S.S.B., Milwaukee, Wisconsin

SUMMARY REPORT BY THE ATTORNEY GENERAL (9-25-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (9-11-97)

The applicant has assets of \$75 million; the target has assets of \$295,000. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

First Farmers Bank & Trust Company, Converse, Indiana to acquire assets and liabilities of the Sheridan, Indiana, branch of NBD Bank, N.A., Indianapolis, Indiana

SUMMARY REPORT BY THE ATTORNEY GENERAL (9-9-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (9-29-97)

The applicant has assets of \$154,000; the target has assets of \$28 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Republic Security Bank, West Palm Beach, Florida to merge with County National Bank of South Florida, North Miami Beach, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (10-9-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (9-30-97)

The applicant has assets of \$624 million; the target has assets of \$238 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Community Bank & Trust Company, Neosho, Missouri to acquire assets and liabilities of two branches of Citizens Bank of Missouri, Carl Junction, Missouri

SUMMARY REPORT BY THE ATTORNEY GENERAL (9-25-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (10-3-97)

The applicant has assets of \$202 million; the targets have assets of \$34 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Centura Bank, Rocky Mount, North Carolina to acquire assets and liabilities of five branches of NationsBank, N.A., Charlotte, North Carolina

SUMMARY REPORT BY THE ATTORNEY GENERAL (10-1-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (10-6-97)

The applicant has assets of \$7 billion; the targets have assets of \$73 million. The parties operate in the same markets. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Weststar Bank, Vail, Colorado to merge with Western Community Bank, Cedaredge, Colorado

SUMMARY REPORT BY THE ATTORNEY GENERAL (10-1-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (10-9-97)

16. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities
Approved by the Board of Governors, 1997—Continued

The applicant has assets of \$148 million; the target has assets of \$44 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Citizens Banking Company, Salineville, Ohio to acquire assets and liabilities of three branches of Metropolitan Savings Bank of Ohio, Youngstown, Ohio

SUMMARY REPORT BY THE ATTORNEY GENERAL (10-1-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (10-10-97)

The applicant has assets of \$1 billion; the targets have assets of \$66 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Compass Bank, Birmingham, Alabama to merge with Gainesville State Bank, Gainesville, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (10-1-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (10-10-97)

The applicant has assets of \$7 billion; the target has assets of \$206 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Citizens Bank, Lawton, Oklahoma to merge with First Commercial Bank, SSB, Lawton, Oklahoma

SUMMARY REPORT BY THE ATTORNEY GENERAL (10-29-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (10-22-97)

The applicant has assets of \$121 million; the target has assets of \$42 million. The parties operate in the same market. The banking factors and consid-

erations relating to the convenience and needs of the community are consistent with approval.

Community Bank and Trust Company, Forest City, Pennsylvania to acquire assets and liabilities of the Factoryville and Enyon branches of First Union National Bank, Avondale, Pennsylvania

SUMMARY REPORT BY THE ATTORNEY GENERAL (10-9-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (10-24-97)

The applicant has assets of \$356,000; the targets have assets of \$22 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Centura Bank, Rocky Mount, North Carolina to acquire assets and liabilities of the Bakersville, North Carolina, branch of First Union National Bank, Charlotte, Pennsylvania

SUMMARY REPORT BY THE ATTORNEY GENERAL (10-9-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (11-10-97)

The applicant has assets of \$7 billion; the target has assets of \$22 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama to merge with Ashville Savings Bank, Ashville, Alabama

SUMMARY REPORT BY THE ATTORNEY GENERAL (11-17-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (11-19-97)

The applicant has assets of \$5 billion; the target has assets of \$142 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

16.—Continued

Colonial Bank, Montgomery, Alabama to merge with First Central Bank, St. Petersburg, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (11-17-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (11-19-97)

The applicant has assets of \$5 billion; the target has assets of \$55 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama to merge with First National Bank at Bonita Springs, Bonita Springs, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (11-21-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (11-19-97)

The applicant has assets of \$5 billion; the target has assets of \$245 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Sabina Bank, Sabina, Ohio to acquire assets and liabilities of the Ada and Waynesfield branches of Fifth Third Bank of Western Ohio, Dayton, Ohio

SUMMARY REPORT BY THE ATTORNEY GENERAL (11-26-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (11-26-97)

The applicant has assets of \$36 million; the targets have assets of \$31 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Bancfirst, Oklahoma City, Oklahoma to acquire assets and liabilities of eleven branches of NationsBank NA, Charlotte, North Carolina

SUMMARY REPORT BY THE ATTORNEY GENERAL (11-26-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-2-97)

The applicant has assets of \$1 billion; the targets have assets of \$230 million. The parties operate in the same markets. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Atlantic Bank, Ocean City, Maryland to acquire assets and liabilities of three branches of Signet Bank, Richmond, Virginia

SUMMARY REPORT BY THE ATTORNEY GENERAL (11-21-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-5-97)

The applicant has assets of \$57 million; the targets have assets of \$75 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Farmers Bank of Maryland, Annapolis, Maryland to acquire assets and liabilities of three branches of Signet Bank, Richmond, Virginia

SUMMARY REPORT BY THE ATTORNEY GENERAL (11-21-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-5-97)

The applicant has assets of \$840 million; the targets have assets of \$46 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

First Virginia Bank of Tidewater, Norfolk, Virginia to acquire assets and liabilities of the Mappsville, Virginia, branch of Signet Bank, Richmond, Virginia

SUMMARY REPORT BY THE ATTORNEY GENERAL (11-21-97)

The proposed transaction would not be significantly adverse to competition.

16. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1997—Continued

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-5-97)

The applicant has assets of \$477 million; the target has assets of \$26 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Citizens Banking Company, Salineville, Ohio to merge with Unibank, Steubenville, Ohio

SUMMARY REPORT BY THE ATTORNEY GENERAL (12-10-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-8-97)

The applicant has assets of \$1 billion; the target has assets of \$220 million. The parties operate in the same markets. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Compass Bank, Birmingham, Alabama to merge with West University Bank, N.A., Houston, Texas

SUMMARY REPORT BY THE ATTORNEY GENERAL (11-26-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-10-97)

The applicant has assets of \$8 billion; the target has assets of \$66 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Farmers and Merchants Bank, Stuttgart, Arkansas to acquire assets and liabilities of the DeValls Bluff, Arkansas, branch of Union Planters NB, Memphis, Tennessee

SUMMARY REPORT BY THE ATTORNEY GENERAL (11-21-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-10-97)

The applicant has assets of \$162 million; the target has assets of \$13 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

First State B&TC of Larned, Larned, Kansas to acquire assets and liabilities of the Pratt and Iuka branches of NationsBank NA, Charlotte, North Carolina

SUMMARY REPORT BY THE ATTORNEY GENERAL (12-10-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-10-97)

The applicant has assets of \$56 million; the targets have assets of \$17 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Colonial Bank, Montgomery, Alabama to merge with United American Bank of Central Florida, Orlando, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (12-10-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-11-97)

The applicant has assets of \$5 billion; the target has assets of \$238 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Capital City Bank, Tallahassee, Florida to acquire assets and liabilities of five branches of First Federal Savings and Loan Association of Florida, Lakeland, Florida

SUMMARY REPORT BY THE ATTORNEY GENERAL (12-30-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-17-97)

The applicant has assets of \$867 million; the targets have assets of \$61 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

King George State Bank, King George, Virginia to acquire assets and liabilities of one

16.—Continued

branch of First Union National Bank, Charlotte, Virginia

SUMMARY REPORT BY THE ATTORNEY GENERAL (12-17-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-17-97)

The applicant has assets of \$53 million; the target has assets of \$18 million. The parties operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Northern Neck State Bank, Warsaw, Virginia to acquire assets and liabilities of six branches of First Union National Bank, Charlotte, Virginia

SUMMARY REPORT BY THE ATTORNEY GENERAL (12-17-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-17-97)

The applicant has assets of \$143 million; the targets have assets of \$68 million. The parties do not

operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

Compass Bank, Birmingham, Alabama to merge with Fidelity Bank, N.A., University Park, Texas

SUMMARY REPORT BY THE ATTORNEY GENERAL (12-11-97)

The proposed transaction would not be significantly adverse to competition.

BASIS FOR APPROVAL BY THE FEDERAL RESERVE (12-18-97)

The applicant has assets of \$8 billion; the target has assets of \$318 million. The parties do not operate in the same market. The banking factors and considerations relating to the convenience and needs of the community are consistent with approval.

16. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities
 Approved by the Board of Governors, 1997—Continued

Mergers Approved Involving Wholly Owned Subsidiaries of the Same Bank Holding Company

The following transactions involve banks that are subsidiaries of the same bank holding company. In each case, the Summary Report by the Attorney General indicates that the transaction would not have a significantly adverse effect on competition because the proposed merger is essentially a cor-

porate reorganization. The Board of Governors, the Federal Reserve Bank, or the Secretary of the Board of Governors, whichever approved the application, determined that the competitive effects of the proposed transaction, the financial and managerial resources and prospects of the banks concerned, as well as the convenience and needs of the community to be served were consistent with approval.

Institution ¹	Assets (millions of dollars)	Date of approval
Pullman Bank and Trust Company, Chicago, Illinois <i>Merger</i>	317	1-9-97
Pullman Bank of Commerce & Industry, Chicago, Illinois	152	
Farmers Bank of Maryland, Annapolis, Maryland <i>Merger</i>	576	1-22-97
First Virginia Bank—Central Maryland, Bel Air, Maryland	268	
Crestar Bank, Vienna, Virginia <i>Merger</i>	18,300	1-29-97
Citizens Bank of Maryland, Laurel, Maryland	3,900	
Citizens Bank of Washington, N.A., Washington, D.C.	285	
La Salle State Bank, La Salle, Illinois <i>Merger</i>	71	2-13-97
Community Bank of Utica, Utica, Illinois	13	
Adams B&TC, Ogallala, Nebraska <i>Merger</i>	174	2-19-97
First State Bank, Lodgepole, Nebraska	12	
Manufacturers and Traders Trust Company, Buffalo, New York <i>Merger</i>	10,854	2-28-97
The East New York Savings Bank, Brooklyn, New York	2,041	
First Bank of Arkansas, Jonesboro, Arkansas <i>Merger</i>	411	3-27-97
First Bank of Arkansas, Wynne, Arkansas	52	
Pointe Bank, Pembroke Pines, Florida <i>Merger</i>	50	3-28-97
Pointe Federal Savings Bank, Boca Raton, Florida	108	
AmSouth Bank of Alabama, Birmingham, Alabama <i>Merger</i>	10,400	4-14-97
AmSouth Bank of Florida, Tampa, Florida	7,000	
AmSouth Bank of Georgia, Rome, Georgia	325	
AmSouth Bank of Tennessee, Chattanooga, Tennessee	1,100	
AmSouth Bank of Walker County, Jasper, Alabama	65	

16.—Continued

Institution ¹	Assets (millions of dollars)	Date of approval
Mercantile Bank of Topeka, Topeka, Kansas	322	4-22-97
<i>Merger</i>		
Mercantile Bank, Overland, Kansas	2,008	
Old Kent Bank, Grand Rapids, Michigan	10,614	4-24-97
<i>Merger</i>		
The Algonac Savings Bank, Algonac, Michigan	124	
The Commercial and Savings Bank of St. Clair County, St. Clair, Michigan	257	
Bank of White Sulphur Springs, White Sulphur Springs, West Virginia	69	4-28-97
<i>Merger</i>		
Bank of Marlinton, Marlinton, West Virginia	60	
M&I Madison Bank, Madison, Wisconsin	1,628	4-28-97
<i>Merger</i>		
M&I Bank Southwest, Spring Green, Wisconsin	321	
M&I Bank of Janesville, Janesville, Wisconsin	391	5-2-97
<i>Merger</i>		
M&I Bank of Beloit, Beloit, Wisconsin	142	
M&I Bank of Delavan, Delavan, Wisconsin	110	
Dacotah Bank, Aberdeen, South Dakota	179	5-5-97
<i>Merger</i>		
Dacotah Bank, Clark, South Dakota	66	
Dacotah Bank, Faulkton, South Dakota	23	
Dacotah Bank, Lemmon, South Dakota	73	
Dacotah Bank, Mobridge, South Dakota	54	
Dacotah Bank, Webster, South Dakota	45	
First Virginia Bank—Southwest, Roanoke, Virginia	486	5-5-97
<i>Merger</i>		
First Virginia Bank—Highlands, Covington, Virginia	128	
The George Mason Bank, Fairfax, Virginia	784	5-7-97
<i>Merger</i>		
George Mason Bank, National Association, Bethesda, Maryland	99	
Colonial Bank, Montgomery, Alabama	4,156	5-14-97
<i>Merger</i>		
Colonial Bank, Ardmore, Tennessee	98	
Colonial Bank, Orlando, Florida	291	
Colonial Bank, Lawrenceville, Georgia	487	
First Interstate Bank of Commerce, Billings, Montana	1,054	5-14-97
<i>Merger</i>		
First Interstate Bank of Montana, N.A., Kalispell, Montana	294	
Mountain Bank, Whitefish, Montana	70	

16. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities
 Approved by the Board of Governors, 1997—Continued

Institution ¹	Assets (millions of dollars)	Date of approval
Citizens Bank, Flint, Michigan	3,300	5-16-97
<i>Merger</i>		
City Bank and Trust Company, Jackson, Michigan	470	
City Bank, St. Johns, Michigan	209	
CB-North, Charlevoix, Michigan	184	
WestAmerica Bank, San Rafael, California	2,400	5-27-97
<i>Merger</i>		
ValliWide Bank, Fresno, California	1,300	
Fifth Third Bank of Western Ohio, Piqua, Ohio	1,000	5-29-97
<i>Merger</i>		
Fifth Third Cincinnati (29 branches), Cincinnati, Ohio	865	
Mercantile Bank, Overland Park, Kansas	2,008	6-10-97
<i>Merger</i>		
Mark Twain Bank Kansas City, Kansas City, Missouri	322	
ElDorado Bank, Tustin, California	404	6-11-97
<i>Merger</i>		
Commerce Security Bank, Sacramento, California	252	
Liberty National Bank, Huntington, California	149	
San Dieguito National Bank, Encinitas, California	58	
Old Kent Bank, Grand Rapids, Michigan	10,614	6-13-97
<i>Merger</i>		
Old Kent Bank, Elmhurst, Illinois	2,189	
M&I Marshall & Ilsley Bank, Milwaukee, Wisconsin	5,184	6-30-97
<i>Merger</i>		
M&I Bank Eagle River, Eagle River, Wisconsin	140	
M&I Bank Fox Valley, Appleton, Wisconsin	715	
M&I Bank NE, Green Bay, Wisconsin	662	
M&I Bank of Menomonee Falls, Menomonee Falls, Wisconsin	265	
M&I Bank of Racine, Racine, Wisconsin	138	
M&I Bank of Shawano, Shawano, Wisconsin	162	
M&I Bank S Central, Watertown, Wisconsin	224	
M&I Central State Bank, Ripon, Wisconsin	365	
M&I First American Bank, Wausau, Wisconsin	401	
M&I Lake Country Bank, Hartland, Wisconsin	253	
M&I Merchants Bank, Rhinelander, Wisconsin	242	
OmniBank, Macomb, Illinois	105	7-31-97
<i>Merger</i>		
Farmers State Bank of Ferris, Ferris, Illinois	45	
Tiskilwa State Bank, Tiskilwa, Illinois	24	7-31-97
<i>Merger</i>		
Tampico National Bank, Tampico, Illinois	17	
First National Bank of Manlius, Manlius, Illinois	55	

16.—Continued

Institution ¹	Assets (millions of dollars)	Date of approval
UnionBank, Streator, Illinois	269	7-31-97
<i>Merger</i>		
UnionBank Sandwich, Sandwich, Illinois	40	
First Virginia Bank—Southwest, Roanoke, Virginia	614	8-6-97
<i>Merger</i>		
Premier Bank—South, National Association, Wytheville, Virginia	225	
The Provident Bank, Cincinnati, Ohio	6,600	8-14-97
<i>Merger</i>		
The Provident Bank of Kentucky, Alexandria, Kentucky	269	
Compass Bank, Birmingham, Alabama	6,000	8-20-97
<i>Merger</i>		
Compass Bank, Jacksonville, Florida	1,200	
Citizens Commercial Bank & Trust Company, Celina, Ohio	215	8-22-97
<i>Merger</i>		
Van Wert National Bank, Van Wert, Ohio	127	
First Bank of Hennessey, Hennessey, Oklahoma	172	8-28-97
<i>Merger</i>		
The Peoples National Bank of Kingfisher, Kingfisher, Oklahoma	148	
Capital City Bank, Tallahassee, Florida	851	8-29-97
<i>Merger</i>		
Levy County State Bank, Chiefland, Florida	81	
Farmers & Merchants Bank of Trenton, Trenton, Florida	37	
Branford State Bank, Branford, Florida	30	
F&M Bank—Fennimore, Fennimore, Wisconsin	47	9-4-97
<i>Merger</i>		
F&M Bank—Potosi, Potosi, Wisconsin	33	
F&M Bank—Lancaster, Lancaster, Wisconsin	43	
Mercantile Bank, Overland, Kansas	3,172	9-11-97
<i>Merger</i>		
Roosevelt Bank, Chesterfield, Missouri	679	
Johnstown Bank & Trust Company, Johnstown, Pennsylvania	949	9-17-97
<i>Merger</i>		
Laurel Bank, Ebensburg, Pennsylvania	233	
Fayette Bank, Uniontown, Pennsylvania	355	
First Virginia Bank—Clinch Valley, Richlands, Virginia	80	9-23-97
<i>Merger</i>		
Premier Bank, National Association, Tazewell, Virginia	199	
First Virginia Bank—Mountain Empire, Damascus, Virginia	115	9-23-97
<i>Merger</i>		
Premier Bank—Central, N.A., Honaker, Virginia	307	

16. Mergers, Consolidations, and Acquisitions of Assets or Assumptions of Liabilities Approved by the Board of Governors, 1997—Continued

Institution ¹	Assets (millions of dollars)	Date of approval
First Bank, Creve Coeur, Missouri	873	10-16-97
<i>Merger</i>		
First Bank, O'Fallon, Illinois	824	
Omni Bank, Macomb, Illinois	100	10-23-97
<i>Merger</i>		
Farmers State Bank of Ferris, Ferris, Illinois	47	
First Interstate Bank, Billings, Montana	1,449	10-29-97
<i>Merger</i>		
First Interstate Bank, fsb, Hamilton, Montana	4	
Alabama Exchange Bank, Tuskegee, Alabama	47	11-12-97
<i>Merger</i>		
First National Bank of Ashland, Ashland, Alabama	56	
Southern California Bank, Anaheim, California	508	11-13-97
<i>Merger</i>		
National Bank of Southern California, Newport Beach, California ..	452	

1. Each proposed transaction was to be effected under the charter of the first-named bank. The entries are in chronological order of approval. Some transactions include the acquisition of certain assets and liabilities of the affiliated bank.

16.—Continued

Mergers Approved Involving a Non-Operating Institution with an Existing Bank

The following transactions have no significant effect on competition; they merely facilitate the acquisition of the voting shares of a bank (or banks) by a holding company. In such cases, the Summary Report by the Attorney General indicates that the transaction will merely combine an existing bank with a non-operating institution; in consequence, and without regard to the acquisition

of the surviving bank by the holding company, the merger would have no effect on competition. The Board of Governors, the Federal Reserve Bank, or the Secretary of the Board, whichever approved the application, determined that the proposal would, in itself, have no adverse competitive effects and that the financial factors and considerations relating to the convenience and needs of the community were consistent with approval.

Institution ¹	Assets (millions of dollars) ²	Date of approval
Blue Ridge Bank, Sparta, North Carolina	106	3-12-97
<i>Merger</i>		
Blue Ridge Acquisition Bank, Inc., Sparta, North Carolina	...	
Guaranty Bank, Charlottesville, Virginia	...	4-15-97
<i>Merger</i>		
Guaranty Savings & Loan, F.A., Charlottesville, Virginia	115	
Quad City Bank and Trust Company, Bettendorf, Iowa	140	5-29-97
<i>Merger</i>		
Quad City Bank and Trust Company—Illinois, Moline, Iowa	...	
New North Shore Bank, Duluth, Minnesota	...	7-17-97
<i>Merger</i>		
North Shore Bank of Commerce, Duluth, Minnesota	119	
Bank of Mecklenburg, Charlotte, North Carolina	273	8-6-97
<i>Merger</i>		
Triangle—Mecklenburg Interim Bank, Charlotte, North Carolina	...	
Premier Bank, Doylestown, Pennsylvania	185	10-30-97
<i>Merger</i>		
Premier Interim Bank, Doylestown, Pennsylvania	...	
Bank of Greenville, Greenville, West Virginia	18	12-11-97
<i>Merger</i>		
Greenville Interim Bank, Greenville, West Virginia	...	

1. Each proposed transaction was to be effected under the charter of the first-named bank. The entries are in chronological order of approval.

2. Where no assets are listed, the bank is newly organized and not in operation.

*Federal Reserve
Directories and Meetings*

Board of Governors of the Federal Reserve System

December 31, 1997

Members

Term expires January 31,

ALAN GREENSPAN, of New York, <i>Chairman</i> ¹	2006
ALICE M. RIVLIN, of Pennsylvania, <i>Vice Chair</i> ¹	2010
SUSAN M. PHILLIPS, of Iowa	1998
ROGER W. FERGUSON, JR., of Massachusetts	2000
LAURENCE H. MEYER, of Missouri.....	2002
EDWARD W. KELLEY, JR., of Texas	2004
EDWARD M. GRAMLICH, of Virginia	2008

Officers

OFFICE OF BOARD MEMBERS

- Joseph R. Coyne, *Assistant to the Board*
- Donald J. Winn, *Assistant to the Board*
- Theodore E. Allison, *Assistant to the Board for Federal Reserve System Affairs*
- Lynn Fox, *Deputy Congressional Liaison*
- Bob Stahly Moore, *Special Assistant to the Board*
- Winthrop P. Hambley, *Special Assistant to the Board*
- Diane E. Werneke, *Special Assistant to the Board*
- Portia W. Thompson, *Equal Employment Opportunity Programs Adviser*

LEGAL DIVISION

- J. Virgil Mattingly, Jr., *General Counsel*
- Scott G. Alvarez, *Associate General Counsel*
- Richard M. Ashton, *Associate General Counsel*
- Oliver Ireland, *Associate General Counsel*
- Kathleen M. O'Day, *Associate General Counsel*
- Robert deV. Frierson, *Assistant General Counsel*
- Katherine H. Wheatley, *Assistant General Counsel*

OFFICE OF THE SECRETARY

- William W. Wiles, *Secretary*
- Jennifer J. Johnson, *Deputy Secretary*
- Barbara R. Lowrey, *Associate Secretary and Ombudsman*

DIVISION OF INTERNATIONAL FINANCE

- Edwin M. Truman, *Staff Director*
- Larry J. Promisel, *Senior Adviser*
- Charles J. Siegman, *Senior Adviser*
- L.S. Alexander, *Associate Director*
- Dale W. Henderson, *Associate Director*
- Peter Hooper III, *Associate Director*
- Karen H. Johnson, *Associate Director*
- David H. Howard, *Senior Adviser*
- Donald B. Adams, *Assistant Director*
- Thomas A. Connors, *Assistant Director*

DIVISION OF MONETARY AFFAIRS

- Donald L. Kohn, *Director*
- David E. Lindsey, *Deputy Director*
- Brian F. Madigan, *Associate Director*
- Richard D. Porter, *Deputy Associate Director*
- Vincent R. Reinhart, *Assistant Director*
- Normand R.V. Bernard, *Special Assistant to the Board*

1. The designations as Chairman and Vice Chair expire on June 20, 2000, and June 24, 2000, respectively, unless the service of these members of the Board shall have terminated sooner.

Board of Governors—Continued

DIVISION OF RESEARCH AND STATISTICS

Michael J. Prell, *Director*
 Edward C. Ettin, *Deputy Director*
 David J. Stockton, *Deputy Director*
 Martha Bethea, *Associate Director*
 William R. Jones, *Associate Director*
 Myron L. Kwast, *Associate Director*
 Patrick M. Parkinson, *Associate Director*
 Thomas D. Simpson, *Associate Director*
 Lawrence Slifman, *Associate Director*
 Martha S. Scanlon, *Deputy
Associate Director*
 Peter A. Tinsley, *Deputy
Associate Director*
 David S. Jones, *Assistant Director*
 Stephen D. Oliner, *Assistant Director*
 Stephen A. Rhoades, *Assistant Director*
 Janice Shack-Marquez, *Assistant Director*
 Charles S. Struckmeyer, *Assistant Director*
 Alice Patricia White, *Assistant Director*
 Joyce K. Zickler, *Assistant Director*
 Glenn B. Canner, *Senior Adviser*
 John J. Mingo, *Senior Adviser*

DIVISION OF BANKING SUPERVISION AND REGULATION

Richard Spillenkothen, *Director*
 Stephen C. Schemering, *Deputy Director*
 Herbert A. Biern, *Associate Director*
 Roger T. Cole, *Associate Director*
 William A. Ryback, *Associate Director*
 Gerald A. Edwards, Jr., *Deputy
Associate Director*
 Stephen M. Hoffman, Jr., *Deputy
Associate Director*
 James V. Houpt, Jr., *Deputy
Associate Director*
 Jack P. Jennings, *Deputy
Associate Director*
 Michael G. Martinson, *Deputy
Associate Director*
 Sidney M. Sussan, *Deputy
Associate Director*
 Molly S. Wassom, *Deputy
Associate Director*
 Howard A. Amer, *Assistant Director*

Norah M. Barger, *Assistant Director*
 Betsy Cross Jacowski, *Assistant Director*
 Richard A. Small, *Assistant Director*
 William C. Schneider, Jr., *Project Director,
National Information Center*

DIVISION OF CONSUMER AND COMMUNITY AFFAIRS

Griffith L. Garwood, *Director*
 Glenn E. Loney, *Associate Director*
 Dolores S. Smith, *Associate Director*
 Maureen P. English, *Assistant Director*
 Irene Shawn McNulty, *Assistant Director*

DIVISION OF FEDERAL RESERVE BANK OPERATIONS AND PAYMENT SYSTEMS

Clyde H. Farnsworth, Jr., *Director*
 David L. Robinson, *Deputy Director
(Finance and Control)*
 Louise L. Roseman, *Associate Director*
 Paul W. Bettge, *Assistant Director*
 Jack Dennis, Jr., *Assistant Director*
 Earl G. Hamilton, *Assistant Director*
 Jeffrey C. Marquardt, *Assistant Director*
 Florence M. Young, *Assistant Director*

OFFICE OF STAFF DIRECTOR FOR MANAGEMENT

S. David Frost, *Staff Director*
 Sheila Clark, *Equal Employment
Opportunity Programs Director*

OFFICE OF THE CONTROLLER

George E. Livingston, *Controller*
 Stephen J. Clark, *Assistant Controller
(Programs and Budgets)*
 Darrell R. Pauley, *Assistant Controller
(Finance)*

DIVISION OF HUMAN RESOURCES MANAGEMENT

David L. Shannon, *Director*
 John R. Weis, *Associate Director*
 Joseph H. Hayes, Jr., *Assistant Director*
 Fred Horowitz, *Assistant Director*

Board of Governors—Continued

DIVISION OF INFORMATION

RESOURCES MANAGEMENT

Stephen R. Malphrus, *Director*
Marianne M. Emerson, *Assistant Director*
Po Kyung Kim, *Assistant Director*
Raymond H. Massey, *Assistant Director*
Edward T. Mulrenin, *Assistant Director*
Day W. Radebaugh, Jr., *Assistant Director*
Elizabeth B. Riggs, *Assistant Director*
Richard C. Stevens, *Assistant Director*

DIVISION OF SUPPORT SERVICES

Robert E. Frazier, *Director*
George M. Lopez, *Assistant Director*
David L. Williams, *Assistant Director*

OFFICE OF THE INSPECTOR GENERAL

Brent L. Bowen, *Inspector General*
Donald L. Robinson, *Assistant Inspector General*
Barry R. Snyder, *Assistant Inspector General*

Federal Open Market Committee

December 31, 1997

Members

ALAN GREENSPAN, *Chairman*, Board of Governors
WILLIAM J. McDONOUGH, *Vice Chairman*, President, Federal Reserve Bank of New York
J. ALFRED BROADDUS, JR., President, Federal Reserve Bank of Richmond
ROGER W. FERGUSON, JR., Board of Governors
EDWARD M. GRAMLICH, Board of Governors
JACK GUYNN, President, Federal Reserve Bank of Atlanta
EDWARD W. KELLY, JR., Board of Governors
LAURENCE H. MEYER, Board of Governors
MICHAEL H. MOSKOW, President, Federal Reserve Bank of Chicago
ROBERT T. PARRY, President, Federal Reserve Bank of San Francisco
SUSAN M. PHILLIPS, Board of Governors
ALICE M. RIVLIN, Board of Governors

Alternate Members

CATHY E. MINEHAN, President, Federal Reserve Bank of Boston
JERRY L. JORDAN, President, Federal Reserve Bank of Cleveland
THOMAS C. MELZER, President, Federal Reserve Bank of St. Louis
THOMAS M. HOENIG, President, Federal Reserve Bank of Kansas City
ERNEST T. PATRIKIS, First Vice President, Federal Reserve Bank of New York

Officers

DONALD L. KOHN,
Secretary and Economist
NORMAND R.V. BERNARD,
Deputy Secretary
JOSEPH R. COYNE,
Assistant Secretary
GARY P. GILLUM,
Assistant Secretary

J. VIRGIL MATTINGLY, JR.,
General Counsel
THOMAS C. BAXTER, JR.,
Deputy General Counsel
MICHAEL J. PRELL,
Economist
EDWIN M. TRUMAN,
Economist

Federal Open Market Committee—Continued

JOHN H. BEEBE,
Associate Economist

ROBERT A. EISENBEIS,
Associate Economist

MARVIN S. GOODFRIEND,
Associate Economist

WILLIAM C. HUNTER,
Associate Economist

DAVID E. LINDSEY,
Associate Economist

STEPHEN G. CECCHETTI,
Associate Economist

LARRY J. PROMISEL,
Associate Economist

CHARLES J. SIEGMAN,
Associate Economist

LAWRENCE SLIFMAN,
Associate Economist

DAVID J. STOCKTON,
Associate Economist

PETER R. FISHER, *Manager, System Open Market Account*

During 1997 the Federal Open Market Committee held eight regularly scheduled meet-

ings (see Minutes of Federal Open Market Committee Meetings in this REPORT.)

Federal Advisory Council

December 31, 1997

Members

District 1—WILLIAM M. CROZIER, JR., *Chairman of the Board*,
Bank of Boston Corporation, Boston, Massachusetts

District 2—WALTER V. SHIPLEY, *Chairman and Chief Executive Officer*,
The Chase Manhattan Corporation, New York, New York

District 3—WALTER E. DALLER, JR., *Chairman, President, and Chief Executive Officer*,
Harleysville National Bank and Trust Company, Harleysville, Pennsylvania

District 4—ROBERT W. GILLESPIE, *Chairman and Chief Executive Officer*,
KeyCorp, Cleveland, Ohio

District 5—KENNETH D. LEWIS, *President*,
NationsBank Corporation, Charlotte, North Carolina

District 6—STEPHEN A. HANSEL, *President and Chief Executive Officer*,
Hibernia National Bank, New Orleans, Louisiana

District 7—ROGER L. FITZSIMONDS, *Chairman and Chief Executive Officer*,
Firstar Corporation, Milwaukee, Wisconsin

District 8—THOMAS H. JACOBSEN, *Chairman, President, and Chief Executive Officer*,
Mercantile Bancorporation, Inc., St. Louis, Missouri

District 9—RICHARD M. KOVACEVICH, *Chairman and Chief Executive Officer*,
Norwest Corporation, Minneapolis, Minnesota

District 10—CHARLES E. NELSON, *Chairman, Chief Executive Officer, and President*,
Liberty Bank and Trust Company of Oklahoma City, N.A., Oklahoma City, Oklahoma

District 11—CHARLES T. DOYLE, *Chairman and Chief Executive Officer*,
Texas First Bank – Texas City, Texas City, Texas

District 12—VACANCY

Officers

WALTER V. SHIPLEY, *President*

CHARLES E. NELSON, *Vice President*

HERBERT V. PROCHNOW, *Secretary Emeritus*

JAMES E. ANNABLE, *Co-Secretary*

WILLIAM J. KORSVIK, *Co-Secretary*

Federal Advisory Council—Continued

Directors

WILLIAM M. CROZIER, JR.

CHARLES T. DOYLE

The Federal Advisory Council met on February 6–7, May 1–2, September 4–5, and October 30–31, 1997. The Board of Governors met with the council on February 7, May 2, September 5, and October 31, 1997. The council, which is composed of one representative of the banking

industry from each of the twelve Federal Reserve Districts, is required by law to meet in Washington at least four times each year and is authorized by the Federal Reserve Act to consult with, and advise, the Board on all matters within the jurisdiction of the Board.

Consumer Advisory Council

December 31, 1997

Members

RICHARD S. AMADOR, *President and Chief Executive Officer*, CHARO Community Development Corporation, Los Angeles, California

WAYNE-KENT A. BRADSHAW, *President and Chief Executive Officer*, Family Savings Bank, FSB, Los Angeles, California

THOMAS R. BUTLER, *President and Chief Operating Officer*, NOVUS Services, Inc., Riverwoods, Illinois

ROBERT A. COOK, *Partner*, Hudson Cook, LLP, Crofton, Maryland

HERIBERTO FLORES, *President and Chief Executive Officer*, Brightwood Development Corporation, Springfield, Massachusetts

EMANUEL FREEMAN, *President*, Greater Germantown Housing Development Corporation, Philadelphia, Pennsylvania

DAVID C. FYNN, *Senior Vice President*, National City Bank, *Regulatory Risk Manager*, National City Corporation, Cleveland, Ohio

ROBERT G. GREER, *Chairman of the Board*, Bank of Tanglewood, Houston, Texas

KENNETH R. HARNEY, *Journalist*, Washington Post Writers Group, Chevy Chase, Maryland

GAIL K. HILLEBRAND, *Litigation Counsel*, West Coast Regional Office, Consumers Union of U.S., Inc., San Francisco, California

TERRY JORDE, *President and Chief Executive Officer*, Towner County State Bank, Cando, North Dakota

FRANCINE C. JUSTA, *Executive Director*, Neighborhood Housing Services of New York, New York, New York

JANET C. KOEHLER, *Senior Manager of Electronic Commerce*, AT&T Universal Card Services, Jacksonville, Florida

EUGENE I. LEHRMANN, *Immediate Past President*, American Association of Retired Persons, Madison, Wisconsin

ERROL T. LOUIS, Central Brooklyn Federal Credit Union, Brooklyn, New York

PAUL E. MULLINGS, *President and Chief Executive Officer*, Mortgage Electronic Registration Systems, Inc., McLean, Virginia

CAROL PARRY, *Executive Vice President*, Chase Manhattan Bank, New York, New York

Consumer Advisory Council—Continued

PHILIP PRICE, JR., *Executive Director*, The Philadelphia Plan, Philadelphia, Pennsylvania

RONALD A. PRILL, *Vice President, Credit*, Dayton Hudson Corporation, Minneapolis, Minnesota

LISA RICE, *Executive Director*, Fair Housing Center, Toledo, Ohio

JOHN R. RINES, *President*, General Motors Acceptance Corporation, Detroit, Michigan

MARILYN ROSS, *Executive Director*, Holy Name Housing Corporation, Omaha, Nebraska

MARGOT SAUNDERS, *Managing Attorney*, National Consumer Law Center, Washington, D.C.

GAIL SMALL, *Executive Director*, Native Action, Lame Deer, Montana

YVONNE S. SPARKS, *Vice President*, Community Investment Department, NationsBank Community Investment Group, St. Louis, Missouri

GREGORY D. SQUIRES, *Professor of Sociology*, University of Wisconsin-Milwaukee, Milwaukee, Wisconsin

GEORGE P. SURGEON, *Chief Financial Officer and Executive Vice President*, Shorebank Corporation, Chicago, Illinois

THEODORE J. WYSOCKI, JR., *Executive Director*, CANDO, Chicago, Illinois

Officers

JULIA W. SEWARD, *Chair*
Vice President and Corporate
Community Reinvestment Officer,
Signet Banking Corporation,
Richmond, Virginia

WILLIAM N. LUND, *Vice Chair*
Director, Office of Consumer Credit
Regulation,
State of Maine,
Augusta, Maine

The Consumer Advisory Council met with members of the Board of Governors on April 17, July 17, and October 30, 1997. The council is composed of academics, state and local government officials, representatives of the financial industry, and representatives of

consumer and community interests. It was established pursuant to the 1976 amendments to the Equal Credit Opportunity Act to advise the Board on consumer financial services.

Thrift Institutions Advisory Council

December 31, 1997

Members

BARRY C. BURKHOLDER, *President and Chief Executive Officer*, Bank United of Texas FSB, Houston, Texas

DAVID E.A. CARSON, *Chairman, President, and Chief Executive Officer*, People's Bank, Bridgeport, Connecticut

MICHAEL T. CROWLEY, JR., *President and Chief Executive Officer*, Mutual Savings Bank, Milwaukee, Wisconsin

DOUGLAS A. FERRARO, *President and Chief Executive Officer*, Belco First Federal Credit Union, Englewood, Colorado

WILLIAM A. FITZGERALD, *Chairman and Chief Executive Officer*, Commercial Federal Bank, Omaha, Nebraska

STEPHEN D. HAILER, *President and Chief Executive Officer*, North Akron Savings Bank, Akron, Ohio

Thrift Institutions Advisory Council—Continued

- DAVID F. HOLLAND, *Chairman, President, and Chief Executive Officer*, Boston Federal Savings Bank, Burlington, Massachusetts
- EDWARD J. MOLNAR, *President and Chief Executive Officer*, Harleysville Savings Bank, Harleysville, Pennsylvania
- GUY C. PINKERTON, *Chairman, President, and Chief Executive Officer*, Washington Federal Savings and Loan Association, Seattle, Washington
- CHARLES R. RINEHART, *Chairman and Chief Executive Officer*, Home Savings of America, FSB, Irwindale, California
- TERRY R. WEST, *President and Chief Executive Officer*, Jax Navy Federal Credit Union, Jacksonville, Florida
- FREDERICK WILLETTS III, *President and Chief Executive Officer*, Cooperative Bank for Savings, Inc., SSB, Wilmington, North Carolina

Officers

DAVID F. HOLLAND, *President*

CHARLES R. RINEHART, *Vice President*

The members of the Thrift Institutions Advisory Council met with the Board of Governors on March 14, June 13, October 10, and December 5, 1997. The council, which is composed of representatives from

credit unions, savings and loan associations, and savings banks, consults with, and advises, the Board on issues pertaining to the thrift industry and on various other matters within the Board's jurisdiction.

Officers of Federal Reserve Banks and Branches

December 31, 1997

BANK or Branch	Chairman ¹ Deputy Chairman	President First Vice President	Vice President in charge of Branch
BOSTON ²	William C. Brainard Frederick J. Mancheski	Cathy E. Minehan Paul M. Connolly	
NEW YORK ²	John C. Whitehead Thomas W. Jones	William J. McDonough Ernest T. Patrikis	Carl W. Turnipseed ³
Buffalo	Bal Dixit		
PHILADELPHIA	Donald J. Kennedy Joan Carter	Edward G. Boehne William H. Stone, Jr.	
CLEVELAND ²	G. Watts Humphrey, Jr. David H. Hoag	Jerry L. Jordan Sandra Pianalto	
Cincinnati	George C. Juilfs		Charles A. Cerino ³
Pittsburgh	John T. Ryan III		Robert B. Schaub
RICHMOND ²	Claudine B. Malone Robert L. Strickland	J. Alfred Broaddus, Jr. Walter A. Varvel	
Baltimore	Rebecca Hahn Windsor		William J. Tignanelli ³
Charlotte	Dennis D. Lowery		Dan M. Bechter ³

*Officers of Federal Reserve Banks and Branches—
Continued*

BANK or Branch	Chairman ¹ Deputy Chairman	President First Vice President	Vice President in charge of Branch
ATLANTA.....	Hugh M. Brown David R. Jones	Jack Guynn Patrick K. Barron	James M. McKee
Birmingham.....	D. Bruce Carr		Fred R. Herr ³
Jacksonville.....	Patrick C. Kelly		James D. Hawkins ³
Miami.....	Kaaren Johnson-Street		James T. Curry III
Nashville.....	James E. Dalton		Melvyn K. Purcell
New Orleans.....	Jo Ann Slaydon		Robert J. Musso
CHICAGO ²	Lester H. McKeever, Jr. Arthur C. Martinez	Michael H. Moskow William C. Conrad	
Detroit.....	Florine Mark		David R. Allardice ³
ST. LOUIS.....	John F. McDonnell Susan S. Elliott	Thomas C. Melzer W. Legrande Rives	
Little Rock.....	Robert D. Nabholtz, Jr.		Robert A. Hopkins
Louisville.....	John A. Williams		Thomas A. Boone
Memphis.....	John V. Myers		Martha L. Perine
MINNEAPOLIS.....	Jean D. Kinsey David A. Koch	Gary H. Stern Colleen K. Strand	
Helena.....	Matthew J. Quinn		John D. Johnson
KANSAS CITY.....	A. Drue Jennings Jo Marie Dancik	Thomas M. Hoenig Richard K. Rasdall	
Denver.....	Peter I. Wold		Carl M. Gambs ³
Oklahoma City.....	Barry L. Eller		Kelly J. Dubbert
Omaha.....	Arthur L. Shoener		Steven D. Evans
DALLAS.....	Roger R. Hemminghaus Cece Smith	Robert D. McTeer, Jr. Helen E. Holcomb	
El Paso.....	Alvin T. Johnson		Sammie C. Clay
Houston.....	Isaac H. Kempner III		Robert Smith III ³
San Antonio.....	H. B. Zachry, Jr.		James L. Stull ³
SAN FRANCISCO.....	Judith M. Runstad Gary G. Michael	Robert T. Parry John F. Moore	
Los Angeles.....	Anne L. Evans		Mark L. Mullinix ³
Portland.....	Carol A. Whipple		Raymond H. Laurence ³
Salt Lake City.....	Gerald R. Sherratt		Andrea P. Wolcott
Seattle.....	Richard R. Sonstelie		Gordon R.G. Werkema ⁴

NOTE. A current list of these officers appears each month in the *Federal Reserve Bulletin*.

1. The Chairman of a Federal Reserve Bank serves, by statute, as Federal Reserve Agent.

2. Additional offices of these Banks are located at Windsor Locks, Connecticut; Utica at Oriskany, New

York; East Rutherford, New Jersey; Columbus, Ohio; Charleston, West Virginia; Columbia, South Carolina; Indianapolis, Indiana; Milwaukee, Wisconsin; Des Moines, Iowa; and Peoria, Illinois.

3. Senior Vice President.

4. Executive Vice President.

Conference of Chairmen

The chairmen of the Federal Reserve Banks are organized into the Conference of Chairmen, which meets to consider matters of common interest and to consult with, and advise, the Board of Governors. Such meetings, attended also by the deputy chairmen, were held in Washington on May 28 and 29, and on December 3 and 4, 1997.

The members of the Executive Committee of the Conference of Chairmen during 1997 were Judith M. Runstad, chair; John F. McDonnell, vice chair; and Donald J. Kennedy, member.

On December 4, 1997, the conference elected its Executive Committee for 1998; it named John F. McDonnell as chair, G. Watts Humphrey as vice chair, and Jo Marie Dancik as the third member.

Conference of Presidents

The presidents of the Federal Reserve Banks are organized into the Conference of Presidents, which meets periodically to consider matters of common interest and to consult with, and advise, the Board of Governors.

Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City, served as chair of the conference in 1997, and Jerry L. Jordan, President of the Federal Reserve Bank of Cleveland, served as its vice chair. Esther L. George, of the Federal Reserve Bank of Kansas City, served as its secretary, and Stephen J. Ong, of the Federal Reserve Bank of Cleveland, served as its assistant secretary.

Conference of First Vice Presidents

The Conference of First Vice Presidents of the Federal Reserve Banks was organized in 1969 to meet periodically for the consideration of operations and other matters.

Sandra Pianalto, First Vice President of the Federal Reserve Bank of Cleveland, served as chair of the conference in 1997, and Colleen K. Strand, First Vice President of the Federal Reserve Bank of Minneapolis, served as its vice chair. Martha Maher, of the Federal Reserve Bank of Cleveland, served as its secretary, and Niel D. Willardson, of the Federal Reserve Bank of Minneapolis, served as its assistant secretary.

On November 10, 1997, the conference elected Colleen Strand as its chair for 1998–99, and Richard Rasdall, First Vice President of the Federal Reserve Bank of Kansas City as its vice chair.

Directors

The following list of directors of Federal Reserve Banks and Branches shows for each director the class of directorship, the director's principal organizational affiliation, and the date the director's term expires. Each Federal Reserve Bank has a nine-member board: three Class A and three Class B directors, who are elected by the stockholding member banks, and three Class C directors, who are appointed by the Board of Governors of the Federal Reserve System.

Class A directors represent the member banks in each Federal Reserve District. Class B and Class C directors represent the public and are chosen with due, but not exclusive, consideration to the interests of agriculture, commerce, industry, services, labor, and consumers; they may not be officers, directors, or employees of any bank or bank holding company. In addition, Class C directors may not be stockholders of any bank or bank holding company.

For the election of Class A and Class B directors, the Board of Governors classifies the member banks of each Federal Reserve District into three groups. Each group, which comprises banks with similar capitalization, elects one Class A director and one Class B director. Annually, the Board of Governors designates one of the Class C directors as chair of the board and Federal Reserve Agent of each District Bank, and it designates another Class C director as deputy chair.

Federal Reserve Branches have either five or seven directors, a majority of whom are appointed by the parent Federal Reserve Bank; the others are appointed by the Board of Governors. One of the directors appointed by the Board is designated annually as chair of the board of that Branch in a manner prescribed by the parent Federal Reserve Bank.

For the name of the chair and deputy chair of the board of directors of each Reserve Bank and of the chair of each Branch, see the preceding table, "Officers of Federal Reserve Banks and Branches."

*Term expires
Dec. 31*

DISTRICT 1—BOSTON

Class A

Jane C. Walsh	President, Northmark Bank, North Andover, Massachusetts	1997
Marshall N. Carter	Chairman and Chief Executive Officer, State Street Bank and Trust Company, Boston, Massachusetts	1998
G. Kenneth Perine	President and Chief Executive Officer, National Bank of Middlebury, Middlebury, Vermont	1999

Class B

Edward Dugger III	President and Chief Executive Officer, UNC Ventures, Inc., Boston, Massachusetts	1997
Robert R. Glauber	Adjunct Lecturer, John F. Kennedy School of Government, Harvard University, Cambridge, Massachusetts	1998
Stephen L. Brown	Chairman and Chief Executive Officer, John Hancock Mutual Life Insurance Company, Boston, Massachusetts	1999

Class C

Frederick J. Mancheski	Chairman Emeritus, Echlin Inc., Branford, Connecticut	1997
William C. Brainard	Professor of Economics, Yale University, New Haven, Connecticut	1998
William O. Taylor,.....	Chairman and Chief Executive Officer, Globe Newspaper Company, Boston, Massachusetts	1999

DISTRICT 2—NEW YORK

Class A

J. Carter Bacot	Chairman and Chief Executive Officer, The Bank of New York, New York, New York	1997
Robert G. Wilmers	Chairman and Chief Executive Officer, Manufacturers and Traders Trust Company, Buffalo, New York	1998
George W. Hamlin IV	President and Chief Executive Officer, The Canandaigua National Bank and Trust Company, Canandaigua, New York	1999

Class B

Eugene R. McGrath	Chairman, President, and Chief Executive Officer, Consolidated Edison Company of New York, Inc., New York, New York	1997
Vacancy		1998
Ann M. Fudge	Executive Vice President, Kraft Foods, Inc., and President, Coffee and Cereals Division, Tarrytown, New York	1999

Term expires
Dec. 31

DISTRICT 2, NEW YORK—Continued

Class C

Thomas W. Jones	Vice Chairman, Travelers Group, and Chairman and Chief Executive Officer, Smith Barney Asset Management, New York, New York	1997
Peter G. Peterson	Chairman, The Blackstone Group, New York, New York	1998
John C. Whitehead	Former Chairman, Goldman Sachs and Company, Inc., New York, New York	1999

BUFFALO BRANCH

Appointed by the Federal Reserve Bank

William E. Swan	President and Chief Executive Officer, Lockport Savings Bank, Lockport, New York	1997
Mark W. Adams	Owner and Operator, Adams Poultry Farm, Naples, New York	1997
Kathleen R. Whelehan	Regional President, Marine Midland Bank, Rochester, New York	1998
Louise Woerner	Chairman and Chief Executive Officer, HCR, Rochester, New York	1999

Appointed by the Board of Governors

Louis J. Thomas	Director, District 4, United Steelworkers of America, Cheektowaga, New York	1997
Bal Dixit	President and Chief Executive Officer, Newtex Industries, Inc., Victor, New York	1998
Patrick P. Lee	Chairman and Chief Executive Officer, International Motion Control, Inc., Orchard Park, New York	1999

DISTRICT 3—PHILADELPHIA

Class A

Dennis W. DiLazzero	President and Chief Executive Officer, Minotola National Bank, Vineland, New Jersey	1997
Albert B. Murry	President and Chief Executive Officer, Lebanon Valley National Bank, Lebanon, Pennsylvania	1998
David B. Lee	President and Chief Executive Officer, Omega Bank, N.A., State College, Pennsylvania	1999

Class B

Robert D. Burris	President and Chief Executive Officer, Burris Foods, Inc., Milford, Delaware	1997
Howard E. Cosgrove	Chairman and Chief Executive Officer, Conectiv (Delmarva Power and Light Company), Wilmington, Delaware	1998

Term expires
Dec. 31

DISTRICT 3, *Class B*—Continued

J. Richard JonesPresident and Chief Executive Officer,
Jackson–Cross Company,
Philadelphia, Pennsylvania 1999

Class C

Donald J. KennedyLegislative Director, International Brotherhood
of Electrical Workers, Local Union No. 269,
Trenton, New Jersey 1997

Charisse R. LilliePartner, Ballard, Spahr, Andrews & Ingersoll,
Philadelphia, Pennsylvania 1998

Joan CarterPresident and Chief Operating Officer,
UM Holdings Ltd., Haddonfield, New Jersey 1999

DISTRICT 4—CLEVELAND

Class A

David S. DahlmannPresident and Chief Executive Officer,
Southwest National Corporation,
Greensburg, Pennsylvania 1997

David A. DaberkoChairman and Chief Executive Officer,
National City Corporation, Cleveland, Ohio 1998

Tiney M. McCombChairman and President, Heartland BancCorp,
Gahanna, Ohio 1999

Class B

Michele Tolela MyersPresident, Denison University, Granville, Ohio 1997

I.N. Rendall Harper, Jr.President and Chief Executive Officer,
American Micrographics Company, Inc.,
Monroeville, Pennsylvania 1998

David L. NicholsChairman and Chief Executive Officer,
Mercantile Stores Inc., Fairfield, Ohio 1999

Class C

G. Watts Humphrey, Jr.President, GWH Holdings, Inc.,
Pittsburgh, Pennsylvania 1997

David H. HoagChairman and Chief Executive Officer,
The LTV Corporation, Cleveland, Ohio 1998

Robert Y. FarringtonFormer Executive Secretary–Treasurer,
Ohio State Building and Construction Trades
Council, Columbus, Ohio 1999

CINCINNATI BRANCH

Appointed by the Federal Reserve Bank

Jerry A. GrundhoferChairman, President, and Chief Executive
Officer, Star Banc Corporation,
Cincinnati, Ohio 1997

Jean R. HalePresident and Chief Executive Officer, Community
Trust Bank N.A., Pikeville, Kentucky 1998

*Term expires
Dec. 31*

DISTRICT 4, CINCINNATI BRANCH

Appointed by the Federal Reserve Bank—Continued

Judith G. Clabes	President and Chief Executive Officer, Scripps Howard Foundation, Cincinnati, Ohio	1999
Phillip R. Cox	President, Cox Financial Corporation, Cincinnati, Ohio	1999

Appointed by the Board of Governors

Wayne Shumate	Chairman and Chief Executive Officer, Kentucky Textiles, Inc., Paris, Kentucky	1997
Thomas Revely III	President and Chief Executive Officer, Cincinnati Bell Supply Co., Cincinnati, Ohio	1998
George C. Juilfs	President and Chief Executive Officer, SENCORP, Newport, Kentucky	1999

PITTSBURGH BRANCH

Appointed by the Federal Reserve Bank

Thomas J. O'Shane	Chairman, President, and Chief Executive Officer, First Western Bancorp, Inc., New Castle, Pennsylvania	1997
Edward V. Randall, Jr.	Chairman, PNC Bank Foundation, Pittsburgh, Pennsylvania	1998
Vacancy		1999
Peter N. Stephans	Chairman and Chief Executive Officer, Trigon Incorporated, McMurray, Pennsylvania	1999

Appointed by the Board of Governors

John T. Ryan III	Chairman, President, and Chief Executive Officer, Mine Safety Appliances Company, Pittsburgh, Pennsylvania	1997
Gretchen R. Haggerty	Vice President and Treasurer, USX Corporation, Pittsburgh, Pennsylvania	1998
Charles E. Bunch	Senior Vice President, Strategic Planning and Corporate Services, PPG Industries, Inc., Pittsburgh, Pennsylvania	1999

DISTRICT 5—RICHMOND

Class A

Philip L. McLaughlin	President, Horizon Bancorp, Inc., Greenbrier Valley National Bank, Lewisburg, West Virginia	1997
George A. Didden III	Chairman and Chief Executive Officer, The National Capital Bank of Washington, Washington, D.C.	1998
J. Walter McDowell	President—North Carolina Banking, Wachovia Bank, N.A., Winston-Salem, North Carolina	1999

Term expires
Dec. 31

DISTRICT 5, RICHMOND—Continued

Class B

L. Newton Thomas, Jr.	Senior Vice President (Retired), ITT/Carbon Industries, Inc., Charleston, West Virginia	1997
Craig A. Ruppert	President and Owner, The Ruppert Companies, Ashton, Maryland	1998
Wesley S. Williams, Jr.	Partner, Covington & Burling, Washington, D.C.	1999

Class C

Claudine B. Malone	President, Financial & Management Consulting, Inc., McLean, Virginia	1997
Robert L. Strickland	Chairman of the Board, Lowe's Companies, Inc., Winston-Salem, North Carolina	1998
Jeremiah J. Sheehan	Chairman and Chief Executive Officer, Reynolds Metals Company, Richmond, Virginia	1999

BALTIMORE BRANCH

Appointed by the Federal Reserve Bank

Thomas J. Hughes	Second Vice Chairman, Navy Federal Credit Union, Merrifield, Virginia	1997
F. Levi Ruark	Chairman, President, and Chief Executive Officer, The National Bank of Cambridge, Cambridge, Maryland	1997
Jeremiah E. Casey	Chairman, First Maryland Bancorp, Baltimore, Maryland	1998
Morton I. Rapoport, M.D. ...	President and Chief Executive Officer, University of Maryland Medical System, Baltimore, Maryland	1999

Appointed by the Board of Governors

Rebecca Hahn Windsor	Chairman and Chief Executive Officer, Hahn Transportation, Inc., New Market, Maryland	1997
Daniel R. Baker	President and Chief Executive Officer, Tate Access Floors, Inc., Jessup, Maryland	1998
George L. Russell, Jr.	Partner, Piper & Marbury L.L.P., Baltimore, Maryland	1999

CHARLOTTE BRANCH

Appointed by the Federal Reserve Bank

Dorothy H. Aranda	President, Dohara Associates, Inc., Hilton Head Island, South Carolina	1997
Cecil W. Sewell, Jr.	Chairman and Chief Executive Officer, Centura Banks, Inc., Rocky Mount, North Carolina	1997

*Term expires
Dec. 31*

DISTRICT 5, CHARLOTTE BRANCH

Appointed by the Federal Reserve Bank—Continued

William G. Stevens	Chief Executive Officer, Greenwood Bank & Trust, Greenwood, South Carolina	1998
Laura M. Fleming	President and Chief Executive Officer, Founders Federal Credit Union, Lancaster, South Carolina	1999

Appointed by the Board of Governors

Joan H. Zimmerman	President, Southern Shows, Inc., Charlotte, North Carolina	1997
James O. Roberson	President, Research Triangle Foundation of North Carolina, Research Triangle Park, North Carolina	1998
Dennis D. Lowery	Chief Executive Officer and Chairman, Continental Industrial Chemicals, Inc., Charlotte, North Carolina	1999

DISTRICT 6—ATLANTA

Class A

D. Paul Jones, Jr.	Chairman and Chief Executive Officer, Compass Bancshares, Inc., Birmingham, Alabama	1997
Waymon L. Hickman	Chairman and Chief Executive Officer, First Farmers and Merchants National Bank, Columbia, Tennessee	1998
Howard L. McMillan, Jr.	President and Chief Operating Officer, Deposit Guaranty National Bank, Jackson, Mississippi	1999

Class B

Maria Camila Leiva	Executive Vice President, Miami Free Zone Corporation, Miami, Florida	1997
Vacancy		1998
Juanita P. Baranco	Executive Vice President, Baranco Automotive Group, Lilburn, Georgia	1999

Class C

Hugh M. Brown	President and Chief Executive Officer, BAMSI, Inc., Titusville, Florida	1997
David R. Jones	President and Chief Executive Officer, AGL Resources Inc., Atlanta, Georgia	1998
John F. Wieland	President, John Wieland Homes, Inc., Atlanta, Georgia	1999

Term expires
Dec. 31

DISTRICT 6, ATLANTA—Continued

BIRMINGHAM BRANCH

Appointed by the Federal Reserve Bank

Marlin D. Moore, Jr.	Chairman, Pritchett-Moore, Inc., Tuscaloosa, Alabama	1997
Columbus Sanders	President, Consolidated Industries, Inc., Huntsville, Alabama	1997
J. Stephen Nelson	Chairman and Chief Executive Officer, First National Bank of Brewton, Brewton, Alabama	1998
W. Charles Mayer III	Senior Executive Vice President, Alabama Banking Group Head, AmSouth Bank of Alabama, Birmingham, Alabama	1999

Appointed by the Board of Governors

D. Bruce Carr	International Representative, Laborers’ International Union of North America, Gadsden, Alabama	1997
Patricia B. Compton	President, Patco, Inc., Georgiana, Alabama	1998
V. Larkin Martin	Managing Partner, Martin Farm, Courtland, Alabama	1999

JACKSONVILLE BRANCH

Appointed by the Federal Reserve Bank

Terry R. West	President and Chief Executive Officer, Jax Navy Federal Credit Union, Jacksonville, Florida	1997
Arnold A. Heggestad	Professor of Finance and Associate Vice President of Research and Technology, College of Business Administration, University of Florida, Gainesville, Florida	1997
Royce B. Walden	Vice President, SouthTrust Securities, Orlando, Florida	1998
William G. Smith, Jr.	President, Capital City Bank Group, Tallahassee, Florida	1999

Appointed by the Board of Governors

Patrick C. Kelly	Chairman and Chief Executive Officer, PSS/World Medical, Inc., Jacksonville, Florida	1997
Judy Jones	President, J. R. Jones and Associates, Tallahassee, Florida	1998
Marsha G. Rydberg	Partner, Foley & Lardner, Tampa, Florida	1999

Term expires
Dec. 31

DISTRICT 6, ATLANTA—Continued

MIAMI BRANCH

Appointed by the Federal Reserve Bank

Carlos A. Migoya	President, Dade/Monroe Counties, First Union National Bank of Florida, Miami, Florida	1997
E. Anthony Newton	Former President and Chief Executive Officer, Island National Bank and Trust Company, West Palm Beach, Florida	1998
D. Keith Cobb	Former Vice Chairman and Chief Executive Officer, Alamo Rent-A-Car, Inc., Ft. Lauderdale, Florida	1999
James W. Moore	President, Gulf Utility Company, Fort Myers, Florida	1999

Appointed by the Board of Governors

Kaaren Johnson-Street	Vice President of Minority Business Development and Urban Initiatives, Enterprise Florida, Coral Gables, Florida	1997
R. Kirk Landon	Chairman, American Bankers Insurance Group, Miami, Florida	1998
Mark T. Soddors	President, Lakeview Farms, Inc., Pahokee, Florida	1999

NASHVILLE BRANCH

Appointed by the Federal Reserve Bank

Vacancy		1997
John E. Seward, Jr.	President and Chief Executive Officer, Paty Lumber Co., Inc., Piney Flats, Tennessee	1997
Dale W. Polley	President, First American National Bank, Nashville, Tennessee	1998
Leonard A. Walker, Jr.	Chairman and Chief Executive Officer, First National Bank and Trust Company, Athens, Tennessee	1999

Appointed by the Board of Governors

James E. Dalton, Jr.	President and Chief Executive Officer, Quorum Health Group, Inc., Brentwood, Tennessee	1997
Frances F. Marcum	Chairman and Chief Executive Officer, Micro Craft, Inc., Tullahoma, Tennessee	1998
Paula Lovell	President, Lovell Communications, Inc., Nashville, Tennessee	1999

Term expires
Dec. 31

DISTRICT 6, ATLANTA—Continued

NEW ORLEANS BRANCH

Appointed by the Federal Reserve Bank

Angus R. Cooper II	Chairman and Chief Executive Officer, Cooper/T. Smith Corporation, Mobile, Alabama	1997
Kay L. Nelson	President, Nelson Capital Corporation, New Orleans, Louisiana	1997
Howell N. Gage	Chairman and Chief Executive Officer, Merchants Bank, Vicksburg, Mississippi	1998
Howard C. Gaines	Chairman, First National Bank of Commerce, New Orleans, Louisiana	1999

Appointed by the Board of Governors

Jo Ann Slaydon	President, Slaydon Consultants and Insight Productions and Advertising, Baton Rouge, Louisiana	1997
Lucimarian Roberts	Community Advocate and Former President, Mississippi Coast Coliseum Commission, Biloxi, Mississippi	1998
Glenn Pumpelly	President and Chief Executive Officer, Pumpelly Oil Inc., Westlake, Louisiana	1999

DISTRICT 7—CHICAGO

Class A

Stefan S. Anderson	Chairman, President, and Chief Executive Officer, First Merchants Corporation, Muncie, Indiana	1997
Arnold C. Schultz	Chairman and Chief Executive Officer, Grundy National Bank, Grundy Center, Iowa	1998
Verne G. Istock	Chairman, President, and Chief Executive Officer, First Chicago NBD Corporation, Chicago, Illinois	1999

Class B

Thomas C. Dorr	President and Chief Executive Officer, Dorr's Pine Grove Farm Co., Marcus, Iowa	1997
Donald J. Schneider	President, Schneider National, Inc., Green Bay, Wisconsin	1998
Migdalia Rivera	Executive Director, Latino Institute, Chicago, Illinois	1999

Class C

Lester H. McKeever, Jr.	Managing Partner, Washington, Pittman & McKeever, Chicago, Illinois	1997
Arthur C. Martinez	Chairman and Chief Executive Officer, Sears Roebuck and Co., Hoffman Estates, Illinois	1998
Robert J. Darnall	Chairman, President, and Chief Executive Officer, Inland Steel Industries, Inc., Chicago, Illinois	1999

DISTRICT 7, CHICAGO—Continued

DETROIT BRANCH

Appointed by the Federal Reserve Bank

Charles R. Weeks	Chairman, Citizens Banking Corporation, Flint, Michigan	1997
Richard M. Bell	President and Chief Executive Officer, The First National Bank of Three Rivers, Three Rivers, Michigan	1998
Denise Ilitch Lites	Vice Chair, Little Caesars Enterprises, and President, Olympia Development, Inc., Detroit, Michigan	1999
Irma B. Elder	President, Troy Motors, Troy, Michigan	1999

Appointed by the Board of Governors

Timothy D. Leuliette	President and Chief Operating Officer, Penske Corporation, Detroit, Michigan	1997
Stephen R. Polk	Chairman and Chief Executive Officer, R.L. Polk & Co., Detroit, Michigan	1998
Florine Mark	President and Chief Executive Officer, The WW Group, Inc., Farmington Hills, Michigan	1999

DISTRICT 8—ST. LOUIS

Class A

Michael A. Alexander	Chairman and President, The First National Bank of Mount Vernon, Mount Vernon, Illinois	1997
Douglas M. Lester	President and Chief Executive Officer, Sea Change Corp., Bowling Green, Kentucky	1998
W.D. Glover	Chairman and Chief Executive Officer, First National Bank of Eastern Arkansas, Forrest City, Arkansas	1999

Class B

Sandra B. Sanderson	President and Chief Executive Officer, Sanderson Plumbing Products, Inc., Columbus, Mississippi	1997
Richard E. Bell	President and Chief Executive Officer, Riceland Foods, Inc., Stuttgart, Arkansas	1998
Joseph E. Gliessner, Jr.	Executive Director, New Directions Housing Corp., Louisville, Kentucky	1999

Class C

Susan S. Elliott	President and Chief Executive Officer, Systems Service Enterprises, Inc., St. Louis, Missouri	1997
John F. McDonnell	Former Chairman, McDonnell Douglas Corporation, St. Louis, Missouri	1998
Veo Peoples, Jr.	Partner, Peoples & Hale, St. Louis, Missouri	1999

Term expires
Dec. 31

DISTRICT 8, ST. LOUIS—Continued

LITTLE ROCK BRANCH

Appointed by the Federal Reserve Bank

Lunsford W. Bridges	President and Chief Executive Officer, Metropolitan National Bank, Little Rock, Arkansas	1997
Mark A. Shelton III	President, M.A. Shelton Farming Company, Wabbaseka, Arkansas	1998
Mark Simmons	Chairman, Simmons Foods, Inc., Siloam Springs, Arkansas	1999
Ross M. Whipple	Chairman and Chief Executive Officer, Horizon Bancorp, Inc., Arkadelphia, Arkansas	1999

Appointed by the Board of Governors

Robert D. Nabholz, Jr.	Chief Executive Officer, Nabholz Construction Corporation, Conway, Arkansas	1997
Betta M. Carney	Chief Executive Officer and Chairman, World Wide Travel Service, Inc., Little Rock, Arkansas	1998
Janet M. Jones	President, The Janet Jones Company, Little Rock, Arkansas	1999

LOUISVILLE BRANCH

Appointed by the Federal Reserve Bank

Thomas E. Spragens, Jr.	President, Farmers National Bank, Lebanon, Kentucky	1997
Orson Oliver	President, Mid-America Bank of Louisville Louisville, Kentucky	1998
Larry E. Dunigan	Chairman and Chief Executive Officer, Holiday Management Corp., Evansville, Indiana	1999
Ronald R. Cyrus	Executive Secretary and Treasurer, Kentucky State AFL-CIO, Frankfort, Kentucky	1999

Appointed by the Board of Governors

Debbie Scoppechio	Chairman and Chief Executive Officer, Creative Alliance, Inc., Louisville, Kentucky	1997
Roger Reynolds	President and Chief Executive Officer, The Reynolds Group, Inc., Louisville, Kentucky	1998
John A. Williams	Chairman and Chief Executive Officer, Computer Services, Inc., Paducah, Kentucky	1999

Term expires
Dec. 31

DISTRICT 8, ST. LOUIS—Continued

MEMPHIS BRANCH

Appointed by the Federal Reserve Bank

Lewis F. Mallory, Jr.	Chairman, President, and Chief Executive Officer, NBC Capital Corporation, Starkville, Mississippi	1997
Anthony M. Rampley	President and Chief Executive Officer, Arkansas Glass Container Corporation, Jonesboro, Arkansas	1998
Katie S. Winchester	President and Chief Executive Officer, First Citizens National Bank, Dyersburg, Tennessee	1999
John C. Kelley, Jr.	President, Memphis Banking Group, First Tennessee Bank, Memphis, Tennessee	1999

Appointed by the Board of Governors

Carol G. Crawley	President, Mid-South Minority Business Council, Memphis, Tennessee	1997
John V. Myers	President, Better Business Bureau, Memphis, Tennessee	1998
Mike P. Sturdivant, Jr.	Partner, Due West Plantation, Glendora, Mississippi	1999

DISTRICT 9—MINNEAPOLIS

Class A

William S. Pickerign	President, The Northwestern Bank of Chippewa Falls, Chippewa Falls, Wisconsin	1997
Dale J. Emmel	President, First National Bank of Sauk Centre, Sauk Centre, Minnesota	1998
Lynn M. Hoghaug	President, Ramsey National Bank and Trust Co., Devils Lake, North Dakota	1999

Class B

Kathryn L. Ogren	Owner, Bitterroot Motors, Missoula, Montana	1997
Dennis W. Johnson	President, TMI Systems Design Corporation, Dickinson, North Dakota	1998
Rob L. Wheeler	Vice President, Wheeler Manufacturing Co., Inc., Lemmon, South Dakota	1999

Class C

Jean D. Kinsey	Professor, Consumption Economics, Director, Retail Food Industry Center, University of Minnesota, St. Paul, Minnesota	1997
James J. Howard	Chairman, President, and Chief Executive Officer, Northern States Power Company, Minneapolis, Minnesota	1998
David A. Koch	Chairman, Graco, Inc., Minneapolis, Minnesota	1999

Term expires
Dec. 31

DISTRICT 9, MINNEAPOLIS—Continued

HELENA BRANCH

Appointed by the Federal Reserve Bank

Ronald D. Scott	President and Chief Executive Officer, The First State Bank of Malta, Malta, Montana	1997
Emil W. Erhardt	Chairman and President, Citizens State Bank, Hamilton, Montana	1998
Sandra M. Stash, P.E.	Vice President, Environmental Services, ARCO Environmental Remediation L.L.C., Anaconda, Montana	1998

Appointed by the Board of Governors

Matthew J. Quinn	President, Carroll College, Helena, Montana	1997
William P. Underriner	General Manager, Selover Buick, Inc., Billings, Montana	1998

DISTRICT 10—KANSAS CITY

Class A

Samuel P. Baird	President, Farmers State Bank & Trust Co., Superior, Nebraska	1997
William L. McQuillan	President, Chief Executive Officer, and Director, City National Bank, Greeley, Nebraska	1998
Dennis E. Barrett	President, FirstBank Holding Company of Colorado, Lakewood, Colorado	1999

Class B

Hans Helmerich	President and Chief Executive Officer, Helmerich & Payne, Inc., Tulsa, Oklahoma	1997
Frank A. Potenziani	M&T Trust, Albuquerque, New Mexico	1998
Charles W. Nichols	Managing Partner, Davison & Sons Cattle Company, Arnett, Oklahoma	1999

Class C

A. Drue Jennings	Chairman, President, and Chief Executive Officer, Kansas City Power & Light Company, Kansas City, Missouri	1997
Jo Marie Dancik	Office Managing Partner, Ernst & Young LLP, Denver, Colorado	1998
Colleen D. Hernandez	Executive Director, Kansas City Neighborhood Alliance, Kansas City, Missouri	1999

DENVER BRANCH

Appointed by the Federal Reserve Bank

Richard I. Ledbetter	President and Chief Executive Officer, First National Bank of Farmington, Farmington, New Mexico	1997
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*Term expires
Dec. 31*

DISTRICT 10, DENVER BRANCH

Appointed by the Federal Reserve Bank—Continued

Clifford E. Kirk	President and Chief Executive Officer, First National Bank of Gillette, Gillette, Wyoming	1997
Albert C. Yates	President, Colorado State University, Ft. Collins, Colorado	1998
C. G. Mammel	President and Chief Executive Officer, The Bank of Cherry Creek, N.A., Denver, Colorado	1999

Appointed by the Board of Governors

Kathryn A. Paul	Division President, Kaiser Permanente, Denver Colorado	1997
Peter I. Wold	Partner, Wold Oil & Gas Company, Casper, Wyoming	1998
Teresa N. McBride	President and Chief Executive Officer, McBride and Associates, Inc., Albuquerque, New Mexico	1999

OKLAHOMA CITY BRANCH

Appointed by the Federal Reserve Bank

Michael S. Samis	President and Chief Executive Officer, Macklanburg–Duncan Co., Oklahoma City, Oklahoma	1997
Betty Bryant Shaull	President-Elect and Director, Bank of Cushing and Trust Company, Cushing, Oklahoma	1998
Dennis M. Mitchell	President, Citizens Bank of Ardmore, Ardmore, Oklahoma	1998
William H. Braum	President, Braum Ice Cream Co., Oklahoma City, Oklahoma	1999

Appointed by the Board of Governors

Victor R. Schock	President and Chief Executive Officer, Credit Counseling Centers, Tulsa, Oklahoma	1997
Barry L. Eller	Senior Vice President and General Manager, MerCruiser, Stillwater, Oklahoma	1998
Larry W. Brummett	Chairman, President, and Chief Executive Officer, ONEOK, Inc., Tulsa, Oklahoma	1999

OMAHA BRANCH

Appointed by the Federal Reserve Bank

Donald A. Leu	President and Chief Executive Officer, Consumer Credit Counseling Service, Omaha, Nebraska	1997
Thomas H. Olson	Chairman, First National Bank, Sidney, Nebraska	1997
Robert L. Peterson	Chairman, President, and Chief Executive Officer, IBP, Inc., Dakota City, Nebraska	1998
Bruce R. Lauritzen	President, First National Bank of Omaha, Omaha, Nebraska	1999

Term expires
Dec. 31

DISTRICT 10, OMAHA BRANCH—Continued

Appointed by the Board of Governors

Arthur L. Shoener	Management Consultant, Omaha, Nebraska	1997
Gladys Styles Johnston	Chancellor, University of Nebraska at Kearney, Kearney, Nebraska	1998
Bob L. Gottsch	Vice President, Gottsch Feeding Corporation, Hastings, Nebraska	1999

DISTRICT 11—DALLAS

Class A

Kirk A. McLaughlin	President and Chief Executive Officer, Security Bank, Ralls, Texas	1997
Dudley K. Montgomery	President and Chief Executive Officer, The Security State Bank of Pecos, Pecos, Texas	1998
Gayle M. Earls	President and Chief Executive Officer, Texas Independent Bank, Dallas, Texas	1999

Class B

Robert C. McNair	Chairman and Chief Executive Officer, Cogen Technologies Energy Group, Houston, Texas	1997
Julie S. England	Vice President, Semiconductor Group, Texas Instruments, Incorporated, Dallas, Texas	1998
Dan Angel	President, Stephen F. Austin State University, Nacogdoches, Texas	1999

Class C

Cece Smith	General Partner, Phillips–Smith Specialty Retail Group, Dallas, Texas	1997
Roger R. Hemminghaus	Chairman and Chief Executive Officer, Ultramar Diamond Shamrock Corp., San Antonio, Texas	1998
James A. Martin	Second General Vice President, International Association of Bridge, Structural & Ornamental Iron Workers, Austin, Texas	1999

EL PASO BRANCH

Appointed by the Federal Reserve Bank

Hugo Bustamante, Jr.	Owner and Chief Executive Officer, CarLube, Inc., ProntoLube, Inc., El Paso, Texas	1997
Lester L. Parker	President and Chief Operating Officer, Bank of the West, El Paso, Texas	1998
James D. Renfrow	President and Chief Executive Officer, The Carlsbad National Bank, Carlsbad, New Mexico	1999
Melissa W. O'Rourke	President, Charlotte's Inc., El Paso, Texas	1999

*Term expires
Dec. 31*

DISTRICT 11, EL PASO BRANCH—Continued

Appointed by the Board of Governors

Alvin T. Johnson	President, Management Assistance Corporation of America, El Paso, Texas	1997
Beauregard Brite White	Rancher, J. E. White, Jr. & Sons, Marfa, Texas	1998
Patricia Z. Holland-Branch ..	President and Chief Executive Officer, PZH Contract Design, Inc., El Paso, Texas	1999

HOUSTON BRANCH

Appointed by the Federal Reserve Bank

Tieman H. Dippel, Jr.	Chairman and President, Brenham Bancshares, Inc., Brenham, Texas	1997
J. Michael Solar	Principal Attorney, Solar & Fernandes, L.L.P., Houston, Texas	1998
Judith B. Craven	President, United Way of the Texas Gulf Coast, Houston, Texas	1999
Ray B. Nesbitt	President, Exxon Chemical Company, Houston, Texas	1999

Appointed by the Board of Governors

Isaac H. Kempner III	Chairman, Imperial Holly Corporation, Sugar Land, Texas	1997
Edward O. Gaylord	Chairman, EOTT Energy Corp., and General Partner, EOTT Energy Partners, L.P., Houston, Texas	1998
Peggy Pearce Caskey	Chief Executive Officer, Laboratories for Genetic Services, Inc., Houston, Texas	1999

SAN ANTONIO BRANCH

Appointed by the Federal Reserve Bank

Calvin R. Weinheimer	President and Chief Operating Officer, Kerrville Communications Corporation, Kerrville, Texas	1997
Richard W. Evans, Jr.	Chairman and Chief Executive Officer, Frost National Bank, San Antonio, Texas	1998
Juliet V. Garcia	President, The University of Texas at Brownsville, Brownsville, Texas	1999
Douglas G. Macdonald	President, South Texas National Bank, Laredo, Texas	1999

Appointed by the Board of Governors

H.B. Zachry, Jr.	Chairman and Chief Executive Officer, H. B. Zachry Company, San Antonio, Texas	1997
Carol L. Thompson	President, The Thompson Group, Austin, Texas	1998
Patty P. Mueller	Vice President/Finance, Mueller Engineering Corp., Corpus Christi, Texas	1999

Term expires
Dec. 31

DISTRICT 12—SAN FRANCISCO

Class A

Gerry B. Cameron	Chairman, U.S. Bancorp, Portland, Oregon	1997
Warren K.K. Luke	Vice Chairman, President, and Chief Executive Officer, Hawaii National Bank, Honolulu, Hawaii	1998
E. Lynn Caswell	Chairman and Chief Executive Officer, Pacific Community Banking Group, Laguna Hills, California	1999

Class B

Krestine Corbin	President and Chief Executive Officer, Sierra Machinery, Inc., Sparks, Nevada	1997
Stanley T. Skinner	Chairman, Pacific Gas and Electric Co., San Francisco, California	1998
Robert S. Attiyeh	Senior Vice President and Chief Financial Officer, Amgen, Inc., Thousand Oaks, California	1999

Class C

Judith M. Runstad	Partner, Foster Pepper & Shefelman, Seattle, Washington	1997
Cynthia A. Parker	Executive Director, Anchorage Neighborhood Housing Services, Inc., Anchorage, Alaska	1998
Gary G. Michael	Chairman and Chief Executive Officer, Albertson's, Inc., Boise, Idaho	1999

LOS ANGELES BRANCH

Appointed by the Federal Reserve Bank

Liam E. McGee	Group Executive Vice President, Bank of America, Los Angeles, California	1997
Antonia Hernandez	President and General Counsel, Mexican American Legal Defense and Educational Fund (MALDEF), Los Angeles, California	1997
Stephen G. Carpenter	Chairman and Chief Executive Officer, California United Bank, Encino, California	1998
John H. Gleason	Senior Vice President, Del Webb Corporation, Phoenix, Arizona	1999

Appointed by the Board of Governors

David L. Moore	President, Western Growers Association, Irvine, California	1997
Anne L. Evans	Chairman, Evans Hotels, San Diego, California	1998
Lori R. Gay	President, Los Angeles Neighborhood Housing, Los Angeles, California	1999

DISTRICT 12, SAN FRANCISCO—Continued

PORTLAND BRANCH

Appointed by the Federal Reserve Bank

Thomas C. Young	President, Chairman, and Chief Executive Officer, Northwest National Bank, Vancouver, Washington	1997
John D. Eskildsen	Retired President and Chief Executive Officer, U.S. Bank, Portland, Oregon	1998
Phyllis A. Bell	President, Oregon Coast Aquarium, Newport, Oregon	1999
Martin Brantley	President and General Manager, KPTV-12, Oregon Television, Inc., Portland, Oregon	1999

Appointed by the Board of Governors

Patrick Borunda	Executive Director, Oregon Native American Business Network, Portland, Oregon	1997
Carol A. Whipple	Proprietor, Rocking C Ranch, Elkton, Oregon	1998
Nancy Wilgenbusch	President, Marylhurst College, Marylhurst, Oregon	1999

SALT LAKE CITY BRANCH

Appointed by the Federal Reserve Bank

R.D. Cash	Chairman, President, and Chief Executive Officer, Questar Corporation, Salt Lake City, Utah	1997
Roy C. Nelson	President, Bank of Utah, Ogden, Utah	1998
J. Pat McMurray	President, First Security Bank, N.A., Boise, Idaho	1999
Maria Garciaz	Executive Director, Salt Lake Neighborhood Housing Services, Salt Lake City, Utah	1999

Appointed by the Board of Governors

Gerald R. Sherratt	Retired President, Southern Utah University, Cedar City, Utah	1997
Richard E. Davis	President and Chief Executive Officer, Salt Lake Convention & Visitors Bureau, Salt Lake City, Utah	1998
Nancy S. Mortensen	Vice President, Marketing Services, ZCMI, Salt Lake City, Utah	1999

SEATTLE BRANCH

Appointed by the Federal Reserve Bank

Betsy Lawer	Vice Chair and Chief Operating Officer, First National Bank of Anchorage, Anchorage, Alaska	1997
Constance L. Proctor	Partner, Alston, Courtnege, Proctor, & Bassetti, LLP, Seattle, Washington	1998

*Term expires
Dec. 31*

DISTRICT 12, SEATTLE BRANCH

Appointed by the Federal Reserve Bank—Continued

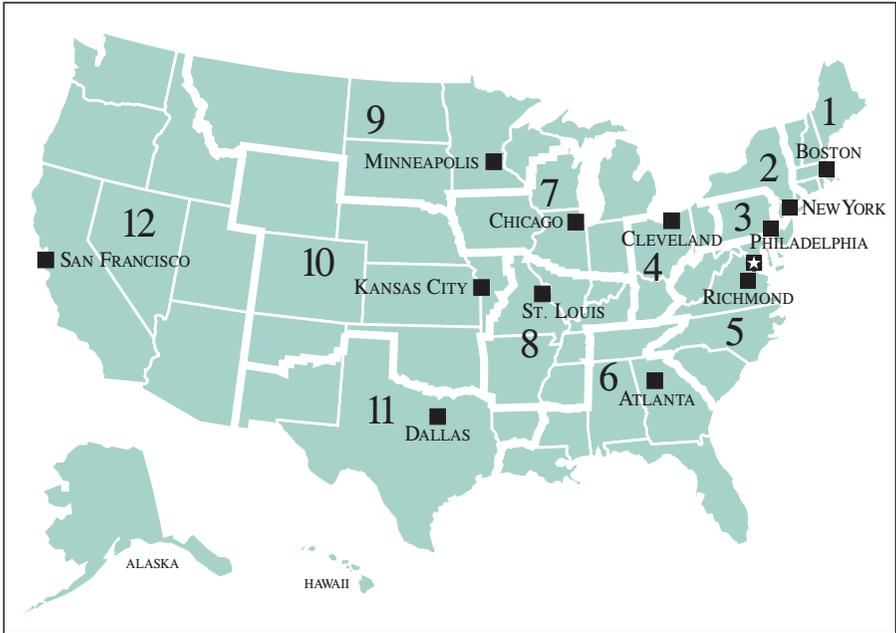
Tomio Moriguchi	Chairman and Chief Executive Officer, Uwajimaya, Inc., Seattle, Washington	1999
John V. Rindlaub	Group Executive Vice President, Bank of America, Northwest Group, Seattle, Washington	1999

Appointed by the Board of Governors

Richard R. Sonsteli	Chairman and Chief Executive Officer, Puget Sound Energy, Inc., Bellevue, Washington	1997
Helen M. Rockey	President and Chief Executive Officer, Brooks Sports, Inc., Bothell, Washington	1998
Boyd E. Givan	Senior Vice President and Chief Financial Officer, The Boeing Company, Seattle, Washington	1999

*Maps of the
Federal Reserve System*

The Federal Reserve System



LEGEND

Both pages

- Federal Reserve Bank city
- ☒ Board of Governors of the Federal Reserve System, Washington, D.C.

Facing page

- Federal Reserve Branch city
- Branch boundary

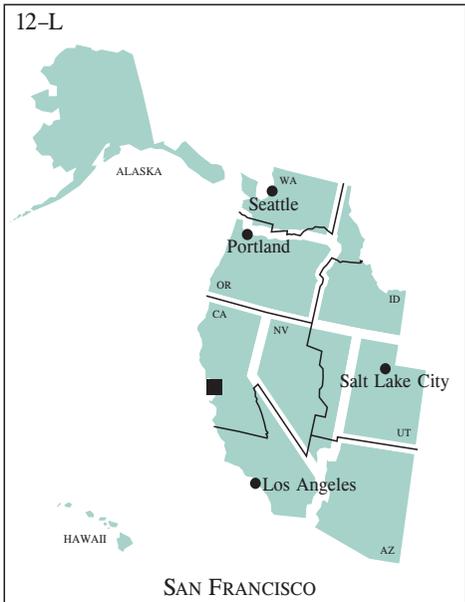
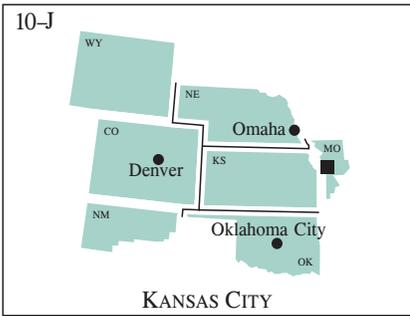
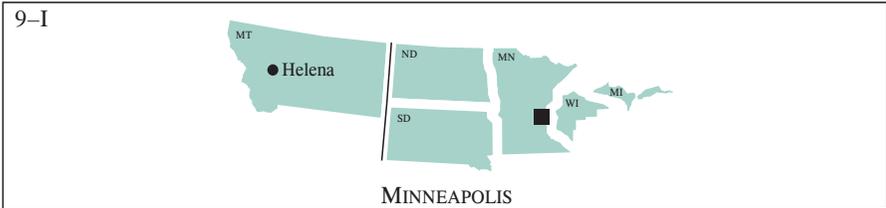
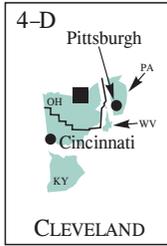
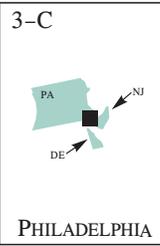
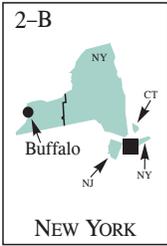
NOTE

The Federal Reserve officially identifies Districts by number and by Reserve Bank city (shown on both pages) and by letter (shown on the facing page).

In the 12th District, the Seattle Branch serves Alaska, and the San Francisco Bank serves Hawaii.

The System serves commonwealths and territories as follows: The New York

Bank serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands; the San Francisco Bank serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands. The maps show the boundaries within the System as of year-end 1997.



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