93rd Annual Report 2006

Board of Governors of the Federal Reserve System

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Letter of Transmittal

Board of Governors of the Federal Reserve System
Washington, D.C.

June 2007

The Speaker of the House of Representatives:

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

This report covers operations of the Board during calendar year 2006.

Sincerely,

Ben Bernanke
Chairman

Overview of the Federal Reserve

As the nation's central bank, the Federal Reserve System has numerous, varied responsibilities:

- conducting the nation's monetary policy by influencing monetary and credit conditions in the economy
- supervising and regulating banking institutions, to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers
- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- providing financial services to depository institutions, the U.S. government, and foreign official institutions

The Federal Reserve is a federal system composed of a central, governmental agency—the Board of Governors—and twelve regional Federal Reserve Banks. The Board of Governors, located in Washington, D.C., is made up of seven members appointed by the President of the United States and supported by a staff of about 1,850. In addition to conducting research, analysis, and policymaking related to domestic and international financial and economic matters, the Board plays a major role in the supervision and regulation of the U.S. banking system and administers most of the nation's laws regarding consumer credit protection. It also has broad oversight responsibility for the nation's payments system and the operations and activities of the Federal Reserve Banks.

The Federal Reserve Banks, which combine public and private elements, are the operating arms of the central banking system. They carry out a variety of System functions, including operating a nationwide payments system; distributing the nation's currency and coin; under authority delegated by the Board of Governors, supervising and regulating bank holding companies and state-chartered banks that are members of the System; serving as fiscal agents of the U.S. Treasury; and providing a variety of financial services for the Treasury, other government agencies, and other fiscal principals.

A major component of the Federal Reserve System is the Federal Open Market Committee (FOMC), which is made up of the members of the Board of Governors, the president of the Federal Reserve Bank of New York, and presidents of four other Federal Reserve Banks, who serve on a rotating basis. The FOMC establishes monetary policy and oversees open market operations, the Federal Reserve's main tool for influencing overall monetary and credit conditions. The FOMC sets the federal funds rate, but the Board has sole authority over changes in reserve requirements and must approve any change in the discount rate initiated by a Reserve Bank.

Two other groups play roles in the functioning of the Federal Reserve: depository institutions, through which monetary policy operates, and advisory councils, which make recommendations to the Board and the Reserve Banks regarding System responsibilities.

All federally chartered banks are, by law, members of the Federal Reserve System. State-chartered banks may become members if they meet Board requirements. ■

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Monetary Policy and Economic Developments

Monetary Policy and the Economic Outlook

The U.S. economy turned in another solid performance in 2006, although the pattern of growth was uneven. After rebounding in the early part of the year from hurricane-related disruptions in the autumn of 2005, the pace of expansion during the remaining three quarters averaged somewhat below that of the preceding two years, responding in part to the removal of monetary policy accommodation since 2004. The housing market cooled substantially, and, in the latter part of 2006, the production of light motor vehicles also stepped down. Elsewhere in the economy, activity remained strong. Consumer spending increased vigorously in 2006 as households' real income made strong gains. Business investment rose at a solid rate for the year as a whole, although it decelerated late in the year in part because of some softening in purchases of equipment related to construction and motor vehicle manufacturing. Demand for U.S. exports rose at a robust pace in 2006, supported by strong economic activity abroad. Against this backdrop, businesses continued to add jobs at a steady rate, and the unemployment rate decreased further.

Total consumer price inflation declined in 2006 from its elevated pace in 2005, as energy prices fell, on net, after rising rapidly over the preceding couple of years. Crude oil prices rose during the first half of 2006 but turned down sharply later in the year. As a result, consumer price inflation climbed in the first half of the year before slowing in the second half. The sharp movements in prices of crude oil appear to have affected not only prices of gasoline and other petroleum-based types of energy but also prices of a broader range of goods and services that use petroleum-based inputs. Partly as a result, consumer price inflation excluding food and energy—so-called core consumer price inflation—moved up during the first half of the year but eased subsequently. On balance, core inflation was a bit higher over the four quarters of 2006 than in 2005. Measures of long-term inflation expectations, however, remained well anchored.

The monetary policy decisions of the Federal Open Market Committee (FOMC) in 2006 were intended to foster sustainable economic expansion and to promote a return to low and stable inflation. In that regard, the economic outlook for this year and next appears favorable. Although the contraction in homebuilding has been a drag on growth, that restraint seems likely to diminish over 2007. Further gains in real wages as well as ongoing increases in employment should support a solid rise in consumer spending. In addition, at the beginning of 2007, households' balance sheets appeared to be in good shape. Whereas gains in home prices slowed last year, household net worth

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NOTE: The discussion here and in the next chapter consists of the text, tables, and selected charts from the Monetary Policy Report submitted to the Congress on February 14, 2007, pursuant to section 2B of the Federal Reserve Act; the complete set of charts is available on the Board's web site, at www.federalreserve.gov/boarddocs/hh.

Other materials in this annual report related to the conduct of monetary policy include the minutes of the 2006 meetings of the Federal Open Market Committee (see the "Records" section) and statistical tables 1–4 (at the back of this report).

increased moderately as stock market wealth grew and households lessened their accumulation of debt. Delinquency rates on consumer loans and on most types of mortgages remained low, although they increased markedly for subprime mortgages with variable interest rates. As for businesses, balance sheets are quite liquid, credit quality is good, and most firms enjoy ready access to funds. These favorable financial conditions, along with further expansion in business output, user costs of capital equipment that remain attractive, and the potential for further gains in efficiency, should continue to spur business investment. In addition, sustained expansion in foreign economies ought to maintain demand for U.S. exports. On balance, growth of real gross domestic product in the United States appears likely to run slightly below that of the economy's potential over the next few quarters and then to rise to a pace around that of the economy's long-run trend.

Regarding inflation, increases in core consumer prices are expected to moderate, on balance, over the next two years. Along with inflation expectations that are well anchored, some of the factors that boosted inflation in recent years seem likely to lessen. In particular, the paths for prices of energy and other commodities embedded in futures markets suggest that the impetus to core inflation from these influences will diminish further. In addition, the outsized increases in shelter costs that boosted core inflation last year are not expected to persist. Although unit labor costs in the nonfarm business sector have been rising, the average markup of prices over such costs is high by historical standards. The relatively high markup suggests that further increases in costs could be absorbed, at least to some extent, by a narrowing of firms' profit margins rather than by passing on the costs in the form of higher consumer prices, especially if pressures on resources ease modestly as anticipated.

The outlook for real economic activity is uncertain. An upside risk is that consumer spending, which has been especially buoyant in recent months, may continue to expand at a pace that would ultimately lead to an escalation of pressures on resources and prices. Alternatively, prospects for residential construction, which are difficult to assess, may pose some downside risks. Although residential real estate markets have shown some recent signs of stabilizing, homebuilders' inventories of unsold homes remain elevated. Further cutbacks in construction to reduce inventories toward more-comfortable levels could become steeper and more persistent than currently anticipated. Moreover, if home values were to depreciate sharply, the resulting erosion of household wealth could impose appreciable restraint on consumer spending.

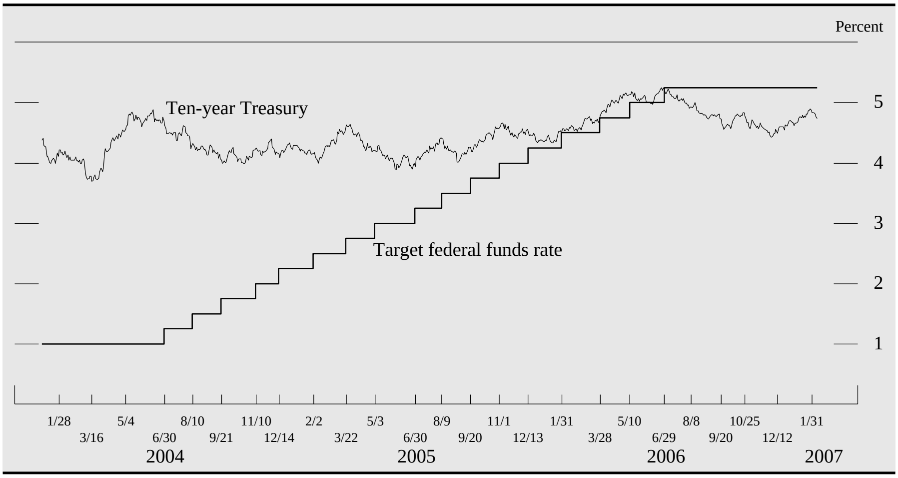
Whether inflation will moderate gradually as expected is also uncertain. On the one hand, the nation's potential to produce could increase more rapidly than anticipated, or product and input markets could work efficiently at higher rates of utilization, either of which could lead to a lower trajectory for inflation than currently forecast. On the other hand, expanding global demand and threats to supply from actual and potential disruptions pose upside risks for energy prices. In addition, brisk world demand for non-energy materials and commodities could lead to further upward pressures on business costs. Also, if inflation were to persist around the elevated average level of the past three years, longer-run inflation expectations could deteriorate, particularly if pressures on resources were to intensify.

At recent meetings, the FOMC indicated that the risk that inflation will fail to moderate as expected is its predominant policy concern.

Monetary Policy, Financial Markets, and the Economy in 2006 and Early 2007

The FOMC firmed the stance of monetary policy 25 basis points at each of its four meetings over the first half of 2006. The Committee raised its target for the federal funds rate at its January and March meetings as available information pointed to accumulating pressures on inflation and solid economic growth. Although readings on core inflation had remained favorable, increases in energy prices and the relatively high level of resource utilization threatened to add to existing inflation pressures. Meanwhile, underlying aggregate demand, supported by robust consumer spending and accelerating business investment, appeared to be growing at a solid rate. By the time of the May and June meetings, data pointed to a moderation in the growth of consumer spending and a further cooling in the housing market. However, core consumer prices had risen more rapidly. Although the Committee judged inflation expectations still to be contained, it was mindful that the rising prices of energy and other commodities could impart greater inflationary momentum. Against this backdrop, the FOMC voted to increase the policy rate a further 25 basis points at both the May and June meetings, bringing the federal funds rate to 5¼ percent. In the statement accompanying its June decision, the FOMC indicated that it believed that the moderation in economic activity would help to limit inflationary pressures over time but also noted that some upside inflation risks remained. As it had in its May statement, the FOMC made clear in June that the extent and

Selected Interest Rates, 2004–07



NOTE: The data are daily and extend through February 7, 2007. The ten-year Treasury rate is the constant-maturity yield based on the most actively traded securities. The dates on the horizontal axis are those of FOMC meetings.

SOURCE: Department of the Treasury and the Federal Reserve.

timing of additional firming would depend on the evolution of the outlook for both inflation and economic growth as implied by incoming information.

In the second half of the year, a further slowdown in residential construction activity and a contraction in motor vehicle production created a significant drag on economic activity. However, consumer spending held up, and employment rose at a solid pace. Meanwhile, energy prices reversed much of their increases of the first half of the year, sending headline inflation lower. Core inflation also eased somewhat, albeit to a rate above its year-earlier level. Against this backdrop, the FOMC left the stance of policy unchanged at its final four meetings of 2006. Committee discussions in those meetings focused in part on developments in the housing market and their implications for the broader economy. Although the housing market was weakening throughout this period, the Committee judged that the downturn had not spilled over significantly to consumer spending. The economy was expected to expand over coming quarters at a rate close to or a little below its long-run sustainable pace. At the same time, FOMC members noted that, even though core inflation had slowed from the very rapid rates of the spring and summer, current rates remained undesirably high. Most members expected core inflation to moderate gradually, but they were uncertain about the likely pace and extent of that moderation. Thus, in statements accompanying each rate announcement over this period, the FOMC reiterated that inflation risks remained and that the extent and timing of any additional policy firming would depend on the outlook for both inflation and economic growth implied by incoming information.

Over the period between the December 2006 and January 2007 FOMC meetings, incoming data on inflation and economic activity were generally more favorable. Core inflation receded further from the elevated levels reached in early 2006, and some indicators suggested that the demand for housing might be stabilizing. Business investment had softened in the fourth quarter, and industrial production decelerated sharply in the fall, but consumer spending posted robust gains in the final months of 2006. At its January 2007 meeting, the Committee again decided to leave its target for the federal funds rate unchanged, reiterated concern about inflation risks, and again cited the role of incoming data in determining the extent and timing of any additional firming.

In recent years, the FOMC has worked to improve the transparency of its decisionmaking process, and the Committee continues to examine whether further changes would improve its communications with the public. In spring 2006, the Chairman appointed a subcommittee to help the FOMC organize the discussion of a broad range of communication issues. The FOMC began its consideration of these issues at its August meeting and has discussed them at several meetings since then.

Economic Projections for 2007 and 2008

In conjunction with the FOMC meeting in January, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, provided economic projections for 2007 and 2008. The projections indicate that the participants expect sustainable expansion of real economic activity during the next two years, assuming an appropriate course for monetary policy. The central tendency of the FOMC participants' forecasts for the increase in real GDP is 2½ percent to 3 percent over the four quarters of 2007 and 2¾ percent to 3 percent over the four quarters of 2008. The central tendency of their forecasts for the civilian unemployment rate is 4½ percent to 4¾ percent in the fourth quarter both of this year and of 2008. For inflation, the central tendency of the forecasts anticipates an increase in the price index for personal consumption expenditures excluding food and energy—the so-called core PCE price index—of 2 percent to 2¼ percent over the four quarters of 2007 and 1¾ percent to 2 percent over the four quarters of 2008.

The economy is projected to expand at a moderate rate. Although the cooling of the housing market continues to damp economic activity, the drag on economic growth from declining construction activity is expected to diminish later this year. Household spending for goods and services should rise at a solid pace, in part as a result of ongoing gains in real wages and employment and of generally strong household balance sheets. Business outlays for new equipment and software are expected to increase at a rate consistent with a moderate expansion in business output and to be supported by continuing declines in the user cost of high-technology capital equipment and by favorable financial conditions. In addition, the solid expansion of economic activity abroad should maintain the rising demand for U.S. exports of goods and services.

Decreased pressures from the costs of energy and other commodities, in an environment of moderate economic expansion and well-anchored longer-run inflation expectations, are expected to contribute to further easing in inflation. In addition, increases in productivity should help to limit cost pressures. ■

Economic Projections of Federal Reserve Governors and Reserve Bank Presidents for 2007 and 2008

Percent

Indicator	Memo: 2006 actual	2007		2008	
		Range	Central tendency	Range	Central tendency
Change, fourth quarter to fourth quarter[1]					
Nominal GDP	5.9	4¾–5½	5–5½	4¾–5½	4¾–5¼
Real GDP	3.4	2¼–3¼	2½–3	2½–3¼	2¾–3
PCE price index excluding food and energy	2.3	2–2¼	2–2¼	1½–2¼	1¾–2
Average level, fourth quarter					
Civilian unemployment rate	4.5	4½–4¾	4½–4¾	4½–5	4½–4¾

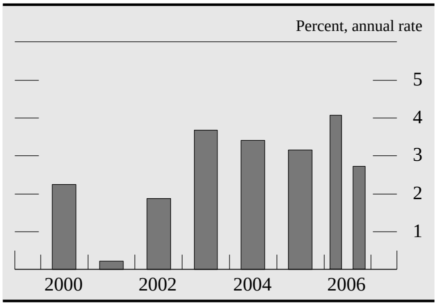
1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

Economic and Financial Developments in 2006 and Early 2007

The especially brisk pace of economic activity in early 2006 primarily reflected a rebound after hurricane-related disruptions in the autumn of 2005. During the rest of the year, however, economic activity slowed to a pace somewhat below the average rate of recent years. Real GDP is reported to have increased at an average annual rate of 2¾ percent over the final three quarters of 2006, down from the average 3¼ percent pace in 2004 and 2005. The slowdown principally was the result of the contraction in residential construction, which intensified later in the year, and the marked decline in production of light motor vehicles in the second half of the year as manufacturers took steps to trim dealers' inventories. In other sectors of the economy, consumer spending remained strong as employment and income made further solid gains, and business outlays for new structures and equipment rose considerably over much of the year. Financial market conditions were generally supportive of economic expansion in 2006. Equity markets recorded sizable gains, and long-term interest rates rose only modestly from historically low levels. Risk spreads on corporate bonds remained narrow or declined further. Overall economic conditions were such that businesses maintained a steady pace of hiring, and the unemployment rate moved down further.

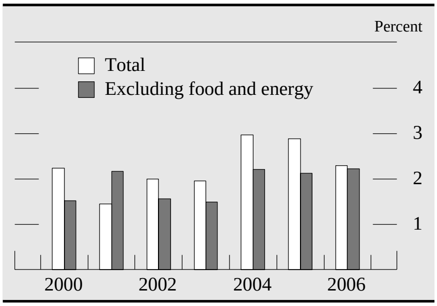
Consumer price inflation, as measured by the rise in the PCE price index, moved down in the second half of 2006 after having stepped up in the first half. Energy prices, which rose during the first half and turned sharply downward later in the year, played an important role in shaping the contour of total consumer price inflation. In addition, core PCE price inflation eased modestly over the second half of 2006. Appar-

Change in Real GDP, 2000–06



NOTE: Here and in subsequent figures, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Change in PCE Chain-Type Price Index, 2000–06



NOTE: The data are for personal consumption expenditures (PCE).
SOURCE: Department of Commerce, Bureau of Economic Analysis.

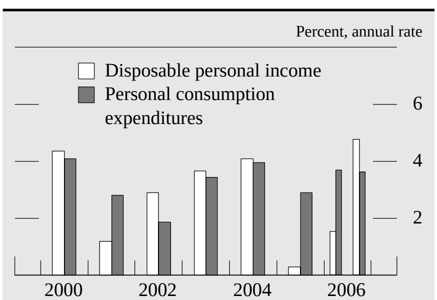
ently influenced by incoming data on inflation and economic activity, measures of long-term inflation expectations rose early in the year but ended the year slightly lower than at the beginning. Nonetheless, core PCE price inflation for the year as a whole—at 2¼ percent—was a bit higher than in the preceding year, which perhaps reflected in part the high level of resource utilization.

The Household Sector

Consumer Spending

The rapid increase in consumer spending in 2006 was supported by rising employment, gains in real income, increases in household wealth, and favorable financial conditions. Over the four quarters of 2006, real PCE rose 3¾ percent—faster than in 2005 and at roughly the same rate as in 2004. The rise in consumer outlays was particularly robust in the first quarter of 2006 but then moderated in the middle of the year, when households' gains in real income slowed and consumer sentiment softened. Consumer spending rose briskly again in the fourth quarter of the year as gains in real income picked up and consumer confidence improved.

Change in Real Income and Consumption, 2000–06



SOURCE: Department of Commerce, Bureau of Economic Analysis.

Household spending for new motor vehicles slowed in 2006; sales of 16.5 million new light vehicles (cars, sport-utility vehicles, and pickup trucks) were below the average of nearly 17 million sold in the preceding two years. Moreover, households' apparent concerns about elevated gasoline prices, particularly early in the year, shifted the composition of light vehicle sales toward more fuel-efficient autos and away from light trucks and SUVs. The shift helped boost the share of total sales captured by foreign producers because they tend to offer more fuel-efficient vehicles.

Real PCE for goods other than motor vehicles rose 4¾ percent over the four quarters of 2006, about in line with the brisk average pace in the preceding two years. Households increased their spending for a broad range of consumer goods, though the rise was particularly strong for electronic equipment and other durables. Real spending on gasoline remained about constant in the first half of the year but increased in the second half as prices fell. Consumer spending for services maintained a moderate pace of growth; expenditures in this category rose 2¾ percent in 2006, about the same average pace as in 2004 and 2005.

In 2006, real household income was boosted by gains in wage and salary income and the increased purchasing power resulting from the deceleration in overall consumer prices. Labor income received by households rose both because of gains in real hourly wages and because of sustained increases in employment. However, the pickup in real after-tax income was damped because tax payments made by households increased at a rate greater than that for income. The acceleration in tax payments likely reflected, at least in part, several factors: tax payments on larger capital gains realizations, which are excluded from income in the national income and product accounts (NIPA); gains in real income that moved some households into higher tax brackets; and possibly a further shift in the distribution of income toward high-income households that typically face higher tax rates. All told, real after-tax income rose 3 percent over the four quarters of 2006, up from the negligible gain posted in 2005 but a little below the average rate of increase in 2003 and 2004.

The rise in after-tax income in 2006 was outpaced by increases in household spending. As a result, the personal saving rate declined further in 2006 and averaged negative 1 percent for the year as a whole. Households apparently were inclined to increase their spending further above their disposable income, at least in part, because their wealth continued to rise. The ratio of household net worth to income, which has been trending higher since 2003, inched up further in 2006. Although increases in the value of homes slowed significantly, the value of corporate equities held by households both indirectly—such as in mutual funds and retirement accounts—and directly appreciated considerably.

Consumer sentiment deteriorated in the first half of 2006, according to the Reuters/University of Michigan Surveys of Consumers (Reuters/Michigan). In the spring, consumer confidence had moved to its lowest level for the year, probably in part because energy prices had surged. The subsequent decline in energy prices, along with the rise in the stock market and reductions in the unemployment rate, boosted consumer confidence in the second half of the year. On net, the Reuters/Michigan index of consumer sentiment was a shade higher at the end of 2006 than at the beginning of the year; sentiment moved up further in early 2007 to near the upper end of its range since 2003.

Residential Investment

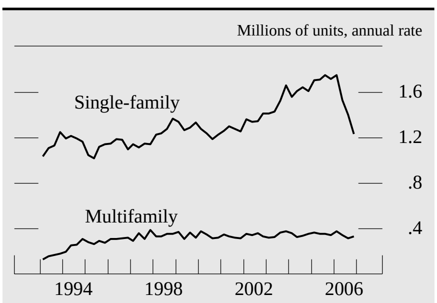
The deterioration of conditions in the housing market played a significant role in restraining the pace of economic expansion in 2006. The demand for new and existing homes began to weaken in the middle of 2005, and the subsequent decline steepened through the first half of 2006. As a result, the inventory of unsold new homes relative to sales rose sharply. Apparently prompted by lower demand and excessive inventories, homebuilders began to cut back on the pace of new construction near the beginning of 2006, and the decline in activity continued throughout the year. Later in the year, however, some indicators were hinting that the demand for housing was starting to stabilize.

By the middle of 2006, sales of both new and existing homes had fallen dramatically to a pace that was about 15 percent below that of a year earlier. Concurrently, inventories of unsold homes relative to sales rose considerably above the level that had prevailed during the period of robust housing demand from the late 1990s into 2005. By the third quarter of 2006, the backlog of unsold new homes had reached 6¾ months' supply, and the stock of existing homes for sale had risen to about 7 months' supply—both well above the average of about 4½ months' supply of new and existing homes in 2005. By the end of 2006, however, there were tentative signs that the demand for homes was stabilizing. The decline in sales of new and existing homes appeared to bottom out in the summer, and sales were roughly constant over the later part of the year. In the fourth quarter, builders' inventories of unsold new homes were reported to have edged down a bit from their third-quarter level, while the stock of existing homes for sale remained about the same as in the third quarter. Despite these developments, the extent of any improvement in the inventories of unsold homes is obscured by the failure of these figures to account for recorded sales of new homes that are subsequently canceled.

The drag on new residential construction in 2006 imposed by the contraction in home sales and the buildup of inventories was significant. Both the number of permits issued for new single-family homes and the number of home starts dropped sharply. As of the fourth quarter of 2006, new single-family homes were started at an annual rate of 1.23 million units, almost 30 percent below the average pace in 2005; permits were down by a similar amount. In contrast to the marked slackening in construction of new single-family homes, the rate of starts of new multifamily homes in 2006, at 337,000 units, was about the same as in the preceding several years.

Housing activity, as measured by real expenditures on residential structures in the NIPA, trimmed ¼ percentage point from the rate of real GDP growth in the first half of 2006, but the drag intensified to subtract about 1¼ percentage points from the annual rate of increase in real GDP in the second half. For 2006 as a whole, the contraction in real residential investment lowered the annual rate of growth in real GDP ¾ percentage point after having added ½ percentage point, on average, to the rate from 2003 through 2005.

Private Housing Starts, 1993–2006



NOTE: The data are quarterly and extend through 2006:Q4.

SOURCE: Department of Commerce, Bureau of the Census.

The rate of house-price appreciation slowed substantially in 2006 after several years of very rapid gains. The repeat-transactions index of home prices published by the Office of Federal Housing Enterprise Oversight (OFHEO) increased at an annual rate of only 1½ percent in the third quarter of 2006, down substantially from average gains of about 10 percent in 2004 and 2005. The OFHEO index attempts to control for the quality of existing single-family homes sold by using prices of homes involved in repeat transactions. The increase in the OFHEO house-price index over the four quarters ending in the third quarter of 2006 (a calculation that smoothes through some of the quarterly volatility in the data) was 6 percent, the smallest four-quarter increase since the late 1990s. The average price of existing single-family homes sold, which is published by the National Association of Realtors (NAR) and does not control for the types of homes sold, declined about 2 percent over the four quarters of 2006, compared with average gains of roughly 9 percent in 2004 and 2005. The outright decline in the NAR index of home prices relative to the deceleration in the constant-quality OFHEO home-price index suggests that the composition of existing homes sold shifted toward lower-priced homes.

The cost of mortgage financing increased in the first half of 2006, but rates decreased in the second half. The average rate for a thirty-year fixed-rate mortgage was 6¼ percent at the end of 2006, about the same as at the beginning of the year. The average for a one-year adjustable-rate mortgage declined also in the second half and stood at 5½ percent at the end of 2006, about ¼ percentage point above the level at the start of the year. According to respondents to the Reuters/Michigan survey, relatively low mortgage rates and the perception that purchase prices were more favorable improved their assessment of homebuying conditions in the second half of 2006.

Household Finance

Household sector debt is estimated to have slowed from the robust 11¾ percent increase posted in 2005 to a still-vigorous 8¼ percent in 2006. The deceleration reflected a drop in the pace of mortgage debt growth from about 14 percent in 2005 to less than 9 percent in 2006. Despite the reduction in mortgage borrowing, home equity lending remained active, and the gross volume of cash-out refinancing exceeded 2005 levels. Meanwhile, consumer debt expanded only moderately in 2006.

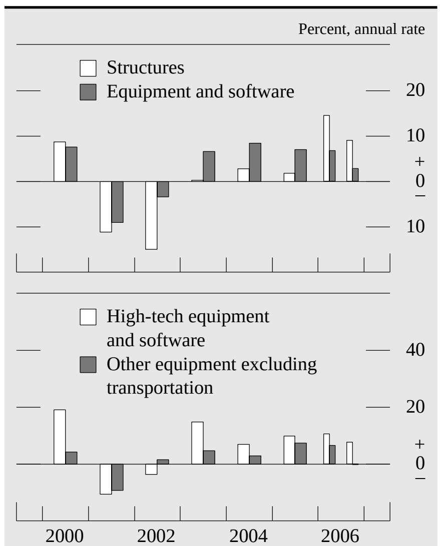
Although household indebtedness increased less rapidly in 2006 than in 2005, it still outpaced the growth of disposable personal income. In addition, the rise in interest rates contributed to higher debt service payments, and the household financial obligations ratio continued its upward trend of the past decade to reach a record high. Evidence to date suggests that most households have been able to meet their debt service obligations, although there are indications of growing strains among some borrowers. Delinquency rates on subprime residential mortgages with variable interest rates have increased markedly; still, delinquency rates on other mortgages and consumer loans have remained low. Household bankruptcy filings during 2006 ran at a pace well below the average of the preceding several years. Bankruptcies likely were damped in 2006 by the decisions of some households to file before the implementation of more-stringent bankruptcy requirements in October 2005. However, even allowing for such an effect, the recent pace is low relative to pre-reform norms.

The Business Sector

Fixed Investment

Total real business fixed investment rose 6¾ percent over the four quarters of 2006, up from a 5½ percent increase in 2005 and about the same pace as in 2004. In general, the fundamentals supporting business capital spending

Change in Real Business Fixed Investment, 2000–06



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

SOURCE: Department of Commerce, Bureau of Economic Analysis.

remained favorable in 2006: The strong rise in profits continued to help firms maintain substantial liquid assets, user costs for equipment declined further, and interest rates and credit spreads remained relatively low. Although the pace of real business outlays for equipment and software slowed somewhat in 2006, investment in nonresidential structures rose 11¾ percent. Capital spending was quite robust during most of the year, adding about 1 percentage point to the annual rate of increase in real GDP over the first three quarters, but it decelerated sharply in the fourth quarter. The deceleration reflected, in part, a slowing in spending for business structures from its brisk pace earlier in the year, a drop in outlays for transportation equipment, and some weakness in purchases of equipment related to construction and motor vehicle manufacturing.

Real investment in high-technology equipment rose 9 percent in 2006, about the same average annual pace as in the preceding two years. Further decreases in the prices of high-technology equipment continued to reduce the user cost of this type of equipment. Real business spending for computing equipment increased 14½ percent, and software spending posted an 8 percent gain, both roughly comparable to their average rates of increase in the previous two years. Business outlays for communications equipment rose almost 7 percent in 2006. Spending for communications equipment was particularly robust in the early part of the year and was likely boosted in part by spending to replace equipment damaged by the hurricanes in the autumn of 2005. Investment in communications equipment last year continued to be supported by demand from telecommunications service providers that were expanding their broadband networks.

Real business investment in transportation equipment—typically a volatile category of investment—was about unchanged on net in 2006. For motor vehicles, business spending increased less than 1 percent over the year. Purchases of light vehicles weakened, partly because of cutbacks in sales to rental companies. In contrast, business outlays for medium and heavy trucks accelerated in 2006, reportedly in anticipation of new emissions regulations by the Environmental Protection Agency that went into effect at the beginning of 2007. New orders for medium and heavy trucks reached new highs early in 2006, and production and sales remained strong through the end of the year. Outlays for new aircraft were brisk in early 2006, but they were depressed over the remainder of the year; all told, aircraft investment declined more than 15 percent for the year as a whole.

Real investment in equipment other than high-tech and transportation goods—a broad category that represents about half of total nominal business spending for equipment and software—rose at an average annual rate of 5½ percent during the first three quarters of 2006. However, spending for these capital goods softened in the final quarter of the year. Although the declines in the fourth quarter were generally broad based, they were led by decreases in spending for equipment related to construction and motor vehicle manufacturing. However, the backlog of orders for capital goods such as industrial machinery and other types of heavy equipment remained substantial at the end of 2006, and it should sustain production and shipments of these items in early 2007.

Real outlays for nonresidential construction increased 11¾ percent in 2006 after having been little changed since 2003. However, the rise in business construction spending slowed near the end of 2006 from its rapid pace earlier in the year; outlays increased at an annual rate of only about 3 percent in the fourth quarter. For 2006 as a whole, sizable gains were posted for office, retail, and industrial buildings. In addition, outlays for drilling and mining structures associated with energy exploration were strong. At the end of 2006, forward-looking indicators for nonresidential construction activity appeared to be favorable: Vacancy rates for buildings in both the office and industrial sectors, which peaked a few years ago, continued to drift down, and the vacancy rate for retail buildings remained at the low level that has prevailed since 2000.

Inventory Investment

In the first half of 2006, dealer stocks of motor vehicles rose noticeably as sales slowed, particularly for light trucks. The increase in the prices of gasoline earlier in the year appeared to have reduced consumers' demand for light trucks and SUVs, which tend to be less fuel efficient. Dealers' inventories of these vehicles reached an elevated 90 days' supply at the end of the second quarter. As a result, motor vehicle manufacturers scaled back the production of light trucks over the second half of 2006, which helped to reduce dealers' inventories during that period. Nonetheless, at the end of 2006, inventories of light vehicles still appeared to be above desired levels. Manufacturers cut production further in January of this year, helping them make additional progress in reducing the stock overhang.

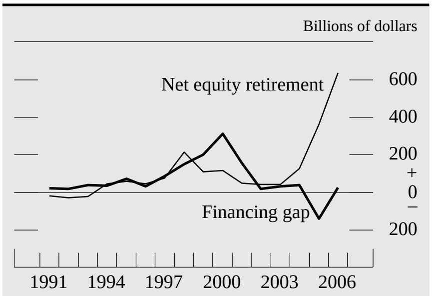
Excluding motor vehicles, inventories held by businesses in the manufacturing and trade sectors appeared generally to be well aligned with sales in the first half of 2006. However, later in the year, a variety of indicators suggested that some businesses accumulated an undesired level of stocks. The book value of manufacturing and trade inventories (excluding motor vehicles) rose relative to sales from September through November. The increases were particularly noticeable for firms that supply the construction and motor vehicle sectors, although increases were apparent in a few other sectors as well. Survey data also suggested that inventories for some businesses were viewed as too high. However, manufacturers outside of the motor vehicles sector appear to be making relatively prompt adjustments to their production, which to date seem to be limiting the extent of undesired stockbuilding.

Corporate Profits and Business Finance

Profits of nonfinancial corporations extended their upward move, pushing the ratio of before-tax profits to income in this sector to nearly 14 percent, the highest level reached since 1969. In the third quarter, operating earnings per share for S&P 500 firms came in 20 percent above levels of a year earlier. About two-thirds of firms in the S&P 500 have reported earnings for the fourth quarter. Current market estimates of earnings per share for S&P 500 firms call for roughly 10 percent growth in the fourth quarter over year-earlier levels. Earnings growth was widespread across sectors in 2006 but was particularly strong for financial firms.

Firms' capital expenditures exceeded internal funds raised in 2006, an indication that businesses funded investments not only with current cash flow but also with external funds and liquid assets. Borrowing by nonfinancial firms picked up in 2006 in association with increased real investment as well as with extensive retirements of equity, which resulted from record share repurchases and heavy merger and acquisition activ-

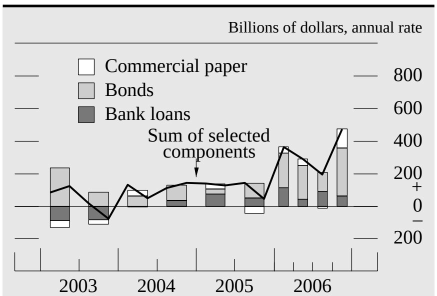
Financing Gap and Net Equity Retirement at Nonfinancial Corporations, 1991–2006



NOTE: The data are annual; the observations for 2006 are based on partially estimated data. The financing gap is the difference between capital expenditures and internally generated funds, adjusted for inventory valuation. Net equity retirement is the difference between equity retired through share repurchases, domestic cash-financed mergers, or foreign takeovers of U.S. firms and equity issued by domestic companies in public or private markets. Equity issuance includes funds invested by private equity partnerships and stock option proceeds.

SOURCE: Federal Reserve Board, flow of funds data.

Selected Components of Net Financing for Nonfinancial Corporate Businesses, 2003–06



NOTE: The data for the components excluding bonds are seasonally adjusted. The data for the sum of selected components are quarterly. The data for 2006:Q4 are estimated.

SOURCE: Federal Reserve Board; Securities Data Company; and Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

ity. Net bond issuance proceeded at a faster clip than in the past several years. Similarly, commercial paper issuance was the strongest it had been since 2000, and commercial and industrial lending by banks was rapid as well. The Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices revealed that a significant net fraction of respondents to that survey eased credit standards and terms on commercial and industrial loans during 2006. Bankers indicated that they were responding to more-aggressive competition and greater liquidity in the secondary market for such loans. Loan officers also reported that a contributing factor was an increased tolerance for risk.

The expansion of commercial mortgage debt in 2006 remained rapid by historical standards but fell off from the swift pace of 2005. The deceleration likely reflected the rise in mortgage rates and a net tightening of credit standards for these loans—an explanation consistent with responses to the loan officer survey.

Gross public issuance of equity by nonfinancial corporations in 2006 roughly maintained the moderate pace of the past couple of years, and private equity issuance appears to have risen a bit to finance buyouts and other restructurings. Still, net equity issuance turned more negative as equity retirements from cash-financed mergers and acquisitions and share repurchases increased considerably.

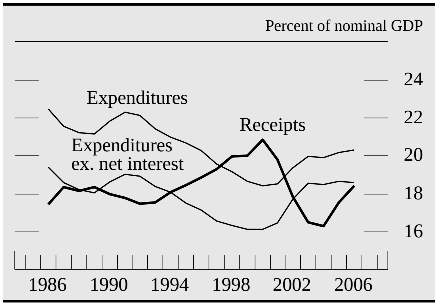
On balance, despite increased borrowing and net equity retirements, the strength of corporate earnings growth has left the credit quality of nonfinancial firms solid. Balance sheet liquidity remains high, and corporate leverage is near historical lows. In addition, net interest payments relative to cash flow remained near the low end of the range seen over the past two decades. The six-month trailing bond default rate fell during the first half of the year as defaults by some large firms in the troubled airline and automobile sectors in late 2005 dropped out of the series, and it was near zero throughout the second half of 2006. Delinquency rates on business loans remained quite low.

The Government Sector

Federal Government

The deficit in the federal unified budget narrowed further during the past year. The unified budget recorded a deficit of $248 billion in fiscal year 2006—$70 billion smaller than in the previous fiscal year. The federal deficit in fiscal 2006 was a bit less than 2 percent of nominal GDP, significantly lower than its recent fiscal year peak of more than 3½ percent of GDP in 2004. In fiscal 2006, outlays rose about in line with nominal GDP, but receipts increased at a faster pace. From October through December—the first quarter of fiscal 2007—the federal deficit was almost $40 billion less than in the same period a year earlier, as the rise in receipts continued to outpace the growth in outlays. The latest projections from the Congressional Budget Office and the Administration anticipate that the unified deficit in fiscal 2007 will be smaller as a percentage of nominal GDP than it was in fiscal 2006. Although the unified deficit has improved recently, the federal budget will face the mounting pressures of providing Social Security and health benefits to a rapidly growing number of beneficiaries as the baby-boom generation ages in coming years.

Federal Receipts and Expenditures, 1986–2006



NOTE: The receipts and expenditures data are on a unified-budget basis and are for fiscal years (October through September); GDP is for the four quarters ending in Q3.

SOURCE: Office of Management and Budget.

In fiscal 2006, nominal federal receipts rose 11¾ percent and were equivalent to almost 18½ percent of nominal GDP, substantially higher than their recent fiscal year low of 16¼ percent of GDP in 2004. Income tax receipts from individuals outpaced the rise in taxable personal income (as measured in the NIPA), while surging corporate tax payments about matched the robust growth in profits. As noted above, the increase in individual income tax liabilities relative to taxable income in the NIPA appears to have reflected, at least in part, taxes on larger capital gains realizations (which are excluded from NIPA income), the effect of some taxpayers moving into higher tax brackets as their real incomes increased, and possibly a further shift in the distribution of income toward high-income households that typically face higher tax rates. In the first quarter of fiscal 2007, revenues were more than 8 percent greater than in the same period a year earlier, as both individual and corporate tax payments continued to rise briskly.

Nominal federal outlays increased about 7½ percent in fiscal 2006 and were about 20¼ percent of nominal GDP, well above their most recent fiscal year low of less than 18½ percent of GDP in 2000. Net interest payments increased 23 percent in fiscal 2006, as interest rates rose and federal debt continued to grow. Outlays for Medicare increased 10½ percent, reflecting in part new benefits payments associated with the Part D prescription drug program, which started in January 2006. At the same time, outlays for Medicaid declined a bit, to some extent because of a shift of some Medicaid payments to Medicare Part D. Spending for disaster relief and national flood insurance was almost $28 billion greater in fiscal 2006 than in the previous fiscal year, primarily owing to the federal government's response to the hurricanes in the autumn of 2005. Outlays for defense in fiscal 2006 slowed to their lowest rate of increase since fiscal 2001, although the rise was still about 6 percent. In the first quarter of fiscal 2007, total federal outlays were only 1 percent greater than those in the same period a year earlier; in this period, defense spending was 12 percent above its year-earlier level, but outlays related to disaster relief and flood insurance were markedly lower than they were a year earlier.

As measured in the NIPA, real federal expenditures on consumption and gross investment—the part of federal spending that is a direct component of real GDP—increased 2½ percent over the four quarters of calendar year 2006 and contributed about ¼ percentage point to the growth rate of real GDP in that year. The increase was the result of a pickup in real defense purchases, which rose more than 4 percent during calendar 2006 after two years of smaller increases. At the same time, real nondefense purchases declined more than 1 percent after having risen, on average, about 2 percent per year over the preceding two years.

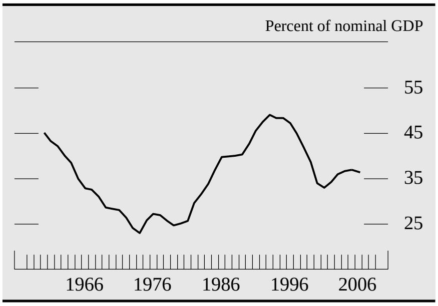
The reduction in the unified deficit in the past two years implies that the federal government required less national saving to finance its operations. However, nonfederal saving, which excludes borrowing by the federal government from total net national saving, remained relatively low. Although the saving rate for private business and state and local governments has increased in recent years, the improvement has been offset by declines in the personal saving rate. Total national saving, net of depreciation, was 2 percent of nominal GDP in the third quarter of 2006. The recent national saving rate is an improvement from the lows of a few years ago, but it has been insufficient to avoid an increasing reliance on borrowing from abroad to finance the nation's capital spending.

Federal Borrowing

The Treasury responded to the reduction in the federal deficit in 2006 by paying down Treasury bills over the course of the year and by trimming the gross issuance of marketable Treasury coupon securities. As of the third quarter of 2006, the quantity of federal debt held by the public as a percentage of nominal GDP had declined about ½ percentage point, to about 36 percent.

Early in the first quarter of 2006, federal debt subject to the statutory limit reached the then-current ceiling of $8.2 trillion. The Treasury employed various methods to avoid breaching the

Federal Government Debt Held by the Public, 1960–2006



NOTE: The final observation is for 2006:Q3. For previous years, the data for debt are as of year-end, and the corresponding values for GDP are for Q4 at an annual rate. Excludes securities held as investments of federal government accounts.

SOURCE: Federal Reserve Board, flow of funds data.

limit until the Congress increased it to nearly $9 trillion in March. As of the end of December, the total amount of federal debt subject to the limit was $8.6 trillion.

In February, the Treasury auctioned thirty-year bonds for the first time since 2001. The offering was apparently well received, as was the reopening of the issue in August. The Treasury announced in August that it would issue thirty-year bonds on a quarterly basis beginning in 2007.

The acquisition of Treasury debt by foreigners slowed further in 2006 from its peak in 2004. However, outstanding Treasury debt also grew more slowly, leaving the share of outstanding debt held by foreign investors little changed, on balance, from its average level over the preceding two years. According to Treasury data on international capital flows, foreigners (official and other) purchased considerably fewer U.S. Treasury coupon securities in 2006 than in 2005. The average proportion of nominal coupon securities purchased by foreign and international investors at auctions in 2006 about matched the average from the previous year at 16 percent, but it was down noticeably from an average level of 25 percent in 2004.

State and Local Government

The fiscal positions of state and local governments improved further in 2006. Apart from federal grants-in-aid, revenues rose at an annual rate of 7 percent over the first three quarters of 2006 after posting relatively strong gains in the preceding two years. Receipts from taxes on retail sales and on individual and corporate incomes continued to rise at a brisk pace; however, decreasing gains in house prices slowed the rise in property tax revenues in the third quarter of 2006 from the rapid pace in the previous two years. The sustained strength in total revenues, along with the efforts of states and localities to restrain spending for health care, has enabled these jurisdictions to step up spending on other programs and still rebuild their reserve funds. As measured in the NIPA, net saving by state and local governments excluding social insurance funds—a measure that is broadly similar to the surplus in an operating budget—was almost $4 billion during the first three quarters of 2006. States and localities generally have seen improvement in their fiscal positions recently, but in coming years most governments will have to face the budget pressures of providing pension and health benefits to an expanding number of retired employees, and the states' costs for Medicaid are expected to rise substantially as the baby-boom generation ages.

Real expenditures by state and local governments on consumption and gross investment, the component of these governments' spending that enters directly into the calculation of real GDP, rose 3 percent over the four quarters of 2006. That increase was the largest since 2001 and contributed about ¼ percentage point to the change in real GDP during the year. Real expenditures for investment rose 4¾ percent, largely because of a strong increase in real construction spending in the first half of the year. Spending for current consumption in real terms increased 2½ percent over the four quarters of 2006. Hiring by state and local governments stepped up last year. Of the cumulative increase in employment of 254,000 in 2006, about two-thirds of the jobs were in education.

State and Local Government Borrowing

Borrowing by state and local governments dropped below its rapid 2005 pace amid improved fiscal positions and fewer advance refunding issues. Nonetheless, bond issuance for new capital expenditures, particularly for education and transportation, boosted long-term borrowing. Credit quality in the state and local sector rose substantially in 2006, as the number of credit-rating upgrades far exceeded the small number of downgrades.

The External Sector

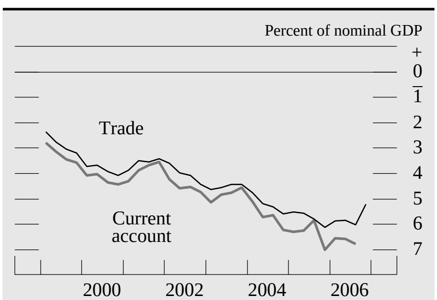
The U.S. current account deficit averaged \$875 billion at an annual rate, or about 6½ percent of nominal GDP, in the first three quarters of 2006 (the latest available data). The deficit was wider than in 2005, partly because of a larger deficit on trade of goods and services. In addition, net investment income, which turned negative in the fourth quarter of 2005, remained negative in the first three quarters of last year, further expanding the current account deficit.

International Trade

After widening through most of 2005, the nominal trade deficit leveled out in the first half of 2006, rose to a record high in August, and then narrowed noticeably through November (the latest available data). On average, the nominal trade deficit was wider in 2006 than in the previous year. Nominal imports of goods grew more slowly than exports did early last year and, after reaching late-summer peaks, dropped because of declines in both the price and volume of imported oil. Meanwhile, imports of services decelerated sharply in the second half of last year. In contrast, nominal exports of goods and services pushed upward steadily throughout the year and grew significantly faster than did nominal imports. Given that the level of exports was smaller than the level of imports, the faster export growth during 2006 was not enough to narrow the nominal trade deficit. Although the nominal trade deficit last year (through November, annualized) was wider in dollar terms, the trade deficit as a share of GDP, at just under 6 percent, was about the same as in 2005.

Real exports of goods and services grew a robust 9¼ percent last year. In the first quarter, growth was boosted by a catch-up of exports affected by hurricane damage in late 2005. Throughout the year, exports were supported by strong foreign economic activity. Real exports of goods rose 10¼ percent last year, a little faster than in the previous year. Export growth was spread fairly evenly across all major end-use categories, though exports of computers and semiconductors expanded noticeably more slowly than in 2005. By destination, exports to China and other emerging Asian economies grew very rapidly, as did those to South America. Exports to Mexico and western Europe rose at a more modest pace. Real exports of services were up a solid 6¾ percent for the year, double the pace of 2005.

U.S. Trade and Current Account Balances, 1999–2006



NOTE: The data are quarterly. For the trade account, the observation for 2006:Q4 is estimated. The data for the current account extend through 2006:Q3.
SOURCE: Department of Commerce.

Prices of exported goods rose at a 3½ percent rate last year, a little faster than their pace in 2005. Reflecting the effects of very large jumps in prices of industrial supplies, particularly fuels and metals, export prices moved up sharply in the second and third quarters; they decelerated toward the end of the year as prices of exported fuels retreated from their high levels and as prices of exported metals moved up more slowly.

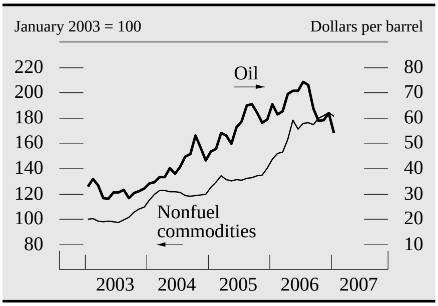
Real imports of goods and services rose 3 percent last year, more slowly than in the previous year. As with the growth in real exports, real import growth got off to a quick start last year amid robust domestic growth. But import growth slowed, on average, in the middle quarters of the year, along with U.S. real GDP growth, and real imports fell in the fourth quarter as a result of a sharp drop in oil and natural gas imports. Despite some fourth-quarter declines, for the year imports increased in every major end-use category except petroleum and natural gas. Imports of services rose more than 5 percent last year, a step-up from the previous year's sluggish pace.

Prices of imported non-oil goods increased less than 1 percent, on balance, in 2006 despite some wide gyrations. After falling in the first quarter, prices reversed course, surged upward, and then cooled in the fourth quarter. The quarterly pattern was driven by movements in nonfuel commodity prices, which soared in the second and third quarters before leveling off in the fourth quarter.

Metals figured prominently among the nonfuel commodities that boosted trade prices last year. Prices for a variety of metals—including copper, aluminum, nickel, and zinc—skyrocketed in the second quarter. Factors contributing to the surge in prices included growing demand, particularly from developing countries, low levels of inventories for some metals, and perhaps increased speculative demand. Prices for nickel and zinc continued to move up throughout the year. In the second half of the year, aluminum prices trended sideways, and copper prices moved down from their peaks as inventory and supply conditions improved somewhat. For most of these metals, those price trends have continued this year. An exception is zinc, the price of which has plummeted.

The spot price of West Texas intermediate crude oil averaged $66 per barrel in 2006, nearly $10 per barrel higher than in 2005; moreover, crude oil prices were especially volatile last year. The spot price climbed from around $61 per barrel at the end of 2005 to a peak of $77 per barrel in August as violence in the Middle East, a shutdown of the Prudhoe Bay oil field in Alaska, and forecasts of an active hurricane season led to increased demand. In the event, oil supply was affected far less than anticipated by these factors, and oil prices declined over the next few months as demand dropped and elevated

Prices of Oil and of Nonfuel Commodities, 2003–07



Note: The data are monthly and extend through January 2007. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is an index of forty-five primary-commodity prices.

Source: For oil, the Commodity Research Bureau; for nonfuel commodities, International Monetary Fund.

petroleum inventories were drawn down. Oil demand for heating was depressed by above-average temperatures in the Northern Hemisphere in the fourth quarter and in the early weeks of 2007, and the spot price fell further, to around $50 per barrel in mid-January, before moving back up to $58 per barrel at the end of the month. Far-dated futures prices began last year at about $60 per barrel, moved in a pattern similar to spot prices throughout most of the year, and averaged just over $61 per barrel in January 2007.

Notwithstanding the decrease of global oil prices since August, several factors continue to support these prices at historically elevated levels. Ongoing violence has diminished oil production in Iraq and Nigeria. The continuing dispute with Iran over its nuclear program threatens a possible curtailment of Iranian exports. Energy investment by international oil companies has been hampered in some countries, such as Russia and Venezuela, by increased government control of domestic energy industries. Moreover, in response to the recent decline in oil prices, OPEC has reduced its crude oil production to the lowest level since 2004. Oil demand over the past year has also increased modestly in developing countries despite high prices.

The Financial Account

Foreign official inflows in the first three quarters of 2006 were above their 2005 pace but remained below the record levels of 2004. Most of these official inflows were attributable to Asian central banks and took the form of purchases of U.S. government securities, primarily bonds and mortgage-backed securities issued by government-sponsored enterprises (GSEs). Preliminary data indicate a slight easing of official purchases in the fourth quarter of 2006. Net private inflows slowed in the first quarter but have changed little since then.

Foreign private purchases of U.S. securities in the second and third quarters of 2006 slowed slightly from the extraordinary pace set in the second half of 2005 and early 2006, but preliminary fourth-quarter data show recent demand to have been strong. More than half of private flows last year took the form of purchases of corporate bonds, and most of the remainder went toward investment in GSE bonds and corporate equities. On net, private foreigners purchased few U.S. Treasuries. Foreign direct investment flows into the United States remained robust.

Net purchases of foreign securities by U.S. residents, a financial outflow, set a record pace in the first three quarters of 2006. Preliminary data show a further surge in net purchases in the fourth quarter. Demand for foreign bonds by U.S. residents slightly exceeded that for foreign equities. After the expiration of the partial tax holiday implemented in the Homeland Investment Act of 2004, U.S. direct investment abroad dropped back to more normal levels.

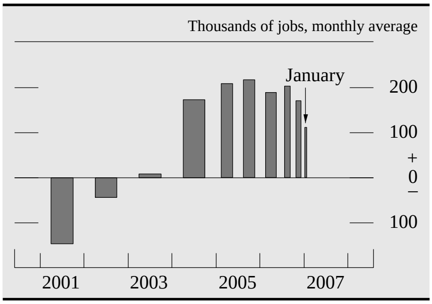
The Labor Market

Employment and Unemployment

Labor markets remained strong in 2006. Nonfarm payroll employment increased 186,000 per month, on average, during the second half of 2006, a rate essentially the same as in the first half of the year. Employment rose 111,000 in January of 2007. The unemployment rate in the fourth quarter of last year—4½ percent—was at its lowest quarterly level since 2001, and it was little changed in January 2007.

In response to the contraction in homebuilding, hiring in the construction sector slowed considerably in the sec-

Net Change in Payroll Employment, 2001–07



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

ond and third quarters of 2006, and this sector shed workers in the fourth quarter. Although hiring for nonresidential building construction remained brisk for most of the year, the steep decline in housing starts curtailed the overall demand for construction workers. Employment in the manufacturing sector, which rose in the first half of 2006, declined in the second half as factory output slowed. From July to December, many of the factory layoffs were at makers of motor vehicles and parts and at producers closely tied to the construction industry. Outside of the construction and manufacturing sectors, employment generally increased at a solid pace in the second half of 2006, and hiring was particularly rapid in a number of service industries—especially those providing education and health services, professional and technical business services, and financial services.

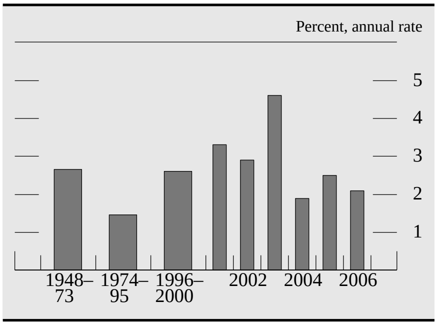
As a result of the continued expansion of labor demand in 2006, the unemployment rate fell further. After remaining around 4¾ percent in the first three quarters of 2006, the unemployment rate edged down to 4½ percent in the fourth quarter. The tighter labor market was associated with a noticeable increase in employment among individuals who had not been participating in the labor force. In line with this cyclical tightening of the labor market, the labor force participation rate ticked up during 2006, from 66 percent in the first quarter to 66¼ percent in the fourth quarter, after a ¼ percentage point rise during 2005. The recent rise in the participation rate follows a period of decline beginning in the late 1990s that in part reflected some longer-term secular trends in labor force behavior. Those trends included a leveling off in the participation rate of women and an increase in the proportion of the workforce in older age groups, which have lower average participation rates.

Other indicators also suggest that labor market conditions remained generally favorable during the second half of 2006. Layoffs remained low as new claims for unemployment insurance fluctuated around a relatively subdued level of 315,000 per week. In addition, data reported by the Bureau of Labor Statistics showed a further increase during the later part of the year in the rate of job openings as a percentage of private-sector employment.

Productivity and Labor Compensation

The growth rate of labor productivity in the nonfarm business sector, which had slowed in 2004 and 2005 from an exceptionally rapid pace earlier in the decade, remained relatively subdued in 2006. Over the four quarters of 2006, output per hour of work in the nonfarm business sector increased 2 percent, compared with about a 3 percent average annual rate of increase during the first half of this decade and the second half of the 1990s. During that earlier period, productivity gains were spurred by the rapid pace of technological change, the

Change in Output per Hour, 1948–2006



NOTE: Nonfarm business sector. Change for each multiyear period is measured from the fourth quarter of the year immediately preceding the period to the fourth quarter of the final year of the period.

SOURCE: Department of Labor, Bureau of Labor Statistics.

growing ability of firms to use information and other technology to improve the efficiency of their operations, and increases in the amount of capital per worker. Despite the recent slowing in productivity growth, these underlying factors do not appear to have waned. Accordingly, the recent slowdown in labor productivity may be at least in part a temporary cyclical response to the moderation in the pace of economic activity in 2006 rather than a meaningful downshift in the longer-run trend.

As the labor market tightened in 2006, the rise in hourly labor compensation, which includes both wages and employer payments for employee benefits, stepped up for workers in the nonfarm business sector. In nominal terms, compensation per hour increased almost 5 percent over the four quarters of 2006, compared with an average 4 percent rise in the preceding two years. After adjusting compensation for increases in the PCE price index, real compensation per hour rose 3 percent in 2006, up from an average gain of about 1 percent in 2004 and 2005.

An alternative measure of employee compensation is the employment cost index (ECI) for private nonfarm businesses, which is based on a survey of firms conducted by the Bureau of Labor Statistics. According to this measure, nominal hourly compensation increased 3¼ percent in 2006, ¼ percentage point faster than in 2005. In real terms, the ECI for hourly compensation rose 1¼ percent last year after averaging a ½ percent increase over the preceding two years. The nominal wages and salaries component of the ECI rose 3¼ percent in 2006, while the benefits component advanced 3 percent.

From the perspective of employers, the acceleration in hourly compensation in the nonfarm business sector last year boosted the average labor costs associated with producing a unit of output 2¾ percent, up from increases of about 1¾ percent in both 2004 and 2005. Although the rise in unit labor costs increased, firms' profit margins appeared to remain elevated in 2006 relative to longer-run standards.

Prices

Headline inflation slowed in 2006. The PCE chain-type price index rose 2 percent over the four quarters of 2006, a step-down from the 3 percent increase recorded in 2005. The drop in energy prices in the latter part of 2006 accounted for the deceleration in the headline number. Core inflation moved higher in the first part of 2006 but then eased toward the end of the year. On balance, core PCE prices rose about 2¼ percent over the four quarters of 2006, a little faster than the 2 percent increase in 2005. The market-based component of the core PCE price index—which excludes imputed prices that are not observed in market transactions and that often change irregularly—

Alternative Measures of Price Change, 2004–06

Percent

Price measure	2004	2005	2006
Chain-type			
Gross domestic product (GDP)	3.2	3.1	2.5
Gross domestic purchases	3.7	3.6	2.2
Personal consumption expenditures (PCE)	3.0	3.1	1.9
Excluding food and energy	2.2	2.1	2.3
Market-based PCE excluding food and energy	1.7	1.8	2.0
Fixed-weight			
Consumer price index	3.3	3.7	1.9
Excluding food and energy	2.1	2.1	2.6

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

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

increased 2 percent in 2006, about ¼ percentage point more than in the previous year.

Energy prices recorded dramatic swings during 2006. PCE energy prices increased at an annual rate of about 15 percent in the first half of the year and declined at an annual rate of almost 17 percent in the second half. The sharp movements in consumer energy prices in 2006 were associated primarily with fluctuations in prices for crude oil. The changes in energy prices also were amplified by a widening in the margin of the retail price of gasoline over the associated cost of crude oil in the first half of the year and by some narrowing of that margin in the second half. On balance, the PCE energy price index decreased 4 percent over the four quarters of 2006.

Food price inflation remained fairly moderate in 2006. The PCE index for food and beverages increased 2¼ percent, roughly the same pace as in the preceding year. Retail prices of meat and poultry rose modestly for 2006, as robust demand was met by ample supplies of meat. Prices of wheat rose over the course of the year, and prices of corn and soybeans spiked at the end of the year in the wake of downward revisions to estimates of crop production. Prices of corn also were boosted during the year by increased demand for corn to produce ethanol. But the small share of wheat, corn, and soybeans in the total value of food production limited their effect on retail food prices. Prices for food consumed away from home, which are influenced importantly by the costs of labor, energy, and other business inputs, increased 3¼ percent in 2006, a more rapid pace than that for prices of food consumed at home.

The core PCE price index accelerated to an annual rate of about 2½ percent in the first half of 2006 on the strength of pickups in the price indexes for both goods and services. In the spring, increases in housing rents were particularly sharp. The rise may have reflected in part a shift in demand toward rental housing as rising mortgage rates and lofty home prices made home purchases less affordable. The pass-through of higher energy costs to a broad range of goods and services also probably contributed to the acceleration in core consumer price inflation in the first half of 2006.

In the second half of 2006, core PCE price inflation edged down to an annual rate of just below 2¼ percent. The deceleration was the result of a decrease in core goods prices, which likely reflected in some measure the waning influence of energy prices. In contrast, core services inflation in the second half of the year remained at about the same pace as in the first half. Although housing rents rose more slowly in the second half of the year, their effect on the PCE for core services was mostly offset by faster price increases for medical care and a number of other services.

The swings in energy costs in 2006 were apparent in the prices of inputs used in the production and sale of final goods and services, especially of items for which energy costs represent a relatively large share of total production costs, including industrial chemicals, plastics, fertilizer, and stone and clay products. In addition, the prices of some commodities, such as a variety of metals, rose significantly in 2006 in response to strong worldwide demand. As a result, the core producer price index for intermediate goods, which excludes food and energy, rose 5¼ percent in 2006, up from the 4¾ percent increase in 2005. The index increased at an annual rate of 7¼ percent in the first half of 2006, but it decelerated to an annual rate of about 3¼ percent in the second half as energy costs declined.

For the year as a whole, measures of long-term inflation expectations remained well anchored, although short-term expectations were heavily influenced by fluctuations in energy prices. The Reuters/Michigan survey measure of the median expectation of households for inflation over the next twelve months was about 3 percent in December, down from its peak of 3¾ percent in August. Longer-term inflation expectations recorded in the Reuters/Michigan survey showed less variability. The median survey respondent in December expected the rate of inflation during the next five to ten years to be 3 percent, down from its peak of 3¼ percent in August. Other indicators likewise suggest that longer-run inflation expectations have remained contained. According to the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, expectations of inflation over the next ten years remained at 2½ percent in 2006, a level that has been essentially unchanged since 1998. In addition, inflation compensation implied by the spread of yields on nominal Treasury securities over their inflation-protected counterparts stayed within the relatively narrow range of 2 percent to 2¾ percent during the year.

U.S. Financial Markets

Financial conditions in the United States supported economic growth in 2006. Yields on long-term Treasury securities climbed a bit, on balance, but stayed low by historical standards, while strong corporate profits helped fuel substantial gains in equity markets. Liquid corporate balance sheets and low corporate leverage helped keep risk spreads on corporate bonds narrow. Meanwhile, business borrowing picked up to a rapid pace, spurred in part by a rise in merger and acquisition activity. In the residential real estate sector, mortgage borrowing slowed markedly, as house prices decelerated, especially in the second half of the year. Consumer credit expanded at a moderate pace. Nonetheless, household debt growth outpaced the growth of disposable personal income, and the financial obligations of households inched higher. Although households generally appeared able to meet their obligations, signs of financial strain were apparent in subprime variable-rate mortgages. The M2 monetary aggregate expanded at a moderate pace in 2006.

Interest Rates

Market interest rates rose modestly, on balance, in 2006—yields on two- and ten-year nominal Treasury securities increased about 40 and 30 basis points respectively. Changes in interest rates seemed largely tied to changes in the outlook for economic growth and inflation. Rates across the maturity spectrum increased notably over the first half of the year, as incoming data on activity

Interest Rates on Selected Treasury Securities, 2003–07

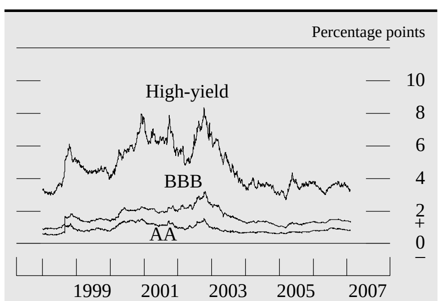
NOTE: The data are daily and extend through February 7, 2007.
SOURCE: Department of the Treasury.

and inflation came in higher than markets had expected and as the FOMC raised the target federal funds rate 25 basis points at each of its first four meetings. At the time of the June FOMC meeting, interest rate futures market quotes indicated that market participants perceived considerable odds of an additional rate tightening by year-end. However, market interest rates declined, on net, over subsequent months in response to incoming data suggesting that inflation pressures were moderating and that economic growth was slowing. Market expectations for the trajectory of the federal funds rate over the next several years shifted down considerably during the second half of the year. More recently, market participants have backed away from expectations of a substantial easing of monetary policy as incoming data on economic activity have been stronger than expected. Investors now expect the FOMC to ease policy only slightly over the next two years. Although investors modestly revised their medium-term policy expectations over the course of the year, the Committee's interest rate decisions were largely anticipated in financial markets by the time of each meeting. Throughout the year, forward-looking measures of uncertainty about monetary policy inferred from interest rate options remained near the low end of historical ranges.

Yields on inflation-indexed Treasury securities increased about as much as those on their nominal counterparts in 2006. Medium- and long-term inflation compensation—measured from spreads between yields on nominal and inflation-indexed securities—were about unchanged to a little lower, on net, and during the year these measures exhibited only modest swings in response to incoming inflation data and oil price movements.

In the corporate bond market, yields on investment-grade securities moved about in line with those on comparable-maturity Treasury securities. In contrast, yields on speculative-grade securities fell slightly, pulling risk spreads lower in that segment of the market. The narrowness of investment- and speculative-grade spreads seems to reflect investors' sanguine perceptions of corporate credit quality over the medium term, which likely reflect in large part the strength of

Spreads of Corporate Bond Yields over Comparable Off-the-Run Treasury Yields, 1998–2007



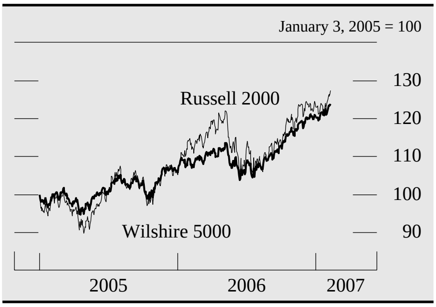
NOTE: The data are daily and extend through February 7, 2007. The ten-year high-yield, ten-year BBB, and ten-year AA indexes are compared with the ten-year Treasury yield.
SOURCE: Derived from smoothed corporate yield curves using Merrill Lynch bond data.

business balance sheets and a benign economic outlook. The term structure of forward risk spreads for corporate bonds supports this view, as forward spreads one and two years ahead are low, while the spreads further out the curve are more in line with historical norms.

Equity Markets

Broad equity indexes soared 10 percent to 20 percent in 2006, boosted by strong growth in corporate earnings. Share prices rose across a wide range of sectors, but increases in telecommunications and security brokerage stocks were especially noteworthy. The difference between the twelve-month forward earnings-price ratio for the S&P 500 and the long-term real Treasury yield—a crude measure of the premium that investors require for holding equity shares—was little changed on balance. The implied volatility of the S&P 500 calculated from options prices spiked temporarily in the late spring in connection with a period of strain in several markets but remained near historical lows for the remainder of the year. Net inflows into domestic equity mutual funds were quite modest in 2006, while inflows into international equity funds were exceptionally strong.

Stock Price Indexes, 2005–07



NOTE: The data are daily and extend through February 7, 2007.
SOURCE: Frank Russell Company; Dow Jones Indexes.

Market Functioning and Financial Stability

Overall, financial markets functioned smoothly over the year and proved resilient to several shocks. Equity markets in the United States and currency and fixed-income markets in several emerging-market economies experienced heightened volatility late in the second quarter, but the turbulence was short lived. The liquidation of a few sizable hedge funds attracted considerable attention for a time but had little discernible effect on the broad functioning of markets. Even the liquidation of Amaranth—a hedge fund that was wound down in the fall after reporting a loss in excess of $6 billion, mostly in energy trades—left little imprint on financial markets, although it raised some concerns about risk-management practices. Implied volatilities, risk spreads, and various other potential measures of financial stress generally stayed at very low levels throughout the year, suggesting that investors were comfortable taking on risk, likely in part because they were confident about the economic and financial outlook.

Throughout the year, bid-ask spreads on the most actively traded Treasury securities remained within narrow ranges. Some instances of questionable trading activities occurred in the secondary market for Treasury securities over the course of the year. The Interagency Working Group for Treasury Market Surveillance monitored these situations closely.[1] In November, the Federal Reserve Bank of New York arranged a

1. The group was established in 1992 and includes representatives from the Board of Governors of the Federal Reserve System, the Treasury, the Securities and Exchange Commission, the

meeting with all primary dealers to discuss developments in Treasury markets and to encourage the firms to review their internal oversight of trading operations. Subsequently, a private-sector group sponsored by the Federal Reserve Bank of New York released a draft report laying out a set of best practices for firms active in the Treasury market on topics such as appropriate trading strategies and internal controls.

In July, the Federal Reserve Board implemented a revision to the treatment of GSEs and certain international organizations under its Policy on Payments System Risk. Under the change, interest and redemption payments on securities issued by these institutions are now released only when the issuer's Federal Reserve account contains sufficient funds to cover the payments; that is, these institutions no longer may employ daylight credit to fund such payments. The Board of Governors determined that the change represents an appropriate risk-management policy for the central bank and is consistent with the general practices of private issuing and paying agents. In addition, GSEs and international organizations are now subject to a penalty fee for daylight overdrafts resulting from general corporate payment activity (activity other than interest and redemption payments). This change aligns the policy for GSEs and international organizations with that for other Federal Reserve account holders that do not have regular access to the Federal Reserve's discount window and thus are not eligible for intraday credit. The transition to the new policy occurred smoothly with minimal effects on the functioning of the payments system and no notable adverse effects on short-term funding markets.

Commodity Futures Trading Commission, and the Federal Reserve Bank of New York.

Following up on a meeting with the Federal Reserve Bank of New York in the fall of 2005, the largest participants in the fast-growing market for credit derivatives agreed to a series of steps to strengthen that market's infrastructure. Over the course of 2006, credit derivatives dealers phased out the practice of transferring positions to a different counterparty without first obtaining the consent of the original counterparty. They also reduced by 85 percent the number of trade confirmations outstanding more than thirty days; they doubled the share of trades that are confirmed via an electronic platform, to 80 percent of total trade volume; and they agreed upon a new protocol for the settlement of such derivatives after a credit event.

Debt and Financial Intermediation by Banks

Total debt of the domestic nonfinancial sectors expanded an estimated 7¾ percent in 2006, well below the pace in 2005 but still faster than that of nominal income. Debt growth slowed markedly in the household and government sectors, but business debt accelerated.

About 30 percent of the growth in nonfinancial sector debt in 2006 was intermediated by the banking sector. This share is about even with the average over the past ten years and is about 5 percentage points above the average observed in the 1980s and early 1990s. Commercial bank credit expanded 9½ percent in 2006, supported by brisk growth in loans to businesses. Bank credit also was boosted in the autumn by a consolidation of a substantial volume of thrift assets onto a commercial bank's balance sheet that had resulted from an internal reorganization at a large bank holding company.

Bank lending to businesses through commercial and industrial loans increased at a rapid pace last year. The growth was fueled by vigorous merger and acquisition activity, rising outlays for investment goods, ongoing inventory accumulation, and an accommodative lending environment. Bank loans secured by commercial real estate, though strong, decelerated over the course of the year. The moderation in commercial real estate lending was consistent with responses by large and medium-sized banks to the Senior Loan Officer Opinion Survey on Bank Lending Practices, which pointed to slowing demand and a net tightening of credit standards for such loans in the second half of the year. Consumer loans and residential mortgages held by banks grew at a moderate rate for the year as a whole. However, excluding the effects of the thrift consolidation, residential real estate lending slowed considerably in the fourth quarter, no doubt reflecting in part the downturn in the housing market.

Commercial bank profits as a percentage of average assets were strong in 2006 and rose slightly above 2005 levels. Net interest margins declined a bit further, likely in response to continued competitive pressures and a modest inversion of the yield curve, but bank profitability was supported by growth in non-interest income and by well-contained costs. Continued strong asset quality also helped to support profitability in 2006 by allowing banks to reduce their loan-loss provisioning. Robust asset quality was reflected in loan delinquency and charge-off rates that remained at low levels through the end of 2006.

The M2 Monetary Aggregate and Reserves

M2 expanded at a 5 percent rate last year, somewhat faster than in 2005. Typically, as short-term interest rates rise, deposit rates lag somewhat, increasing the opportunity cost of holding money. In 2006, this effect apparently slowed money growth less than would have been expected on the basis of historical norms, and the velocity of M2 rose only about ¾ percent. Retail money market mutual funds and small time deposits, components of M2 whose yields move most closely with market rates, grew rapidly. However, liquid deposits, which constitute the largest component of M2, and whose yields adjust more gradually, were about flat on net. Currency expanded a modest 3½ percent, an increase similar to that in 2005, reflecting weak, possibly negative, net demand from overseas.

Part of the Financial Services Regulatory Relief Act of 2006 gave the Federal Reserve authority, beginning in October 2011, to pay interest on reserve balances and to further reduce or eliminate reserve requirements. At the October FOMC meeting, the Chairman asked the staff to prepare for the implementation of this legislation.

International Developments

Foreign economic growth was generally strong in 2006, as expansion continued in all major regions of the world. The Japanese economy decelerated somewhat but maintained positive growth, and the pace of activity in the euro area picked up. Labor market conditions in both areas improved. Emerging-market economies also recorded solid growth last year and experienced no apparent lasting ill effects from the brief period of financial market volatility that hit some of them particularly hard in the late spring. Although there are signs that steps taken to slow growth of investment in China have been effective, the Chinese economy continued to grow rapidly. Rising energy prices boosted consumer price inflation in many areas of the world early last year, but monetary tightening appears to have prevented inflation from moving significantly higher, and the effects of higher energy prices on core prices were modest.

Industrial countries tightened monetary policy in 2006. Some countries paused around the same time as the Federal Reserve, and others continued to tighten throughout the year. After ending its policy of quantitative easing in the spring, the Bank of Japan (BOJ) raised its policy rate 25 basis points in July. Weak consumer spending and low inflation have apparently deterred the BOJ from tightening since then. With growth in the European economies firming, concerns over inflationary pressures prompted the European Central Bank to raise its policy rate five times last year, to 3.5 percent. The Bank of Canada tightened 75 basis points in several steps over the first half of the year but has left the overnight rate unchanged since then. After keeping its policy rate constant in the first half of the year, the Bank of England tightened policy 25 basis points in August and November 2006 and in January 2007. The statements accompanying each tightening cited the upside risks to inflation posed by low levels of spare capacity.

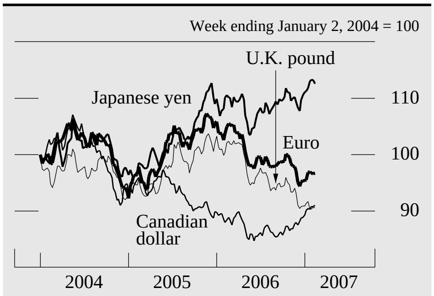
During the first half of 2006, ten-year sovereign yields in the euro area, Canada, and Japan rose sharply on balance: Increases ranged from 45 basis points in Japan to 75 basis points in Germany. Yields on inflation-protected long-term securities in these economies also rose during the first half of 2006 but not as much as nominal yields and thus implied a noteworthy rise in inflation compensation. These developments occurred largely in reaction to continuing upward pressures on inflation, which stemmed from a further run-up in energy prices and indications that global economic growth remained robust.

From their midyear highs, nominal government benchmark bond yields fell noticeably until about the beginning of December in most major advanced economies, as investors reacted to moves in U.S. rates and evaluated the implications for the global economy of the economic slowdown that seemed to be under way in the United States. Over this period, yields on ten-year nominal bonds declined by amounts that ranged from about 25 basis points in the United Kingdom to about 70 basis points in Canada. Yields on inflation-indexed securities declined less; modest declines in inflation breakeven rates were attributed in part to lower energy prices in the second half of the year.

Since the beginning of December, however, nominal and indexed government bond yields have risen once again in most advanced economies, partly because new data releases appeared to alleviate investors' concerns that global economic growth might slow appreciably. Yields on both ten-year nominal and indexed securities have risen 15 basis points in Japan and 25 to 50 basis points in the euro area, the United Kingdom, and Canada since their December lows. As a result, inflation breakeven rates have been little changed.

The Federal Reserve's broadest measure of the nominal trade-weighted exchange value of the dollar declined 3¾ percent from the beginning of last year through early February of this year. Over that period, the dollar appreciated 2¼ percent against the yen and 1½ percent against the Canadian dollar, but it depreciated about 9 percent, on net, against the euro, almost 13 percent against sterling, and 4 percent against the Chinese renminbi. The renminbi's

U.S. Dollar Exchange Rate against Selected Major Currencies, 2004–07



NOTE: The data are weekly and are in foreign currency units per dollar. The last observation for each series is the average for February 5 through February 7, 2007.

SOURCE: Bloomberg L.P.

rate of appreciation stepped up in late 2006 and early 2007, but daily fluctuations in the dollar-renminbi exchange rate were very small.

Most of the dollar's overall decline in 2006 occurred between mid-April and early May. During this period, market participants reportedly sensed that the FOMC was approaching the end of its series of policy tightenings, and interest rate differentials moved against the dollar. Traders also refocused on the large and persistent U.S. current account deficit, which was further boosted by crude oil prices that had moved above $70 per barrel. To date in 2007, the dollar's broad nominal exchange value has risen 1 percent on balance.

In the wake of strong advances in 2005, major global equity indexes posted solid gains, on balance, in 2006 and in early 2007. After rising 5 percent to 10 percent in the first quarter of 2006, most global indexes fell sharply beginning in early May to reach intra-year lows in mid-June. Market participants attributed the drops in share prices to increased uncertainty about prospective inflation, caused in part by the run-up in energy prices, and to a retreat from risk-taking. Broad-based gains in stock prices since midsummer appear to be associated with a scaling back of expectations for future tightening of monetary policy in several countries and with declines in energy prices. Since mid-June, broad stock market indexes have gained 10 percent to 20 percent in Europe, Japan, and Canada.

Industrial Economies

After increasing at an annual rate of roughly 2 percent in the first half of 2006, Japanese real GDP grew only ¾ percent in the third quarter, largely because of slower growth of consumption. Capital spending was an important contributor to growth of output throughout the year, supported by strong corporate profitability. Labor market conditions continued to improve; the unemployment rate was about 4 percent in December, its lowest level since 1998, and the ratio of job offers to applicants remained close to a thirteen-year high. However, wage growth was very subdued, as firms controlled cost increases, and unit labor costs continued to fall. In 2006, consumer prices started to rise again, posting small twelve-month increases after June, and land prices in Japan's six largest cities rose for the first time since 1991. However, the GDP deflator continued to decline slowly.

Real GDP in the euro area accelerated somewhat in 2006, posting average growth of 3¼ percent at an annual rate over the first three quarters. Output growth was supported in part by strong consumer spending, which grew substantially faster than in 2005. The stronger performance of the economy was reflected in improving labor market conditions: The unemployment rate in the euro area fell 0.8 percentage point during the year to reach 7.5 percent in

December, continuing a downward movement that began in 2004. Wages and salaries in the manufacturing and services sector grew at an average annual rate of 2¼ percent in the first three quarters of the year—a bit lower than their rate of growth in 2005. Higher energy prices boosted euro-area consumer price inflation, which rose to about 2½ percent in the first half of 2006; late in the year, it dropped below the European Central Bank's target ceiling of 2 percent. Core inflation remained near 1½ percent.

Real GDP in the United Kingdom grew 3 percent last year, and real GDP in Canada grew 3 percent, on average, through the first three quarters. Despite declining consumer confidence in the United Kingdom, the pace of consumption growth over the year was slightly higher than in 2005, and consumer spending in Canada, supported by moderate employment growth, also remained robust. Declines in energy prices brought Canadian consumer price inflation down after the middle of the year to a twelve-month change of about 1½ percent in December, below the Bank of Canada's 2 percent inflation target. Inflation in the United Kingdom edged up throughout the year, partly because of increases in electricity and natural gas prices that were implemented in the fall.

Emerging-Market Economies

Real GDP growth in China remained strong but moderated a bit in the second half. The mild slowdown suggests that the administrative measures put in place by the Chinese authorities to cool investment have had an effect. The trade surplus recorded a substantial increase in 2006. Four-quarter inflation picked up near the end of last year to over 2 percent, reflecting higher food prices.

Elsewhere in emerging Asia, economic performance was generally solid in 2006. In Korea, GDP growth slowed from the strong pace registered in 2005, partly because of monetary tightening, and consumer price inflation remained modest. The pace of growth in other countries stayed strong throughout 2006 as a result of robust exports and, in some cases, strengthening domestic demand. Four-quarter inflation moderated across the region. That moderation resulted from the waning effects of earlier reductions or removals of domestic fuel subsidies, but the previous tightening of monetary policy in the region and an appreciation of exchange rates also made a contribution. Capital inflows into several Asian emerging-market economies—particularly Thailand—in late 2006 and early this year put upward pressure on local currencies. Measures taken by Thai authorities seemed to succeed in limiting upward movement of the baht, but share prices in the Thai stock market fell sharply. Financial markets in other countries in the region were less affected and showed no noticeable spillovers from events in Thailand.

Output growth in Mexico was exceptionally strong in the first half of last year, especially in the manufacturing, construction, and services sectors. Growth stepped down in the second half; construction activity remained robust but was offset by a slowdown in exports of manufactured goods to the United States. Mexican consumer price inflation was elevated during the second half by higher food prices and reached rates above the 4 percent upper limit of the central bank's inflation target range; at year-end, inflation was still at the top end of the range.

Brazilian output growth was solid in the first quarter but slowed noticeably later in the year, partly because of weak manufacturing performance. Brazilian four-quarter inflation fell markedly, from almost 6 percent at the end of 2005 to just over 3 percent in December. In Argentina, steady growth in investment and consumption kept real GDP on a solid uptrend throughout 2006. The Argentine government continued to attempt to bring down inflation through voluntary price agreements with producers in several sectors; although inflation had edged down to the single-digit range by year-end, it was still high. ■

Monetary Policy Report of July 2006

Monetary Policy and the Economic Outlook

The U.S. economy continued to expand at a brisk rate, on balance, over the first half of 2006. Spending in the first quarter, which was especially robust, was temporarily buoyed by several factors, including federal spending for hurricane relief and the effects of favorable weather on homebuilding. The pace of the expansion moderated in the spring, to some degree because the influence of these special factors dissipated. More fundamentally, consumer spending slowed as further increases in energy prices restrained the real incomes of households. In addition, home sales and new homebuilding dropped back noticeably from the elevated levels of last summer, partly in response to higher mortgage interest rates. Outside of the household sector, increases in demand and production appear to have been well maintained in the second quarter. Demand for U.S. exports was supported by strong economic activity abroad, and business fixed investment remained on a solid upward trend. Early in the year, as aggregate output increased rapidly, businesses added jobs at a relatively robust pace, and the unemployment rate moved down further. Since April, monthly gains in payroll employment have been smaller but still sufficient to keep the jobless rate steady.

Thus far in 2006, inflation pressures have been elevated. Higher prices for crude oil contributed to a further run-up in domestic energy costs; this year's increases, combined with the steep increases in 2004 and 2005, not only boosted the prices of gasoline and heating fuel but also put upward pressure on the costs of production for a broad range of goods and services. Partly as a result of these cost pressures, the rate of core consumer price inflation picked up. Nevertheless, measures of inflation expectations remained contained, and the rate of increase in labor costs was subdued, having been held down by strong gains in productivity and moderate increases in labor compensation.

Taking a longer perspective, the U.S. economy appears to be in the midst of a transition in which the rate of increase in real gross domestic product (GDP) is moving from a pace above that of its longer-run capacity to a more moderate and sustainable rate. An important element in the transition is the lagged effect of the changes in monetary policy since mid-2004, changes that have been intended to keep inflation low and to promote sustainable economic expansion by aligning real economic activity more closely with the economy's productive potential. Moreover, longer-term interest rates have risen, contributing to increased borrowing costs for both households and businesses. Over time, pressures on inflation should abate as the pace of real activity moderates and, as futures markets suggest, the prices of energy and other commodities roughly stabilize. The resulting easing in inflation should help contain long-run inflation expectations.

NOTE: The discussion in this chapter consists of the text and tables from the Monetary Policy Report submitted to the Congress on July 19, 2006; the charts from that report (as well as earlier reports) are available on the Board's web site, at www.federalreserve.gov/boarddocs/hh.

Even as the rate of increase in real economic activity moderates, the prospects for sustained expansion of household and business spending appear favorable. Higher energy prices have put strains on household budgets, but once that effect fades, households should experience gains in real income consistent with the ongoing expansion of jobs. Household balance sheets remain generally sound; although some pockets of distress have surfaced, average delinquency rates on mortgages and other consumer debt are still low. Similarly, in the business sector, balance sheets are strong, credit quality is high, and most firms have ready access to funds. Sustained expansion of the global economy, along with the effects of the earlier depreciation of the foreign exchange value of the dollar, should support demand for U.S. exports. The potential for efficiency gains, as well as further declines in the relative cost of capital, are likely to continue to spur capital spending. Indeed, the ongoing advances in efficiency should sustain solid growth of labor productivity, providing support for gains in real wages and income.

As always, considerable uncertainties attend the outlook. Regarding inflation, the margin between production and consumption of crude oil worldwide is quite narrow, and oil markets are especially sensitive to news about the balance of supply and demand and to geopolitical events with the potential to affect that balance; adverse developments could result in yet another surge in energy costs. Indeed, futures markets provide only imperfect readings on the prospects for energy markets, as witnessed by the fact that the surprises in crude oil prices during the past few years have been predominantly to the upside. In addition, a further rise in prices of other, non-energy materials and commodities, if it materializes, could also intensify cost pressures. Another risk is that the effect on imported-goods prices of earlier declines in the foreign exchange value of the dollar, which has been limited to date, could become larger. More broadly, if the higher rate of core inflation seen this year persists, it could induce a deterioration in longer-run inflation expectations that, in turn, might give greater momentum to inflation. However, the risks to the inflation outlook are not entirely to the upside. In the current environment of elevated profit margins, competitive forces, both in domestic markets and from abroad, could impose significant restraint on the pricing decisions of businesses.

Regarding risks to the outlook for real activity, rates of increase in real GDP have been uneven during the past year, complicating the assessment of whether the pace of the economic expansion is moving into line with its underlying potential rate. One possible risk to the upside is that the softer tone of the recent data on real activity will prove transitory rather than mark a shift to a more sustainable underlying rate of expansion. For example, slower spending and hiring in recent months may represent a shorter-lived adjustment to a higher level of energy prices or to the unusually robust increases in economic activity earlier in the year. In coming months, a sharp rebound in consumer spending accompanied by an acceleration of capital spending could return real activity to a pace that would be unsustainable over the longer run. But downside risks also exist. In particular, the slowing in real estate markets since last summer has been moderate, and the easing of house-price inflation has been gradual. If the softening in the demand for housing and in real estate values becomes more pronounced, the resulting drop in construction activity and the erosion of household wealth could weaken aggregate demand noticeably. Consumer spending might be depressed by the loss of income and wealth, and that effect could be amplified if the downturn is abrupt enough to shake households' confidence about their ability to finance spending or manage their current financial obligations.

The Conduct of Monetary Policy over the First Half of 2006

The Federal Open Market Committee (FOMC) continued to firm the stance of monetary policy over the first half of 2006. At the time of the January meeting, available information suggested that underlying growth in aggregate demand was solid at the turn of the year. The expansion of real GDP in the fourth quarter of 2005 was estimated to have slowed temporarily, in part because of the disruptions associated with last autumn's hurricanes. Core inflation had stayed relatively low, and inflation expectations had remained contained. With rising energy prices and increases in resource utilization having the potential to add to inflationary pressures, the FOMC decided to extend the firming of policy that it had implemented over the previous eighteen months by tightening the policy rate 25 basis points, to 4½ percent. The Committee indicated that some further policy firming might be needed to keep the risks to price stability and to sustainable economic growth roughly in balance.

By March, economic activity appeared to be expanding rapidly, propelled by robust consumer spending and accelerating business investment. Although readings on core inflation for January and February were generally favorable, higher prices for energy and other commodities, together with relatively tight labor and product markets, threatened to add to existing inflation strains. Against this backdrop, the Committee raised the target federal funds rate another 25 basis points, to 4¾ percent. The statement released at the end of the meeting continued to point to the possible need for further policy firming.

Data received by the time of the May meeting confirmed that the economy had expanded robustly in the first quarter, though both consumer spending and housing activity appeared to have moderated in late winter. In addition, inflationary pressures had intensified as core consumer prices rose more rapidly in March than in earlier months. Inflation expectations, as measured by some surveys and by comparisons of yields on nominal and inflation-indexed Treasury securities, also rose in April. The Committee still judged those expectations to be contained, but it was mindful that a further increase could impart additional momentum to inflation, as could the surge in energy and other commodity prices and the drop in the foreign exchange value of the dollar that took place in April and early May. To gain greater assurance that inflationary forces would not intensify, the FOMC decided to raise the target federal funds rate another 25 basis points, bringing it to 5 percent. The FOMC also indicated in the policy statement that some further policy firming could be required. However, the Committee was aware that the cumulative effects of past monetary policy actions on economic activity could turn out to be larger than expected. Accordingly, the FOMC stressed that the extent and timing of any further firming would depend importantly on the evolution of the economic outlook as implied by incoming data.

By the time of the June meeting, available data appeared to confirm that economic growth had moderated from the strong pace evident earlier in the year. Consumer spending had softened, and activity in housing markets had continued to cool gradually. Evidence of inflationary pressures was accumulating, however, and core price inflation had increased. In addition, the high levels of resource utilization and of the prices for energy and other commodities had the potential to spur further inflation. Consequently, the FOMC decided to increase the target federal funds rate an additional 25 basis points, to 5¼ percent. The Committee recognized that the moderation in the growth of aggregate demand that appeared to be under way would help to limit inflationary pressures over time, but it judged that, even after its policy action, some upside inflation risks remained. Yet the FOMC made clear that the extent and timing of any additional firming needed to address those risks will depend on the evolution of the outlook for both inflation and economic growth as implied by incoming information.

In recent years, the FOMC has worked to improve the transparency of its decisionmaking process, and it continues to seek further improvements. Between the March and May meetings, the Chairman appointed a subcommittee to help the FOMC frame and organize the discussion of a broad range of communication issues. At the June meeting, the Committee discussed the subcommittee's plans for work in coming months and decided to begin its consideration of communication issues at its August meeting and to lengthen meetings later this year to allow a fuller discussion of these issues.

Economic Projections for 2006 and 2007

In conjunction with the FOMC meeting at the end of June, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, provided economic projections for 2006 and 2007. In broad terms, the participants expect a sustained, moderate expansion of real economic activity during the next year and a half. The central tendency of the FOMC participants' forecasts for the increase in real GDP is 3¼ percent to 3½ percent over the four quarters of 2006 and 3 percent to 3¼ percent in 2007. The central tendency of their forecasts for the civilian unemployment rate is 4¾ percent to 5 percent in the fourth quarter of this year, and the jobless rate is expected to still be in that range at the end of 2007. For inflation, the central tendency of the forecasts is an increase in the price in-

Economic Projections for 2006 and 2007

Percent

Indicator	Federal Reserve Governors and Reserve Bank presidents: Range	Federal Reserve Governors and Reserve Bank presidents: Central tendency
	2006	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	5½–6½	6–6¼
Real GDP	3–3¾	3¼–3½
PCE price index excluding food and energy	2¼–3	2¼–2½
Average level, fourth quarter		
Civilian unemployment rate	4½–5	4¾–5
	2007	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4¾–6	5–5½
Real GDP	2½–3¼	3–3¼
PCE price index excluding food and energy	2–2¼	2–2¼
Average level, fourth quarter		
Civilian unemployment rate	4¼–5¼	4¾–5

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

dex for personal consumption expenditures excluding food and energy (core PCE) of 2¼ percent to 2½ percent over the four quarters of 2006; in 2007, the forecast shows a slower rate of 2 percent to 2¼ percent, which is similar to the rate of core PCE price inflation in 2004 and 2005.

A slowing in activity now appears to be under way in the housing sector, where home sales and residential construction have receded from the elevated levels of last summer. The associated easing in house-price appreciation will likely temper gains in household wealth, which, over time, may be a factor in damping consumer spending. However, households' financial positions should receive a boost from an acceleration of real income if energy prices stabilize as suggested by futures markets. In the business sector, participants view the outlook for fixed investment over the forecast period as positive. Although outlays for new equipment and software may increase a little more slowly with the deceleration in real output, investment opportunities appear to remain attractive: The relative user cost of capital for equipment, particularly high-technology items, is expected to remain favorable, and competitive pressures should maintain strong incentives to exploit opportunities for efficiency gains and cost reduction. At the same time, nonresidential construction seems likely to continue to move up. Finally, the strong performance of the economies of the United States' major trading partners should continue to stimulate U.S. exports of goods and services.

The more moderate pace of expansion and the stability in resource utilization, when coupled with less pressure from the prices of energy and other commodities, should contribute to an environment in which inflation expectations are contained and inflation edges lower. Moreover, ongoing solid gains in productivity should work to limit increases in unit labor costs.

Over the next year and a half, FOMC participants expect the economy to achieve a sustainable rate of economic expansion. That rate will be determined in large part by the rate of increase in productivity. Productivity has been rising at a solid rate over the past two years, albeit more slowly than the especially rapid pace that prevailed during the first three years of the expansion. A strong trend in productivity is likely to be maintained as businesses take advantage of new investment in facilities and equipment, as diffusion of technology continues, and as organizational advancements and business process improvements yield further increases in efficiency.

Economic and Financial Developments in 2006

Although last year's hurricanes caused the pace of aggregate economic activity around the turn of the year to be uneven, real GDP increased at an average annual rate of 3.6 percent in the final quarter of 2005 and first quarter of 2006—about the same pace that prevailed during the preceding year and a half. Over this period, payroll employment posted additional solid gains, and the unemployment rate declined further. In recent months, the incoming information on real activity has suggested that the pace of the expansion is moderating, with the deceleration in spending most apparent in the household sector. Still, as of midyear, resource utilization in labor and in product markets remained high.

Inflation picked up over the first five months of the year, boosted importantly by the effects of rising energy prices. Long-term inflation expectations fluctuated over the period but remained contained, and increases in unit labor costs were subdued. Although short-term market interest rates rose in line with the FOMC's firming of monetary policy, financial market conditions were still generally supportive of economic expansion in the first half of 2006. Long-term interest rates rose but were still moderate by historical standards, and credit spreads and risk premiums stayed narrow.

The Household Sector

Consumer Spending

After increasing at a robust rate around the turn of the year, consumer spending has been rising at a more moderate pace in recent months. Over the first half of 2006, rising employment and the lagged effect of increases in wealth continued to provide support for spending by households. However, consumers' purchasing power was restrained by a further run-up in energy costs in the spring.

Sales of new cars and light trucks bounced back sharply at the turn of the year; those sales had slackened in late 2005 after manufacturers ended the special "employee discount" programs that had boosted sales last summer. New light vehicles sold at an annual rate of 16.8 million units between January and April, about the same as the average rate in 2004 and 2005. However, elevated gasoline prices affected the composition of demand, and consumers shifted their purchases away from light trucks and sport-utility vehicles (SUVs) and toward autos. That shift led to an increase in the market share captured by foreign producers. As households' concerns about the higher price of gasoline weighed on their attitudes toward buying vehicles, sales dipped to an annual rate of 16.2 million units in May and June.

Spending for other household goods, such as furniture, electronic equipment, food, and clothing, was quite strong in the first quarter of 2006; real outlays for goods other than motor vehicles increased at an annual rate of 8¾ percent. Some moderation was to be expected after such a surge in spending. Estimates of retail sales, which are available through June, suggest that real expenditures for these goods rose more slowly in the second quarter. In contrast to the uneven pattern of spending for goods, real outlays for consumer services remained on a moderate upward trend over the first half of 2006; they rose at an annual rate of 2½ percent from the fourth quarter of 2005 through May 2006.

Boosted by gains in nominal wage and salary income, after-tax aggregate personal income rose at an annual rate of 4 percent over the first five months of 2006. However, the acceleration in consumer prices held real income about constant. As a result, the steep decline in the personal saving rate, which began in 2004, extended into 2006. Since 2003, rising household wealth has provided important support for spending, even as gains in real income have been damped by increases in energy prices. In 2005 and the first part of 2006, much of the increase in wealth was the result of the rapid appreciation in the value of homes.

According to the survey by the University of Michigan Survey Research Center (SRC), the run-up in energy prices contributed importantly to the deterioration in consumer confidence this spring. Consumers' pessimism peaked in May and then lessened somewhat, on average, in June and early July. Nonetheless, at midyear, households indicated that they were still concerned about the effect of the high cost of energy on their financial situation. In addition, households' assessments of current and expected business conditions remained considerably less optimistic than they were at the beginning of the year.

Residential Investment

The demand for homes had begun to soften in the summer of 2005, and, by the spring of 2006, starts of new single-family homes were well below the very rapid pace that had prevailed in the preceding two years. The reduced level of activity in real estate markets also led to some easing in house-price appreciation early this year.

Sales of new and existing single-family homes, which had been climbing steadily since 2003, stopped rising during the third quarter of 2005. By May, sales of new and existing homes together were 7¼ percent below their peak in June 2005. The cooling in sales caused inventories of unsold homes to rise. In May, the backlog of unsold new homes equaled 5½ months' supply at that month's selling rate, and the backlog of existing homes on the market was 6½ months' supply; in 2005, the stocks of both unsold new and existing homes averaged roughly 4½ months of supply.

An increase in mortgage rates contributed to the slackening in the demand for housing. Since the middle of 2005, the average rate for a thirty-year fixed-rate mortgage has increased about 1 percentage point, to 6¾ percent, and the average for a one-year adjustable-rate mortgage has risen a bit more, to 5¾ percent. According to respondents to the Michigan SRC survey, the rise in borrowing costs has been an important consideration damping their assessment of buying conditions for homes since mid-2005; the rise in home prices has apparently also weighed on consumers' attitudes.

Although recent increases in house prices have been smaller than those that accompanied the robust real estate markets of 2004 and 2005, the deceleration thus far appears to have been modest. The repeat-transactions index of house prices, which is published by the Office of Federal Housing Enterprise Oversight, increased at an annual rate of 7¼ percent in the first quarter of 2006, the smallest quarterly increase since the fourth quarter of 2001; that index attempts to control for the quality of existing single-family homes sold by using prices of homes involved in repeat transactions (excluding refinancings). The first-quarter reading brought the year-over-year change in this measure to 10 percent; in the second and third quarters of 2005, purchase prices according to this index were up 11½ percent from the level of a year earlier. An alternative measure of house prices is the average price of existing single-family homes sold, which is published by the National Association of Realtors. This measure, which does not control for the type of homes sold, showed that the year-over-year change in prices peaked at 11½ percent in August 2005 and then fell to 4 percent in April and May of this year. The greater deceleration in the latter measure suggests that, in addition to some softening in prices, the mix of existing units sold may have shifted toward lower-priced homes.

The effect of the slowdown in demand on new construction became apparent during the second half of 2005, when the number of permits issued for new single-family homes began to fall. This year, the decline in permit issuance was relatively steady from January to May. Nonetheless, new single-family homes were started at an exceptionally high annual rate of 1.75 million units during the first quarter, when builders were able to begin work on scheduled projects earlier than normal because of favorable weather conditions. With some starts having been advanced into the first quarter, single-family starts dropped to an average rate of 1.57 million units in April and May. In contrast to the recent trend in the single-family sector, construction of new multifamily homes averaged an annual rate of 360,000 units from January to May, about where it has been for more than four years.

Housing activity, as measured by real expenditures on residential structures, contributed almost ½ percentage point per year to the annual rate of increase in real GDP in 2004 and 2005. In the first quarter of 2006, that contribution dropped to 0.2 percentage point; with the reduced pace of sales and construction since the winter, a decline in residential investment is likely to have held down the rise in real GDP in the second quarter.

Household Finance

Household debt expanded at an annual rate of about 11½ percent in the first quarter of 2006, about the same pace as in 2005. Despite the rise in mortgage rates and the slowing in housing activity, home mortgage debt expanded rapidly again early in the year as homeowners apparently continued to extract some of the substantial gains in equity that they have accumulated on their homes in the past several years. Indeed, according to industry estimates, although the number of homeowners refinancing their mortgages has remained well below that seen during the refinancing boom of several years ago, a large fraction of homeowners who have refinanced so far this year have chosen to withdraw equity from their homes. As has been the case in recent years, this mortgage-related borrowing likely replaced, in part, some consumer credit borrowing, which, at an annual rate of a bit less than 3 percent, continued to expand modestly in the first five months of 2006.

The ratio of household financial obligations to disposable income rose 0.1 percentage point in the first quarter to about 18¾ percent, narrowly exceeding the top of its historical range. Nonetheless, the evidence points to only limited pockets of financial distress in the household sector. Delinquency rates on residential mortgages were low by historical standards in the first quarter, though they have edged higher since the middle of last year, particularly in the subprime sector. Delinquency rates on consumer debt also continued to be low. Meanwhile, household bankruptcy filings remained subdued in the first half of 2006, running at a pace well below the average of recent years. Bankruptcies have likely been damped this year in part by the decision of some households in the fall of 2005 to accelerate their filings to avoid the implementation of a stricter bankruptcy law in October. More recently, they may also have been restrained by the greater costs of bankruptcy under the new law.

The Business Sector

Fixed Investment

Real business fixed investment increased at a solid rate, on average, during the final quarter of 2005 and the first quarter of 2006. Over that period, real business spending for new equipment and software rose at an annual rate of 9¾ percent, a pace similar to that over the first three quarters of 2005. In addition, investment in nonresidential structures, which had remained weak in 2005, turned up noticeably in early 2006. The underlying determinants of capital spending have stayed quite positive: Businesses have seen steady increases in sales, robust profits, and declining user costs for equipment; they have ample liquid assets; and, despite the rise in interest rates, credit quality is strong.

Real outlays for equipment and software rose at an annual rate of 14¾ percent in the first quarter after having risen at a 5 percent rate in the fourth quarter of 2005. As can often be the case, the timing of spending for a number of types of equipment was uneven between these two quarters. Business purchases of cars and trucks slowed in late 2005, after manufacturers reduced their special discounts on light vehicles, and then recovered in the first quarter. The first-quarter rebound was strengthened by a further acceleration of outlays for medium and heavy trucks. According to industry analysts, businesses have been pulling forward these purchases because the engines in the 2007 models will be required to meet new emission regulations by the Environmental Protection Agency that will make the new vehicles more costly to operate. Deliveries of commercial aircraft to domestic customers also rebounded in the first quarter from a very low level in the fourth quarter.

Demand for high-technology equipment stepped up noticeably in the first quarter because of a sharp jump in outlays for communications equipment. Providers of telecommunications services appear to be investing heavily in fiber-optic networks, which will allow them to offer a wider range of Internet services; the recent spurt likely also includes some replacement demand for equipment damaged by last year's hurricanes. In contrast, business demand for computing equipment, while still increasing at a double-digit pace in real terms, has been relatively modest by historical standards so far this year. Industry analysts suggest that firms may be delaying investment in anticipation of introductions, later this year and in early 2007, of several products that will allow faster and more energy-efficient processing. Spending on equipment other than transportation and high-tech goods continued to trend up at a solid pace, on average, during the fourth and first quarters. Demand was particularly strong for metalworking and general industrial machinery as well as for equipment used in construction, energy extraction, and services industries.

Demand for equipment and software appears to have risen again in the second quarter. The information from U.S. manufacturers on their orders and shipments of nondefense capital goods and the data on imports of capital goods suggest that business spending for equipment other than transportation and high-tech items remained on a strong upward trajectory in April and May. The elevated backlog of unfilled orders at domestic firms likely provided support for factory production of capital equipment in the second quarter. The indicators of demand for high-tech equipment suggest that spending for communications equipment remained at a high level, and real outlays for computing equipment were still rising slowly. Sales of medium and heavy trucks continued to be robust in the second quarter, although they eased slightly from the exceptional rate at the beginning of the year.

Real expenditures for nonresidential construction increased at an annual rate of 12½ percent in the first quarter after having edged up slightly during 2005. Last year, the small net increase in this sector reflected a sharp upturn in spending on structures used in domestic energy exploration; construction of new office and industrial buildings was restrained by elevated vacancy rates. However, vacancy rates for office and industrial properties gradually declined over the course of 2005, and, by the turn of the year, nonresidential construction began to firm. As a result, the increase in nonresidential investment in the first quarter of 2006 was broadly based; it included pickups in outlays in the office, retail, and industrial sectors in addition to another steep rise in spending on structures associated with energy exploration.

Inventory Investment

Business inventories appear generally to be well aligned with sales. In surveys taken during the first six months of 2006, about two-thirds of purchasing managers at manufacturing firms who responded characterized the level of their customers' inventories as about right. A similar proportion of respondents at nonmanufacturing firms reported that they were comfortable with their own levels of inventories. However, dealer stocks of new light motor vehicles, particularly trucks (including SUVs), have risen noticeably as sales have slowed; inventories of light trucks reached an uncomfortable 89 days' supply in May. In late June, a number of manufacturers introduced a new round of incentives aimed at reducing dealer stocks in advance of the introduction of their new models this fall.

Corporate Profits and Business Finance

Corporate profits were again strong in the first quarter of 2006, and earnings per share for S&P 500 firms rose about 15 percent from the same time last year. Gains were widespread but were especially large for firms in the energy sector. Before-tax profits of nonfinancial corporations measured as a share of sector GDP rose to about 14 percent in the first quarter, above the previous peak reached in 1997.

The expansion of business debt picked up to an annual rate of nearly 10 percent in the first quarter of this year, and data in hand suggest a robust pace in the second quarter. A substantial fraction of borrowing proceeds reportedly went to finance mergers and acquisitions in the first half of the year. Net bond issuance has been strong so far in 2006. Short-term borrowing by nonfinancial corporations stepped up in the first quarter of 2006 after slowing somewhat in the fourth quarter of last year; it appears to have remained strong in the second quarter as well. Commercial paper outstanding started rising again, on balance, after edging lower in 2005. Bank business loans outstanding expanded at an annual rate of 15½ percent in the first quarter. Businesses benefited from a more accommodative lending environment: For example, a significant net fraction of respondents to the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices in April 2006 noted that their institutions had eased both standards and terms on commercial and industrial loans in the first three months of the year. The most commonly cited reasons for the easing of lending policies were more-aggressive competition from other banks and nonbank lenders, increased liquidity in the secondary market for business loans, and increased tolerance for risk.

Gross equity issuance has remained moderate so far this year, while an elevated level of cash-financed mergers along with record share repurchases has produced further sizable net equity retirements. Taken together, net funds raised by nonfinancial corporations in the credit and equity markets have been slightly negative in 2006, an indication that nonfinancial corporations have financed their increased investment spending with internal funds.

With profitability strong and balance sheets flush with liquid assets, credit quality in the nonfinancial business sector generally has remained quite high. The six-month trailing default rate on corporate bonds dropped after some large firms in the troubled airline and automobile sectors defaulted during the past fall and winter. Delinquency rates on business loans have stayed near the bottom of their historical range.

Commercial real estate debt expanded briskly in the first half of 2006, albeit not as quickly as during 2005. Spreads on BBB-rated commercial-mortgage-backed securities have fallen this year. The decline reversed an increase that took place at the end of last year, when issuance surged; these spreads are now back in line with those of comparable-quality corporate bonds. With rents climbing and vacancy rates falling, delinquency rates on commercial real estate loans have been low, and credit quality has remained generally good.

The Government Sector

Federal Government

The deficit in the federal unified budget narrowed further during the past year. Over the twelve months ending in June, the unified budget recorded a deficit of $276 billion, about $60 billion less than during the comparable period last year. The federal deficit over the twelve months ending in June was approximately 2 percent of nominal GDP and was significantly lower than its recent fiscal year peak of 3.6 percent of GDP in 2004. Although outlays increased faster than nominal GDP over the past year, the rise in receipts was even larger. Thus, in its recent *Mid-Session Review* of the budget, the Administration estimated that the federal government will finish fiscal 2006 with a deficit of $296 billion; that figure marks a decline from the fiscal 2005 deficit of $318 billion and is much lower than most analysts had projected at the beginning of this year.

During the twelve months ending in June, federal receipts were 13¼ percent higher than over the same period a year earlier and equivalent to almost 18¼ percent of nominal GDP. Income tax receipts from individuals have outpaced the rise in nominal income; final tax payments on income from 2005 were especially strong in April and May. Corporate tax payments continued to rise at a robust rate, even faster than corporate profits.

Nominal federal outlays rose 9 percent between June 2005 and June 2006 and were about 20½ percent of nominal GDP. The rise in outlays was bolstered by increases in several components of federal spending. Net interest payments increased 20 percent over the year ending in June as federal debt continued to rise and interest rates increased. Medicare outlays were up 14½ percent; since the inception of the new Part D prescription drug program in January, outlays for benefits have added more than $20 billion to spending in this category. Legislative actions related to the hurricanes in the Gulf Coast region last autumn have added significantly to spending for disaster relief over the past ten months. Although defense spending has slowed from the annual double-digit rates of increase from 2002 to 2004, it still has increased about 8 percent per year in the past two years.

As measured in the national income and product accounts (NIPA), real federal expenditures on consumption and gross investment—the part of federal spending that is a direct component of real GDP—increased at an annual rate of 3¾ percent, on average, during the final calendar quarter of 2005 and the first calendar quarter of 2006 and contributed roughly 0.3 percentage point to the annualized change in real GDP over the period. Over these two quarters, real defense purchases were about constant, on average, while spending related to disaster relief from the hurricanes contributed importantly to a rise in real nondefense purchases.

The narrowing of the federal deficit recently has reduced its drain on national saving. However, net national saving excluding the federal government has remained low relative to historical norms. Although the saving rate for private business has moved up during the past two years, the improvement has been offset by the further decline in personal saving. Overall, national saving, net of depreciation, stood at 2½ percent of nominal GDP in the first quarter of 2006. Although the recent rate is a noticeable improvement from the lows of the preceding few years, it has been insufficient to avoid an increasing reliance on borrowing from abroad to finance the nation's capital spending.

Federal Borrowing

Federal debt rose at an annual rate of 13 percent in the first quarter, a bit less than in the corresponding quarter of 2005. In February, federal debt subject to the statutory limit reached the ceiling of $8.184 trillion, and the Treasury resorted to accounting devices to avoid breaching the limit. The Congress subsequently increased the debt ceiling to $8.965 trillion in March. In the second quarter, federal debt likely declined temporarily because of a surge in tax receipts. On net, the Treasury has raised substantially less cash in the market so far this year than in the comparable period of 2005.

In February, the Treasury conducted an auction of thirty-year bonds for the first time since 2001. The issue generated strong interest, especially from investment funds; foreign investors were awarded only a small fraction of the total. In general, foreign demand for Treasury securities appears to have eased somewhat in 2006. The proportion of nominal coupon securities bought at auction by foreign investors has continued to fall from its peak of 24 percent in 2004; it averaged about 14 percent in the first six months of 2006. Data from the Treasury International Capital system generally suggested subdued demand from both foreign private investors and foreign official institutions over this period. The amount of Treasury securities held in custody at the Federal Reserve Bank of New York on behalf of foreign official and international accounts has changed little since the end of 2005.

State and Local Governments

The fiscal positions of states and localities continued to improve through early 2006. In particular, revenues are on track to post a relatively strong gain for a third consecutive year. Tax receipts from sales, property, and personal and corporate income were up 8¼ percent during the year ending in the first quarter of 2006, a rate similar to the increase in the preceding year. The sustained strength in revenues has enabled these jurisdictions to increase their nominal spending somewhat while rebuilding their reserve funds. On a NIPA basis, net saving by state and local governments—a measure that is broadly similar to the surplus in an operating budget—rose to an annual rate of $21½ billion in the first quarter of 2006 after having been close to zero in 2005. Although most states have seen improvement, a number of states are still struggling with structural imbalances in their budgets, and those in the Gulf Coast region are coping with demands related to damage from last year's hurricanes. In addition, local governments may face pressure to hold the line on property taxes after the sharp increases in the past several years, and governments at all levels will have to contend with the need to provide pensions and health benefits to a rising number of retirees in coming years.

Real expenditures by state and local governments on consumption and gross investment, as estimated in the NIPA, rose at an annual rate of 1½ percent in the first quarter of 2006 after having increased roughly 1 percent per year in 2004 and 2005. Real expenditures for investment turned up in the first quarter after having fallen during the second half of 2005. Real outlays for current consumption posted a moderate increase in the first quarter, and that trend appears to have continued into midyear. Hiring by state and local governments was slow early in the year but appears to have firmed in the spring. Of the cumulative increase in employment of 100,000 between December and June, 40 percent of the jobs were in education.

State and Local Government Borrowing

Borrowing by state and local governments has slowed thus far in 2006. The deceleration likely reflects the general improvement in budget conditions and a decline in advance refundings, which have dropped below their 2005 pace amid rising interest rates and a dwindling pool of eligible securities. Credit quality in the state and local sector has continued to improve, and upgrades of credit ratings have far outnumbered downgrades. Consistent with the improvement in credit quality, yields on long-dated municipal bonds have increased substantially less than those on comparable-maturity Treasury securities, and the yield ratio has accordingly fallen sharply.

The External Sector

The U.S. current account deficit narrowed in the first quarter of 2006 to $835 billion at an annual rate, or about 6½ percent of nominal GDP, from $892 billion in the fourth quarter of 2005. The narrowing resulted from three factors. Unilateral transfer payments to foreigners dropped, largely because of a decrease in government grants. The trade deficit narrowed, primarily because the value of imported oil and natural gas declined. In addition, higher direct investment receipts and lower direct investment payments produced an increase in the investment income balance.

International Trade

Real exports of goods and services increased 14¾ percent at an annual rate in the first quarter of 2006, far faster than the 6½ percent rate recorded in 2005. The surge in export growth in the first quarter resulted in part from a recovery in exports of many types of industrial supplies following a period of hurricane-related disruptions late last year. Exports of capital goods also increased rapidly in the first quarter, with deliveries of aircraft to foreign carriers exhibiting particular strength. The first-quarter increase in exports was widespread across destinations, a sign of robust economic activity in many parts of the world, and exports to Mexico and Canada showed especially large increases. Real exports of services rose at an annual rate of about 6½ percent in the first quarter after increasing just 2¾ percent in 2005. Available data for nominal exports in April and May suggest that the increase in real exports was smaller in the second quarter, held down in part by a drop in aircraft exports after a strong first quarter.

Prices of exported goods increased at an annual rate of 2¾ percent in the first quarter of 2006, a pace somewhat faster than in the second half of 2005. Prices of non-agricultural industrial supplies continued to increase steadily in the first quarter, driven importantly by higher prices for oil and metals. An acceleration in prices for finished goods, especially for capital and consumer goods, contributed to the faster pace of export price inflation in the first quarter. The available data for the second quarter point to further increases in export prices on the strength of additional run-ups in the prices of non-agricultural industrial supplies, especially metals.

Real imports of goods and services rose at an annual rate of 10¾ percent in the first quarter, slightly slower than in the fourth quarter but still considerably faster than the 5¼ percent rate observed for 2005 as a whole. Robust growth of real GDP in the United States supported the first-quarter increase in imports. Among categories of goods, large increases in imports of consumer goods, automotive products, and capital goods, particularly computers, more than offset declines in imports of oil and some other industrial supplies. The rise in imports in the first quarter was widely distributed across countries, and the increases for China and Mexico were especially large. Real imports of services jumped at an annual rate of 8½ percent in the first quarter. Nominal imports in April and May point to an abrupt slowing of real imports in the second quarter from the first quarter's rapid pace.

Prices of imported goods excluding oil and natural gas rose at an annual rate of about 1 percent in the first quarter of 2006, ¾ percentage point faster than the pace in the second half of 2005. Prices of material-intensive goods, such as nonfuel industrial supplies and foods, increased steadily in the last quarter of 2005 and in the first quarter of 2006. Also in the first quarter, prices of finished goods, such as consumer goods and many kinds of capital goods, turned up slightly. Available data for the second quarter indicate that prices of finished goods kept rising at a subdued pace. However, prices of material-intensive goods continued to increase sharply, a development reflecting higher prices for metals. The International Monetary Fund's index of global metals prices rose 46 percent between December 2005 and May 2006, largely because of robust global demand. In June, metals prices retreated about 8 percent, although they remained well above the levels of earlier this year.

The spot price of West Texas intermediate crude oil increased from around $60 per barrel at the end of last year to more than $75 per barrel in July, higher than the peak that followed last year's hurricanes. Oil prices have been highly sensitive to news about both supply and demand, particularly in light of the narrow margin of worldwide spare production capacity. Global oil demand has continued to grow as the foreign economic expansion has spread, and developing countries have posted the largest increases in oil consumption. Recent events in the Middle East—including concerns over Iran's nuclear program, violence in Iraq, and the recent conflict in Lebanon—have put additional upward pressure on oil prices. In Nigeria, attacks against oil infrastructure have reduced oil production for most of this year. Government intervention in energy markets also raised concerns about supply from some countries: In recent months, Bolivia nationalized its natural gas reserves, and Venezuela and Russia continued to tighten governmental control of their energy industries.

The rise in the price of the far-dated NYMEX oil futures contract (currently for delivery in 2012) to more than $70 per barrel likely reflects a belief by oil market participants that the balance of supply and demand will remain tight over the next several years.

The Financial Account

The U.S. current account deficit continues to be financed primarily by foreign purchases of U.S. debt securities. Foreign official inflows in the first quarter maintained the strength exhibited in 2005 but remained below the record levels of 2004. As in recent years, the majority of these official inflows were attributable to Asian central banks and have taken the form of purchases of U.S. government securities.

Foreign private purchases of U.S. securities continued in the first quarter at the extraordinary pace set in the second half of 2005. Although private flows into U.S. Treasury bonds were significantly smaller than in recent quarters, this slowing was more than offset by larger flows into agency bonds and equities. Preliminary data for April and May suggest a slowdown in foreign purchases of U.S. securities relative to the first quarter. Foreign direct investment flows into the United States continued in the first quarter near last year's average levels.

Net purchases of foreign securities by U.S. residents, which represent a financial outflow, strengthened slightly in the first quarter and continued at a solid pace in April and May. In addition, significant outflows were associated with U.S. direct investment abroad, a reversal of some unusual inflows in the second half of 2005. These second-half inflows were prompted by the partial tax holiday offered under the 2004 Homeland Investment Act (HIA), which induced the foreign affiliates of U.S. firms to repatriate a portion of earlier earnings that had been retained abroad. In the first quarter, the foreign affiliates partially unwound the HIA-induced flows by retaining an unusually large portion of their first-quarter earnings. Increased merger activity abroad also boosted direct investment outflows in the first quarter.

The Labor Market

Employment and Unemployment

Conditions in the labor market continued to improve in the first half of 2006, although the pace of hiring has slowed in recent months. Nonfarm payroll employment increased 176,000 per month during the first quarter, a rate roughly in line with the relatively brisk pace that prevailed during 2004 and 2005. During the second quarter, hiring slowed, and monthly gains in payrolls averaged 108,000 jobs per month. Over the two quarters, the civilian unemployment rate edged down further, to the lowest quarterly level of joblessness in five years.

In the first quarter, with homebuilding quite strong, hiring continued to be particularly robust at construction sites; part of this strength was the result of favorable weather, which allowed more construction activity than is typical during the winter months. Although nonresidential construction activity was firming by the spring, the pullback in housing starts slowed the demand for residential contractors and workers in the building trades. As a result, monthly additions to construction industry payrolls declined from more than 25,000 per month in the first quarter to just 3,000 per month in the second quarter. Cutbacks at retailers also were an important factor holding down the overall gain in employment in the second quarter. After having been stable early in 2006, employment at retail outlets fell almost 30,000 per month between March and June; most of the cutbacks occurred at general merchandisers.

In other sectors, employment remained on a solid upward trend during the first half of the year. As has been the case since mid-2004, establishments providing education and health services, those offering professional and technical business services, and those involved in financial activities, taken together, added more than 60,000 jobs per month. Employment in manufacturing, which had turned up at the end of 2005, rose further over the first half of 2006. Expanding industrial production was also associated with further job gains in related industries, such as wholesale trade and transportation. In addition, the increase in energy production led to a sustained rise in employment in the natural resources and mining industry over the first half of the year.

The increase in job opportunities so far in 2006 led to a further reduction in the civilian unemployment rate, from an average of 5.0 percent in the second half of 2005 to 4.7 percent in the second quarter of 2006. Although hiring moderated in the spring, layoffs remained low. New claims for unemployment insurance (UI) dipped below 300,000 per week in January and February and then fluctuated around a still-low level of about 315,000 per week for most of the period from March through early July. Over the first half of 2006, longer-term unemployment (fifteen weeks or more) also moved down, and the proportion of UI claimants who remained on the unemployment rolls until the exhaustion of their benefits continued to recede.

After having edged up during 2005, the labor force participation rate was relatively stable over the first half of 2006 despite the ongoing improvement in labor market conditions. Rates for most broad age groups were little changed from last year's levels. From a longer perspective, developments during the past decade highlight the importance of structural as well as cyclical influences on participation. The rise in the attachment of adult women to the workforce, which was a significant factor in the secular rise in participation over much of the post-World War II period, appears to have leveled off. And the aging of the population is increasing the proportion of the workforce that is 55 years and older; it rose from less than 12 percent in 1996 to 16¾ percent in recent months. Although older workers have tended in recent years to stay in the labor force longer, their participation rate, at 38 percent in the second quarter, was less than half the rate for workers who are age 25 to 54. Thus, the demographic shift to an older population has already begun to reduce the overall rate of labor force participation and has offset part of the rise in participation that has been associated with the cyclical upturn in job creation. The secular forces that are slowing the expansion of the labor force imply that the increase in employment that is consistent with a stable unemployment rate will, over time, be smaller than it was during the period when labor force participation was rising steadily.

Productivity and Labor Costs

After having advanced at an unusually rapid rate from 2001 to mid-2004, labor productivity in the nonfarm business sector increased at a more moderate annual rate of 2½ percent from mid-2004 to early 2006. Nonetheless, by historical standards, productivity performance recently has still been solid, with gains at a rate matching those during the second half of the 1990s. In an environment of a sustained expansion of aggregate demand, businesses have gradually adjusted their use of labor, capital, and services to achieve ongoing gains in efficiency. Productivity has continued to benefit importantly from investment in new technologies, organizational changes, and improvements in business processes, although the contribution from capital deepening has been smaller in recent years than it was during the capital investment boom of the late 1990s.

Broad measures of hourly labor compensation, which include both wages and the costs of benefits, posted moderate gains over the year ending in early 2006 despite the run-up in headline price inflation and the further tightening of labor markets. Both the employment cost index (ECI) and the estimate of compensation per hour that uses data from the national income and product accounts increased 2¾ percent between the first quarter of 2005 and the first quarter of 2006.[1] Both series had reported higher rates of change in hourly labor compensation a year earlier.

The deceleration in labor compensation appears to have been associated largely with smaller increases in employers' benefit costs. The benefits component of the ECI was up just 3 percent between March 2005 and March 2006, compared with an increase of 5.5 percent between March 2004 and March 2005. The cost of health insurance, which typically accounts for about one-fourth of overall benefit costs, rose just 4¾ percent during the year ending in March 2006; between 2000 and 2005, these costs increased, on average, 8¾ percent per year. Another likely contributor to the slower rise in benefit costs over the past year was smaller employer contributions to their defined-benefit pension plans; those costs dropped back somewhat after employers made sizable payments to bolster those pension assets in 2004.

Indicators of the recent trend in the wage component of worker compensation have been providing mixed signals. As measured in the ECI, wages rose 2.4 percent between March 2005 and March 2006, slightly less than in the preceding two years. In contrast, the year-over-year change in average hourly earnings of production or nonsupervisory workers—which refers to a narrower group of private nonfarm employees and has tended to show greater cyclical variation than the ECI—has increased steadily over the past three years. Average hourly earnings rose 3.9 percent over the twelve months ending in June 2006, compared with an increase of 2.7 percent over the twelve months ending in June 2005.

Prices

Inflation pressures were elevated during the first half of 2006. The chain-type price index for personal consumption expenditures (PCE) rose at an annual rate of 4¼ percent between December 2005 and May 2006. Over the same period, core PCE prices increased at an annual rate of 2.6 percent, nearly 0.6 percentage point faster than over the twelve months of 2005.

Although energy prices eased temporarily in February, they turned up

1. The Bureau of Labor Statistics (BLS) developed a new ECI series and has provided data for the changes in that series beginning in 2001. The BLS considers the new ECI to be continuous with the old series.

Alternative Measures of Price Change
Percent

Price measure	2004 to 2005	2005 to 2006
Chain-type (Q1 to Q1)		
Gross domestic product (GDP)	2.8	3.1
Gross domestic purchases	3.1	3.5
Personal consumption expenditures (PCE)	2.7	3.0
Excluding food and energy	2.2	1.9
Market-based PCE excluding food and energy	1.8	1.5
Fixed-weight (Q2 to Q2)		
Consumer price index	3.0	4.0
Excluding food and energy	2.1	2.4

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

sharply again from March to May; as a result, the PCE price index for energy increased 13 percent (not at an annual rate) over the first five months of 2006, a rise that marked a continuation of the steep climb in prices that began in 2004. This year, almost the entire rise in energy prices has been associated with higher prices for petroleum-based products. The PCE price index for gasoline and motor fuel, which increased more than 16½ percent last year, climbed another 24 percent (not at an annual rate) by May. Although recent data from the Department of Energy indicate that gasoline prices fell back in June, they moved up again in early July. Retail prices of gasoline this year have risen faster than the cost of crude oil in part because of the additional cost of producing and distributing reformulated product with ethanol. Also, the demand for fuel ethanol has been strong relative to the current capacity to produce it. In contrast, the consumer price of natural gas has turned down this year as inventories have remained relatively high; the price decline between January and May almost completely reversed the steep run-up that occurred last autumn.

Food price inflation remained moderate during the first five months of 2006; between December 2005 and May 2006, the PCE price index for food and beverages increased at an annual rate of 2¼ percent. Retail prices of meat and poultry have fallen so far this year. Domestic supplies of meat have been ample. Production has been expanding at a time when export demand for beef has been soft largely because of bans on imports of U.S. beef by Japan and Korea. Prices of processed food have continued to rise at only a moderate rate despite higher prices for grains; export demand for grains has been strong, and the price of corn has been boosted by demand from producers of ethanol. Prices for food consumed away from home, which typically are influenced heavily by labor and other business costs, have continued to increase relatively rapidly, rising at an annual rate of 3¾ percent over the first five months of the year.

The pickup in core inflation in the first half of 2006 was evident in the indexes for both goods and services. Prices of consumer goods excluding food and energy, which were unchanged in 2005, edged up at an annual rate of ¾ percent this year. Prices of consumer services also accelerated this spring; as a result, the PCE price index for nonenergy services increased at an annual rate of 3½ percent between December 2005 and May 2006, compared with a rise of 2¾ percent in 2005. In the three months ending in May, increases in housing rents were especially steep; the rise may reflect, in part, a shift in demand toward rental units because home purchases have become less affordable. Another contributor to the higher inflation rate for consumer services has been the acceleration in the index for nonmarket services to an annual rate of 4 percent over the first five months of the year from 3 percent last year.[2] More broadly, the pickup in core consumer price inflation over the first five months of 2006 likely is the result of the pass-through of higher energy costs to a wide range of goods and services.

The cost pressures from the increase in energy costs during the past three years have been apparent in rising prices of inputs used in the production and sale of final goods and services. The producer price index for intermediate goods, excluding food and energy, rose at an annual rate of 7¼ percent between December 2005 and May 2006; this index rose 4¾ percent in 2005 and 8¼ percent in 2004. In particular, prices of industrial chemicals, fertilizer, and stone and clay products, for which energy represents a relatively high share of the total costs of production, accelerated over the past several years. The costs of a number of important business services, particularly transportation by air, rail, and truck, have also been boosted by higher energy costs. The pass-through of the costs of energy to consumer prices is clear for a few items, such as airfares. For other components of core consumer price indexes, however, the extent of the pass-through is harder to trace. Quantifying the extent of the pass-through is difficult, in part because it is diffused through a wide range of retail goods and services. In addition, the cost of energy is a small share of overall costs—and that share has been declining over time as businesses adopt more energy-efficient technologies and households reduce their consumption of energy. Nonetheless, the cumulative rise in energy costs in recent years has been large enough to show through to pricing of final goods and services even as businesses have seen their labor costs, which represent roughly two-thirds of their costs, remain restrained.

Near-term inflation expectations were also influenced importantly over the first half of 2006 by movements in energy prices, but, as of midyear, they were only slightly higher than they were at the turn of the year. The Michigan SRC survey measure of the median expectation of households for inflation over the next twelve months held steady at 3 percent during the first three months of the year but then rose sharply to 4 percent in May as gasoline prices climbed. By early July, this measure of near-term inflation expectations dropped back to 3.1 percent. Longer-term inflation expectations remained within the ranges in which they have fluctuated in recent years. On average over the first half of 2006, the median respondent to the Michigan SRC survey continued to expect the rate of inflation during the next five to ten years to be just under 3 percent. In June, the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, reported expected inflation at a rate of 2½ percent over the next ten years, an expectation that has been roughly unchanged for the past eight years. Inflation compensation implied by the spread of yields on nominal Treasury securities over their inflation-protected counterparts rose slightly, on net, over the first half of the year; in early July it was just above 2½ percent.

U.S. Financial Markets

U.S. financial markets functioned smoothly in the first half of 2006 against the backdrop of increased volatility in some asset prices. Yields on nominal Treasury coupon securities rose about

2. These are services—such as foreign travel or the financial services provided by banks—for which no prices based on market transactions are available; the Bureau of Economic Analysis must impute or estimate these indexes.

70 basis points, on net, through early July as investors came to appreciate that economic conditions and inflation pressures required more monetary policy tightening than they had expected at the end of 2005. Equity prices advanced until mid-May but then reversed those gains. Apparently, evidence of increased inflationary pressures and some softer-than-expected data on economic activity induced market participants to revise down their longer-term outlook for business profits and to perceive greater risks to that outlook. With corporate balance sheets remaining strong and liquid, risk spreads on corporate bonds stayed low, an indication that the revision to the outlook had not sparked broad concerns about credit quality. Firms had ample access to funds, and business-sector debt expanded rapidly in the first quarter. The need to finance brisk merger and acquisition activity was one factor that reportedly induced nonfinancial businesses to tap the credit markets heavily. Bond issuance picked up noticeably, and commercial and industrial loans increased robustly. Banks continued to ease terms and standards on such loans. Household debt expanded further in the first quarter amid rising house prices and brisk cash-out refinancing activity. As was the case in 2005, the M2 monetary aggregate has advanced moderately so far in 2006.

Interest Rates

The FOMC increased the target federal funds rate 25 basis points at each of its four meetings this year. These actions brought the rate to 5¼ percent, about 60 basis points above the rate expected at the end of last year for early July. In contrast to the situation earlier in the tightening cycle, when it was evident to investors that considerable monetary policy accommodation was in place and had to be removed, market participants more recently have had to focus to a greater degree on economic data releases and their implications for the outlook for economic growth and inflation to form expectations about near-term policy. Although the information currently available suggests that growth of real output slowed appreciably in the second quarter, incoming price data have pointed to greater-than-expected inflationary pressures throughout the first half of the year. Investors anticipated that the FOMC would act to counter such pressures, and the expected policy path moved upward, on balance, over the first half of 2006. Nevertheless, market participants currently appear to expect the target federal funds rate to ease after the end of the year. Despite investors' apparent awareness that monetary policy decisions increasingly depend on the implications of incoming information for the economic outlook, the implied volatility on short-term Eurodollar rates calculated from option prices has remained near the low end of its historical range.

Yields on nominal Treasury coupon securities rose about 70 basis points across the maturity spectrum through early July, in part because of the expectations for firmer policy. In addition, it appears that a modest rebound in term premiums, including investor compensation for inflation risk, may have contributed to the rise in longer-term rates; still, estimated premiums remain low by historical standards. Yields on inflation-indexed Treasury securities rose less than those on their nominal counterparts, leaving inflation compensation at medium- and long-term horizons 20 to 30 basis points higher than at the turn of the year.

In the corporate bond market, yields on investment-grade securities moved about in line with those on comparable-maturity Treasury securities through early July. In contrast, those on speculative-grade securities rose only about 40 basis points; as a result, risk spreads were 30 basis points lower in that segment of the market. The narrowness of high-yield spreads was likely a reflection of investors' sanguine views about corporate credit quality over the medium term, given the strength of business balance sheets and the outlook for continued economic expansion.

Equity Markets

Broad equity indexes changed little, on net, through early July. Stock prices were boosted up to the first part of May by an upbeat economic outlook and by strong corporate earnings in the first quarter. However, those gains were subsequently reversed as incoming data clouded the prospects for economic growth and continued to point to upward pressures on inflation; the drop in share prices was led by stocks that had logged the largest gains in the previous months, including those of firms with small capitalizations and of firms in cyclically sensitive sectors. A measure of the equity risk premium—computed as the difference between the twelve-month forward earnings–price ratio for the S&P 500 and an estimate of the real long-term Treasury yield—has increased slightly so far this year and remains near the high end of its range of the past two decades. The implied volatility of the S&P 500 calculated from option prices spiked temporarily in late May and early June and remained somewhat elevated compared with its levels earlier in the year.

Net inflows to equity mutual funds were very strong through April, as investors were evidently attracted by the solid performance of the equity market up to that point. In May and June, however, investors withdrew funds as share prices began to sag.

Debt and Financial Intermediation

In the first quarter of 2006, the total debt of domestic nonfinancial sectors expanded at an annual rate of 11 percent. The household, business, and federal government components all increased at double-digit rates, while state and local government debt advanced at about a 6 percent pace. Preliminary data suggest somewhat slower growth of the debt of nonfinancial sectors in the second quarter. The slowdown is particularly noticeable in the federal and state and local government sectors, where strong tax receipts held down borrowing. The available data also point to somewhat reduced growth of nonfinancial business debt in the second quarter.

Commercial bank credit increased at an annual rate of about 11 percent in the first quarter of 2006, a little faster than in 2005, and picked up further to an almost 13 percent pace in the second quarter. A continued rapid increase in business loans was likely supported by brisk merger and acquisition activity, rising outlays for investment goods, ongoing inventory accumulation, and an accommodative lending environment. Growth in commercial mortgages was also strong, as fundamentals in that sector continued to improve. Despite a slowing of housing activity in recent months, residential mortgage holdings expanded robustly. However, higher short-term interest rates likely contributed to a runoff in loans drawn down under revolving home-equity lines of credit. Consumer loans adjusted for securitizations decelerated in the second quarter after rising at a solid pace in the first quarter.

Bank profitability remained solid, and asset quality continued to be excellent in the first quarter. Profits were supported by gains in non-interest income and reductions in loan-loss provisions that more than offset a rise in non-interest expenses. Delinquency and charge-off rates remained low across all loan types. Delinquency rates on residential mortgages on banks' books edged lower in the first quarter after moving up during 2005. Charge-off rates on consumer loans declined to the lowest level seen in recent years after a fourth-quarter surge in charge-offs on credit card loans that was associated with the implementation of the bankruptcy legislation in October of last year.

As the policy debate about the possibility of curbing the balance sheet growth of both Fannie Mae and Freddie Mac continued, the combined size of the mortgage investment portfolios at the two government-sponsored enterprises increased about 1 percent over the first five months of 2006.

The M2 Monetary Aggregate

In the first quarter of 2006, M2 increased at an annual rate of about 6½ percent, but its expansion moderated in the second quarter to a 2¾ percent pace, likely because of some slowing in the growth of nominal GDP. Rising short-term interest rates continued to push up the opportunity cost of holding M2 assets. Growth in liquid deposits, whose rates tend to adjust sluggishly to changes in market rates, was particularly slack. By contrast, the expansion in retail money market funds and, especially, small time deposits was brisk, as the yields on those instruments kept better pace with rising market interest rates. Despite apparently modest demand from abroad, currency growth was strong in the first quarter but has slowed since. The velocity of M2 rose at an annual rate of 2¼ percent in the first quarter and appears to have continued to rise in the second quarter.

International Developments

Foreign economic growth was strong in the first quarter of 2006 as the expansion spread to all major regions of the world. Accelerating domestic demand boosted growth in the foreign industrial countries, especially Canada and the euro area. Emerging-market economies continued to benefit from rapid export growth, and Chinese economic activity was also spurred by a surge in investment spending. Data for the second quarter suggest continued strong growth abroad but with moderation in some countries. Rising energy prices have pushed up inflation in many countries this year, but upward pressure on core inflation has generally continued to be moderate.

Foreign monetary policy tightened in the first half of this year in the context of solid growth and some heightened inflation concerns. The European Central Bank (ECB) raised its policy rate ¼ percentage point in March and again in June, citing rapid credit growth and the ECB's expectation of above-target inflation. At its July policy meeting, the Bank of Canada kept its target for the overnight rate unchanged at 4¼ percent, but it had increased its target for the overnight rate ¼ percentage point at each of its previous seven policy meetings. On July 14, the Bank of Japan (BOJ) ended its zero-interest-rate policy by raising its target for the call money rate to ¼ percent for the first time since 2001. Earlier, on March 9, the BOJ, announcing an end to its five-year-old policy of quantitative easing, said that it would set policy in the future to control inflation over the medium to long run, defined as one to two years ahead.

Long-term bond yields abroad have risen along with U.S. bond yields on indications of robust global growth and expectations of additional tightening of monetary policy. Ten-year sovereign yields have risen roughly 70 basis points in the euro area since the end of last year, while the increases on similar securities in Canada and the United Kingdom have been about 50 basis points. Part of the rise in yields abroad has been increased compensation for possible future inflation as measured by the difference in yield between ten-year nominal and inflation-indexed bonds. Yield spreads of emerging-market bonds over U.S. Treasuries narrowed somewhat early in the year, but that narrowing was more than reversed in the second quarter as investors apparently demanded greater compensation for risk amid uncertainties about economic growth and inflation.

The foreign exchange value of the dollar has declined about 4½ percent, on net, this year against a basket of the currencies of the major industrial countries but is down only about 1 percent, on net, against the currencies of the other important trading partners of the United States. Much of the dollar's downward move occurred at times when the market was focused on concerns about global current account imbalances. The dollar has recovered some ground since early May, as investors reportedly have engaged in flight-to-safety transactions into dollar-denominated assets in conjunction with the volatility in global commodity and asset markets. On net, the dollar has depreciated since the turn of the year about 6½ percent against the euro and sterling, 3 percent against the Canadian dollar, and 1½ percent against the Japanese yen. In contrast, the dollar has risen roughly 4 percent, on balance, against the Mexican peso this year. During the first half of this year, several smaller countries experienced episodes of substantial financial volatility that in some cases involved sharp depreciations in the exchange value of their currencies.

Through the first four months of 2006, a favorable economic outlook and low interest rates supported gains in equity prices in all major foreign countries. During May and early June, however, equity prices registered widespread declines, as market participants grew more concerned about inflation, monetary policy, and global economic growth. More recently, developments in the Middle East have weighed further on stock prices. On net, equity price indexes are up between 1 percent and 4 percent so far in 2006 in Europe and Canada, but they have fallen roughly 8 percent since year-end in Japan. Latin American and Asian emerging-market equity indexes, which had generally gained more than industrial-country indexes early in the year, have fallen more sharply since early May. Equity indexes in Mexico, Brazil, and Argentina have dropped between 12 percent and 15 percent—leaving them still between 5 percent and 7 percent higher so far this year—while stock prices in Korea have fallen about 9 percent, on net, for the year.

Industrial Economies

The Japanese economy has continued to strengthen this year, although economic growth has stepped down a bit from the comparatively strong rate recorded in 2005. Household consumption maintained a solid rate of growth in the first quarter, and private investment spending rose 11 percent. However, net exports, which previously had been an additional source of strength, did not contribute to growth in the first quarter; the growth of imports increased while export growth remained firm. The labor market in Japan improved further in April and May: The unemployment rate fell to 4 percent, and the ratio of job offers to applicants reached a thirteen-year high. Although the GDP deflator has continued to decline, other signs indicate that deflation is ending. In the first quarter of 2006, land prices in Japan's six largest cities rose 3.8 percent over their year-ago level, the first increase since 1991. Core consumer prices have shown small twelve-month increases over the past several months.

Real GDP in the euro area accelerated in the first quarter, expanding 2½ percent, a rate of growth somewhat above its average in recent years. The acceleration was spurred by strength in domestic demand, especially private consumption spending, which increased in the first quarter at double its pace in 2005. Retail sales were also strong at the start of the second quarter. The revival in household spending has been supported by a small rise in the growth rate of employment and by an improvement in employer and consumer perceptions of employment prospects. Private investment spending has remained strong in the euro area, and business sentiment has continued to brighten in recent months. Energy price increases have pushed euro-area consumer price inflation to about 2½ percent recently, a level above the ECB's 2 percent ceiling, but core inflation has remained near 1½ percent.

In the United Kingdom, real GDP expanded at an annual rate of 3 percent in the first quarter after rising about 1¾ percent in 2005. Consumer spending grew about 1½ percent, the same moderate pace seen last year. House prices, which remained relatively flat during late 2004 and most of 2005, picked up in late 2005 and have continued to rise in the first half of this year. The twelve-month change in consumer prices was 2.2 percent in May. Consumer prices have been boosted importantly by increases in energy prices over the past several months.

In Canada, real GDP grew at an annual rate of nearly 4 percent in the first quarter, an increase led by a jump in spending on consumer durables and housing. Investment in residential structures grew at its fastest rate in more than two years, and business investment continued to exhibit the strength observed in the previous two quarters. Indicators for the second quarter point generally to a deceleration of GDP. Housing starts in the second quarter were significantly below their elevated first-quarter levels; the merchandise trade balance declined, on balance, during the first five months of this year; and in the manufacturing sector, the volume of new orders and of shipments both fell in April. In contrast, in the second quarter, the labor market maintained its strength of the past year, and the unemployment rate has fallen to 6.2 percent, the lowest level in more than thirty years. Consumer prices rose 2.8 percent in the twelve months ending in May.

Emerging-Market Economies

In China, growth of real output was especially robust in the first half. Economic indicators suggest that fixed investment surged and that export growth continued to be strong. The rapid growth of investment prompted the Chinese government to impose a series of new measures to slow capital spending, including controls on credit and land use and stricter criteria for approving investment projects. In addition, to restrain credit, which has soared more than 15 percent over the past year, China's central bank raised the one-year bank lending rate in April and raised banks' reserve requirements ½ percentage point in June. The Chinese trade surplus widened in the first half of this year as exports accelerated. Chinese consumer price inflation is about 1½ percent, slightly above its pace in the second half of last year but well below the more than 5 percent rate seen in 2004.

Economic growth in India, Malaysia, and Hong Kong also was quite strong in the first quarter, although the pace of activity of some of the other Asian emerging-market economies has moderated a bit from last year's rapid rate. Concerns about inflationary pressures have increased, largely because of rising energy prices. In response, monetary policy has been tightened in some countries, including Korea, India, and Thailand.

In Mexico, strong performance in the industrial sector, an expansion in services output, and a recovery in agricultural production propelled real GDP growth to more than 6 percent at an annual rate in the first quarter. In addition, a surge in manufacturing exports boosted Mexico's trade and current account balances noticeably. Industrial production continued to increase early in the second quarter. In June, Mexican inflation was 3.2 percent, just above the center of the Bank of Mexico's target range of 2 percent to 4 percent. After easing policy nine times between August and April, the Bank of Mexico signaled in April that it would leave its policy rate unchanged for a time.

Real GDP growth in Brazil also increased in the first quarter, rising to 5¾ percent, and was supported by very strong performances in manufacturing, mining, and construction. The rate of inflation has been declining from a high of 8 percent reached in April 2005; in June, the twelve-month change in prices edged down to 4 percent. In late May, the central bank reduced its target for the overnight interest rate 50 basis points, to 15¼ percent, bringing the cumulative decline to 450 basis points since the current easing phase began last September. In the minutes of its late-May meeting, the policymaking committee said that the onset of market volatility over the past month had increased its uncertainty about the prospects for inflation and had thus prompted it to ease less than it would have otherwise.

In Argentina, output growth slowed slightly in the first quarter. Amid emerging capacity constraints, inflation rose to about 11 percent, up from 6 percent in 2004. The Argentine government has tried to hold down inflation, with limited success, through voluntary price agreements in several sectors. ■

Federal Reserve Operations

Banking Supervision and Regulation

The Federal Reserve has supervisory and regulatory authority over a variety of financial institutions and activities. It works with other federal and state supervisory authorities to ensure the safety and soundness of supervised financial institutions and the stability of U.S. financial markets as a whole.

In 2006, U.S. banking organizations reported record earnings despite tight net interest margins resulting from a persistently flat yield curve and heightened competition for deposits and loans. Credit quality indicators remained historically strong, although nonperforming assets increased, particularly in residential real estate portfolios. For a second consecutive year, there were no failures of insured banks. Banking supervisors focused on banking activities that could prove vulnerable in the event of an economic downturn. In particular, the federal banking agencies during the year issued guidance for supervised financial institutions on extensions of credit for nontraditional residential mortgages and for commercial real estate. Delinquencies among loans of these and most other types remained low.

Federal Reserve staff continued to work throughout the year with the other federal banking agencies to prepare for U.S. implementation of the Basel II capital accord.[1] In September, the agencies issued a joint notice of proposed rulemaking (NPR) describing proposals for implementing the Basel II framework in the United States. In December, they issued an NPR proposing revisions to capital requirements for trading book positions subject to the market risk capital rule. The agencies are also developing Basel II supervisory guidance for examiners and the banking industry.

Under the NPR implementing Basel II, the new capital framework would be mandatory for large, internationally active banking organizations and optional for all others. Federal banking supervisors expect that the vast majority of banking organizations will remain subject to the existing risk-based capital framework (Basel I). To update Basel I and mitigate some of the consequences of the differences between Basel I and Basel II, the agencies in December issued an NPR proposing changes to the Basel I framework that would be optional for banking organizations not subject to Basel II.

Scope of Responsibilities for Supervision and Regulation

The Federal Reserve is the federal supervisor and regulator of all U.S. bank holding companies, including financial holding companies formed under the authority of the 1999 Gramm-Leach-Bliley Act, and state-chartered commercial banks that are members of the Federal Reserve System. In overseeing these organizations, the Federal Reserve seeks

1. The Basel II capital accord, an international agreement formally titled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," was developed by the Basel Committee on Banking Supervision, which is made up of representatives of the central banks or other supervisory authorities of thirteen countries. The original document was issued in 2004; the original version and an updated version issued in November 2005 are available on the web site of the Bank for International Settlements (www.bis.org).

primarily to promote their safe and sound operation, including their compliance with laws and regulations.[2]

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

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

Supervision for Safety and Soundness

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

Examinations and Inspections

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

Inspections of bank holding companies, including financial holding companies, are built around a rating system introduced in 2005 that reflects the recent shift in supervisory practices for these organizations away from the historical analysis of financial condition toward a more dynamic, forward looking assessment of risk-management practices and financial factors. Under the system, known as RFI but more fully termed RFI/C(D), holding companies are assigned a composite rating (C) that is based on assessments of three components: risk management (R), financial condition (F), and potential

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

State Member Banks and Holding Companies, 2002–2006

Entity/Item	2006	2005	2004	2003	2002
State member banks					
Total number	901	907	919	935	949
Total assets (billions of dollars)	1,405	1,318	1,275	1,912	1,863
Number of examinations	761	783	809	822	814
By Federal Reserve System	500	563	581	581	550
By state banking agency	261	220	228	241	264
Top-tier bank holding companies					
Large (assets of more than $1 billion)					
Total number	448	394	355	365	329
Total assets (billions of dollars)	12,179	10,261	8,429	8,295	7,483
Number of inspections	566	501	500	454	439
By Federal Reserve System[1]	557	496	491	446	431
On site	500	457	440	399	385
Off site	57	39	51	47	46
By state banking agency	9	5	9	8	8
Small (assets of $1 billion or less)					
Total number	4,654	4,760	4,796	4,787	4,806
Total assets (billions of dollars)	947	890	852	847	821
Number of inspections	3,449	3,420	3,703	3,453	3,726
By Federal Reserve System	3,257	3,233	3,526	3,324	3,625
On site	112	170	186	183	264
Off site	3,145	3,063	3,340	3,141	3,361
By state banking agency	192	187	177	129	101
Financial holding companies					
Domestic	599	591	600	612	602
Foreign	44	38	36	32	30

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

impact (I) of the parent company and its nondepository subsidiaries on the subsidiary depository institution.[3] The fourth component, depository institution (D), is intended to mirror the primary regulator's rating of the subsidiary depository institution.

In managing the supervisory process, the Federal Reserve takes a risk-focused approach that directs resources to (1) those business activities posing the greatest risk to banking organizations and (2) the organizations' management processes for identifying, measuring, monitoring, and controlling risks. The key features of the supervision program for large complex banking organizations (LCBOs) are (1) identifying those LCBOs that are judged, on the basis of their shared risk characteristics, to present the highest level of supervisory risk to the Federal Reserve System; (2) maintaining continual supervision of these organizations so that the Federal Reserve's assessment of each organization's condition is current; (3) assigning to each LCBO a supervisory team composed of Reserve Bank staff members who have skills appropriate for the organization's risk profile (the team leader is the System's central point of contact for the organization, has responsibility for only one LCBO, and is supported by specialists capable of evaluating the

3. Each of the first two components has four subcomponents: *Risk Management*—Board and Senior Management Oversight; Policies, Procedures, and Limits; Risk Monitoring and Management Information Systems; and Internal Controls. *Financial Condition*—Capital; Asset Quality; Earnings; and Liquidity.

risks of LCBO business activities and functions); and (4) promoting System-wide and interagency information-sharing through automated systems.

For other banking organizations, the risk-focused supervision program provides that examination procedures are tailored to each banking organization's size, complexity, and risk profile. As with the LCBOs, examinations entail both off-site and on-site work, including planning, pre-examination visits, detailed documentation, and examination reports tailored to the scope and findings of the examination.

State Member Banks

At the end of 2006, 901 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented approximately 12 percent of all insured U.S. commercial banks and held approximately 14 percent of all insured commercial bank assets in the United States.

The guidelines for Federal Reserve examinations of state member banks are fully consistent with section 10 of the Federal Deposit Insurance Act, as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and by the Riegle Community Development and Regulatory Improvement Act of 1994. A full-scope, on-site examination of these banks is required at least once a year, although certain well-capitalized, well-managed organizations having total assets of less than $250 million may be examined once every eighteen months. The Financial Services Regulatory Relief Act of 2006, signed into law in October, authorized the federal banking agencies to raise the total asset threshold for certain institutions from $250 million to $500 million. Interim rules that will incorporate this change into existing regulations are being developed. The Federal Reserve conducted 500 exams of state member banks in 2006.

Bank Holding Companies

At year-end 2006, a total of 5,825 U.S. bank holding companies were in operation, of which 5,102 were top-tier bank holding companies. These organizations controlled 6,106 insured commercial banks and held approximately 96 percent of all insured commercial bank assets in the United States.

Federal Reserve guidelines call for annual inspections of large bank holding companies as well as complex smaller companies. In judging the financial condition of the subsidiary banks owned by holding companies, Federal Reserve examiners consult examination reports prepared by the federal and state banking authorities that have primary responsibility for the supervision of those banks, thereby minimizing duplication of effort and reducing the supervisory burden on banking organizations. Noncomplex bank holding companies with consolidated assets of $1 billion or less are subject to a special supervisory program that permits a more flexible approach.[4] In 2006, the Federal Reserve conducted 557 inspections of large bank holding companies and 3,257 inspections of small, noncomplex bank holding companies.

Financial Holding Companies

Under the Gramm-Leach-Bliley Act, bank holding companies that meet certain capital, managerial, and other re-

4. The program was implemented in 1997 and modified in 2002. See SR letter 02-01 for a discussion of the factors considered in determining whether a bank holding company is complex or noncomplex (www.federalreserve.gov/boarddocs/srletters/).

quirements may elect to become financial holding companies and thereby engage in a wider range of financial activities, including full-scope securities underwriting, merchant banking, and insurance underwriting and sales. The statute streamlines the Federal Reserve's supervision of all bank holding companies, including financial holding companies, and sets forth parameters for the supervisory relationship between the Federal Reserve and other regulators. The statute also differentiates between the Federal Reserve's relations with regulators of depository institutions and its relations with functional regulators (that is, regulators for insurance, securities, and commodities firms).

As of year-end 2006, 604 domestic bank holding companies and 44 foreign banking organizations had financial holding company status. Of the domestic financial holding companies, 38 had consolidated assets of $15 billion or more; 121, between $1 billion and $15 billion; 86, between $500 million and $1 billion; and 359, less than $500 million.

International Activities

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

Foreign Operations of U.S. Banking Organizations

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

At the end of 2006, 53 member banks were operating 675 branches in foreign countries and overseas areas of the United States; 34 national banks were operating 625 of these branches, and 19 state member banks were operating the remaining 50. In addition, 17 nonmember banks were operating 21 branches in foreign countries and overseas areas of the United States.

Edge Act and Agreement Corporations

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

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

At year-end 2006, 71 banking organizations, operating 9 branches, were chartered as Edge Act or agreement corporations. These corporations are examined annually.

U.S. Activities of Foreign Banks

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

As of year-end 2006, 178 foreign banks from 54 countries were operating 214 state-licensed branches and agencies, of which 8 were insured by the Federal Deposit Insurance Corporation (FDIC), and 45 OCC-licensed branches, of which 4 were insured by the FDIC. These foreign banks also owned 12 Edge Act and agreement corporations and 2 commercial lending companies; in addition, they held a controlling interest in 62 U.S. commercial banks. Altogether, the U.S. offices of these foreign banks at the end of 2006 controlled approximately 19 percent of U.S. commercial banking assets. These 178 foreign banks also operated 85 representative offices; an additional 59 foreign banks operated in the United States solely through a representative office.

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

In cooperation with the other federal and state banking agencies, the Federal Reserve conducts a joint program for supervising the U.S. operations of foreign banking organizations. The program has two main parts. One part involves examination of those foreign banking organizations that have multiple U.S. operations and is intended to ensure coordination among the various U.S. supervisory agencies. The other part is a review of the financial and operational profile of each organization to assess its general ability to support its U.S. operations and to determine what risks, if any, the organization poses through its U.S. operations. Together, these two processes provide critical information to U.S. supervisors in a logical, uniform, and timely manner. The Federal Reserve conducted or participated with state and federal regulatory authorities in 339 examinations in 2006.

Anti-Money-Laundering Examinations

The U.S. Department of the Treasury regulations (31 CFR 103) implementing the Bank Secrecy Act (BSA) generally require banks and other types of financial institutions to file certain reports and maintain certain records that are useful in criminal or regulatory proceedings. The BSA and separate Board regulations require banking organizations supervised by the Board to file reports on suspicious activity related to possible violations of federal law, including money laundering, terrorist financing, and other financial crimes. In addition, BSA and Board regulations require that banks develop written programs on BSA/anti-money-laundering compliance and that the programs be formally approved by bank boards of directors. An institution's compliance program must (1) establish a system of internal controls to ensure compliance with the BSA, (2) provide for independent compliance testing, (3) identify individuals responsible for coordinating and monitoring day-to-day compliance, and (4) provide training for personnel as appropriate.

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

Specialized Examinations

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

Information Technology Activities

In recognition of the importance of information technology to safe and sound operations in the financial industry, the Federal Reserve reviews the information technology activities of supervised banking organizations as well as certain independent data centers that provide information technology services to these organizations. All safety and soundness examinations include a risk-focused review of information technology risk management activities. During 2006, the Federal Reserve was the lead agency in 1 cooperative, multiagency examination of a large, multiregional data processing servicer.

Fiduciary Activities

The Federal Reserve has supervisory responsibility for state member commercial banks and depository trust companies that together reported, at the end of 2006, $36 trillion of assets in various fiduciary or custodial capacities. Additionally, state member nondepository trust companies supervised by the Federal Reserve reported $33 trillion of assets held in a fiduciary or custodial capacity. During on-site examinations of fiduciary activities, an organization's compliance with laws, regulations, and general fiduciary principles and potential conflicts of interest are reviewed; its management and operations, including its asset- and account-management, risk-management, and audit and control procedures, are also evaluated. In 2006, Federal Reserve examiners conducted 97 on-site fiduciary examinations.

Transfer Agents and Securities Clearing Agencies

As directed by the Securities Exchange Act of 1934, the Federal Reserve conducts specialized examinations of those state member banks and bank holding companies that are registered with the Board as transfer agents. Among other things, transfer agents countersign and monitor the issuance of securities, register the transfer of securities, and exchange or convert securities. On-site examinations focus on the effectiveness of an organization's operations and its compliance with relevant securities regulations. During 2006, the Federal Reserve conducted on-site examinations at 15 of the 78 state member banks and bank holding companies that were registered as transfer agents and examined 1 state member limited-purpose trust company acting as a national securities depository.

Government and Municipal Securities Dealers and Brokers

The Federal Reserve is responsible for examining state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with Department of the Treasury regulations governing dealing and brokering in government securities. Twenty-five state member banks and 8 state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 2006, the Federal Reserve conducted 6 examinations of broker-dealer activities in government securities at these organizations. These examinations are generally conducted concurrently with the Federal Reserve's examination of the state member bank or branch.

The Federal Reserve is also responsible for ensuring that both state member banks and bank holding companies that act as municipal securities dealers comply with the Securities Act Amendments of 1975. Municipal securities dealers are examined pursuant to the Municipal Securities Rulemaking Board's rule G-16 at least once every two calendar years. Of the 20 entities that dealt in municipal securities during 2006, 9 were examined during the year.

Securities Credit Lenders

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

At the end of 2006, 602 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 210 of these lenders, and the remaining 392 were subject to limited Federal Reserve supervision. On the basis of regulatory requirements and annual reports, the Federal Reserve exempted 290 lenders from its on-site inspection program. The securities credit activities of the remaining 102 lenders were subject to either biennial or triennial inspection. Sixty inspections were conducted during the year.

Business Continuity

In 2006, the Federal Reserve continued its efforts to strengthen the resilience of the U.S. financial system in the event of unexpected disruptions. Throughout the year, the staff continued to work with financial institutions to assess implementation of the sound practices identified in the April 2003 “Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System,” a joint publication with the OCC and the Securities and Exchange Commission (SEC). During 2006, the agencies provided additional guidance to help institutions implement testing of their business continuity plans. The agencies continue to coordinate their efforts to ensure a consistent supervisory approach for business continuity practices.

Enforcement Actions and Special Examinations

The Federal Reserve has enforcement authority over the banking organizations it supervises and their affiliated parties. Enforcement actions may be taken to address unsafe and unsound practices or violations of any law or regulation. Formal enforcement actions include cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalties. In 2006, the Federal Reserve completed 37 formal enforcement actions. Civil money penalties totaling $212,050 were assessed. All civil money penalties, as directed by statute, are remitted to either the Department of the Treasury or the Federal Emergency Management Agency. Enforcement orders, which are issued by the Board, and written agreements, which are executed by the Reserve Banks, are made public and are posted on the Board’s web site (www.federalreserve.gov/boarddocs/enforcement).

In addition to taking these formal enforcement actions, the Reserve Banks completed 70 informal enforcement actions in 2006. Informal enforcement actions include memoranda of understanding and board of directors resolutions. Information about these actions is not available to the public.

Surveillance and Off-Site Monitoring

The Federal Reserve uses automated screening systems to monitor the financial condition and performance of state member banks and bank holding companies between on-site examinations. Such monitoring and analysis helps direct examination resources to institutions that have higher risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities.

In January 2006, the Federal Reserve replaced its primary off-site monitoring tool, SEER (System to Estimate Examination Ratings), with the Supervision and Regulation Statistical Assessment of Bank Risk model (SR-SABR). Drawing primarily on the financial data that banks report on their Reports of Condition and Income (Call Reports), SR-SABR uses econometric techniques to identify banks that report financial characteristics weaker than those of other banks assigned similar supervisory ratings. To supplement the SR-SABR screening, the Federal Reserve also monitors various market data, including equity prices, debt spreads, agency ratings, and measures of expected default frequency, to gauge market perceptions of the risk in banking organizations. In addition, the Federal Reserve prepares quarterly Bank Holding Company Performance Reports (BHCPRs) for use in monitoring and inspecting supervised banking organizations. The reports, which are compiled from data provided by large bank holding companies in quarterly regulatory reports (FR Y-9C and FR Y-9LP), contain, for individual companies, financial statistics and comparisons with peer companies. BHCPRs are made available to the public on the National Information Center web site, which can be accessed at www.ffiec.gov.

During the year, four major upgrades to the web-based Performance Report Information and Surveillance Monitoring (PRISM) application were completed. PRISM is a querying tool used by Federal Reserve analysts to access and display financial, surveillance, and examination data. In the analytical module, users can customize the presentation of institutional financial information drawn from Call Reports, Uniform Bank Performance Reports, FR Y-9 statements, BHCPRs, and other regulatory reports. In the surveillance module, users can generate reports summarizing the results of surveillance screening for banks and bank holding companies. The upgrades made more regulatory data available for querying, added the results of surveillance screens (including SR-SABR), added new search options, and improved the user interface.

The Federal Reserve works through the Federal Financial Institutions Examination Council (FFIEC) Task Force on Surveillance Systems to coordinate surveillance activities with the other federal banking agencies.[5]

Technical Assistance

In 2006, the Federal Reserve continued to provide technical assistance on bank supervisory matters to foreign central banks and supervisory authorities. Technical assistance involves visits by Federal Reserve staff members to foreign authorities as well as consultations with foreign supervisors who visit the Board or the Reserve Banks. Technical assistance in 2006 was concentrated in Latin America, Asia, and former Soviet bloc countries. The Federal Reserve, along with the OCC, the FDIC, and the Department of the Treasury, was also an active participant in the Middle East and North Africa Financial Regulators' Training Initiative, which is part of the U.S. government's Middle East Partnership Initiative.

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

The Federal Reserve is also an associate member of the Association of Supervisors of Banks of the Americas (ASBA), an umbrella group of bank supervisors from countries in the Western Hemisphere. The group, headquartered in Mexico, promotes communication and cooperation among bank supervisors in the region; coordinates training programs throughout the region, with the help of national banking supervisors and international agencies; and aims to help members develop banking laws, regulations, and supervisory practices that conform to international best practices. The Federal Reserve contributes significantly to ASBA's organizational management and to its training and technical assistance activities.

5. The federal banking agencies that are members of the FFIEC are the Federal Reserve Board, the FDIC, the NCUA, the OCC, and the OTS.

Supervisory Policy

The Federal Reserve's supervisory policy function is responsible for developing guidance for examiners and banking organizations as well as regulations for banking organizations under the Federal Reserve's supervision. Staff members participate in supervisory and regulatory forums, provide support for the work of the FFIEC, and participate in international forums such as the Basel Committee on Banking Supervision, the Joint Forum, and the International Accounting Standards Board.

Capital Adequacy Standards

Risk-Based Capital Standards for Certain Internationally Active Banking Organizations

On September 25, 2006, the Federal Reserve, OCC, FDIC, and OTS published a joint notice of proposed rulemaking (NPR) setting forth their views on Basel II and seeking public comment on the U.S. plan for implementing the agreement. Under the proposal, the basic minimum risk-based capital ratio format—regulatory capital divided by risk-weighted assets—would be maintained, with the minimum for tier 1 capital set at 4 percent and the minimum for total qualifying capital set at 8 percent. The primary differences between the current and proposed rules are the internal-ratings-based methodologies used to calculate risk-weighted assets and the advanced measurement approach for operational risk under Basel II. Banking organizations using the methods set forth in the NPR would also be subject to certain public disclosure requirements, to foster transparency and market discipline. All banking organizations, including those using the internal-ratings-based approach for credit risk and the advanced measurement approach for operational risk, would continue to be subject to the tier 1 leverage ratio requirement and the market risk capital rule, if applicable, as well as the prompt corrective action rules.

Revisions to Market Risk Capital Rule

On September 25, 2006, the agencies issued for public comment a notice of proposed rulemaking proposing revisions to the market risk capital rule used by the OCC, Board, and FDIC since 1997 for banking organizations having significant exposure to market risk. Under the market risk capital rule, certain banking organizations are required to calculate a capital requirement for the general market risk of their covered positions and the specific risk of their covered debt and equity positions. The proposed revisions would enhance the rule's risk sensitivity, require the market risk capital charge to reflect any incremental default risk of traded positions, and require public disclosure of certain qualitative and quantitative market risk information. The comment period will end on January 23, 2007.

Risk-Based Capital Standards for Banking Organizations Not Subject to Basel II

On December 26, 2006, the banking agencies issued for public comment an NPR proposing modifications to Basel I that would be optional for banking organizations not subject to Basel II. The proposals aim to enhance risk sensitivity without unduly increasing regulatory burden. They would expand the number of risk-weight categories, allow the use of external credit ratings to risk-weight certain exposures, expand the range of recognized collateral and eligible guarantors, use loan-to-value (LTV) ratios to risk-weight residential mortgages, increase the credit conversion factor for certain commitments having an original maturity of one year or less, assess a capital charge for early amortizations in securitizations of revolving credit exposures, and remove the 50 percent limit on the risk weight for certain over-the-counter derivatives transactions. The comment period for the NPR will end on March 26, 2007.

Other Capital Issues

Board staff conduct supervisory analyses of innovative capital instruments and novel transactions to determine whether such instruments qualify for inclusion in tier 1 capital.[6] Much of this work in 2006 involved evaluating enhanced forms of trust preferred securities that bank holding companies developed in order to be granted more credit for equity by the rating agencies under the Board's 2005 revisions to the rule on the qualifying components of tier 1 capital.

Staff members also identify and address supervisory concerns related to supervised banking organizations' capital issuances and work with the Reserve Banks to evaluate the overall composition of banking organizations' capital. In this work, the staff often must review the funding strategies proposed in applications for acquisitions and other transactions submitted to the Federal Reserve by banking organizations.

Accounting Policy

The supervisory policy function is also responsible for monitoring major domestic and international proposals, standards, and other developments affecting the banking industry in the areas of accounting, auditing, internal controls, disclosure, and supervisory financial reporting. Federal Reserve staff members interact with key entities in the accounting and auditing professions, including standards-setters and accounting firms, the other banking agencies, and the banking industry, and issue supervisory guidance as appropriate.

During 2006, the Federal Reserve, together with the other banking agencies, issued a comment letter to the Financial Accounting Standards Board (FASB) on its then-proposed Statement of Financial Accounting Standards titled *The Fair Value Option for Financial Assets and Financial Liabilities*.[7] The agencies also jointly issued guidance on loan and lease losses and on limitations on the liability of external auditors.

Policy Statement on the Allowance for Loan and Lease Losses

In December the Federal Reserve, FDIC, NCUA, OCC, and OTS issued "Interagency Policy Statement on the Allowance for Loan and Lease Losses," which updates and replaces earlier guidance on the methodology for calculating the allowance for loan and lease losses (ALLL). Revisions were made to ensure that policy is consistent with generally accepted accounting principles and with recent supervisory guidance related to the ALLL. Updated in the guidance are the responsibilities of boards of directors, management, and banking organization examiners; factors to be considered in estimating the ALLL; and the objectives and elements of an effective loan review system, including a sound credit-grading system. The guidance

6. Tier 1 capital comprises common stockholders' equity and qualifying forms of preferred stock, less required deductions such as goodwill and certain intangible assets.

7. The FASB issued the final standard, Statement of Financial Accounting Standard No. 159, in February 2007.

also reiterates the points of agreement between the SEC and the banking agencies since 1999. To assist in application of the revised guidance, the agencies also issued a supplemental document anticipating frequently asked questions.

Advisory on Limitations on the Liability of External Auditors

The Federal Reserve, FDIC, NCUA, OCC, and OTS in May issued "Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagements." The guidance addresses safety and soundness concerns that may arise when financial institutions enter into external audit contracts that limit the auditor's liability for audit services. Specifically, the guidance informs financial institutions that the inclusion of certain auditor liability limitations in external audit contracts (typically referred to as engagement letters) for audits of financial statements, audits of internal control over financial reporting, or attestations on management's assessment of internal control over financial reporting is generally unsafe and unsound.

Bank Secrecy Act and Anti–Money Laundering

In 2006, the FFIEC updated the *Bank Secrecy Act/Anti–Money Laundering Examination Manual* issued in 2005 by adding sections on risk assessment and automated clearinghouse transactions, updating the section on trade finance, and incorporating regulatory changes. The manual continues to contain an overview of Bank Secrecy Act (BSA) and anti-money-laundering requirements and supervisory expectations, resource materials, and examination procedures and to emphasize a banking organization's responsibility to establish and implement a risk-based approach to complying with the BSA.

In January, the Federal Reserve, the Department of the Treasury's Financial Crimes Enforcement Network, and the other federal banking agencies issued guidance on sharing Suspicious Activity Reports (SARs) with head offices or controlling companies. The guidance confirmed that a U.S. branch or agency of a foreign bank may disclose a SAR to its head office outside the United States. Similarly, a U.S. bank or savings association may disclose a SAR to its controlling company, whether domestic or foreign.

In March, the Federal Reserve issued a final rule amending Regulation K (International Banking Operations) to conform the Board's regulations to BSA requirements and to clarify that Edge and agreement corporations and U.S. branches, agencies, and representative offices of foreign banks supervised by the Federal Reserve must establish and maintain procedures reasonably designed to ensure and monitor compliance with the BSA and its implementing regulations.

In April, the Federal Reserve and the other federal banking agencies entered into a memorandum of understanding with the Office of Foreign Assets Control within the Department of the Treasury to facilitate information-sharing and to further enhance interagency coordination in implementing U.S. sanctions rules.

International Guidance on Supervisory Policies

As a member of the Basel Committee on Banking Supervision (Basel Committee), the Federal Reserve participates in efforts to advance sound supervisory policies for internationally active banking organizations and to improve the stability of the international banking system. In 2006, the Federal Reserve continued to work cooperatively on Basel II, the 2004 accord to revise the international capital regime, and to develop international supervisory guidance. The Federal Reserve also continued to participate in Basel Committee working groups to address issues not fully resolved in the Basel II framework.

Risk Management

The Federal Reserve contributed to supervisory policy papers, reports, and recommendations issued by the Basel Committee during 2006 that were generally aimed at improving the supervision of banking organizations' risk-management practices.[8]

- "Enhancing Corporate Governance for Banking Organizations," final paper issued in February, updating guidance published in 1999
- "Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework—Comprehensive Version," published in June

Core Principles for Effective Banking Supervision

The Core Principles, developed by the Basel Committee in 1997, have become the de facto international standard for sound prudential regulation and supervision of banks. In 2006, the Federal Reserve participated in a Basel Committee effort to update the Core Principles in light of the significant changes in international banking regulation and experience gained since the principles were last revised in 1999. The revised guidance, "Core Principles for Effective Banking Supervision," was issued in October.

Joint Forum

In 2006, the Federal Reserve also continued to participate in the Joint Forum—a group established under the aegis of the Basel Committee to address issues related to the banking, securities, and insurance sectors, including the regulation of financial conglomerates. It is made up of representatives of the Basel Committee, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. The Federal Reserve contributed to the following supervisory policy papers, reports, and recommendations issued by the Joint Forum during 2006.[9]

- "Regulatory and Market Differences: Issues and Observations," issued in May
- "The Management of Liquidity Risk in Financial Groups," issued in May
- "High-Level Principles for Business Continuity," issued in August

International Accounting

The Federal Reserve participates in the Basel Committee's Accounting Task Force (ATF) and represents the Basel Committee at international meetings on accounting, auditing, and disclosure issues affecting global banking organizations. During 2006, Federal Reserve staff were involved in the development of two key Basel Committee documents issued to national supervisors and also of various comment letters related to accounting and auditing that were submitted to the International Accounting

8. Papers issued by the Basel Committee can be accessed via the Bank for International Settlements web site at www.bis.org.

9. Papers issued by the Joint Forum can be accessed via the Bank for International Settlements web site at www.bis.org.

Standards Board and the International Auditing and Assurance Standards Board.

The Basel Committee document "Supervisory Guidance on the Use of the Fair Value Option for Financial Instruments by Banks," issued in June, provides guidance on the prudential supervision of banks in their implementation of the fair value option included in the amended International Accounting Standard (IAS) 39, which became effective January 1, 2006. Under IAS 39, the fair value option allows an organization to irrevocably elect, at the date of purchase, a fair value measurement for certain financial instruments and to record in current earnings the gains and losses resulting from changes in fair value.

The Basel Committee document "Sound Credit Risk Assessment and Valuation for Loans," issued in June, provides guidance on assessing credit risk and accounting for loan impairment. Specifically, the document addresses supervisory expectations for, and supervisory evaluations of, a banking organization's establishment and support of its loan-loss-allowance accounts.

Response to Hurricane Katrina

Since Hurricane Katrina, the federal banking agencies—the Federal Reserve, FDIC, NCUA, OCC, and OTS—and the state banking agencies in Alabama, Louisiana, and Mississippi have worked together to monitor and support the recovery efforts of financial institutions and their customers in the U.S. Gulf Coast region. In 2006, the interagency efforts included

- developing examiner guidance on the agencies' expectations related to assessments of the financial condition of institutions affected by the hurricane;
- conducting a public service campaign encouraging individuals affected by Hurricane Katrina to contact their lenders (and also issuing a statement encouraging financial institutions to work with their borrowers to assist them in their financial recovery); and
- releasing "Lessons Learned from Hurricane Katrina: Preparing Your Institution for a Catastrophic Event," a booklet describing financial institutions' experiences with Hurricane Katrina and the lessons they learned that other institutions might find helpful in considering their readiness for a catastrophic event.

Credit Risk Management

The Federal Reserve works with the other federal banking agencies to develop guidance on the management of credit risk.

Real Estate Appraisals

Under the federal banking agencies' regulations on real estate appraisals, regulated institutions must ensure that the appraisals they use in connection with federally related transactions adhere to the Uniform Standards of Professional Appraisal Practice (USPAP). In June 2006, the Federal Reserve, FDIC, NCUA, OCC, and OTS issued an interagency statement informing regulated institutions that the Appraisal Standards Board of the Appraisal Foundation had made significant revisions to USPAP, effective July 1, 2006; providing an overview of the revisions; and discussing the ramifications of the revisions for the institutions' compliance with the regulations.

Home Equity Lending

In September, the Federal Reserve, FDIC, NCUA, OCC, and OTS issued an addendum to guidance issued in 2005—"Interagency Credit Risk Management Guidance for Home Equity Lending"—that provided additional guidance on managing the risks associated with open-end home equity lines of credit (HELOCs) that have interest-only or negative amortization features. While such HELOCs may give consumers some flexibility, the agencies are concerned that consumers may not fully understand the product terms and associated risks. The addendum addressed the timing and content of communications with consumers that are obtaining HELOCs having these features and clarified the agencies' expectations for assessing borrower repayment capacity.

Nontraditional Mortgage Products

In September, the Federal Reserve, FDIC, NCUA, OCC, and OTS issued guidance, titled "Interagency Guidance on Nontraditional Mortgage Product Risks," that addresses risk-management and consumer disclosure practices that institutions should employ to effectively assess and manage the risks associated with residential mortgage loans that allow borrowers to defer repayment of principal and, sometimes, interest (referred to as nontraditional mortgage loans). Specifically, the guidance states that regulated institutions should

- ensure that loan terms and underwriting standards are consistent with prudent lending practices (including, for example, that they evaluate the borrower's repayment capacity);
- recognize that many nontraditional mortgage loans, particularly those that have risk-layering features, are untested in a stressed environment and warrant strong risk-management standards, capital levels commensurate with risk, and allowances for loan and lease losses that reflect the collectibility of the portfolio; and
- ensure that consumers have sufficient information to understand the loan terms and the associated risks before they choose a product or a payment arrangement.

Commercial Real Estate Concentrations

In December, the Federal Reserve, FDIC, and OCC issued guidance titled "Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" to remind institutions that strong risk-management practices and appropriate levels of capital are important elements of a sound lending program, particularly if the institution has a concentration in commercial real estate loans. The guidance reinforced and enhanced existing regulations and guidelines for safe and sound real estate lending. (For more information, see the box "Guidance on Concentrations in Commercial Real Estate Lending.")

Complex Structured Finance Activities

During the year, the Federal Reserve, FDIC, OCC, OTS, and SEC prepared a final statement on sound practices for complex structured finance transactions (CSFTs). The statement, to be issued in early 2007, describes the types of internal controls and risk-management procedures that financial institutions should use to identify, manage, and address the heightened legal and reputational risks that may arise from certain CSFTs. (Excluded are most structured finance transactions that are familiar to participants in the financial markets and have well-established track records—such as standard public mortgage-backed securities and hedging-type transactions involving "plain vanilla" derivatives or collateralized debt obligations.) Financial institutions that engage in CSFTs should, as part of their process for approving transactions and new products, establish and maintain policies, procedures, and systems that are designed to identify elevated-risk CSFTs and should ensure that transactions and new products so identified are subject to greater review by appropriate levels of management. An institution should decline to participate in an elevated-risk CSFT if it determines that the transaction presents unacceptable risks or would result in a violation of applicable laws, regulations, or accounting principles.

Banks' Securities Activities

In December, the Board and the SEC requested comments on joint proposed rules that would help define the scope of securities activities that a bank may conduct without registering with the SEC as a securities broker. The Gramm-Leach-Bliley Act eliminated the blanket "broker" exception for banks that had been contained in section 3(a)(4) of the Securities Exchange Act of 1934, but it granted exceptions designed to allow banks to continue to engage in securities transactions for customers in connection with their normal trust, fiduciary, custodial, and other banking operations. The proposed rules would implement the most important "broker" exceptions. Comments on the proposal are due by March 26, 2007.

Small Bank Holding Company Threshold

In February, the Board issued a final rule that raises, from $150 million to $500 million, the asset-size threshold used to determine whether a bank holding company qualifies for (1) the Board's Small Bank Holding Company Policy Statement and (2) an exemption from the Board's risk-based and leverage capital adequacy guidelines for bank holding companies. The final rule also modifies the qualitative criteria used in determining whether a bank holding company that is under the asset-size threshold nevertheless would not qualify for the policy statement or the exemption. In addition, the final rule clarifies the treatment under the policy statement of subordinated debt associated with trust preferred securities.

Economic Growth and Regulatory Paperwork Reduction Act of 1996

The Economic Growth and Regulatory Paperwork Reduction Act of 1996 requires that the federal banking agencies review their regulations every ten years to identify and eliminate any unnecessary requirements imposed on insured depository institutions. (In addition, the Board periodically reviews each of its regulations.) During 2006, the Federal Reserve, OCC, FDIC, and OTS conducted the required review. Among other activities, they met with representatives of the banking industry and of consumer groups around the country to hear their concerns and their suggestions for reducing regulatory burden. The agencies expect to issue a final report in 2007.

Bank Holding Company Regulatory Financial Reports

The Federal Reserve requires that U.S. bank holding companies periodically submit reports providing financial and structure information. This information is essential to the supervision of the companies and the formulation of regulations and supervisory policies. It is

Guidance on Concentrations in Commercial Real Estate Lending

As any banker worth his or her salt knows, lending concentrations must be carefully identified, monitored, and managed. It is one of the basics of banking to understand the consequences of placing all your eggs in one basket. Naturally, supervisors from time to time have concerns about growing credit risk concentrations at banks and bankers' ability to manage them.

Susan Schmidt Bies, *Member*, Board of Governors
June 2006

In response to rising concentrations of commercial real estate (CRE) loans at many financial institutions, the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation on December 12, 2006, issued guidance promoting sound risk-management practices in this sector.[1] In the guidance, titled "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices," the agencies recognize that financial institutions play a vital role in funding real estate development in their communities and can do so in a profitable way. However, as an institution's concentration in CRE lending increases, management should understand its possible exposure to a downturn in the CRE market or to other adverse market and economic events.

Supervisors have observed over the past decade that CRE concentrations have been rising at many institutions, especially at small and medium-size banks. Between 1993 and 2005, CRE loans as a proportion of total equity plus reserves rose from 145 percent to 280 percent for commercial banks with assets between $100 million and $1 billion and from 120 percent to 230 percent for commercial banks with assets of $1 billion to $10 billion. Experience has shown that credit concentrations add a dimension of risk that compounds the simple risk inherent in individual loans.

1. As defined by the guidance, CRE loans include land development and construction loans (including one- to four-family residential and commercial construction loans) and other land loans; loans secured by multifamily property; and loans secured by nonfarm nonresidential property for which 50 percent or more of the source of repayment is third-party, nonaffiliated, rental income or the proceeds of the sale, refinancing, or permanent financing of the property. The guidance also applies to some loans to real estate investment trusts and unsecured loans to developers.

also used in responding to requests from Congress and the public for information on bank holding companies and their nonbank subsidiaries. Foreign banking organizations are also required to periodically submit reports to the Federal Reserve.

The FR Y-9 series of reports provides standardized financial statements for bank holding companies on both a consolidated basis and a parent-only basis. The reports are used to detect emerging financial problems, to review performance and conduct pre-inspection analysis, to monitor and evaluate risk profiles and capital adequacy, to evaluate proposals for bank holding company mergers and acquisitions, and to analyze the holding company's overall financial condition. The nonbank subsidiary reports—FRY-11, FR 2314, and FR Y-7N—help the Federal Reserve

Further, supervisors are concerned that risk-management practices at some institutions may not have kept pace with the growth of CRE concentrations.

The agencies developed the 2006 CRE guidance to remind financial institutions that strong risk-management practices and appropriate capital levels are important elements of a sound CRE lending program, particularly when an institution has a concentration in CRE loans or has experienced rapid portfolio growth. The guidance provides the agencies' examiners with two supervisory screening criteria designed to identify institutions whose CRE concentrations may require additional scrutiny:

- Total loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or
- Total CRE loans represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's commercial real estate loan portfolio has increased 50 percent or more during the previous thirty-six months.

These screening criteria serve as a starting point for a dialogue between the agencies' supervisory staff and an institution's management about the level and nature of CRE concentration risk. The guidance focuses on CRE loans for which the risk of default is sensitive to CRE market demand, capitalization rates, vacancy rates, or rents.

The agencies recognize that different types of CRE lending present different levels of risk. For example, a well-structured loan for a multifamily housing project would generally have a lower risk profile than a loan for an office building to be built on speculation. The guidance acknowledges that institutions are in the best position to make such assessments about the level and nature of concentration risk in their CRE portfolios.

Building upon the agencies' existing regulations and guidelines for real estate lending and loan portfolio management, the guidance describes the key elements that an institution should address in the areas of board and management oversight, portfolio management, management information systems, market analysis, credit-underwriting standards, portfolio stress-testing and sensitivity analysis, and the credit-risk review function.

The Federal Reserve recognizes that commercial real estate lending is a critically important activity that has become the "bread and butter" business of many small and medium-size banks. Supervisors emphasize that they did not intend the guidance to limit commercial real estate lending; rather, they expect that the guidance will encourage institutions to develop and maintain appropriate corporate-governance structures to address the risks posed by their lending strategies.

determine the condition of bank holding companies that are engaged in nonbank activities and also aid in monitoring the volume, nature, and condition of the companies' nonbank subsidiaries.

In March, several revisions to the FR Y-9C, FR Y-9LP, and FR Y-9SP reports were approved for implementation during 2006. Effective March 31, the asset-size threshold for filing the FR Y-9C and FR Y-9LP reports was raised from $150 million to $500 million, reducing the number of respondents by approximately 60 percent. Other FR Y-9C revisions effective March 31 included the elimination of a number of data items; the addition of data items on loans for purchasing and carrying securities, regulatory capital, and credit derivatives; and the removal of the FR Y-9C filing requirement for lower-tier bank holding companies having total assets of $1 billion or more. Revisions effective September 30 included new officer signature requirements and additional data items on mortgage banking activities and secured borrowings.

Effective June 30, the asset-size cap for the FR Y-9SP was raised from $150 million to $500 million, increasing the number of respondents by approximately 50 percent. Other FR Y-9SP revisions effective June 30 included the addition of two items identifying the total value of off-balance-sheet activities conducted directly or through a nonbank subsidiary and the total value of debt and equity securities registered with the SEC. Revised officer signature requirements for the FR Y-9SP were effective December 31.

In March, the Board also revised the asset-size threshold for the quarterly FR Y-11 and FR 2314 nonbank subsidiary reports, to make it consistent with the revised threshold for the FR Y-9C and to reduce reporting burden. Revising the threshold for the FR Y-11 reduced the number of quarterly respondents by approximately 30 percent; the revision had no immediate effect on the number of FR 2314 filers. Other FR Y-11 and FR 2314 revisions effective March 31 included the addition of a new equity capital component to the balance sheet for reporting partnership interest and, for the FR Y-11 only, the expansion of the scope of several loan items reported on the balance sheet memoranda.

Effective December 31, a new report was implemented: the Annual Report of Merchant Banking Investments Held for an Extended Period (FR Y-12A). The report collects data concerning merchant banking investments that are approaching the end of the holding period permissible under Regulation Y (Bank Holding Companies and Change in Bank Control).

Commercial Bank Regulatory Financial Reports

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

For the 2006 reporting period, the FFIEC implemented various revisions to the Call Report to streamline the reporting requirements and to add new items that focus on areas of increasing supervisory concern. The principal revisions included the collection of data related to the implementation of deposit insurance reform provisions, funding sources (Federal Home Loan Bank advances and other borrowings), and mortgage banking activities. The signature and attestation requirements were revised to add the chief financial officer, or equivalent, to the list of officials required to attest to and sign the Call Report.

In October, the FFIEC proposed revisions for the 2007 reporting period to address new safety and soundness considerations and to facilitate supervision. Among the proposed revisions are changes in data collection related to the deposit insurance assessment collection process; changes in generally accepted accounting principles (including certain financial instruments measured at fair value and principles for accounting for defined benefit pension and other post-retirement plans); and nontraditional mortgage products.

Supervisory Information Technology

Information technology supporting Federal Reserve supervisory activities is managed within the System supervisory information technology (SSIT) function in the Board's Division of Banking Supervision and Regulation. SSIT works through assigned staff at the Board and the Reserve Banks, as well as through System committees, to ensure that key staff members throughout the System participate in identifying requirements and setting priorities for IT initiatives.

In 2006, the SSIT function worked on the following strategic projects and initiatives: (1) align technology investments with business needs; (2) improve security of information-sharing technologies and provide for seamless collaboration in interagency efforts; (3) identify and implement improvements in the accessibility of technology to staff working in the field; (4) identify opportunities to converge and streamline IT applications, including key administrative systems, to provide consistent and seamless information; (5) evaluate and implement technologies (such as portals, search engines, and content management tools) to integrate supervisory and management information systems that support both office-based and field staff; and (6) enhance the information security framework for the supervisory function, improving both overall security and compliance with best-practices and regulatory requirements.

National Information Center

The National Information Center (NIC) is the Federal Reserve's comprehensive repository for supervisory, financial, and banking structure data and supervisory documents. NIC includes comprehensive data on banking structure throughout the United States; the National Examination Database (NED), which enables supervisory personnel and state banking authorities to access NIC data; the Banking Organization National Desktop (BOND), an application that facilitates secure, real-time electronic information-sharing and collaboration among federal and state banking regulators for the supervision of banking organizations; and the Central Document and Text Repository (CDTR), which contains documents supporting the supervisory processes.

The structure and supervisory data systems are continually being updated to extend their useful lives and improve business workflow efficiency. During 2006, the NED system was modified to begin collecting Bank Secrecy Act information in an automated format, to support Federal Reserve enforcement activities. In 2006, the BOND and CDTR systems were modified to provide further integration with the Federal Reserve's internal surveillance program, to provide additional support for the supervision of large financial institutions, and to allow integration of examinations of technology service providers. In addition, user authentication software was upgraded for external agency users, and use of the BOND and CDTR systems was extended to additional federal and state regulatory agencies.

Staff Development

The System Staff Development Program trains staff members at the Board, the Reserve Banks, state banking departments, and foreign supervisory authorities. Training is offered at the basic, intermediate, and advanced levels in several disciplines within bank supervision: safety and soundness, information technology, international banking, and consumer affairs. Classes are conducted in Washington, D.C., as well as at Reserve Banks and other locations. The Federal Reserve System also participates in training offered by the FFIEC and by certain other regulatory agencies. The System's involvement includes developing and implementing basic and advanced training in relation to various emerging issues as well as in specialized areas such as international banking, information technology, anti–money laundering, capital markets, payment systems risk, and real estate appraisal. In addition, the System co-hosts the World Bank Seminar for supervisors from developing countries.

In 2006, the Federal Reserve trained 3,619 students in System schools, 952 in schools sponsored by the FFIEC, and 24 in other schools, for a total of 4,595, including 312 representatives of foreign central banks and supervisory agencies (see table). The number of training days in 2006 totaled 23,321.

The System gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program, 605 state examiners were trained—308 in Federal Reserve courses, 293 in FFIEC programs, and 4 in other courses.

A staff member seeking an examiner's commission is required to take a first proficiency examination as well as a second proficiency examination in one of two specialty areas: safety and soundness or consumer affairs. In 2006, 190 examiners passed the first proficiency examination, and 61 passed the second proficiency examination: 53 the safety and soundness exam, and 8 the consumer affairs exam.

Regulation of the U.S. Banking Structure

The Federal Reserve administers several federal statutes that apply to bank holding companies, financial holding companies, member banks, and foreign banking organizations—the Bank Holding Company Act, the Bank Merger Act, the Change in Bank Control Act, the Federal Reserve Act, and the International Banking Act. In administering these statutes, the Federal Reserve acts on a variety of proposals that directly or indirectly affect the structure of the U.S. banking system at the local, regional, and national levels; the international operations of domestic banking organizations; or the U.S. banking operations of foreign banks. The proposals concern bank holding company formations and acquisitions, bank mergers, and other transactions involving bank or nonbank firms. In 2006, the Federal Reserve acted on 1,378 proposals, which represented 3,171 individual applications filed under the five administered statutes.

Bank Holding Company Act

Under the Bank Holding Company Act, a corporation or similar legal entity must obtain the Federal Reserve's approval before forming a bank holding company through the acquisition of one or more banks in the United States. Once formed, a bank holding company must receive Federal Reserve approval before acquiring or establishing additional banks. The act also identifies the

Training Programs for Banking Supervision and Regulation, 2006

Program	Number of sessions conducted: Total	Number of sessions conducted: Regional
Schools or seminars conducted by the Federal Reserve		
Core schools		
Banking and supervision elements	8	7
Financial analysis and risk management	8	7
Bank management	3	1
Report writing	15	15
Management skills	8	8
Conducting meetings with management	14	14
Other schools		
Credit risk analysis	5	4
Examination management	5	5
Real estate lending seminar	3	2
Senior forum for current banking and regulatory issues	2	2
Basel II corporate activities	3	2
Basel II operational risk	2	0
Basel II retail activities	3	1
Principles of fiduciary supervision	2	2
Commercial lending essentials for consumer affairs	1	1
Consumer compliance examinations I	2	0
Consumer compliance examinations II	2	2
CRA examination techniques	2	2
CA risk-focused examination techniques	2	2
Fair lending examination techniques	3	3
Foreign banking organizations seminar	1	1
Information systems continuing education	7	7
Asset liability management (ALM1)	2	2
Asset liability management (ALM2)	2	1
Fundamentals of interest rate risk management	8	8
Trading and operations	1	1
Technology risk integration	3	3
Leadership dynamics	6	4
Fundamentals of fraud	16	15
Information technology seminars[1]	11	11
Seminar for senior supervisors of foreign central banks[2] and 13 other international courses	34	26
Self-study or online learning[3]		
Orientation (core and specialty)	...	...
Self-study modules (26 modules)	...	...
Other agencies conducting courses[4]		
Federal Financial Institutions Examination Council	78	2
The Options Institute	1	1

1. Held at the IT Lab at the Chicago Reserve Bank.
2. Conducted jointly with the World Bank.
3. Self-study programs do not involve group sessions.
4. Open to Federal Reserve employees.

nonbanking activities permissible for bank holding companies; depending on the circumstances, these activities may or may not require Federal Reserve approval in advance of their commencement.

When reviewing a bank holding company application or notice that requires prior approval, the Federal Reserve may consider the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, and the applicant's ability to make available to the Federal Reserve information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home-country supervisor. In 2006, the Federal Reserve acted on 638 applications filed by bank holding companies to acquire a bank or a nonbank firm, or to otherwise expand their activities.

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

A bank holding company may repurchase its own shares from its shareholders. When the company borrows money to buy the shares, the transaction increases the company's debt and decreases its equity. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's capital adequacy guidelines. In 2006, the Federal Reserve reviewed 7 stock-repurchase proposals by bank holding companies.

The Federal Reserve also reviews elections from bank holding companies seeking financial holding company status under the authority granted by the Gramm-Leach-Bliley Act. Bank holding companies seeking financial holding company status must file a written declaration with the Federal Reserve. In 2006, 48 domestic financial holding company declarations and 7 foreign bank declarations were approved.

Bank Merger Act

The Bank Merger Act requires that all proposals involving the merger of insured depository institutions be acted on by the appropriate federal banking agency. The Federal Reserve has primary jurisdiction if the institution surviving the merger is a state member bank. Before acting on a merger proposal, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of the existing and combined organizations, the convenience and needs of the community(ies) to be served, and the competitive effects of the proposed merger. In 2006, the Federal Reserve approved 65 merger applications under the act.

As a result of enactment of the Financial Services Regulatory Relief Act of 2006, the Federal Reserve is no longer required for each proposed bank merger to either request competitive factors reports from the other federal banking and thrift regulatory agencies or provide reports on competitive factors to those other agencies. The Federal Reserve now must consider only the views of the U.S. Department of Justice regarding the competitive aspects of a proposed bank merger. In addition, the views of the Department of Justice need not be solicited for bank mergers involving affiliated insured depository institutions. Before these statutory changes occurred in the third quarter of 2006, the Federal Reserve had submitted 451 reports on competitive factors to the other agencies.

Change in Bank Control Act

The Change in Bank Control Act requires individuals and certain other parties that seek control of a U.S. bank or bank holding company to obtain approval from the appropriate federal banking agency before completing the transaction. The Federal Reserve is responsible for reviewing changes in the control of state member banks and bank holding companies. In its review, the Federal Reserve considers the financial position, competence, experience, and integrity of the acquiring person; the effect of the proposed change on the financial condition of the bank or bank holding company being acquired; the effect of the proposed change on competition in any relevant market; the completeness of the information submitted by the acquiring person; and whether the proposed change would have an adverse effect on the federal deposit insurance funds. In addition, with enactment of the Financial Services Regulatory Relief Act of 2006, the Federal Reserve must also consider the future prospects of the institution to be acquired: a proposed transaction should not jeopardize the stability of the institution or the interests of depositors. During its review of a proposed transaction, the Federal Reserve may contact other regulatory or law enforcement agencies for information about relevant individuals.

In 2006, the Federal Reserve approved 98 changes in control of state member banks and bank holding companies.

Federal Reserve Act

Under the Federal Reserve Act, a member bank may be required to seek Federal Reserve approval before expanding its operations domestically or internationally. State member banks must obtain Federal Reserve approval to establish domestic branches, and all member banks (including national banks) must obtain Federal Reserve approval to establish foreign branches. When reviewing proposals to establish domestic branches, the Federal Reserve considers, among other things, the scope and nature of the banking activities to be conducted. When reviewing proposals for foreign branches, the Federal Reserve considers, among other things, the condition of the bank and the bank's experience in international banking. In 2006, the Federal Reserve acted on new and merger-related branch proposals for 2,033 domestic branches and granted prior approval for the establishment of 7 new foreign branches.

State member banks must also obtain Federal Reserve approval to establish financial subsidiaries. These subsidiaries may engage in activities that are financial in nature or incidental to financial activities, including securities and insurance agency-related activities. In 2006, 1 application for a financial subsidiary was approved.

Overseas Investments by U.S. Banking Organizations

U.S. banking organizations may engage in a broad range of activities overseas. Many of the activities are conducted indirectly through Edge Act and agreement corporation subsidiaries. Although most foreign investments are made under general consent procedures that involve only after-the-fact notification to the Federal Reserve, large and other significant investments require prior approval. In 2006, the Federal Reserve approved 29 proposals for significant overseas investments by U.S. banking organizations. The Federal Reserve also approved 16 applications to make additional investments through an Edge

Act or agreement corporation, 1 application to establish an Edge Act corporation, and 2 applications to extend the corporate existence of an Edge Act corporation.

International Banking Act

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

In reviewing proposals, the Federal Reserve generally considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home-country supervisor. It also considers whether the home-country supervisor has consented to the establishment of the U.S. office; the financial condition and resources of the foreign bank and its existing U.S. operations; the managerial resources of the foreign bank; whether the home-country supervisor shares information regarding the operations of the foreign bank with other supervisory authorities; whether the foreign bank has provided adequate assurances that information concerning its operations and activities will be made available to the Federal Reserve, if deemed necessary to determine and enforce compliance with applicable law; whether the foreign bank has adopted and implemented procedures to combat money laundering and whether the home country of the foreign bank is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering; and the record of the foreign bank with respect to compliance with U.S. law. In 2006, the Federal Reserve approved 19 applications by foreign banks to establish branches, agencies, or representative offices in the United States.

Public Notice of Federal Reserve Decisions

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

Enforcement of Other Laws and Regulations

The Federal Reserve's enforcement responsibilities also extend to the disclosure of financial information by state member banks and the use of credit to purchase and carry securities.

Financial Disclosures by State Member Banks

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including annual and quarterly financial reports and proxy statements. By statute, the Board's financial disclosure rules must be substantially similar to those of the SEC. At the end of 2006, 17 state member banks were registered with the Board under the Securities Exchange Act of 1934.

Securities Credit

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

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

Federal Reserve Membership

At the end of 2006, 2,593 banks were members of the Federal Reserve System and were operating 53,938 branches. These banks accounted for 35 percent of all commercial banks in the United States and for 71 percent of all commercial banking offices. ■

Consumer and Community Affairs

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

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

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

Implementation of Statutes Designed to Inform and Protect Consumers

The Board of Governors writes regulations to implement federal laws involving consumer financial services and fair lending. The Board revises and updates these regulations to address the introduction of new products and technologies, to implement legislative changes to existing laws, and to address problems consumers may encounter in their financial transactions. To interpret and clarify the regulations, Board staff issue commentaries and other guidance.

During 2006, the Board published final amendments to its Regulation E, which implements the Electronic Fund Transfer Act, and the associated commentary to make the regulation applicable to payroll card accounts established through an employer to provide a consumer with electronic fund transfers of salary, wages, or other employee compensation on a recurring basis. The Board also amended Regulation E to clarify that a person, such as a merchant, must obtain a consumer's authorization to collect returned-item fees electronically from the consumer's account. The Board engaged in several rulemaking and other activities with the other federal banking agencies and the Federal Trade Commission (FTC). The Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) issued final guidance on the most recent amendments to the agencies' Community Reinvestment Act (CRA) regulations. The Board also issued joint final guidance with the OCC, the FDIC, the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) to address the risks associated with nontraditional mortgage products. In addition, the Board and the FTC jointly issued a report to Congress on the consumer dispute provisions of the Fair Credit Reporting Act.

Furthermore, the Board raised the dollar threshold that triggers additional requirements under the Home Ownership and Equity Protection Act and raised the exemption threshold for depository institutions required to collect data under the Home Mortgage Disclosure Act.

Amendments to Regulation E (Electronic Fund Transfers)

Payroll Cards

In August, the Board published final amendments to Regulation E that address payroll card accounts established through an employer on behalf of a consumer and to which recurring electronic fund transfers of salary, wages, or other employee compensation are made. Under the final rule, payroll card accounts are subject to the same requirements that apply to traditional transaction accounts under Regulation E; these requirements include a financial institution's duty to provide payroll-card account holders with initial disclosures, periodic statements, and error-resolution and liability provisions. For periodic statements, however, the final rule allows financial institutions to provide the specified account information electronically, and in writing upon the consumer's request, rather than through paper statements.

Regulation E applies to financial institutions that (1) hold an account belonging to a consumer or (2) both issue an access device (such as a debit card) to a consumer and agree with the consumer to provide electronic fund transfer (EFT) services. The final rule clarifies that the depository institution holding the consumer's funds in a payroll card account is a financial institution under the regulation. The final rule does not generally cover employers or third-party service providers. The mandatory compliance date for the final rule is July 1, 2007.

Returned-Item Fees

In December, the Board published a final rule amending Regulation E and its official staff commentary. These amendments clarify the consumer-authorization requirements for the electronic collection of returned-item fees. The final rule states that a person seeking to collect a fee for a returned check or any other item must obtain a consumer's authorization to initiate an EFT to collect this fee. This requirement applies to the person initiating the EFT, not to the consumer's account-holding financial institution. Consumer authorization is obtained when (1) a notice stating the specific amount of the fee (or explaining how the fee is calculated, if the fee may vary) and a statement that the fee will be collected via an EFT is provided to the consumer and (2) the consumer goes forward with the transaction. For point-of-sale transactions, the notice must be posted in a prominent and conspicuous location, and a copy of the notice must be given to the consumer to retain. The required copy of the notice may be given to the consumer at the time of the transaction or mailed to the consumer's address as soon as reasonably practicable after the EFT has been initiated.

Joint Guidance on the Community Reinvestment Act Regulations

In March, the Board, along with the FDIC and the OCC, issued joint final guidance to implement changes to the agencies' CRA regulations, which were effective in September 2005. The guidance answers frequently asked questions about the new CRA rules, including a new rule that provides CRA "community development" consideration for bank activities that revitalize or stabilize designated disaster areas. The guidance states that banks will receive consideration for activities they conduct within 36 months of an area's designation as a disaster area when such activities help to attract new, or to retain existing, businesses or residents to the area and are related to disaster recovery.

The guidance also implements a new rule that provides "community development" consideration for bank activities that revitalize or stabilize underserved or distressed middle-income rural areas. The guidance describes the types of activities that will receive consideration as well as how such activities will be evaluated. In addition, the guidance discusses the new community development test for intermediate small banks (banks that have assets of between $250 million and $1 billion).

Interagency Guidance on the Risks of Nontraditional Mortgage Products

In September, the Board, along with the OCC, the FDIC, the OTS, and the NCUA, issued final guidance to address the risks associated with the growing use of so-called nontraditional mortgage products, such as interest-only mortgages and payment-option adjustable-rate mortgages.[1] These products, which allow borrowers to defer repayment of the loan's principal and sometimes interest, are being offered to a wide spectrum of borrowers. Among other issues, the interagency guidance addresses concerns that some borrowers may not fully understand the risks of these products, including their potential for negative amortization.

Specifically, the agencies provided guidance in three primary areas: loan terms and underwriting standards, portfolio and risk-management practices, and consumer protection issues. The first section of the guidance advises financial institutions to ensure that their loan terms and underwriting standards for nontraditional mortgage products are consistent with prudent lending practices, which include considering whether a borrower has the capacity to repay a loan. The second section outlines the need for financial institutions to have strong risk-management standards, capital levels commensurate with the risk of their products and activities, and an allowance for loan and lease losses that reflects the collectibility of their loan portfolio. The third section describes recommended practices to ensure that financial institutions are providing consumers with clear and balanced information that allows them to understand the terms and associated risks of a loan before they choose a specific product or payment option. (See related box "Nontraditional Mortgages—Balancing Innovation, Regulation, and Education.")

Report on Compliance with Consumer Dispute Provisions of the Fair Credit Reporting Act

In August, the Board and the FTC issued a joint report to Congress pursuant to section 313(b) of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act). In addition to other changes, the FACT Act amended the Fair Credit Reporting Act (FCRA) to enhance the FCRA's consumer dispute provisions. The joint report describes the extent to which consumer reporting agencies (CRAs) and furnishers of information to CRAs comply with the consumer dispute provisions of the FCRA. Before writing the report, the Board and the FTC conducted a study that examined several sources of information: public comments from consumers, CRAs, and consumer and industry groups; consumer complaints sent to the federal financial institution regulatory agencies; bank examination data on FCRA compliance; and other studies,

1. See www.federalreserve.gov/boarddocs/press/bcreg/2006/20060929/default.htm.

Nontraditional Mortgages— Balancing Innovation, Regulation, and Education

Homeownership has long been viewed as a fundamental step to furthering personal and financial well-being. A home is often the largest and most important asset individuals and families acquire, and the equity earned on a home can, over time, provide homeowners with financial flexibility and security. Consumers have benefited from public policies to encourage and facilitate homeownership, as well as from innovations in the financial services industry that have increased both the number of lenders and types of home loans available. While increased competition and product choice provide consumers with new opportunities, they also present many challenges for both borrowers, who must be prepared to evaluate their options, and for regulators, who seek to ensure consumer protections without hindering market innovation through overly restrictive regulation.

In recent years, so-called nontraditional mortgages, including interest-only and payment-option adjustable-rate mortgages, have become increasingly popular. Originally designed as niche products to meet the needs of certain borrowers, such as wealthy customers or customers who have seasonal or other fluctuations in their incomes, nontraditional mortgages are now commonplace among more-typical borrowers. In 2006, nontraditional mortgages accounted for one-third of all mortgage originations, compared with only one-tenth of mortgage originations in 2003. Nontraditional mortgages can provide borrowers with greater flexibility by allowing them to repay only interest for a period of time or to choose among other repayment options, in contrast to a fully amortizing loan that requires fixed payments throughout the loan term. The interest rate and payments are adjusted later in the term of a nontraditional mortgage in order to recapture repayment of principal. Because nontraditional mortgages typically allow a borrower to make lower payments early in the loan, these loans have become increasingly popular in high-cost housing markets.

But nontraditional mortgages can also carry significant risk, including negative amortization, which occurs when the amount of the loan increases over time, and "payment shock," which occurs when interest rate adjustments result in a much higher payment later in the loan term. Further, reports of aggressive marketing practices for these loans, as well as reported incidents of consumers receiving inadequate or misleading loan disclosures, have raised concerns among consumer groups, financial institution regulatory agencies, and some lawmakers that nontraditional mortgages are inappropriately marketed to and used by some borrowers. However, the need to ensure that consumer protections are in place for nontraditional mortgages must be balanced with the desire to encourage innovation and flexibility in the mortgage industry.

In 2006, the Federal Reserve Board took a multifaceted approach to responding to consumer-related issues in today's mortgage market, including the risks presented by the growing use of nontraditional mortgage products. During the summer, the Board convened a series of public hearings to discuss home equity lending markets and practices. After conducting initial outreach to an array of interested groups, Federal Reserve regulatory and research staff structured the hearings to include discussion panels on the impact of the 2002 changes to the Home Ownership and Equity Protection Act (HOEPA) regulations, as well as panels on key issues in the mortgage market. Topics included trends and issues associated with complex products, such as nontraditional mortgages and reverse mortgages, as well as efforts to provide consumers with pre- and post-purchase counseling and intervention, lender "best practices" and the role of mortgage brokers, and the results of research on state predatory lending laws. The hearings also explored consumer behavior in shopping for mortgage loans and discussed the challenges of designing more effective and informative consumer disclosures. Both lenders and consumer advocates participated in the hearings, which enabled diverse viewpoints on both the benefits and pitfalls of nontraditional mortgages to be presented.

Lenders testified that nontraditional mortgage loans are appropriately underwritten and have historically shown strong performance. Consumer advocates and state officials, on the other hand, testified that aggressive marketing and the complexity of these products increase the risk that a borrower will obtain a mortgage he or she does not understand and might not be able to afford. They also questioned whether additional loan disclosures would only overwhelm consumers, because the products are so complex. Board staff are considering the comments from these hearings, as well as insights gained from consumer focus groups and other sources of information, as they evaluate potential revisions to the mortgage disclosure requirements in Regulation Z.

Recognizing the important role of education in understanding mortgage transactions, the Board partnered with other federal supervisory agencies to improve the resources available to both consumers and lenders on nontraditional mortgages. For consumers, the Federal Reserve, in partnership with the Office of Thrift Supervision, updated the "Consumer Handbook on Adjustable-Rate Mortgages," which includes an in-depth discussion of nontraditional mortgages and illustrations of how loan payments may result in negative amortization.[1] The Board also published a consumer information brochure, "Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You?," which includes a glossary of lending terms, a mortgage shopping worksheet, and a list of additional information sources to help consumers evaluate whether these types of loans are right for them.[2] This publication stresses the importance of understanding key mortgage loan terms, warns of the risks consumers may face, and urges borrowers to be realistic about whether they can handle future payment increases. In addition, interagency guidance on nontraditional mortgages, issued in September, highlights the increased risk for lenders and borrowers that nontraditional mortgages can present.[3] The guidance discusses the importance of (1) carefully managing the potential heightened risk levels, for the benefit of both lenders and borrowers; (2) using prudent loan-structuring and -underwriting standards; (3) considering a borrower's repayment capacity; and (4) ensuring that consumers have sufficient information to understand the terms and risks before making a loan or payment choice.

The mortgage industry has proven to be innovative in developing a wide range of mortgage credit products. Through its supervisory responsibilities, research, consumer education, and outreach to communities and lenders, the Federal Reserve will continue to strive to balance such innovation in the financial services industry with responsive oversight and consumer protection.

1. www.federalreserve.gov/pubs/arms/arms_english.htm
2. www.federalreserve.gov/pubs/mortgage_interestonly/default.htm
3. www.federalreserve.gov/boarddocs/press/bcreg/2006/20060929/default.htm

reports, and data conducted or maintained by the federal financial institution regulatory agencies. The report found that most CRAs appear to be processing consumer disputes within the statutory time frame; however, there was disagreement as to the adequacy of the dispute investigations conducted by CRAs and furnishers of information to CRAs.

To ensure that the FACT Act provisions enhancing the consumer dispute process are given enough time to be effective, the Board and the FTC did not recommend any additional administrative or legislative actions at this time. However, as discussed in the report, the FTC and the Board will continue to monitor the performance of the dispute process, explore possible enhancements, and recommend actions, if appropriate.

Other Regulatory Actions

The Board also took the following regulatory actions during 2006:

- In August, the Board amended the official staff commentary to Regulation Z to raise from $528 to $547 the total dollar amount of points and fees that triggers additional requirements for certain mortgage loans under the Home Ownership and Equity Protection Act. As prescribed by that statute, the increased threshold (effective January 1, 2007) reflects changes in the consumer price index.
- In December, the Board amended the official staff commentary to Regulation C to raise from $35 million to $36 million the asset-size exemption threshold for depository institutions required to collect data under the Home Mortgage Disclosure Act. As prescribed by that statute, the increased threshold reflects changes in the consumer price index. As a result, depository institutions that have assets of $36 million or less as of December 31, 2006, are exempt from data collection, effective January 1, 2007.

Supervision for Compliance with Consumer Protection and Community Reinvestment Laws

Activities Related to the Community Reinvestment Act

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

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

Examinations for Compliance with the CRA

The Federal Reserve assesses and rates the CRA performance of state member banks in the course of examinations conducted by staff at the twelve Reserve Banks. During the 2006 reporting period, the Reserve Banks conducted CRA examinations of 276 banks: 27 were rated Outstanding, 248 were rated Satisfactory, none was rated Needs to

Improve, and one was rated Substantial Noncompliance.[2]

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

During 2006, the Board considered applications for several significant banking mergers. The Board approved the application by Capital One Financial Corporation, McLean, Virginia, to acquire North Fork Bancorporation, Inc., Melville, New York, in November; this acquisition was a major expansion of Capital One Corporation's relatively new retail banking operations. In addition, three large bank holding companies, National City Corporation, in Cleveland, Ohio; BB&T Corporation, in Winston-Salem, North Carolina; and Marshall & Ilsley Corporation, in Milwaukee, Wisconsin, each acquired two large banking organizations in 2006.

Several other significant applications are listed below.

- An application by Trustmark Corporation, Jackson, Mississippi, to acquire Republic Bancshares of Texas, Inc., Houston, Texas, was approved in August.
- An application by Wachovia Corporation, Charlotte, North Carolina, to acquire Golden West Financial Corporation, Oakland, California, was approved in September.
- An application by Regions Financial Corporation, Birmingham, Alabama, to acquire AmSouth Bancorporation, also of Birmingham, was approved in October.

The public submitted comments on each of these applications. Commenters expressed concerns that minority applicants were being denied mortgage loans more frequently than nonminority applicants; other concerns described included potentially predatory lending practices of subprime and payday lenders; potential adverse effects of branch closings; and lenders' failure to address the convenience and needs of low- and moderate-income communities. Many of the comments referenced pricing information on residential mortgage loans that was required to be reported beginning with the 2004 Home Mortgage Disclosure Act (HMDA) data. Commenters' concerns that minority applicants were more likely than nonminority applicants to receive higher-priced mortgages were largely based on observations of the 2004 and 2005 HMDA pricing data.[3]

In total, the Board acted on twenty-four bank and bank holding company applications that involved protests by members of the public concerning the CRA performance of insured depository institutions. The Board also reviewed thirty-six applications involving other issues related to CRA, fair lending, or compliance with consumer credit protection laws.[4]

Other Consumer Compliance Activities

The Division of Consumer and Community Affairs supports and oversees the supervisory efforts of the Reserve Banks to ensure that consumer protection laws and regulations are fully and fairly en-

2. The 2006 reporting period for examination data was July 1, 2005, through June 30, 2006.

3. HMDA requires lenders to collect price information on loans they originated in the higher-priced segment of the home-loan market. "Higher-priced mortgages" refers to mortgage loans whose annual percentage rates are 3 percentage points or more over the yield on comparable Treasury securities on first-lien loans, and 5 percentage points or more over that yield on junior-lien loans.

4. In addition, four applications involving consumer compliance issues were withdrawn.

forced. Division staff provide guidance and expertise to the Reserve Banks on consumer protection regulations, examination and enforcement techniques, examiner training, and emerging issues. The staff develop and update examination policies, procedures, and guidelines, as well as review Reserve Bank supervisory reports and work products. They also participate in interagency activities that promote uniformity in examination principles and standards.

Examinations are the Federal Reserve's primary means of enforcing compliance with consumer protection laws. During the 2006 reporting period, the Reserve Banks conducted 321 consumer compliance examinations—303 of state member banks and 18 of foreign banking organizations.[5]

The Board periodically issues guidance for Reserve Bank examiners on consumer protection laws and regulations. In addition to updating examination procedures and guidance in concert with the other federal financial institution regulatory agencies, the Board issued guidance on state member banks' activities in disaster areas affected by the 2005 hurricanes in the Gulf Coast region.[6] As put forth in the guidance, state member banks located outside of the hurricane disaster areas will receive CRA consideration for their activities that revitalize or stabilize the disaster areas, if the banks have otherwise adequately met the needs of their assessment areas. (See "Response to the 2005 Hurricanes" later in this chapter.")

Fair Lending

The Federal Reserve is committed to ensuring that every institution it supervises complies fully with the federal fair lending laws—the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. Fair lending reviews are conducted regularly within the supervisory cycle. Additionally, examiners may conduct fair lending reviews outside of the usual supervisory cycle, if warranted. To promote rigorous and consistent fair lending enforcement, the Division of Consumer and Community Affairs staff coordinate investigations of potential fair lending violations with Reserve Bank staff.

The Federal Reserve enforces the ECOA and the provisions of the Fair Housing Act that apply to lending institutions. The ECOA prohibits creditors from discriminating against any applicant, in any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex, marital status, or age. In addition, creditors may not discriminate against an applicant because the applicant receives income from a public assistance program or has exercised, in good faith, any right under the Consumer Credit Protection Act. The Fair Housing Act prohibits discrimination in residential real estate–related transactions, including the making and purchasing of mortgage loans, on the basis of race, color, religion, national origin, handicap, familial status, or sex.

Pursuant to the ECOA, if the Board has reason to believe that a creditor has engaged in a pattern or practice of discrimination in violation of the ECOA, the matter will be referred to the Depart-

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

6. The guidance was released in a letter (CA 06-5) to the Reserve Banks on February 24, 2006 (www.federalreserve.gov/boarddocs/caletters).

ment of Justice. If a violation of the ECOA also constitutes a violation of the Fair Housing Act and a referral is not made to the Department of Justice, the matter will be referred to the Department of Housing and Urban Development.

During 2006, the Board referred the following matters to the Department of Justice, on the basis of these findings:

- The Board determined that a mortgage company owned by a state member bank had engaged in redlining—that is, discrimination against potential borrowers on the basis of the racial composition of their neighborhoods—in violation of the ECOA and the Fair Housing Act. The mortgage company had adopted a marketing strategy that was based on negative racial stereotypes and, as a result, excluded a cluster of minority neighborhoods from its lending activity.

- The Board found that a state member bank had violated the ECOA and the Fair Housing Act by discriminating against several mortgage applicants on the basis of race and national origin.[7] The bank rejected several minority applicants on the basis of "insufficient collateral" without ordering an appraisal, even though, in contrast, the bank did not deny any white applicants for insufficient collateral without ordering an appraisal.

- Two state member banks were found to have engaged in discrimination on the basis of marital status in their pricing of auto loans, in violation of the ECOA. The banks used rate sheets that expressly provided that non-spousal co-applicants (applicants who were not married to each other) should be charged higher interest rates.

- The Board determined that a state member bank discriminated on the basis of age, in violation of the ECOA, by offering customers over 50 years of age a special account with preferential credit features. The "over 50" account provided for an interest rate reduction on consumer loans if payment was made through automatic debit. This interest rate reduction was not offered to borrowers who did not have an "over 50" account. The ECOA generally prohibits creditors from considering age when evaluating creditworthiness, except that a creditor may consider the age of an applicant 62 years or older in the applicant's favor.

Since the addition of pricing information to the data reported under HMDA, the Federal Reserve has used the pricing data to facilitate its fair lending enforcement efforts. (See "Reporting on Home Mortgage Disclosure Act Data" later in this chapter.) The Federal Reserve does not rely on HMDA data alone in its enforcement efforts, however, because HMDA data do not include many potential determinants of loan pricing, such as the borrower's credit history and the loan-to-value ratio. Instead, the Federal Reserve analyzes the HMDA pricing data in conjunction with other fair lending risk factors—such as discretionary pricing and incentives for loan officers to charge higher prices—to identify lenders that are at risk for pric-

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7. The Board referred this case to the Department of Justice in December 2005. It was not included in the 2005 *Annual Report* because the referral occurred outside the reporting period for the 2005 report (July 1, 2004, through June 30, 2005). It is included in the 2006 *Annual Report*, which otherwise reports referrals occurring during the 2006 calendar year.

ing discrimination.[8] These lenders will receive a targeted pricing review. During a targeted pricing review, examiners collect additional information (including factors that are not available in the HMDA data) to determine whether a pricing disparity by race or ethnicity is fully attributable to legitimate factors, or whether any portion of the pricing disparity is attributable to discrimination.

Flood Insurance

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

During 2006, the Board imposed civil money penalties against four state member banks. The penalties, which were assessed via consent orders, totaled $32,050.

Coordination with Other Federal Banking Agencies

The member agencies of the Federal Financial Institutions Examination Council (FFIEC) develop uniform examination principles, standards, procedures, and report formats.[9] In 2006, the FFIEC revised examination procedures for the Fair Credit Reporting Act (FCRA). Section 604(g) of the FCRA generally prohibits creditors from obtaining and using medical information in connection with any determination of a consumer's eligibility, or continued eligibility, for credit unless permitted by regulation. The agencies have issued regulations creating exceptions to the statute's general prohibition; therefore, the FCRA examination procedures have been revised to reflect these new regulations. In addition, the FFIEC revised the CRA examination procedures for large banks, small banks, wholesale or limited-purpose banks, and banks operating under strategic plans. The revisions incorporate the CRA regulatory changes that were approved in 2005.

In 2006, the four banking agencies (the FDIC; the Federal Reserve, the OCC; and the OTS) convened the first Interagency Consumer Affairs Conference. The conference's objectives were to (1) discuss the banking regulatory issues that affect consumers, (2) determine more-effective ways for the agencies to share information about the complaints they receive, and (3) identify best practices for communicating and interacting with the public. These agencies plan to hold regular consumer

8. See the Interagency Fair Lending Examination Procedures for a full discussion of fair lending risk factors (www.ffiec.gov/PDF/fairlend.pdf).

9. The FFIEC member agencies are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA).

affairs conferences; the next conference is scheduled for October 2007.

Finally, the Board, the OCC, and the FDIC updated the host-state loan-to-deposit ratios used to determine compliance with section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.[10]

Response to 2005 Hurricanes

In 2006, the Federal Reserve and the other banking agencies continued initiatives to help financial institutions affected by the 2005 hurricanes in the Gulf Coast. The Board, the FDIC, the OCC, and the OTS sponsored an interagency forum, "The Future of Banking in the Gulf Coast: Helping Banks and Thrifts Rebuild Communities," that focused on the short-term and long-term challenges facing these financial institutions, including how they can help meet the needs of their local communities. In addition to officials from the sponsoring agencies, senior executives from both large and small financial institutions and representatives from community development corporations and a number of other federal agencies participated in the forum.

The FFIEC member agencies and the Conference of State Bank Supervisors released a booklet, "Lessons Learned from Hurricane Katrina: Preparing Your Institution for a Catastrophic Event."[11] Using financial institutions' experiences and lessons learned during Hurricane Katrina and its aftermath, the booklet is intended to help other institutions plan for an emergency or a catastrophic event.

The FFIEC member agencies, along with state financial institution regulators, also conducted a public service campaign to encourage banks, thrifts, and credit unions to continue working with borrowers affected by Hurricane Katrina or Hurricane Rita. Public service announcements (PSAs) were distributed to radio stations and print publications in geographic areas that had the highest concentrations of people affected by the hurricanes. The radio PSAs played more than 1,495 times on thirty-one stations, reaching an estimated audience of 4.13 million people in the targeted regions. The print PSAs appeared more than sixteen times in ten newspapers and other local publications, reaching approximately 565,000 people.

Training for Bank Examiners

Ensuring that financial institutions comply with laws that protect consumers and encourage community reinvestment is an important part of the bank examination and supervision process. As the number and complexity of consumer financial transactions grow, training for examiners of the organizations under the Federal Reserve's supervisory responsibility becomes even more important. The consumer compliance examiner training curriculum consists of six courses focused on various consumer protection laws, regulations, and examining concepts. In 2006, these courses were offered in ten sessions to more than 195 consumer compliance examiners and System staff members.

Board and Reserve Bank staff regularly review the core curriculum for examiner training, updating subject matter and adding new elements as appropriate. During 2006, staff conducted curriculum reviews of the following two courses in order to incorporate technical changes in policy and laws, along with

10. See the June 13, 2006, press release (www.federalreserve.gov/boarddocs/press/bcreg/2006/).

11. The booklet is available on the FFIEC's web site (www.ffiec.gov/Katrina_lessons.htm).

changes in instructional delivery techniques:

- *Community Reinvestment Act Examination Techniques Course.* Equips assistant examiners to participate in all aspects of a CRA examination, including the evaluation of a bank's CRA program and the determination of its CRA rating.
- *Fair Lending Examination Techniques Course.* Provides assistant examiners with the skills and knowledge to plan and conduct the risk-focused fair lending portion of a consumer compliance examination.

When appropriate, courses are delivered via alternative methods, such as the Internet or other distance-learning technologies. The CRA course discussed above uses a combination of instructional methods: (1) classroom instruction focused on case studies and (2) specially developed computer-based instruction that includes interactive self-check exercises. The computer-based instruction is reinforced through daily conference calls and discussions on electronic bulletin boards. The Fair Lending course discussed above also uses computer-based training.

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

Reporting on Home Mortgage Disclosure Act Data

The Home Mortgage Disclosure Act (HMDA), enacted by Congress in 1975, requires most mortgage lenders located in metropolitan areas to collect data about their housing-related lending activity, report the data annually to the government, and make the data publicly available. In 1989, Congress expanded the data required by HMDA to include information about loan applications that did not result in a loan origination, as well as information about the race, sex, and income of applicants and borrowers.

In response to the growth of the subprime-loan market, the Federal Reserve updated Regulation C in 2002. The revisions, which became effective in 2004, require lenders to collect price information for loans they originated in the higher-priced segment of the home-loan market. When applicable, lenders report the number of percentage points by which a loan's annual percentage rate exceeds the threshold that defines "higher-priced loans." The threshold is 3 percentage points or more above the yield on comparable Treasury securities for first-lien loans, and 5 percentage points or more above that yield for junior-lien loans. The HMDA data collected in 2004 and released to the public in 2005 provided the first publicly available loan-level data about loan prices. The FFIEC released the 2005 HMDA data to the public in September 2006.

A September 2006 article published by Federal Reserve staff in the *Federal Reserve Bulletin* uses the 2005 data to describe the market for higher-priced loans and patterns of lending across loan products, geographic markets, and borrowers and neighborhoods of different races and incomes.[12]

As in 2004, relatively few lenders accounted for most of the higher-priced

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12. The complete article is available at www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf.

loan originations in 2005. Of the 8,850 home lenders reporting HMDA data, 1,120 of them made 100 or more higher-priced loans. The 10 home lenders that had the largest volume of higher-priced loans accounted for about 59 percent of all such loans. Higher-priced lending is also concentrated by price: in 2005, the vast majority of higher-priced loans had annual percentage rates within 3 percentage points of the reporting thresholds. As in 2004, the majority of all loan originations were not higher priced in 2005, however, the incidence of higher-priced lending did increase substantially—26.2 percent in 2005, compared with 15.5 percent in 2004. Some of the increase in the incidence of higher-priced lending is attributed to changes in the interest rate environment from 2004 to 2005, as well as to changes in borrower profiles and lender practices.

Loan pricing is a complex process that may reflect a wide variety of factors about the level of risk a particular loan or borrower presents to the lender. As a result, the prevalence of higher-priced lending varies widely. First, the incidence of higher-priced lending varies by product type. For example, manufactured-home loans show the greatest incidence of higher-priced lending, because these loans are considered higher risk. In addition, first-lien mortgages are generally less risky than comparable junior-lien loans, and the pricing for these loans reflects their risk profiles: 25.7 percent of first-lien refinance loans were reported as higher-priced in 2005, compared with 30.2 percent of comparable junior-lien loans.

Second, higher-priced lending varies widely by geography. As in 2004, many of the metropolitan areas that reported the greatest incidence of higher-priced lending were in the southern region of the country. Several metropolitan areas on the West Coast also had an elevated incidence of higher-priced lending in 2005. For example, in many metropolitan areas in the South, Southwest, and West, 30 percent to 40 percent of the homebuyers who obtained conventional loans in 2005 received higher-priced loans.

Third, the incidence of higher-priced lending varies greatly among borrowers of different races and ethnicities. In 2005, as in 2004, blacks and Hispanics were much more likely than non-Hispanic whites and Asians to receive higher-priced loans. For example, in 2005, 55 percent of black borrowers, and 46 percent of Hispanic borrowers, received higher-priced home-purchase loans, compared with only 17 percent of non-Hispanic white or Asian borrowers. To a large extent, these differences reflect a segmentation of the home-loan market, that is, black and Hispanic borrowers were much more likely to obtain mortgage loans from institutions that specialize in higher-priced lending.

Because HMDA data lack information about credit risk and other legitimate pricing factors, it is not possible to determine from HMDA data alone whether the observed pricing disparities and market segmentation reflect discrimination. When analyzed in conjunction with other fair lending risk factors and supervisory information, however, the HMDA data can facilitate fair lending supervision and enforcement. (See “Fair Lending” earlier in this chapter.)

Agency Reports on Compliance with Consumer Protection Laws

The Board reports annually on compliance with consumer protection laws by entities supervised by federal agencies. This section summarizes data collected from the twelve Federal Reserve Banks, the FFIEC member agencies, and other federal enforcement agencies.[13]

Regulation B
(Equal Credit Opportunity)

The FFIEC agencies reported that 87 percent of the institutions examined during the 2006 reporting period were in compliance with Regulation B, compared with 85 percent for the 2005 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- abstain from inquiring about the race, color, religion, national origin, or sex of an applicant in connection with a credit transaction unless permitted by regulation
- collect information for monitoring purposes about the race, ethnicity, sex, marital status, and age of applicants seeking credit primarily for the purchase or refinancing of a principal residence
- note on the application form monitoring information regarding ethnicity, race, and sex when an applicant chooses not to provide the information
- provide a written notice of denial or other adverse action to a credit applicant that contains the specific reason for the adverse action, along with other required information

During this reporting period, the OTS issued one supervisory agreement to a savings association for its alleged violations of the Equal Credit Opportunity Act (ECOA) and Regulation B, as well as other consumer regulations. The other FFIEC agencies did not issue any formal enforcement actions relating to Regulation B during the reporting period.

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 activities revealed that most Regulation B violations involved either creditors' providing inadequate statements of specific reasons for denial or creditors' failure to request or provide information for government monitoring purposes. As reported by the SEC, an examination conducted by the National Association of Securities Dealers, Inc., found one violation of Regulation B at a member firm. The firm's written supervisory procedures did not contain information regarding the denial of credit to customers. However, none of these other agencies initiated any formal enforcement actions relating to Regulation B during 2006.

Regulation E
(Electronic Fund Transfers)

The FFIEC agencies reported that approximately 95 percent of the institutions examined during the 2006 reporting period were in compliance with Regulation E, which is comparable to the level of compliance for the 2005 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

13. Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2006 reporting period was July 1, 2005, through June 30, 2006.

- determine whether an error occurred, within ten business days of receiving a notice of error from a consumer
- give the consumer provisional credit for the amount of an alleged error when an investigation into the alleged error cannot be completed within ten business days
- provide initial disclosures that contain required information, including limitations on the types of transfers permitted and error-resolution procedures, at the time a consumer contracts for an electronic fund transfer service
- when a determination is made that no error has occurred, provide a written explanation and note the consumer's right to request documentation supporting the institution's findings

The Federal Trade Commission (FTC) filed two complaints in federal district court for alleged violations of Regulation E and federal statutes. Among other allegations, one complaint alleged that the defendants charged consumers' credit cards or debited their bank accounts, both on a recurring basis, to pay for a discount health plan, without obtaining the consumers' authorization for preauthorized electronic fund transfers. The other complaint alleged that defendants enrolled consumers in a mail-order program for dietary supplements and then automatically billed consumers on a recurring basis, without obtaining their authorizations for the recurring debits. The FFIEC agencies and the SEC did not issue any formal enforcement actions relating to Regulation E during the period.

Regulation M (Consumer Leasing)

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2006 reporting period were in compliance with Regulation M, which is comparable to the level of compliance for the 2005 reporting period. The FFIEC agencies did not issue any formal enforcement actions relating to Regulation M during the period.

Regulation P (Privacy of Consumer Financial Information)

The FFIEC agencies reported that 98 percent of the institutions examined during the 2006 reporting period were in compliance with Regulation P, compared with 97 percent for the 2005 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- provide a clear and conspicuous annual privacy notice to customers
- disclose the institution's information-sharing practices in initial, annual, and revised privacy notices
- provide customers with a clear and conspicuous initial privacy notice that accurately reflects the institution's privacy policies and practices, not later than when the customer relationship is established

The FFIEC agencies did not issue any formal enforcement actions relating to Regulation P during the reporting period.

Regulation Z (Truth in Lending)

The FFIEC agencies reported that 85 percent of the institutions examined during the 2006 reporting period were in compliance with Regulation Z, compared with 80 percent for the 2005 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- in closed-end credit transactions, accurately disclose the finance charge and the security interest that the creditor has or will acquire in the property identified
- ensure that disclosures reflect the terms of the legal obligation between the parties and, when any information necessary for an accurate disclosure is unknown, ensure that the creditor states that the disclosure is an estimate
- on certain residential mortgage transactions, provide a good faith estimate of the required disclosures before consummation, or not later than three business days after receipt of the loan application

In addition, 106 banks supervised by the Federal Reserve and the FDIC were required, under the Interagency Enforcement Policy on Regulation Z, to reimburse a total of approximately $1.5 million to consumers for understating the annual percentage rate or the finance charge in their consumer loan disclosures.

The OTS issued three supervisory agreements for violations of a number of consumer regulations, including Regulation Z, during the reporting period. The other FFIEC agencies did not issue any formal enforcement actions relating to Regulation Z during the reporting period.

The Department of Transportation investigated one air carrier for its improper handling of credit card and cash refunds for unused refundable tickets. As a result of this investigation, the air carrier made the required refunds and entered into a consent order under which it was directed to cease and desist from further violations of the credit refund requirements of Regulation Z. The air carrier was assessed a civil penalty of $50,000.

The FTC continued litigation against a mortgage broker and its principals for their alleged violations of Regulation Z and federal statutes, in connection with advertisements for extremely low mortgage rates. In 2004, the court entered a stipulated preliminary injunction against the defendants. In 2006, the defendant's chief executive filed for bankruptcy, following his 2005 agreement to—among other terms—pay the FTC $400,000 under a stipulated order releasing him from confinement for civil contempt of the 2004 stipulated preliminary injunction. The FTC filed a proof of claim for amounts it is owed in the underlying federal district court action and the contempt action. Litigation is ongoing in this case.

In 2006, the FTC settled charges in a case alleging that a defendant violated Regulation Z and federal statutes. The defendant allegedly engaged in misrepresentation about refunds for tax information products. After accepting product returns from consumers, or otherwise acknowledging that the consumers were owed refunds, the defendant failed to credit the consumers' credit card accounts in a timely fashion.

Regulation AA (Unfair or Deceptive Acts or Practices)

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2006 reporting period were in compliance with Regulation AA, which is comparable to the level of compliance for the 2005 reporting period. No formal enforcement actions relating to Regulation AA were issued during the reporting period.

Regulation CC (Availability of Funds and Collection of Checks)

The FFIEC agencies reported that 92 percent of institutions examined during the 2006 reporting period were in compliance with Regulation CC, compared with 93 percent for the 2005 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- make available on the next business day the lesser of $100 or the aggregate amount of checks deposited that are not subject to next-day availability
- follow procedures when invoking the exception for large-dollar deposits
- provide required information when placing an exception hold on an account
- make funds from local and certain other checks available for withdrawal within the times prescribed by regulation

The OTS issued one supervisory agreement for violations of a number of consumer regulations, including Regulation CC. The other FFIEC agencies did not issue any formal enforcement actions related to Regulation CC during the reporting period.

Regulation DD (Truth in Savings)

The FFIEC agencies reported that 91 percent of institutions examined during the 2006 reporting period were in compliance with Regulation DD, which is comparable to the level of compliance for the 2005 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- use the phrase "annual percentage yield" in an advertisement disclosing required additional terms and conditions for customer accounts
- provide account disclosures containing all required information
- provide account disclosures clearly and conspicuously, in writing, and in a form that the consumer may keep

The FFIEC agencies did not issue any formal enforcement actions related to Regulation DD during the reporting period.

Consumer Complaints

The Federal Reserve investigates complaints against state member banks and forwards to the appropriate enforcement agency any complaints that it receives that involved other creditors and businesses. Each Reserve Bank investigates complaints against state member banks in its District. In 2006, the Federal Reserve received 641 consumer complaints about regulated practices by state member banks—complaints were received by mail, by telephone, in person, and electronically via the Internet.

Complaints against State Member Banks

Of the 641 complaints about regulated practices, 70 percent involved consumer loans: 2 percent alleged discrimination on a basis prohibited by law (race, color, religion, national origin, sex, marital status, handicap, age, the fact that the applicant's income comes from a public assistance program, or the fact that the applicant has exercised a right under the Consumer Credit Protection Act), and the remainder concerned other credit-related practices, such as fair credit reporting; billing-error resolution; and credit card rates, terms, and fees. Twenty-eight percent of the complaints involved disputes about insufficient-funds charges and procedures, amounts withdrawn from a consumer's account, funds availability, and other deposit account practices, including electronic

Consumer Complaints against State Member Banks, by Classification, 2006

Classification	Number
Regulation B (Equal Credit Opportunity)	53
Regulation C (Home Mortgage Disclosure)	0
Regulation E (Electronic Fund Transfers)	73
Regulation H (Bank Sales of Insurance)	1
Regulation H (Flood Insurance)	3
Regulation M (Consumer Leasing)	1
Regulation P (Privacy of Consumer Financial Information)	17
Regulation Q (Payment of Interest)	0
Regulation Z (Truth in Lending)	243
Regulation BB (Community Reinvestment)	1
Regulation CC (Expedited Funds Availability)	39
Regulation DD (Truth in Savings)	60
Fair Credit Reporting Act	117
Fair Debt Collection Practices Act	20
Fair Housing Act	3
Regulations T, U, and X	0
Real Estate Settlement Procedures Act	10
Total	**641**

fund transfers; the remaining 2 percent concerned disputes about trust services or other practices. (See tables.)

In 97.5 percent of the 641 complaints against state member banks regarding regulated practices that were investigated in 2006, the banks had correctly handled the customer's account. The remaining 2.5 percent of the complaints against state member banks resulted in a finding that the bank had violated a consumer protection regulation. The most common violations involved real estate loans, deposit accounts, and electronic fund transfers.

Unregulated Practices

As required by section 18(f) of the Federal Trade Commission Act, the Board continued to monitor complaints about banking practices that are not subject to existing regulations and to focus on those that concern possible unfair or deceptive practices. In 2006, the Federal Reserve received more than 1,300 complaints against state member banks that involved unregulated practices. The most common complaints involved checking accounts and credit cards. Consumers most frequently complained about problems with either opening or closing an account (113 complaints), issues involving fraud (104), insufficient-funds charges and procedures (77), and concerns over specific interest rates, terms, and fees on credit cards (70). The remainder of the com-

Complaints against State Member Banks That Involve Regulated Practices, 2006

Subject of complaint	All complaints		Complaints involving violations	
	Number	Percent	Number	Percent
Total	**641**	**100**	**16**	**2.50**
Loans				
Discrimination alleged				
Real estate loans	3	0.47	0	0
Credit cards	4	0.62	0	0
Other loans	3	0.47	0	0
Other types of complaints				
Real estate loans	57	8.89	4	7.02
Credit cards	342	53.35	3	0.88
Other loans	41	6.40	1	2.44
Deposits	108	16.85	3	2.78
Electronic fund transfers	73	11.39	5	6.85
Trust services	1	0.16	0	0
Other	9	1.40	0	0

plaints concerned a wide range of unregulated practices involving credit cards, including errors or delays in processing consumers' payments, the amounts banks charged for late payments, and overlimit fees and procedures.

Complaint Referrals to HUD

In accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies that requires that a complaint alleging a violation of the Fair Housing Act be forwarded to HUD, in 2006 the Federal Reserve referred three complaints to HUD that alleged state member bank violations of the Fair Housing Act. In two of the three cases, the Federal Reserve's investigations revealed no evidence of illegal discrimination. The remaining case was pending at year-end.

Advice from the Consumer Advisory Council

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

During their March meeting, council members discussed proposed changes to Regulation E, which implements the Electronic Fund Transfer Act (EFTA). The proposed changes addressed payroll card accounts, specifically the disclosure and notification requirements of financial institutions that provide payroll card account services to consumers. Under the interim final rule, financial institutions are granted relief from the requirement to provide consumers with paper periodic statements—if they provide the information in periodic statements to consumers through alternative means (such as electronically or by telephone). Both industry and consumer representatives generally supported the proposed changes and agreed that their scope and approach effectively addressed consumer protection issues. Several industry representatives noted that substituting alternative methods for the delivery of account information appropriately balances consumers' rights and their need to access their accounts, on the one hand, with financial institutions' potential compliance costs, on the other. Some consumer representatives, however, suggested that the periodic statements are an important educational tool for consumers and, therefore, consumers would benefit from receiving paper periodic statements.

Council members also discussed proposed changes to Regulation Z, which implements the Truth in Lending Act (TILA), at their March meeting. Members shared their views on whether the Board should establish a standard cutoff time for the crediting of payments on open-end credit accounts. The council did not reach a consensus on a specific cutoff time; however, members noted that such a cutoff would have important consequences, including high fees and increased interest rates, for consumers who make late payments. Several members suggested that the need to provide consumers with more transparency about the costs and fees imposed as a result of late payments may be greater than the need to establish cutoff times for the crediting of payments. Council members also discussed a TILA amendment that requires creditors that offer open-end credit accounts to provide consumers with disclosures, on each periodic statement, about the effects of making only minimum payments on their accounts. Members expressed a wide range of views on whether such disclosures would be meaningful and useful to consumers; members also shared concerns about ensuring the accuracy of the disclosures.

During its March and June meetings, the council discussed issues related to the Board's public hearings on the home equity lending market, as well as the adequacy of existing consumer disclosures and protections. Members discussed the Board's 2002 revisions to the Home Ownership and Equity Protection Act (HOEPA) rules and their effect on consumer protections and the availability of credit in the high-cost and subprime-lending markets. The council also discussed several issues related to how consumers shop for credit and how that process may affect the loan terms they ultimately receive. Members discussed the increased role that mortgage brokers play in the loan-making process—and whether this role highlights a need for additional regulation of brokers, specifically regulation on the broker practice of directing potential borrowers to certain mortgage products. Members addressed the need to strengthen consumer disclosures to ensure that borrowers understand key credit terms and costs, particularly for mortgage products that feature interest-only periods, prepayment penalties, and adjustable or "teaser rates." Several members also expressed a need for additional research on consumer behavior in the home mortgage market.

In June, the council discussed several issues related to financial literacy, including goals for financial education programs, methods for educating consumers, and how to measure and evaluate the effectiveness of financial education programs. Members identified financial education as a fundamental tool for helping consumers build and preserve assets. Because financial literacy not only enhances the well-being of individuals or households but also strengthens neighborhoods and communities, council members support (1) making financial literacy a national public policy priority and (2) creating national education initiatives and more-formalized methods to train and educate consumers.

At the October meeting, members also discussed proposed regulations and guidelines to implement provisions of the Fair and Accurate Credit Transactions Act (FACT Act) that require financial institutions to identify "red flags" for detecting possible cases of identity theft. Most industry representatives expressed the need for more-flexible guidelines that would allow financial institutions to use a risk-based approach to address identity-theft risks, which change rapidly. Consumer representatives were concerned that the proposed guidelines give covered institutions and creditors too much discretion over their identity-theft prevention and detection policies. Council members also shared their views on the implementation of the proposed regulations, including the staff training requirement and requirements for covered institutions to develop and implement a written identity-theft prevention program.

At their October meeting, members discussed the importance of creating greater incentives to encourage investment in affordable housing. Homeownership is a fundamental part of a consumer's asset-building strategy; the availability of affordable housing in a neighborhood can create economic opportunities that, in turn, support future investments in entrepreneurship and education. Members noted that financial institutions play a critical role by providing mortgage credit to consumers and by financing the development of affordable housing. They highlighted the need for federal bank regulators to play a larger role by providing institutions with greater incentives for (1) meeting affordable housing needs and (2) expanding their outreach to local community organizations, as part of their community reinvestment strategies.

During each of their meetings this past year, council members discussed interagency guidance on managing the potential heightened risk of new and emerging residential mortgage products, often referred to as "nontraditional," "alternative," or "exotic" mortgage loans. Members generally supported the guidance, noting its importance in light of the recent proliferation and use of nontraditional mortgage products, especially by consumers whose household incomes are not keeping up with home-price appreciation. Members generally agreed that these products do not present problems for some borrowers. But the loans are risky for consumers whose cash flows or income projections may limit their ability to repay, who may not have the capacity or discipline to manage the loan, or who are not fully informed about the terms and conditions such loans carry.

Several members expressed concern that the guidance has given certain mortgage originators a competitive advantage, since the key principles of the guidance apply only to banking and thrift organizations and federal credit unions. Others reiterated this concern by emphasizing that the agencies are only providing guidance rather than creating requirements that could be enforced by consumers or law enforcement agencies. Members also commented on the proposed illustrations of consumer information, which were part of the guidance. The illustrations are designed to help borrowers better understand the features of nontraditional mortgages. The council was generally supportive of the illustrations. Members stated that the illustrations highlight important information, such as the costs, terms, features, and risks of a loan, for borrowers. However, members expressed a need to include additional loan information, such as information on the risk of payment shock to the consumer, the costs of reduced-documentation loans, prepayment penalties, and the potential for negative amortization of the loan.

Consumer Education and Research

The Consumer Education and Research section produces the Board's consumer education materials and supports the Board's consumer outreach initiatives. Section staff also conduct research in support of the division's policy development and community development functions. For example, research staff analyze the annual HMDA data, which are then used in the monitoring and enforcement of the fair lending laws.

The Federal Reserve maintains a consumer information web site (www.federalreserve.gov/consumer.htm) that contains publications and educational materials related to the Board's consumer regulations. In 2006, staff produced or updated the following publications on nontraditional mortgages:

- "Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You?" (a new publication, issued jointly with the FFIEC agencies, that includes a glossary of lending terms, a mortgage-shopping worksheet, and a list of additional information sources)

- "Consumer Handbook on Adjustable-Rate Mortgages" (substantially revised and updated in conjunction with the OTS to incorporate descriptions and illustrations of how changes in interest rates affect a consumer's loan payments, including an example of how an increase in interest rates may actually increase the total loan amount)

In addition, the Board's brochure "How to File a Consumer Complaint about a Bank," was updated. (The brochure is available in both English and Spanish.) Print and web-based versions of these publications are available on the web site.

Throughout the year, Board staff participated in a number of financial education events, including events for community members, federal employees, and congressional staff. The Board continued to work with the interagency Financial Literacy and Education Commission (FLEC); last year, staff helped update and expand the FLEC's MyMoney.gov web site to incorporate links to Reserve Bank consumer education resources. In their speeches and other appearances, Board members underscored the importance of financial education to an individual's economic well-being. Former Governor Mark Olson spoke at the press conference for the announcement of FLEC's National Strategy for Financial Education in April. Chairman Ben Bernanke testified on the Federal Reserve's role in financial education before the U.S. Senate Committee on Banking, Housing, and Urban Affairs in May.[14]

In cooperation with the Department of Defense, the U.S. Army, and Army Emergency Relief (a private nonprofit organization), staff are studying whether a two-day financial education program had an impact on how the participating soldiers manage their finances. At this stage, baseline data have been collected, and staff will be working to gather follow-up data.

Research on Financial Information and Disclosures

A financial institution is required to provide consumers with disclosures about its products and services, including disclosures about its privacy policy or the terms of a loan. The Federal Reserve is one of seven agencies working to develop more "consumer-friendly" disclosures, that is, disclosures written in clear, understandable language that provide information a consumer can use to compare financial services providers. In the spring, the agencies released a report that summarized their research on developing a comprehensible financial privacy notice for consumers.[15] The Financial Services Regulatory Relief Act of 2006, which was signed in October, subsequently required the federal financial regulatory agencies to develop a model privacy notice. The design, format, and language of the model notice must be easily understood and allow consumers to compare the privacy policies of different financial institutions.

As part of its overall effort to improve consumer disclosures, the Board studied how consumers use different types of information sources—both the quantity and quality of the sources—and whether this information affected their credit and investment decisions. This study, in addition to the research on privacy notices, will be used in the upcoming

14. See www.federalreserve.gov/boarddocs/testimony/2006/20060523/default.htm.

15. See www.federalreserve.gov/boarddocs/press/bcreg/2006/20060331/default.htm.

review of the Board's open-end credit regulations. The Board has contracted with a market research firm to conduct formative and usability testing on credit card disclosures, including the disclosures used in solicitation letters, applications, periodic statements, and change-in-terms notices. Consumer testing will continue in early 2007; the Board will consider data collected in these sessions as it develops new proposed rules under Regulation Z.

Promotion of Community Economic Development and Access to Financial Services in Historically Underserved Markets

In 2006, the community affairs function within the Federal Reserve System supported several initiatives to promote community economic development and fair access to credit for low- and moderate-income communities and populations. The function continued to focus on improving the sustainability and financial capacity of community development organizations, creating asset-building opportunities for low-income individuals, and promoting initiatives to help homeowners preserve this important asset and avoid foreclosure. Activities included publishing newsletters and articles, sponsoring conferences and seminars, conducting research, and supporting the dissemination of information to both general and targeted audiences.

As a decentralized function, the Community Affairs Offices (CAOs) at each of the twelve Reserve Banks design activities in response to the needs of communities in the Districts they serve in conjunction with staff from the Board. The CAOs focus on providing information and promoting awareness of investment opportunities to financial institutions, government agencies, and organizations that serve low- and moderate-income communities and populations. Similarly, the Board's CAO promotes and coordinates Systemwide efforts, in addition to engaging in activities and exploring issues that have public policy implications. In 2006, the Board and the Reserve Banks collaborated on a number of activities that focused on asset-building for individuals and strengthening community development organizations, while continuing their efforts to expand public understanding of the need to enhance access to affordable credit in underserved markets.

Collaborative Efforts

The Reserve Banks and the Board continued their work on two substantial collaborative efforts over the past year. The System resumed its asset-building and wealth-creation partnership with the CFED, a nonprofit organization dedicated to expanding access to economic opportunity by bringing together community development practitioners, public policy analysts, and private-sector representatives. In 2006, the Federal Reserve System and the CFED held the last three in a series of five forums convening leaders in economic policy, community development, philanthropy, and the financial industry. Starting with the initial forum in June 2005, the forums were convened to encourage more individuals to engage in asset-building activities, such as homeownership, entrepreneurship, savings, and investment. One session, held in Kansas City, focused on the unique challenges to developing asset-building programs in rural communities; the forum was cosponsored by the Reserve Banks of Kansas City, Dallas, Minneapolis, and St. Louis. A second meeting, hosted by the Reserve Bank of Atlanta, explored asset-building for low- and moderate-income savers, but from the perspective of financial institutions. The discussions focused on developing products to help this population begin or expand its saving efforts. The final forum, hosted by the Board of Governors, gathered a roundtable of leaders in the asset-building field. The leaders reflected on the results of the regional forums and identified next steps to help the industry progress.[16]

A related initiative, led by the San Francisco Reserve Bank, was a call for papers on asset-building issues and strategies. Twenty-eight of the more than 100 papers received were presented at a research forum during CFED's 2006 Assets Learning Conference, "A Lifetime of Assets: Building Families, Communities and Economies." More than 1,000 participants attended; staff from each Reserve Bank and the Board were actively involved in planning the conference, including developing the agenda, presenting research, and serving as moderators and participants in formal discussion groups. The Board's Community Affairs officer delivered a keynote address during the conference. Board staff presented research on the asset portfolios of low-income households and how these assets have changed over the past fifteen years (from 1989 to 2004). Staff also explored homeownership and foreclosure patterns that affect the asset-building capabilities of low-income households.[17]

Beyond the CFED partnership, Reserve Banks have been active in the promotion and development of regional asset-building coalitions. Staff from the Richmond Reserve Bank chaired the planning committee for the South Carolina Asset Development Collaborative, and staff from the San Francisco Reserve Bank facilitated both the Oregon Asset Building Convergence and the Washington State Asset Building Summit. Other Reserve Banks continued to provide advisory services for more than a dozen other state and regional asset-building coalitions throughout the country, such as the Houston Asset Building Coalition, Minnesota Saves, and the Nashville Wealth Building Alliance.

Another Systemwide collaboration was a partnership with the Aspen Institute, a national research and leadership development organization. The goal of this collaboration was to identify sustainable and scalable business models that community development organizations can use to more effectively advance their goals. In 2006, the Federal Reserve System and the Aspen Institute cosponsored four conferences around the country that explored a variety of business models that have led to successful community development finance programs. A forum at the San Francisco Reserve Bank highlighted funding efforts for community development financial institutions (CDFIs), individual development account programs, charter schools, and child care facilities. A forum at the Chicago Reserve Bank focused on collaborative efforts to promote the earned-income tax credit by helping low- to moderate-income families prepare their taxes. Participants at a forum at the New York Reserve Bank examined several collaborative efforts undertaken by development organizations, including efforts to share infrastructure resources (facilities, equipment, etc.), collaborate on fundraising, and pool other resources and strategies to increase their organizational capacity.

16. Summaries of the forum sessions are available on the CFED web site (www.cfed.org/focus.m).

17. The research papers presented at this conference are available at www.frbsf.org/community/research/assets.html.

Finally, a forum at the Dallas Reserve Bank focused on the formation of potential new sources of capital for CDFIs and community development corporations. These forums generated ongoing Systemwide research on various aspects of public and private subsidies for community development. Staff from several of the Reserve Banks and the Board are currently involved in a research project to measure the magnitude of the need for public and private groups to subsidize community development, measure how effectively these subsidies are utilized, and identify emerging strategies for optimizing the leverage of subsidy dollars.

Access to Financial Services

Staff from around the System have continued working on several initiatives to enhance access to affordable credit in currently underserved markets. In 2006, the San Francisco Reserve Bank and the Board partnered to study issues related to the creation of a secondary market for community development loans. The San Francisco Reserve Bank devoted an issue of its *Community Development Investment Review* to an overview of the community development finance industry, which included advice on best practices from industry practitioners. The Board and the San Francisco Reserve Bank followed up by hosting a conference in Washington, D.C., for lenders, investors, and financial intermediaries, in addition to policymakers and academics. The conference sought to (1) assess the status of the industry and (2) discuss ways to innovate and collaborate to increase liquidity for community development lending. The next edition of the *Review* included the conference proceedings and essays by conference participants laying out a possible road map for the creation of a secondary market for community development loans, and included remarks by Governor Kroszner, who keynoted the conference.

The Minneapolis Reserve Bank has taken the lead in another initiative to expand access to financial services through its work with Native American communities. On many reservations, access to affordable credit is often limited by ambiguities and inconsistencies in the various tribal laws that govern secured transactions. In response, Minneapolis Reserve Bank staff have worked to help investors and lenders better understand the property rights of Native Americans. For the past few years, the Reserve Bank staff have worked to create an improved legal structure that tribes can use to facilitate their efforts to borrow from off-reservation partners or other tribes. In 2005, staff were part of a team that completed a draft Model Tribal Secured Transactions Act (MTA) for the National Conference of Commissioners on Uniform State Laws (NCCUSL). Throughout 2006, staff supported education and dissemination efforts for the MTA by providing technical assistance and making numerous presentations, including one to tribal judges, on the benefits of tribal adoption of the MTA. During the year, the Crow tribe adopted the MTA, three additional tribes in Montana passed resolutions to adopt it, and approximately fifteen tribes were in various stages of considering adoption of the MTA.

Resources, Advisory Services, and Outreach

In 2006, the Board released an update of the Federal Reserve Fiscal Impact Tool (FIT). First released in 2003, the FIT software helps users analyze the fiscal impacts of economic development in small- and mid-sized communities. FIT supports economic development planning by producing a cost-benefit analysis of proposed development projects; FIT estimates a project's impact on local sales and property tax revenues and on costs to local government. To supplement this analysis, FIT integrates a wide array of data, at the city, county, and state levels, on incorporated locations in the United States. The 2006 update contains more and newer data, along with a module that allows for time discounting and the calculation of a net present value. The Board distributed more than 1,000 copies of the updated software in 2006. Users include state and local economic development organizations, academics, and consultants. A recent survey of users identified two communities—El Paso, Texas, and Lincoln, Nebraska—that have employed FIT to assist in setting limits on incentives for development projects.

During the past year, the foreclosure rate has risen for certain housing markets. Low- and moderate-income families and communities may be especially at risk for foreclosure. Consequently, the Board and the Reserve Banks have enhanced their efforts to preserve homeownership among these populations. The Board continued its involvement with NeighborWorks® America (NeighborWorks), a national network of more than 240 community-based organizations providing financial support, technical assistance, and training for community rehabilitation efforts. A member of the Board of Governors serves on the NeighborWorks board of directors, and members of the Board's staff serve on the organization's Center for Homeownership Education and Counseling. Staff from the Reserve Banks have led regional collaborative efforts with NeighborWorks through their participation in foreclosure-prevention training workshops for homeownership counselors. The Banks have also provided support to and endorsement of state-level activities, for example, the Minneapolis Reserve Bank's participation in Minnesota's Emerging Market Homeownership Initiative and the Cleveland Reserve Bank's promotion (through the Pittsburgh Branch) of the foreclosure-mitigation efforts of the Pennsylvania secretary of banking.

Over the past year, the Board continued its outreach activities to provide the public with information about the Board's responsibilities, to facilitate understanding of changes in banking regulations and their impact on banks and consumers, to promote community development and consumer education, and to foster discussion of policy issues. Board staff periodically met with financial institutions, community groups, and other members of the public in formal and informal settings. For example, the Board expanded its prior work with Operation HOPE, a national nonprofit organization dedicated to developing and implementing programs focused on connecting minority communities with mainstream, private-sector resources and to empowering underserved communities. The System has collaborated with Operation HOPE in prior years, and the director of the Board's Division of Consumer and Community Affairs serves on the Operation HOPE Mid-Atlantic Advisory Board. In 2006, Chairman Bernanke delivered a keynote address at the "Anacostia Economic Summit," a conference sponsored by Operation HOPE and the District of Columbia. (Anacostia is an underdeveloped neighborhood in southeast Washington, D.C.) The summit focused on ways to encourage revitalization in this area and highlighted the importance of obtaining both targeted public and private investment to jump-start the development efforts in this and other underserved neighborhoods. In preparation for the conference, Chairman Bernanke toured the Anacostia community with lenders, community development leaders, and local property developers to gain first-hand insight into the community's redevelopment. ■

Federal Reserve Banks

In addition to contributing to the setting of national monetary policy and supervising and regulating banks and other financial entities (discussed in preceding chapters), the Federal Reserve Banks provide payment services to depository and certain other institutions, distribute the nation's currency and coin, and serve as fiscal agents and depositories for the United States.

Developments in Federal Reserve Priced Services

The Federal Reserve Banks provide a range of payment and related services to depository institutions, including collecting checks, operating an automated clearinghouse service, transferring funds and securities, and providing a multilateral settlement service. The Reserve Banks charge fees for providing these "priced services."

The Monetary Control Act of 1980 requires that the Federal Reserve establish fees for priced services provided to depository institutions so as to recover, over the long run, all direct and indirect costs actually incurred as well as the imputed costs that would have been incurred, including financing costs, taxes, and certain other expenses, and the return on equity (profit) that would have been earned if a private business firm had provided the services. The imputed costs and imputed profit are collectively referred to as the private-sector adjustment factor (PSAF).[1] Over the past ten years, the Reserve Banks have recovered 99.0 percent of their priced services costs, including the PSAF (table).[2] In 2006, the Board implemented changes to the method for calculating the target return on equity measure in the PSAF.[3]

Overall, the price index for priced services increased 2.4 percent from 2005 to 2006. Revenue from priced services amounted to $908.4 million, other income was $122.8 million, and costs were $875.5 million, resulting in net income from priced services of $155.7 million. In 2006, the Reserve Banks recovered 108.8 percent of total costs of $947.5 million, including the PSAF.[4]

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

2. Effective December 31, 2006, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (FAS 158), which resulted in the recognition of a $343.9 million reduction in equity related to the priced services' benefit plans. Including this reduction in equity, which represents a decline in economic value, results in cost recovery of 95.5 percent for the ten-year period. For details on how implementing FAS 158 affected the pro forma financial statements, refer to notes 2, 3, and 5 at the end of this chapter.

3. In 2005, the Board approved changing the method from using the average of the results of three analytical methods—the comparable accounting earnings model, the discounted cash-flow model, and the capital asset pricing model (CAPM)—to using only the CAPM.

4. Financial data reported throughout this chapter—revenue, other income, cost, net revenue, and income before taxes—can be linked to the pro forma financial statements at the end of this chapter. *Other income* is revenue from invest-

Priced Services Cost Recovery, 1997–2006

Millions of dollars except as noted

Year	Revenue from services[1]	Operating expenses and imputed costs[2]	Targeted return on equity	Total costs	Cost recovery (percent)[3, 4]
1997	818.8	752.8	54.3	807.1	101.5
1998	839.8	743.2	66.8	809.9	103.7
1999	867.6	775.7	57.2	832.9	104.2
2000	922.8	818.2	98.4	916.6	100.7
2001	960.4	901.9	109.2	1,011.1	95.0
2002	918.3	891.7	92.5	984.3	93.3
2003	881.7	931.3	104.7	1,036.1	85.1
2004	914.6	842.6	112.4	955.0	95.8
2005	994.7	834.7	103.0	937.7	106.1
2006	1,031.2	875.5	72.0	947.5	108.8
1997–2006	9,149.9	8,367.5	870.5	9,238.1	99.0

NOTE: Here and elsewhere in this chapter, totals and percentages may not reflect components shown because of rounding.

1. For the ten-year period, includes revenue from services of $8,727.4 million and other income and expense (net) of $422.5 million.

2. For the ten-year period, includes operating expenses of $7,722.6 million, imputed costs of $296.4 million, and imputed income taxes of $348.5 million.

3. Revenue from services divided by total costs.

4. For the ten-year period, cost recovery is 95.5 percent, including the reduction in equity related to FAS 158 reported by the priced services in 2006.

Commercial Check Collection Service

In 2006, operating expenses and imputed costs for the Reserve Banks' commercial check collection service totaled $716.9 million, of which $35.4 million was attributable to the transportation of commercial checks between Reserve Bank check-processing centers. Revenue amounted to $745.0 million, of which $34.2 million was attributable to estimated revenues derived from the transportation of commercial checks between Reserve Bank check-processing centers, and other income was $100.7 million. The resulting net income was $128.7 million. Check service revenue in 2006 increased $4.7 million from 2005, largely because of price increases and faster-than-anticipated adoption of check-processing services associated with the Check Clearing for the 21st Century Act (Check 21).[5]

The Reserve Banks handled 11.0 billion checks in 2006, a decrease of 9.9 percent from 2005 (table). The decline in Reserve Bank check volume is consistent with nationwide trends away from the use of checks and toward greater use of electronic payment methods.[6] Of all the checks presented by the Reserve Banks to paying banks in 2006, 14.0 percent of the checks were deposited and 4.3 percent were presented using Check 21 products, compared with 1.8 percent and 0.0 percent, respec-

ment 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 FDIC assessment), imputed income taxes, and the targeted return on equity.

5. The Reserve Banks' Check 21 product suite includes electronic alternatives to paper-check collection, return, and presentment.

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

Activity in Federal Reserve Priced Services, 2004–2006

Thousands of items

Service	2006	2005	2004	Percent change	
				2005 to 2006	2004 to 2005
Commercial check	10,982,367	12,195,301	13,904,382	–9.9	–12.3
Commercial ACH	8,230,782	7,338,950	6,486,091	12.2	13.1
Funds transfer	136,399	135,227	128,270	0.9	5.4
Multilateral settlement	470	440	435	6.8	1.3
Securities transfer	9,053	9,235	9,208	–2.0	0.3

NOTE: Activity in *commercial check* is the total number of commercial checks collected, including processed and fine-sort items; in *commercial ACH*, the total number of commercial items processed; in *funds transfer* and *securities transfer*, the number of transactions originated online and offline; and in *multilateral settlement*, the number of settlement entries processed.

tively, in 2005.[7] Overall, the price index for check services increased 3.6 percent from 2005.

In response to the continuing decline in check volume, the Reserve Banks in 2006 continued to reduce check service operating costs through a combination of measures, including consolidating some check-processing sites. Check processing at New Orleans has now been consolidated to Atlanta; New York's East Rutherford Operations Center to Philadelphia; Columbus to Cleveland; and Boston to Windsor Locks, Connecticut. Additional consolidations are planned for 2007 and beyond.

Commercial Automated Clearinghouse Services

Reserve Bank operating expenses and imputed costs for commercial automated clearinghouse (ACH) services totaled $80.1 million in 2006. Revenue from ACH operations totaled $80.5 million and other income totaled $10.9 million, resulting in net income of $11.3 million. The Banks processed 8.2 billion commercial ACH transactions (worth $13.1 trillion), an increase of 12.2 percent from 2005. Overall, the price index for ACH services decreased 9.1 percent from 2005.

In 2006, the Reserve Banks began offering ACH risk-management services to all depository institutions. These services help originating institutions manage the operational and credit risk associated with originating ACH payments. By the end of 2006, 76 financial institutions subscribed to these services.

Fedwire Funds and National Settlement Services

Reserve Bank operating expenses and imputed costs for the Fedwire Funds and National Settlement Services totaled $59.3 million in 2006. Revenue from these operations totaled $63.6 million and other income amounted to $8.6 million, resulting in net income of $13.0 million.

Fedwire Funds Service

The Fedwire Funds Service allows participants to draw on their reserve or clearing balances at the Reserve Banks and transfer funds to other institutions that maintain accounts at the Banks. In 2006, the number of Fedwire funds transfers originated by depository insti-

7. The Reserve Banks also offer non-Check 21 electronic presentment products. In 2006, 25.2 percent of the Reserve Banks' deposit volume was presented to paying banks using these products.

tutions increased 0.9 percent from 2005, to approximately 136.4 million. The average daily value of Fedwire funds transfers in 2006 was $2.3 trillion. Overall, the price index for the Fedwire Funds and National Settlement Services increased 3.4 percent from 2005.

Last year, the Reserve Banks collaborated with The Clearing House Payments Company to study the use of funds transfers for business-to-business payments. The study examined why businesses select one payment type over another and what changes are needed to make funds transfers a more attractive payment alternative. Key findings from the study suggested that businesses wanted a more streamlined process for making funds transfers and favored the inclusion of remittance information in funds transfer orders.

National Settlement Service

The National Settlement Service is a multilateral settlement system that allows participants in private-sector clearing arrangements to exchange and settle transactions on a net basis using reserve or clearing balances. In 2006, the service processed settlement files for approximately fifty-four local and national private arrangements, primarily check clearinghouse associations. The Reserve Banks processed slightly more than 17,300 files that contained more than 470,000 settlement entries for these arrangements in 2006.

Fedwire Securities Service

The Fedwire Securities Service allows participants to transfer electronically securities issued by the U.S. Treasury, federal government agencies, government-sponsored enterprises, and certain international organizations to other participants in the service.[8] Reserve Bank operating expenses and imputed costs for providing this service totaled $19.1 million in 2006. Revenue from the service totaled $19.2 million, and other income totaled $2.6 million, resulting in net income of $2.7 million. Overall, the price index for the service increased 2.8 percent from 2005.

In 2006, approximately 9.1 million non-Treasury securities transfers were processed by the service, slightly lower than in 2005. Last year, the Reserve Banks also implemented technical changes to the Fedwire Securities Service applications to support changes to the Federal Reserve Policy on Payments System Risk (PSR). The PSR policy changes require that government-sponsored enterprises and certain international organizations fund principal and interest payments before the Reserve Banks distribute those payments in order to limit the credit exposure of the Reserve Banks.

Float

The Federal Reserve had daily average credit float of $85.9 million in 2006, compared with debit float of $133.4 million in 2005.[9]

8. The expenses, revenues, volumes, and fees reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and certain international organizations. The Reserve Banks provide Treasury securities services in their role as the U.S. Treasury's fiscal agent. These services are not considered priced services. For details, see the section "Debt Services" later in this chapter.

9. Credit float occurs when the Reserve Banks present items for collection to the paying bank prior to providing credit to the depositing bank, and debit float occurs when the Reserve Banks credit the depositing bank prior to presenting items for collection to the paying bank.

Developments in Currency and Coin

The Federal Reserve Banks distribute the nation's currency (in the form of Federal Reserve notes) and coin through depository institutions and also receive currency and coin from circulation through these institutions. As currency flows into the Reserve Banks, the Banks inspect the notes and destroy those that are unfit for recirculation.

The Reserve Banks received 38.5 billion Federal Reserve notes from circulation in 2006, a 3.5 percent increase from 2005, and made payments of 39.1 billion notes into circulation in 2006, a 1.5 percent increase from 2005. They received 59.7 billion coins from circulation in 2006, a 6.5 percent increase from 2005, and made payments of 73.9 billion coins into circulation, a 2.7 percent increase from 2005.

In March, the Board approved a policy that provides incentives to encourage depository institutions to recirculate fit currency to their customers rather than return it to the Federal Reserve for processing. Under the policy, the Federal Reserve implemented a custodial inventory program that allows depository institutions to transfer a portion of the currency holdings in their vaults to the books of a Reserve Bank. As of December 31, the Reserve Banks had established twenty-nine custodial inventory sites with depository institutions. Beginning in July 2007, the Reserve Banks will charge fees to institutions that, within a one-week period, deposit fit $10 or $20 notes and reorder currency of the same denomination, above a de minimis amount, within the same Reserve Bank office's service area.

In March, the Reserve Banks began issuing the redesigned $10 Federal Reserve note that includes enhanced security features and subtle background colors.

The Presidential $1 Coin Act requires, among other things, that the Federal Reserve and the Mint take steps to ensure that an adequate supply of $1 coins is available for commerce. To that end, the Federal Reserve worked with the United States Mint to develop an effective distribution strategy for Presidential $1 coins, the first of which was issued by the Mint in February 2007. Consistent with the requirements of the Presidential $1 Coin Act, the Federal Reserve and the Mint conducted outreach to depository institutions and coin users in an effort to gauge demand for the coins and to anticipate and eliminate obstacles to the efficient circulation of $1 coins.

The Reserve Banks conducted extensive testing of a prototype upgrade to the high-speed currency-processing machines. The Reserve Banks will begin implementing the upgrades on their machines in 2007; the upgrades are scheduled to be completed in 2009.

The Federal Reserve developed the requirements for an automation system to replace the current platform used to support and facilitate the System's provision of cash services. The Reserve Banks issued a preview request for proposal for development of the new automation system and held an orientation with potential vendors in December.

The Reserve Banks completed a comprehensive study of cost-effective alternatives to the existing infrastructure for providing cash services. The study resulted in the elimination of cash processing at the Oklahoma City and Birmingham offices in March and May, respectively, and the replacement of these offices with outsourced cash depots. In these cash depot arrangements, armored carrier facilities serve as collection and distribution points for deposi-

Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2004–2006

Thousands of dollars

Agency and service	2006	2005	2004
DEPARTMENT OF THE TREASURY			
Bureau of the Public Debt			
Treasury retail securities	73,931.4	86,503.2	103,257.7
Treasury securities safekeeping and transfer	7,535.2	6,055.8	6,267.0
Treasury auction	23,594.9	17,553.5	17,159.5
Computer infrastructure development and support	3,853.1	2,575.5	5,935.1
Other services	1,578.7	1,806.5	1,709.8
Total	110,493.2	114,494.5	134,329.1
Financial Management Service			
Payment services			
Government check processing	20,918.6	20,988.0	24,245.4
Automated clearinghouse	5,823.1	5,709.5	5,352.9
Fedwire funds transfers	123.1	109.4	111.6
Other payment programs	69,696.8	49,366.0	33,646.9
Collection services			
Tax and other revenue collections	37,095.5	39,736.0	34,248.4
Other collection programs	14,122.6	14,354.2	12,922.8
Cash-management services	48,320.2	40,496.7	21,835.8
Computer infrastructure development and support	67,046.4	67,703.3	52,673.3
Other services	7,414.8	2,332.2	6,931.6
Total	270,561.2	240,795.4	191,968.6
Other Treasury			
Total	16,786.3	15,726.7	15,106.1
Total, Treasury	397,840.7	371,016.6	341,403.7
OTHER FEDERAL AGENCIES			
Department of Agriculture			
Food coupons	2,929.8	2,642.4	4,519.0
United States Postal Service			
Postal money orders	9,334.4	7,647.8	7,774.6
Other agencies			
Other services	15,977.1	14,870.2	16,104.0
Total, other agencies	28,241.4	25,160.4	28,397.5
Total reimbursable expenses	426,082.1	396,177.0	369,801.2

tory institutions' currency deposits and orders. The deposits and orders are transported to and from the nearest Reserve Bank by armored carrier for processing.

Developments in Fiscal Agency and Government Depository Services

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

The total cost of providing fiscal agency and depository services to the Treasury and other entities in 2006 amounted to $426.1 million, compared with $396.2 million in 2005 (table). Treasury-related costs were $397.8 million in 2006, compared with $371.0 million in 2005, an increase of 7.2 percent. The cost of providing services to other entities was $28.2 million, compared with $25.2 million in 2005. In 2006, as in 2005, the Treasury and other entities reimbursed the Reserve Banks for the costs of providing these services.

Debt Services

The Reserve Banks auction, provide safekeeping for, and transfer Treasury securities. Reserve Bank operating expenses for these activities totaled $31.1 million in 2006, compared with $23.6 million in 2005. The Banks processed 148,000 commercial tenders for Treasury securities, compared with 169,000 in 2005. They originated 12.9 million transfers of Treasury securities in 2006, a 1.8 percent increase from 2005. The Reserve Banks are developing a new Treasury auction application and infrastructure that will provide increased functionality and security. The application will be operational in late 2007.

The Reserve Banks also operate computer applications and provide customer service and back-office support for the Treasury's retail securities programs. Reserve Bank operating expenses for these activities were $73.9 million in 2006, compared with $86.5 million in 2005. The Reserve Banks operate Legacy Treasury Direct, a program that allows investors to purchase and hold Treasury securities directly with the Treasury through the Reserve Banks instead of through a broker. The program held $72 billion (par value) of Treasury securities as of December 31. Because the program was designed for investors who plan to hold their securities to maturity, it does not provide transfer services. Investors may, however, sell their securities for a fee through Sell Direct, a program operated by one of the Reserve Banks. Approximately 13,000 securities worth $678.9 million were sold through Sell Direct in 2006, compared with 14,000 securities worth $874.8 million in 2005. The Banks printed and mailed more than 28.9 million savings bonds in 2006, a 10 percent decrease from 2005. They issued more than 5.3 million Series I (inflation-indexed) bonds and 23.1 million Series EE bonds.

Payments Services

The Reserve Banks process both electronic and check payments for the Treasury. Reserve Bank operating expenses for processing government payments and for payments-related programs totaled $96.6 million in 2006, compared with $76.2 million in 2005. The Banks processed 991.6 million ACH payments for the Treasury, an increase of 2.8 percent from 2005, and more than 855,000 Fedwire funds transfers. They also processed 192 million paper government checks, a decline of 11 percent from 2005. In addition, the Banks issued more than 170,000 fiscal agency checks, a decrease of 17.4 percent from 2005.

Collection Services

The Reserve Banks support several Treasury programs to collect funds owed the federal government. Reserve Bank operating expenses related to these programs totaled $51.2 million in 2006, compared with $54.1 million in 2005. The Banks operate the Federal Reserve Electronic Tax Application (FR-ETA) as an adjunct to the Treasury's Electronic Federal Tax Payment System (EFTPS). EFTPS allows businesses and individual taxpayers to pay their taxes electronically. It uses the automated clearinghouse (ACH) to collect funds, so tax payments must be scheduled at least one day in advance. Some business taxpayers, however, do not know their tax liability until the tax due date. FR-ETA allows these taxpayers to use EFTPS by providing a same-day electronic federal tax payment alternative. FR-ETA collected $456.3 billion for the Treasury in 2006, compared with $409.2 billion in 2005.

In addition, the Reserve Banks operate Pay.gov, a Treasury program that allows members of the public to pay for goods and services offered by the federal government over the Internet. They also operate the Treasury's Paper Check Conversion and Electronic Check Processing programs, whereby checks written to government agencies are converted into ACH transactions at the point of sale or at lockbox locations. In 2006, the Reserve Banks originated more than 2.6 million ACH transactions through these programs, roughly the same number of transactions as in 2005.

Cash-Management Services

The Treasury maintains its bank account at the Reserve Banks and invests the funds it does not need for current payments with qualified depository institutions through the Treasury Tax and Loan (TT&L) program, which the Reserve Banks operate. Reserve Bank operating expenses related to this program and other cash-management initiatives totaled $48.3 million in 2006, compared with $40.5 million in 2005. The investments either are callable on demand or are for a set term. In 2006, the Reserve Banks placed a total of $309.2 billion in immediately callable investments, which includes funds invested through retained tax deposits and direct, special direct, and dynamic investments, and $508 billion in term investments. The rate for term investments is set by auction; the Reserve Banks held 104 such auctions in 2006, roughly the same number of auctions as in 2005. In 2006, the Treasury's income from the TT&L program was $1.04 billion. In March, Treasury launched the Repurchase Agreement Program, a pilot program that allows Treasury to place a portion of its excess operating funds directly with TT&L depositaries through a repurchase transaction for a set period at an agreed-on interest rate. In 2006, the Reserve Banks placed a total of $478.9 billion of investments through repurchase agreements.

Services Provided to Other Entities

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

Electronic Access to Reserve Bank Services

In 2006, the Federal Reserve Banks completed the migration of their FedLine DOS customers to FedLine Advantage. About 6,200 customers were converted to FedLine Advantage, a web-based access delivery channel typically used by small and medium-sized depository institutions to access critical payment services, such as the Fedwire Funds, Fedwire Securities, National Settlement, and FedACH Services. In addition, the Reserve Banks began migrating their high-volume computer-interface customers, which are typically large depository institutions, to FedLine Direct, an internet-protocol-based computer-to-computer access delivery channel for critical payment services. Also in 2006, the Reserve Banks announced a new option, FedLine Command, a lower-cost computer-to-computer access delivery channel for FedACH customers. The Reserve Banks will continue to migrate customers to

FedLine Direct and FedLine Command in 2007.

Information Technology

In early 2006, the Federal Reserve Banks initiated the first phase of the Information Security Architecture Framework (ISAF), a program that will cost $30.5 million by the end of 2008, when this phase of the program will be completed. The ISAF program is intended to respond to the continuing and increasingly sophisticated threats facing information technology systems and to improve information security at all points in the Federal Reserve System's networks. ISAF is a portfolio of initiatives to improve (1) targeted security services by ensuring that overall risks are reduced and the residual risks of these services are acceptable and (2) the overall efficiency and coherence of the provisioning of these services.

The System established a National Information Security Assurance (NISA) function in 2006 to enhance information security governance. By managing and coordinating information security at the enterprise level, NISA will have an integrated view of information security compliance across the Reserve Banks. NISA will implement a business-oriented model of information security responsibility and accountability and will establish comprehensive information security standards and processes for all the Reserve Banks.

In mid-2006, the Federal Reserve System adopted the Technology Project Standards (TPS), a set of standards for managing information technology projects. The standards are based on the Project Management Book of Knowledge (PMBOK), a recognized industry best practice. All Reserve Banks are expected to train their staff members who are involved in information technology projects and to fully transition to the TPS by January 1, 2008.

Also in 2006, the Federal Reserve Bank of New York migrated its primary dealers (banks and securities broker-dealers) to the FedTrade application, which provides increased functionality and security. The FedTrade application is used to execute various forms of open market operations using electronic auctions with the primary dealers as bidders.

Throughout 2006, the Reserve Banks continued to focus on initiatives to reduce IT costs over the long term by standardizing processes, increasing productivity, and strengthening the Federal Reserve's ability to respond to cyber security threats.

Examinations of the Federal Reserve Banks

Section 21 of the Federal Reserve Act requires the Board of Governors to order an examination of each Federal Reserve Bank at least once a year. The Board performs its own reviews and engages a public accounting firm. The public accounting firm performs an annual audit of the combined financial statements of the Reserve Banks (see the section "Federal Reserve Banks Combined Financial Statements") and audits the annual financial statements of each of the twelve Banks. The Reserve Banks use the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in assessing their internal controls over financial reporting, including the safeguarding of assets. The Reserve Banks have further enhanced their assessments under the COSO framework to strengthen the key control assertion process and in 2006 met the requirements of the Sarbanes-Oxley Act of 2002. Within this framework, management of each Reserve Bank provides an assertion letter to its board of directors annually confirming adherence to COSO standards, and a public accounting firm confirms management's assertion and issues an attestation report to the Bank's board of directors and to the Board of Governors.

The firm engaged for the audits of the individual and combined financial statements of the Reserve Banks for 2006 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $4.2 million. To ensure auditor independence, the Board requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2006, the Reserve Banks did not engage PwC for nonaudit services.

The Board's annual examination of the Reserve Banks includes a wide range of off-site and on-site oversight activities conducted by the Division of Reserve Bank Operations and Payment Systems. Division personnel monitor the activities of each Reserve Bank on an ongoing basis and conduct on-site reviews based on the division's risk-assessment methodology. The examinations also include assessing the efficiency and effectiveness of the internal audit function. To assess compliance with the policies established by the Federal Reserve's Federal Open Market Committee (FOMC), the division also reviews the accounts and holdings of the System Open Market Account at the Federal Reserve Bank of New York and the foreign currency operations conducted by that Bank. In addition, PwC audits the schedule of participated asset and liability accounts and the related schedule of participated income accounts at year-end. The FOMC receives the external audit reports and the report on the division's examination.

Income and Expenses

The accompanying table summarizes the income, expenses, and distributions of net earnings of the Federal Reserve Banks for 2005 and 2006.

Income in 2006 was $38,410 million, compared with $30,729 million in 2005. Expenses totaled $4,056 million ($2,987 million in operating expenses, $276 million in earnings credits granted to depository institutions, $301 million in assessments for expenditures by the Board of Governors, and $492 million for the cost of new currency). Revenue from priced services was $908 million. Net additions to and deductions from current net income showed a net loss of $159 million. The loss was due primarily to interest expense on securities sold under agreements to repurchase offset, in part, by unrealized gains on assets denominated in foreign currencies revalued to reflect current market exchange rates. Statutory dividends paid to member banks totaled $871 million, $90 million more than in 2005; the increase reflects an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Reserve Banks.

Payments to the U.S. Treasury in the form of interest on Federal Reserve notes totaled $29,052 million in 2006, up from $21,468 million in 2005; the payments equal net income after the deduction of dividends paid and of the amount necessary to equate the Reserve Banks' surplus to paid-in capital. The implementation of FAS 158 required a reduction to surplus of $1,849 million and increased the amount necessary to equate surplus to paid-in capital in 2006.

Income, Expenses, and Distribution of Net Earnings
of the Federal Reserve Banks, 2006 and 2005

Millions of dollars

Item	2006	2005
Current income	38,410	30,729
Current expenses	3,264	2,890
Operating expenses[1]	2,987	2,677
Earnings credits granted	276	213
Current net income	35,147	27,840
Net additions to (deductions from, –) current net income	–159	–3,577
Assessments by the Board of Governors	793	743
For expenditures of Board	301	266
For cost of currency	492	477
Net income before payments to Treasury	34,195	23,520
Dividends paid	871	781
Transferred to surplus[2]	4,272	1,272
Payments to Treasury[3]	29,052	21,468

1. Includes a net periodic pension expense of $53 million in 2006 and a net periodic pension credit of $11 million in 2005.
2. The implementation of FAS 158 in 2006 reduced surplus by $1,849 million and increased the amount of the transfer required to equate capital and surplus.
3. Interest on Federal Reserve notes.

In the “Statistical Tables” section of this report, table 10 details the income and expenses of each Reserve Bank for 2006 and table 11 shows a condensed statement for each Bank for the years 1914 through 2006; table 9 is a statement of condition for each Bank, and table 13 gives the number and annual salaries of officers and employees for each Bank. A detailed account of the assessments and expenditures of the Board of Governors appears in the section “Board of Governors Financial Statements.”

Holdings of Securities and Loans

The Federal Reserve Banks’ average daily holdings of securities and loans during 2006 amounted to $794,395 million, an increase of $32,886 million from 2005 (table). Holdings of U.S. government securities increased $32,879 million, and holdings of loans increased $7 million. The average rate of interest earned on the Reserve Banks’ holdings of government securities increased to 4.59 percent, from 3.80 percent in 2005, and the average rate of interest earned on loans increased to 5.44 percent, from 3.49 percent.

Volume of Operations

Table 12 in the ”Statistical Tables” section shows the volume of operations in the principal departments of the Federal Reserve Banks for the years 2003 through 2006.

Federal Reserve Bank Premises

In 2006, construction continued on the Kansas City Bank’s new headquarters building and construction began on the San Francisco Bank’s new Seattle Branch building after the Board approved the project’s final design. The multiyear renovation program at the New York Bank’s headquarters building continued, as did facility renovation projects at several Reserve Bank offices to accommodate the consolidation of check activities. A long-term facility re-

Securities and Loans of the Federal Reserve Banks, 2004–2006

Millions of dollars except as noted

Item and year	Total	U.S. government securities[1]	Loans[2]
Average daily holdings[3]			
2004	719,647	719,494	153
2005	761,509	761,295	214
2006	794,395	794,174	221
Earnings[4]			
2004	22,347	22,344	3
2005	28,966	28,959	7
2006	36,464	36,452	12
Average interest rate (percent)			
2004	3.11	3.11	1.74
2005	3.80	3.80	3.49
2006	4.59	4.59	5.44

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

development program at the St. Louis Bank continued. Construction of a new pedestrian-screening vestibule was completed, and construction of an addition to the Board's headquarters building began.

Security enhancement programs continue at several facilities. One such project is the recently completed external perimeter security improvement project at the Boston Bank. In addition, the Richmond Bank continued construction of additional security improvements to its headquarters building. The Dallas Bank completed the purchase of property behind its headquarters building for the construction of a remote vehicle-screening and shipping/receiving facility. Planning continues for a similar screening facility at the Philadelphia Bank.

Also during 2006, the Board approved the Richmond Bank's purchase of property adjacent to its headquarters building for construction of a new parking garage. The sales of the Chicago Bank's former Detroit Branch building, the Kansas City Bank's Oklahoma City Branch building, and the San Francisco Bank's Portland Branch building were finalized. Efforts to sell the St. Louis Bank's Little Rock Branch building continued, as did efforts by the Dallas Bank to sell excess land at its Houston Branch.

Activities for the Portland Branch were moved to leased facilities. The Kansas City Bank sold its Oklahoma City Branch building and is leasing space in the building for the Branch's administrative activity. The Birmingham Branch check and cash operations were relocated to the head office in Atlanta. The Birmingham building will house the remaining Branch activities, and available space will be leased.

Table 14 in the "Statistical Tables" section of this report details the acquisition costs and net book value of the Federal Reserve Banks and Branches. ■

Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 2006 and 2005

Millions of dollars

Item	2006		2005	
Short-term assets (Note 1)				
Imputed reserve requirements on clearing balances	821.7		993.2	
Imputed investments	7,245.7		8,626.4	
Receivables	73.6		77.0	
Materials and supplies	0.9		1.3	
Prepaid expenses	24.2		25.6	
Items in process of collection	3,391.0		5,934.4	
Total short-term assets		11,557.1		15,657.7
Long-term assets (Note 2)				
Premises	424.9		424.5	
Furniture and equipment	127.9		156.1	
Leases, leasehold improvements, and long-term prepayments	83.3		88.5	
Prepaid pension costs	399.0		796.8	
Deferred tax asset	146.0		0.0	
Total long-term assets		1,181.0		1,465.9
Total assets		12,738.1		17,123.6
Short-term liabilities				
Clearing balances and balances arising from early credit of uncollected items	8,015.6		10,703.2	
Deferred-availability items	3,592.5		5,163.0	
Short-term debt	0.0		0.0	
Short-term payables	100.4		126.2	
Total short-term liabilities		11,708.4		15,992.4
Long-term liabilities				
Long-term debt	0.0		0.0	
Postretirement/postemployment benefits obligation	392.8		275.0	
Total long-term liabilities		392.8		275.0
Total liabilities		12,101.2		16,267.4
Equity (including accumulated other comprehensive loss of $343.9 million at December 31, 2006)		636.9		856.2
Total liabilities and equity (Note 3)		12,738.1		17,123.6

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

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

Pro Forma Income Statement for Federal Reserve Priced Services, 2006 and 2005

Millions of dollars

Item	2006		2005	
Revenue from services provided to depository institutions (Note 4)		908.4		901.0
Operating expenses (Note 5)		803.5		750.0
Income from operations		104.8		150.9
Imputed costs (Note 6)				
Interest on float	–4.9		6.1	
Interest on debt	0.0		0.0	
Sales taxes	10.8		11.3	
FDIC insurance	0.0	5.9	0.0	17.4
Income from operations after imputed costs		98.9		133.5
Other income and expenses (Note 7)				
Investment income	383.6		292.7	
Earnings credits	–260.8	122.8	–199.0	93.7
Income before income taxes		221.8		227.2
Imputed income taxes (Note 6)		66.1		67.3
Net income		155.7		160.0
MEMO: Targeted return on equity (Note 6)		72.0		103.0

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

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

Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 2006

Millions of dollars

Item	Total	Commercial check collection	Commercial ACH	Fedwire funds	Fedwire securities
Revenue from services (Note 4)	908.4	745.0	80.5	63.6	19.2
Operating expenses (Note 5)	803.5	658.2	74.7	52.9	17.7
Income from operations	104.8	86.8	5.8	10.7	1.5
Imputed costs (Note 6)	5.9	4.1	0.6	0.8	0.3
Income from operations after imputed costs	98.9	82.7	5.2	9.9	1.3
Other income and expenses, net (Note 7)	122.8	100.7	10.9	8.6	2.6
Income before income taxes	221.8	183.3	16.1	18.5	3.9
Imputed income taxes (Note 6)	66.1	54.6	4.8	5.5	1.2
Net income	155.7	128.7	11.3	13.0	2.7
MEMO: Targeted return on equity (Note 6)	72.0	57.1	7.5	5.6	1.8

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

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

FEDERAL RESERVE BANKS

Notes to Pro Forma Financial Statements for Priced Services

(1) Short-Term Assets

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

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-service 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 December 31, 2006, the Reserve Banks implemented FAS 158, which requires an employer to record the funded status of its benefit plans on its balance sheet, resulting in a reduction to the prepaid pension asset related to priced services and the recognition of an associated deferred tax asset with an offsetting adjustment, net of tax, to accumulated other comprehensive income (AOCI) (see note 3).

(3) Liabilities and Equity

Under the matched-book capital structure for assets, short-term assets are financed with short-term payables and clearing balances. Long-term assets are financed with long-term liabilities and clearing balances. As a result, no short- or long-term debt is imputed. Other short-term liabilities include clearing balances maintained at Reserve Banks and deposit balances arising from float. Other long-term liabilities consist of accrued postemployment, postretirement, and nonqualified pension benefits costs and obligations on capital leases.

In order to reflect the funded status of its benefit plans as required by FAS 158, the Reserve Banks recognized the deferred items related to these plans, which include prior service costs and actuarial gains or losses, on the balance sheet. This resulted in an increase to the benefits obligation related to the priced services and an offsetting adjustment, net of tax, to AOCI, which is included in equity.

Equity is imputed at 5 percent of total assets.

(4) Revenue

Revenue represents charges to depository institutions for priced services and is realized from each institution through one of two methods: direct charges to an institution's account or charges against its accumulated earnings credits.

(5) Operating Expenses

Operating expenses consist of the direct, indirect, and other general administrative expenses of the Reserve Banks for priced services plus the expenses for staff members of the Board of Governors working directly on the development of priced services. The expenses for Board staff members were $7.5 million in 2006 and $6.6 million in 2005.

Effective January 1, 1987, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (FAS 87). Accordingly, the Reserve Banks recognized operating expenses for the qualified pension plan of $11.5 million in 2006 and a credit to expenses of $1.3 million in 2005. Operating expenses also include the nonqualified pension expense of $3.2 million in 2006 and $1.0 million in 2005. The implementation of FAS 158 does not change the systematic approach required by generally accepted accounting principles to recognize the expenses associated with the Reserve Banks' benefit plans in the income statement.

The income statement by service reflects revenue, operating expenses, and imputed costs. Certain corporate overhead costs not closely related to any particular priced service are allocated to priced services based on an expense-ratio method. Corporate overhead was allocated among the priced services during 2006 and 2005 as follows (in millions):

	2006	2005
Check	30.6	29.4
ACH	4.1	3.7
Fedwire funds	2.8	2.6
Fedwire securities	1.5	1.3
Total	39.0	37.0

(6) Imputed Costs

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

Interest is imputed on the debt assumed necessary to finance priced-service assets; however, no debt was imputed in 2006 or 2005. The sales taxes and FDIC assessment that the Federal Reserve would have paid had it been a private-sector firm are also among the components of the PSAF.

Interest on float is derived from the value of float to be recovered, either explicitly or through per-item fees, during the period. Float costs include costs for checks, book-entry securities, ACH, and funds transfers.

Float cost or income is based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses less shipping expenses for each service to the total expenses for all services less the total shipping expenses for all services.

The following list shows the daily average recovery of actual float by the Reserve Banks for 2006 in millions of dollars:

Total float	–84.7
Unrecovered float	15.6
Float subject to recovery	–100.3
Sources of recovery of float	
Income on clearing balances	–10.0
As-of adjustments	–1.2
Direct charges	497.6
Per-item fees	–589.1

Unrecovered float includes float generated by services to government agencies and by other central bank services. Float recovered through income on clearing balances is the result of the increase in investable clearing balances; the increase is produced by a deduction for float for cash items in process of collection, which reduces imputed reserve requirements. The income on clearing balances reduces the float to be recovered through other means. As-of adjustments and direct charges refer to float that is created by interterritory check transportation and the observance of non-standard holidays by some depository institutions. Such float may be recovered from the depository institutions through adjustments to institution reserve or clearing balances or by billing institutions directly. Float recovered through direct charges and per-item fees is valued at the federal funds rate; credit float recovered through per-item fees has been subtracted from the cost base subject to recovery in 2006.

(7) Other Income and Expenses

Consists of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances for 2006 and 2005 represents the average coupon-equivalent yield on three-month Treasury bills plus a constant spread, based on the return on a portfolio of investments. In both years, the return is applied to the total clearing balance maintained, adjusted for the effect of reserve requirements on clearing balances. Expenses for earnings credits granted to depository institutions on their clearing balances are derived by applying a discounted average coupon-equivalent yield on three-month Treasury bills to the *required* portion of the clearing balances, adjusted for the net effect of reserve requirements on clearing balances.

The Board of Governors and the Government Performance and Results Act

The Government Performance and Results Act (GPRA) of 1993 requires that federal agencies, in consultation with Congress and outside stakeholders, prepare a strategic plan covering a multiyear period and submit an annual performance plan and performance report. Although the Federal Reserve is not covered by the GPRA, the Board of Governors voluntarily complies with the spirit of the act.

Strategic Plan, Performance Plan, and Performance Report

The Board's strategic plan articulates the Board's mission, sets forth major goals, outlines strategies for achieving those goals, and discusses the environment and other factors that could affect their achievement. It also addresses issues that cross agency jurisdictional lines, identifies key quantitative performance measures, and discusses performance evaluation. The most recent strategic plan covers the period 2006–09.

Both the performance plan and the performance report are prepared biennially. The performance plan sets forth specific targets for some of the performance measures identified in the strategic plan and describes the operational processes and resources needed to meet those targets. It also discusses data validation and results verification. The most recent performance plan covers the period 2006–07.

The performance report discusses the Board's performance in relation to its goals. The most recent performance report indicates that the Board generally met its goals for 2004–05.

All of the aforementioned documents are available on the Board's web site, at www.federalreserve.gov/boarddocs/rptcongress. The Board's mission statement and a summary of the Federal Reserve's goals and objectives, as set forth in the most recently released strategic and performance plans, are listed below.

Mission

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

Goals and Objectives

The Federal Reserve has six primary goals with interrelated and mutually reinforcing elements.

Goal

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

Objectives

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

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

Goal

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

Objectives

- Promote overall financial stability, manage and contain systemic risk, and identify emerging financial problems early so that crises can be averted.
- Provide a safe, sound, competitive, and accessible banking system through comprehensive and effective supervision of U.S. banks, bank and financial holding companies, foreign banking organizations, and related entities. At the same time, remain sensitive to the burden on supervised institutions.
- Provide a dynamic work environment that is challenging and rewarding. Enhance efficiency and effectiveness, while remaining sensitive to the burden on supervised institutions, by addressing the supervision function's procedures, technology, resource allocation, and staffing issues.
- Promote compliance by domestic and foreign banking organizations supervised by the Federal Reserve with applicable laws, rules, regulations, policies, and guidelines through a comprehensive and effective supervision program.

Goal

To effectively implement federal laws designed to inform and protect the consumer, to encourage community development, and to promote access to banking services in historically underserved markets

Objectives

- Take a leadership role in shaping the national dialogue on consumer protection in financial services, addressing the rapidly emerging issues that affect today's consumers, strengthening consumer compliance supervision programs when required, and remaining sensitive to the burden on supervised institutions.
- Promote, develop, and strengthen effective communications and collaborations within the Board, the Federal Reserve Banks, and other agencies and organizations.
- Increase public understanding of consumer protection and community development and the Board's role in these areas through increased outreach and by developing programs that address the information needs of consumers and the financial services industry.
- Develop a staff that is highly skilled, professional, innovative, and diverse, providing career development opportunities to ensure the retention of highly productive staff and recruiting highly qualified and skilled employees.

- Promote an efficient and effective work environment by aligning business functions with appropriate work processes and implementing solutions for work products and processes that can be handled more efficiently through automation.

Goal

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

Objectives

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

Goal

To provide high-quality professional oversight of Reserve Banks

Objective

- Produce high-quality assessments and oversight of Federal Reserve System strategies, projects, and operations, including adoption of technology to the business and operational needs of the Federal Reserve. The oversight process and outputs should help Federal Reserve management foster and strengthen sound internal control systems, efficient and reliable operations, effective performance, and sound project management and should assist the Board in the effective discharge of its oversight responsibilities.

Goal

To foster the integrity, efficiency, and effectiveness of Board programs

Objectives

- Oversee a planning and budget process that clearly identifies the Board's mission, results in concise plans for the effective accomplishment of operations, transmits to the staff the information needed to attain objectives efficiently, and allows the public to measure our accomplishments.
- Develop appropriate policies, oversight mechanisms, and measurement criteria to ensure that the recruiting, training, and retention of staff meet Board needs.
- Establish, encourage, and enforce a climate of fair and equitable treatment for all employees regardless of race, creed, color, national origin, age, or sex.
- Provide financial management support needed for sound business decisions.
- Provide cost-effective and secure information resource management services to Board divisions, support divisional distributed-processing requirements, and provide analysis on information technology issues to the Board, Reserve Banks, other financial regulatory institutions, and central banks.
- Efficiently provide safe, modern, and secure facilities and necessary support for activities conducive to efficient and effective Board operations. ■

Federal Legislative Developments

The following federal laws enacted during 2006 affect the Federal Reserve System and the institutions it regulates: the Financial Services Regulatory Relief Act of 2006; the Unlawful Internet Gambling Enforcement Act of 2006; the Military Personnel Financial Services Protection Act; and the Financial Netting Improvements Act of 2006.

Financial Services Regulatory Relief Act of 2006

On October 13, 2006, President Bush signed into law the Financial Services Regulatory Relief Act of 2006 (Regulatory Relief Act), culminating more than four years of work by Congress, the Board, and other interested parties. The act incorporates a number of significant monetary policy, supervisory, and regulatory provisions that were proposed or supported by the Board. These provisions should reduce unnecessary burden on banking organizations and improve operation of the financial system. The most important provisions of the Regulatory Relief Act affecting the Federal Reserve System and banking organizations supervised by the Federal Reserve are discussed below. Except as noted below, the act became effective on October 13, 2006.

Monetary Policy Provisions

Authority to Pay Interest on Balances Held at Reserve Banks and Greater Flexibility in Setting Reserve Requirements

For monetary policy purposes, federal law obliges the Board to establish reserve requirements on certain deposits held at depository institutions and mandates that the Board set the ratio of required reserves on transaction accounts above a certain percentage (8 percent for amounts above the so-called low reserve tranche, and 3 percent for amounts within the low reserve tranche). Because the Federal Reserve does not pay interest on balances held at Reserve Banks to meet reserve requirements, depositories have an incentive to reduce their reserve balances to a minimum. To do so, they engage in a variety of reserve-avoidance activities, including using “sweep” arrangements that move funds from accounts that are subject to reserve requirements to accounts and money market investments that are not. These sweep programs and similar activities absorb resources and therefore diminish banking system efficiency. Depository institutions also may voluntarily hold contractual clearing balances and excess reserve balances at a Reserve Bank. These balances also do not explicitly earn interest, although contractual clearing balances implicitly earn interest in the form of credits that may be used to pay for Federal Reserve services, such as check clearing.

The Regulatory Relief Act gives the Federal Reserve the authority, effective as of October 1, 2011, to pay explicit interest on all types of balances (including required reserves, excess reserves, and contractual clearing balances) held by or for depository institutions at a Reserve Bank. Paying interest on required reserve balances, once authorized, will remove a substantial portion of the incentive for depositories to engage in reserve-avoidance measures, and the resulting improvements in efficiency should eventually be passed through to bank borrowers and depositors.

Moreover, if the Board were to determine to pay explicit interest on contractual clearing balances, once authorized to do so, the action could provide a stable enough supply of voluntary balances to allow the Federal Reserve to effectively implement monetary policy using existing procedures without the need for required reserves.

Importantly, the Regulatory Relief Act gives the Board the discretion, effective as of October 1, 2011, to lower the ratio of reserves that a depository institution must maintain against its transaction accounts *below* the ranges currently established by law, including potentially establishing a zero reserve ratio. Thus, once these authorities become effective, the Board could reduce or even eliminate reserve requirements if it determined that such action was consistent with the effective implementation of monetary policy. Such action, if taken, would reduce a significant regulatory burden for all depository institutions.

Having the authority to pay interest on excess reserves also will enhance the Federal Reserve's monetary policy toolkit. If the Board were to determine to pay interest on such balances at some point in the future, the rate paid would act as a minimum for overnight interest rates and, thus, could help mitigate potential volatility in overnight interest rates.

Authority for Member Banks to Use Pass-Through Reserves

The Regulatory Relief Act also eliminated the statutory provisions that prohibited banks that are members of the Federal Reserve from counting as reserves their deposits in other banks that are "passed through" by those banks to the Federal Reserve as required reserve balances. These amendments, once implemented, will enable national and state member banks to take advantage of the same type of pass-through reserve arrangements previously available only to state nonmember banks.

Supervisory and Regulatory Provisions

Rules Implementing the "Broker" Exceptions for Banks Adopted as Part of the Gramm-Leach-Bliley Act

Before the Gramm-Leach-Bliley Act (GLB Act) of 1999, banks had a blanket exception from the definition of "broker" in the Securities Exchange Act of 1934. This meant that banks could engage in any type of securities activity permissible under federal and state banking laws without registering with the Securities and Exchange Commission (SEC) as a broker and without complying with the SEC's rules applicable to registered brokers. In the GLB Act, Congress eliminated this blanket exception for banks from the definition of "broker" and replaced it with eleven exceptions for broad types of securities activities conducted by banks. These new activity-focused exceptions were designed and intended to allow banks to continue to provide their customers with securities services as part of their usual trust, fiduciary, custodial, and other banking functions. The SEC requested comment on rules that would implement these "broker" exceptions for banks in 2001 and 2004.

The Regulatory Relief Act requires that the SEC and the Board, within 180 days of enactment, jointly request comment on a new "single set" of rules to implement the "broker" exceptions for banks that were adopted as part of the GLB Act. The Regulatory Relief Act also requires that the SEC and the Board jointly adopt a "single set" of final rules to implement these exceptions after consulting with, and seeking the concurrence of, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS). In addition, the act provides that the single set of final rules adopted jointly by the Board and the SEC shall supersede the rules previously issued by the SEC to implement these exceptions.

On December 18, 2006—well before the end of the 180-day period established by the Regulatory Relief Act—the Board and the SEC issued and requested comment on joint proposed rules to implement the "broker" exceptions for banks. *See* 71 FR 77,522 (Dec. 26, 2006). These joint proposed rules—designated Regulation R—are designed to accommodate the securities activities that banks conduct as part of their normal banking functions, consistent with the purposes of the GLB Act.

Expanded Eligibility for Eighteen-Month Examination Schedule for Small Banks

The Regulatory Relief Act expands the number of well-capitalized and well-managed small insured depository institutions that may qualify for an eighteen-month (rather than a twelve-month) on-site safety and soundness examination schedule. Before the act, an insured depository institution could qualify for an extended eighteen-month safety and soundness examination schedule only if the institution had less than $250 million in total assets, was well capitalized and well managed, and met certain other supervisory criteria. *See* 12 USC 1820(d)(4). The act raised this $250 million asset threshold for an eighteen-month exam cycle to $500 million, thereby allowing additional small, well-run institutions to potentially qualify for an extended examination schedule. On January 11, 2007, President Bush also signed into law a complementary bill, Pub. L. 109-473, that allows an insured depository institution that meets the new $500 million total assets threshold to potentially qualify for an eighteen-month on-site exam cycle if the institution received a composite rating of either a 1 or a 2 at its most recent safety and soundness examination.

Nonwaiver of Privileges

The Regulatory Relief Act includes an important provision that should facilitate the sharing of information between banking organizations and federal, state, and foreign banking authorities. Specifically, the act provides that any privilege (for example, attorney-client or work-product privilege) a person may have with respect to information is not waived or destroyed if the person provides that information to "any federal banking agency, state bank supervisor, or foreign banking authority for any purpose in the course of the supervisory or regulatory process of such agency, supervisor, or authority."

Voting State Representative Added to the Federal Financial Institutions Examination Council

Another provision of the Regulatory Relief Act adds a state representative as a voting member of the Federal Financial Institutions Examination Council (FFIEC). Specifically, the act provides for the current State Liaison Committee of the FFIEC (which is composed of five representatives of state supervisory agencies for depository institutions) to elect a chairperson, and adds this chairperson as a full voting member of the FFIEC.

Elimination of Certain Reporting Requirements Relating to Insider Lending

The Regulatory Relief Act eliminated certain reporting requirements previously imposed on banks and their executive officers and principal shareholders that the federal banking agencies did not find particularly useful in monitoring insider lending or preventing insider abuse. Specifically, the act eliminated the statutory provisions that previously required

- an executive officer of a bank to file a report with the bank's board of directors whenever the executive officer obtained a loan from *another* bank in an amount that exceeded the amount the executive officer could obtain from his or her own bank (12 USC 375a(g)(6)),
- a bank to file a separate report with its quarterly Call Report concerning any loans the bank made to its executive officers since its previous Call Report (12 USC 375a(g)(9)), and
- an executive officer or principal shareholder of a bank to file an annual report with the bank's board of directors if the officer or shareholder had a loan outstanding from a *correspondent* bank of the bank (12 USC 1972(2)(G)).

Although the act eliminated these reporting requirements, it did not alter the statutory and regulatory limits and restrictions on lending to insiders or the ability of the federal banking agencies to examine for potential insider lending abuses as part of the supervisory process. On December 6, 2006, the Board adopted, on an interim basis, and requested public comment on amendments to the Board's Regulation O (12 CFR 215) that implement the elimination of these reporting requirements. *See* 71 FR 71,472 (December 11, 2006).

Streamlining the Supervisory Process for Bank Merger Transactions

The Regulatory Relief Act streamlines the supervisory process for Bank Merger Act (12 USC 1828(c)) transactions in two respects. First, it eliminates the need for the responsible agency in a Bank Merger Act transaction to request a report on the competitive effects of the transaction from *each* of the other federal banking agencies, as well as the Attorney General. Instead, the act requires that the responsible agency request a competitive factors report only from the Attorney General and provide a copy of the request to the FDIC (if it is not the responsible agency). Second, the Regulatory Relief Act allows the reviewing agency for a Bank Merger Act transaction to avoid requesting a competitive factors report from the other federal banking agencies *and* the Attorney General if the transaction involves affiliated institutions. The act also eliminates the post-approval waiting period for bank mergers involving affiliated institutions, as these transactions typically do not present any competitive issues. The act does not, however, alter in any way the reviewing agency's obligation to conduct a competitive analysis of a proposed Merger Act transaction.

Amendment Allowing the Board to Grant Exceptions from the Attribution Rule in Section 2(g)(2) of the Bank Holding Company Act

Section 2(g)(2) of the Bank Holding Company Act (BHC Act) (12 USC 1841(g)(2)) provides that in all circumstances, a company is deemed to control any shares that are held by a trust for the benefit of the company or its shareholders, members, or employees. This attribution rule was intended to prevent a bank holding company from using a trust established for the benefit of its management, shareholders, or employees to evade the BHC Act's restrictions on the acquisition of shares of banks and nonbanking companies. However, the rule can create inappropriate results in situations in which the bank holding company does not have the ability to control, directly or indirectly, the shares acquired by the trust. Accordingly, the Regulatory Relief Act allows the Board to waive application of this attribution rule if the Board determines that the exception is appropriate in light of the facts and circumstances of the case and the purposes of the BHC Act. Such an exception might be appropriate, for example, if the shares are held by the trust as part of a participant-directed and widely held 401(k) plan and the plan's investment options are selected by an independent fiduciary (and not by the bank holding company or its officers, directors, or employees).

Streamlining Reports of Condition

The Regulatory Relief Act requires the Board and the other federal banking agencies to conduct a review of the Call Report forms within one year of enactment, and at least once every five years thereafter, and to eliminate any information or schedule that the agencies determine is no longer necessary or appropriate.

Increase in Asset Threshold for the Small Depository Institution Exception under the Depository Institution Management Interlocks Act

The Depository Institution Management Interlocks Act, among other things, generally prohibits a management official of one depository organization from serving as a management official of any other nonaffiliated depository organization if the organizations have offices located in the same metropolitan statistical area. The act provides an exception from this restriction if each of the depository organizations involved has less than a specified amount of total assets. The Regulatory Relief Act raised this specified amount from $20 million to $50 million, thus allowing a greater number of small depository organizations to qualify for the exception.

Protection of Confidential Information Received by Federal Banking Agencies from Foreign Banking Supervisors

The Regulatory Relief Act clarifies the authority of the Board and the other federal banking agencies to maintain the confidentiality of information obtained from a foreign regulatory or supervisory authority. Specifically, the act provides that a federal banking agency may not be compelled to disclose information received from a foreign regulatory or supervisory authority if public disclosure of the information would violate the law of the foreign country and the federal banking agency obtained the information in connection with the administration and enforcement of the federal banking laws or under a memorandum of understanding between the foreign authority and the agency. The act, however, would not authorize the agencies to withhold such information from Congress or if the information was sought under a court order in an action initiated by the United States or the agency.

Modification to Cross-Marketing Restrictions Applicable to Merchant Banking Investments

Another provision of the Regulatory Relief Act allows the depository institution subsidiaries of a financial holding company, with prior Board approval, to engage in cross-marketing activities through “statement stuffers” and Internet web sites with nonfinancial portfolio companies held by the financial holding company under the GLB Act’s merchant banking authority. Previously, the depository institution subsidiaries of a financial holding company were permitted to engage, with Board approval, in these limited types of cross-marketing activities only with portfolio companies held by the financial holding company under the GLB Act’s insurance company investment authority.

Change in Bank Control Act Amendments

The Regulatory Relief Act expands the factors that the Board and the other federal banking agencies may consider in determining whether to disapprove, or extend the time period for processing, a notice filed under the Change in Bank Control Act (CIBC Act). In particular, the act allows the appropriate federal banking agency to disapprove a CIBC Act notice if the agency determines that the future prospects of the institution to be acquired might jeopardize the stability of the institution or the interests of depositors. (Currently, the financial and managerial factors in the CIBC Act focus on the resources of the acquiring person, not the institution to be acquired.) In addition, the act allows an agency to extend the time for processing a CIBC Act notice for up to an additional two 45-day periods (beyond the initial 60-day review period and discretionary 30-day extension) if the agency determines that additional time is needed to analyze (1) the future prospects of the institution to be acquired or (2) the safety and soundness of any plans by the acquiring person to make major changes in the business, corporate structure, or management of the institution.

Amendments to Allow D.C.-Chartered Banks to Become State Member Banks

The Regulatory Relief Act makes several technical changes to the Federal Reserve Act to allow banks chartered in the District of Columbia to become state member banks.

Enforcement-Related Provisions

Amendments Expanding the Agencies’ Suspension Authority

The Federal Deposit Insurance Act (FDI Act) currently allows the appropriate federal banking agency to suspend, remove, or prohibit an institution-affiliated party (IAP) from participating in the affairs of the depository institution with which he or she is affiliated if the IAP is charged with or convicted of certain crimes involving dishonesty, breach of trust, or money laundering. *See* 12 USC 1818(g)(1). The Regulatory Relief Act expands this authority by allowing the appropriate federal banking agency to suspend an IAP that has been charged with such a crime from participating in the affairs of *any* depository institution (not just the institution at which the IAP then serves). In addition, the act clarifies that the appropriate agency may suspend, remove, or prohibit an IAP even if the IAP is no longer associated with any depository institution at the time the action is taken.

Restricting the Ability of Convicted Individuals to Participate in the Affairs of a Bank Holding Company or Edge Act or Agreement Corporation

Section 19 of the Federal Deposit Insurance Act (12 USC 1829) automatically prohibits a person that has been convicted of a crime involving dishonesty, a breach of trust, or money laundering from participating in the affairs of an insured depository institution without the consent of the FDIC. The Regulatory Relief Act extends this prohibition so that persons convicted of such crimes also may not participate in the affairs of a bank holding company (other than a foreign bank), an Edge or agreement corporation, or a savings and loan holding company unless the individual receives the prior consent of the Board or the OTS, as appropriate. The Regulatory Relief Act also gives the Board and the OTS additional discretionary authority to remove a person convicted of such a crime from, respectively, a nonbank subsidiary of a bank holding company or a savings and loan holding company.

Authority to Enforce Deposit Insurance Conditions

Section 8 of the Federal Deposit Insurance Act currently permits the appropriate federal banking agency for an insured depository institution to enforce a written condition imposed by that agency on the institution or an IAP of the institution. The Regulatory Relief Act amended section 8 of the FDI Act to allow the appropriate federal banking agency for an institution to enforce a condition imposed on an insured depository institution by another federal banking agency. This will allow, for example, the Board (as the appropriate agency for a state member bank) to enforce a condition imposed on a state member bank by the FDIC in connection with the bank's application for deposit insurance

Standards for Enforcing Written Conditions and Written Agreements

The Regulatory Relief Act also amended section 8 of the Federal Deposit Insurance Act to allow the appropriate federal banking agency for an insured depository institution to enforce a written condition imposed on the institution or an IAP, or a written agreement entered into by the agency with the institution or IAP, without demonstrating that the institution or IAP was unjustly enriched or acted in reckless disregard of the law or a prior agency order. Similarly, the act allows the appropriate federal banking agency for an undercapitalized institution to enforce a written condition imposed on, or a written agreement entered into with, the institution or an IAP without regard to the limit in the FDI Act (12 USC 1831o(e)(2)(E)) that normally caps the liability of a controlling shareholder under a capital restoration plan.

Clarifying the Ability of the Banking Agencies to Enforce Conditions Imposed in Connection with CIBC Act Notices

The Regulatory Relief Act amends section 8(b) of the Federal Deposit Insurance Act to provide that the appropriate federal banking agency for an insured depository institution may enforce written conditions imposed in connection with "any action on any application, notice, or other request" by the depository institution or an IAP. These changes are designed to clarify and confirm the agencies' ability to enforce conditions imposed in connection with a notice filed under the Change in Bank Control Act.

Board Approval of OCC Removal Actions

The Regulatory Relief Act strikes the provision in the FDI Act (*see* 12 USC 1818(e)(4)) that required the Board to issue a final decision in any contested administrative action by the OCC to remove or prohibit an IAP of a national bank. Thus, the OCC now has the same authority as the Board, the FDIC, and the OTS to independently remove or prohibit an IAP of an institution under the agency's jurisdiction.

Consumer-Related Provisions

Public Welfare Investments by National and State Banks

The Regulatory Relief Act makes several important modifications to the statutes that authorize national and state member banks to make "public welfare" investments. *See* 12 USC 24 (eleventh) and 338a. First, it raises, from 10 percent of capital and surplus to 15 percent of capital and surplus, the aggregate amount of "public welfare" investments that a national or state member bank may make under these authorities.[1] In addition, the act refocuses these investments on low- and moderate-income (LMI) families and communities by providing that to be considered a "public welfare" investment, an investment must primarily benefit LMI families or communities (such as by providing housing, services, or jobs). The act also clarifies that each "public welfare" investment made by a national or state member bank, either directly or through a subsidiary, must benefit primarily LMI communities or families.

Development of Model Privacy Disclosure Forms

The Regulatory Relief Act requires the Board, the other federal banking agencies, the National Credit Union Administration, the Secretary of the Treasury, the Securities and Exchange Commission, and the Federal Trade Commission to jointly develop a model form that may be used by financial institutions, at their option, to fulfill the initial and annual privacy policy disclosure requirements imposed by section 503 of the Gramm-Leach-Bliley Act (12 USC 6803). The model form must be issued in proposed form for public comment within 180 days of enactment. The Board has been working extensively with the other relevant agencies and conducting consumer testing to develop potential model privacy forms that may be used by financial institutions.

Studies and Reports

GAO Study of Currency Transaction Reports

The Regulatory Relief Act directs the Government Accountability Office (GAO) to conduct a study of the volume of currency transaction reports (CTRs) filed with the Secretary of the Treasury under the Bank Secrecy Act. The study must evaluate, among other things, (1) the extent to which depository institutions avail themselves of the current exemption system for CTRs, (2) ways to improve the current exemption system for CTRs, and (3) the usefulness of CTRs to law enforcement agencies. The Regulatory Relief Act also provides that the study should include recommendations for changes to the CTR exemption system that would reduce burden without adversely affecting the reporting system's effectiveness. The GAO must submit a report on its findings to Congress by January 13, 2007.

Unlawful Internet Gambling Enforcement Act of 2006

The Unlawful Internet Gambling Enforcement Act of 2006, Pub. L. 109-347, (codified at 31 USC 5361 et seq.) prohibits a person engaged in the busi-

1. As under current law, a national or state member bank would have to obtain the approval of the OCC or the Board, respectively, to make "public welfare" investments that, in the aggregate, exceed 5 percent of the bank's capital and surplus.

ness of betting or wagering from knowingly accepting credit, electronic fund transfers, checks, drafts, or similar instruments drawn on or payable through any financial institution in connection with the participation of another person in unlawful Internet gambling ("restricted transactions"). The act generally defines "unlawful Internet gambling" as transmitting a bet by any means that involves the use, at least in part, of the Internet and where such bet or wager is unlawful under any applicable federal or state law in the state or tribal lands in which the bet or wager is initiated, received, or otherwise made.

The act charges the Secretary of the Treasury and the Board, in consultation with the Attorney General, with developing regulations to require each payment system that the agencies determine could be used to process restricted payments (as well as financial transaction providers participating in such payment systems) to establish "policies and procedures reasonably designed to identify and block or otherwise prevent or prohibit the acceptance of restricted transactions." In prescribing the regulations, the Secretary and the Board must identify the types of policies and procedures, including nonexclusive examples, deemed by the agencies to be reasonably designed to identify and block restricted transactions. To the extent practical, any participant in a designated payment system must be permitted to choose among alternative means of complying, including by relying on and complying with the policies and procedures of the designated payment system, so long as these policies and procedures comply with the regulation. The act also requires the Secretary and the Board to grant exemptions from any requirement imposed under the regulations to particular types of transactions or designated payment systems if the agencies jointly find that it is not reasonably practical to identify and block, or otherwise prevent or prohibit, such restricted transactions. The regulations must be published by July 10, 2007.

Military Personnel Financial Services Protection Act

The National Defense Authorization Act for Fiscal Year 2007, Pub. L. No. 109-364, enacted on September 30, 2006, imposes restrictions on and disclosure requirements for consumer credit provided to members of the military and their families. The act charges the Department of Defense (DOD) with defining "consumer credit" in its regulations and permits the DOD to include all consumer credit apart from residential mortgages, loans to fund the purchase of a motor vehicle, and other personal property loans when the property purchased from the proceeds of the loan serves as collateral for the loan. Requirements for creditors include a 36 percent annual percentage rate (APR) cap, which includes all fees, along with APR calculations and disclosures that differ from the APR used in disclosures under the Truth in Lending Act (TILA). The act mandates that all credit disclosures, including TILA disclosures, be provided both orally and in writing prior to the extension of credit.

Moreover, the act imposes limitations on lending to members of the military and their dependents, such as prohibiting rollovers and refinancings of consumer credit by the same creditor, and prohibiting loans with prepayment penalties and mandatory arbitration clauses. The act imposes criminal and monetary penalties for knowing violations and voids contracts that are prohibited under the statute. The legislation was intended, at least in part, to address concerns about payday loans, installment loans that are secured by a motor vehicle (other than loans for the purchase of a motor vehicle), and other forms of short-term credit to military members and their dependents. In prescribing regulations for this legislation, the DOD must consult with the Board, among other federal agencies. The effective date of the act is October 1, 2007, regardless of whether the DOD adopts regulations. This statute would become effective earlier if interim regulations are issued by the DOD.

Financial Netting Improvements Act of 2006

In 2005, Congress passed comprehensive legislation to revise the federal bankruptcy laws (Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8). Title IX of that act contained amendments to banking laws and the Bankruptcy Code to provide increased certainty that netting and close-out of financial market contracts would be enforceable, even in the event of a counterparty insolvency. Title IX also clarified certain duties and obligations of the FDIC as receiver or conservator of an insured depository institution.

The Financial Netting Improvements Act of 2006 (Pub. L. 109-390), enacted on December 12, 2006, makes technical changes to the netting and financial contract provisions that were added or revised by title IX of the 2005 act. The 2006 act updates the descriptions of various financial contracts ("securities contract," "forward contract," and "swap agreement") in the Federal Deposit Insurance Act, the Federal Credit Union Act (FCUA), and the Bankruptcy Code to reflect current market and regulatory practice. The 2006 act also revises provisions in the Bankruptcy Code to clarify the rights of certain counterparties to exercise self-help foreclosure-on-collateral rights, setoff rights, and netting rights with respect to financial contracts with a debtor. These provisions conform the Bankruptcy Code with parallel provisions in the FDI Act and the FCUA. In addition, the 2006 act amends the FDI Act and the FCUA to clarify the conditions under which a receiver of an insolvent depository institution can enforce a financial contract that contains a "walkaway" clause (a clause that would otherwise allow a contract participant to suspend, condition, or extinguish a payment obligation when the other party becomes insolvent). The 2006 act also makes other technical and conforming revisions to the FDI Act, FCUA, Bankruptcy Code, Federal Deposit Insurance Corporation Improvement Act of 1991, and Securities Investor Protection Act of 1970. ■

Records

Record of Policy Actions of the Board of Governors

Regulation D
Reserve Requirements of Depository Institutions

[Docket No. R-1268]

On October 18, 2006, the Board approved amendments to reflect the annual indexing of the low reserve tranche and of the reserve requirement exemption for use in 2007 reserve requirement calculations. The amendments decrease the 3 percent low reserve tranche for net transaction accounts to $45.8 million (from $48.3 million in 2006) and increase the reserve requirement exemption to $8.5 million (from $7.8 million in 2006).

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Warsh, Kroszner, and Mishkin. Absent and not voting: Governor Bies.

Regulation E
Electronic Fund Transfers

[Docket No. R-1247]

On August 24, 2006, the Board approved amendments to Regulation E and its official staff commentary to apply the regulation to payroll card accounts established to distribute employee salaries, wages, or other compensation on a recurring basis. The amendments also provide financial institutions with an alternative to sending periodic statements for payroll card accounts if they make account information available to account holders by certain specified means. The amendments are effective July 1, 2007.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, and Kroszner.

[Docket No. R-1265]

On November 27, 2006, the Board approved amendments to Regulation E and its official staff commentary to clarify that the requirement to obtain consumer authorization applies to any person who intends to collect electronically a fee for a check or other item that is returned unpaid. The amendments also provide guidance on the regulation's requirements concerning consumer notice when a returned-item fee is collected electronically or a transaction involves an electronic check conversion. The amendments, which are based substantially on an interim final rule approved on August 24, 2006, are effective January 1, 2007; compliance with certain disclosure requirements for returned-item fees collected in connection with point-of-sale transactions is delayed until January 1, 2008.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, and Kroszner. Absent and not voting: Governor Mishkin.

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

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

Regulation Y
Bank Holding Companies
and Change in Bank Control

[Docket No. R-1087]

On February 2, 2006, the Board, acting with the other federal bank regulatory agencies, approved amendments to the agencies' market risk rules to reduce the capital requirement for certain securities-borrowing transactions collateralized with cash. The interagency rule, which makes permanent and expands an interim final rule approved in 2000, is effective February 22, 2006.

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

Regulation K
International Banking Operations

[Docket No. R-1147]

On March 15, 2006, the Board approved amendments requiring Edge Act and agreement corporations and the U.S. branches, agencies, and representative offices of foreign banks supervised by the Board to establish and maintain procedures that ensure and monitor compliance with the Bank Secrecy Act and related regulations. The amendments are effective April 19, 2006.

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

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

[Docket No. R-1271]

On December 6, 2006, the Board approved an interim final rule, with request for comment, to implement section 601 of the Financial Services Regulatory Relief Act of 2006 by eliminating certain reporting requirements that have not contributed significantly to effective monitoring or prevention of insider lending abuse. The interim final rule is effective December 11, 2006.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, Kroszner, and Mishkin.

Regulation Y
Bank Holding Companies
and Change in Bank Control

[Docket No. R-1235]

On February 22, 2006, the Board approved amendments to expand the applicability of its Small Bank Holding Company Policy Statement and related exemptions from its consolidated capital adequacy guidelines on risk-based and leverage measures by increasing the asset-size limitation specified in the policy statement from $150 million to $500 million. The amended policy statement does not apply, however, to bank holding companies with less than $500 million in assets that engage in significant nonbanking or off-balance-sheet activities or have a material amount of debt or equity securities registered with the Securities and Exchange Commission. The amendments also clarify that subordinated debt related to the issuance of trust preferred securities generally would be treated as debt under the policy statement, subject to a five-year transition period. The amendments are effective March 30, 2006.

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

Regulation BB
Community Reinvestment

[Docket No. OP-1240]

On March 1, 2006, the Board, acting with the other federal bank regulatory agencies, approved guidance intended to aid implementation of recent changes to the agencies' regulations under the Community Reinvestment Act (CRA). The guidance discusses, among other regulatory topics, (1) the criteria for determining if an area is distressed, is underserved, or has suffered a disaster; (2) the period of time that bank activities in those areas are eligible for consideration in a CRA evaluation; and (3) the standards used by CRA examiners to decide if such activities qualify as "community development." The guidance also explains how the new community development test for intermediate small banks (banks with assets between $250 million and $1 billion) will be applied. The interagency guidance is effective March 10, 2006.

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

Rules Regarding Equal Opportunity

[Docket No. OP-1264]

On August 1, 2006, the Board approved an interim rule, with request for comment, to extend eligibility for access to confidential supervisory information to certain noncitizen employees. The interim rule is effective August 7, 2006, and also applies to all grants of access made as of that date.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, and Kroszner.

Policy Statements and Other Actions

Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters

On January 30, 2006, the Board, acting with the other federal financial regulatory agencies, approved an advisory to address safety and soundness concerns associated with agreements by financial institutions that limit the liability of their external auditors. The advisory applies to provisions that (1) indemnify an external auditor against claims made by third parties (including punitive damages); (2) hold harmless or release an external auditor from liability for claims or potential claims that might be asserted by the client financial institution; or (3) limit the remedies available to the client financial institution. Provisions that waive the right of financial institutions to seek punitive damages against their external auditors are not considered unsafe and unsound under the advisory. The interagency advisory is effective for engagement letters executed on or after February 9, 2006.

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

Federal Reserve Currency Recirculation Policy

[Docket No. OP-1164]

On March 17, 2006, the Board revised the Federal Reserve System's cash services policy, with the intention of increasing the recirculation of fit currency by (1) initiating a custodial inventory program to encourage depository institutions to hold $10 and $20 notes in their vaults to meet customer demand and (2) charging a fee to depository institutions that deposit fit $10 or $20 notes at a Reserve Bank and order the same denominations, above a de minimis amount, during the same business week. The custodial inventory program will begin in July 2006, and fee assessments are expected to begin in July 2007.

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

Nontraditional Mortgage Product Risks

[Docket No. OP-1246]

On September 27, 2006, the Board, acting with the other federal financial regulatory agencies, approved interagency guidance on underwriting and managing nontraditional mortgage products (loans that allow borrowers to defer payment of principal and in some cases interest) in a safe and sound manner and on clearly disclosing the potential risks of those products.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, Kroszner, and Mishkin.

Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices

[Docket No. OP-1248]

On December 6, 2006, the Board, acting with the other federal bank regulatory agencies, approved guidance intended to reinforce sound risk-management practices for institutions that have high and increasing concentrations of commercial real estate loans on their balance sheets. The guidance includes supervisory criteria to assist in identifying institutions that have potentially significant concentrations. The interagency guidance is effective December 12, 2006.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, Kroszner, and Mishkin.

Interagency Statement on Sound Practices concerning Elevated Risk Complex Structured Finance Activities

[Docket No. OP-1254]

On December 20, 2006, the Board, acting with the Securities and Exchange Commission and the other federal bank and thrift regulatory agencies, approved a statement that describes internal controls and risk-management procedures to assist financial institutions in identifying, managing, and addressing the heightened legal and reputational risks associated with certain complex structured finance transactions. The interagency statement is effective January 11, 2007.

Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Kroszner, and Mishkin. Absent and not voting: Governor Warsh.

Discount Rates in 2006

Under the Federal Reserve Act, boards of directors of the Federal Reserve Banks must establish rates on loans to depository institutions at least every fourteen days, subject to review and determination by the Board of Governors.

Primary Credit

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

During 2006, the Board approved four increases in the primary credit rate, bringing the rate from 5¼ percent to 6¼ percent. The Board reached its determinations on the primary credit rate recommendations of the Reserve Bank boards of directors in conjunction with the FOMC's decisions to raise the target federal funds rate from 4¼ percent to 5¼ percent and related economic and financial developments. Rising energy prices coupled with high levels of resource utilization contributed to heightened inflation pressures over the first half of the year. Those pressures receded over the second half of the year as energy prices dropped and weakness in the housing sector weighed on economic activity. In light of these conditions, the Federal Reserve raised the structure of policy rates at a measured pace in the first half of the year and kept those rates unchanged for the remainder of the year. Monetary policy developments are reviewed more fully in other parts of this report (see the section "Monetary Policy and Economic Developments" and the minutes of FOMC meetings held in 2006).

Secondary and Seasonal Credit

Secondary credit is available in appropriate circumstances to depository institutions that do not qualify for primary credit. The secondary credit rate is set at a spread above the primary credit rate. In 2006, the spread was set at 50 basis points.

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

At year-end, the secondary and seasonal credit rates were 6¾ percent and 5.30 percent, respectively.

Votes on Discount Rate Changes

About every two weeks during 2006, the Board approved proposals by the twelve Reserve Banks to maintain the formulas for computing the secondary and seasonal credit rates. Details on the four actions by the Board to approve changes in the primary credit rate are provided below.

January 31, 2006. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 5½ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective February 1, 2006. The

Board also approved an identical action subsequently taken by the directors of the Federal Reserve Bank of Minneapolis, effective February 2, 2006.

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

March 28, 2006. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 5¾ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective March 29, 2006. The Board also approved an identical action subsequently taken by the directors of the Federal Reserve Bank of Kansas City, effective March 30, 2006.

> Votes for this action: Chairman Bernanke and Governors Bies, Olson, Kohn, Warsh, and Kroszner. Votes against this action: None.

May 10, 2006. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 6 percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective May 11, 2006. The Board also approved an identical action subsequently taken by the directors of the Federal Reserve Bank of Kansas City, effective May 11, 2006.

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

June 29, 2006. Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, and Dallas to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 6¼ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective June 30, 2006. The Board also approved identical actions subsequently taken by the directors of the Federal Reserve Banks of San Francisco, effective June 29, 2006, and Kansas City, effective July 6, 2006.

> Votes for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Bies, Warsh, and Kroszner. Votes against this action: None. ■

Minutes of Federal Open Market Committee Meetings

The policy actions of the Federal Open Market Committee, contained in the minutes of its meetings, are presented in the Annual Report of the Board of Governors pursuant to the requirements of section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each policy action, and that it shall include in its annual report to 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 summary of the information and discussions that led to the decisions. The descriptions of economic and financial conditions are based solely on the information that was available to the Committee at the time of the meetings.

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

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market operations, the Federal Reserve Bank of New York operates under instructions from the Federal Open Market Committee that take the form of 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 Federal Reserve Bank of New York 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 2006. 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, 2006

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.

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

(c) To sell U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding. The Federal Reserve Bank of New York shall set a minimum lending fee consistent with the objectives of the program and apply reasonable limitations on the total amount of a specific issue that may be auctioned and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York and accounts maintained at the Federal Reserve Bank of New York as fiscal agent of the United States pursuant to Section 15 of the Federal Reserve Act, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities in 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and such foreign, international, and fiscal agency accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

Domestic Policy Directive

In Effect January 1, 2006[1]

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 4¼ percent.

Authorization for Foreign Currency Operations

In Effect January 1, 2006

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

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

Canadian dollars	Mexican pesos
Danish kroner	Norwegian kroner
Euro	Swedish kronor
Pounds sterling	Swiss francs
Japanese yen	

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

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

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

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

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada	2,000
Bank of Mexico	3,000

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

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

1. Adopted by the Committee at its meeting on December 13, 2005.

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

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

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

7. The Chairman is authorized:

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

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

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

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

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

Foreign Currency Directive

In Effect January 1, 2006

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

2. To achieve this end the System shall:

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

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

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

3. Transactions may also be undertaken:

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

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

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

4. System foreign currency operations shall be conducted:

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

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

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

Procedural Instructions with Respect to Foreign Currency Operations

In Effect January 1, 2006

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

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

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

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

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

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

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

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

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

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

Meeting Held on January 31, 2006

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, January 31, 2006 at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Ferguson
Mr. Guynn
Mr. Kohn
Mr. Lacker
Mr. Olson
Ms. Pianalto
Ms. Yellen

Mses. Cumming and Minehan, Messrs. Moskow, Poole, and Hoenig, Alternate Members of the Federal Open Market Committee

Messrs. Fisher, Stern, and Santomero, Presidents of the Federal Reserve Banks of Dallas, Minneapolis, and Philadelphia, respectively

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Eisenbeis, Judd, Kamin, Madigan, Sniderman, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Oliner and Slifman, Associate Directors, Division of Research and Statistics, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Messrs. English and Sheets, Assistant Directors, Division of Monetary Affairs and International Finance, respectively, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Chaboud and Mses. Kusko and Weinbach, Senior Economists, Divisions of International Finance, Research and Statistics, and Monetary Affairs, respectively, Board of Governors

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

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Mr. Stone, First Vice President, Federal Reserve Bank of Philadelphia

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Messrs. Evans and Hakkio, Mses. Mester and Perelmuter, and Messrs. Rasche, Rolnick, and Steindel, Senior Vice Presidents, Federal Reserve Banks of Chicago, Kansas City, Philadelphia, New York, St. Louis, Minneapolis, and New York, respectively

Mr. Hetzel, Senior Economist, Federal Reserve Bank of Richmond

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for a term beginning January 31, 2006 had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

Timothy F. Geithner, President of the Federal Reserve Bank of New York, with Christine M. Cumming, First Vice President, Federal Reserve Bank of New York as alternate.

Jeffrey M. Lacker, President of the Federal Reserve Bank of Richmond, with Cathy E. Minehan, President of the Federal Reserve Bank of Boston as alternate.

Sandra Pianalto, President of the Federal Reserve Bank of Cleveland, with Michael H. Moskow, President of the Federal Reserve Bank of Chicago as alternate.

Jack Guynn, President of the Federal Reserve Bank of Atlanta, with William Poole, President of the Federal Reserve Bank of St. Louis as alternate.

Janet L. Yellen, 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 selected to serve until the selection of their successors at the first regularly scheduled meeting of the Committee in 2007, 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[2]
Timothy F. Geithner	Vice Chairman
Vincent R. Reinhart	Secretary and Economist
Deborah J. Danker	Deputy Secretary
David W. Skidmore	Assistant Secretary
Michelle A. Smith	Assistant Secretary
Scott G. Alvarez	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Karen H. Johnson	Economist
David J. Stockton	Economist

Thomas A. Connors, Robert A. Eisenbeis, John P. Judd, Steven B. Kamin, Brian F. Madigan, Mark S. Sniderman, Charles S. Struckmeyer, Joseph S. Tracy, John A. Weinberg, and David W. Wilcox, Associate Economists

In addition, it was agreed that the Committee would conduct a notation vote upon the swearing in of a new Chairman of the Board of Governors to elect Alan Greenspan's successor as Chairman of the Committee.[3]

By unanimous vote, Deborah J. Danker, or her successor as Deputy Secretary, was elected to serve as Chief Freedom of Information Act Officer to comply with an Executive Order issued on December 14, 2005 that requires federal agencies to take certain actions relating to FOIA activities.

By unanimous vote, the Committee amended its Program for Security of FOMC Information, primarily to reflect incorporation of the Board's new rules on access to confidential information by non-citizens.

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market.

By unanimous vote, Dino Kos was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.[4]

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

Authorization for Domestic Open Market Operations (Reaffirmed January 31, 2006)

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

2. Alan Greenspan was elected to serve for the remainder of the day.

3. Secretary's note: By notation vote completed on February 1, 2006 the Committee unanimously approved the election of Ben S. Bernanke as Chairman of the Federal Open Market Committee.

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

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;

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

(c) To sell U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding. The Federal Reserve Bank of New York shall set a minimum lending fee consistent with the objectives of the program and apply reasonable limitations on the total amount of a specific issue that may be auctioned and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York and accounts maintained at the Federal Reserve Bank of New York as fiscal agent of the United States pursuant to Section 15 of the Federal Reserve Act, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such accounts on the bases set forth in paragraph l(a) under agreements providing for the resale by such accounts of those securities in 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph l(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and such foreign, international, and fiscal agency accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

With Mr. Lacker dissenting, the Committee approved the Authorization for Foreign Currency Operations with an amendment to paragraph 5 which clarifies the language about permissible investment activities for the foreign portfolio and brings that language into alignment with that present in the authorization for the domestic portfolio. Accordingly, the Authorization for Foreign Currency Operations was adopted, effective January 31, 2006, as shown below.

Authorization for Foreign Currency Operations (Amended January 31, 2006)

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

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

Canadian dollars	Mexican pesos
Danish kroner	Norwegian kroner
Euro	Swedish kronor
Pounds sterling	Swiss francs
Japanese yen	

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

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

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

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

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada	2,000
Bank of Mexico	3,000

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

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

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

agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). Such investments may include buying or selling outright obligations of, or fully guaranteed as to principal and interest by, a foreign government or agency thereof; buying such securities under agreements for repurchase of such securities; selling such securities under agreements for the resale of such securities; and holding various time and other deposit accounts at foreign institutions. In addition, when appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

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

7. The Chairman is authorized:

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

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

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

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

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

With Mr. Lacker dissenting, the Foreign Currency Directive was reaffirmed in the form shown below.

Foreign Currency Directive (Reaffirmed January 31, 2006)

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

2. To achieve this end the System shall:

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

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

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

3. Transactions may also be undertaken:

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

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

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

4. System foreign currency operations shall be conducted:

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

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

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

Mr. Lacker dissented in the votes on the Foreign Currency Directive and Authorization for Foreign Currency Operations to indicate his opposition to foreign currency intervention by the Federal Reserve. In his view, such intervention would be ineffective if it did not also signal a shift in domestic monetary policy. And if it did signal such a shift, it could potentially compromise the Federal Reserve's monetary policy independence.

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

Procedural Instructions with Respect to Foreign Currency Operations (Reaffirmed January 31, 2006)

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

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

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

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

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

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

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

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

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

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

Among the organizational matters raised, the Committee indicated that it intended to take up at a future meeting the relationship between its formal vote and the policy statement issued after each meeting.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that underlying growth in aggregate demand remained solid, even though the expansion of real GDP was estimated to have slowed in the fourth quarter. Household spending rose smartly, outside of autos, and orders and shipments of nondefense capital goods in the business sector were generally quite strong. Housing markets showed some signs of cooling, but starts and sales remained at high levels. Industrial production posted moderate gains, even after excluding hurricane-related rebounds in some production categories, and private payrolls expanded at a firm rate on average. Headline consumer inflation had been held down by falling consumer energy prices; more recently, however, crude oil prices climbed back up to high levels. Meanwhile, core inflation had moved up a bit from low levels seen last summer.

Labor demand expanded further in the fourth quarter, as private nonfarm payrolls showed large gains in November followed by more-modest gains in December. The average increase over those two months represented sturdy job gains, even after accounting for the likely catch-up in employment following Hurricanes Katrina and Rita. Several sectors, including manufacturing and several service groups, added vigorously to payrolls in December, but the total for the month was held down by employment declines in a number of sectors, such as retail trade and construction, where seasonal adjustment can be difficult this time of year. Aggregate hours fell slightly in December owing to a decrease in the workweek, but they rose over the fourth quarter as a whole. The unemployment rate edged down to 4.9 percent in part due to the labor force participation rate ticking down.

Industrial production rose notably in November and December, boosted by partial recovery from the effects of the hurricanes. Production in the mining industry, which includes oil and gas extraction, increased sharply. Utilities output also popped up in December as temperatures turned unseasonably cold in the first half of the month. Abstracting from the effects of these special factors, underlying activity in the industrial sector advanced moderately. Modest production increases in most manufacturing categories in December, including high-tech, consumer goods, and business equipment, outweighed production declines in the motor vehicles and parts sector. The capacity utilization rate in manufacturing stood a bit above its level of one year ago and near its long-run average.

Real personal consumption expenditures appeared to have increased only modestly in the fourth quarter, as spending on motor vehicles was restrained following a surge in the summer in response to manufacturers' price incentives. Outside of motor vehicles, consumption was brisk, supported by job growth, increases in personal income, and the decline in energy prices. Consumption was also likely supported by further gains in home values and equity prices that raised the ratio of household wealth to disposable income relative to that seen earlier in 2005. Consumer sentiment measured by surveys moved up in December and, judging by the preliminary reading of the Michigan Survey, edged up further in January.

Activity in the housing market appeared to continue at high levels, although there were some indications of slowing. Single-family housing starts decreased markedly in December; however, this decline may have been due in part to unusually cold and wet weather in some areas of the country. Multifamily housing starts increased in December. Sales of new and existing homes remained at elevated levels but slowed somewhat toward the end of the year. Moreover, the stock of homes for sale increased to the upper end of ranges seen in recent years. Recent data on mortgage applications and survey measures of homebuying attitudes also pointed to some cooling in the housing market.

Real outlays for equipment and software appeared to have slowed significantly in the fourth quarter, as expenditures for transportation and communications equipment reversed some of their earlier sharp increases. With few exceptions, however, new orders appeared to be quite strong, and order backlogs increased for several goods in the transportation sector. Underlying fundamentals continued to support gains in capital spending as business sector output expanded, firms remained flush with funds, and relative price declines pushed down the user cost of capital equipment. Anecdotal reports and surveys also indicated that businesses were optimistic about near-term capital spending plans. Vacancy rates for nonresidential properties drifted lower as construction expenditures on commercial and manufacturing structures remained well below recent peaks. However, spending on drilling and mining structures continued to increase strongly. Business investment in real nonfarm inventories increased moderately in the fourth quarter, boosted by a rapid accumulation of motor vehicle inventories. Outside of motor vehicles, stocks continued to rise slowly. The restrained growth in inventories in recent months suggested that firms outside the motor vehicle sector were intentionally keeping stockbuilding low; however, it could also have reflected an unanticipated increase in sales or supply interruptions following the hurricanes last fall. That said, the level of stocks appeared reasonably well aligned with demand in most industries.

After increasing further in October, the U.S. international trade deficit narrowed somewhat in November. The reduction in the deficit reflected a modest increase in exports and a similar-sized decrease in imports that owed importantly to a decline in imports of oil. The firm pace of third-quarter GDP growth in foreign economies generally appeared to continue in the fourth quarter.

Core consumer price inflation remained moderate over the second half of last year. Core prices had posted a string of very low increases last summer, held down in part by falling motor vehicle prices. In recent months, increases in core prices had rebounded. The overall consumer price index edged down further in December in response to substantial declines in its volatile energy price components. However, survey data pointed to large increases in gasoline prices in January, which were due to the backup in crude oil prices. Preliminary survey measures of near-term inflation expectations for January had nonetheless ticked down, continuing the reversal of a sharp increase after the hurricanes last fall, and longer-term inflation expectations had moved lower as well. Input prices increased somewhat less in December, as upward pressure from previous energy price increases receded somewhat. Indeed, the increase in core intermediate producer prices over the year was estimated to be considerably lower than over the previous year. At its December meeting, the Federal Open Market Committee decided to increase the target level of the federal funds rate 25 basis points, to 4¼ percent. In its accompanying statement, the Committee indicated that, despite elevated energy prices and hurricane-related disruptions, the expansion in economic activity appeared solid. Core inflation had stayed relatively low in recent months, and longer-term inflation expectations had remained contained. Nevertheless, the Committee noted that possible increases in resource utilization as well as elevated energy prices had the potential to add to inflationary pressures. In these circumstances, the Committee believed that some further measured policy firming was likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance.

Investors had largely anticipated the Committee's interest rate decision at the December meeting and a change in the portions of the statement characterizing policy as accommodative. Accordingly, the policy announcement elicited only modest reactions in financial markets. With mixed readings on economic activity and inflation over the intermeeting period, the market's expectations for the path of monetary policy and yields on Treasury coupon securities ended the period little changed, on balance. Yields on investment- and speculative-grade corporate debt moved largely in line with Treasury yields. Major stock price indexes rose modestly, and the trade-weighted foreign exchange value of the dollar depreciated slightly over the period.

Domestic nonfinancial sector debt appeared to have expanded at a somewhat slower pace in the fourth quarter, down from the rapid increase in the third quarter. Household debt growth likely moderated amid hints of a downshift in mortgage borrowing from its robust third-quarter pace and an outright decline in consumer credit, which owed in part to increased charge-offs from October's spike in bankruptcy filings. Business sector debt slowed somewhat in the fourth quarter, mainly reflecting a runoff of commercial paper by multinational firms that were reported to have repatriated foreign earnings to take advantage of a recently enacted tax provision. M2 expanded at a somewhat faster pace in the fourth quarter than had been predicted from historical relationships with income and opportunity costs. In part, the monetary aggregate was likely boosted by payments to hurricane victims by the federal government and insurance companies.

The staff forecast prepared for this meeting suggested that, after slow growth in the fourth quarter of 2005, real GDP would expand at a fairly robust pace over the first half of this year, boosted in part by spending on recovery activities associated with the hurricanes. Thereafter, real GDP growth was expected to moderate, importantly reflecting a reduced impetus to consumption from house price appreciation and some slowing in residential housing expenditures. Core PCE inflation was expected to be a touch higher this year than in 2005, largely because of the pass-through of higher energy and nonfuel import prices, but, with energy prices leveling out, core inflation was projected to drop back modestly in 2007.

In their discussion of the economic situation and outlook, meeting participants noted the slowing in GDP growth in the fourth quarter of 2005, but believed that it probably owed in large part to transitory factors and that economic growth would bounce back in the current quarter. In that regard, several high frequency indicators of production, labor markets, and private demand suggested greater underlying strength of late than had been reflected in the most recent GDP data. Over the next couple of years, the economy seemed poised to expand at a moderate rate in the neighborhood of its sustainable pace. Most participants expected core inflation to move up slightly in the near term, reflecting some pass-through of increased energy and other commodity prices. Although heightened inflation pressures could also arise from possible increases in resource utilization, the outlook for economic growth and the stability of inflation expectations suggested that core inflation should remain contained over time.

In preparation for the Federal Reserve's semiannual report to the Congress on the economy and monetary policy, the members of the Board of Governors and the presidents of the Federal Reserve Banks submitted individual projections of the growth of GDP, the rate of unemployment, and core consumer price inflation for the years 2006 and 2007. The forecasts of the rate of expansion in real GDP for 2006 were in a range of 3¼ to 4 percent, centered at 3½ percent, while those for 2007 were in a range of 3 to 4 percent, with a central tendency of 3 to 3½ percent. These rates of growth were associated with projections of the civilian unemployment rate in a range of 4½ to 5 percent, with a central tendency of 4¾ to 5 percent, in both the fourth quarter of 2006 and the fourth quarter of 2007. Expectations for the rate of inflation, as measured by the core PCE price index, were in a range of 1¾ to 2½ percent this year, centered at about 2 percent, and in a range of 1¾ to 2 percent in 2007.

In their discussion of major sectors of the economy, meeting participants noted that consumer spending in the latter months of 2005 had been buffeted by the effects of hurricanes, increased energy prices, and reduced auto sales incentives. However, anecdotal reports contributed to a view that consumer spending had been solid over the holiday season and in recent weeks, while measures of consumer confidence remained high. Nevertheless, signs of slowing in the housing sector had become more evident, and the boost to construction from hurricane-related rebuilding now seemed likely to be spread over the next couple of years rather than being more concentrated in the near term. In some areas, home price appreciation reportedly had slowed noticeably, highlighting the risks to aggregate demand of a pullback in the housing sector. For instance, the effects of a leveling out of housing wealth on the saving rate were difficult to predict, but, in the view of some, potentially sizable. Rising debt service costs, owing in part to the repricing of variable-rate mortgages, were also mentioned as possibly restraining the discretionary spending of consumers. The most likely outlook, however, was for a gradual moderation in house price appreciation and in the growth of consumption, which would continue to be supported by increases in jobs and incomes.

Participants generally anticipated fairly strong growth of capital expenditures. Though firms had been cautious about expanding their plant and equipment, business confidence was high, capacity utilization was tightening, and companies were continuing to look for investment opportunities that increased productivity. As a result, the outlook was for reasonably robust spending on capital equipment even if economic growth slowed a bit. Anecdotal reports suggested that nonresidential real estate markets were improving in some areas.

The slowdown in government spending in the fourth quarter was generally seen as reflecting shifts in the timing of outlays, rather than a change in the underlying trend. However, fiscal stimulus was expected to diminish somewhat by next year. By contrast, global demand had picked up of late and would provide ongoing support for U.S. exports; indeed, the sharp increases in commodity prices and rallies in world equity markets suggested the possibility of an even stronger path for demand abroad.

Financial market conditions in the United States, as well as those abroad, suggested that investors were optimistic about the economic outlook. The recent strength in equity markets and the low prevailing term premiums and bond spreads perhaps reflected market assessments that economic risks were lower than usual, as well as strong demands for longer-term assets and an ample supply of liquidity. The possibility that term premiums and credit spreads could return to more typical settings represented a downside risk for interest-sensitive components of aggregate demand.

A variety of indicators, along with anecdotal reports, suggested that employment was expanding at a fairly good pace and labor compensation was rising moderately. Some participants remarked on the uncertainties regarding the extent of remaining capacity in labor markets and the outlook for labor costs. In particular, developments affecting the participation rate in the labor force and the pace of growth in productivity would importantly condition prospects for employment and business cost pressures.

Participants noted that, while the pass-through of higher energy and other commodity prices to prices of core goods and services had remained subdued, there were continuing upside risks to inflation from these sources. Whatever the size of such pass-through effects, however, it was thought that they would probably be temporary in nature and likely diminish as energy prices flattened out, as long as inflation expectations did not move higher. In that regard, participants were encouraged that, despite recent energy price increases, survey measures of inflation expectations had notched down and longer-term inflation compensation in financial markets was little changed. Although high profit margins could imply some existing pricing power, they might also provide a cushion to absorb some future cost increases. Indeed, anecdotal reports suggested that the ability of firms to pass through higher input costs generally remained limited. Nevertheless, the increased prices of energy and other commodities and the possibility of a further rise in resource utilization, which some members viewed as nearly full at present, represented continuing risks, potentially adding to inflation pressures.

In the Committee's discussion of monetary policy for the intermeeting period, all members favored raising the target federal funds rate 25 basis points to 4½ percent at this meeting. Although recent economic data had been uneven, the economy seemed to be expanding at a solid pace. Members were concerned that, even after their action today, possible increases in resource utilization and elevated energy prices had the potential to add to inflation pressures. Although the stance of policy seemed close to where it needed to be given the current outlook, some further policy firming might be needed to keep inflation pressures contained and the risks to price stability and sustainable economic growth roughly in balance. In the view of some members, the possibility of additional policy moves was reinforced by readings on core inflation and inflation expectations that were somewhat higher than was desirable over the long run. However, all members agreed that the future path for the funds rate would depend increasingly on economic developments and could no longer be prejudged with the previous degree of confidence.

As this meeting marked Alan Greenspan's last as a member of the Committee, meeting participants took the opportunity individually and collectively to pay tribute to his many years of outstanding service to the Federal Reserve and to the nation. They expressed their appreciation for his collegial and successful leadership of the Committee and of the Federal Reserve System and emphasized the privilege and honor they felt in having served with him.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 4½ percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

> The Committee judges that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. In any event, the Committee will respond to changes in economic prospects as needed to foster these objectives.

> Votes for this action: Messrs. Greenspan and Geithner, Ms. Bies, Messrs. Ferguson, Guynn, Kohn, Lacker, and Olson, Mses. Pianalto and Yellen. Votes against this action: None.

The confirmation of the date of the next meeting of the Committee was postponed, pending the election of a successor Chairman.

The meeting adjourned at 12:25 p.m.

Notation Vote

By notation vote completed on December 30, 2005, the Committee unanimously approved the minutes of the Federal Open Market Committee meeting held on December 13, 2005.

Vincent R. Reinhart
Secretary

Meeting Held on March 27–28, 2006

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 Monday, March 27, 2006 at 3:00 p.m. and continued on Tuesday, March 28, 2006 at 9:00 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Guynn
Mr. Kohn
Mr. Kroszner
Mr. Lacker

Mr. Olson
Ms. Pianalto
Mr. Warsh
Ms. Yellen

Mses. Cumming and Minehan, Messrs. Moskow, Poole, and Hoenig, Alternate Members of the Federal Open Market Committee

Messrs. Fisher and Stern, Presidents of the Federal Reserve Banks of Dallas and Minneapolis, respectively

Mr. Stone, First Vice President, Federal Reserve Bank of Philadelphia

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Eisenbeis, Kamin, Madigan, Sniderman, Struckmeyer, Tracy, Weinberg, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Hambley,[5] Assistant to the Board, Office of Board Members, Board of Governors

Messrs. Oliner and Slifman, Associate Directors, Division of Research and Statistics, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

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

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Orphanides, Adviser, Division of Monetary Affairs, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors.

5. Attended Monday's session only.

Mr. Wright, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Perli, Senior Economist, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Mr. Connolly, First Vice President, Federal Reserve Bank of Boston

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Messrs. Evans and Hakkio, Ms. Mester, and Messrs. Rasche, Rolnick, and Rudebusch, Senior Vice Presidents, Federal Reserve Banks of Chicago, Kansas City, Philadelphia, St. Louis, Minneapolis, and San Francisco, respectively

Ms. Mosser, Vice President, Federal Reserve Bank of New York

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that economic activity was expanding strongly in the first quarter. Consumer spending was on track to rise at a robust pace, and business purchases of equipment and software picked up appreciably. Warm weather boosted housing construction in January and February, although sales of new homes dropped back and house prices decelerated slightly. Private payrolls advanced solidly in the first two months of the year. Headline consumer price inflation jumped in January but moderated in February as energy prices moved down. Core inflation remained contained.

Labor demand continued to increase in the first two months of 2006, as private nonfarm payroll employment showed large gains in both January and February. With favorable weather conditions, employment growth was especially brisk in the construction sector. Financial activities, business services, and nonbusiness services also posted solid payroll gains. Although the average workweek edged down in February, the level of aggregate hours for production and nonsupervisory workers was above its average for the fourth quarter of 2005. The unemployment rate continued to decline and averaged 4¾ percent over the first two months of the year. Several other labor market indicators also signaled a further tightening of labor market conditions.

Industrial production picked up in February after a modest decline in January. That pattern was attributable to swings in utilities output, as temperatures were historically warm early in the year before reverting to near seasonal norms in February. Excluding utilities, industrial production posted a sizable gain in January before flattening out in February, pointing to a solid rise in the first quarter. Mining output—which includes oil and natural gas extraction—slipped in February after registering robust gains in each of the previous three months. Manufacturing output was unchanged in February after a significant increase in January. The rate of capacity utilization in the manufacturing sector stood a bit above its long-run average.

Consumer spending appeared to have rebounded strongly in the first quarter. Motor vehicle purchases bounced back in late 2005 and early 2006 from the sluggish pace that followed the end of the past summer's "employee pricing" programs. Excluding motor vehicles, consumption spending was robust, supported by continuing improvement in the labor market and advances in wage and salary income. The annual raise in the pay of federal employees, cost-of-living adjustments to Social Security benefits and other transfer programs, and the initiation of the Medicare Prescription Drug Plan boosted the level of personal disposable income in January. Consumption was likely supported also by ongoing increases in home prices and gains in the stock market. Consumer confidence as measured by surveys remained consistent with moderate increases in consumer spending.

Housing activity had moderated somewhat from the robust pace of the past summer. Although the level of single-family housing starts was unusually high in January and February, much of this strength was likely the result of mild winter weather; new permit issuance extended the downward trajectory that began in October. After an unusual spike in January, multifamily housing starts dropped back in February to a rate well within their historical range. Sales of new homes fell in the first two months of the year, while sales of existing homes turned up in February for the first time since last August; both measures were well below their peaks of mid-2005. The stock of homes for sale was elevated compared with its range of the last several years. Mortgage applications continued to decline in February, and survey measures of homebuying attitudes also maintained their recent downward trend. Housing demand was likely damped by rising mortgage rates, which moved up further in late 2005 and early 2006. House price appreciation appeared to have slowed from the rapid pace of the summer, but price increases for both new and existing homes remained well within the elevated range that has prevailed in recent years.

Real outlays for equipment and software decelerated in the fourth quarter of 2005 but appeared to have gained strength in early 2006. This pattern reflected sizable swings in outlays for transportation equipment. The fundamentals underlying capital spending continued to be supportive, as business sector output expanded briskly, firms remained flush with funds, and relative price declines for high-tech equipment continued to push down its user cost. Although vacancy rates for nonresidential properties were well below the peaks reached in the first quarter of 2004, real spending on new construction had yet to gain traction. In contrast, outlays for drilling and mining structures continued to rise rapidly and appeared poised to increase further in the near term.

The book value of manufacturing and trade inventories excluding motor vehicles rose at a moderate pace in the fourth quarter of 2005, and inventories appeared to have continued to build in January. Much of the increase reflected rising prices of goods held, and real inventory accumulation was subdued. The inventory-sales ratio declined slightly in January, extending its long-run downward trend. Inventory stocks appeared to be well aligned with demand in most industries.

The U.S. international trade deficit rose in the fourth quarter and widened further in January, as gains in exports of goods and services were outweighed by a substantially larger rise in imports. Exports of industrial supplies, capital goods, and agricultural products picked up robustly in January, while the increase in imports was widespread across most product categories. Real GDP growth in foreign industrial economies was mixed in the fourth quarter, as economic activity slowed in the euro area and in Canada while the Japanese economy expanded briskly and growth in the United Kingdom firmed. Recent indicators of economic activity in developing economies were generally quite positive.

Readings on core consumer price inflation were favorable in recent months. Nonetheless, the overall consumer price index edged up in February after registering a large increase in January that was driven mostly by a spike in energy prices. While prices of food and core items recorded only modest increases in February, energy prices fell back amid increases in oil inventories and unseasonably mild temperatures since the latter part of December. Weekly data for March, however, indicated that gasoline prices rose sharply. Prices of capital equipment inched up in February after a more substantial gain in January. Nevertheless, prices of capital equipment decelerated over the past twelve months. Higher energy prices still seemed to be passing through to the prices of a number of core intermediate materials, although such increases were more moderate than those observed in the immediate aftermath of the hurricanes last autumn. The increase in the employment cost index in the fourth quarter of 2005 was relatively modest. Compensation per hour in the nonfarm business sector, after having increased substantially in the third quarter, was estimated to have risen somewhat less in the fourth quarter. Preliminary survey measures of short-term inflation expectations in

March edged up, but longer-term measures remained steady.

At its January meeting, the Federal Open Market Committee decided to raise the target level of the federal funds rate 25 basis points, to 4½ percent. In its accompanying statement, the Committee indicated that, although recent economic data had been uneven, the expansion in economic activity appeared solid. Core inflation had stayed relatively low in recent months, and longer-term inflation expectations had remained contained. Nevertheless, the Committee noted that possible increases in resource utilization as well as elevated energy prices had the potential to add to inflation pressures. In these circumstances, the Committee judged that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance but reiterated that it would respond to changes in economic prospects as needed to foster its objectives.

Investors had largely anticipated both the Committee's interest rate decision at the January meeting and the text of the accompanying statement. Consequently, the policy announcement elicited little market reaction. Policy expectations and yields on Treasury coupon securities subsequently firmed, on net, over the intermeeting period, as incoming data indicated robust economic growth in the United States and strengthening expansion abroad. Yields on investment-grade corporate debt rose roughly in line with those on comparable-maturity Treasury securities, while yields on speculative-grade corporate debt were little changed. Broad stock market indexes were modestly higher amid favorable economic news and lower oil prices, and the trade-weighted foreign exchange value of the dollar appreciated slightly over the period.

Growth of domestic nonfinancial sector debt appeared to have moderated only a bit in the first quarter from its robust pace in the fourth quarter of 2005. Net issuance of corporate bonds and expansion of business loans at commercial banks had abated in February and early March after robust growth in January; commercial paper outstanding was about flat in the first quarter. Household mortgage borrowing was thought to have slowed somewhat in the first quarter in response to increased mortgage interest rates. Consumer credit rebounded some in January after contracting in the fourth quarter because of elevated charge-offs related to the spike in bankruptcy filings. Based on monthly Treasury statements, federal debt seemed likely to have accelerated in the first quarter. On average, M2 grew briskly in January and February. While liquid deposits expanded moderately, small time deposits and retail money funds advanced strongly, supported by further increases in offering rates.

The staff forecast prepared for this meeting showed real GDP expanding briskly in the current quarter. Economic growth was expected to moderate later this year. The level of output in the current quarter was estimated to be close to the economy's potential and was anticipated to remain so over the projection period. Core PCE inflation was expected to move slightly higher in 2006 because of cost pressures induced by high energy and import prices and to step back down in 2007 as these cost pressures were anticipated to abate.

In their discussion of the economic situation and outlook, meeting participants saw the economy as having rebounded strongly from the slowdown in the fourth quarter of last year, with aggregate spending and employment expanding briskly in the current quarter. Growth was expected to moderate to a more sustainable pace later this year. The ongoing cooling in the housing market would act to restrain residential construction and growth in consumption, but business and household confidence and supportive financial conditions would help to foster growth in employment and incomes, keeping consumption and investment on a solid upward track. Several meeting participants observed that, although the economy's sustainable potential output could not be observed directly or estimated with precision, historical patterns and recent data suggested that current levels of labor and product market resource utilization were in a zone consistent with little or no remaining economic slack. The recent behavior of core consumer prices seemed to indicate that any pass-through of higher energy and other commodity prices had been limited. In addition, productivity growth, moderate increases in compensation, contained inflation expectations, and international competition were helping to restrain unit labor costs and price pressures. Nonetheless, meeting participants generally remained concerned about the risk that possible increases in resource utilization, in combination with the elevated prices of energy and other commodities, could add to inflation pressures.

Regarding the major sectors of the economy, meeting participants noted that consumer spending appeared to be growing at a solid pace, notwithstanding earlier rises in energy prices. Contacts in the retail sector reported strong demand, and lending to households seemed to be robust. However, some automobile dealers reported subdued demand for domestic name-plate products. In coming quarters, consumer outlays were expected to be supported by continued employment gains, household income growth, and relatively low long-term interest rates, even if gains in housing wealth abated.

Meeting participants discussed at some length signs of cooling in the residential real estate market. Published data on housing starts showed little evidence of a significant weakening in construction activity. However, anecdotal reports from several markets, surveys of homebuyer attitudes, and data on inventories, home sales, and new home cancellation rates all pointed to a moderation in housing activity. It was noted that the relatively robust data on construction activity could owe in part to unseasonably warm weather. Going forward, participants expected a deceleration in house prices to contribute to an increase in the household saving rate and to weigh on consumption growth. Aggregate demand was also expected to be restrained directly by a softening in the pace of home building. Moreover, rebuilding following last year's major hurricanes appeared to be proceeding at a slow pace, and so would provide only limited offset to the implications of more fundamental developments in this market.

Generally, however, the economic expansion appeared to be broad-based. Contacts indicated that certain sectors, such as energy and semiconductor production, were particularly strong. Against this backdrop, robust growth in business spending was seen as likely, even as household spending growth moderated somewhat. Business capital expenditures, especially on equipment and software, appeared to have considerable momentum, supported by strong corporate profits, exceptionally liquid balance sheets, and greater business optimism. Some participants indicated that nonresidential construction was in the process of picking up and commercial vacancy rates were declining in some regions.

Financial market conditions remained supportive of growth, with long-term rates relatively low, risk spreads in corporate debt markets narrow, and banks seeking lending opportunities. Merger and acquisition activity was strong and infusions of private equity continued at a rapid pace, but the domestic market for initial public offerings was reported to be quite weak. Although rates on fixed-rate mortgages remained historically low, some ratcheting up of rates on adjustable-rate mortgages was seen as a factor weighing to some degree on the housing market. More generally, the effects on spending of the substantial increase in short- and intermediate-term rates since June 2004 had probably not yet been fully felt.

There were reports of increased construction by state and local governments, which were benefiting from strong tax collections. Federal defense expenditures had leveled out. Foreign economic growth appeared to have strengthened of late, prompting some firming of monetary policy by several foreign central banks. Nonetheless, increases in imports were expected to continue to outpace increases in exports in coming quarters, trimming the rate of expansion of domestic output.

Meeting participants saw both upside and downside risks to their outlook for expansion around the rate of growth of the economy's potential. In the housing market, for instance, some downshift from the rapid price increases and strong activity of recent years seemed to be underway, but the magnitude of the adjustment and its effects on household spending were hard to predict. Some participants cited stronger growth abroad and robust nonresidential investment spending as potentially contributing more to activity than expected. It was also noted that an abrupt rise in long-term interest rates, reflecting, for example, a reversion of currently low term premiums to more typical levels, could weigh on both household and business spending.

Several participants noted that the labor market had continued to strengthen, with payrolls increasing at a solid pace. The labor market was now showing some signs of tightness, consistent with a relatively low jobless rate. There were anecdotal reports of shortages of skilled labor in a few sectors, such as health care, technology, and finance. Still, participants expressed uncertainty about how much slack remained. Pressures on unit labor costs appeared contained, despite rising health-care costs, amid continued robust productivity growth and still-moderate increases in several comprehensive measures of compensation growth.

In their discussion of prices, participants indicated that data over the intermeeting period, including measures of inflation expectations, suggested that underlying inflation was not in the process of moving higher. Crude oil prices, though volatile, had not risen appreciably in recent months on balance, and a flattening in energy prices was beginning to damp headline inflation. In addition, core consumer inflation was flat or even a bit lower by some measures. Some meeting participants expressed surprise at how little of the previous rise in energy prices appeared to have passed through into core inflation measures. However, with energy prices remaining high, and prices of some other commodities continuing to rise, the risk of at least a temporary impact on core inflation remained a concern.

Participants noted that there were as yet few signs that any tightness in product and labor markets was adding to inflation pressures. To date, unit labor costs were not placing pressure on inflation, and high profit margins left firms a considerable buffer to absorb cost increases. Moreover, actual and potential competition from abroad could be restraining cost and price pressures, though participants exchanged views on the extent to which conditions in foreign markets might be constraining prices domestically. However, participants observed that there was a risk that continuing increases in resource utilization could add to inflationary pressures. Some participants held that core inflation and inflation expectations were already toward the upper end of the range that they viewed as consistent with price stability, making them particularly vigilant about upside risks to inflation, especially given how costly it might be to bring inflation expectations back down if they were to rise.

In the Committee's discussion of monetary policy for the intermeeting period, all members favored raising the target federal funds rate 25 basis points to 4¾ percent at this meeting. The economy seemed to be on track to grow near a sustainable pace with core inflation remaining close to recent readings against a backdrop of financial conditions embodying an expectation of some tightening. Since the available indicators showed that the economy could well be producing in the neighborhood of its sustainable potential and that aggregate demand remained strong, keeping rates unchanged would run an unacceptable risk of rising inflation. Most members thought that the end of the tightening process was likely to be near, and some expressed concerns about the dangers of tightening too much, given the lags in the effects of policy. However, members also recognized that in current circumstances, checking upside risks to inflation was important to sustaining good economic performance. The need for further policy firming would be determined by the implications of incoming information for future activity and inflation.

With regard to the Committee's announcement to be released after the meeting, members expressed some difference in views about the appropriate level of detail to include in the statement. In the end, they concurred that the statement should note that economic growth had rebounded in the current quarter but that it appeared likely to moderate to a more sustainable pace in coming quarters. Policymakers agreed that the announcement should also highlight the favorable outlook for inflation and summarize their reasons for that assessment, but that it should reiterate that possible increases in resource utilization, along with elevated levels of commodity and energy prices, had the potential to add to inflation pressures. Changes in the sentence on the balance of risks to the Committee's objectives were discussed. Several members were concerned that market participants might not fully appreciate the extent to which future policy action will depend on incoming economic data, especially when an end to the tightening process seems likely to be near. Some members expressed concern that retention of the phrase "some further policy firming may be needed to keep the risks... roughly in balance" could be misconstrued as suggesting that the Committee thought that several further tightening steps were likely to be necessary. Nonetheless, all concurred that the current risk assessment could be retained at this meeting.

The Committee also discussed its experience with the two-day meeting. Participants agreed that the additional time had facilitated their discussion of the economy, policy, and the wording of the announcement. It was agreed that, because of scheduling conflicts, the next meeting of the Committee would be held on one day, Wednesday, May 10, 2006. After experience with that and perhaps the subsequent meeting that is already scheduled for two days, a decision would be taken about the general format of future meetings.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 4¾ percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

> The Committee judges that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. In any event, the Committee will respond to changes in economic prospects as needed to foster these objectives.

Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Guynn, Kohn, Kroszner, Lacker, and Olson, Ms. Pianalto, Mr. Warsh, and Ms. Yellen. Vote against this action: None.

The meeting adjourned at 12:15 p.m.

Notation Vote

By notation vote completed on February 1, 2006, the Committee unanimously approved the election of Ben S. Bernanke as Chairman of the Federal Open Market Committee.

By notation vote completed on February 17, 2006, the Committee unanimously approved the minutes of the Federal Open Market Committee meeting held on January 31, 2006.

Vincent R. Reinhart
Secretary

Meeting Held on May 10, 2006

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, May 10, 2006 at 8:30 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Guynn
Mr. Kohn
Mr. Kroszner
Mr. Lacker
Mr. Olson
Ms. Pianalto
Mr. Warsh
Ms. Yellen

Mr. Hoenig, Ms. Minehan, and Messrs. Moskow and Poole, Alternate Members of the Federal Open Market Committee

Messrs. Fisher and Stern, Presidents of the Federal Reserve Banks of Dallas and Minneapolis, respectively

Mr. Stone, First Vice President, Federal Reserve Bank of Philadelphia

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Mr. Alvarez, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Eisenbeis, Judd, Kamin, Madigan, Sniderman, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Oliner and Slifman, Associate Directors, Division of Research and Statistics, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Orphanides, Adviser, Division of Monetary Affairs, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Wright, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Mr. Werkema, First Vice President, Federal Reserve Bank of Chicago

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Messrs. Evans and Hakkio, Ms. Mester, and Mr. Rasche, Senior Vice Presidents, Federal Reserve Banks of Chicago, Kansas City, Philadelphia, and St. Louis, respectively

Mr. Hilton, Vice President, Federal Reserve Bank of New York

Mr. Potter, Assistant Vice President, Federal Reserve Bank of New York

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

Mr. Hetzel, Senior Economist, Federal Reserve Bank of Richmond

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

With Mr. Lacker dissenting, the Committee voted to extend for one year beginning in mid-December 2006 the reciprocal currency ("swap") arrangements with the Bank of Canada and the Banco de Mexico. The arrangement with the Bank of Canada is in the amount of $2 billion equivalent, and that with the Banco de Mexico is in the amount of $3 billion equivalent. Both arrangements are associated with the Federal Reserve's participation in the North American Framework Agreement of 1994. The vote to renew the System's participation in the swap arrangements maturing in December was taken at this meeting because of the provision that each party must provide six months prior notice of an intention to terminate its participation. Mr. Lacker dissented because of his opposition, as indicated at the January meeting, to foreign exchange market intervention by the Federal Reserve, which such swap arrangements facilitate, and because of his opposition to direct lending to foreign central banks.

By unanimous vote, the Committee delegated the authority to review and determine appeals of a denial of access to Committee records under FOIA and other rules to the Board members designated as the primary and alternate Administrative Governors for Freedom of Information and Privacy Act Matters. Also by unanimous vote, the Committee established a FOIA Requester Service Center and designated Carol R. Low to fulfill the associated responsibilities.

The information reviewed at this meeting suggested that economic activity expanded strongly in the first quarter and that gains were widespread across most categories of final sales. Consumer spending posted a sizable increase, driven by January's bounceback in motor vehicle purchases and an acceleration in spending on other goods at the turn of the year. In addition, favorable weather boosted housing construction early in the quarter. Later in the quarter, however, the pace of consumer spending moderated, and housing starts retraced their earlier run-up. Business investment spending strengthened in the first quarter, in part because of a surge in the purchases of transportation and high-tech equipment and a step-up in nonresidential construction. Manufacturing production also posted solid gains in the first quarter and payroll growth moderated a bit in April after robust gains in employment in the first quarter. Overall consumer prices jumped in March because of higher energy prices, while core prices rose a bit more rapidly than in earlier months.

Nonfarm payrolls increased by 138,000 jobs in April following robust growth in March. The gains in April were widespread: Manufacturing and related industries registered significant increases, mining activity and employment were boosted by rising energy prices, construction hiring posted a moderate gain, and a range of services-producing industries strengthened, with the important exception of retail trade, which more than reversed its March gains. Average hours of production or nonsupervisory workers on private nonfarm payrolls edged up in April. The increases in the workweek and employment in April led to notable growth in aggregate hours of production or nonsupervisory workers. The unemployment rate edged down to 4.7 percent in March and remained at that level in April.

Industrial production in March expanded at about the same strong pace as it did in February, with gains posted across all major components of the index. Manufacturing activity picked up in March after a lull in February. While manufacturing growth for the first quarter as a whole slowed from the rapid pace of the fourth quarter, it exceeded that of the previous year. Manufacturing capacity utilization during the quarter was a bit above its long-run average. Mining output—which includes oil and natural gas extraction—strengthened in the first quarter as a whole. Within the quarter, however, the boost from hurricane-related recovery seemed to ebb. While utility output surged in February and moved up a bit more in March, these increases only partly reversed the weather-related plunge in January.

Growth of consumer spending appeared to moderate after posting sizable gains around the turn of the year. Excluding motor vehicles, real outlays rose temperately in March, boosted by the continued rise in spending on services. Spending on goods excluding motor vehicles posted a second-straight monthly decline after robust gains over the previous four months. Sales of light vehicles held steady in March and picked up a bit in April, bringing the average pace for the year well above that of the fourth quarter but about even with the rate of last year. Although continued improvements in the labor market had been generating considerable gains in nominal wage and salary income, rising gasoline prices held down the increase in real disposable personal income in March and were expected to damp it in April as well. Ongoing increases in home prices and additional gains in the stock market, however, further boosted household wealth during the first quarter. Measures of consumer confidence remained consistent with moderate increases in consumer spending.

The underlying pace of residential activity seemed to moderate in the first quarter. After unseasonably warm weather allowed a high level of single-family housing starts in January and February, starts fell in March to their lowest level in a year. New permit issuance for single-family homes also fell in March, continuing its downward trend. Multifamily starts recovered a bit in March from their low rate in February but remained well within their historical range. Home sales also declined, on net, in recent months. Although sales of existing single-family homes edged up in February and March, the level of sales for the first quarter as a whole was notably below the record high in the second quarter of last year. Sales of new homes also moved up in March, but their average in the first quarter was down substantially from the peak in the third quarter of last year. House price appreciation appeared to have slowed from the elevated rates seen over the past summer. Growth in the average sales price of existing homes in March, versus a year earlier, decelerated sharply, and the average price for new homes in March fell compared to a year earlier. In addition, other indicators, such as months' supply of both new and existing homes for sale and the index of pending home sales, supported the view that housing markets had cooled in recent months.

Real outlays for equipment and software surged in the first quarter after a relatively subdued performance in the fourth quarter of last year. Much of the growth reflected a sharp jump in business purchases of transportation equipment, such as airplanes and motor vehicles. Spending on high-tech equipment and software also improved as exceptionally strong growth in expenditures for communications equipment more than compensated for fairly soft spending on computers and peripherals and on software. Conditions in the nonresidential construction sector improved noticeably. Although spending on nonresidential building construction remained well short of the robust levels seen in late 2000, growth of expenditures in this sector was at its fastest pace in the first quarter in nearly six years. Outlays on drilling and mining structures continued to climb in the first quarter, and available data pointed to ongoing growth.

Real nonfarm inventories stepped down in the first quarter, largely reflecting a decline in investment in motor vehicle inventories. Excluding motor vehicles, inventories increased at a pace well above that in the fourth quarter. Over the past twelve months, inventories relative to shipments and sales had moved down moderately on balance, extending the long-run downward trend.

The U.S. international trade deficit narrowed in February as a sharp decrease in imports more than offset a modest fall in exports. The declines in both categories were generally widespread across sectors with the exception of oil imports, which were flat, and imported services, which rose. Incoming data for foreign industrial economies were generally favorable and pointed to continued expansion. Available data showed continued growth in GDP in the United Kingdom in the first quarter, continuing strong domestic demand in Canada through February, ongoing recovery in Japan, and a first-quarter rebound in euro-area economic performance.

Headline inflation turned up in March. Although the price of natural gas had fallen because of continued plentiful inventories, retail gasoline prices surged, leading to a jump in overall energy prices for the month. Prices of core goods and services also rose more quickly in March, largely because of a spike in the apparel component that unwound a decline in February and a one-time step-up in medical prices related to changes in Medicare reimbursement rules. During the twelve months ending in March, overall inflation rose at a slightly faster pace than that in the preceding twelve-month period, while core prices for the same period increased a bit more slowly than in the previous year. Producer price inflation also moved up in March, driven largely by higher food and energy prices. Readings on the growth in the cost of labor were mixed. Over the three months ending in March, the employment cost index for hourly compensation of private industry workers rose at its slowest pace in several years. Data on compensation per hour in the nonfarm business sector, however, pointed toward notably faster growth in the first quarter. Some financial-market and survey indicators suggested that inflation expectations, both for the upcoming year and for the longer term, had moved up since the March meeting.

At its March meeting, the Federal Open Market Committee decided to raise its target for the federal funds rate 25 basis points, to 4¾ percent. In its accompanying statement, the Committee indicated that the slowing of the growth of real GDP in the fourth quarter of 2005 seemed largely to have reflected temporary or special factors. Economic growth had rebounded strongly in the first quarter but seemed likely to moderate to a more sustainable pace. As yet, the run-up in the prices of energy and other commodities appeared to have had only a modest effect on core inflation, ongoing productivity gains had helped to hold the growth of unit labor costs in check, and inflation expectations had remained contained. Still, the Committee noted that possible increases in resource utilization, in combination with the elevated prices of energy and other commodities, had the potential to add to inflation pressures. In these circumstances, the Committee judged that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance, but reiterated that in any event the Committee would respond to changes in economic prospects as needed to foster these objectives.

Investors anticipated the FOMC's decision at its March meeting to raise the target federal funds rate 25 basis points, but the Committee's post-meeting statement evidently led them to mark up somewhat their expected path for the federal funds rate. Subsequently, the path was pushed up further by data releases that were, on balance, stronger than market participants had expected. Speeches by Federal Reserve officials, the minutes of the March meeting, and Congressional testimony by the Chairman combined to restrain policy expectations some. On net, the anticipated path of the federal funds rate over the next two years nonetheless rotated upward. Yields on inflation-indexed Treasury securities moved up over the intermeeting period, but yields on nominal Treasury issues rose more. Spreads of yields on investment-grade bonds over those on comparable-maturity Treasury securities were about unchanged, while those on speculative-grade bonds declined. Major stock price indexes were up a bit over the intermeeting period, as positive first-quarter earnings reports more than offset the negative effects of higher energy prices and rising interest rates.

The trade-weighted exchange value of the dollar against major foreign currencies fell since the March meeting. Increased focus in public debate on the risks posed by the large U.S. external imbalance appeared to erode investor support for the dollar.

Domestic nonfinancial sector debt was estimated to have grown at a robust pace in the first quarter, down only slightly from the brisk pace of 2005. Business sector debt appeared to have expanded strongly, supported by significant net issuance of U.S. corporate bonds and double-digit growth of business loans at commercial banks. In the household sector, consumer credit continued to rise slowly, and the growth of household mortgage debt was thought, based on limited data, to have moderated somewhat in the first quarter against a backdrop of higher mortgage interest rates and some signs of a deceleration in house prices. M2 advanced at a pace somewhat below that of nominal GDP in the first quarter and was estimated to have expanded moderately in April.

The staff forecast prepared for this meeting showed real GDP growth moderating somewhat from the average pace of the previous several quarters. The projected deceleration of real GDP reflected the lagged effects of the tightening of monetary policy, the waning impetus from increases in household wealth, and reduced stimulus from fiscal policy. While higher energy prices were expected to boost inflation in the near term, structural productivity was strong, and the influence of higher energy and material costs was thought likely to moderate. Thus, consumer prices, after increasing at a faster rate in the first half of the year, were expected to decelerate later this year and next year.

In their discussion of the economic situation and outlook, meeting participants saw the economy as having rebounded strongly so far this year after the slowing of growth in the fourth quarter. The advance in output had been vigorous in the first quarter of this year, with real GDP increasing at around a 5 percent annual rate. Although the expansion appeared likely to moderate, it evidently remained solid. Inflation pressures appeared to be somewhat greater than the Committee had anticipated at the time of its March meeting. Consumer prices recently had risen at a pace noticeably above the average rise over the previous twelve months. Also, prices of energy and many other commodities had climbed sharply of late, and inflation expectations appeared to have risen slightly. If economic growth continued to moderate over coming quarters, as anticipated, pressures on productive resources would most likely continue to be limited. Most participants expected that, after allowing for some possible near-term volatility related to the recent jump in energy and other commodity prices, core inflation would probably remain around the levels experienced on average over the past year. However, recent developments suggested that upside risks to inflation had risen somewhat since the time of the March meeting.

In their discussion of major sectors of the economy, some participants noted that growth of household spending was likely to slow over the remainder of the year. Anecdotal information pointed to some cooling of housing markets. That cooling was especially noticeable for high-end homes and for houses in markets that previously had experienced the steepest appreciation. Data on home sales, permits, and starts on the whole likewise suggested that activity was gradually diminishing. Some reports indicated that speculative building of homes had dropped off considerably, but inventories of unsold homes still seemed to be expanding. Although fresh comprehensive data were not available, home prices on average appeared still to be rising, but at a slower pace than over the past few years. Going forward, growth in consumption spending was likely to be supported by gains in employment and personal income. But slower appreciation of home prices and the effects of the increases in energy prices and interest rates that had already occurred would likely act to restrain consumption spending somewhat. Certain features of recently popular nontraditional mortgage products had the potential to cause financial difficulties for some households and erode mortgage loan performance for some lenders. Nonetheless, the household sector seemed likely to remain in sound financial condition overall. On balance, consumption spending was viewed as most likely to expand at a moderate pace in coming quarters.

Several participants remarked that business investment spending was robust. Nonresidential construction was accelerating notably, in the process absorbing some of the resources that were being diverted from housing. Office vacancy rates were declining, spurring construction of new office buildings. Drilling and mining activity was said to be particularly strong, propelled by the high levels of energy prices. Investment in equipment and software appeared to be expanding at a solid rate. Capital formation was likely to continue to be supported by rising output, strong balance sheets in the business sector, and ready availability of financing on attractive terms.

Some participants commented on the recent surge in federal tax revenues, a development that was being mirrored at the state level. While the precise reasons for the increase in federal receipts were not entirely clear, robust income growth was probably an important factor. In any case, the effect was to trim the current federal budget deficit noticeably. Nonetheless, the longer-run federal fiscal imbalance remained a serious concern.

Data on economic growth outside the United States indicated that the global expansion was firming, a sense amplified by reports from international contacts. The apparent strengthening of global growth was likely to support U.S. exports and economic activity and would also tend to maintain upward pressures on energy and commodity prices.

Meeting participants expressed some concern about recent price developments and their implications for inflation prospects. Core consumer inflation lately had been a little higher than expected. Moreover, energy prices had risen steeply in the period since the March meeting, and, although pass-through apparently had been limited to date, the most recent increases might be reflected to a greater degree in core inflation in coming months. Participants noted that prices of non-energy commodities, such as industrial metals and building supplies, also had been climbing. The recent decline in the dollar was another factor that could add to inflation pressures, although the effect of prior changes in the foreign exchange value of the dollar on core consumer prices had apparently been limited. Business contacts had reported continued shortages of certain types of skilled labor and related wage pressures in some occupations, which would tend to boost costs.

However, participants also cited some factors that could be expected to restrain inflation. Although alternative measures of labor compensation provided divergent readings, growth of total compensation on balance appeared to remain moderate. And, even if nominal wages should accelerate somewhat, relatively wide profit margins could buffer the effect on prices of final goods and services. While firms would seek to maintain those margins, recent experience suggested that this might be accomplished in part through further productivity gains, which had remained fairly strong on balance in recent quarters, rather than through more rapid price hikes.

Participants discussed in some detail inflation expectations—a potentially important factor influencing future inflation trends. Some surveys suggested that inflation expectations had risen in recent weeks, but others implied that expectations were little changed. Measures of inflation compensation based on the difference between yields on nominal Treasury securities and inflation-indexed issues had edged higher. It was possible, though, that investors' uncertainty regarding inflation prospects, not just inflation expectations themselves, had risen. On balance, participants judged that inflation expectations had risen somewhat—a development that would have to be taken into account in policymaking and warranted close monitoring—but remained contained.

Although the Committee discussed policy approaches ranging from leaving the stance of policy unchanged at this meeting to increasing the federal funds rate 50 basis points, all members believed that an additional 25 basis point firming of policy was appropriate today to keep inflation from rising and promote sustainable economic expansion. Recent price developments argued for another firming step at today's meeting. Core inflation recently had been a bit higher than had been expected, and several members remarked that core inflation was now around the upper end of what they viewed as an acceptable range. Moreover, a number of factors were augmenting the upside risks to inflation: the surge in energy and commodity prices, some recent weakness in the foreign exchange value of the dollar, and the possibility that the apparent increase in inflation expectations could, if it persisted, impart momentum to inflation. In addition, the economy appeared to be operating at a relatively high level of resource utilization and had been growing quite strongly, and whether economic growth would moderate to a sustainable pace was not yet clear. At the same time, members also saw downside risks to economic activity. For example, the cumulative effect of past monetary policy actions and the recent rise in longer-term interest rates on housing activity and prices could turn out to be larger than expected. Still, it seemed most likely that, with modest further policy action, including a 25 basis point firming today, growth in activity would moderate gradually over coming quarters, pressures on resources would remain limited, and core inflation would stay close to levels experienced over the past year.

Given the risks to growth and inflation, Committee members were uncertain about how much, if any, further tightening would be needed after today's action. In view of the risk that the outlook for inflation could worsen, the Committee decided to repeat the indication in the policy statement released after the March meeting that some further policy firming could be required. However, the Committee agreed to emphasize that "the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information." Members debated the appropriate characterization of inflation expectations in the statement. Low and stable inflation expectations were key to the attainment of the Committee's dual objectives of price stability and maximum sustainable economic growth. However, the apparent pickup in longer-term expectations, while worrisome, was relatively small. They remained within the range seen over the past couple of years, and the increase could well reverse before long. Accordingly, it appeared appropriate to characterize inflation expectations again as "contained."

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 5 percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

> The Committee judges that some further policy firming may yet be needed to address inflation risks but emphasizes that the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information. In any event, the Committee will respond to changes in economic prospects as needed to support the attainment of its objectives.

Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Guynn, Kohn, Kroszner, Lacker, and Olson, Ms. Pianalto, Mr. Warsh, and Ms. Yellen. Votes against this action: None.

During the interval between the March and May meetings, Chairman Bernanke had appointed a subcommittee on communications issues to be chaired by Governor Kohn and including Presidents Stern and Yellen. At today's meeting, Governor Kohn indicated that the objective of the subcommittee was to help the Committee frame and organize discussion of a broad range of such issues over coming meetings.

The meeting adjourned at 1:10 p.m.

Notation Vote

By notation vote completed on April 17, 2006, the Committee unanimously approved the minutes of the Federal Open Market Committee meeting held on March 27–28, 2006.

Vincent R. Reinhart
Secretary

Meeting Held on June 28–29, 2006

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, June 28, 2006 at 2:00 p.m. and continued on Thursday, June 29, 2006 at 9:00 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Guynn
Mr. Kohn
Mr. Kroszner
Mr. Lacker
Ms. Pianalto
Mr. Warsh
Ms. Yellen

Ms. Minehan, Messrs. Moskow, Poole, and Hoenig, Alternate Members of the Federal Open Market Committee

Messrs. Fisher and Stern, Presidents of the Federal Reserve Banks of Dallas and Minneapolis, respectively

Mr. Stone, First Vice President, Federal Reserve Bank of Philadelphia

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Eisenbeis, Judd, Kamin, Madigan, Sniderman, Struckmeyer, Tracy, Weinberg, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Oliner and Slifman, Associate Directors, Division of Research and Statistics, Board of Governors

Ms. Zickler, Deputy Associate Director, Division of Research and Statistics, Board of Governors

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

Messrs. Dale[6] and Simpson, Senior Advisers, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

Mr. Gross, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Nelson, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Perli, Senior Economist, Division of Monetary Affairs, Board of Governor

Mr. Doyle and Ms. Judson, Economists, Divisions of International Finance and Monetary Affairs, respectively, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Mr. Moore, First Vice President, Federal Reserve Bank of Cleveland

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Mr. Evans, Ms. Mester, and Messrs. Rasche, Rolnick, and Sellon, Senior Vice Presidents, Federal Reserve Banks of Chicago, Philadelphia, St. Louis, Minneapolis, and Kansas City, respectively

Ms. Mucciolo, Vice President, Federal Reserve Bank of New York

By unanimous vote, the Committee approved a "Report and Plan of the Federal Open Market Committee to Improve FOIA Operations" and approved a delegation of authority to the Chairman (or his designee) to take actions required under the Freedom of Information Act.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at the June meeting suggested that the growth of economic activity in the second quarter slowed substantially from its rapid first-quarter pace. The expansion of consumer spending softened, and activity in

6. Attended Thursday's session only.

the housing market continued to cool. In contrast, the underlying rate of business spending remained strong and was well supported by fundamentals. The demand for labor appeared to moderate as hiring stepped down in recent months. Consumer price inflation remained elevated in April and May, reflecting sharp rises in energy prices and more rapid increases in core prices.

Gains in nonfarm private payrolls averaged 112,000 over the three months ending in May, a pace considerably below the average of about 170,000 jobs per month for the prior three-month period. The slowing in hiring was most pronounced in retail trade but was also evident in construction and information services. Establishments in professional and business services, nonbusiness services, and wholesale trade continued to add jobs at roughly the same pace as earlier in the year. Average hours of production or nonsupervisory workers on private nonfarm payrolls edged up in April but reversed these gains in May. The unemployment rate was 4.6 percent in May, near its average for the year so far.

Industrial production edged down in May after strong growth in April, largely reflecting the patterns of manufacturing output. For the year to date, manufacturing production advanced at a rate significantly below its rapid fourth-quarter growth rate but only a bit below its average pace of expansion since mid-2003. The mining sector, which includes oil and natural gas extraction, expanded solidly in April before falling back in May. Utilities output also grew strongly in April but retreated in May as temperatures returned to normal after having been unseasonably warm in April. Capacity utilization in manufacturing remained somewhat above its long-run average in both April and May.

Real consumer spending appeared to be on track to decelerate noticeably in the current quarter after posting robust growth in the first quarter. The slowing reflected both a marked reduction in the growth in real outlays for motor vehicles from an elevated first-quarter pace and a moderation in the advance of real expenditures for other goods in recent months. Underlying this slowing in the expansion of consumer expenditures was a moderation in the fundamental determinants of spending. The level of nominal wages and salaries beginning in the fourth quarter of 2005 was revised down considerably, and rising consumer prices held down the gains in real disposable income. Higher interest rates also likely restrained spending. Nonetheless, despite recent declines in equity prices, the wealth-to-income ratio remained well above its historical average, and consumer sentiment, which dipped in May, rebounded some in early June.

Residential construction activity moderated over the past few months but remained at a historically high level. Single-family starts posted a sizable drop in May for the third consecutive month. Although a substantial portion of May's decline seemed to be a partial payback for the elevated level of starts early in the year, when weather conditions had been favorable, the underlying pace of single-family housing construction appeared to have slowed. In the multifamily sector, starts in May were well within the typical range seen since 1995. Sales of both new and existing single-family homes in April and May were significantly below their peaks of the summer of 2005, though new home sales continued to regain some ground after having fallen in February. The most reliable measures of house prices indicated modest growth following the rapid increases seen last year.

After a first-quarter surge, real spending on equipment and software appeared on track for a much smaller gain in the second quarter. Incoming data for the current quarter suggested that spending on transportation equipment reversed the run-up that occurred in the first quarter. Spending on high-tech equipment and software advanced at a slower pace in the second quarter as a flattening out of spending on communications equipment after a huge increase in the first quarter offset some pickup in business-sector demand for computers and software. The construction of nonresidential buildings picked up noticeably so far this year, although activity remained well short of its previous peak in mid-2000. Outlays on drilling and mining structures continued to climb in response to high projected energy prices.

The book value of manufacturing and trade inventories excluding motor vehicles stepped up in April. The ratio of book-value inventories to sales held steady for the year so far after having fallen considerably last year. In general, inventories appeared to be well aligned with demand, and business surveys suggested that firms were comfortable with the level of inventories.

The U.S. international trade deficit widened in April, reflecting a large increase in imports coupled with a slight decline in exports. Import growth was led by sharp rises in the value of imported oil and natural gas and increased imports of automotive products and capital goods. Exports were restrained in part by a decline in aircraft exports. Expansion of economic activity in the foreign industrial countries was solid in the first quarter, but indications for the second quarter were more mixed. Incoming data pointed to a possible slowing in Canada, but signs of further expansion in the euro area and of continued growth in Japan were evident, notwithstanding sharp declines in equity indexes in these countries.

Headline inflation picked up in April and May, driven partly by sharp increases in the prices of petroleum-based products. In contrast, natural gas prices continued to decline in response to excess supply, fully reversing last autumn's rises. Higher oil prices showed through to producer prices for a variety of energy-intensive intermediate goods. Consumer food prices decelerated markedly since January, reflecting slower price increases for food away from home and declines, on balance, in the prices of fruits and vegetables. Core price inflation rose less than headline inflation in April and May but above its pace earlier in the year. Core prices were boosted in part by an acceleration in shelter costs, especially those imputed for owner-occupied residences. Readings on the growth of labor costs were revised down for the fourth quarter of 2005 and first quarter of 2006, but recent data suggested a pickup in the second quarter. A number of indicators of inflation expectations largely reversed increases recorded in the spring.

At its May meeting, the Federal Open Market Committee (FOMC) decided to raise its target for the federal funds rate 25 basis points, to 5 percent. The Committee's accompanying statement indicated that economic growth had been quite strong so far this year. The Committee saw growth as likely to moderate to a more sustainable pace, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices. At that time, the run-up in the prices of energy and other commodities appeared to have had only a modest effect on core inflation. Ongoing productivity gains had helped to hold the growth of unit labor costs in check, and inflation expectations remained contained. Still, possible increases in resource utilization and the elevated prices of energy and other commodities had the potential to add to inflation pressures. In these circumstances, the Committee foresaw the possibility of a need for some further policy firming to address inflation risks but emphasized that the extent and timing of any such firming would depend importantly on the evolution of the economic outlook as implied by incoming information.

Investors anticipated the FOMC's decision at its May meeting to raise the federal funds rate target 25 basis points, but near-term policy expectations edged up, apparently in response to the accompanying statement. Subsequent data releases reporting higher-than-expected inflation, the release of the FOMC minutes, and speeches by Federal Reserve policymakers all led investors to push up their expectations for the future path of the federal funds rate. Yields on near-term nominal Treasury securities rose in line with policy expectations over the intermeeting period, but those on longer-dated securities moved up by smaller amounts. Yields on inflation-indexed Treasury securities increased by more than those on nominal securities, and the resulting decline in inflation compensation retraced a substantial share of the rise that had occurred over the preceding intermeeting period. Major stock price indexes fell sharply over the period. Spreads of yields on corporate bonds over those on comparable-maturity Treasury securities widened somewhat, while those on speculative-grade issues rose by more.

After changing little on balance during much of May, the dollar's foreign exchange value against other major currencies moved up in June and showed a modest increase, on net, over the intermeeting period. The dollar appreciated after comments by FOMC policymakers that were interpreted by market participants as suggesting a higher likelihood of policy tightening at the June FOMC meeting. Prices of precious and industrial metals, which had risen sharply since early March, particularly in May, reversed those gains later in the intermeeting period.

Debt of the domestic nonfinancial sectors was estimated to have decelerated in the second quarter after a robust first-quarter increase. Business sector debt advanced more slowly in the second quarter, although the expansion of business loans remained brisk and net issuance of corporate bonds was solid. In the household sector, mortgage borrowing slowed in response to more subdued housing activity and moderating house-price appreciation. M2 growth in the second quarter was tepid, as the growth of nominal income had apparently softened and rising opportunity cost continued to dampen demand for money.

The staff forecast prepared for this meeting indicated that, after the significant deceleration of real GDP in the current quarter from the first quarter of 2006, growth would proceed through the end of 2007 at a pace a bit below the rate of growth of the economy's potential. The outlook for modest growth of real GDP reflected a slowdown in the housing market, the effects of past policy tightening, and a diminished boost to consumer spending from increases in household wealth. Core consumer price inflation was projected to have stepped up in the second quarter from its average pace over the preceding several quarters but to then drop back somewhat, albeit to a level higher than previously forecasted, as energy and import prices flatten out and some slack emerges in labor and product markets.

In their discussion of the economic situation and outlook, meeting participants saw economic growth as having moderated in the second quarter from its robust pace in the first quarter, reflecting a cooling of the housing market and the lagged effects of increases in interest rates and energy prices. Most participants expected output to advance over the next year and a half at a pace close to that which the economy can sustain over time. All participants found the elevated readings on core inflation of recent months to be of concern and, if sustained, inconsistent with the maintenance of price stability. However, contained inflation expectations, the abatement of upward pressure from past increases in energy and other commodity prices, and the slowing in the growth of economic activity that was under way were expected to contribute to a moderation in core inflation in coming quarters. Nonetheless, participants noted a risk that the drop-back in inflation could be slower or more limited than the Committee would find desirable since resource utilization was currently tight and the pickup in price increases had been broadly based rather than being limited to a few specific sectors that could be linked to energy costs.

In preparation for the Federal Reserve's semiannual report to the Congress on monetary policy, the members of the Board of Governors and the presidents of the Reserve Banks submitted individual projections of the growth of GDP, the rate of unemployment, and core consumer price inflation for 2006 and 2007, conditioned on the participants' views of the appropriate path for monetary policy. The forecasts of the rate of fourth-quarter to fourth-quarter expansion in real GDP for 2006 were in a range of 3 to 3¾ percent, with a central tendency of 3¼ to 3½ percent, and those for 2007 were in a range of 2½ to 3¼ percent, with a central tendency of 3 to 3¼ percent. These rates of growth were associated with a civilian unemployment rate in a range of 4½ to 5 percent in the fourth quarter of this year and 4¼ to 5¼ percent in the fourth quarter of 2007, with a central tendency at both horizons of 4¾ to 5 percent. Forecasts of the rate of inflation, as measured by the change in the average fourth-quarter core PCE price index from a year earlier, ranged from 2¼ to 3 percent for this year, with a central tendency of 2¼ to 2½ percent, and the range and central tendency were 2 to 2¼ percent for next year.

In their discussion of the major sectors of the economy, participants observed that housing construction activity had declined notably in recent months as indicated by lower housing starts and permits; moreover, higher inventories of unsold homes, a sharp rise in cancellations of new home sales, and reports from construction companies suggested that the weakness was likely to be extended. Several participants pointed out that the decline was broadly in line with expectations in light of the tightening in monetary policy and the rapid run-up in home prices and residential construction in recent years. Participants also observed that the evidence to date indicated that the slowdown was orderly but were mindful of the possibility of a sharper downturn in the sector.

The growth of consumer spending had dropped off significantly in the second quarter from a robust pace earlier in the year. The slowdown was attributed in part to higher energy prices and also to a likely downshift in home price appreciation and higher interest rates. A reduction in the attractiveness of home equity borrowing was mentioned as possibly contributing to the slowdown. Some retailers, especially those catering to lower- and middle-income customers, reported weaker growth in sales. Consumer spending was expected to advance modestly in coming quarters as the effects of more moderate gains in home prices and a gradual rebound in the household saving rate from recent historically low levels were offset by further gains in employment and growth in labor income. A few participants noted that the surge in federal tax receipts this year and a similar advance in revenue at the state level could be a sign of vigorous gains in income, indicating that household spending may expand more rapidly than many were anticipating.

Participants interpreted the incoming data on orders and shipments of durable goods, positive readings on business sentiment, and continued high levels of corporate profitability as suggesting that business investment would remain a source of strength going forward. In a shift from the pattern observed in the past few years, some contacts suggested that businesses were now directing their capital expenditures toward expanding capacity rather than increasing efficiency, a signal of the anticipation of continued solid growth in demand. Business expenditures on nonresidential structures also were seen to be advancing robustly in a number of markets, possibly providing some offset to reduced residential construction activity. Several participants observed that the continued ready availability of credit would support business expenditures. Others, however, noted that the pullback from risk-taking that had been observed in some financial markets over the preceding few months could intensify, raising the cost of funds.

Participants observed that many foreign central banks had tightened monetary policy over the intermeeting period in response to strengthening activity and indications of inflation pressures. Greater uncertainty about inflation pressures and the needed policy response had perhaps contributed to a reassessment of risks by investors globally. Despite the tighter policy, however, economic growth in the United States' major trading partners appeared likely to remain solid, supporting U.S. exports. Participants also discussed the role of global capacity utilization in the inflation process.

All meeting participants expressed concern about recent elevated readings on core inflation. A key issue was the extent to which this spring's increase in inflation reflected transitory or persistent influences. Many noted that a number of factors were temporarily boosting inflation. The pass-through of the substantial rise in energy prices could account for a considerable part of the step-up in core inflation in recent quarters. In addition, rising rents had been boosting the cost of shelter and so contributing to the increase in core inflation. However, energy prices were expected to level out, and rents, while difficult to forecast, were viewed by some participants as likely to decelerate in coming quarters. The moderation in the economic expansion was expected to prevent pressures on resource utilization from intensifying. In sum, with inflation expectations contained and unit labor costs held down by ongoing gains in productivity and modest advances in compensation, inflation was seen by most participants as likely to edge down.

Nevertheless, several factors were cited as potentially sustaining upward pressure on inflation, and the range of participants' forecasts for core inflation in 2007 rose by ¼ percentage point relative to the range of forecasts made in February. Some participants noted that businesses in their Districts were experiencing difficulty hiring certain types of skilled workers, suggesting that increased wage pressures might emerge. In addition, some business contacts indicated a greater ability to pass higher costs on to customers, although other businesses continued to report that their pricing power remained limited. The relatively taut resource markets and the lagged effects of the increase in energy prices raised the possibility that inflation could continue at somewhat elevated levels for some time. Higher levels of inflation, should they persist, could become embedded in inflation expectations. In that vein, several participants noted that inflation expectations had been sensitive to incoming data and to communications regarding monetary policy over the intermeeting period.

All Committee members agreed that raising the target for the federal funds rate 25 basis points, to 5¼ percent, at this meeting was appropriate given the recent readings on inflation and the associated deterioration in the inflation outlook. Such an action would also help preserve the decline in inflation expectations that had occurred over the intermeeting period and which appeared to be conditioned on an outlook for a policy firming. Characterizing the resulting stance of policy was quite difficult in the view of most members; those who did venture a judgment saw the stance as ranging from modestly restrictive to somewhat accommodative. Many members noted that significant uncertainty accompanied the appropriate setting of policy going forward, and one indicated that the decision to raise the target federal funds rate at this meeting was a close call.

In their discussion of the wording of the statement to be released after the meeting, members expressed a wide range of views. Some members favored a shorter statement that focused on the Committee's desire to see core inflation decline from its recent elevated levels, while others were inclined to provide more information about the forces that would likely influence the future path of policy. In light of the possibility that the lessening of inflation pressures could be more limited than consistent with sustained good performance of the economy, members agreed to indicate that "[a]lthough the moderation in the growth of aggregate demand should help to limit inflation pressures over time . . . some inflation risks remain." Nevertheless, with the economy slowing and some of the effects of past tightening still in the pipeline, members recognized the value of accumulating more information for determining what, if any, additional policy action would be needed following the tightening adopted at the current meeting. To indicate that policy action at future meetings was not foreordained and would depend on the forecasts for inflation and activity in the medium term, the Committee agreed to state that "[t]he extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information."

After consulting with the participants, the communications subcommittee recommended that the Committee begin its discussions of communications issues at the FOMC meeting in August and that the FOMC meetings scheduled for later this year be lengthened to allow a fuller initial discussion of some of these issues. The Committee also discussed briefly the schedule for FOMC meetings next year and tentatively agreed to increase the number of two-day meetings to four.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 5¼ percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

Although the moderation in the growth of aggregate demand should help to limit inflation pressures over time, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information. In any event, the Committee will respond to changes in economic prospects as needed to support the attainment of its objectives.

Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Guynn, Kohn, Kroszner, and Lacker, Ms. Pianalto, Mr. Warsh, and Ms.Yellen. Votes against this action: None.

The meeting adjourned at 11:10 a.m.

Notation Vote

By notation vote completed on May 30, 2006, the Committee unanimously approved the minutes of the Federal Open Market Committee meeting held on May 10, 2006.

Vincent R. Reinhart
Secretary

Meeting Held on August 8, 2006

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 8, 2006 at 8:30 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Guynn
Mr. Kohn
Mr. Kroszner
Mr. Lacker
Ms. Pianalto
Mr. Warsh
Ms. Yellen

Mr. Hoenig, Ms. Minehan, Messrs. Moskow and Poole, Alternate Members of the Federal Open Market Committee

Messrs. Fisher, Plosser, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis, respectively

Mr. Reinhart, Secretary and Economist
Ms. Smith, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Mr. Alvarez, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Eisenbeis, Kamin, Madigan, Sniderman, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. English and Ms. Liang, Associate Directors, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

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

Messrs. Dale and Orphanides, Senior Advisers, Division of Monetary Affairs, Board of Governors

Mr. Gross, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

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

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Mr. Hakkio, Ms. Mester, Messrs. Rasche and Williams, Senior Vice Presidents, Federal Reserve Banks of Kansas City, Philadelphia, St. Louis, and San Francisco, respectively

Messrs. Peach and Krane, and Ms. Weir, Vice Presidents, Federal Reserve Banks of New York, Chicago, and New York, respectively

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

Mr. Hetzel, Senior Economist, Federal Reserve Bank of Richmond

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at the meeting suggested that the growth of economic activity in the second quarter slowed from its rapid pace in the first quarter. Residential investment contracted as activity in the housing market continued to cool. Consumer spending and business investment decelerated after posting substantial increases in the first quarter. The demand for labor moderated, with hiring in recent months below the pace of earlier this year. Consumer price inflation remained elevated in July, reflecting further increases in energy prices and shelter costs.

Nonfarm payrolls increased in June and July, but more slowly than in the first quarter. The moderation in hiring was most pronounced in retail trade but was also evident in construction and non-business services. Establishments in professional and business services continued to add jobs at roughly the same pace as that of earlier in the year. Average hours of production or nonsupervisory workers on private nonfarm payrolls edged up. The unemployment rate rose to 4.8 percent in July, above its average over the first half of the year.

Industrial production picked up in June. For the second quarter as a whole, it grew at a robust rate that was faster than its first-quarter pace. Gains in manufacturing production were widespread across industries. The mining sector, which includes oil and natural gas extraction, expanded solidly in June, although average growth in the second quarter was below that of the first quarter, in part because the recovery from the disruptions caused by last year's hurricanes neared completion. Utilities output grew strongly in the second quarter. The rate of capacity utilization in the manufacturing sector stepped up in June and remained above its long-run average.

The growth of consumer spending slowed considerably in the second quarter after the surge in purchases around the turn of the year. Spending on goods excluding motor vehicles posted a modest increase in June after remaining flat, on average, over the previous four months. Although nominal wages and salaries rose briskly in the first half of the year, gains in real disposable income were held down by rising consumer prices. While past gains in household wealth, particularly from home prices, supported consumer spending, higher interest rates and energy prices were likely a restraining influence. Indicators of consumer sentiment for July were mixed.

Residential construction activity contracted in the second quarter. Single-family starts declined in June to a level well below the average of the previous twelve months. Construction in the multifamily sector remained steady, with starts in June well within the typical range seen since 1995. Sales of both new and existing single-family homes slowed in June and were significantly below their peaks of the summer of 2005. Available measures of house prices indicated that price increases had moderated over the past four quarters.

After surging in the first quarter, real spending on equipment and software edged down in the second quarter. The decline was accounted for primarily by a drop in expenditures on communications and transportation equipment. Spending on high-tech equipment and software declined as well. The construction of nonresidential buildings moved up at a solid pace over the first half of the year, although activity remained well short of its previous peak in mid-2000. Outlays on drilling and mining structures continued to climb in response to high energy prices, and spending on office construction edged up as vacancy rates continued to trend down. Overall, economic fundamentals and business sentiment continued to support increased investment.

The book value of manufacturing and trade inventories excluding motor vehicles rose in May, and real nonfarm inventories excluding motor vehicles appeared to be slightly higher in the second quarter than earlier in the year. The ratio of book-value inventories to sales edged down in May in both the trade and manufacturing sectors after having remained relatively steady over the previous three months. In the manufacturing sector, however, inventories ticked up again in June. In general, inventories appeared to be well aligned with demand, and business surveys suggested that firms were comfortable with the level of inventories.

The U.S. international trade deficit widened in May, reflecting a sharp increase in imports that more than offset a sizable gain in exports. Import growth was heavily concentrated in oil, reflecting both higher prices and quantities; other categories of imports fell on balance. Exports rose across almost all major product categories; the largest gains were in consumer goods and capital goods, especially aircraft. Expansion of economic activity in the advanced foreign economies appeared to continue in the second quarter at a pace roughly comparable to that of the first quarter, on net. Incoming data for the second quarter pointed to a pickup in economic growth in the euro area and Japan but indicated that growth slowed somewhat in Canada. Recent economic indicators from the developing economies were mixed but, in general, suggested some moderation in growth from the rapid first-quarter pace.

Headline inflation continued to move up, on balance, in recent months, and consumer prices increased at a faster pace in the second quarter than over the previous twelve months. Consumer energy prices, while declining slightly in June, surged during the second quarter, on net. Core consumer prices also continued to rise, boosted by an acceleration in shelter costs, particularly those for owner-occupied residences, and some pass-through of energy cost increases. Higher oil prices showed through in producer prices for a variety of energy-intensive intermediate goods. Rising import prices, higher domestic rates of capacity utilization, and strong global demand for materials were factors underlying an acceleration in core prices for intermediate materials. The price of crude oil increased further over the intermeeting period, and strong weather-related demand caused the price of natural gas to rise considerably. The employment cost index rose somewhat faster in the second quarter than over the preceding three months, but the twelve-month change was less than that of a year ago. Survey measures of households' inflation expectations in June and July reversed their increases in April and May.

At its June meeting, the Federal Open Market Committee (FOMC) decided to raise its target for the federal funds rate 25 basis points, to 5¼ percent. The Committee's accompanying statement indicated that economic growth had been moderating from its quite strong pace earlier in the year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices. Readings on core inflation had been elevated in recent months, but ongoing productivity gains had held down the rise in unit labor costs, and inflation expectations remained contained. However, high levels of resource utilization and the high prices for energy and other commodities had the potential to sustain inflation pressures. Although the moderation in the growth of aggregate demand would help limit inflation pressures over time, the Committee judged that some inflation risks remained. The extent and timing of any additional firming would depend on the evolution of the economic outlook as implied by incoming information.

Investors anticipated the FOMC's decision at its June meeting to raise the federal funds rate 25 basis points, but near-term policy expectations edged lower, apparently in response to the accompanying statement. Subsequently, data releases on real activity that were weaker than expected, the Chairman's testimony on the semiannual Monetary Policy Report, and the release of the June FOMC minutes all led investors to revise down their expectations for the future path of the federal funds rate. Yields on nominal Treasury securities fell in line with policy expectations over the intermeeting period. Yields on inflation-indexed Treasury securities declined a bit more than those on comparable nominal Treasury securities, leaving inflation compensation up slightly, albeit within recent ranges. Spreads of yields on corporate bonds over those on comparable-maturity Treasury securities were about unchanged, while those on speculative-grade bonds widened. Major stock price indexes rose modestly. The foreign exchange value of the dollar against other major currencies fell, on net, over the intermeeting period.

Debt of the domestic nonfinancial sectors was estimated to have decelerated in the second quarter after a robust first-quarter increase. Business-sector debt increased briskly, as the expansion of business loans remained robust. In the household sector, mortgage debt decelerated from the first quarter's rapid pace in response to higher mortgage rates and slower house-price appreciation. M2 growth dropped in the second quarter and remained modest in July, consistent with moderating growth of nominal income and rising opportunity cost.

The staff forecast prepared for this meeting indicated that real GDP growth would slow in the second half of 2006 and 2007, and to a lower rate than had been anticipated in the prior forecast. The marking down of the outlook was largely attributable to the annual revision of the national income and product accounts, which involved downward revisions to actual GDP growth in prior years and prompted reductions in the staff's estimate of potential output. The slowdown in the housing market, the effects of higher energy prices on household purchasing power, the waning impetus of household wealth effects on consumer spending, and the effects of past policy tightening were expected to hold economic growth below potential over the next six quarters. Core consumer price inflation was projected to drop back somewhat later this year and next, mainly as the effects of higher energy and import prices abated.

In their discussion of the economic situation and outlook, meeting participants noted that the slowing of GDP growth in the second quarter was generally in line with expectations, reflecting the continued cooling of the housing market, the restraining influence on demand of higher energy prices, and the lagged effects of past increases in interest rates. Going forward, output was expected to advance at a pace at or slightly below the economy's potential rate of growth, but several participants noted that the annual revision to the national income and product accounts suggested this growth rate likely was lower than previously believed. Incoming information with regard to inflation had not been encouraging. Still, most participants thought that, with energy prices possibly leveling out, aggregate demand moderating, and long-term inflation expectations contained, core PCE inflation likely would decline gradually from its recent elevated level, though the upside risks to inflation were significant.

In their discussion of the major sectors of the economy, participants noted that residential construction activity had continued to recede over the past few months and cited the housing sector as a downside risk to the outlook for growth. The rate of new home sale cancellations, which was identified as an important leading indicator by some contacts in the construction industry, had spiked higher. Single-family housing starts and permits continued to fall, and inventories of unsold housing appeared to have risen significantly, pointing to continued slowing in this sector. Some participants observed that the slowing seemed to be orderly thus far, but it was also noted that in some areas of the country housing construction had experienced a relatively sharp fall. In general, participants expressed considerable uncertainty regarding prospects for the housing sector.

Meeting participants noted that the continued increases in energy prices and borrowing costs appeared to have restrained consumer spending growth in recent months. Contacts in the retail sector generally reported a continued slowing of growth in sales, although the situation differed somewhat by region and type of good or service. Reliable, comprehensive data were not yet available on recent house price movements, but the rate of appreciation appeared to be moderating and was likely to slow further in coming months. The slower pace of increase in housing wealth would restrain consumption growth, though by how much was uncertain. However, the financial condition of households, as judged by indicators such as bankruptcy filings and loan delinquencies, appeared to remain solid. Overall, consumption spending seemed likely to expand at a moderate pace in coming quarters.

Although business fixed investment in the second quarter was a little lower than had been expected, participants noted that this development appeared mainly to reflect the timing of purchases, particularly of transportation equipment, and not weakness in the underlying trend. Some participants noted that nonresidential construction had continued to strengthen, offsetting some of the contraction in residential construction. Looking forward, strong business balance sheets and high profitability were seen as supporting continued growth in expenditures on software and equipment. However, it was noted that if the reported slowing of increases in retail sales continued, businesses might trim capital spending plans.

With regard to the federal sector, spending related to last year's hurricanes appeared likely to abate, and federal expenditures overall would probably be providing less impetus to aggregate demand going forward. Federal receipts had been increasing rapidly, a development that reflected continued strong growth in labor and non-labor income.

Some participants noted that global demand remained strong, potentially adding to worldwide pressures on resources. Increased geopolitical risks, particularly related to developments in the Middle East, continued to put pressure on energy prices, and the prices of many other commodities also had firmed over the intermeeting period. Central banks had been raising interest rates globally, however, and this was viewed as a factor that should help to restrain global inflation pressures. But it was also noted that the recent decline in the foreign exchange value of the dollar could lead to a weakening of import competition in the form of increases in the prices of tradable goods in the United States.

As at the June meeting, all participants expressed concern about continued elevated readings on core inflation and inflation risks going forward. Several participants took note of the revisions to historical data that painted a more worrisome picture of cost trends; measures of unit labor costs had been marked up, reflecting upward revisions to labor compensation and downward revisions to labor productivity. Core PCE inflation now appeared to have been running at or above a 2 percent annual rate for more than two years, with prices accelerating over the first half of 2006. Many participants noted that the extent to which the increase in core inflation so far this year reflected transitory or persistent influences remained unclear. The recent pickup in price increases appeared to be broad-based, and a number of business contacts reported greater ability to pass through higher costs. However, some types of price pressures were not likely to continue to increase. The recent acceleration in shelter costs, which contributed substantially to the increase in core inflation this year, could prove short-lived. Moreover, while energy prices had risen further in the intermeeting period, energy prices could well level out in coming quarters. Also, the anticipated moderation in aggregate demand implied that pressures on resource utilization likely would not increase and could abate to a degree going forward. Finally, inflation expectations appeared to have remained contained despite adverse news about prices. In light of these factors, most participants expressed the view that core inflation was likely to decline gradually over the next several quarters, although appreciable upside risks remained.

In the Committee's discussion of monetary policy for the intermeeting period, nearly all members favored keeping the target federal funds rate at 5¼ percent at this meeting. In view of the elevated readings on costs and prices, many members thought that the decision to keep policy unchanged at this meeting was a close call and noted that additional firming could well be needed. But with economic growth having moderated some, most members anticipated that inflation pressures quite possibly would ease gradually over coming quarters and the current stance of policy could well prove to be consistent with satisfactory economic performance. Under these circumstances, keeping policy unchanged at this meeting would allow the Committee to accumulate more information before judging whether additional firming would be necessary to foster the attainment of price stability over time. The full effect of previous increases in interest rates on activity and prices probably had not yet been felt, and a pause was viewed as appropriate to limit the risks of tightening too much. Following seventeen consecutive policy firming actions, members generally saw limited risk in deferring further policy tightening that might prove necessary, as long as inflation expectations remained contained.

All members agreed that the statement to be released after the meeting should convey that inflation risks remained dominant and that consequently keeping policy unchanged at this meeting did not necessarily mark the end of the tightening cycle. They concurred that an indication that economic growth had moderated was appropriate, and a consensus favored citing the same reasons for that moderation as in the June statement. Members also agreed that the statement should both mention factors contributing to the likely moderation of inflation pressures over time and reiterate the forces that were seen as having the potential to sustain inflation pressures.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5¼ percent.

The vote encompassed approval of the text below for inclusion in the statement to be released at 2:15 p.m.:

> The Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

> Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Guynn, Kohn, Kroszner, Ms. Pianalto, Mr. Warsh, and Ms. Yellen. Votes against this action: Mr. Lacker.

Mr. Lacker dissented because he believed that further tightening was needed to bring inflation down more rapidly than would be the case if the policy rate were kept unchanged. The inflation outlook had deteriorated in the intermeeting period; the recent surge in core inflation had persisted and appeared to be broad-based, while the revision of the national income and product accounts indicated a recent upswing in compensation and unit labor costs. Although real growth was likely to be somewhat lower in coming quarters, in his view it was unlikely to moderate by enough to bring core inflation down. He noted, moreover, that real short-term interest rates had fallen in the intermeeting period and were still low relative to rates typically associated with sustained expansions.

The Committee then turned to a discussion of the goals and principles that should guide the review of its approaches to policy communications that it had recently undertaken. Participants agreed that communication was important for democratic accountability and could promote the effectiveness of policy. Although considerable strides had been made in FOMC communications over the past ten years or so, participants generally thought that further advances were possible. In that regard, consideration of how the Committee expressed both its economic objectives and its assessments of expected progress toward those objectives was likely to be particularly important. Conveying the degree of uncertainty and conditionality about Committee expectations of future developments was seen as a major challenge. It was recognized that communications should support appropriate decisionmaking, including respect for the diversity of views that contributed to good decisions. Participants agreed to continue the Committee's review of communications issues at the FOMC meeting in October.

The meeting adjourned at 3:05 p.m.

Notation Vote

By notation vote completed on July 19, 2006, the Committee unanimously approved the minutes of the FOMC meeting held on June 28–29, 2006.

Vincent R. Reinhart
Secretary

Meeting Held on September 20, 2006

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 20, 2006 at 8:30 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Guynn
Mr. Kohn
Mr. Kroszner
Mr. Lacker
Mr. Mishkin
Ms. Pianalto
Mr. Warsh
Ms. Yellen

Ms. Cumming, Mr. Hoenig, Ms. Minehan, and Messrs. Moskow and Poole, Alternate Members of the Federal Open Market Committee

Messrs. Fisher, Plosser, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis, respectively

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Eisenbeis, Kamin, Madigan, Sniderman, Struckmeyer, Tracy, Weinberg, and Wilcox, Associate Economists Mr. Kos, Manager, System Open Market Account

Messrs. English and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

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

Mr. Oliner, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Gross, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Durham, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

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

Mr. Lyon, First Vice President, Federal Reserve Bank of Minneapolis

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Mr. Evans, Ms. Mester, Messrs. Rasche, Rolnick, Rudebusch, and Sellon, Senior Vice Presidents, Federal Reserve Banks of Chicago, Philadelphia, St. Louis, Minneapolis, San Francisco, and Kansas City, respectively

Ms. Mosser, Vice President, Federal Reserve Bank of New York

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at the meeting suggested that economic activity continued to decelerate in recent months. Consumer and business spending held up well, and payroll employment continued to rise moderately in July and August. However, a contraction in homebuilding was damping the economic expansion. Core consumer price inflation eased somewhat but nonetheless remained higher than it was in 2005. Total consumer price inflation moderated in August, reflecting a substantial slowing of the increase in energy prices.

Nonfarm payrolls rose in August at a pace similar to that recorded over the previous four months. Employment gains were widespread in the service sector, and the construction industry also added jobs, particularly in nonresidential building. However, employment in retail trade and manufacturing fell again in August. Average hours of production or nonsupervisory workers edged lower. The unemployment rate ticked back down to 4.7 percent in August, but it remained within the narrow band that prevailed since the beginning of the year.

Industrial production rose in July but edged down in August. Manufacturing output was unchanged in August, as a small increase in the production of motor vehicles and parts was offset by a slight net decline in other sectors. Output of construction supplies, for example, dropped a little. In the high-technology sector, the production of computers rose tepidly through the summer, while output of communications equipment turned down in August after increasing markedly during the first half of the year. Semiconductor production remained sluggish through August.

Consumer spending appeared to be rising at a moderate pace in recent months. Spending on cars and light trucks increased somewhat in July after a lackluster pace in the second quarter but apparently weakened in August. Consumer spending on goods excluding motor vehicles increased modestly during the four months ending in July. Despite the sharp net increase in energy prices, real disposable income rose further, with solid gains in June and July. Increases in household wealth earlier in the year continued to boost consumer spending. However, consumer borrowing costs had risen since the beginning of the year with the increase in short-term interest rates. Recent readings on consumer sentiment were mixed. The personal saving rate fell further in July.

Residential construction activity continued to contract in recent months. Single-family starts fell further in July and August to a level well below the peak in the third quarter of 2005. Construction in the multifamily sector also fell back. Sales of both new and existing single-family homes fell in July and were significantly below the peaks of last summer. A range of indicators suggested that housing market activity was likely to slow further in the near term. Pending home sales dropped noticeably in July, and mortgage rates had increased since the beginning of the year. Available measures suggested that prices of existing homes increased through the second quarter at a much lower rate than the one observed during the same period last year.

After strong increases in the first half of 2006, real spending on equipment and software remained robust into the summer against a backdrop of rising business output, plentiful corporate cash reserves, positive sentiment among executives, and falling relative prices for high-tech equipment. Orders and shipments of communications equipment leveled off in recent months after climbing earlier this year. Real computer spending remained sluggish in July. Business purchases of light vehicles picked up in August after a weak performance in July, and sales of medium and heavy trucks remained brisk. Available data indicated that aircraft purchases remained flat. Real spending on equipment outside the high-tech and transportation sectors appeared to be increasing moderately in the current quarter.

Book-value data for the manufacturing and trade sectors suggested that inventory accumulation slowed only modestly in July from a brisk pace in the second quarter. Outside the motor vehicle sector, inventories appeared to be well aligned with demand, and surveys indicated that firms continued to be generally comfortable with their level of inventories.

Both imports and exports increased in the second quarter, but imports increased and exports decreased in July, widening the U.S. trade deficit. The growth of imports was heavily concentrated in oil, reflecting higher petroleum prices, and in non-oil industrial supplies and capital goods. Imports of services fell slightly. Exports of capital goods and industrial supplies declined after considerable gains in June, but exports of telecommunications equipment and automotive products were strong. Exports of services were unchanged in July.

Economic activity in the advanced foreign economies decelerated in the second quarter but remained strong. A fall in net exports held back expansion in Japan and Canada, while strong domestic demand boosted growth in the United Kingdom and the euro area. Incoming data suggested that overall GDP growth in these countries for the current quarter was dropping a bit from the second-quarter pace. Recent economic indicators from the emerging-market economies generally pointed to robust, but moderating, growth.

The overall price index for personal consumption expenditures rose relatively steeply in July and was estimated to have increased further in August, bringing the advance over the twelve-month period above the year-earlier rise. After July, though, crude oil and gasoline prices dropped back significantly, and with inventories of natural gas remaining near seasonal highs, natural gas prices fell from their spike earlier this summer. Core consumer prices increased at a somewhat more subdued pace over July and August, but despite the recent moderation, the twelve-month change in core prices remained above the increase over the comparable period twelve months earlier. The producer price index for core intermediate materials rose significantly in July and August. Substantial upward revisions to wages and salaries boosted compensation per hour in the first quarter. The increase likely owed in part to the exercise of stock options and cash bonuses; other data that did not include such forms of compensation pointed to more moderate increases. Hourly compensation rose further in the second quarter and recorded an increase of about 7¾ percent from four quarters earlier. After more favorable readings in June and July, survey measures of households' inflation expectations turned back up in August, but preliminary September readings suggested a decline.

At its August meeting, the Federal Open Market Committee (FOMC) decided to maintain its target for the federal funds rate at 5¼ percent. The Committee's accompanying statement indicated that economic growth had moderated from its quite strong pace earlier in the year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices. Readings on core inflation had been elevated in recent months, and the high levels of resource utilization and of the prices of energy and other commodities had the potential to sustain inflation pressures. However, inflation pressures seemed likely to moderate over time, reflecting contained inflation expectations and the cumulative effects of monetary policy actions, as well as reduced impetus from higher energy and materials costs. Nonetheless, the Committee judged that some inflation risks remained. The extent and timing of any additional firming that may be needed to address these risks would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Investors had largely anticipated the FOMC's decision at its August meeting to maintain the federal funds rate at its current level, and short-term rates dropped only a bit in response. Subsequently, data on inflation that were weaker than expected, substantial declines in oil prices, and the release of the minutes of the August FOMC meeting led investors to revise down their expectations for the future path of the federal funds rate. Over the intermeeting period, yields on short- and intermediate-term nominal Treasury securities fell, while yields on inflation-indexed Treasury securities of comparable maturity increased somewhat, pushing inflation compensation considerably lower at those horizons. Nominal forward rates further out the yield curve fell about the same amount as real forward rates, implying little change in far-forward inflation compensation. Spreads of yields on investment- and speculative-grade corporate bonds over those on Treasury securities were about unchanged. Major stock price indexes posted solid gains. The foreign exchange value of the dollar against other major currencies was little changed, on net, over the intermeeting period.

Debt of the domestic nonfinancial sectors in the third quarter was estimated to be rising at about the same pace as in second quarter. Business-sector debt was increasing briskly, as the expansion of business loans remained robust. In the household sector, debt expanded in the second quarter at a rate slightly below that in the first quarter, as mortgage debt decelerated somewhat. M2 growth remained modest in August, consistent with moderating growth of nominal income and lagged increases in opportunity cost.

The staff forecast prepared for this meeting indicated that real GDP growth would continue to slow into the second half of 2006 before strengthening gradually thereafter. By 2008, output was projected to be expanding at a pace about equal to the staff's forecast of potential output growth. The staff, however, had again reduced its projection for potential GDP growth, and the projected slow pace of growth over the next several quarters was thus consistent with an opening of only a small gap in resource utilization. In the near term, the cooling of the housing market and lower motor vehicle production were expected to hold growth back. At the same time, though, significantly lower energy prices, sustained increases in labor income, and favorable labor market conditions were anticipated to support expansion through the end of the year. Further ahead, the lagged effects of the previous tightening of monetary policy and waning stimulus from household wealth and fiscal policy were anticipated to restrain growth, but the drag from the downturn in residential construction was expected to abate. Core consumer price inflation was projected to drop back somewhat later this year and next, reflecting the emergence of slack in the economy and lower energy costs.

In their discussion of the economic situation and outlook, meeting participants noted that the pace of the expansion appeared to be continuing to moderate in the third quarter. In particular, activity in the housing market seemed to be cooling considerably, which would contribute to relatively subdued growth over the balance of the year. Growth was likely to strengthen next year as the housing correction abated, with activity also encouraged by the recent decline in energy prices and still-supportive financial conditions. In the view of many participants, economic expansion would probably track close to the rate of growth of the economy's potential next year and in 2008. Many participants also noted that core inflation had been running at an undesirably high rate. Although most participants expected core inflation to decline gradually, substantial uncertainty attended this outlook.

In their discussion of major sectors of the economy, meeting participants focused especially on developments in the housing market. Although the situation varied somewhat across the nation, housing activity was continuing to contract in most regions. Home sales had slowed considerably, and anecdotal reports suggested that more buyers were canceling contracts for purchases. Participants noted that inventories of unsold homes had climbed sharply in many areas and that builders were taking a number of measures to reduce inventories. Both permits for new construction and housing starts had declined significantly. Available measures of home prices suggested that appreciation had slowed considerably but prices in most areas were not falling, although some sellers were reported to be providing various inducements to potential purchasers that reduced effective prices.

Thus far, the drop in housing market activity appeared not to have spilled over significantly to other sectors of the economy. Indeed, consumer expenditures appeared to have been expanding moderately over the previous few months, buoyed by increases in employment, personal income, and household wealth. Contacts in some Districts reported that retail sales had picked up a little most recently. Meeting participants noted that consumer spending going forward would be supported by the higher levels of personal income indicated by recent revisions to the national income and product accounts, by further gains in employment, and by the decline in consumer energy prices over recent months. However, considerable uncertainty was expressed regarding the ultimate extent of the downturn in the housing sector and the degree to which the slowing in housing activity and the deceleration in home prices would affect consumption and other expenditures going forward.

Business investment spending generally was seen as expanding at a reasonably good pace. Meeting participants noted broad strength in manufacturing of capital goods. Nonresidential construction activity continued to strengthen, and in the process was absorbing some of the resources that were no longer employed in homebuilding. Although some survey evidence suggested that some firms were trimming capital spending plans, participants reported that their business contacts generally were quite positive about the economic outlook and the strength of demand for their products. In this environment, investment spending would likely continue to be supported by expansion of overall output, strong balance sheets and profits, and the ready availability of funding from financial markets and institutions.

Participants noted that the financial condition of federal and state governments continued to improve. Inflows of tax revenues remained strong, consistent with expanding personal incomes, sales, and business profits.

Economic activity abroad appeared to be slowing a little from the unusually rapid rate of the first half of the year, but still expanding at a reasonably good pace overall. Foreign economic growth was expected to continue, albeit perhaps at a somewhat slower pace than expected by some outside forecasters, contributing to increases in U.S. exports.

Participants took note of the jump in labor compensation in the first half of the year, but commented that the increase likely reflected in part the exercise of stock options. Nonetheless, some participants viewed the recent increase in overall compensation as pointing to upside risks to inflation. Participants reported steady gains in employment in various regions, roughly in line with expansion of the labor force. Many business contacts continued to experience shortages of labor and accelerating wages, particularly for certain types of professionals and skilled workers and, in some areas, unskilled workers.

One participant highlighted that, in the staff forecast, labor force growth would begin to slow over the next few years as more members of the baby-boom generation retired. Even if resource utilization rates were unchanged, slower growth of the labor force would mean that increases in employment would be significantly lower, on average, than those registered in recent years. In that case, the slower growth of the labor force and employment implied that the expansion of potential GDP could be somewhat lower than it had been earlier this decade.

Some participants commented, however, that they viewed potential output growth, as well as expansion of actual output, as likely to remain solid over the next several years.

Many meeting participants emphasized that they continued to be quite concerned about the outlook for inflation. Recent rates of core inflation, if they persisted, were seen as higher than consistent with price stability, and participants underscored the importance of ensuring a moderation in inflation. To be sure, very recent data on inflation suggested some improvement from the situation in the late spring, partly reflecting slower increases in owners' equivalent rent. Also, the considerably lower level of energy prices of recent weeks, if sustained, would help reduce overall inflation and damp increases in core prices. Moreover, businesses would meet more resistance to attempts to pass through cost increases in the less robust economic circumstances that were likely to prevail at least for a time. However, energy prices remained quite sensitive to a wide range of forces, including geopolitical developments, and might well rebound. To date, the available evidence indicated that inflation expectations remained contained—indeed, expectations of price increases for the next few years had fallen some as energy prices declined. Nonetheless, several participants worried that inflation expectations could rise and the Federal Reserve's willingness to carry through on its intention to seek price stability could be called into question if cost and price pressures mounted or even if there was no moderation in core inflation. Looking forward, most participants thought that the most likely outcome was a reduction in inflation pressures, but the anticipated decline was only gradual and the uncertainties around that forecast were skewed toward higher rather than lower inflation rates.

In the Committee's discussion of monetary policy for the intermeeting period, nearly all members favored keeping the target federal funds rate at 5¼ percent at this meeting. Members generally expected economic activity to expand at a pace below the rate of growth of potential output in the near term before strengthening some over time. Moreover, given the uncertainties in forecasting, significantly more sluggish performance than anticipated could not be entirely ruled out. Although the uncertainties were substantial, core inflation seemed most likely to ebb gradually from its elevated level, in part owing to the waning effects of past increases in energy prices. The anticipated expansion of economic activity at a pace slightly below the rate of growth of the economy's potential would likely also play a role by easing pressures on resources. Members noted that certain developments of late—appreciable declines in energy prices, some softer indicators of economic activity, and slightly lower readings on core inflation—pointed to a modestly better inflation outlook and hence made the policy decision today somewhat less difficult than it was in August, when it was seen as a particularly close call.

In view of the most recent information on the economy, members agreed that it was appropriate for the post-meeting statement to characterize economic growth as apparently continuing to moderate. However, in view of still-high energy and other commodity prices and elevated rates of resource utilization as well as recent indications of a possible acceleration in labor costs, members continued to see a substantial risk that inflation would not decline as anticipated by the Committee. Consequently, the Committee agreed that the statement should again cite such risks to inflation and explicitly reference the possibility of additional policy firming.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5¼ percent.

The vote encompassed approval of the text below for inclusion in the statement to be released at 2:15 p.m.:

> Nonetheless, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Guynn, Kohn, Kroszner, and Mishkin, Ms. Pianalto, Mr. Warsh, and Ms. Yellen.
Votes against this action: Mr. Lacker.

Mr. Lacker dissented because he believed that further tightening was needed to bring inflation down more rapidly than would be the case if the policy rate were kept unchanged. Recent data indicated that inflation remained above levels consistent with price stability. Moreover, the upswing in compensation and unit labor costs in the first half of the year indicated that inflation risks were tilted to the upside. Although real growth was likely to be moderate in coming quarters, in his view it was unlikely to be slow enough to bring core inflation down.

The meeting adjourned at 1:20 p.m.

Notation Vote

By notation vote completed on August 28, 2006, the Committee unanimously approved the minutes of the FOMC meeting held on August 8, 2006.

Vincent R. Reinhart
Secretary

Meeting Held on October 24–25, 2006

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, October 24, 2006 at 2:00 p.m. and continued on Wednesday, October 25, 2006 at 9:00 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Kohn
Mr. Kroszner
Mr. Lacker
Mr. Mishkin
Ms. Pianalto
Mr. Warsh
Ms. Yellen

Mr. Hoenig, Ms. Minehan, and Messrs. Moskow and Poole, Alternate Members of the Federal Open Market Committee

Messrs. Fisher, Plosser, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis, respectively

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Mr. Alvarez, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Eisenbeis, Judd, Kamin, Madigan, Sniderman, Struckmeyer, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. English and Slifman, Associate Directors, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

Messrs. Gagnon and Wascher, Deputy Associate Directors, Divisions of International Finance and Research and Statistics, respectively, Board of Governors

Messrs. Dale and Oliner, Senior Advisers, Divisions of Monetary Affairs and Research and Statistics, respectively, Board of Governors

Mr. Gross, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors.

Ms. Weinbach, Senior Economist, Division of Monetary Affairs, Board of Governors

Messrs. Kumasaka[7] and Luecke,[8] Senior Financial Analysts, Division of Monetary Affairs, Board of Governors

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

Messrs. Fuhrer and Rosenblum, Executive Vice Presidents, Federal Reserve Banks of Boston and Dallas, respectively

Mr. Evans, Ms. Mester, and Messrs. Rasche and Sellon, Senior Vice Presidents, Federal Reserve Banks of Chicago, Philadelphia, St. Louis, and Kansas City, respectively

Ms. Mucciolo and Mr. Todd, Vice Presidents, Federal Reserve Banks of New York and Minneapolis, respectively

Ms. McConnell, Assistant Vice President, Federal Reserve Bank of New York

Mr. Hetzel, Senior Economist, Federal Reserve Bank of Richmond

The manager of the System Open Market Account (SOMA) reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The Manager also discussed with the Committee the results of a recent review of the management of the domestic security holdings of the SOMA. The Manager noted that in 2000, in response to reduced issuance of Treasury securities, limits were adopted on the SOMA's holdings of individual Treasury bonds, notes, and bills that ranged between 15 percent and 35 percent of amounts outstanding. In recent years, those limits had created occasional operational complications for the Trading Desk. Meanwhile, circumstances in the Treasury securities market had changed considerably, and the Manager noted that he intended to revert to the previous practice of applying a single 35 percent limit across all issues.

The Chairman noted that the President had recently signed the Financial Services Regulatory Relief Act of 2006, which among its provisions gave the

7. Attended Tuesday's session only.
8. Attended Wednesday's session only.

Federal Reserve discretion, beginning October 2011, both to pay interest on reserve balances and to reduce further or eliminate reserve requirements. The Act potentially has important implications for many aspects of the Federal Reserve's operations and the Chairman asked Vincent Reinhart, Director of the Division of Monetary Affairs, to form a committee of Federal Reserve System staff to consider these issues.

The information reviewed at the October meeting suggested that economic activity increased at a slow pace in the third quarter. The contraction in home construction remained a significant drag on economic activity, and steep reductions in motor vehicle assemblies further weighed on growth in the third quarter. Nonetheless, consumer spending and business investment continued to hold up well. Payroll employment extended its moderate expansion, on average, through September. Sharp declines in energy prices reduced total consumer price inflation in September, but the twelve-month change in core prices remained elevated relative to year-earlier readings.

Nonfarm payrolls rose modestly in September after a larger increase in August, with some of the variation apparently a result of seasonal factors. In September, job increases in the service-producing sectors were fairly widespread and were again led by the health-care industry. The construction sector also added jobs; the lift came from gains associated with nonresidential building that more than offset further losses in the residential sector. Job cutbacks in the retail trade and manufacturing sectors continued. Aggregate hours of private production or nonsupervisory workers again edged lower. The unemployment rate ticked down to 4.6 percent in August.

After having been flat in August, industrial production declined in September, reflecting a sizable weather-related decrease in the output of utilities and a fairly broad-based reduction in manufacturing output. These declines were partially offset by a rise in output in the mining sector that was led by gains in crude oil extraction and in mined construction supplies, such as stone, sand, and gravel. The output of motor vehicles and parts fell in September, as automakers continued to trim production of light trucks in response to bloated inventories. Output growth in the high-technology sector softened a bit in September relative to the summer months, reflecting a smaller rise in the production of semiconductors. Computer production continued to increase at a tepid rate, while output of communications equipment turned up noticeably after a decline in August. For the third quarter as a whole, growth in industrial production moderated a bit relative to the first half of the year; stronger output in the high-technology sector and a pickup in the production of business equipment partially offset a steep contraction in the output of motor vehicles and parts and a slowdown in mining output.

Real consumer spending appeared to regain some steam in September after a lackluster August. Although nominal retail sales fell noticeably in September, the steep drop in gasoline prices more than accounted for the decline. Excluding sales at gasoline stations, the step-up in consumer spending was the result of faster sales of motor vehicles and broad-based strength in outlays for other categories of goods, particularly apparel. Real disposable income rose moderately in both July and August; the pace was somewhat above its second-quarter average. Consumer spending continued to draw support from the lagged effects of the increases in household wealth over the past two years. But interest rates on some types of household loans, both short- and long-term, had risen this year, on balance. The latest readings on consumer sentiment had been positive, perhaps reflecting the recent declines in oil prices. The personal saving rate edged up in August after a dip in July.

Residential construction activity remained weak. Single-family starts ticked up in September, but new permit issuance slid further to its lowest level in nearly five years. Construction in the multifamily sector continued to fluctuate within the range that has prevailed for several years. Sales of new single-family homes edged up in August, while sales of existing homes held steady. Pending home sales, which rose somewhat in August after a noticeable drop in July, and the decline in mortgage rates since July likely indicated some support for housing demand in the near term. Still, the overhang of unsold homes remained historically high, and price appreciation of existing homes continued to slow through the second quarter.

Real spending on equipment and software increased at a solid pace during the summer as the fundamental influences on such spending remained favorable for the most part. In particular, although business output had recently been rising at a slower rate, corporate financial reserves remained plentiful and the cost of high-tech capital goods continued to fall. In the high-tech sector, real outlays on communications equipment likely stabilized in August after having surged earlier this year, and the available data suggested that real computer spending picked up in the third quarter. In the transportation sector, business purchases of motor vehicles were brisk of late; the Environmental Protection Agency's regulations on truck emissions that are scheduled to take effect in 2007 likely pulled forward some spending on medium and heavy trucks. Outlays on aircraft appeared to have risen somewhat in the third quarter from their extremely low second-quarter level. Real spending on equipment other than high-tech and transportation items seemed to have retained considerable momentum in the third quarter. Activity in the nonresidential construction sector continued to strengthen in August.

Book-value data on manufacturing and trade inventories, which were available through August, suggested that the rate of stockbuilding remained substantial in the third quarter. A major exception was the motor vehicle sector, where the cutbacks in assemblies probably began to reduce the inventory overhang in that sector. Outside of the motor vehicle sector, inventories generally appeared to be well aligned with demand. Although survey data in September showed a noticeable rise in the share of firms that viewed their inventories as being too high, a large majority remained comfortable with their level.

The U.S. international trade deficit widened to another record in August, reflecting a surge in imports that more than offset a sizable jump in exports. The sharp increase in imports was driven importantly by oil and natural gas, but imports of capital goods and non-oil industrial supplies, particularly metals, also exhibited large gains. Imports of services fell back slightly. The increase in exports was led by capital goods, with aircraft, computers, semiconductors, and other machinery all climbing briskly. Exports of industrial supplies and consumer goods also rose strongly, while exports of services expanded modestly.

Economic activity in the foreign industrial economies continued to expand at a relatively solid pace in the third quarter. Investment spending boosted the expansion in Japan. In the euro area, data on industrial production and retail sales were consistent with robust growth in real activity. Mixed indicators in Canada and the United Kingdom suggested that output growth in those countries remained around recent rates. Incoming data across the emerging-market economies continued to point to moderating, but solid, growth in economic activity in the third quarter.

Core prices for personal consumption expenditures were expected to have risen in September at the same pace as in July and August, leaving the change over the twelve months ending in September a bit higher than the year-earlier period. Increases in shelter costs, which accounted for a significant proportion of the pickup in core inflation over the past year, had slowed considerably in recent months but remained well above the rates that prevailed from 2003 to 2005. The price index for total personal consumption expenditures was estimated to have fallen markedly in September because of the steep decline in gasoline prices, bringing its twelve-month increase to a two-and-one-half-year low. Retail gasoline prices fell especially rapidly in September as crude oil prices declined and as the historically high level of gasoline inventories likely led to a sharp narrowing of margins between retail gasoline prices and crude oil prices. The producer price index for core intermediate materials rose only slightly in September; the increase was well below its average monthly advance over the preceding twelve months, reflecting a drop in prices of some chemicals that have a high energy content. Average hourly earnings increased moderately in both August and September after a larger gain in July. Survey measures of households' year-ahead inflation expectations eased substantially in early October with the sharp drop in energy prices. Respondents' longer-term inflation expectations changed little, remaining well within the narrow range reported over the past year.

At its September meeting, the Federal Open Market Committee (FOMC) decided to maintain its target for the federal funds rate at 5¼ percent. The Committee's accompanying statement indicated that the moderation in economic growth had appeared to be continuing, partly reflecting a cooling of the housing market. Readings on core inflation had been elevated, and the high levels of resource utilization and of the prices of energy and other commodities had the potential to sustain inflation pressures. However, inflation pressures seemed likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand. Nonetheless, the Committee judged that some inflation risks remained. The extent and timing of any additional firming that may be needed to address these risks would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

The FOMC's decision at its September meeting to leave the target federal funds rate unchanged had been largely anticipated by investors, and policy expectations for mid-2007 and beyond rose only slightly. Investors subsequently revised down their expectations for the future path of the federal funds rate in light of some data releases that indicated weaker-than-expected economic activity. However, those declines were then rolled back in the wake of speeches by FOMC members, the release of the minutes of the September FOMC meeting, and stronger-than-expected economic data. Over the intermeeting period, yields on nominal and inflation-indexed Treasury coupon securities rose somewhat, on net. Inflation compensation for 2007 declined modestly, perhaps reflecting the further drop in spot energy prices, but was largely unchanged at longer maturities. Spreads of investment-grade corporate bond yields over those on comparable-maturity Treasury securities held steady, while those on speculative-grade corporate bonds narrowed a little. Broad equity indexes rose noticeably. The trade-weighted index of the foreign exchange value of the dollar versus major currencies rose somewhat on balance, and the gains were spread evenly against most currencies.

Debt of the domestic nonfinancial sectors in the third quarter was estimated to be expanding at around its second-quarter pace. Business debt rose more moderately as bank lending to businesses slowed. In particular, bank lending to finance commercial real estate activity waned in August and September, while commercial and industrial loans, which had been expanding briskly for many months, slowed sharply in September. In the household sector, the further slowing of the rate of increase of house prices appeared to have continued to weigh on the expansion of mortgage debt in the third quarter. M2 grew slowly in the third quarter, exhibiting the lagged effects of earlier increases in opportunity costs and the slow rise in nominal spending.

The staff forecast prepared for this meeting indicated that growth of real GDP had slowed further in the third quarter, reflecting both a significant drag from the continuing contraction in residential construction and a steep decline in motor vehicle assemblies. Looking ahead, a gradual reduction in the restraining effects of the contraction in residential investment and further solid gains in consumer and business spending were expected to lead to a pickup in GDP growth through 2007 and into 2008. These gains in spending were likely to be supported by past declines in energy prices and continued gains in payroll employment and labor income. Real GDP was expected to rise at a somewhat slower rate over the next two years than in 2006 in part as a result of less impetus from household wealth, interest rates, and fiscal policy. The projected increase in real output over the next year or so was a little below the staff's estimate of potential output growth, leading to a lessening in pressures on resource utilization. Core inflation was anticipated to edge down in 2007 and 2008 relative to the second half of this year because of the diminishing impetus from the prices of energy and other commodities and because of the modest easing in resource utilization.

In their discussion of the economic situation and outlook, meeting participants noted that incoming data over the relatively brief intermeeting period had come in broadly as anticipated. The most recent indicators suggested that economic growth had probably slowed more sharply in the third quarter than had been expected at the time of the September meeting, but that appeared to largely reflect the impact of temporary influences. Participants continued to expect the economy to expand at a rate close to or a little below the economy's long-run sustainable pace over coming quarters. The ongoing adjustment in the housing market was likely to depress real activity in the near term, but this effect was expected to wane gradually; private final domestic purchases had held up well in recent months and looked set to expand at a reasonably good pace. Although recent monthly inflation readings indicated some slowing of core inflation from the very rapid rates of spring and early summer, many participants noted that current rates of core inflation remained undesirably high. Most participants expected core inflation to moderate gradually, but they were quite uncertain as to the likely pace and extent of that moderation.

In their discussion of the major sectors of the economy, participants noted that housing activity was likely to remain a substantial drag on economic growth over the next few quarters. Many participants drew some comfort from the most recent data, which suggested that the correction in the housing market was likely to be no more severe than they had previously expected and that the risk of an even larger contraction in this sector had ebbed. But further adjustment in the housing market appeared likely. Single-family housing permits continued to fall and inventories of unsold homes remained at historically high levels. Contacts in the building sector suggested that construction firms were attempting to reduce their backlogs of unsold homes, both by cutting back sharply on new construction and by offering substantial price incentives. Several meeting participants noted the considerable strain on some small- and medium-sized residential construction firms.

To date, weakness in the housing market and the associated downshift in house price appreciation did not seem to be spilling over into consumer spending, which appeared to have grown at a steady pace in recent months. Retail activity in most Districts had been relatively robust and contacts in the retail sector were generally upbeat about the outlook. Several participants noted, however, that contacts within the transportation sector had reported that activity in anticipation of the holiday shopping season appeared to be softer than in previous years. Meeting participants judged that consumer expenditures going forward were likely to expand at a steady pace a little below the growth in disposable income, supported by favorable financial conditions, continued increases in employment and income, and the recent decline in energy prices. Nonetheless, many participants expressed concern that ongoing developments in the housing market could have a more pronounced impact on consumer and other spending, especially if house prices declined significantly.

Investment spending also appeared to be holding up well. Meeting participants reported that their business contacts were generally optimistic and perceived the economic outlook as relatively favorable. Several participants noted that growth in nonresidential construction remained robust and was absorbing some of the resources displaced from the residential sector. The strength of corporate balance sheets and profits was seen as likely to help maintain a solid profile for investment spending over the next year or so, despite some restraint from the slower growth in final sales. However, one participant observed that the uncertainty concerning the possible severity of the current slowing in economic growth could lead some businesses to delay investment plans.

In contrast to the steady expansion of consumer and business investment spending in recent months, several other components of output and demand appeared to have been somewhat weaker than expected. In particular, apparently uncomfortably high levels of inventories within the auto sector had prompted a sharp reduction in light vehicle production in the third quarter. Federal expenditures had been held down by surprisingly weak defense outlays. And strong growth in imports in July and August, driven in part by a surge in oil imports, suggested that net exports probably posed an arithmetic drag on economic growth in the third quarter. However, participants judged that the recent weakness in these components largely reflected temporary influences and was not likely to depress the pace of economic expansion going forward. That said, one participant did note the possibility that the recent decline in oil prices may in part stem from weakness in global demand.

Both data and reports from businesses indicated that the labor market remained tight. Employment had continued to rise at a steady pace, and participants reported that many of their contacts were increasingly concerned about the difficulty of recruiting suitably qualified workers. Shortages were most pronounced for certain types of professional and skilled workers. These reports of shortages and the associated wage pressures had not unambiguously shown through in the aggregate compensation data, which were giving contradictory signals about whether compensation increases were picking up. However, the possibility that the tightness of the labor market could lead to a sustained increase in wage pressure was viewed by participants as an upside risk to costs and their expectations of a gradual decline in inflation. It was noted, though, that continuing high profit margins provided some scope for increased labor costs to be absorbed without necessarily leading to elevated price pressures.

All meeting participants expressed concern about the outlook for inflation. Most participants expected core inflation to edge lower, in part as the effects of the run-up in energy prices in recent years waned. And shelter costs were not expected to add materially to inflation going forward. Moreover, moderate growth in aggregate demand and the associated modest easing of pressures on resource utilization should also contribute slightly to the slowing in core inflation. Recent changes in core prices had declined slightly from earlier in the year. Nonetheless, nearly all participants viewed the current rates of core inflation as uncomfortably high and stressed the importance of further moderation. The available measures suggested that medium- and long-term inflation expectations remained around the levels seen for the past several years, although in the view of some participants these expectations were probably higher than would be consistent with their assessment of long-run price stability. Participants were concerned that inflation expectations could begin to drift upwards if core inflation remained elevated for a protracted period. Any such rise in inflation expectations and associated upward pressure on inflation itself would likely prove costly to reverse. Although some participants noted that the recent slowing in core inflation had helped to allay their fears of a further sustained increase in inflation, all participants emphasized that the risks around the desired downward path to inflation remained to the upside.

In the Committee's discussion of monetary policy for the intermeeting period, nearly all members favored keeping the target federal funds rate at 5¼ percent at this meeting. The Committee's view of the outlook for economic growth and inflation had changed little since the previous meeting. Nearly all members expected that the economy would expand close to or a little below its potential growth rate and that inflation would ebb gradually from its elevated levels. Although substantial uncertainty continued to attend that outlook, most members judged that the downside risks to economic activity had diminished a little, and likewise, some members felt that the upside risks to inflation had declined, albeit only slightly. All members agreed that the risks to achieving the anticipated reduction in inflation remained of greatest concern. Members noted that a significant amount of data would be published before the next Committee meeting in December, giving the Committee ample scope to refine its assessment of the economic outlook before judging whether any additional firming was needed to address those risks.

Members agreed that the statement to be released after the meeting should continue to convey that inflation risks remained the dominant concern and that additional policy firming was possible. The Committee concurred that the statement should mention both that economic growth had slowed over the course of the year and that, going forward, the economy seemed likely to expand at a moderate pace. With energy prices well off the highs reached earlier in the year, members felt that it was no longer appropriate to note that the high level of energy prices had the potential to sustain inflation pressures.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5¼ percent.

The vote encompassed approval of the text below for inclusion in the statement to be released at 2:15 p.m.:

> Nonetheless, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

> Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Kohn, Kroszner, and Mishkin, Ms. Pianalto, Messrs. Poole and Warsh, and Ms. Yellen. Votes against this action: Mr. Lacker

Mr. Lacker dissented because he believed that further tightening was needed to help ensure that core inflation declines to an acceptable rate in coming quarters.

The Committee then continued its discussion of communication issues and considered the advantages and disadvantages of quantifying an inflation objective. Participants stressed that any such step had to be consistent with the statutory objectives for monetary policy. In that regard, it was noted that over time price stability is a prerequisite for maximum employment and moderate long-term interest rates. However, the possible specification of a numerical price objective raised a number of complex and interrelated issues that required considerable further discussion. The Committee reached no decisions on these issues at this meeting, and participants agreed to continue the Committee's review of communication issues at its meeting in January 2007.

The meeting adjourned at 1:30 p.m.

Notation Vote

By notation vote completed on October 10, 2006, the Committee unanimously approved the minutes of the FOMC meeting held on September 20, 2006.

Vincent R. Reinhart
Secretary

Meeting Held on December 12, 2006

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 12, 2006 at 8:30 a.m.

Present:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Kohn
Mr. Kroszner
Mr. Lacker
Mr. Mishkin
Ms. Pianalto
Mr. Warsh
Ms. Yellen

Ms. Cumming, Mr. Hoenig, Ms. Minehan, and Messrs. Moskow and Poole, Alternate Members of the Federal Open Market Committee

Messrs. Fisher, Plosser, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis, respectively

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Mr. Reinhart, Secretary and Economist

Ms. Danker, Deputy Secretary

Ms. Smith, Assistant Secretary

Mr. Skidmore, Assistant Secretary

Mr. Alvarez, General Counsel

Mr. Baxter, Deputy General Counsel

Ms. Johnson, Economist

Mr. Stockton, Economist

Messrs. Connors, Eisenbeis, Kamin, Madigan, Sniderman, Struckmeyer, Weinberg, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Clouse and English, Associate Directors, Division of Monetary Affairs, Board of Governors

Ms. Liang and Mr. Slifman, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Gagnon and Wascher, Deputy Associate Directors, Divisions of International Finance and Research and Statistics, respectively, Board of Governors

Mr. Dale, Senior Adviser, Division of Monetary Affairs, Board of Governors

Mr. Gross, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

Mr. Driscoll, Economist, Division of Monetary Affairs, Board of Governors

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

Mr. Rasdall, First Vice President, Federal Reserve Bank of Kansas City

Mr. Rosenblum, Executive Vice President, Federal Reserve Bank of Dallas

Mr. Hakkio, Mses. Mester and Perelmuter, and Messrs. Rasche, Rolnick, and Williams, Senior Vice Presidents, Federal Reserve Banks of Kansas City, Philadelphia, New York, St. Louis, Minneapolis, and San Francisco, respectively

Messrs. Kahn and Sullivan, Vice Presidents, Federal Reserve Banks of New York and Chicago, respectively

Mr. Olivei, Senior Economist, Federal Reserve Bank of Boston

The Manager of the System Open Market Account (SOMA) reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at the December meeting suggested that economic activity was increasing at a subdued rate during the second half of the year. The contraction in homebuilding was continuing to restrain overall activity, and a step-down in motor vehicle output held down industrial production. In contrast, consumer spending and business investment were increasing at a moderate rate, and payroll employment expanded solidly through November. Additional sharp declines in energy prices reduced total consumer price inflation in October, but the twelve-month change in core prices remained above its year-earlier level.

Indicators from the labor market were generally strong through November. Nonfarm payrolls increased at a solid pace, while revisions to previous estimates showed a larger gain, on balance, over the preceding two months. Employment in manufacturing and construction industries fell in November, but hiring continued to be brisk in the professional and nonbusiness service industries. Aggregate weekly hours of private production or nonsupervisory workers edged up. The unemployment rate had fallen to 4.4 percent in October but ticked back up to 4.5 percent in November, remaining below the average of 4.7 percent during the first three quarters of the year.

Industrial production (IP) declined in September but rose slightly in October. In October, total industrial production was boosted by a weather-related rebound in electricity generation, while output in the mining sector posted a sizable gain as crude oil extraction in Alaska returned to full production following pipeline repairs. Manufacturing output fell in both months, partly because of cutbacks in motor vehicle production as vehicle makers pared elevated inventories in light trucks. Although less pronounced than in the motor vehicle sector, the recent softness in factory output was also apparent in a number of other sectors. A notable exception was production in high-tech industries, which posted another solid increase in October, reflecting a pickup in computer output and a rise in semiconductor production attributable to the rollout of a new generation of microprocessors.

The National Income and Product Accounts for the third quarter incorporated an estimate by the Bureau of Economic Analysis (BEA) that gross output of new motor vehicles increased at a rapid pace in the third quarter, a sharp contrast to a drop in the IP index for motor vehicles (including parts production) for that same period. Much of that difference could be attributed to the BEA's method of inferring motor vehicle output from separate data on sales, net international trade, and changes in inventories rather than measuring output directly using data on production. In addition, a large drop in the producer price index for light trucks in the third quarter resulted in a jump in the BEA's implied unit values of light trucks in inventory. In the staff's view, these measurement issues likely caused an overstatement of the rate of increase in real GDP in the third quarter, and the gradual unwinding of those effects would probably lead to an understatement of real GDP growth over the next several quarters.

Real consumer spending increased strongly in October after a more modest gain in September. Although purchases of motor vehicles weakened in October, outlays on a broad range of other categories of goods, including gasoline, food, and apparel, rose briskly. Spurred by sharp declines in consumer energy prices, real disposable income also increased rapidly in September and October. Despite the further deceleration in house prices, the ratio of household wealth to disposable income remained well above its historical average, buoyed by robust gains in the stock market. Readings on consumer sentiment edged down in November and early December but stayed above levels seen in the summer.

Residential construction activity continued to be very weak. Single-family housing starts dropped substantially in October after a slight increase in September, while new permit issuance fell to nearly its lowest level in the past ten years. Construction in the much-smaller multifamily sector continued to fluctuate within a range that had prevailed for the past several years. Inventories of unsold homes remained high in October but were a bit lower than those in preceding months. Sales of new and existing homes showed tentative signs of stabilizing, although at levels well below their mid-2005 peaks. Price appreciation of existing homes continued to slow in the third quarter, and some price measures showed outright declines.

Real spending on equipment and software continued to increase at a solid pace in the third quarter, supported by strong corporate cash positions and a low cost of capital. Early indicators for the fourth quarter, including survey measures of business conditions, suggested a slowdown in spending, in part reflecting the deceleration in business output. Business purchases of motor vehicles were likely to continue to be boosted by an increase in spending in advance of the upcoming change in regulations on truck engines from the Environmental Protection Agency. Although spending on high-tech capital goods and software expanded at a robust pace in the third quarter, data on new orders and shipments in October pointed to more moderate growth in the fourth quarter. Growth of nonresidential construction spending appeared to have slowed from a rapid rate earlier in the year, responding in part to still-high vacancy rates in the office and industrial categories. The number of natural gas and petroleum drilling rigs in operation had moved down, on balance, since September in response to the moderation in energy prices.

Unit stocks of light motor vehicles dropped in the third quarter. Outside the motor vehicle sector, real nonfarm inventories edged up, and the ratio of book-value inventories to sales for both the manufacturing and trade sectors rose in September to levels last seen in mid-2005. Inventory imbalances appeared more widespread than a few months earlier, although business surveys through November indicated that a large majority of firms perceived that their customers' inventories remained at comfortable levels.

The U.S. international trade deficit declined in September from a record level in August. The narrowing primarily reflected a sharp falloff in the value of imported oil, although non-oil imports, including industrial supplies, capital goods, and automotive products, also declined. Export growth in September was led by aircraft and industrial supplies, while exports of automotive products, consumer goods, and semiconductors fell. The trade deficit shrank a bit further in October.

Economic activity in the advanced foreign economies rose at a moderate rate in the third quarter. The expansion in real activity in the euro area, although slower than the staff had expected, was supported by strong domestic demand. Canada's real GDP growth was dragged down by weakness in inventories and government spending, while slumping private consumption weighed on growth in Japan. The U.K. economy, buoyed by strong investment, continued to expand solidly. Recent economic indicators for the developing economies were somewhat mixed but suggested generally brisk growth in the third quarter.

The overall price index for personal consumption expenditures fell in September and October, reflecting sharp declines in energy prices in both months; the declines left the change in that index over the twelve months ending in October substantially lower than over the preceding twelve-month period. In contrast, the change in the core price index for personal consumption expenditures over the twelve months ending in October was still somewhat higher than it was a year earlier, largely reflecting an acceleration in shelter costs over that period. The producer price index for core intermediate materials was flat in October. Increases in average hourly earnings had been moderate in recent months, and compensation per hour in the nonfarm business sector appeared to have risen at a subdued rate in the third quarter. The estimated increase in hourly compensation for the second quarter had been revised down substantially; hourly compensation was now estimated to have declined in the second quarter following the sharp gain recorded in the first quarter. This uneven pattern suggested that the surge in hourly compensation in the first quarter had largely been driven by transitory factors. Hourly compensation of private industry workers, as measured by the employment cost index, increased at a somewhat faster rate in the three months ending in September than it had in preceding quarters.

At its October meeting, the Federal Open Market Committee (FOMC) decided to maintain its target for the federal funds rate at 5¼ percent. The Committee's accompanying statement indicated that economic growth had slowed over the course of the year, partly reflecting a cooling of the housing market. Going forward, the economy seemed likely to expand at a moderate pace. Readings on core inflation had been elevated, and the high level of resource utilization had the potential to sustain inflation pressures. However, inflation pressures seemed likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand. Nonetheless, the Committee judged that some inflation risks remained. The extent and timing of any additional firming that might be needed to address these risks would depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Investors had largely anticipated the FOMC's decision at its October meeting to leave the target federal funds rate unchanged and to make only modest changes in the accompanying policy statement. As a result, the announcement of the decision elicited little market reaction, as did the subsequent publication of the minutes of the meeting. However, somewhat weaker-than-anticipated economic data over the intermeeting period apparently led to some softening of investors' perception of the economic outlook. As a result, the likely pace and extent of policy easing expected by investors increased, and yields on nominal and inflation-indexed Treasury coupon securities fell. Inflation compensation measures were little changed. Spreads of investment-grade corporate bond yields over those of comparable-maturity Treasury securities remained about unchanged, while those on speculative-grade corporate bonds rose a bit. Broad equity indexes showed solid gains. The foreign exchange value of the dollar against other major currencies fell, on net, over the intermeeting period, with pronounced declines against the euro and sterling.

Debt of the domestic nonfinancial sectors in the third quarter expanded at around its second-quarter pace. Business debt rose slightly more slowly than in the second quarter, in part reflecting reduced borrowing in the bond and commercial paper markets. In the household sector, mortgage debt increased at its lowest pace since the late 1990s, reflecting the continued deceleration in house prices. M2 rose more strongly in October and November than it had in preceding months.

The staff forecast prepared for this meeting indicated that growth in economic activity had slowed to a pace below that of the economy's long-run potential in the second half of 2006, partly as a result of the ongoing adjustment of the housing sector. The rate of increase in real GDP was expected to pick up gradually as the drag from the contraction in residential construction diminished, returning towards the end of 2007 to a rate close to the staff's estimate of potential output growth. Core inflation was anticipated to edge down in 2007 and 2008 in response to a waning of the effects of higher energy and import prices, a step-down in rent increases, and the emergence of a small amount of slack in the economy.

In their discussion of the economic situation and outlook, meeting participants noted that their assessments of the medium-term prospects for economic growth and inflation were little changed from the previous meeting. Incoming indicators of near-term activity had been mixed, with some spending and production data pointing to a more subdued picture than that suggested by the still-solid labor market data. Many participants judged that economic activity in the second half of this year was probably a touch softer than had been expected at the time of the October meeting. But looking over the next year or so, participants continued to expect the economy to expand at a rate close to or a little below the economy's long-run sustainable pace. The ongoing adjustment of the housing market was likely to damp economic growth in the near term, but this effect was expected to dissipate, and spending in other categories looked set to expand at a reasonably good pace. Although readings on core inflation had improved modestly since the spring, price pressures were not yet viewed as convincingly on a downward trend. Most participants expected core inflation to moderate slowly over time, but stressed that the risks to the inflation outlook remained to the upside.

In their discussion of the major sectors of the economy, participants noted that developments in the housing market continued to weigh heavily on economic activity. Housing starts and permits for new construction had dropped sharply in October, and contacts in the building sector reported that construction firms were continuing to cancel options on land purchases. However, there were some indications that home sales might be starting to stabilize, aided by a marked slowing in the rate of increase of house prices and a decline in mortgage rates in recent months. Several participants also noted that a range of nonprice incentives and concessions were being offered by construction firms to bolster sales. But even if home purchases had begun to level off, residential investment was likely to fall further in coming quarters as homebuilders sought to reduce their backlogs of unsold homes.

Thus far, the adjustment of activity and prices in the housing market did not appear to have spilled over significantly to consumer spending, which had expanded at a steady pace in recent months, buoyed by continued gains in employment and by a decline in energy prices. Retailers in most Districts expected good sales over the holiday season, although some contacts at package delivery and trucking firms reported that activity was less busy than usual for this time of year. Participants noted the downward revision to the BEA's estimate of personal income in the second quarter of this year, but nonetheless continued to anticipate consumer expenditures to expand at a steady pace going forward. Growth in consumer spending was expected to be supported by favorable financial conditions and solid gains in income from employment, outweighing any damping effect of sluggish increases in housing wealth. Still, considerable uncertainty regarding the ultimate extent of the housing market correction meant that spillovers to consumption could become more evident, especially if house prices were to decline significantly.

Business investment appeared to have decelerated recently, and surveys and orders data pointed to a relatively slow rise in equipment and software spending over the next few quarters. Incoming data on construction activity and employment also suggested that, following very rapid growth earlier in the year, increases in nonresidential construction spending could be moderating considerably. However, the weaker cast of some of these data contrasted with the sense of optimism among business contacts. Moreover, several participants noted that contacts within the construction sector had reported that commercial real estate activity remained robust, encouraged by lower vacancy rates, some firming in rents, and accommodative financial conditions. Looking further ahead, meeting participants expected investment to expand at a solid pace, supported by strong corporate balance sheets and profits and by the ready availability of funding from financial markets and institutions, factors that were expected to be offset only partially by restraint from slower growth in final sales.

Recent data suggested that aggregate demand in the rest of the world was likely to continue to expand at a somewhat faster rate than in the United States. Participants noted that the strength of global demand and the recent decline in the foreign exchange value of the dollar should help to support increases in U.S. exports.

The slowing in the pace of economic expansion in recent quarters evidenced by the business spending data was also apparent in measures of industrial production. Much of the slowing in production had been concentrated in the motor vehicle sector—as producers had cut assemblies in order to reduce high inventory levels—and in construction-related sectors. But, more recently, inventories had increased in a number of other sectors, and manufacturing production had been trimmed in response. Further adjustments remained possible, suggesting an additional source of downside risk to economic growth in the near term. In contrast, indicators of activity in the services sector implied continued brisk growth.

Participants noted that recent indicators provided mixed signals about the strength of near-term activity. Solid gains in employment over recent quarters stood in contrast to the softer pace of economic expansion suggested by the spending and production data. That difference most likely reflected lags between movements in activity and employment, implying that growth in employment would probably slow over the next quarter or so. Participants suggested that other forces might be at work as well. The growth of structural labor productivity could be weaker than currently thought, helping to reconcile the steady growth in employment with more subdued advances in spending and output. Moreover, the recent pace of activity may have been stronger than that indicated by the spending and production data. With regard to this possibility, it was noted that gross domestic income had grown substantially more quickly than measured GDP over the past year.

Incoming data and reports from businesses suggested that the labor market remained tight. The unemployment rate had moved slightly lower on balance over recent months, and many business contacts reported difficulties in recruiting suitably qualified workers, especially for certain types of professional and skilled positions. The downward revision to the estimated increases in labor compensation and unit labor costs earlier in the year had eased some participants' concerns about the extent of the pressures on labor resources. Nonetheless, the possibility that the tightness of the labor market could lead to sustained upward pressure on nominal labor costs was viewed as an upside risk to the expected moderation in inflation.

All meeting participants remained concerned about the outlook for inflation. Although readings on core inflation had improved modestly since the spring, nearly all participants viewed core inflation as uncomfortably high and stressed the importance of further moderation. Participants expected core inflation to edge lower over time, in part as the pass-through of higher prices for energy and other commodities ran its course and as the moderate growth in aggregate demand likely led to a modest easing of pressures on resources. Some participants also highlighted the impact that movements in the prices of individual components of the price index, such as owners' equivalent rent and medical costs, could have on near-term readings on core inflation. More generally, participants stressed there was considerable uncertainty as to the probable pace and extent of the moderation in core inflation and that the risks around this desired downward path remained to the upside. Moreover, participants expressed concern that a failure of inflation to moderate as expected could entail significant costs if an upward drift in inflation expectations ensued.

In the Committee's discussion of monetary policy for the intermeeting period, nearly all members favored keeping the target federal funds rate at 5¼ percent at this meeting. The outlook for economic growth and inflation was thought to have changed relatively little since the previous meeting. Nearly all members felt that maintaining the current target for now was most likely to foster moderate economic growth and a gradual ebbing of core inflation from its elevated levels. Several members judged that the subdued tone of some incoming indicators meant that the downside risks to economic growth in the near term had increased a little and become a bit more broadly based than previously thought. Nonetheless, all members agreed that the risk that inflation would fail to moderate as desired remained the predominant concern.

In light of the data received over the intermeeting period, members felt that the statement should characterize the cooling in the housing market as substantial and should note that recent indicators had been mixed. The Committee thought that the statement should reiterate that the economy seemed likely to expand at a moderate pace, while also recognizing the possibility that measured GDP growth could be somewhat uneven in coming quarters. Members agreed that the statement should continue to convey that inflation risks remained of greatest concern and that additional policy firming was possible. One member did not favor language that referenced only the possibility of additional policy firming and believed that, although the risks to inflation remained the predominant concern, the statement should emphasize that policy could be adjusted in either direction depending on the evolution of the outlook for inflation and economic growth.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5¼ percent.

The vote encompassed approval of the text below for inclusion in the statement to be released at 2:15 p.m.:

> Nonetheless, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

> Votes for this action: Messrs. Bernanke and Geithner, Ms. Bies, Messrs. Kohn, Kroszner, and Mishkin, Ms. Pianalto, Messrs. Poole and Warsh, and Ms. Yellen. Votes against this action: Mr. Lacker

Mr. Lacker dissented because he believed that further tightening was needed to help ensure that core inflation declines to an acceptable rate in coming quarters.

Meeting participants briefly reviewed some issues regarding communications and the next steps in their continuing discussion of the topic. At the next FOMC meeting, confirmed for January 30–31, 2007, the Committee intended to consider the role that economic projections and forecasts can play in communicating information.

The meeting adjourned at 1:35 p.m.

Notation Vote

By notation vote completed on November 14, 2006, the Committee unanimously approved the minutes of the FOMC meeting held on October 24–25, 2006.

Vincent R. Reinhart
Secretary

Litigation

During 2006, the Board of Governors was a party in two lawsuits or appeals filed that year and was a party in five other cases pending from previous years, for a total of seven cases; in 2005, the Board had been a party in a total of thirteen cases. As of December 31, 2006, five cases were pending.

Price v. Bernanke, No. 06-1569 (D.D.C., filed September 8, 2006), is an employment discrimination action.

Texas State Bank v. United States, No. 05-1168 (U.S. Supreme Court, filed March 10, 2006), was an appeal of a decision of the Court of Appeals for the Federal Circuit dismissing an action challenging on constitutional grounds the failure to pay interest on reserve accounts held at Federal Reserve Banks. On June 19, 2006, the Supreme Court denied *certiorari.* 126 S. Ct. 2889.

Inner City Press/Community on the Move v. Board of Governors, No. 05-6162 (Second Circuit, filed November 21, 2005), is an appeal of the district court's order (No. 04-CV-8337, 380 F. Supp. 2d 211 (S.D.N.Y. 2005)) granting in part and denying in part the Board's motion for summary judgment in a Freedom of Information Act case. On September 11, 2006, the court of appeals affirmed in part and reversed in part the ruling of the district court, and remanded the case. 463 F.3d 239.

Price v. Bernanke, No. 05-5361 (D.C. Circuit, filed September 29, 2005), was an appeal of an order of the district court (No. 04-CV-0973, 374 F. Supp. 2d 177) dismissing an employment discrimination action. On December 15, 2006, the court of appeals affirmed the district court's dismissal. 470 F.3d 384.

Barnes v. Greenspan, No. 04-CV-1989 (CKK) (D.D.C., filed November 15, 2004), is a case under the Age Discrimination in Employment Act.

Jones v. Greenspan, No. 04-CV-1696 (RMU) (D.D.C., filed October 4, 2004), is an employment discrimination action. On December 13, 2005, the district court granted in part and denied in part the Board's motion to dismiss and for summary judgment. 402 F. Supp. 2d 294.

Artis v. Greenspan, No. 01-0400 (D.D.C., filed February 22, 2001), is an employment discrimination action. An identical action, No. 99-2073 (EGS) (D.D.C., filed August 3, 1999), was consolidated with this action on August 15, 2001. ■

Federal Reserve System Organization

Board of Governors

December 31, 2006

Members

	Term expires January 31,
BEN S. BERNANKE, *Chairman*[1]	2020
DONALD L. KOHN, *Vice Chairman*[1]	2016
SUSAN S. BIES	2012
KEVIN M. WARSH	2018
RANDALL S. KROSZNER	2008
FREDERIC S. MISHKIN	2014

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WILLIAM NELSON, *Assistant Director*

JONATHAN H. WRIGHT, *Assistant Director*

1. The designations as Chairman and Vice Chairman expire on January 31, 2010, and June 22, 2010, respectively, unless the service of these members of the Board terminates sooner.

Board of Governors—Continued

Division of Research and Statistics

David J. Stockton, *Director*
Patrick M. Parkinson, *Deputy Director*
David W. Wilcox, *Deputy Director*
Myron L. Kwast, *Senior Associate Director*
J. Nellie Liang, *Associate Director*
Lawrence Slifman, *Associate Director*
Charles S. Struckmeyer, *Associate Director*
Alice Patricia White, *Associate Director*
Glenn B. Canner, *Senior Adviser*
David S. Jones, *Senior Adviser*
Stephen D. Oliner, *Senior Adviser*
S. Wayne Passmore, *Deputy Associate Director*
David L. Reifschneider, *Deputy Associate Director*
Janice Shack-Marquez, *Deputy Associate Director*
William L. Wascher III, *Deputy Associate Director*
Joyce K. Zickler, *Deputy Associate Director*
Michael S. Cringoli, *Assistant Director and Chief*
Michael S. Gibson, *Assistant Director and Chief*
Diana Hancock, *Assistant Director and Chief*
Robin A. Prager, *Assistant Director and Chief*
Douglas W. Elmendorf, *Assistant Director*
Daniel E. Sichel, *Assistant Director*
Mary M. West, *Assistant Director*

Division of Banking Supervision and Regulation

Roger T. Cole, *Acting Director*
Steven M. Roberts, *Senior Adviser*
William F. Treacy, *Adviser*
Sarkis Yoghourtdjian, *Adviser*
Deborah P. Bailey, *Associate Director*
Norah M. Barger, *Associate Director*
Betsy Cross, *Associate Director*
Gerald A. Edwards, Jr., *Associate Director*
Charles H. Holm, *Associate Director*
Jack P. Jennings II, *Associate Director*
Robin L. Lumsdaine, *Associate Director*
Peter J. Purcell, *Associate Director and Chief Technology Officer*
William G. Spaniel, *Associate Director*
Molly S. Wassom, *Associate Director*
David M. Wright, *Associate Director*
Barbara J. Bouchard, *Deputy Associate Director*
James A. Embersit, *Deputy Associate Director*
Jon D. Greenlee, *Deputy Associate Director*
Arthur W. Lindo, *Deputy Associate Director*
William C. Schneider, Jr., *Deputy Associate Director*
Robert T. Ashman, *Assistant Director*
Kevin M. Bertsch, *Assistant Director*
Stacy Lee Coleman, *Assistant Director*
Robert T. Maas, *Assistant Director*
Nina A. Nichols, *Assistant Director*
Dana E. Payne, *Assistant Director*
Nancy J. Perkins, *Assistant Director*
Sabeth I. Siddique, *Assistant Director*

Division of Consumer and Community Affairs

Sandra F. Braunstein, *Director*
Glenn E. Loney, *Deputy Director*
Leonard Chanin, *Associate Director*
Adrienne D. Hurt, *Associate Counsel and Adviser*
Mary T. Johnsen, *Associate Director*
Tonda E. Price, *Associate Director*
Maryann F. Hunter, *Adviser*
Timothy R. Burniston, *Assistant Director*
Suzanne G. Killian, *Assistant Director*
Sheila F. Maith, *Assistant Director*
James A. Michaels, *Assistant Director*

Board of Governors—Continued

Division of Reserve Bank Operations and Payment Systems

Louise L. Roseman, *Director*
Jeffrey C. Marquardt, *Deputy Director*
Paul W. Bettge, *Senior Associate Director*
Kenneth D. Buckley, *Associate Director*
Dorothy LaChapelle, *Associate Director*
Jack K. Walton II, *Associate Director*
Jeff J. Stehm, *Deputy Associate Director*
Gregory L. Evans, *Assistant Director*
Lisa Hoskins, *Assistant Director*
Michael J. Lambert, *Assistant Director*

Office of Staff Director for Management

Stephen R. Malphrus, *Staff Director for Management*
Sheila Clark, *Equal Employment Opportunity Programs Director*
Lynn S. Fox, *Senior Adviser*

Management Division

H. Fay Peters, *Director*
Darrell R. Pauley, *Deputy Director*
Stephen J. Clark, *Senior Associate Director*
Todd A. Glissman, *Senior Associate Director*
Marsha W. Reidhill, *Senior Associate Director*
Billy J. Sauls, *Senior Associate Director*
Donald A. Spicer, *Senior Associate Director*
Christine M. Fields, *Associate Director*
James R. Riesz, *Deputy Associate Director*
Keith F. Bates, *Assistant Director*
Elaine M. Boutilier, *Assistant Director*
Tara C. Tinsley Jones, *Assistant Director*
Charles F. O'Malley, *Assistant Director*

Division of Information Technology

Marianne M. Emerson, *Director*
Maureen T. Hannan, *Deputy Director*
Tillena G. Clark, *Assistant Director*
Geary L. Cunningham, *Assistant Director*
Wayne A. Edmondson, *Assistant Director*
Po Kyung Kim, *Assistant Director*
Susan F. Marycz, *Assistant Director*
Sharon L. Mowry, *Assistant Director*
Raymond Romero, *Assistant Director*
Jill R. Rosen, *Assistant Director*

Office of Inspector General

Barry R. Snyder, *Inspector General*
Anthony J. Castaldo, *Assistant Inspector General*
Elizabeth A. Coleman, *Assistant Inspector General*
Laurence A. Froehlich, *Assistant Inspector General*
William L. Mitchell, *Assistant Inspector General*

Federal Open Market Committee

December 31, 2006

Members

BEN S. BERNANKE, *Chairman,* Board of Governors

TIMOTHY F. GEITHNER, *Vice Chairman,* President, Federal Reserve Bank of New York

SUSAN SCHMIDT BIES, Board of Governors

DONALD L. KOHN, Board of Governors

RANDALL S. KROSZNER, Board of Governors

JEFFREY M. LACKER, *President,* Federal Reserve Bank of Richmond

FREDERIC S. MISHKIN, Board of Governors

SANDRA PIANALTO, *President,* Federal Reserve Bank of Cleveland

KEVIN M. WARSH, Board of Governors

JANET L. YELLEN, *President,* Federal Reserve Bank of San Francisco

Alternate Members

CHRISTINE M. CUMMING, *First Vice President,* Federal Reserve Bank of New York

THOMAS M. HOENIG, *President,* Federal Reserve Bank of Kansas City

CATHY E. MINEHAN, *President,* Federal Reserve Bank of Boston

MICHAEL H. MOSKOW, *President,* Federal Reserve Bank of Chicago

WILLIAM POOLE, *President,* Federal Reserve Bank of St. Louis

Officers

VINCENT R. REINHART, *Secretary and Economist*

DEBORAH J. DANKER, *Deputy Secretary*

MICHELLE A. SMITH, *Assistant Secretary*

DAVID W. SKIDMORE, *Assistant Secretary*

SCOTT G. ALVAREZ, *General Counsel*

THOMAS C. BAXTER, JR., *Deputy General Counsel*

KAREN H. JOHNSON, *Economist*

DAVID J. STOCKTON, *Economist*

THOMAS A. CONNORS, *Associate Economist*

ROBERT A. EISENBEIS, *Associate Economist*

JOHN P. JUDD, *Associate Economist*

STEPHEN B. KAMIN, *Associate Economist*

BRIAN F. MADIGAN, *Associate Economist*

MARK S. SNIDERMAN, *Associate Economist*

CHARLES S. STRUCKMEYER, *Associate Economist*

JOSEPH S. TRACY, *Associate Economist*

JOHN A. WEINBERG, *Associate Economist*

DAVID W. WILCOX, *Associate Economist*

DINO KOS, *Manager, System Open Market Account*

During 2006 the Federal Open Market Committee held eight regularly scheduled meetings (see "Minutes of Federal Open Market Committee Meetings" in this volume).

Federal Advisory Council

December 31, 2006

Members

District 1—James C. Smith, *Chairman and Chief Executive Officer,* Webster Bank, N.A. and Webster Financial Corporation, Waterbury, Conn.

District 2—Thomas A. Renyi, *Chairman and Chief Executive Officer,* The Bank of New York, New York, N.Y.

District 3—Ted T. Cecala *Chairman and Chief Executive Officer,* Wilmington Trust Company, Wilmington, Del.

District 4—George A. Schaefer, Jr., *President and Chief Executive Officer,* Fifth Third Bancorp, Cincinnati, Ohio.

District 5—G. Kennedy Thompson, *Chairman, President, and Chief Executive Officer,* Wachovia Corporation, Charlotte, N.C.

District 6—Fred L. Green III, *Vice Chairman,* Synovus Financial Corporation, Columbus, Ga.

District 7—Dennis J. Kuester, *Chairman and Chief Executive Officer,* Marshall & Ilsley Corporation, Milwaukee, Wis.

District 8—J. Kenneth Glass, *Chairman, President, and Chief Executive Officer,* First Horizon National Corporation, Memphis, Tenn.

District 9—Lyle R. Knight, *President and Chief Executive Officer,* First Interstate BancSystem, Inc., Billings, Mont.

District 10—David C. Boyles, *Chairman,* Guaranty Bank and Trust Company, Denver, Colo.

District 11—James Goudge, *Chairman and Chief Executive Officer,* Broadway Bank, San Antonio, Tex.

District 12—Richard M. Kovacevich, *Chairman, President, and Chief Executive Officer,* Wells Fargo and Company, San Francisco, Calif.

Officers

Thomas A. Renyi, *President*

Dennis J. Kuester, *Vice President*

James E. Annable, *Secretary*

The Federal Advisory Council, which is a statutory body established under the Federal Reserve Act, consults with, and advises, the Board of Governors on all matters within the Board's jurisdiction. It is composed of one representative from each Federal Reserve District, chosen by the Reserve Bank in that District. The Federal Reserve Act requires the council to meet in Washington, D.C., at least four times a year. In 2006, it met on February 9–10, May 11–12, September 7–8, and November 30–December 1. The council met with the Board on February 10, May 12, September 8, and December 1, 2006.

Consumer Advisory Council

December 31, 2006

Members

STELLA ADAMS, *Executive Director*, North Carolina Fair Housing Center, Durham, N.C.

DENNIS L. ALGIERE, *Senior Vice President*, The Washington Trust Company, Westerly, R.I.

FAITH L. ANDERSON, *Vice President—Legal Compliance and General Counsel*, American Airlines Federal Credit Union, Fort Worth, Tex.

DOROTHY BRIDGES, *Chief Executive Officer and President*, Franklin National Bank of Minneapolis, Minneapolis, Minn.

TONY T. BROWN, *President and Chief Executive Officer*, Uptown Consortium, Inc., Cincinnati, Ohio

SHEILA CANAVAN, *Consumer Attorney*, Law Office of Sheila Canavan, Moab, Utah

CAROLYN CARTER, *Attorney*, National Consumer Law Center, Boston, Mass.

MICHAEL COOK, *Vice President*, Wal-Mart Stores, Inc., Bentonville, Ark.

DONALD S. CURRIE, *Executive Director*, Community Development Corporation of Brownsville, Brownsville, Tex.

ANNE DIEDRICK, *Senior Vice President*, JPMorgan Chase Bank, New York, N.Y.

HATTIE B. DORSEY, *President and Chief Executive Officer*, Atlanta Neighborhood Development Partnership, Atlanta, Ga.

KURT EGGERT, *Professor of Law and Director of Clinical Legal Education*, Chapman University School of Law, Orange, Calif.

DEBORAH HICKOK, *Vice President*, MoneyGram Payment Systems, Inc., Ooltewah, Tenn.

SARAH LUDWIG, *Director*, Neighborhood Economic Development Advocacy Project, New York, N.Y.

MARK K. METZ, *Senior Vice President and Deputy General Counsel*, Wachovia Corporation, Charlotte, N.C.

BRUCE B. MORGAN, *Chairman, President, and Chief Executive Officer*, Valley State Bank, Roeland Park, Kans.

LANCE MORGAN, *President*, Ho-Chunk, Incorporated, Winnebago Tribe of Nebraska, Winnebago, Neb.

JOSHUA PEIREZ, *Senior Vice President and Associate General Counsel*, MasterCard International, Purchase, N.Y.

ANNA MCDONALD RENTSCHLER, *BSA Officer*, Central Bancompany, Jefferson City, Mo.

FAITH ARNOLD SCHWARTZ, *Senior Vice President, Enterprise Risk Management and Public Affairs*, Option One Mortgage Corporation, Washington, D.C.

MARY JANE SEEBACH, *Managing Director, Public Affairs*, Countrywide Financial Corporation, Calabasas, Calif.

EDWARD SIVAK, *Director of Policy and Evaluation*, Enterprise Corporation of the Delta, Jackson, Miss.

PAUL J. SPRINGMAN, *Chief Marketing Officer*, Equifax, Atlanta, Ga.

FORREST F. STANLEY, *Senior Vice President and Deputy General Counsel*, KeyBank National Association, Cleveland, Ohio

ANSELMO VILLARREAL, *Executive Director*, LaCasa de Esperanza, Inc., Waukesha, Wis.

ALAN WHITE, *Supervising Attorney*, Community Legal Services, Philadelphia, Pa.

MARVA E. WILLIAMS, *Senior Vice President*, Woodstock Institute, Chicago, Ill.

Officers

LORI SWANSON, *Chair*, Solicitor General, Office of the Minnesota Attorney General, St. Paul, Minn.

LISA SODEIKA, *Vice Chair*, Executive Vice President—Corporate Affairs, HSBC North America Holdings, Inc., Prospect Heights, Ill.

The Consumer Advisory Council—a statutory body established pursuant to the 1976 amendments to the Equal Credit Opportunity Act—advises the Board of Governors on consumer financial services. Its members, who are appointed by the Board, are academics, state and local government officials, and representatives of the financial services industry and of consumer and community interests. In 2006, the council met with members of the Board on March 30, June 22, and October 26.

Thrift Institutions Advisory Council

December 31, 2006

Members

FRANK E. BERRISH, *President and Chief Executive Officer*, Visions Federal Credit Union, Endicott, N.Y.

CRAIG G. BLUNDEN, *Chairman, President, and Chief Executive Officer*, Provident Savings Bank, FSB, Riverside, Calif.

ALEXANDER R.M. BOYLE, *Vice Chairman*, Chevy Chase Bank, Bethesda, Md.

JEFFREY H. FARVER, *President and Chief Executive Officer*, San Antonio Federal Credit Union, San Antonio, Tex.

A. THOMAS HOOD, *President and Chief Executive Officer*, First Federal Savings and Loan Association, Charleston, S.C.

KENNETH KORANDA, *President*, Mid America Bank, Downers Grove, Ill.

ARKADI KUHLMANN, *Chairman, President, and Chief Executive Officer*, ING DIRECT USA, Wilmington, Del.

DAVID E. POULSEN, *President and Chief Executive Officer*, American Express Centurion Bank, Salt Lake City, Utah

GEORGE JEFFREY RECORDS, JR., *Chairman and Chief Executive Officer*, MidFirst Bank, Oklahoma City, Okla.

STEVEN SWIONTEK, *Chairman, President, and Chief Executive Officer*, Gate City Bank, Fargo, N.D.

DAVID RUSSELL TAYLOR, *President and Chief Executive Officer*, Rahway Savings Institution, Rahway, N.J.

ROY M. WHITEHEAD, *President and Chief Executive Officer*, Washington Federal Savings, Seattle, Wash.

Officers

ROY M. WHITEHEAD, *President*

DAVID RUSSELL TAYLOR, *Vice President*

The Thrift Institutions Advisory Council was established by the Board of Governors to consult with, and advise, the Board on issues pertaining to the thrift industry and on other matters within the Board's jurisdiction. Its members, who are appointed by the Board, represent credit unions, savings and loan associations, and savings banks. In 2006, the council met with the Board on March 3, July 7, and December 8.

Federal Reserve Banks and Branches

December 31, 2006

Officers

BANK or Branch	Chairman[1] Deputy Chairman	President First Vice President	Officer in charge of Branch
BOSTON[2]	Blenda J. Wilson Lisa M. Lynch	Cathy E. Minehan Paul M. Connolly	
NEW YORK[2]	John E. Sexton Jerry I. Speyer	Timothy F. Geithner Christine M. Cumming	
Buffalo	Alphonso O'Neil-White		Kausar Hamdani
PHILADELPHIA	Doris M. Damm William F. Hecht	Charles I. Plosser William H. Stone, Jr.	
CLEVELAND[2]	Charles E. Bunch Tanny B. Crane	Sandra Pianalto R. Chris Moore	
Cincinnati	James M. Anderson		Barbara B. Henshaw
Pittsburgh	Roy W. Haley		Robert B. Schaub
RICHMOND	Thomas J. Mackell, Jr. Theresa M. Stone	Jeffrey M. Lacker Sarah G. Green	
Baltimore	William C. Handorf		David Beck
Charlotte	Jim Lowry		Jeffrey S. Kane
ATLANTA	David M. Ratcliffe V. Larkin Martin	Vacant Patrick K. Barron[3]	
Birmingham	W. Miller Welborn		Lee C. Jones
Jacksonville	Linda H. Sherrer		Christopher L. Oakley
Miami	Brian E. Keeley		Juan del Busto
Nashville	David Williams II		Melvyn K. Purcell
New Orleans	Ben Tom Roberts		Robert J. Musso
CHICAGO[2]	Miles D. White John A. Canning, Jr.	Michael H. Moskow Gordon Werkema	
Detroit	Roger A. Cregg		Glenn Hansen
ST. LOUIS	Walter L. Metcalfe, Jr. Irl F. Engelhardt	William Poole David A. Sapenaro	
Little Rock	Sonja Yates Hubbard		Robert A. Hopkins
Louisville	John L. Huber		Maria Gerwing Hampton
Memphis	Russell Gwatney		Martha Perine Beard
MINNEAPOLIS	Frank L. Sims James J. Hynes	Gary H. Stern James M. Lyon	
Helena	Dean Folkvord		Samuel H. Gane

Officers—Continued

BANK or Branch	Chairman[1] Deputy Chairman	President First Vice President	Officer in charge of Branch
KANSAS CITY	Robert A. Funk	Thomas M. Hoenig	
	Lu M. Cordova	Richard K. Rasdall, Jr.	
Denver	Thomas Williams		Michael Orlando
Oklahoma City	Richard K. Ratcliffe		Chad Wilkerson
Omaha	James A. Timmerman		Jason Henderson
DALLAS	Ray L. Hunt	Richard W. Fisher	
	Anthony R. Chase	Helen E. Holcomb	
El Paso	Ron C. Helm		Robert W. Gilmer
Houston	Lupe Fraga		Robert Smith III
San Antonio	Elizabeth Chu Richter		D. Karen Diaz
SAN FRANCISCO[2]	David K.Y. Tang	Janet L. Yellen	
	T. Gary Rogers	John F. Moore	
Los Angeles	James L. Sanford		Mark L. Mullinix
Portland	James H. Rudd		Mary E. Lee
Salt Lake City	William C. Glynn		Andrea P. Wolcott
Seattle	Mic R. Dinsmore		Mark A. Gould

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; Des Moines, Iowa; Midway at Bedford Park, Illinois; and Phoenix, Arizona.
3. Served as acting president as of October 1, 2006, following the retirement of Jack Guynn.

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, also attended by the deputy chairmen, were held in Washington, D.C., on May 31 and June 1, and on November 29 and 30, 2006.

The members of the executive committee of the Conference of Chairmen during 2006 were John E. Sexton, chair; Charles E. Bunch, vice chair; and Robert A. Funk, member.

On November 30, the conference elected its executive committee for 2007, naming Robert A. Funk as chair; V. Larkin Martin as vice chair; and Miles D. White 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.

Cathy E. Minehan, president of the Federal Reserve Bank of Boston, served as chair of the conference in 2006, and Sandra Pianalto, president of the Federal Reserve Bank of Cleveland, served as vice chair. Jacqueline P. Palladino, of the Federal Reserve Bank of Boston, served as secretary, and Gregory L. Stefani, of the Federal Reserve Bank of Cleveland, served as assistant secretary.

On November 1, 2006, the conference elected Sandra Pianalto as chair for 2007–08 and Jeffrey M. Lacker, president of the Federal Reserve Bank of Richmond, as vice chair.

Conference of First Vice Presidents

The Conference of First Vice Presidents of the Federal Reserve Banks was organized in 1969 to meet periodically for the consideration of operations and other matters.

Helen E. Holcomb, first vice president of the Federal Reserve Bank of Dallas, served as chair of the conference in 2006, and James M. Lyon, first vice president of the Federal Reserve Bank of Minneapolis, served as vice chair. Harvey R. Mitchell, of the Federal Reserve Bank of Dallas, served as secretary, and Sheryl Britsch, of the Federal Reserve Bank of Minneapolis, served as assistant secretary.

Directors

Each Federal Reserve Bank has a nine-member board: three Class A and three Class B directors, who are elected by the stockholding member banks, and three Class C directors, who are appointed by the Board of Governors.

Class A directors represent the stockholding member banks in each Federal Reserve District. Class B and Class C directors represent the public and are chosen with due, but not exclusive, consideration to the interests of agriculture, commerce, industry, services, labor, and consumers; they may not be officers, directors, or employees of any bank or bank holding company. In addition, Class C directors may not be stockholders of any bank or bank holding company.

For the election of Class A and Class B directors, the member banks of each Federal Reserve District are classified into three groups. Each group, which comprises banks with similar capitalization, elects one Class A director and one Class B director. Annually, the Board of Governors designates one of the Class C directors as chair of the board and Federal Reserve agent of each District Bank, and it designates another Class C director as deputy chair.

Federal Reserve Branches have either five or seven directors, a majority of whom are appointed by the parent Federal Reserve Bank; the others are appointed by the Board of Governors. One of the directors appointed by the Board is designated annually as chair of the board of that Branch in a manner prescribed by the parent Federal Reserve Bank.

The chairs and deputy chairs of the Reserve Bank boards of directors, and the chairs of the Branches, are listed in the preceding table, titled “Officers.” The directors of the Banks and Branches are listed in the following table. For each director, the class of directorship, the director’s principal organizational affiliation, and the date the director’s term expires are shown.

Directors

BANK OR BRANCH, *Category* Name	Title	Term expires Dec. 31
	DISTRICT 1—BOSTON	
RESERVE BANK		
Class A		
Peter A. Blyberg	President and Chief Executive Officer, Union Trust Company, Ellsworth, Maine	2006
Ronald E. Logue	Chairman and Chief Executive Officer, State Street Corporation, Boston, Massachusetts	2007
Kathleen C. Marcum	President and Chief Executive Officer, Millbury National Bank, Millbury, Massachusetts	2008
Class B		
Kirk P. Pond	Former President, Chief Executive Officer, and Chairman, Fairchild Semiconductor International, South Portland, Maine	2006
Robert K. Kraft	Chairman and Chief Executive Officer, The Kraft Group, Foxborough, Massachusetts	2007
Michael T. Wedge	Former President and Chief Executive Officer, BJ’s Wholesale Club, Inc., Natick, Massachusetts	2008
Class C		
Lisa M. Lynch	William L. Clayton Professor of International Economic Affairs, The Fletcher School of Law and Diplomacy, Tufts University, Medford, Massachusetts	2006
Samuel O. Thier, M.D.	Professor of Medicine and Professor of Health Care Policy−Harvard Medical School, Massachusetts General Hospital, Boston, Massachusetts	2007
Blenda J. Wilson	Former President and Chief Executive Officer, Nellie Mae Education Foundation, Quincy, Massachusetts	2008
	DISTRICT 2—NEW YORK	
RESERVE BANK		
Class A		
Sanford I. Weill	Chairman Emeritus, Citigroup Inc., New York, New York	2006
Jill M. Considine	Chairman, The Depository Trust Company, New York, New York	2007
Charles V. Wait	President, Chief Executive Officer, and Chairman, The Adirondack Trust Company, Saratoga Springs, New York	2008
Class B		
Indra K. Nooyi	President and Chief Executive Officer, PepsiCo, Inc., Purchase, New York	2006
Richard S. Fuld, Jr.	Chairman and Chief Executive Officer, Lehman Brothers, New York, New York	2007
Jeffrey R. Immelt	Chairman and Chief Executive Officer, General Electric Company, Fairfield, Connecticut	2008

Directors—Continued

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Class C		
Jerry I. Speyer	President and Chief Executive Officer, Tishman Speyer, New York, New York	2006
John E. Sexton	President, New York University, New York, New York	2007
Denis M. Hughes	President, New York State AFL-CIO, New York, New York	2008
Buffalo Branch		
Appointed by the Federal Reserve Bank		
Maureen Torrey Marshall	Vice President, Torrey Farms, Inc., Elba, New York	2006
Peter G. Humphrey	President and Chief Executive Officer, Financial Institutions, Inc. and Five Star Bank, Warsaw, New York	2006
Vacancy		2007
Joseph J. Ashton	Regional Director−Region 9, United Auto Workers, Amherst, New York	2008
Appointed by the Board of Governors		
Alphonso O'Neil-White	President and Chief Executive Officer, HealthNow New York Inc., Buffalo, New York	2006
James P. Laurito	President and Chief Executive Officer, Rochester Gas and Electric Corporation and New York State Electric and Gas Corporation, Rochester, New York	2007
Vacancy		2008
	DISTRICT 3—PHILADELPHIA	
Reserve Bank		
Class A		
Eugene W. Rogers	Director and Chief Executive Officer, Newfield National Bank, Newfield, New Jersey	2006
Wayne R. Weidner	Chairman, National Penn Bancshares, Inc., Boyertown, Pennsylvania	2007
John G. Gerlach	President and Chief Executive Officer, Pocono Community Bank, Stroudsburg, Pennsylvania	2008
Class B		
Garry L. Maddox	President and Chief Executive Officer, A. Pomerantz & Company, Philadelphia, Pennsylvania	2006
P. Coleman Townsend, Jr.	Chairman and Chief Executive Officer, Townsends, Inc., Wilmington, Delaware	2007
Vacancy		2008
Class C		
William F. Hecht	Retired Chairman, President, and Chief Executive Officer, PPL Corporation, Allentown, Pennsylvania	2006
Doris M. Damm	President and Chief Executive Officer, ACCU Staffing Services, Cherry Hill, New Jersey	2007
Charles P. Pizzi	President and Chief Executive Officer, Tasty Baking Company, Philadelphia, Pennsylvania	2008

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
	DISTRICT 4—CLEVELAND	
Reserve Bank		
Class A		
Stephen P. Wilson	Chairman, President and Chief Executive Officer, Lebanon Citizens National Bank, Lebanon, Ohio	2006
Henry L. Meyer, III	Chairman and Chief Executive Officer, KeyCorp, Cleveland, Ohio	2007
Bick Weissenrieder	Chairman and Chief Executive Officer, Hocking Valley Bank, Athens, Ohio	2008
Class B		
V. Ann Hailey	Executive Vice President, Corporate Development, Limited Brands, Columbus, Ohio	2006
Les C. Vinney	President and Chief Executive Officer, STERIS Corporation, Mentor, Ohio	2007
Edwin J. Rigaud	President and Chief Executive Officer, Enova Partners, LLC, Cincinnati, Ohio	2008
Class C		
Tanny B. Crane	President and Chief Executive Officer, Crane Group Company, Columbus, Ohio	2006
Charles E. Bunch	Chairman and Chief Executive Officer, PPG Industries, Inc., Pittsburgh, Pennsylvania	2007
Alfred M. Rankin, Jr.	Chairman, President and Chief Executive Officer, NACCO Industries, Inc., Cleveland, Ohio	2008
Cincinnati Branch		
Appointed by the Federal Reserve Bank		
Charlotte W. Martin	President and Chief Executive Officer, Great Lakes Bankers Bank, Gahanna, Ohio	2006
James H. Booth	President, Czar Coal Corporation, Lovely, Kentucky	2007
Janet B. Reid	Managing Partner, Global Lead Management Consulting, Cincinnati, Ohio	2008
Glenn D. Leveridge	President, Lexington Market, JPMorgan Chase Bank, NA, Lexington, Kentucky	2008
Appointed by the Board of Governors		
Charles Whitehead	Retired President, Ashland Inc. Foundation, Covington, Kentucky	2006
Herbert R. Brown	Senior Vice President, Western and Southern Financial Group, Cincinnati, Ohio	2007
James M. Anderson	President and Chief Executive Officer, Cincinnati Children's Hospital Medical Center, Cincinnati, Ohio	2008
Pittsburgh Branch		
Appointed by the Federal Reserve Bank		
Kristine N. Molnar	Executive Vice President, WesBanco Bank, Inc., Wheeling, West Virginia	2006

Directors—Continued

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Michael J. Hagan	President and Chief Executive Officer, Iron and Glass Bank, Pittsburgh, Pennsylvania	2007
Sunil T. Wadhwani	Chief Executive Officer and Co-founder, iGATE Corporation, Pittsburgh, Pennsylvania	2008
Georgiana N. Riley	President and Chief Executive Officer, TIGG Corporation, Bridgeville, Pennsylvania	2008
Appointed by the Board of Governors		
James I. Mitnick	Senior Vice President, Turner Construction Company, Pittsburgh, Pennsylvania	2006
Robert O. Agbede	President and Chief Executive Officer, ATS-Chester Engineers, Inc., Pittsburgh, Pennsylvania	2007
Roy W. Haley	Chairman and Chief Executive Officer, WESCO International, Inc., Pittsburgh, Pennsylvania	2008
	DISTRICT 5—RICHMOND	
Reserve Bank		
Class A		
Ernest J. Sewell	Senior Advisor, FNB Southeast, Greensboro, North Carolina	2006
Kathleen Walsh Carr	President, Cardinal Bank Washington, Washington, D.C.	2007
Hunter R. Hollar	President and Chief Executive Officer, Sandy Spring Bancorp, Sandy Spring Bank, Olney, Maryland	2008
Class B		
Kenneth R. Sparks	President and Chief Executive Officer, Ken Sparks Associates LLC, White Stone, Virginia	2006
Harry M. Lightsey, III	State President−South Carolina, BellSouth, Columbia, South Carolina	2007
Dana S. Boole	President and Chief Executive Officer, Community Affordable Housing Equity Corporation, Raleigh, North Carolina	2008
Class C		
Lemuel E. Lewis	Director, Landmark Communications, Inc., Norfolk, Virginia	2006
Theresa M. Stone	President (Retired), Lincoln Financial Media, Greensboro, North Carolina	2007
Thomas J. Mackell, Jr.	Warrenton, Virginia	2008
Baltimore Branch		
Appointed by the Federal Reserve Bank		
Kenneth C. Lundeen	President, Environmental Reclamation Company, Baltimore, Maryland	2006
Michael L. Middleton	Chairman and President, Community Bank of Tri-County, Waldorf, Maryland	2006
Donald P. Hutchinson	President and Chief Executive Officer, SunTrust Bank, Maryland, Baltimore, Maryland	2007

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Biana J. Arentz	President and Chief Executive Officer, Hemingway's Inc., Stevensville, Maryland	2008
Appointed by the Board of Governors		
William C. Handorf	Professor of Finance, George Washington University, Washington, D.C.	2006
William R. Roberts	President, Verizon Maryland Inc., Baltimore, Maryland	2007
Cynthia Collins Allner	Principal, Miles & Stockbridge P.C., Baltimore, Maryland	2008
CHARLOTTE BRANCH		
Appointed by the Federal Reserve Bank		
Michael C. Miller	Chairman and President, FNB Corp. and First National Bank and Trust Company, Asheboro, North Carolina	2006
Donald K. Truslow	Chief Risk Officer, Wachovia Corporation, Charlotte, North Carolina	2006
Barry L. Slider	President and Chief Executive Officer, First South Bancorp, Inc., First South Bank, Spartanburg, South Carolina	2007
James H. Speed, Jr.	President and Chief Executive Officer, North Carolina Mutual Life Insurance Company, Durham, North Carolina	2008
Appointed by the Board of Governors		
Jim Lowry	Automotive Consultant, High Point, North Carolina	2006
Anthony J. DiGiorgio	President, Winthrop University, Rock Hill, South Carolina	2007
Linda L. Dolny	President, PML Associates, Inc., Greenwood, South Carolina	2008
	DISTRICT 6—ATLANTA	
RESERVE BANK		
Class A		
William G. Smith, Jr.	Chairman, President, and Chief Executive Officer, Capital City Bank Group, Inc., Tallahassee, Florida	2006
James F. Beall	Chairman, President, and Chief Executive Officer, Farmers & Merchants Bank, Centre, Alabama	2007
L. Phillip Humann	Chairman and Chief Executive Officer, SunTrust Banks, Inc., Atlanta, Georgia	2008
Class B		
Teri G. Fontenot	President and Chief Executive Officer, Woman's Hospital, Baton Rouge, Louisiana	2006
Lee M. Thomas	Past President and Chief Operating Officer, Georgia-Pacific Corporation, Atlanta, Georgia	2007
Egbert L.J. Perry	Chairman and Chief Executive Officer, The Integral Group, LLC, Atlanta, Georgia	2008

Directors—Continued

BANK OR BRANCH, *Category* Name	Title	Term expires Dec. 31
Class C		
D. Scott Davis	Chief Financial Officer and Vice Chairman, United Parcel Service, Atlanta, Georgia	2006
David M. Ratcliffe	Chairman, President, and Chief Executive Officer, Southern Company, Atlanta, Georgia	2007
V. Larkin Martin	Managing Partner, Martin Farm, Courtland, Alabama	2008
BIRMINGHAM BRANCH		
Appointed by the Federal Reserve Bank		
Samuel F. Dodson	Business Manager, International Union of Operating Engineers–Local 312, Birmingham, Alabama	2006
Bobby A. Bradley	Managing Partner, Lewis Properties, LLC and Anderson Investments, LLC, Huntsville, Alabama	2006
John B. Barnett III	Monroeville President, BankTrust, Monroeville, Alabama	2007
John H. Holcomb III	Chairman and Chief Executive Officer, Alabama National Bancorporation, Birmingham, Alabama	2008
Appointed by the Board of Governors		
W. Miller Welborn	President, Welborn and Associates, Inc., Lookout Mountain, Tennessee	2006
Maryam B. Head	President, Ram Tool and Supply Company, Inc., Birmingham, Alabama	2007
James H. Sanford	Chairman of the Board, HOME Place Farms, Inc., Prattville, Alabama	2008
JACKSONVILLE BRANCH		
Appointed by the Federal Reserve Bank		
Robert L. Fisher	President and Chief Executive Officer, MacDill Federal Credit Union, Tampa, Florida	2006
Ellen S. Titen	President, E.T. Consultants, Winter Park, Florida	2006
Jack B. Healan, Jr.	President, Amelia Island Plantation Company, Amelia Island, Florida	2007
Alan Rowe	President and Chief Executive Officer, First Commercial Bank of Florida, Orlando, Florida	2008
Appointed by the Board of Governors		
Linda H. Sherrer	President and Chief Executive Officer, Prudential Network Realty, Jacksonville, Florida	2006
H. Britt Landrum, Jr.	President and Chief Executive Officer, Landrum Human Resource Companies, Inc., Pensacola, Florida	2007
Fassil Gabremariam	President and Founder, US–Africa Free Enterprise Education Foundation, Tampa, Florida	2008

BANK OR BRANCH, *Category* Name	Title	Term expires Dec. 31
MIAMI BRANCH		
Appointed by the Federal Reserve Bank		
Miriam Lopez	Chairman and Chief Executive Officer, TransAtlantic Bank, Miami, Florida	2006
Dennis S. Hudson III	Chairman and Chief Executive Officer, Seacoast Banking Corporation of Florida, Stuart, Florida	2007
Francis V. Gudorf	President/Executive Director, Jubilee Community Development Corporation, Miami, Florida	2008
Thomas H. Shea	Regional Chief Executive Officer–Florida/Caribbean, Right Management, Fort Lauderdale, Florida	2008
Appointed by the Board of Governors		
Brian E. Keeley	President and Chief Executive Officer, Baptist Health South Florida, Coral Gables, Florida	2006
Gay Rebel Thompson	President and Chief Executive Officer, Cement Industries, Inc., Fort Myers, Florida	2007
Edwin A. Jones, Jr.	President, Angus Investments, Inc., Port St. Lucie, Florida	2008
NASHVILLE BRANCH		
Appointed by the Federal Reserve Bank		
James W. Spradley, Jr.	President and Chief Executive Officer, Standard Candy Company, Inc., Nashville, Tennessee	2006
Daniel A. Gaudette	Senior Vice President, North American Manufacturing and Supply Chain Management, Nissan North America, Inc., Smyrna, Tennessee	2006
M. Terry Turner	President and Chief Executive Officer, Pinnacle Financial Partners, Nashville, Tennessee	2007
Michael B. Swain	Chairman, First National Bank, Oneida, Tennessee	2008
Appointed by the Board of Governors		
David Williams II	Vice Chancellor and General Counsel, Vanderbilt University, Nashville, Tennessee	2006
Debra K. London	President and Chief Executive Officer, St. Mary's Health System, Knoxville, Tennessee	2007
Richard Q. Ford	President and Chief Executive Officer, The Sage Group, Brentwood, Tennessee	2008
NEW ORLEANS BRANCH		
Appointed by the Federal Reserve Bank		
Lawrence E. Kurzius	President, U.S. Consumer Foods, McCormick & Company, Incorporated, Baltimore, Maryland	2006
Christel C. Slaughter	Partner, SSA Consultants, LLC, Baton Rouge, Louisiana	2006
David E. Johnson	Chairman and Chief Executive Officer, The First Bancshares, Inc., and The First, A National Banking Association, Hattiesburg, Mississippi	2007
J. Herbert Boydstun	President and Chief Executive Officer, Capital One, N.A., New Orleans, Louisiana	2008

Directors—Continued

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Appointed by the Board of Governors		
Ben Tom Roberts	President, Roberts Brothers Commercial and Property Management, Inc., Realtors, Mobile, Alabama	2006
Dave Dennis	President and Chief Executive Officer, Specialty Contractors & Associates, Inc., Gulfport, Mississippi	2007
Earl L. Shipp	President—Dow India, Middle East and Africa, Global Vice President for Oxides and Glycols, The Dow Chemical Company, Dubai, United Arab Emirates	2008
	DISTRICT 7—CHICAGO	
Reserve Bank		
Class A		
Michael L. Kubacki	Chairman, President, and Chief Executive Officer, Lakeland Financial Corporation, Warsaw, Indiana	2006
Jeff Plagge	Chairman, Chief Executive Officer, and President, Midwest Heritage Bank, Clive, Iowa	2007
William A. Osborn	Chairman and Chief Executive Officer, Northern Trust Corporation and The Northern Trust Company, Chicago, Illinois	2008
Class B		
Mark T. Gaffney	President, Michigan AFL-CIO, Lansing, Michigan	2006
Vacancy		2007
Valerie B. Jarrett	Managing Director and Executive Vice President, The Habitat Company, Chicago, Illinois	2008
Class C		
W. James Farrell	Retired Chairman and Chief Executive Officer, Illinois Tool Works, Inc., Glenview, Illinois	2006
Miles D. White	Chairman and Chief Executive Officer, Abbott, Abbott Park, Illinois	2007
John A. Canning, Jr.	Chairman and Chief Executive Officer, Madison Dearborn Partners, LLC, Chicago, Illinois	2008
Detroit Branch		
Appointed by the Federal Reserve Bank		
Ralph W. Babb, Jr.	Chairman, President, and Chief Executive Officer, Comerica Incorporated, Detroit, Michigan	2006
Michael M. Magee, Jr.	President and Chief Executive Officer, Independent Bank Corporation, Ionia, Michigan	2007
Tommi A. White	Chief Executive Officer, ER-One, Inc., Livonia, Michigan	2008
Linda S. Likely	Director of Housing & Community Development, Kent County Community Development Department & Housing Commission, Grand Rapids, Michigan	2008

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Appointed by the Board of Governors		
Roger A. Cregg	Executive Vice President and Chief Financial Officer, Pulte Homes, Inc., Bloomfield Hills, Michigan	2006
Irvin D. Reid	President, Wayne State University, Detroit, Michigan	2007
Timothy M. Manganello	Chairman and Chief Executive Officer, BorgWarner Incorporated, Auburn Hills, Michigan	2008
	DISTRICT 8—ST. LOUIS	
Reserve Bank		
Class A		
David R. Pirsein	President and Chief Executive Officer, First National Bank in Pinckneyville, Pinckneyville, Illinois	2006
Lewis F. Mallory, Jr.	Chairman and Chief Executive Officer, Cadence Financial Corporation, Starkville, Mississippi	2007
J. Thomas May	Chairman and Chief Executive Officer, Simmons First National Corporation, Pine Bluff, Arkansas	2008
Class B		
A. Rogers Yarnell, II	President, Yarnell Ice Cream Company, Inc., Searcy, Arkansas	2006
Paul T. Combs	President, Baker Implement Company, Kennett, Missouri	2007
Jay Fitzsimmons	Sr. Vice President of Finance and Treasurer, Wal-Mart Stores, Inc., Bentonville, Arkansas	2008
Class C		
Walter L. Metcalfe, Jr.	Partner, Bryan Cave LLP, St. Louis, Missouri	2006
Irl F. Engelhardt	Chairman, Peabody Energy, St. Louis, Missouri	2007
Cynthia J. Brinkley	President, AT&T Missouri, St. Louis, Missouri	2008
Little Rock Branch		
Appointed by the Federal Reserve Bank		
Raymond E. Skelton	Retired Regional President, U.S. Bank, North Little Rock, Arkansas	2006
Sharon Priest	Executive Director, The Downtown Partnership, Little Rock, Arkansas	2007
Robert A. Young III	Chairman, Arkansas Best Corporation, Fort Smith, Arkansas	2008
Phillip N. Baldwin	President and Chief Executive Officer, Southern Bancorp, Arkadelphia, Arkansas	2008
Appointed by the Board of Governors		
C. Sam Walls	Chief Executive Officer, Arkansas Capital Corporation, Little Rock, Arkansas	2006

Directors—Continued

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Sonja Yates Hubbard	Chief Executive Officer, E-Z Mart Stores, Inc., Texarkana, Texas	2007
Cal McCastlain	Partner, Pender & McCastlain, P.A., Little Rock, Arkansas	2008
Louisville Branch		
Appointed by the Federal Reserve Bank		
Gordon B. Guess	Chairman, President, and Chief Executive Officer, The Peoples Bank, Marion, Kentucky	2006
Steven E. Trager	Chairman and Chief Executive Officer, Republic Bank & Trust Company, Louisville, Kentucky	2007
L. Clark Taylor, Jr.	Chief Executive Officer, Ephraim McDowell Health, Danville, Kentucky	2008
John C. Schroeder	President, Wabash Plastics, Inc., Evansville, Indiana	2008
Appointed by the Board of Governors		
Norman E. Pfau, Jr.	President and Chief Executive Officer, Geo. Pfau's Sons Company, Inc., Jeffersonville, Indiana	2006
Gary A. Ransdell	President, Western Kentucky University, Bowling Green, Kentucky	2007
John L. Huber	President and Chief Executive Officer, Louisville Water Company, Louisville, Kentucky	2008
Memphis Branch		
Appointed by the Federal Reserve Bank		
David P. Rumbarger, Jr.	President and Chief Executive Officer, Community Development Foundation, Tupelo, Mississippi	2006
Thomas G. Miller	President, Southern Hardware Company, Inc., West Helena, Arkansas	2007
Levon Mathews	President, Regions Bank, Memphis, Tennessee	2008
Hunter Simmons	President and Chief Executive Officer, First South Bank, Jackson, Tennessee	2008
Appointed by the Board of Governors		
Russell Gwatney	President, Gwatney Companies, Memphis, Tennessee	2006
Charles S. Blatteis	Member (Partner), The Bogatin Law Firm, PLC, Memphis, Tennessee	2007
Meredith B. Allen	Vice President, Marketing, Staple Cotton Cooperative Association, Greenwood, Mississippi	2008
	DISTRICT 9—MINNEAPOLIS	
Reserve Bank		
Class A		
Douglas C. Morrison	Chief Financial Officer, Citibank (South Dakota) N.A., Sioux Falls, South Dakota	2006
John H. Hoeven, Jr.	Chairman, First Western Bank & Trust, Minot, North Dakota	2007
Peter J. Haddeland	President and Chief Executive Officer, First National Bank, Mahnomen, Minnesota	2008

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Class B		
D. Greg Heineman	Chairman, Williams Insurance Agency, Sioux Falls, South Dakota	2006
Todd L. Johnson	President and Chief Executive Officer, Reuben Johnson & Son, Inc. & Affiliated Companies, Superior, Wisconsin	2007
Randy Peterson	Facility Director, Lake Superior State University, Sault Ste. Marie, Michigan	2008
Class C		
James J. Hynes	Executive Administrator, Twin City Pipe Trades Service Association, St. Paul, Minnesota	2006
Frank L. Sims	Corporate Vice President, Transportation, Cargill, Inc., Wayzata, Minnesota	2007
John W. Marvin	Chairman and Chief Executive Officer, Marvin Windows and Doors, Warroad, Minnesota	2008
Helena Branch		
Appointed by the Federal Reserve Bank		
Marilyn F. Wessel	Retired Dean and Director, Museum of the Rockies, Bozeman, Montana	2006
Joy N. Ott	Regional President and Chief Executive Officer, Wells Fargo Bank Montana, N.A., Billings, Montana	2006
John L. Franklin	President and Chief Executive Officer, 1st Bank, Sidney, Montana	2008
Appointed by the Board of Governors		
Dean Folkvord	President and Chief Executive Officer, Wheat Montana Farms and Bakery, Three Forks, Montana	2006
Lawrence R. Simkins	President, Washington Corporations, Missoula, Montana	2008
	DISTRICT 10—KANSAS CITY	
Reserve Bank		
Class A		
Mark W. Schifferdecker	President and Chief Executive Officer, Girard National Bank, Girard, Kansas	2006
Robert C. Fricke	President and Chief Executive Officer, Farmers & Merchants National Bank, Ashland, Nebraska	2007
Rick L. Smalley	Chief Executive Officer, Dickinson Financial Corporation, Kansas City, Missouri	2008
Class B		
Kevin K. Nunnink	Chairman, Integra Realty Resources, Westwood, Kansas	2006
Frank Moore	President, Spearhead Ranch Company, Douglas, Wyoming	2007
Dan L. Dillingham	Chief Executive Officer, Dillingham Insurance, Enid, Oklahoma	2008

Directors—Continued

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Class C		
Robert A. Funk	Chairman and Chief Executive Officer, Express Personnel Services, Oklahoma City, Oklahoma	2006
Terry L. Moore	President, Omaha Federation of Labor, Omaha, Nebraska	2007
Lu M. Cordova	Chief Executive Officer, Corlund Industries; Chairman, CTEK Angels, Boulder, Colorado	2008
Denver Branch		
Appointed by the Federal Reserve Bank		
James A. Helzer	President and Chief Executive Officer, Unicover Corporation, Cheyenne, Wyoming	2006
John D. Pearson	Real Estate Broker/Owner, Pearson Real Estate Co., Inc., Buffalo, Wyoming	2006
Michael R. Stanford	President and Chief Executive Officer, First State Bancorporation, Albuquerque, New Mexico	2007
Bruce K. Alexander	President and Chief Executive Officer, Vectra Bank Colorado, Denver, Colorado	2008
Appointed by the Board of Governors		
Thomas Williams	President and Chief Executive Officer, Williams Group LLC, Golden, Colorado	2006
Kristy A. Schloss	President and Chief Executive Officer, Schloss Engineered Equipment, Inc., Aurora, Colorado	2007
Diane Leavesley	President, Mercy Loan Fund, Denver, Colorado	2008
Oklahoma City Branch		
Appointed by the Federal Reserve Bank		
Barry H. Golsen	Board Vice-Chairman, President and Chief Operating Officer, LSB Industries, Inc., Oklahoma City, Oklahoma	2006
Robert R. Gilbert, III	President, Chief Operating Officer, and Director, The F&M Bank & Trust Company, Tulsa, Oklahoma	2007
Terry M. Almon	President and Chief Executive Officer, Arkansas Valley State Bank, Broken Arrow, Oklahoma	2007
Fred M. Ramos	Executive Director, State Hispanic Chamber of Commerce, Oklahoma City, Oklahoma	2008
Appointed by the Board of Governors		
Richard K. Ratcliffe	Chairman, Ratcliffe's Inc., Weatherford, Oklahoma	2006
Steven C. Agee	President, Agee Energy, LLC, Oklahoma City, Oklahoma	2007
Michael A. Cawley	President and Chief Operating Officer, The Samuel Roberts Noble Foundation, Inc., Ardmore, Oklahoma	2008

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
Omaha Branch		
Appointed by the Federal Reserve Bank		
Rodrigo Lopez	President and Chief Executive Officer, AmeriSphere Multifamily Finance, LLC, Omaha, Nebraska	2006
Michael J. Nelson	Chairman, FirsTier Bank, Kimball, Nebraska	2006
Cynthia Hardin Milligan	Dean–College of Business Administration, University of Nebraska-Lincoln, Lincoln, Nebraska	2007
Mark A. Sutko	President and Chief Executive Officer, Platte Valley State Bank, Kearney, Nebraska	2008
Appointed by the Board of Governors		
Charles R. Hermes	President, Dutton-Lainson Company, Hastings, Nebraska	2006
Lyn Wallin Ziegenbein	Executive Director, Peter Kiewit Foundation, Omaha, Nebraska	2007
James A. Timmerman	Chief Financial Officer, Timmerman and Sons Feeding Company, Springfield, Nebraska	2008
	DISTRICT 11—DALLAS	
Reserve Bank		
Class A		
Matthew T. Doyle	Vice Chairman and Chief Executive Officer, Texas First Bank, Texas City, Texas	2006
David S. Barnard	Chairman and Chief Executive Officer, The National Banks of Central Texas, Gatesville, Texas	2007
Richard W. Evans, Jr.	Chairman and Chief Executive Officer, Cullen/Frost Bankers, Inc., San Antonio, Texas	2008
Class B		
Judy Ley Allen	Partner, Allen Investments, Inc., Houston, Texas	2006
Robert A. Estrada	Chairman, Estrada Hinojosa & Company, Inc., Dallas, Texas	2007
James B. Bexley	Associate Professor, Finance, Sam Houston State University, Huntsville, Texas	2008
Class C		
Anthony R. Chase	Chairman and Chief Executive Officer, ChaseCom, LP, Houston, Texas	2006
Ray L. Hunt	Chairman, President, and Chief Executive Officer, Hunt Consolidated, Inc., Dallas, Texas	2007
James T. Hackett	Chairman, President, and Chief Executive Officer, Anadarko Petroleum Corporation, Houston, Texas	2008
El Paso Branch		
Appointed by the Federal Reserve Bank		
Gerald J. Rubin	Chairman, President, and Chief Executive Officer, Helen of Troy Limited, El Paso, Texas	2006

Directors—Continued

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
F. James Volk	Regional President, State National Bank, El Paso, Texas	2007
Pete Cook	President and Chief Executive Officer, First National Bank of Alamogordo, Alamogordo, New Mexico	2008
Fred J. Loya	Chairman, Fred Loya Insurance, El Paso, Texas	2008
Appointed by the Board of Governors		
William V. Flores	Provost, New Mexico State University, Las Cruces, New Mexico	2006
Cecilia Ochoa Levine	President, MFI International Mfg., LLC, El Paso, Texas	2007
Ron C. Helm	Owner, Helm Land and Cattle Company, Van Horn, Texas	2008
Houston Branch		
Appointed by the Federal Reserve Bank		
Timothy N. Bryan	Chairman and Chief Executive Officer, The First National Bank of Bryan, Bryan, Texas	2006
Jodie L. Jiles	Managing Director, RBC Capital Markets, Houston, Texas	2007
S. Reed Morian	Chairman, President, and Chief Executive Officer, DX Service Company, Inc., Houston, Texas	2008
Peter G. Traber, M.D.	President and Chief Executive Officer, Baylor College of Medicine, Houston, Texas	2008
Appointed by the Board of Governors		
Nancy T. Chang	Chairman, Tanox, Inc., Houston, Texas	2006
Douglas L. Foshee	President and Chief Executive Officer, El Paso Corporation, Houston, Texas	2007
Lupe Fraga	Chairman and Chief Executive Officer, Tejas Office Products, Inc., Houston, Texas	2008
San Antonio Branch		
Appointed by the Federal Reserve Bank		
Steven R. Vandegrift	Founder and President, SRV Holdings, Austin, Texas	2006
G.P. Singh	Chairman and Chief Executive Officer, Karta Technologies Inc., San Antonio, Texas	2007
Matt F. Gorges	Chairman and Chief Executive Officer, Valley International Cold Storage, Inc., Harlingen, Texas	2008
Guillermo F. Trevino	Vice President, Southern Distributing, Lorado, Texas	2008
Appointed by the Board of Governors		
J. Dan Bates	President, Southwest Research Institute, San Antonio, Texas	2006
Ricardo Romo	President, The University of Texas at San Antonio, San Antonio, Texas	2007
Elizabeth Chu Richter	Chairman and Chief Executive Officer, Richter Architects, Corpus Christi, Texas	2008

BANK OR BRANCH, *Category* Name	Title	Term expires Dec. 31
	DISTRICT 12—SAN FRANCISCO	
RESERVE BANK		
Class A		
Kenneth P. Wilcox	President and Chief Executive Officer, Silicon Valley Bank, Santa Clara, California	2006
Richard W. Decker, Jr.	Chairman and Co-Founder, Belvedere Capital Partners LLC, San Francisco, California	2007
Candace Hunter Wiest	President and Chief Executive Officer, West Valley National Bank, Avondale, Arizona	2008
Class B		
Barbara L. Wilson	Consultant; and Regional Vice President (Retired), Qwest Corporation, Boise, Idaho	2006
Jack McNally	Principal, JKM Consulting, Sacramento, California	2007
Karla S. Chambers	Vice President and Co-Owner, Stahlbush Island Farms, Inc., Corvallis, Oregon	2008
Class C		
T. Gary Rogers	Chairman and Chief Executive Officer, Dreyer's Grand Ice Cream, Inc., Oakland, California	2006
David K.Y. Tang	Partner, Preston Gates & Ellis LLP, Seattle, Washington	2007
Charles H. Smith	Former President and Chief Executive Officer, AT&T West, San Ramon, California	2008
LOS ANGELES BRANCH		
Appointed by the Federal Reserve Bank		
D. Linn Wiley	President and Chief Executive Officer, Citizens Business Bank, Ontario, California	2006
Karen B. Caplan	President and Chief Executive Officer, Frieda's, Inc., Los Alamitos, California	2006
Dominic Ng	Chairman, President and Chief Executive Officer, East West Bank, Pasadena, California	2007
Peter M. Thomas	Managing Partner, Thomas & Mack Co., Las Vegas, Nevada	2008
Appointed by the Board of Governors		
Anita Santiago	Chief Executive Officer, Anita Santiago Advertising, Santa Monica, California	2006
James L. Sanford	Corporate Vice President and Treasurer, Northrop Grumman Corporation, Los Angeles, California	2007
Ann E. Sewill	President, Community Foundation Land Trust, California Community Foundation, Los Angeles, California	2008
PORTLAND BRANCH		
Appointed by the Federal Reserve Bank		
Robert D. Sznewajs	President and Chief Executive Officer, West Coast Bancorp, Lake Oswego, Oregon	2006
Alan V. Johnson	Regional President, Wells Fargo Bank, Portland, Oregon	2007

Directors—Continued

Bank or Branch, *Category* Name	Title	Term expires Dec. 31
William D. Thorndike, Jr.	Chairman and President, Medford Fabrication, Medford, Oregon	2008
George J. Puentes	President, Don Pancho Authentic Mexican Foods, Inc., Salem, Oregon	2008
Appointed by the Board of Governors		
David Y. Chen	Partner, OVP Venture Partners, Portland, Oregon	2006
James H. Rudd	Chief Executive Officer and Principal, Ferguson Wellman Capital Management, Inc., Portland, Oregon	2007
Peter O. Kohler, M.D.	President, Oregon Health & Science University, Portland, Oregon	2008
Salt Lake City Branch		
Appointed by the Federal Reserve Bank		
Annette K. Herman	Vice President, Strategic Initiatives, Uniprise, UnitedHealth Group, Salt Lake City, Utah	2006
Michael M. Mooney	President, Farmers & Merchants Bank, A Bank of the Cascades Company, Boise, Idaho	2007
A. Scott Anderson	President and Chief Executive Officer, Zions Bank, Salt Lake City, Utah	2008
Deborah Bayle Nielsen	President and Chief Executive Officer, United Way of Salt Lake, Salt Lake City, Utah	2008
Appointed by the Board of Governors		
William C. Glynn	President, Intermountain Industries, Inc., Boise, Idaho	2006
Gary L. Crocker	Chairman of the Board, Merrimack Pharmaceuticals, Inc., Salt Lake City, Utah	2007
Clark D. Ivory	Chief Executive Officer, Ivory Homes, Ltd., Salt Lake City, Utah	2008
Seattle Branch		
Appointed by the Federal Reserve Bank		
Helvi K. Sandvik	President, NANA Development Corporation, Anchorage, Alaska	2006
Blake W. Nordstrom	President, Nordstrom, Inc., Seattle, Washington	2007
Kenneth M. Kirkpatrick	President, Washington State, U.S. Bank, Seattle, Washington	2008
H. Stewart Parker	President and Chief Executive Officer, Targeted Genetics Corporation, Seattle, Washington	2008
Appointed by the Board of Governors		
David W. Wyckoff	Chairman and Chief Executive Officer, Wyckoff Farms, Inc., Grandview, Washington	2006
Mic R. Dinsmore	Chief Executive Officer, Port of Seattle, Seattle, Washington	2007
James R. Gill	President, Pacific Northwest Title Holding Company, Seattle, Washington	2008

Members of the Board of Governors, 1913–2006

Appointed Members

Name	Federal Reserve District	Date initially took oath of office	Other dates[1]
Charles S. Hamlin	Boston	Aug. 10, 1914	Reappointed in 1916 and 1926. Served until Feb. 3, 1936.[2]
Paul M. Warburg	New York	Aug. 10, 1914	Term expired Aug. 9, 1918.
Frederic A. Delano	Chicago	Aug. 10, 1914	Resigned July 21, 1918.
W.P.G. Harding	Atlanta	Aug. 10, 1914	Term expired Aug. 9, 1922.
Adolph C. Miller	San Francisco	Aug. 10, 1914	Reappointed in 1924. Reappointed in 1934 from the Richmond District. Served until Feb. 3, 1936.[2]
Albert Strauss	New York	Oct. 26, 1918	Resigned Mar. 15, 1920.
Henry A. Moehlenpah	Chicago	Nov. 10, 1919	Term expired Aug. 9, 1920.
Edmund Platt	New York	June 8, 1920	Reappointed in 1928. Resigned Sept. 14, 1930.
David C. Wills	Cleveland	Sept. 29, 1920	Term expired Mar. 4, 1921.
John R. Mitchell	Minneapolis	May 12, 1921	Resigned May 12, 1923.
Milo D. Campbell	Chicago	Mar. 14, 1923	Died Mar. 22, 1923.
Daniel R. Crissinger	Cleveland	May 1, 1923	Resigned Sept. 15, 1927.
George R. James	St. Louis	May 14, 1923	Reappointed in 1931. Served until Feb. 3, 1936.[3]
Edward H. Cunningham	Chicago	May 14, 1923	Died Nov. 28, 1930.
Roy A. Young	Minneapolis	Oct. 4, 1927	Resigned Aug. 31, 1930.
Eugene Meyer	New York	Sept. 16, 1930	Resigned May 10, 1933.
Wayland W. Magee	Kansas City	May 18, 1931	Term expired Jan. 24, 1933.
Eugene R. Black	Atlanta	May 19, 1933	Resigned Aug. 15, 1934.
M.S. Szymczak	Chicago	June 14, 1933	Reappointed in 1936 and 1948. Resigned May 31, 1961.
J.J. Thomas	Kansas City	June 14, 1933	Served until Feb. 10, 1936.[2]
Marriner S. Eccles	San Francisco	Nov. 15, 1934	Reappointed in 1936, 1940, and 1944. Resigned July 14, 1951.
Joseph A. Broderick	New York	Feb. 3, 1936	Resigned Sept. 30, 1937.
John K. McKee	Cleveland	Feb. 3, 1936	Served until Apr. 4, 1946.[2]
Ronald Ransom	Atlanta	Feb. 3, 1936	Reappointed in 1942. Died Dec. 2, 1947.
Ralph W. Morrison	Dallas	Feb. 10, 1936	Resigned July 9, 1936.
Chester C. Davis	Richmond	June 25, 1936	Reappointed in 1940. Resigned Apr. 15, 1941.
Ernest G. Draper	New York	Mar. 30, 1938	Served until Sept. 1, 1950.[2]
Rudolph M. Evans	Richmond	Mar. 14, 1942	Served until Aug. 13, 1954.[2]
James K. Vardaman, Jr.	St. Louis	Apr. 4, 1946	Resigned Nov. 30, 1958.
Lawrence Clayton	Boston	Feb. 14, 1947	Died Dec. 4, 1949.
Thomas B. McCabe	Philadelphia	Apr. 15, 1948	Resigned Mar. 31, 1951.
Edward L. Norton	Atlanta	Sept. 1, 1950	Resigned Jan. 31, 1952.
Oliver S. Powell	Minneapolis	Sept. 1, 1950	Resigned June 30, 1952.
Wm. McC. Martin, Jr.	New York	Apr. 2, 1951	Reappointed in 1956. Term expired Jan. 31, 1970.
A.L. Mills, Jr.	San Francisco	Feb. 18, 1952	Reappointed in 1958. Resigned Feb. 28, 1965.
J.L. Robertson	Kansas City	Feb. 18, 1952	Reappointed in 1964. Resigned Apr. 30, 1973.
C. Canby Balderston	Philadelphia	Aug. 12, 1954	Served through Feb. 28, 1966.
Paul E. Miller	Minneapolis	Aug. 13, 1954	Died Oct. 21, 1954.

Appointed Members—Continued

Name	Federal Reserve District	Date initially took oath of office	Other dates[1]
Chas. N. Shepardson	Dallas	Mar. 17, 1955	Retired Apr. 30, 1967.
G.H. King, Jr.	Atlanta	Mar. 25, 1959	Reappointed in 1960. Resigned Sept. 18, 1963.
George W. Mitchell	Chicago	Aug. 31, 1961	Reappointed in 1962. Served until Feb. 13, 1976.[2]
J. Dewey Daane	Richmond	Nov. 29, 1963	Served until Mar. 8, 1974.[2]
Sherman J. Maisel	San Francisco	Apr. 30, 1965	Served through May 31, 1972.
Andrew F. Brimmer	Philadelphia	Mar. 9, 1966	Resigned Aug. 31, 1974.
William W. Sherrill	Dallas	May 1, 1967	Reappointed in 1968. Resigned Nov. 15, 1971.
Arthur F. Burns	New York	Jan. 31, 1970	Term began Feb. 1, 1970. Resigned Mar. 31, 1978.
John E. Sheehan	St. Louis	Jan. 4, 1972	Resigned June 1, 1975.
Jeffrey M. Bucher	San Francisco	June 5, 1972	Resigned Jan. 2, 1976.
Robert C. Holland	Kansas City	June 11, 1973	Resigned May 15, 1976.
Henry C. Wallich	Boston	Mar. 8, 1974	Resigned Dec. 15, 1986.
Philip E. Coldwell	Dallas	Oct. 29, 1974	Served through Feb. 29, 1980.
Philip C. Jackson, Jr.	Atlanta	July 14, 1975	Resigned Nov. 17, 1978.
J. Charles Partee	Richmond	Jan. 5, 1976	Served until Feb. 7, 1986.[2]
Stephen S. Gardner	Philadelphia	Feb. 13, 1976	Died Nov. 19, 1978.
David M. Lilly	Minneapolis	June 1, 1976	Resigned Feb. 24, 1978.
G. William Miller	San Francisco	Mar. 8, 1978	Resigned Aug. 6, 1979.
Nancy H. Teeters	Chicago	Sept. 18, 1978	Served through June 27, 1984.
Emmett J. Rice	New York	June 20, 1979	Resigned Dec. 31, 1986.
Frederick H. Schultz	Atlanta	July 27, 1979	Served through Feb. 11, 1982.
Paul A. Volcker	Philadelphia	Aug. 6, 1979	Resigned Aug. 11, 1987.
Lyle E. Gramley	Kansas City	May 28, 1980	Resigned Sept. 1, 1985.
Preston Martin	San Francisco	Mar. 31, 1982	Resigned Apr. 30, 1986.
Martha R. Seger	Chicago	July 2, 1984	Resigned Mar. 11, 1991.
Wayne D. Angell	Kansas City	Feb. 7, 1986	Served through Feb. 9, 1994.
Manuel H. Johnson	Richmond	Feb. 7, 1986	Resigned Aug. 3, 1990.
H. Robert Heller	San Francisco	Aug. 19, 1986	Resigned July 31, 1989.
Edward W. Kelley, Jr.	Dallas	May 26, 1987	Resigned Dec. 31, 2001.
Alan Greenspan	New York	Aug. 11, 1987	Resigned Jan. 31, 2006.
John P. LaWare	Boston	Aug. 15, 1988	Resigned Apr. 30, 1995.
David W. Mullins, Jr.	St. Louis	May 21, 1990	Resigned Feb. 14, 1994.
Lawrence B. Lindsey	Richmond	Nov. 26, 1991	Resigned Feb. 5, 1997.
Susan M. Phillips	Chicago	Dec. 2, 1991	Served through June 30, 1998.
Alan S. Blinder	Philadelphia	June 27, 1994	Term expired Jan. 31, 1996.
Janet L. Yellen	San Francisco	Aug. 12, 1994	Resigned Feb. 17, 1997.
Laurence H. Meyer	St. Louis	June 24, 1996	Term expired Jan. 31, 2002.
Alice M. Rivlin	Philadelphia	June 25, 1996	Resigned July 16, 1999.
Roger W. Ferguson, Jr.	Boston	Nov. 5, 1997	Resigned Apr. 28, 2006.
Edward M. Gramlich	Richmond	Nov. 5, 1997	Resigned Aug. 31, 2005.
Susan S. Bies	Chicago	Dec. 7, 2001	
Mark W. Olson	Minneapolis	Dec. 7, 2001	Resigned June 20, 2006.
Ben S. Bernanke	Atlanta	Aug. 5, 2002	Resigned June 21, 2005.
Donald L. Kohn	Kansas City	Aug. 5, 2002	
Ben. S. Bernanke	Atlanta	Feb. 1, 2006	
Kevin M. Warsh	New York	Feb. 22, 2006	
Randall S. Kroszner	Richmond	Feb. 27, 2006	
Frederic S. Mishkin	Boston	Sept. 5, 2006	

Appointed Members—Continued

Name	Term
Chairmen [3]	
Charles S. Hamlin	Aug. 10, 1914–Aug. 9, 1916
W.P.G. Harding	Aug. 10, 1916–Aug. 9, 1922
Daniel R. Crissinger	May 1, 1923–Sept. 15, 1927
Roy A. Young	Oct. 4, 1927–Aug. 31, 1930
Eugene Meyer	Sept. 16, 1930–May 10, 1933
Eugene R. Black	May 19, 1933–Aug. 15, 1934
Marriner S. Eccles	Nov. 15, 1934–Jan. 31, 1948 [4]
Thomas B. McCabe	Apr. 15, 1948–Mar. 31, 1951
Wm. McC. Martin, Jr.	Apr. 2, 1951–Jan. 31, 1970
Arthur F. Burns	Feb. 1, 1970–Jan. 31, 1978
G. William Miller	Mar. 8, 1978–Aug. 6, 1979
Paul A. Volcker	Aug. 6, 1979–Aug. 11, 1987
Alan Greenspan	Aug. 11, 1987–Jan. 31, 2006 [5]
Vice Chairmen [3]	
Frederic A. Delano	Aug. 10, 1914–Aug. 9, 1916
Paul M. Warburg	Aug. 10, 1916–Aug. 9, 1918
Albert Strauss	Oct. 26, 1918–Mar. 15, 1920
Edmund Platt	July 23, 1920–Sept. 14, 1930
J.J. Thomas	Aug. 21, 1934–Feb. 10, 1936
Ronald Ransom	Aug. 6, 1936–Dec. 2, 1947
C. Canby Balderston	Mar. 11, 1955–Feb. 28, 1966
J.L. Robertson	Mar. 1, 1966–Apr. 30, 1973
George W. Mitchell	May 1, 1973–Feb. 13, 1976
Stephen S. Gardner	Feb. 13, 1976–Nov. 19, 1978
Frederick H. Schultz	July 27, 1979–Feb. 11, 1982
Preston Martin	Mar. 31, 1982–Apr. 30, 1986
Manuel H. Johnson	Aug. 4, 1986–Aug. 3, 1990
David W. Mullins, Jr.	July 24, 1991–Feb. 14, 1994
Alan S. Blinder	June 27, 1994–Jan. 31, 1996
Alice M. Rivlin	June 25, 1996–July 16, 1999
Roger W. Ferguson, Jr.	Oct. 5, 1999–Apr. 28, 2006

NOTE: Under the original Federal Reserve Act, the Federal Reserve Board was composed of five appointed members, the Secretary of the Treasury (ex officio chairman of the Board), and the Comptroller of the Currency. The original term of office was ten years; the five original appointed members had terms of two, four, six, eight, and ten years. In 1922 the number of appointed members was increased to six, and in 1933 the term of office was raised to twelve years. The Banking Act of 1935 changed the name to the Board of Governors of the Federal Reserve System and provided that the Board be composed of seven appointed members; that the Secretary of the Treasury and the Comptroller of the Currency continue to serve until Feb. 1, 1936; that the appointed members in office on Aug. 23, 1935, continue to serve until Feb. 1, 1936, or until their successors were appointed and had qualified; and that thereafter the terms of members be fourteen years and that the designation of Chairman and Vice Chairman of the Board be for four years.

1. Date following "Resigned" and "Retired" denotes final day of service.
2. Successor took office on this date.
3. Before Aug. 23, 1935, Chairmen and Vice Chairmen were designated Governor and Vice Governor.
4. Served as Chairman Pro Tempore from Feb. 3, 1948, to Apr. 15, 1948.
5. Served as Chairman Pro Tempore from March 3, 1996, to June 20, 1996.

Ex Officio Members

Name	Term
Secretaries of the Treasury	
W.G. McAdoo	Dec. 23, 1913–Dec. 15, 1918
Carter Glass	Dec. 16, 1918–Feb. 1, 1920
David F. Houston	Feb. 2, 1920–Mar. 3, 1921
Andrew W. Mellon	Mar. 4, 1921–Feb. 12, 1932
Ogden L. Mills	Feb. 12, 1932–Mar. 4, 1933
William H. Woodin	Mar. 4, 1933–Dec. 31, 1933
Henry Morgenthau, Jr.	Jan. 1, 1934–Feb. 1, 1936
Comptrollers of the Currency	
John Skelton Williams	Feb. 2, 1914–Mar. 2, 1921
Daniel R. Crissinger	Mar. 17, 1921–Apr. 30, 1923
Henry M. Dawes	May 1, 1923–Dec. 17, 1924
Joseph W. McIntosh	Dec. 20, 1924–Nov. 20, 1928
J.W. Pole	Nov. 21, 1928–Sept. 20, 1932
J.F.T. O’Connor	May 11, 1933–Feb. 1, 1936

Statistical Tables

1. Federal Reserve Open Market Transactions, 2006

Millions of dollars

Type of security and transaction	Jan.	Feb.	Mar.	Apr.
U.S. TREASURY SECURITIES[1]				
Outright transactions[2]				
Treasury bills				
Gross purchases	1,563	1,308	1,228	0
Gross sales	0	0	0	0
Exchanges	67,302	68,077	79,509	64,886
For new bills	67,302	68,077	79,509	64,886
Redemptions	0	0	0	0
Others within 1 year				
Gross purchases	0	1,200	0	0
Gross sales	0	0	0	0
Maturity shifts	13,599	11,858	8,000	0
Exchanges	–13,594	–10,989	–8,334	–834
Redemptions	1,321	0	0	0
1 to 5 years				
Gross purchases	2,809	2,498	2,136	1,096
Gross sales	0	0	0	0
Maturity shifts	–13,599	–4,775	–4,500	0
Exchanges	11,830	9,306	8,334	834
5 to 10 years				
Gross purchases	1,505	25	174	0
Gross sales	0	0	0	0
Maturity shifts	0	–5,205	–3,500	0
Exchanges	0	841	0	0
More than 10 years				
Gross purchases	205	924	90	0
Gross sales	0	0	0	0
Maturity shifts	0	–1,878	0	0
Exchanges	1,765	841	0	0
All maturities				
Gross purchases	6,082	5,955	3,628	1,096
Gross sales	0	0	0	0
Redemptions	1,321	0	0	0
Net change in U.S. Treasury securities	4,761	5,955	3,628	1,096

For notes see end of table.

1.—Continued

May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
0	0	1,649	0	0	0	0	0	5,748
0	0	0	0	0	0	0	0	0
75,196	95,728	70,972	90,885	72,636	65,400	85,342	69,275	905,208
75,196	95,728	70,972	90,885	72,636	65,400	85,342	69,275	905,208
0	0	0	0	0	0	0	0	0
1,375	0	0	415	0	1,757	220	0	4,967
0	0	0	0	0	0	0	0	0
24,441	6,667	6,614	20,379	6,861	7,427	14,046	0	119,892
–15,746	–7,997	–10,078	–13,535	0	–16,498	–15,441	0	–113,046
1,217	0	3,931	0	0	3,749	335	0	10,553
2,317	2,650	549	1,454	1,320	1,395	3,151	4,979	26,354
0	0	0	0	0	0	0	0	0
–21,298	–3,167	–3,784	–13,673	–6,861	–5,246	–11,009	0	–87,912
13,452	7,997	7,254	10,421	0	15,086	13,147	0	97,661
101	1,080	0	0	548	33	411	445	4,322
0	0	0	0	0	0	0	0	0
949	–3,500	–2,830	–5,149	0	–2,181	2,073	0	–19,343
2,294	0	1,588	1,557	0	1,412	2,294	0	9,986
0	0	0	0	228	0	780	1,072	3,299
0	0	0	0	0	0	0	0	0
–4,092	0	0	–1,557	0	0	–5,110	0	–12,637
0	0	1,235	1,557	0	0	0	0	5,398
3,793	3,730	2,198	1,869	2,096	3,185	4,562	6,496	44,690
0	0	0	0	0	0	0	0	0
1,217	0	3,931	0	0	3,749	335	0	10,553
2,576	3,730	-1,733	1,869	2,096	-564	4,227	6,496	34,137

1. Federal Reserve Open Market Transactions, 2006—Continued

Millions of dollars

Type of security and transaction	Jan.	Feb.	Mar.	Apr.
FEDERAL AGENCY OBLIGATIONS				
Outright transactions [2]				
Gross purchases	0	0	0	0
Gross sales	0	0	0	0
Redemptions	0	0	0	0
Net change in federal agency obligations	0	0	0	0
TEMPORARY TRANSACTIONS				
Repurchase agreements [3]				
Gross purchases	185,750	157,000	204,250	163,750
Gross sales	206,750	151,250	209,000	166,250
Reverse repurchase agreements [4]				
Gross purchases	504,837	445,563	558,568	488,091
Gross sales	498,351	446,346	560,306	485,659
Net change in temporary transactions	–14,514	4,967	–6,488	–68
Total net change in System Open Market Account	–9,752	10,922	–2,860	1,028

NOTE: Sales, redemptions, and negative figures reduce holdings of the System Open Market Account; all other figures increase such holdings. Components may not sum to totals because of rounding.

1. Transactions exclude changes in compensation for the effects of inflation on the principal of inflation-indexed securities. Transactions include the rollover of inflation compensation into new securities.

2. Excludes the effect of temporary transactions—repurchase agreements, matched sale–purchase agreements (MSPs), and reverse repurchase agreements (RRPs).

3. Cash value of agreements, which are collateralized by U.S. government and federal agency securities.

4. Cash value of agreements, which are collateralized by U.S. Treasury securities.

1.—Continued

May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
200,750	182,000	177,000	178,000	128,000	178,000	194,500	176,500	2,125,500
194,250	181,500	178,000	178,000	136,750	169,750	186,500	173,500	2,131,500
531,844	567,926	584,190	642,084	554,480	649,172	665,558	586,711	6,779,024
532,338	572,488	584,959	640,413	557,372	651,821	662,802	585,277	6,778,132
6,006	–4,061	–1,769	1,671	–11,643	5,601	10,756	4,434	–5,108
8,582	**–331**	**–3,502**	**3,540**	**–9,547**	**5,037**	**14,983**	**10,930**	**29,030**

2. Federal Reserve Bank Holdings of U.S. Treasury and Federal Agency Securities, December 31, 2004–2006

Millions of dollars

Description	December 31			Change	
	2006	2005	2004	2005 to 2006	2004 to 2005
U.S. TREASURY SECURITIES					
Held outright[1]	**778,915**	**744,215**	**717,819[r]**	**34,700**	**26,396[r]**
By remaining maturity					
Bills					
1–90 days	193,034	187,370	179,748	5,664	7,622
91 days to 1 year	83,985	83,900	83,222	85	678
Notes and bonds					
1 year or less	129,594	128,287[r]	116,443	1,307	11,844[r]
More than 1 year through 5 years	224,177	210,745[r]	208,269	13,432	2,476[r]
More than 5 years through 10 years	67,645	56,699[r]	54,372	10,946	2,327[r]
More than 10 years	80,479	77,215[r]	75,765	3,264	1,450[r]
By type					
Bills	277,019	271,270	262,970	5,749	8,300
Notes	402,367	380,118	360,832[r]	22,249	19,286[r]
Bonds	99,528	92,827	94,017[r]	6,701	–1,190[r]
FEDERAL AGENCY SECURITIES					
Held outright[1]	**0**	**0**	**0**	**0**	**0**
By remaining maturity					
1 year or less	0	0	0	0	0
More than 1 year through 5 years	0	0	0	0	0
More than 5 years through 10 years	0	0	0	0	0
More than 10 years	0	0	0	0	0
By issuer					
Federal National Mortgage Association	0	0	0	0	0
TEMPORARY TRANSACTIONS					
Repurchase agreements[2]	**40,750**	**46,750**	**33,000[r]**	**–6,000**	**13,750[r]**
Matched sale–purchase agreements	**0**	**0**	**0**	**0**	**0**
Foreign official and international accounts	0	0	0	0	0
Dealers	0	0	0	0	0
Reverse repurchase agreements[3]	**29,615**	**30,505**	**30,783[r]**	**–890**	**–278[r]**
Foreign official and international accounts	29,615	30,505	30,783[r]	–890	–278[r]
Dealers	0	0	0	0	0

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

1. Excludes the effect of temporary transactions—repurchase agreements, matched sale–purchase agreements (MSPs), and reverse repurchase agreements (RRPs).

2. Cash value of agreements, which are collateralized by U.S. government and federal agency securities.

3. Cash value of agreements, which are collateralized by U.S. Treasury securities.

r. Revised.

3. Federal Reserve Bank Interest Rates on Loans to Depository Institutions, December 31, 2006

Reserve Bank	Primary credit[1]	Secondary credit[2]	Seasonal credit[3]
All Federal Reserve Banks	6.25	6.75	5.30

NOTE: For details on rate changes over the course of 2006, see the section on discount rates in the chapter "Record of Policy Actions of the Board of Governors."

1. Primary credit is available for very short terms as a backup source of liquidity to depository institutions that are in generally sound financial condition in the judgment of the lending Federal Reserve Bank.

2. Secondary credit is available in appropriate circumstances to depository institutions that do not qualify for primary credit.

3. Seasonal credit is available to help relatively small depository institutions meet regular seasonal needs for funds that arise from a clear pattern of intra-yearly movements in their deposits and loans. The discount rate on seasonal credit takes into account rates charged by market sources of funds and is reestablished on the first business day of each two-week reserve maintenance period.

4. Reserve Requirements of Depository Institutions, December 31, 2006

Type of deposit	Requirements	
	Percentage of deposits	Effective date
Net transaction accounts [1]		
$0 million–$8.5 million [2]	0	12-21-06
More than $8.5 million–$45.8 million [3]	3	12-21-06
More than $45.8 million	10	12-21-06
Nonpersonal time deposits	0	12-27-90
Eurocurrency liabilities	0	12-27-90

NOTE: Required reserves must be held in the form of vault cash and, if vault cash is insufficient, also in the form of a deposit with a Federal Reserve Bank. An institution that is a member of the Federal Reserve System must hold that deposit directly with a Reserve Bank; an institution that is not a member of the System can maintain that deposit directly with a Reserve Bank or with another institution in a pass-through relationship. Reserve requirements are imposed on commercial banks, savings banks, savings and loan associations, credit unions, U.S. branches and agencies of foreign banks, Edge corporations, and agreement corporations.

1. Total transaction accounts consists of demand deposits, automatic transfer service (ATS) accounts, NOW accounts, share draft accounts, telephone or preauthorized transfer accounts, ineligible banker's acceptances, and affiliate-issued obligations maturing in seven days or less. Net transaction accounts are total transaction accounts less amounts due from other depository institutions and less cash items in the process of collection.

For a more detailed description of these deposit types, see Form FR 2900 at www.federalreserve.gov/boarddocs/reportforms/.

2. The amount of net transaction accounts subject to a reserve requirement ratio of 0 percent (the "exemption amount") is adjusted each year by statute. The exemption amount is adjusted upward by 80 percent of the previous year's (June 30 to June 30) rate of increase in total reservable liabilities at all depository institutions. No adjustment is made in the event of a decrease in such liabilities.

3. The amount of net transaction accounts subject to a reserve requirement ratio of 3 percent is the "low reserve tranche." By statute, the upper limit of the low reserve tranche is adjusted each year by 80 percent of the previous year's (June 30 to June 30) rate of increase or decrease in net transaction accounts held by all depository institutions.

5. Banking Offices and Banks Affiliated with Bank Holding Companies (BHCs) in the United States, December 31, 2005 and 2006

Type of office	Total	Commercial banks[1]					State-chartered savings banks
		Total	Member			Nonmember	
			Total	National	State		
	All banking offices						
BANKS							
Number, Dec. 31, 2005	**7,853**	**7,484**	**2,696**	**1,794**	**902**	**4,788**	**369**
Changes during 2006							
New banks	190	187	41	24	17	146	3
Banks converted into branches	–290	–284	–132	–92	–40	–152	–6
Ceased banking operation[2]	–21	–18	–8	–7	–1	–10	–3
Other[3]	0	–1	–4	–23	19	3	1
Net change	–121	–116	–103	–98	–5	–13	–5
Number, Dec. 31, 2006	**7,732**	**7,368**	**2,593**	**1,696**	**897**	**4,775**	**364**
BRANCHES AND ADDITIONAL OFFICES							
Number, Dec. 31, 2005	**77,830**	**74,681**	**53,122**	**39,155**	**13,967**	**21,559**	**3,149**
Changes during 2006							
New branches	2,765	2,694	2,071	1,546	525	623	71
Branches converted from banks	290	287	131	94	37	156	3
Discontinued[2]	–2,009	–1,832	–1,645	–1,417	–228	–187	–177
Other[3]	0	53	259	286	–27	–206	–53
Net change	1,046	1,202	816	509	307	386	–156
Number, Dec. 31, 2006	**78,876**	**75,883**	**53,938**	**39,664**	**14,274**	**21,945**	**2,993**
	Banks affiliated with BHCs						
BANKS							
Number, Dec. 31, 2005	**6,265**	**6,143**	**2,336**	**1,540**	**796**	**3,807**	**122**
Changes during 2006							
BHC-affiliated new banks	183	174	58	38	20	116	9
Banks converted into branches	–244	–239	–112	–76	–36	–127	–5
Ceased banking operation[2]	–18	–17	–7	–6	–1	–10	–1
Other[3]	0	0	0	–18	18	0	0
Net change	–79	–82	–61	–62	1	–21	3
Number, Dec. 31, 2006	**6,186**	**6,061**	**2,275**	**1,478**	**797**	**3,786**	**125**

NOTE: Includes banking offices and BHCs in U.S. territories and possessions.

1. For purposes of this table, banks are entities that are defined as banks in the Bank Holding Company Act, as amended, which is implemented by Federal Reserve Regulation Y. Generally, a bank is any institution that accepts demand deposits and is engaged in the business of making commercial loans or any institution that is defined as an insured bank in section 3(h) of the FDIC Act. Covers entities in the United States and its territories and possessions (affiliated insular areas).

2. Institutions that no longer meet the Regulation Y definition of bank.

3. Interclass changes and sales of branches.

6A. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1984–2006 and Month-End 2006

Millions of dollars

Period	Factors supplying reserve funds								
	Federal Reserve Bank credit outstanding						Gold stock	Special drawing rights certificate account	Treasury currency outstanding[3]
	Securities held outright[1]	Repurchase agreements[2]	Loans	Float	Other Federal Reserve assets	Total			
1984	167,612	2,015	3,577	833	12,347	186,384	11,096	4,618	16,418
1985	186,025	5,223	3,060	988	15,302	210,598	11,090	4,718	17,075
1986	205,454	16,005	1,565	1,261	17,475	241,760	11,084	5,018	17,567
1987	226,459	4,961	3,815	811	15,837	251,883	11,078	5,018	18,177
1988	240,628	6,861	2,170	1,286	18,803	269,748	11,060	5,018	18,799
1989	233,300	2,117	481	1,093	39,631	276,622	11,059	8,518	19,628
1990	241,431	18,354	190	2,566	39,880	302,421	11,058	10,018	20,402
1991	272,531	15,898	218	1,026	34,524	324,197	11,059	10,018	21,014
1992	300,423	8,094	675	3,350	30,278	342,820	11,056	8,018	21,447
1993	336,654	13,212	94	963	33,394	384,317	11,053	8,018	22,095
1994	368,156	10,590	223	740	33,441	413,150	11,051	8,018	22,994
1995	380,831	13,862	135	231	33,483	428,543	11,050	10,168	24,003
1996	393,132	21,583	85	5,297	32,222	452,319	11,048	9,718	24,966
1997	431,420	23,840	2,035	561	32,044	489,901	11,047	9,200	25,543
1998	452,478	30,376	17	1,009	37,692	521,573	11,046	9,200	26,270
1999	478,144	140,640	233	407	34,799	654,223	11,048	6,200	28,013
2000	511,833	43,375	110	795	36,896	593,009	11,046	2,200	31,643
2001	551,685	50,250	34	698	36,885	639,552	11,045	2,200	33,017
2002	629,416	39,500	40	832	38,574	708,363	11,043	2,200	34,597
2003	666,665	43,750	62	211	40,214	750,901	11,043	2,200	35,475
2004	717,819	33,000	43	927	42,161	793,950	11,045	2,200	36,434
2005	744,215	46,750	72	891	39,319	831,247	11,043	2,200	36,540[r]
2006	778,915	40,750	67	–326	39,885	859,290	11,041	2,200	38,233

For notes see end of table.

6A.—Continued

Factors absorbing reserve funds								Reserve balances with Federal Reserve Banks[6]
Currency in circulation	Reverse repurchase agreements[4]	Treasury cash holdings[5]	Deposits with Federal Reserve Banks, other than reserve balances			Required clearing balances	Other Federal Reserve liabilities and capital	
			Treasury	Foreign	Other			
183,796	0	513	5,316	253	867	1,126	5,952	20,693
197,488	0	550	9,351	480	1,041	1,490	5,940	27,141
211,995	0	447	7,588	287	917	1,812	6,088	46,295
230,205	0	454	5,313	244	1,027	1,687	7,129	40,097
247,649	0	395	8,656	347	548	1,605	7,683	37,742
260,456	0	450	6,217	589	1,298	1,618	8,486	36,713
286,963	0	561	8,960	369	242	1,960	8,147	36,698
307,756	0	636	17,697	968	1,706	3,946	8,113	25,467
334,701	0	508	7,492	206	372	5,897	7,984	26,182
365,271	0	377	14,809	386	397	6,332	9,292	28,619
403,843	0	335	7,161	250	876	4,196	11,959	26,593
424,244	0	270	5,979	386	932	5,167	12,342	24,444
450,648	0	249	7,742	167	892	6,601	13,829	17,923
482,327	0	225	5,444	457	900	6,679	15,500	24,159
517,484	0	85	6,086	167	1,605	6,781	16,354	19,525
628,359	0	109	28,402	71	1,261	7,482	17,256	16,545
593,694	0	450	5,149	216	1,382	6,332	17,962	12,713
643,301	0	425	6,645	61	820	8,525	17,083	8,953
687,518	21,091	367	4,420	136	1,152	10,534[r]	18,977	12,007[r]
724,194	25,652	321	5,723	162	717	11,829[r]	19,793	11,229[r]
754,877	30,783	270	5,912	80	1,285	9,963	26,378	14,080
794,014[r]	30,505	202	4,573	83	2,144	8,650[r]	30,466	10,393[r]
820,204	29,615	252	4,708	98	958	6,842	36,231	11,857

6A. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1984–2006 and Month-End 2006—Continued

Millions of dollars

Period	Factors supplying reserve funds								
	Federal Reserve Bank credit outstanding						Gold stock	Special drawing rights certificate account	Treasury currency out-standing [3]
	Securities held outright [1]	Repurchase agreements [2]	Loans	Float	Other Federal Reserve assets	Total			
2006									
Jan	748,824	25,750	40	1,796	40,285	816,694	11,044	2,200	36,539
Feb	754,676	31,500	38	1,466	37,675	825,355	11,044	2,200	37,813
Mar	758,542	26,750	566	–836	39,046	824,068	11,043	2,200	37,879
Apr	759,690	24,250	138	–1,084	41,283	824,277	11,041	2,200	37,936
May	762,411	30,750	207	1,028	39,151	833,547	11,041	2,200	37,980
Jun	766,364	31,250	291	–1,032	40,133	837,005	11,041	2,200	37,990
Jul	764,811	30,250	361	48	41,103	836,574	11,041	2,200	38,026
Aug	766,739	30,250	349	–606	38,436	835,168	11,041	2,200	38,025
Sep	768,924	21,500	322	–1,104	40,063	829,705	11,041	2,200	38,084
Oct	768,493	29,750	157	2,604	40,672	841,677	11,041	2,200	38,133
Nov	772,604	37,750	102	–411	37,409	847,455	11,041	2,200	38,177
Dec	778,915	40,750	67	–326	39,885	859,290	11,041	2,200	38,233

6A.—Continued

Factors absorbing reserve funds								Reserve balances with Federal Reserve Banks[6]
Currency in circulation	Reverse repurchase agreements[4]	Treasury cash holdings[5]	Deposits with Federal Reserve Banks, other than reserve balances			Required clearing balances	Other Federal Reserve liabilities and capital	
			Treasury	Foreign	Other			
782,356	24,019	216	5,606	83	281	8,710	31,667	13,540
789,289	24,802	185	5,024	82	279	8,015	32,510	16,226
788,769	26,540	209	5,455	84	217	7,731	32,894	13,291
790,794	24,108	182	4,784	86	278	6,696	33,807	14,718
799,103	24,603	196	2,637	86	242	7,580	34,508	15,815
797,157	29,164	174	5,525	142	226	7,162	34,886	13,801
792,624	29,933	148	4,546	88	320	7,028	35,688	17,466
797,545	28,263	171	4,907	89	259	6,791	35,677	12,734
790,582	31,155	150	5,451	98	236	6,987	36,027	10,343
796,047	33,805	179	5,617	104	344	6,933	36,955	13,067
806,375	31,049	164	4,373	90	278	6,832	36,163	13,549
820,204	29,615	252	4,708	98	958	6,842	36,231	11,857

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

1. Includes U.S. Treasury and federal agency securities. U.S. Treasury securities include securities lent to dealers, which are fully collateralized by other U.S. Treasury securities. Federal agency securities are included at face value.

2. Cash value of agreements, which are collateralized by U.S. Treasury and federal agency securities.

3. Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are fractional and dollar coins. For details see ''U.S. Currency and Coin Outstanding and in Circulation,'' *Treasury Bulletin*.

4. Cash value of agreements, which are collateralized by U.S. Treasury securities.

5. Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

6. Excludes required clearing balances and adjustments to compensate for float.

r. Revised.

6B. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1918–1983

Millions of dollars

Period	Factors supplying reserve funds									
	Federal Reserve Bank credit outstanding							Gold stock [6]	Special drawing rights certificate account	Treasury currency out-standing [7]
	Securities held outright [1]	Repur-chase agree-ments [2]	Loans	Float [3]	All other [4]	Other Federal Reserve assets [5]	Total			
1918	239	0	1,766	199	294	0	2,498	2,873	. . .	1,795
1919	300	0	2,215	201	575	0	3,292	2,707	. . .	1,707
1920	287	0	2,687	119	262	0	3,355	2,639	. . .	1,709
1921	234	0	1,144	40	146	0	1,563	3,373	. . .	1,842
1922	436	0	618	78	273	0	1,405	3,642	. . .	1,958
1923	80	54	723	27	355	0	1,238	3,957	. . .	2,009
1924	536	4	320	52	390	0	1,302	4,212	. . .	2,025
1925	367	8	643	63	378	0	1,459	4,112	. . .	1,977
1926	312	3	637	45	384	0	1,381	4,205	. . .	1,991
1927	560	57	582	63	393	0	1,655	4,092	. . .	2,006
1928	197	31	1,056	24	500	0	1,809	3,854	. . .	2,012
1929	488	23	632	34	405	0	1,583	3,997	. . .	2,022
1930	686	43	251	21	372	0	1,373	4,306	. . .	2,027
1931	775	42	638	20	378	0	1,853	4,173	. . .	2,035
1932	1,851	4	235	14	41	0	2,145	4,226	. . .	2,204
1933	2,435	2	98	15	137	0	2,688	4,036	. . .	2,303
1934	2,430	0	7	5	21	0	2,463	8,238	. . .	2,511
1935	2,430	1	5	12	38	0	2,486	10,125	. . .	2,476
1936	2,430	0	3	39	28	0	2,500	11,258	. . .	2,532
1937	2,564	0	10	19	19	0	2,612	12,760	. . .	2,637
1938	2,564	0	4	17	16	0	2,601	14,512	. . .	2,798
1939	2,484	0	7	91	11	0	2,593	17,644	. . .	2,963
1940	2,184	0	3	80	8	0	2,274	21,995	. . .	3,087
1941	2,254	0	3	94	10	0	2,361	22,737	. . .	3,247
1942	6,189	0	6	471	14	0	6,679	22,726	. . .	3,648
1943	11,543	0	5	681	10	0	12,239	21,938	. . .	4,094
1944	18,846	0	80	815	4	0	19,745	20,619	. . .	4,131
1945	24,252	0	249	578	2	0	15,091	20,065	. . .	4,339
1946	23,350	0	163	580	1	0	24,093	20,529	. . .	4,562
1947	22,559	0	85	535	1	0	23,181	22,754	. . .	4,562
1948	23,333	0	223	541	1	0	24,097	24,244	. . .	4,589
1949	18,885	0	78	534	2	0	19,499	24,427	. . .	4,598
1950	20,725	53	67	1,368	3	0	22,216	22,706	. . .	4,636
1951	23,605	196	19	1,184	5	0	25,009	22,695	. . .	4,709
1952	24,034	663	156	967	4	0	25,825	23,187	. . .	4,812
1953	25,318	598	28	935	2	0	26,880	22,030	. . .	4,894
1954	24,888	44	143	808	1	0	25,885	21,713	. . .	4,985
1955	24,391	394	108	1,585	29	0	26,507	21,690	. . .	5,008
1956	24,610	305	50	1,665	70	0	26,699	21,949	. . .	5,066
1957	23,719	519	55	1,424	66	0	25,784	22,781	. . .	5,146
1958	26,252	95	64	1,296	49	0	27,755	20,534	. . .	5,234
1959	26,607	41	458	1,590	75	0	28,771	19,456	. . .	5,311

For notes see end of table.

6B.—Continued

Factors absorbing reserve funds								Member bank reserves[9]			
Currency in circulation	Treasury cash holdings[8]	Deposits with Federal Reserve Banks, other than reserve balances			Other Federal Reserve accounts[5]	Required clearing balances	Other Federal Reserve liabilities and capital[5]	With Federal Reserve Banks	Currency and coin[10]	Required[11]	Excess[11, 12]
		Treasury	Foreign	Other							
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

6B. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1918–1983—Continued

Millions of dollars

Period	Factors supplying reserve funds									
	Federal Reserve Bank credit outstanding							Gold stock[6]	Special drawing rights certificate account	Treasury currency outstanding[7]
	Securities held outright[1]	Repurchase agreements[2]	Loans	Float[3]	All other[4]	Other Federal Reserve assets[5]	Total			
1960	26,984	400	33	1,847	74	0	29,338	17,767	. . .	5,398
1961	30,478	159	130	2,300	51	0	31,362	16,889	. . .	5,585
1962	28,722	342	38	2,903	110	0	33,871	15,978	. . .	5,567
1963	33,582	11	63	2,600	162	0	36,418	15,513	. . .	5,578
1964	36,506	538	186	2,606	94	0	39,930	15,388	. . .	5,405
1965	40,478	290	137	2,248	187	0	43,340	13,733	. . .	5,575
1966	43,655	661	173	2,495	193	0	47,177	13,159	. . .	6,317
1967	48,980	170	141	2,576	164	0	52,031	11,982	. . .	6,784
1968	52,937	0	186	3,443	58	0	56,624	10,367	. . .	6,795
1969	57,154	0	183	3,440	64	2,743	64,584	10,367	. . .	6,852
1970	62,142	0	335	4,261	57	1,123	67,918	10,732	400	7,147
1971	69,481	1,323	39	4,343	261	1,068	76,515	10,132	400	7,710
1972	71,119	111	1,981	3,974	106	1,260	78,551	10,410	400	8,313
1973	80,395	100	1,258	3,099	68	1,152	86,072	11,567	400	8,716
1974	84,760	954	299	2,001	999	3,195	92,208	11,652	400	9,253
1975	92,789	1,335	211	3,688	1,126	3,312	102,461	11,599	500	10,218
1976	100,062	4,031	25	2,601	991	3,182	110,892	11,598	1,200	10,810
1977	108,922	2,352	265	3,810	954	2,442	118,745	11,718	1,250	11,331
1978	117,374	1,217	1,174	6,432	587	4,543	131,327	11,671	1,300	11,831
1979	124,507	1,660	1,454	6,767	704	5,613	140,705	11,172	1,800	13,083
1980	128,038	2,554	1,809	4,467	776	8,739	146,383	11,160	2,518	13,427
1981	136,863	3,485	1,601	1,762	195	9,230	153,136	11,151	3,318	13,687
1982	144,544	4,293	717	2,735	1,480	9,890	63,659	11,148	4,618	13,786
1983	159,203	1,592	918	1,605	418	8,728	172,464	11,121	4,618	15,732

NOTE: For a description of figures and discussion of their significance, see *Banking and Monetary Statistics, 1941–1970* (Board of Governors of the Federal Reserve System, 1976), pp. 507–23.

Components may not sum to totals because of rounding.

1. In 1969 and thereafter, includes securities loaned—fully guaranteed by U.S. government securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale–purchase transactions. On September 29, 1971, and thereafter, includes federal agency issues bought outright.

2. On December 1, 1966, and thereafter, includes federal agency obligations held under repurchase agreements.

3. In 1960 and thereafter, figures reflect a minor change in concept; see *Federal Reserve Bulletin,* vol. 47 (February 1961), p. 164.

4. Principally acceptances and, until August 21, 1959, industrial loans, the authority for which expired on that date.

5. For the period before April 16, 1969, includes the total of Federal Reserve capital paid in, surplus, other capital accounts, and other liabilities and accrued dividends, less the sum of bank premises and other assets, and is reported as "Other Federal Reserve accounts"; thereafter, "Other Federal Reserve assets" and "Other Federal Reserve liabilities and capital" are shown separately.

6. Before January 30, 1934, includes gold held in Federal Reserve Banks and in circulation.

7. Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are fractional and dollar coins. For details see "U.S. Currency and Coin Outstanding and in Circulation," *Treasury Bulletin*.

6B.—Continued

Factors absorbing reserve funds								Member bank reserves[9]			
Currency in circulation	Treasury cash holdings[8]	Deposits with Federal Reserve Banks, other than reserve balances			Other Federal Reserve accounts[5]	Required clearing balances	Other Federal Reserve liabilities and capital[5]				
		Treasury	Foreign	Other				With Federal Reserve Banks	Currency and coin[10]	Required[11]	Excess[11, 12]
32,869	377	485	217	533	941	0	0	17,081	2,544	18,988	637
33,918	422	465	279	320	1,044	0	0	17,387	2,544	18,988	96
35,338	380	597	247	393	1,007	0	0	17,454	3,262	20,071	645
37,692	361	880	171	291	1,065	0	0	17,049	4,099	20,677	471
39,619	612	820	229	321	1,036	0	0	18,086	4,151	21,663	574
42,056	760	668	150	355	211	0	0	18,447	4,163	22,848	–238
44,663	1,176	416	174	588	–147	0	0	19,779	4,310	24,321	–232
47,226	1,344	1,123	135	563	–773	0	0	21,092	4,631	25,905	–182
50,961	695	703	216	747	–1,353	0	0	21,818	4,921	27,439	–700
53,950	596	1,312	134	807	0	0	1,919	22,085	5,187	28,173	–901
57,903	431	1,156	148	1,233	0	0	1,986	24,150	5,423	30,033	–460
61,068	460	2,020	294	999	0	0	2,131	27,788	5,743	32,496	1,035
66,516	345	1,855	325	840	0	0	2,143	25,647	6,216	32,044	98[12]
72,497	317	2,542	251	1,419[13]	0	0	2,669	27,060	6,781	35,268	–1,360
79,743	185	2,113	418	1,275[13]	0	0	2,935	25,843	7,370	37,011	–3,798
86,547	483	7,285	353	1,090	0	0	2,968	26,052	8,036	35,197	–1,103[14]
93,717	460	10,393	352	1,357	0	0	3,063	25,158	8,628	35,461	–1,535
103,811	392	7,114	379	1,187	0	0	3,292	26,870	9,421	37,615	–1,265
114,645	240	4,196	368	1,256	0	0	4,275	31,152	10,538	42,694	–893
125,600	494	4,075	429	1,412	0	0	4,957	29,792	11,429	44,217	–2,835
136,829	441	3,062	411	617	0	0	4,671	27,456	13,654	40,558	675
144,774	443	4,301	505	781	0	117	5,261	25,111	15,576	42,145	–1,442
154,908	429	5,033	328	1,033	0	436	4,990	26,053	16,666	41,391	1,328
171,935	479	3,661	191	851	0	1,013	5,392	20,413	17,821	39,179	–945

8. Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

9. In November 1979 and thereafter, includes reserves of member banks, Edge Act corporations, and U.S. agencies and branches of foreign banks. On November 13, 1980, and thereafter, includes reserves of all depository institutions.

10. Between December 1, 1959, and November 23, 1960, part was allowed as reserves; thereafter, all was allowed.

11. Estimated through 1958. Before 1929, data were available only on call dates (in 1920 and 1922 the call date was December 29). Since September 12, 1968, the amount has been based on close-of-business figures for the reserve period two weeks before the report date.

12. For the week ending November 15, 1972, and thereafter, includes $450 million of reserve deficiencies on which Federal Reserve Banks are allowed to waive penalties for a transition period in connection with bank adaptation to Regulation J as amended, effective November 9, 1972. Allowable deficiencies are as follows (beginning with first statement week of quarter, in millions): 1973—Q1, $279; Q2, $172; Q3, $112; Q4, $84; 1974—Q1, $67; Q2, $58. The transition period ended with the second quarter of 1974.

13. For the period before July 1973, includes certain deposits of domestic nonmember banks and foreign-owned banking institutions held with member banks and redeposited in full with Federal Reserve Banks in connection with voluntary participation by nonmember institutions in the Federal Reserve System program of credit restraint.

As of December 12, 1974, the amount of voluntary nonmember bank and foreign-agency and branch deposits at Federal Reserve Banks that are associated with marginal reserves is no longer reported. However, two amounts are reported: (1) deposits voluntarily held as reserves by agencies and branches of foreign banks operating in the United States and (2) Eurodollar liabilities.

14. Adjusted to include waivers of penalties for reserve deficiencies, in accordance with change in Board policy, effective November 19, 1975.

. . . Not applicable.

7. Principal Assets and Liabilities of Insured Commercial Banks, by Class of Bank, June 30, 2006 and 2005

Millions of dollars, except as noted

Item	Total	Member banks			Nonmember banks
		Total	National	State	
	2006				
ASSETS					
Loans and investments	6,782,584	5,298,487	4,224,793	1,073,694	1,484,097
Loans, gross	5,177,276	4,018,755	3,218,246	800,509	1,158,520
Net	5,175,292	4,017,598	3,217,313	800,285	1,157,693
Investments	1,605,308	1,279,731	1,006,547	273,184	325,576
U.S. Treasury and federal agency securities	285,687	162,185	102,455	59,730	123,502
Other	1,319,621	1,117,546	904,092	213,454	202,075
Cash assets, total	277,134	219,429	182,292	37,137	57,704
LIABILITIES					
Deposits, total	5,255,716	3,987,644	3,185,042	802,603	1,268,072
Interbank	88,201	74,038	60,177	13,861	14,163
Other transaction	679,778	485,240	386,663	98,577	194,538
Other nontransaction	4,487,738	3,428,366	2,738,202	690,164	1,059,372
Equity capital	949,489	760,868	624,281	136,587	188,621
Number of banks	7,453	2,672	1,776	896	4,781
	2005				
ASSETS					
Loans and investments	6,253,909	4,891,946	3,885,394	1,006,552	1,361,963
Loans, gross	4,713,929	3,690,671	2,955,356	735,315	1,023,258
Net	4,712,060	3,689,551	2,954,491	735,060	1,022,510
Investments	1,539,980	1,201,275	930,038	271,238	338,705
U.S. Treasury and federal agency securities	300,837	182,559	120,732	61,827	118,278
Other	1,239,144	1,018,717	809,306	209,411	220,427
Cash assets, total	262,672	209,055	172,007	37,048	53,618
LIABILITIES					
Deposits, total	4,844,523	3,691,818	2,941,861	749,958	1,152,704
Interbank	80,546	66,730	55,023	11,707	13,816
Other transaction	702,873	504,424	396,555	107,869	198,449
Other nontransaction	4,061,104	3,120,664	2,490,283	630,381	940,440
Equity capital	872,023	700,699	570,770	129,929	171,324
Number of banks	7,527	2,762	1,862	900	4,765

NOTE: Includes U.S.-insured commercial banks located in the United States but not U.S.-insured commercial banks operating in U.S. territories or possessions. Data are domestic assets and liabilities (except for those components reported on a consolidated basis only). Components may not sum to totals because of rounding.

8. Initial Margin Requirements under Regulations T, U, and X

Percent of market value

Effective date	Margin stocks	Convertible bonds	Short sales, T only[1]
1934, Oct. 1	25–45	. . .	. . .
1936, Feb. 1	25–55	. . .	. . .
Apr. 1	55	. . .	. . .
1937, Nov. 1	40	. . .	50
1945, Feb. 5	50	. . .	50
July 5	75	. . .	75
1946, Jan. 21	100	. . .	100
1947, Feb. 1	75	. . .	75
1949, Mar. 3	50	. . .	50
1951, Jan. 17	75	. . .	75
1953, Feb. 20	50	. . .	50
1955, Jan. 4	60	. . .	60
Apr. 23	70	. . .	70
1958, Jan. 16	50	. . .	50
Aug. 5	70	. . .	70
Oct. 16	90	. . .	90
1960, July 28	70	. . .	70
1962, July 10	50	. . .	50
1963, Nov. 6	70	. . .	70
1968, Mar. 11	70	50	70
June 8	80	60	80
1970, May 6	65	50	65
1971, Dec. 6	55	50	55
1972, Nov. 24	65	50	65
1974, Jan. 3	50	50	50

NOTE: These regulations, adopted by the Board of Governors pursuant to the Securities Exchange Act of 1934, limit the amount of credit that may be extended for the purpose of purchasing or carrying ‘‘margin securities’’ (as defined in the regulations) when the loan is collateralized by such securities. The margin requirement, expressed as a percentage, is the difference between the market value of the securities being purchased or carried (100 percent) and the maximum loan value of the collateral as prescribed by the Board. Regulation T was adopted effective October 1, 1934; Regulation U, effective May 1, 1936; and Regulation X, effective November 1, 1971. The former Regulation G, which was adopted effective March 11, 1968, was merged into Regulation U, effective April 1, 1998.

1. From October 1, 1934, to October 31, 1937, the requirement was the margin ‘‘customarily required’’ by brokers and dealers.

9. Statement of Condition of the Federal Reserve Banks, by Bank, December 31, 2006 and 2005

Millions of dollars

Item	Total 2006	Total 2005	Boston 2006	Boston 2005
Assets				
Gold certificate account	11,037	11,039	486	510
Special drawing rights certificate account	2,200	2,200	115	115
Coin	801	686	27	31
Loans				
To depository institutions	67	72	10	2
Securities purchased under agreements to resell (triparty)	40,750	46,750	0	0
U.S. Treasury securities				
Bought outright[1]	778,915	744,215	37,169	38,076
Held under repurchase agreements	0	0	0	0
Total loans and securities	819,731	791,036	37,178	38,078
Items in process of collection	4,276	6,834	97	368
Bank premises	1,953	1,827	117	112
Other assets				
Denominated in foreign currencies[2]	20,482	18,928	491	2,405
Other[3]	18,015	18,579	782	792
Interdistrict settlement account	0	0	124	–3,268
Total assets	**878,494**	**851,130**	**39,416**	**39,143**
Liabilities				
Federal Reserve notes outstanding (issued to Bank)	958,680	906,511	39,020	38,971
Less: Notes held by Federal Reserve Bank	175,661	148,152	3,020	4,424
Federal Reserve notes, net	783,019	758,359	36,000	34,548
Securities sold under agreements to repurchase	29,615	30,505	1,413	1,561
Deposits				
Depository institutions	18,699	19,043	549	622
U.S. Treasury, general account	4,708	4,573	0	0
Foreign, official accounts	98	83	1	5
Other[4]	1,496	2,168	42	1,068
Total deposits	25,002	25,867	592	1,695
Deferred credit items	4,602	5,943	352	488
Other liabilities and accrued dividends[5]	5,608	4,019	267	218
Total liabilities	**847,846**	**824,693**	**38,624**	**38,510**
Capital Accounts				
Capital paid in	15,324	13,536	396	317
Surplus (including accumulated other comprehensive income)	15,324	12,901	396	317
Total liabilities and capital accounts	**878,494**	**851,130**	**39,416**	**39,143**
Federal Reserve Note Statement				
Federal Reserve notes outstanding	958,680	906,511	...	...
Less: Held by Banks not subject to collateralization	175,661	148,152	...	...
Collateralized Federal Reserve notes	**783,019**	**758,359**	...	...
Collateral for Federal Reserve notes				
Gold certificate account	11,037	11,039	...	...
Special drawing rights certificate account	2,200	2,200	...	...
Other eligible assets	0	0	...	...
U.S. Treasury and federal agency securities	769,782	745,120	...	...
Total collateral	**783,019**	**758,359**	...	...

For notes see end of table.

9.—Continued

New York		Philadelphia		Cleveland		Richmond	
2006	2005	2006	2005	2006	2005	2006	2005
4,139	4,357	463	432	446	453	853	836
874	874	83	83	104	104	147	147
47	47	53	34	73	55	78	66
0	0	0	0	0	0	0	1
40,750	46,750	0	0	0	0	0	0
288,297	295,107	33,817	26,401	33,633	31,439	64,704	56,796
0	0	0	0	0	0	0	0
329,047	341,857	33,817	26,401	33,633	31,439	64,704	56,797
70	625	649	586	451	820	237	225
212	207	58	53	158	158	170	153
5,707	5,514	1,152	473	1,569	1,712	5,625	3,454
7,099	8,740	1,055	672	759	718	1,502	1,341
–29,471	–45,332	836	6,148	–2,264	833	4,858	8,521
317,724	**316,889**	**38,166**	**34,883**	**34,929**	**36,293**	**78,174**	**71,540**
341,947	327,194	38,658	37,426	36,516	36,539	75,090	69,647
56,821	43,521	6,957	6,130	6,709	5,081	11,394	11,887
285,126	283,673	31,700	31,296	29,807	31,457	63,695	57,759
10,961	12,096	1,286	1,082	1,279	1,289	2,460	2,328
6,609	6,389	584	485	954	658	2,748	3,182
4,708	4,573	0	0	0	0	0	0
69	55	2	1	3	4	11	7
821	523	1	4	32	82	121	146
12,207	11,539	587	490	990	743	2,880	3,336
111	797	718	363	405	581	384	509
1,864	1,414	255	164	275	196	569	359
310,270	**309,519**	**34,547**	**33,395**	**32,756**	**34,266**	**69,987**	**64,291**
3,727	3,685	1,810	744	1,087	1,013	4,093	3,942
3,727	3,685	1,810	744	1,087	1,013	4,093	3,307
317,724	**316,889**	**38,166**	**34,883**	**34,929**	**36,293**	**78,174**	**71,540**
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9. Statement of Condition of the Federal Reserve Banks, by Bank, December 31, 2006 and 2005—Continued

Millions of dollars

Item	Atlanta		Chicago	
	2006	2005	2006	2005
ASSETS				
Gold certificate account	1,023	945	947	928
Special drawing rights certificate account	166	166	212	212
Coin	93	89	100	76
Loans				
To depository institutions	3	7	24	27
Securities purchased under agreements to resell (triparty)	0	0	0	0
U.S. Treasury securities				
Bought outright[1]	65,208	57,576	71,520	67,020
Held under repurchase agreements	0	0	0	0
Total loans and securities	65,211	57,583	71,544	67,047
Items in process of collection	324	1,281	241	414
Bank premises	232	232	206	211
Other assets				
Denominated in foreign currencies[2]	1,382	830	1,357	1,228
Other[3]	1,430	1,276	1,481	1,386
Interdistrict settlement account	12,404	10,086	–3,742	1,908
Total assets	**82,264**	**72,489**	**72,346**	**73,408**
LIABILITIES				
Federal Reserve notes outstanding (issued to Banks)	98,175	84,653	79,818	76,740
Less: Notes held by Federal Reserve Banks	23,938	19,039	14,202	10,216
Federal Reserve notes, net	74,237	65,614	65,616	66,524
Securities sold under repurchase agreements	2,479	2,360	2,719	2,747
Deposits				
Depository institutions	1,980	1,626	1,395	1,591
U.S. Treasury, general account	0	0	0	0
Foreign, official accounts	3	2	3	3
Other[4]	63	13	105	72
Total deposits	2,046	1,641	1,503	1,665
Deferred credit items	473	763	276	349
Other liabilities and accrued dividends[5]	476	326	515	371
Total liabilities	**79,711**	**70,704**	**70,630**	**71,656**
CAPITAL ACCOUNTS				
Capital paid in	1,276	892	858	876
Surplus (including accumulated other comprehensive income)	1,276	892	858	876
Total liabilities and capital accounts	**82,264**	**72,489**	**72,346**	**73,408**

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

1. Includes securities loaned—fully guaranteed by U.S. Treasury securities pledged with Federal Reserve Banks—and excludes securities purchased under agreements to resell.

2. Valued daily at market exchange rates.

3. The System total includes depository institution overdrafts of $2 million for 2006 and 2005.

9.—Continued

St. Louis		Minneapolis		Kansas City		Dallas		San Francisco	
2006	2005	2006	2005	2006	2005	2006	2005	2006	2005
328	327	211	212	324	318	575	549	1,242	1,172
71	71	30	30	66	66	98	98	234	234
39	43	31	22	62	61	81	68	117	94
0	0	22	16	7	11	0	3	1	5
0	0	0	0	0	0	0	0	0	0
24,747	23,094	15,835	15,543	22,808	21,050	34,957	36,654	86,218	75,459
0	0	0	0	0	0	0	0	0	0
24,747	23,094	15,857	15,560	22,815	21,060	34,957	36,657	86,219	75,464
196	217	219	339	560	591	348	535	884	834
80	70	116	119	159	84	260	261	185	165
223	379	380	409	271	246	236	217	2,089	2,062
552	524	348	338	480	441	751	786	1,777	1,563
1,807	2,010	–237	38	4,734	2,422	3,537	–2,693	7,414	19,327
28,045	**26,735**	**16,955**	**17,067**	**29,469**	**25,290**	**40,844**	**36,477**	**100,160**	**100,916**
29,169	28,096	17,442	17,854	30,770	27,832	57,150	50,474	114,925	111,084
3,175	3,494	2,549	2,789	3,717	5,016	19,391	17,163	23,787	19,391
25,994	24,602	14,893	15,065	27,053	22,816	37,759	33,311	91,138	91,694
941	947	602	637	867	863	1,329	1,502	3,278	3,093
434	482	455	388	546	655	705	811	1,741	2,154
0	0	0	0	0	0	0	0	0	0
0	1	1	1	1	1	0	0	4	4
24	108	18	25	32	22	37	31	200	74
458	591	474	414	579	678	742	843	1,946	2,232
103	151	288	353	435	457	306	303	749	830
217	156	147	107	183	128	284	212	556	369
27,713	**26,447**	**16,404**	**16,576**	**29,117**	**24,941**	**40,420**	**36,172**	**97,667**	**98,218**
166	144	276	245	176	175	212	153	1,247	1,349
166	144	276	245	176	175	212	153	1,247	1,349
28,045	**26,735**	**16,955**	**17,067**	**29,469**	**25,290**	**40,844**	**36,477**	**100,160**	**100,916**

4. Includes international organization deposits of $144 million for 2006 and $125 million for 2005.

5. Includes exchange-translation account reflecting the monthly revaluation at market exchange rates of foreign exchange commitments.

. . . Not applicable.

10. Income and Expenses of the Federal Reserve Banks, by Bank, 2006

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
CURRENT INCOME					
Loans	12,038	551	1,597	14	478
U.S. Treasury securities	36,452,265	1,712,534	14,520,198	1,454,413	1,511,710
Foreign currencies	368,905	12,756	103,272	19,564	28,793
Priced services	908,363	0	65,846	0	0
Compensation received for services provided[1]	572,329	46,466	37,091	32,272	67,696
Other	96,527	2,395	61,125	1,918	2,278
Total	**38,410,427**	**1,774,702**	**14,789,129**	**1,508,181**	**1,610,954**
CURRENT EXPENSES					
Salaries and other personnel expenses	1,407,617	76,544	286,428	67,218	86,172
Retirement and other benefits	427,673	19,968	81,799	22,285	25,881
Net periodic pension benefit expense[2]	65,601	1,071	57,394	374	534
Fees	114,852	2,860	9,949	1,422	4,713
Travel	67,247	2,988	8,717	2,356	4,482
Software expenses	142,574	4,174	18,653	8,775	23,215
Postage and other shipping costs	94,173	1,596	3,489	1,815	5,904
Communications	39,339	2,036	3,193	513	717
Materials and supplies	55,909	3,532	8,945	3,762	5,255
Building expenses					
Taxes on real estate	33,260	4,572	4,841	1,551	1,886
Property depreciation	94,732	5,884	17,604	4,056	7,570
Utilities	38,389	3,653	7,444	2,787	2,550
Rent	42,392	1,261	16,021	371	598
Other	34,195	1,277	6,661	1,775	3,177
Equipment					
Purchases	30,100	2,484	5,507	1,023	1,537
Rentals	4,160	266	1,873	350	233
Depreciation	96,727	4,737	8,600	5,115	5,749
Repairs and maintenance	85,982	5,023	9,559	4,693	6,316
Earnings credit costs	276,389	12,765	80,953	12,508	23,233
Compensation paid for services costs incurred[1]	572,329	0	29,073	0	0
Other	79,957	23,526	57,522	11,633	13,559
Recoveries	–92,292	–13,459	–11,060	–2,409	–3,112
Expenses capitalized[3]	–21,075	–1,270	–9,580	–315	0
Total	**3,690,228**	**165,488**	**703,586**	**151,657**	**220,173**
Reimbursements	–426,384	–23,368	–85,297	–30,547	–59,375
Net expenses	3,263,844	142,120	618,289	121,110	160,798

For notes see end of table.

10.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
412	431	3,031	1,112	2,582	1,159	164	506
2,861,861	2,888,396	3,216,671	1,111,823	721,055	1,021,749	1,621,236	3,810,619
97,807	23,987	24,389	4,364	6,959	4,866	4,254	37,893
0	787,847	54,670	0	0	0	0	0
44,012	469	58,784	21,996	74,126	70,644	59,750	59,024
7,665	4,474	4,488	1,593	910	1,266	1,944	6,472
3,011,757	**3,705,604**	**3,362,033**	**1,140,888**	**805,632**	**1,099,685**	**1,687,348**	**3,914,513**
191,575	129,149	108,688	73,743	74,153	91,041	83,001	139,904
64,130	41,586	32,966	22,130	23,075	22,588	28,771	42,494
760	1,295	402	626	720	762	475	1,187
59,317	8,064	5,974	9,225	1,553	4,189	3,688	3,897
9,829	7,882	6,851	3,591	3,042	4,871	3,911	8,728
53,282	3,460	3,641	7,625	3,230	4,220	4,780	7,518
3,334	57,295	3,954	2,357	2,860	2,053	3,810	5,706
23,241	1,648	1,427	1,279	1,036	1,081	1,514	1,655
5,897	6,709	4,467	2,669	2,440	2,962	4,558	4,714
2,232	3,197	3,507	518	3,153	1,206	3,366	3,230
8,496	9,130	11,083	5,150	4,679	4,166	8,527	8,388
3,621	3,806	2,456	1,734	1,894	794	4,358	3,291
14,272	622	2,423	1,708	251	3,653	159	1,053
3,399	3,925	4,568	1,005	1,472	485	4,016	2,434
6,457	2,455	1,874	1,449	1,730	2,538	1,292	1,754
286	393	300	182	22	42	53	160
35,919	8,747	4,430	3,325	2,759	4,893	5,090	7,364
18,944	10,670	7,009	2,990	2,470	3,212	5,601	9,495
52,610	17,434	26,003	5,100	5,329	8,173	6,080	26,199
0	543,255	0	0	0	0	0	0
–256,628	19,562	42,951	75,530	22,613	17,538	36,101	16,050
–29,564	–3,985	–8,758	–1,867	–1,056	–3,866	–7,025	–6,131
–3,041	0	–456	–2,372	–384	–652	–705	–2,301
268,368	**876,298**	**265,759**	**217,697**	**157,042**	**175,949**	**201,422**	**286,791**
–28,208	–14,613	–4,646	–115,598	–26,347	–10,472	–13,686	–14,226
240,159	861,685	261,113	102,100	130,694	165,476	187,736	272,564

10. Income and Expenses of the Federal Reserve Banks, by Bank, 2006—Continued

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
PROFIT AND LOSS					
Current net income	35,146,583	1,632,582	14,170,841	1,387,071	1,450,157
Additions to and deductions from (–) current net income[4]					
Profits on foreign exchange transactions	1,185,560	31,981	330,788	65,609	91,326
Other additions	7,286	7	23	2	0
Total additions	1,192,847	31,989	330,811	65,610	91,326
Interest expense on reverse repurchase agreements	–1,342,144	–65,129	–505,075	–55,771	–57,659
Other deductions	–9,550	0	0	0	0
Total deductions	–1,351,694	–65,129	–505,075	–55,771	–57,659
Net addition to or deduction from (–) current net income	–158,847	–33,141	–174,264	9,840	33,667
Cost of unreimbursed Treasury services	–2	0	1	–3	0
Assessments by Board					
Board expenditures[5]	301,014	7,379	81,676	21,904	22,535
Cost of currency	491,962	31,062	106,608	29,515	23,255
Net income before payment to U.S. Treasury	34,194,762	1,560,999	13,808,291	1,345,494	1,438,034
Dividends paid	871,255	21,592	221,339	80,190	63,285
Payments to U.S. Treasury (interest on Federal Reserve notes)	29,051,678	1,453,044	11,977,585	175,737	1,279,262
Transferred to/from surplus	4,271,828	86,363	1,609,367	1,089,567	95,487
Adjustments to surplus[6]	–1,848,716	–7,094	–1,567,462	–23,790	–22,222
Surplus, January 1	12,901,176	316,824	3,685,179	744,048	1,013,470
Surplus, December 31	15,324,288	396,093	3,727,084	1,809,826	1,086,735

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

1. During 2005, the Federal Reserve Bank of Atlanta was assigned the overall responsibility for managing the Reserve Banks' provision of check services and recognizes total System check revenue on its Statements of Income. In 2006, this policy was extended to ACH services managed by the Federal Reserve Bank of Atlanta, as well as to Fedwire funds transfer and securitites transfer services, which are managed by the Federal Reserve Bank of New York. The Federal Reserve Bank of Atlanta and the Federal Reserve Bank of New York compensate the other Reserve Banks for the costs incurred in providing these services.

2. Reflects the effect of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). The System Retirement Plan for employees is recorded on behalf of the System on the books of the Federal Reserve Bank of New York, resulting in an increase in expenses of $53,150 thousand. The expenses related to the Retirement Benefit Equalization Plan and the Supplemental Employee Retirement Plan are recorded by each Federal Reserve Bank.

3. Includes expenses for labor and materials capitalized and depreciated or amortized as charges to activities in the periods benefited.

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 chapter "Board of Governors Financial Statements."

6. The implementation of FAS 158 in 2006 required an adjustment in the amount of $1,848,716 thousand to accumulated other comprehensive income, which is reported as a component of surplus.

10.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
2,771,597	2,843,919	3,100,920	1,038,788	674,938	934,209	1,499,612	3,641,949
322,377	79,152	78,502	13,225	22,097	15,658	13,679	121,167
3	20	44	0	0	1,291	0	5,896
322,380	79,172	78,546	13,225	22,097	16,949	13,679	127,063
–109,366	–110,361	–122,680	–42,409	–27,460	–38,987	–61,610	–145,636
0	0	–610	–555	0	–8,386	0	0
–109,367	–110,361	–123,289	–42,964	–27,460	–47,372	–61,610	–145,636
213,013	–31,189	–44,743	–29,738	–5,363	–30,424	–47,931	–18,573
0	0	0	0	0	0	0	0
80,873	20,742	19,585	3,254	5,427	3,874	3,688	30,075
40,241	65,067	51,165	17,276	12,383	17,174	24,924	73,291
2,863,497	2,726,921	2,985,426	988,520	651,765	882,737	1,423,068	3,520,010
240,681	64,625	52,280	9,205	15,064	10,502	11,959	80,533
1,764,199	2,251,659	2,910,601	935,913	594,235	864,852	1,323,733	3,520,859
858,617	410,636	22,546	43,402	42,466	7,382	87,377	-81,382
–72,769	–26,515	–40,756	–21,196	–12,026	–5,795	–28,263	–20,829
3,307,452	892,166	876,301	144,000	245,322	174,757	152,628	1,349,029
4,093,301	1,276,288	858,091	166,206	275,762	176,344	211,742	1,246,817

11. Income and Expenses of the Federal Reserve Banks, 1914–2006

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (–)[1]	Assessments by Board of Governors	
				Board expenditures	Costs of currency
All Banks					
1914–15	2,173	2,018	6	302	. . .
1916	5,218	2,082	–193	192	. . .
1917	16,128	4,922	–1,387	238	. . .
1918	67,584	10,577	–3,909	383	. . .
1919	102,381	18,745	–4,673	595	. . .
1920	181,297	27,549	–3,744	710	. . .
1921	122,866	33,722	–6,315	741	. . .
1922	50,499	28,837	–4,442	723	. . .
1923	50,709	29,062	–8,233	703	. . .
1924	38,340	27,768	–6,191	663	. . .
1925	41,801	26,819	–4,823	709	. . .
1926	47,600	24,914	–3,638	722	1,714
1927	43,024	24,894	–2,457	779	1,845
1928	64,053	25,401	–5,026	698	806
1929	70,955	25,810	–4,862	782	3,099
1930	36,424	25,358	–93	810	2,176
1931	29,701	24,843	311	719	1,479
1932	50,019	24,457	–1,413	729	1,106
1933	49,487	25,918	–12,307	800	2,505
1934	48,903	26,844	–4,430	1,372	1,026
1935	42,752	28,695	–1,737	1,406	1,477
1936	37,901	26,016	486	1,680	2,178
1937	41,233	25,295	–1,631	1,748	1,757
1938	36,261	25,557	2,232	1,725	1,630
1939	38,501	25,669	2,390	1,621	1,356
1940	43,538	25,951	11,488	1,704	1,511
1941	41,380	28,536	721	1,840	2,588
1942	52,663	32,051	–1,568	1,746	4,826
1943	69,306	35,794	23,768	2,416	5,336
1944	104,392	39,659	3,222	2,296	7,220
1945	142,210	41,666	–830	2,341	4,710
1946	150,385	50,493	–626	2,260	4,482
1947	158,656	58,191	1,973	2,640	4,562
1948	304,161	64,280	–34,318	3,244	5,186
1949	316,537	67,931	–12,122	3,243	6,304
1950	275,839	69,822	36,294	3,434	7,316
1951	394,656	83,793	–2,128	4,095	7,581
1952	456,060	92,051	1,584	4,122	8,521
1953	513,037	98,493	–1,059	4,100	10,922
1954	438,486	99,068	–134	4,175	6,490
1955	412,488	101,159	–265	4,194	4,707
1956	595,649	110,240	–23	5,340	5,603
1957	763,348	117,932	–7,141	7,508	6,374
1958	742,068	125,831	124	5,917	5,973
1959	886,226	131,848	98,247	6,471	6,384

For notes see end of table.

11.—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

11. Income and Expenses of the Federal Reserve Banks, 1914–2006—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
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
1970	3,877,218	276,572	11,442	21,228	23,574
1971	3,723,370	319,608	94,266	32,634	24,943
1972	3,792,335	347,917	–49,616	35,234	31,455
1973	5,016,769	416,879	–80,653	44,412	33,826
1974	6,280,091	476,235	–78,487	41,117	30,190
1975	6,257,937	514,359	–202,370	33,577	37,130
1976	6,623,220	558,129	7,311	41,828	48,819
1977	6,891,317	568,851	–177,033	47,366	55,008
1978	8,455,309	592,558	–633,123	53,322	60,059
1979	10,310,148	625,168	–151,148	50,530	68,391
1980	12,802,319	718,033	–115,386	62,231	73,124
1981	15,508,350	814,190	–372,879	63,163	82,924
1982	16,517,385	926,034	–68,833	61,813	98,441
1983	16,068,362	1,023,678	–400,366	71,551	152,135
1984	18,068,821	1,102,444	–412,943	82,116	162,606
1985	18,131,983	1,127,744	1,301,624	77,378	173,739
1986	17,464,528	1,156,868	1,975,893	97,338	180,780
1987	17,633,012	1,146,911	1,796,594	81,870	170,675
1988	19,526,431	1,205,960	–516,910	84,411	164,245
1989	22,249,276	1,332,161	1,254,613	89,580	175,044
1990	23,476,604	1,349,726	2,099,328	103,752	193,007
1991	22,553,002	1,429,322	405,729	109,631	261,316
1992	20,235,028	1,474,531	–987,788	128,955	295,401
1993	18,914,251	1,657,800	–230,268	140,466	355,947
1994	20,910,742	1,795,328	2,363,862	146,866	368,187
1995	25,395,148	1,818,416	857,788	161,348	370,203
1996	25,164,303	1,947,861	–1,676,716	162,642	402,517
1997	26,917,213	1,976,453	–2,611,570	174,407	364,454
1998	28,149,477	1,833,436	1,906,037	178,009	408,544
1999	29,346,836	1,852,162	–533,557	213,790	484,959
2000	33,963,992	1,971,688	–1,500,027	188,067	435,838
2001	31,870,721	2,084,708	–1,117,435	295,056	338,537
2002	26,760,113	2,227,078	2,149,328	205,111	429,568
2003	23,792,725	2,462,658	2,481,127	297,020	508,144
2004	23,539,942	2,238,705	917,870	272,331	503,784
2005	30,729,357	2,889,544	–3,576,903	265,742	477,087
2006	38,410,427	3,263,844	–158,846	301,014	491,962
Total, 1914–2006	**710,889,641**	**53,347,257**	**4,041,796**	**4,704,801**	**8,832,012**

11.—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		
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
41,137	. . .	3,493,571	. . .	32,580
43,488	. . .	3,356,560	. . .	40,403
46,184	. . .	3,231,268	. . .	50,661
49,140	. . .	4,340,680	. . .	51,178
52,580	. . .	5,549,999	. . .	51,483
54,610	. . .	5,382,064	. . .	33,828
57,351	. . .	5,870,463	. . .	53,940
60,182	. . .	5,937,148	. . .	45,728
63,280	. . .	7,005,779	. . .	47,268
67,194	. . .	9,278,576	. . .	69,141
70,355	. . .	11,706,370	. . .	56,821
74,574	. . .	14,023,723	. . .	76,897
79,352	. . .	15,204,591	. . .	78,320
85,152	. . .	14,228,816	. . .	106,663
92,620	. . .	16,054,095	. . .	161,996
103,029	. . .	17,796,464	. . .	155,253
109,588	. . .	17,803,895	. . .	91,954
117,499	. . .	17,738,880	. . .	173,771
125,616	. . .	17,364,319	. . .	64,971
129,885	. . .	21,646,417	. . .	130,802
140,758	. . .	23,608,398	. . .	180,292
152,553	. . .	20,777,552	. . .	228,356
171,763	. . .	16,774,477	. . .	402,114
195,422	. . .	15,986,765	. . .	347,583
212,090	. . .	20,470,011	. . .	282,122
230,527	. . .	23,389,367	. . .	283,075
255,884	5,517,716	14,565,624	. . .	635,343
299,652	20,658,972	0	. . .	831,705
343,014	17,785,942	8,774,994	. . .	731,575
373,579	. . .	25,409,736	. . .	479,053
409,614	. . .	25,343,892	. . .	4,114,865
428,183	. . .	27,089,222	. . .	517,580
483,596	. . .	24,495,490	. . .	1,068,598
517,705	. . .	22,021,528	. . .	466,796
582,402	. . .	18,078,003	. . .	2,782,587
780,863	. . .	21,467,545	. . .	1,271,672
871,255	. . .	29,051,678	. . .	4,271,828
8,738,777	**44,113,958**	**573,927,960**	**–4**	**21,266,676** [3]

11. Income and Expenses of the Federal Reserve Banks, 1914–2006—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
Aggregate for each Bank, 1914–2006					
Boston	37,823,486	3,416,852	-48,223	207,260	518,973
New York	249,731,575	8,384,931[4]	833,624	1,168,193	2,781,090
Philadelphia	26,369,964	2,776,143	112,671	198,455	375,069
Cleveland	42,583,372	3,269,494	297,125	342,922	512,316
Richmond	54,923,061	4,585,203	691,529	669,078	725,744
Atlanta	40,448,737	6,527,615	290,459	350,725	659,959
Chicago	85,257,610	6,465,618	613,784	525,507	1,005,353
St. Louis	24,240,701	2,597,202	42,722	115,126	321,728
Minneapolis	12,223,622	2,549,119	129,352	140,300	156,232
Kansas City	25,486,625	3,401,053	103,704	146,764	321,689
Dallas	32,411,865	3,448,353	338,948	218,444	437,554
San Francisco	79,389,024	5,925,674	636,099	622,028	1,016,305
Total	**710,889,641**	**53,347,257**	**4,041,796**	**4,704,801**	**8,832,012**

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 through 1932; transfers made under section 13b of the Federal Reserve Act from 1935 through 1947; and transfers made under section 7 of the Federal Reserve Act for 1996 and 1997.

11.—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		
410,646	2,579,504	30,051,671	135	590,222
2,176,006	17,307,161	212,590,458	–433	6,157,793
407,602	1,312,118	19,437,229	291	1,975,729
649,488	2,827,043	33,884,049	–10	1,395,195
1,403,928	3,083,928	39,972,837	–72	5,173,944
617,505	2,713,230	28,273,211	5	1,596,946
916,679	4,593,811	71,087,653	12	1,276,762
208,306	1,833,837	18,917,298	–27	289,952
256,828	416,227	8,400,348	65	433,854
248,040	1,249,703	19,924,327	–9	298,763
350,811	1,510,802	26,405,056	55	379,737
1,092,938	4,686,594	64,983,822	–17	1,697,779
8,738,777	**44,113,958**	**573,927,960**	**–4**	**21,266,676**[3]

3. The $21,266,676 thousand transferred to surplus was reduced by direct charges of $500 thousand for charge-off on Bank premises (1927), $139,300 thousand for contributions to capital of the Federal Deposit Insurance Corporation (1934), $4 thousand net upon elimination of section 13b surplus (1958), and $106,000 thousand (1996), $107,000 thousand (1997), and $3,752,000 thousand (2000) transferred to the Treasury as statutorily required; and was increased by transfer of $11,131 thousand from reserves for contingencies (1955). The implementation of FAS 158 in 2006 required an adjustment to accumulated other comprehensive income of $1,848,716 thousand, which is reported as a component of surplus, leaving a balance of $15,324,288 thousand on December 31, 2006.

4. This amount is reduced by $2,717,806 thousand for expenses of the System Retirement Plan. See note 2, table 10.

. . . Not applicable.

12. Operations in Principal Departments of the Federal Reserve Banks, 2003–2006

Operation	2006	2005	2004	2003
Millions of pieces				
Currency processed	37,694	36,463	36,242	34,832
Currency destroyed	6,766	6,551	6,748	7,375
Coin received	59,705	56,080	55,655	48,138
Checks handled				
U.S. government checks	192	215	234	267
Postal money orders	171	176	187	198
All other	10,983	12,195	13,904	15,806
Securities transfers[1]	22	22	20	20
Funds transfers	134	132	125	123
Automated clearinghouse transactions				
Commercial	8,231	7,339	6,486	5,588
Government	992	964	941	914
Millions of dollars				
Currency processed	664,592	639,832	625,127	584,915
Currency destroyed	84,742	83,187	90,943	101,338
Coin received	5,779	5,412	5,403	4,879
Checks handled				
U.S. government checks	231,314	250,865	277,649	308,055
Postal money orders	28,066	28,395	29,045	29,197
All other	13,628,348	14,379,874	14,287,740	15,431,625
Securities transfers[1]	377,258,592	368,896,819	313,425,252	267,644,194
Funds transfers[2]	572,645,790	**518,546,733**	**478,946,947**	**447,341,692**
Automated clearinghouse transactions				
Commercial	13,124,434	12,801,914	12,543,907	13,951,600
Government	3,474,364	3,156,556	2,913,189	2,810,283

1. The title of this category has changed from previous years, but the composition of the category is the same; therefore, the data here are comparable with data reported in previous years.

2. Amounts in bold are restatements.

13. Number and Annual Salaries of Officers and Employees of the Federal Reserve Banks, December 31, 2006

Federal Reserve Bank (including Branches)	President[1]	Other officers		Employees			Total	
	Salary (dollars)[2]	Number	Salaries (dollars)[2]	Number, Full-time	Number, Part-time	Salaries (dollars)[2]	Number	Salaries (dollars)[2]
Boston	374,100	62	10,567,765	837	70	57,522,048	970	68,463,913
New York	381,000	279	54,289,191	2,454	54	198,746,036	2,791	254,007,727
Philadelphia	276,500	56	8,595,200	982	34	53,274,392	1,073	62,146,092
Cleveland	281,400	60	9,200,500	1,491	34	72,454,563	1,586	81,936,463
Richmond	276,500	72	10,764,700	1,681	40	95,642,478	1,794	106,683,678
Atlanta	Vacant[3]	78	12,948,880	1,912	40	106,293,498	2,031	119,242,378
Chicago	374,100	86	13,118,406	1,310	59	84,242,032	1,456	97,734,538
St. Louis	311,000	75	10,910,680	954	58	53,627,203	1,088	64,848,883
Minneapolis	374,100	43	6,422,280	1,155	101	62,186,058	1,300	68,982,438
Kansas City	340,600	73	11,504,000	1,218	19	67,284,920	1,311	79,129,520
Dallas	276,500	53	8,337,504	1,219	18	65,143,411	1,291	73,757,415
San Francisco	326,900	75	13,691,634	1,656	28	111,625,788	1,760	125,644,322
Federal Reserve Information Technology	...	39	5,947,200	719	6	59,314,205	764	65,261,405
Office of Employee Benefits	...	8	1,618,400	33	0	2,669,126	41	4,287,526
Total	**3,592,700**	**1,059**	**177,916,340**	**17,621**	**561**	**1,090,025,758**	**19,256**	**1,272,126,298**

1. Under current policies, the appointment salaries of Federal Reserve Bank presidents are normally 85 percent of the salary-range midpoint (an 85 compa-ratio), with the exception of the New York Reserve Bank president, whose appointment salary normally is set at a 95 compa-ratio. The Board has discretion to approve a higher starting salary if requested by a Reserve Bank's board of directors.

On January 1 each year, all presidents receive salary increases equal to the percentage increase in the midpoint of their respective salary ranges. In addition, on every third-year anniversary of his or her initial appointment (through year 9), each president receives a salary increase that results in a compa-ratio as follows: year 3, 95 (for the New York Bank, 105); year 6, 105 (New York, 115); year 9, 115 (New York, 125).

There continue to be tiered salary ranges for Reserve Bank officers, including presidents, reflecting differences in the costs of labor in the head-office cities. The Board reviews Reserve Bank officer salary ranges and Reserve Bank placement in the salary tiers annually. In 2006, New York and San Francisco were in tier 1, which had a midpoint for presidents' salaries of $362,900. Boston, Philadelphia, Richmond, Atlanta, Chicago, Minneapolis, and Dallas were in tier 2, which had a midpoint for presidents' salaries of $325,300. Cleveland, St. Louis, and Kansas City were in tier 3, which had a midpoint for presidents' salaries of $296,200.

2. Annualized salary liability based on salaries in effect on December 31, 2006.

3. Atlanta president retired in October 2006.

. . . Not applicable.

14. Acquisition Costs and Net Book Value of the Premises of the Federal Reserve Banks and Branches, December 31, 2006

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	27,293	127,979	28,019	183,290	117,283	. . .
NEW YORK	20,103	254,486	66,929	341,517	211,798	. . .
Buffalo	0	0	0	0	0	. . .
PHILADELPHIA	2,779	84,976	13,545	101,300	57,782	. . .
CLEVELAND	4,219	124,865	25,386	154,470	112,851	. . .
Cincinnati	2,593	32,466	11,624	46,683	24,993	. . .
Pittsburgh	1,739	19,488	14,503	35,730	20,349	. . .
RICHMOND	22,649	107,558	38,279	168,486	118,391	. . .
Baltimore	6,482	29,566	5,828	41,876	24,081	. . .
Charlotte	3,130	31,498	6,847	41,475	27,295	. . .
ATLANTA	22,735	149,625	16,367	188,727	166,998	. . .
Birmingham	5,347	11,744	1,525	18,616	12,323	. . .
Jacksonville	1,730	20,987	3,810	26,527	16,960	48
Miami	4,254	22,143	4,869	31,266	20,746	. . .
Nashville	603	5,690	3,532	9,825	4,843	. . .
New Orleans	3,785	8,827	5,231	17,843	9,924	. . .
CHICAGO	4,512	165,149	20,268	189,929	115,789	. . .
Detroit	9,980	72,293	10,690	92,962	90,657	. . .
ST. LOUIS	8,392	73,386	12,578	94,356	65,315	. . .
Little Rock	0	0	0	0	0	4,106
Louisville	0	0	0	0	0	. . .
Memphis	2,472	14,127	5,164	21,763	14,975	. . .
MINNEAPOLIS	15,666	104,652	13,834	134,153	106,397	. . .
Helena	2,890	9,716	943	13,549	9,587	. . .
KANSAS CITY	29,460	114,121	0	143,580	143,580	. . .
Denver	3,511	9,167	4,502	17,179	8,525	. . .
Oklahoma City	0	108	0	108	108	. . .
Omaha	3,559	7,374	1,726	12,658	6,390	. . .
DALLAS	35,638	111,106	23,715	170,459	123,479	1
El Paso	262	3,584	1,553	5,400	1,616	. . .
Houston	23,754	101,555	8,088	133,397	129,024	7,204
San Antonio	826	7,917	2,674	11,418	6,335	. . .
SAN FRANCISCO	20,129	96,419	22,370	138,919	80,904	. . .
Los Angeles	6,306	71,935	13,009	91,250	57,911	. . .
Portland	0	0	0	0	0	. . .
Salt Lake City	1,294	4,680	1,385	7,360	3,083	. . .
Seattle	8,191	37,798	4,545	50,534	42,639	13
Total	**306,282**	**2,036,985**	**393,340**	**2,736,606**	**1,952,930**	**11,372**

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

1. Includes expenditures for construction at some offices, pending allocation to appropriate accounts.

2. Excludes charge-offs of $17,699 thousand before 1952.

3. Covers acquisitions for banking-house purposes and Bank premises formerly occupied and being held pending sale.

. . . Not applicable.

Federal Reserve System Audits

Audits of the Federal Reserve System

The Board of Governors, the Federal Reserve Banks, and the Federal Reserve System as a whole are all subject to several levels of audit and review. The Board's financial statements, and its compliance with laws and regulations affecting those statements, are audited annually by an outside auditor retained by the Board's Office of Inspector General. The Office of Inspector General also conducts audits, reviews, and investigations relating to the Board's programs and operations as well as to Board functions delegated to the Reserve Banks.

The Reserve Banks' financial statements are audited annually by an independent outside auditor retained by the Board of Governors. In addition, the Reserve Banks are subject to annual examination by the Board. As discussed in the chapter ''Federal Reserve Banks,'' the Board's examination includes a wide range of ongoing oversight activities conducted on and off site by staff of the Board's Division of Reserve Bank Operations and Payment Systems.

Federal Reserve operations are also subject to review by the Government Accountability Office. ■

Board of Governors Financial Statements

The financial statements of the Board for 2006 and 2005 were audited by KPMG LLP, independent auditors.

KPMG

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

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, 2006 and 2005, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows (hereinafter referred to as "financial statements") for the years then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Board's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, 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 of Governors of the Federal Reserve System, as of December 31, 2006 and 2005, and the results of its operations, and its cash flows, for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 3 to the financial statements, in 2006, the Board adopted the provisions of the Financial Accounting Standard Board Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans.*

In accordance with *Government Auditing Standards*, we have also issued our reports dated April 17, 2007, on our consideration of the Board's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in assessing the results of our audits.

KPMG LLP

April 17, 2007

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEETS

	As of December 31, 2006	2005
ASSETS		
CURRENT ASSETS		
Cash	$ 60,030,706	$ 45,970,435
Accounts receivable	2,625,907	3,081,520
Prepaid expenses and other assets	4,260,507	2,992,412
Total current assets	66,917,120	52,044,367
NONCURRENT ASSETS		
Property and equipment, net (Note 4)	151,205,386	155,441,553
Total noncurrent assets	151,205,386	155,441,553
Total assets	$218,122,506	$207,485,920
LIABILITIES AND CUMULATIVE RESULTS OF OPERATIONS		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	$ 10,950,470	$ 16,906,350
Accrued payroll and related taxes	5,421,666	4,860,572
Accrued annual leave	16,334,512	15,456,484
Capital lease payable (current portion)	327,663	270,167
Unearned revenues and other liabilities	366,304	783,711
Total current liabilities	33,400,615	38,277,284
LONG-TERM LIABILITIES		
Capital lease payable (non-current portion)	108,755	406,188
Accumulated retirement benefit obligation (Note 5)	1,354,662	813,497
Accumulated postretirement benefit obligation (Note 6)	8,111,829	6,237,290
Accumulated postemployment benefit obligation (Note 7)	6,515,301	5,111,365
Total long-term liabilities	16,090,547	12,568,340
Total liabilities	49,491,162	50,845,624
CUMULATIVE RESULTS OF OPERATIONS		
Working capital	33,844,168	14,037,250
Unfunded long-term liabilities	(14,325,986)	(12,162,152)
Net investment in property and equipment	150,768,968	154,765,198
Accumulated other comprehensive income (loss) (Note 8)	(1,655,806)	. . .
Total cumulative results of operations	168,631,344	156,640,296
Total liabilities and cumulative results of operations	$218,122,506	$207,485,920

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF REVENUES AND EXPENSES AND CHANGES IN CUMULATIVE RESULTS OF OPERATIONS

	For the years ended December 31, 2006	2005
BOARD OPERATING REVENUES		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures	$301,013,500	$265,742,100
Other revenues (Note 9)	8,508,949	8,520,342
Total operating revenues	309,522,449	274,262,442
BOARD OPERATING EXPENSES		
Salaries	182,239,595	174,523,825
Retirement and insurance	35,853,297	31,847,951
Contractual services and professional fees	23,944,564	24,695,564
Depreciation, amortization, and net losses on disposals	13,058,667	12,954,506
Utilities	9,185,840	9,065,329
Travel	8,820,503	7,613,280
Software	6,637,765	6,052,617
Postage and supplies	4,560,368	7,169,829
Repairs and maintenance	2,634,459	3,361,179
Printing and binding	1,505,470	1,973,594
Other expenses (Note 9)	7,435,067	7,486,158
Total operating expenses	295,875,595	286,743,832
RESULTS OF OPERATIONS	13,646,854	(12,481,390)
ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES		
Assessments levied on Federal Reserve Banks for currency costs	491,962,202	477,087,471
Expenses for currency printing, issuance, retirement, and shipping	491,962,202	477,087,471
CURRENCY ASSESSMENTS OVER (UNDER) EXPENSES	0	0
TOTAL RESULTS OF OPERATIONS	13,646,854	(12,481,390)
CUMULATIVE RESULTS OF OPERATIONS, Beginning of year	156,640,296	169,121,686
OTHER COMPREHENSIVE INCOME		
Adjustment to initially apply FASB Statement No. 158 (Note 8)	(1,655,806)	. . .
Total Other Compehensive Income	(1,655,806)	. . .
CUMULATIVE RESULTS OF OPERATIONS, End of year	$168,631,344	$156,640,296

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF CASH FLOWS

	For the years ended December 31, 2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
RESULTS OF OPERATIONS	$13,646,854	$(12,481,390)
Adjustments to reconcile results of operations to net cash provided by (used in) operating activities:		
Depreciation and net losses on disposals	13,058,667	12,954,506
Increase in assets:		
Accounts receivable, and prepaid expenses and other assets	(812,482)	(362,385)
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	(5,955,880)	3,014,489
Accrued payroll and related taxes	561,094	308,533
Accrued annual leave	878,028	1,260,574
Unearned revenues and other liabilities	(417,407)	316,047
Accumulated retirement benefit obligation	541,165	219,328
Accumulated postretirement benefit obligation	1,874,539	447,724
Accumulated postemployment benefit obligation	1,403,936	(197,200)
Accumulated other comprehensive income	(1,655,806)	...
Net cash provided by operating activities	23,122,708	5,480,226
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from disposals	7,212	2,850
Capital expenditures	(8,829,712)	(19,370,223)
Net cash used in investing activities	(8,822,500)	(19,367,373)
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital lease payments	(239,937)	(249,710)
Net cash used in financing activities	(239,937)	(249,710)
NET INCREASE (DECREASE) IN CASH	14,060,271	(14,136,857)
CASH BALANCE, Beginning of year	45,970,435	60,107,292
CASH BALANCE, End of year	$60,030,706	$ 45,970,435

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED
DECEMBER 31, 2006 AND 2005

(1) Structure

The Federal Reserve System was established by Congress in 1913 and consists of the Board of Governors (Board), the Federal Open Market Committee, the twelve regional Federal Reserve Banks, the Federal Advisory Council, and the private commercial banks that are members of the System. The Board, unlike the Reserve Banks, was established as a federal government agency and is supported by Washington DC based staff numbering approximately 1,800, as it carries out its responsibilities in conjunction with other components of the Federal Reserve System.

The Board is required by the Federal Reserve Act to report its operations to the Speaker of the House of Representatives. The Act also requires the Board, each year, to order a financial audit of each Federal Reserve Bank and to publish each week a statement of the financial condition of each such Reserve Bank and a consolidated statement for all of the Reserve Banks. Accordingly, the Board believes that the best financial disclosure consistent with law is achieved by issuing separate financial statements for the Board and for the Reserve Banks. Therefore, the accompanying financial statements include only the results of operations and activities of the Board. Combined financial statements for the Federal Reserve Banks are included in the Board's annual report to the Speaker of the House of Representatives.

(2) Operations and Services

The Board's responsibilities require thorough analysis of domestic and international financial and economic developments. The Board carries out those responsibilities in conjunction with other components of the Federal Reserve System. The Board also supervises and regulates the operations of the Federal Reserve Banks, exercises broad responsibility in the nation's payments system, and administers most of the nation's laws regarding consumer credit protection. Policy regarding open market operations is established by the Federal Open Market Committee. However, the Board has sole authority over changes in reserve requirements, and it must approve any change in the discount rate initiated by a Federal Reserve Bank.

The Board also plays a major role in the supervision and regulation of the U.S. banking system. It has supervisory responsibilities for state-chartered banks that are members of the Federal Reserve System, bank holding companies, foreign activities of member banks, and U.S. activities of foreign banks.

(3) Significant Accounting Policies

Basis of Accounting—The financial statements have been prepared on the accrual basis of accounting.

Revenues—Assessments for operating expenses and additions to property are based on expected cash needs.

Issuance and Redemption of Federal Reserve Notes—The Board incurs expenses and assesses the Federal Reserve Banks for currency printing, issuance, retirement, and shipping of Federal Reserve Notes. These assessments and expenses are separately reported in the statements of revenues and expenses because they are passed through the Board account and are not Board operating transactions.

Property, Equipment, and Software—The Board's property, buildings, equipment, and software are stated at cost less accumulated depreciation and amortization. Depreciation and amortization is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 3 to 10 years for furniture and equipment, 10 to 50 years for building equipment and structures, and 2 to 10 years for software. Upon the sale or other disposition of a depreciable asset, the cost and related accumulated depreciation or amortization are removed from the accounts and any gain or loss is recognized.

Art Collections—The Board has collections of works of art, historical treasures, and similar assets. These collections are maintained and held for public exhibition in furtherance of public service. Proceeds from any sales of collections are used to acquire other items for collections. As permitted by Statement of Financial Accounting Standards Number 116, *Accounting for Contributions Received and Contributions Made,* the cost of collections purchased by the Board is charged to expense in the year purchased and donated collection items are not recorded. The value of the Board's collections has not been determined.

Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications—Certain 2005 amounts have been reclassified to conform with the 2006 presentation.

Implementation of FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—The Board initially applied the provisions of FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, at December 31, 2006. This accounting standard requires recognition of the overfunded or underfunded status of a defined benefit postretirement plan in the Balance Sheets, and recognition of changes in the funded status in the years in which the changes occur through comprehensive income. The transition rules for implementing the standard require applying the provisions as of the end of the year of initial implementation with no retrospective application.

(4) Property and Equipment

The following is a summary of the components of the Board's property and equipment, at cost, net of accumulated depreciation and amortization.

	As of December 31, 2006	As of December 31, 2005
Land	$ 18,640,314	$ 18,640,314
Buildings and improvements	147,504,169	135,152,735
Furniture and equipment	47,271,434	39,926,270
Software in use	13,681,508	12,415,000
Software in process	941,912	575,050
Construction in process	360,966	13,928,149
	228,400,304	220,637,518
Less accumulated depreciation and amortization	(77,194,918)	(65,195,965)
Property and equipment, net	$151,205,386	$155,441,553

Furniture and equipment includes $1,230,000 each year for capitalized leases as of December 31, 2006 and 2005. Accumulated depreciation includes $867,000 and $612,000 for capitalized leases as of December 31, 2006 and 2005, respectively. The Board paid interest related to these capital leases in the amount of $54,000 and $83,000 for 2006 and 2005, respectively.

Construction in process includes costs incurred in 2006 and 2005 for long-term security projects and building enhancements.

The future minimum lease payments required under the capital leases and the present value of the net minimum lease payments as of December 31, 2006, are as follows:

	Year ending December 31	Amount
	2007	$ 463,491
	2008	138,279
	2009	. . .
Total minimum lease payments		601,770
Less: Amount representing maintenance included in total amounts above		(130,540)
Net minimum lease payments		471,230
Less: Amount representing interest		(34,812)
Present value of net minimum lease payments		436,418
Less: Current maturities of capital lease obligations		(327,663)
Long-term capital lease obligations		$ 108,755

(5) Accumulated Retirement Benefits

The following information provides disclosure requirements contained in Statement of Financial Accounting Standards No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*.

Substantially all of the Board's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). The System Plan is a multi-employer plan which covers employees of the Federal Reserve Banks, the Board, and the Office of Employee Benefits. No separate accounting is maintained of assets contributed by the participating employers. The Federal Reserve Bank of New York acts as a sponsor of the System Plan, and the costs associated with the Plan are not redistributed to other participating employers.

Employees of the Board who became employed prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who became employed after 1983 are covered by a non-contributory defined benefits program under the System Plan. Contributions to the System Plan are actuarially determined and funded by participating employers. Based on actuarial calculations, it was determined that employer funding contributions were not required for the years 2006 and 2005, and the Board was not assessed a contribution for these years. Because the plan is part of a multi-employer plan, information as to vested and non-vested benefits, as well as plan assets, as it relates solely to the Board, is not readily available.

Effective January 1, 1996, Board employees covered under the System Plan are also covered under a Benefits Equalization Plan (BEP). Benefits paid under the BEP are limited to those benefits that cannot be paid from the System Plan due to limitations imposed by Sections 401(a)(17), 415(b), and 415(e) of the Internal Revenue Code of 1986. Activity for the BEP for 2006 and 2005 is summarized in the following table:

	2006	2005
Change in projected benefit obligation		
Benefit obligation at beginning of year	$ 536,339	$ 140,953
Service cost	185,483	193,209
Interest cost	45,004	35,964
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss	596,114	168,027
Benefits paid	(8,278)	(1,814)
Benefit obligation at end of year	$1,354,662	$ 536,339
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	8,278	1,814
Plan participants' contributions	0	0
Benefits paid	(8,278)	(1,814)
Fair value of plan assets at end of year	$ 0	$ 0

	2006	2005
Reconciliation of funded status at end of year		
Funded status	$(1,354,662)	$ (536,339)
Unrecognized net actuarial (gain)/loss	580,386	(15,728)
Unrecognized prior service cost	(247,417)	(261,430)
Unrecognized net transition obligation	0	0
Prepaid/(Accrued) pension cost	$(1,021,693)	$ (813,497)
Amounts recognized in the financial statements consist of		
Prepaid benefit cost	$ 0	$ 0
Accrued benefit liability	(1,021,693)	(813,497)
Intangible asset	0	0
Accumulated other comprehensive income	(332,969)	0
Net amount recognized	$(1,354,662)	$ (813,497)
Information for pension plans with an accumulated benefit obligation in excess of plan asset:		
Projected benefit obligation	$ 1,354,662	$ 536,339
Accumulated benefit obligation	$ 546,854	$ 278,252
Weighted-average assumptions used to determine benefit obligation as of December 31		
Discount rate	5.75%	5.75%
Rate of compensation increase	4.50%	4.50%
Components of net periodic benefit cost		
Service cost—benefits earned during the period	$ 185,483	$ 193,209
Interest cost on projected benefit obligation	45,004	35,964
Expected return on plan assets	0	0
Amortization of prior service cost	(14,013)	(14,013)
Amortization of (gains)/losses	0	5,982
Amortization of initial (asset)/obligation	0	0
Net periodic benefit cost (credit)	$ 216,474	$ 221,142
Additional information:		
Increase in minimum liability included in other comprehensive income	$ 0	$ 0

	2006	2005
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31		
Discount rate	5.75%	5.75%
Rate of compensation increase	4.50%	4.25%

A relatively small number of Board employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). These defined benefit plans are administered by the U.S. Office of Personnel Management, which determines the required employer contribution levels. The Board's contributions to these plans totaled $334,000 and $324,000 in 2006 and 2005, respectively. The Board has no liability for future payments to retirees under these programs and is not accountable for the assets of the plans.

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan. Board contributions to members' accounts are based upon a fixed percentage of each member's basic contribution and were $8,964,000 and $8,617,000 in 2006 and 2005, respectively.

(6) Accumulated Postretirement Benefits

The following information provides disclosure requirements contained in Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

The Board provides certain life insurance programs for its active employees and retirees. Activity for 2006 and 2005 is summarized in the following table:

	2006	2005
Change in benefit obligation		
Benefit obligation at beginning of year	$ 8,273,831	$ 8,404,551
Service cost	230,567	217,421
Interest cost	470,256	437,320
Plan participants' contributions	0	0
Plan amendments	0	(196,970)
Actuarial (gain)/loss	(603,500)	(304,006)
Benefits paid	(259,325)	(284,485)
Benefit obligation at end of year	$ 8,111,829	$ 8,273,831
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contribution	259,325	284,485
Plan participants' contributions	0	0
Benefits paid	(259,325)	(284,485)
Fair value of plan assets at end of year	$ 0	$ 0

	2006	2005
Reconciliation of funded status at end of year		
Benefit obligations	$(8,111,829)	$(8,273,832)
Unrecognized net actuarial (gain)/loss	0	2,145,920
Unrecognized prior service cost	0	(109,378)
Amount recognized at end of year	$(8,111,829)	$(6,237,290)
Amounts recognized in the financial statements consist of:		
Liability	$(8,111,829)	$ 0
Accrued benefit cost	0	(6,237,290)
Accumulated other comprehensive income	0	0
Net amount recognized . .	$(8,111,829)	$(6,237,290)
Amounts recognized in accumulated other comprehensive income consist of:		
Net actuarial loss/ (gain)	$1,422,398	$ 0
Prior service cost/ (credit)	(99,560)	0
Transition obligation/ (asset)	0	0
Deferred curtailment (gain)/loss	0	0
	$1,322,838	$ 0
Expected cash flows		
Expected employer contributions:		
2007	$ 274,901	
Expected benefit payments:		
2007	$ 274,901	
2008	$ 296,030	
2009	$ 325,793	
2010	$ 350,050	
2011	$ 364,265	
2012-2016	$ 2,132,108	

The liability and costs for the postretirement benefit plan were determined using discount rates of 5.75 percent as of December 31, 2006 and 2005. Unrecognized losses of $2,145,920 as of December 31, 2005 result from changes in the discount rate used to measure the liabilities. The assumed salary trend rate for measuring the increase in postretirement benefits related to life insurance was an average of 4.50 percent.

The above accumulated postretirement benefit obligation is related to the Board-sponsored life insurance programs. The Board has no liability for future payments to employees who continue coverage under the federally sponsored life and health programs upon retiring. Contributions for active employees participating in federally sponsored health programs totaled $9,607,000 and $8,933,000 in 2006 and 2005, respectively.

(7) Accumulated Postemployment Benefit Plan

The following information provides disclosure requirements contained in Statement of Financial Accounting Standards No. 112, *Employers' Accounting for Postemployment Benefits*.

The Board provides certain postemployment benefits to eligible former or inactive employees and their dependents during the period subsequent to employment but prior to retirement. Costs were projected using the same discount rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Board for the years ended December 31, 2006 and 2005, were $1,963,000 and $155,800, respectively.

(8) Accumulated Other Comprehensive Income

Following is a reconciliation of beginning and ending balances of accumulated other comprehensive income.

	Amount related to defined benefit retirement plans	Amount related to postretirement benefits other than pensions
Balance January 1, 2006	$(1,021,693)	$(6,788,992)
Adjustment to initially apply Statement No. 158	(332,969)	(1,322,837)
Balance December 31, 2006	$(1,354,662)	$(8,111,829)

	Total accumulated other comprehensive income (loss)
Balance January 1, 2006	$(7,810,685)
Adjustment to initially apply Statement No. 158	(1,655,806)
Balance December 31, 2006	$(9,466,491)

Additional detail regarding the classification of accumulated other comprehensive income is included in note 6.

(9) Other Revenues and Other Expenses

The following are summaries of the components of Other Revenues and Other Expenses.

	For the years ended December 31,	
	2006	2005
Other revenues		
Data processing revenue	$4,180,692	$3,788,217
Rent	2,450,576	2,433,833
Subscription revenue	716,294	782,743
Reimbursable services to other agencies	599,827	664,755
Board sponsored conferences	0	250,650
Miscellaneous	561,560	600,144
Total other revenues	$8,508,949	$8,520,342
Other expenses		
Tuition, registration, and membership fees	$2,676,871	$2,573,028
Contingency operations	1,087,429	956,476
Public transportation subsidy	988,950	872,467
Subsidies and contributions	706,497	656,150
Meals and representation	529,557	518,640
Equipment and facilities rental	393,122	336,342
Administrative law judges	105,587	268,228
Security investigations	236,448	184,880
Former employee related payments	19,296	319,461
Miscellaneous	691,309	800,486
Total other expenses	$7,435,067	$7,486,158

(10) Commitments and Contingencies

Leases

The Board has entered into several operating leases to secure office, training, and warehouse space for remaining periods ranging from one to four years. Minimum annual payments under the operating leases having an initial or remaining noncancelable lease term in excess of one year at December 31, 2006, are as follows:

2007	$ 176,807
2008	183,880
2009	191,235
2010	198,884
2011	84,218
	$ 835,024

Rental expenses under the operating leases were $193,000 in 2006 and $157,000 in 2005.

Commitments

The Board has entered into an agreement with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, through the Federal Financial Institutions Examination Council (the "Council") to fund a portion of enhancements and maintenance fees for a central data repository project through 2013. Estimated Board expense to support this effort is $7.5 million.

Litigation

The Board is subject to contingent liabilities which include litigation cases. These contingent liabilities arise in the normal course of operations and their ultimate disposition is unknown. Based on information currently available to management, it is management's opinion that the expected outcome of these matters, individually or in the aggregate, will not have a materially adverse effect on the financial statements. Management believes the Board has substantial defenses and that the likelihood of an adverse judgement is remote.

One action currently pending in U.S. District Court for the District of Columbia alleges discrimination on behalf of a class of African American secretaries at the Board under Title VII of the Civil Rights Act of 1964, as amended. On January 31, 2007, the action was dismissed for failure to exhaust administrative remedies. The plaintiffs have moved to alter or amend judgment on this ruling; that motion is pending. Should the case be reinstated either as a result of the pending motion or following appeal, the Board believes it has substantial defenses and intends to defend the case vigorously.

Four additional actions are pending in the United States District Court for the District of Columbia under Title VII of the Civil Rights Act of 1964, as amended and/or the Age Discrimination in Employment Act. All four are believed to be without merit and are being vigorously contested.

Five additional matters alleging employment discrimination are currently pending administrative resolution. One case is related to, and likely will be joined with, a case currently pending in district court. In that and another case there has not yet been an investigative report. Therefore, management is unable at this time to determine the potential for a materially adverse effect on the financial statements. Management believes that the likelihood of an unfavorable outcome in the remaining three cases is remote.

(11) Federal Financial Institutions Examination Council

The Board is one of the five member agencies of the Council, and currently performs certain management functions for the Council. The five agencies which are represented on the Council are the Board, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision. The Board's financial statements do not include financial data for the Council. Activity related to the Board and Council for 2006 and 2005 is summarized in the following table:

	2006	2005
Board paid to the Council:		
Assessments for operating expenses of the Council	$ 109,760	$ 83,811
Central Data Repository	740,003	1,096,062
Uniform Bank Performance Report	204,617	202,666
Total Board paid to the Council	$1,054,380	$1,382,539
Council paid to the Board:		
Data processing related services	$3,429,499	$3,572,816
Administrative services	183,000	175,000
Total Council paid to the Board	$3,612,499	$3,747,816
Accounts receivable due from the Council	$ 395,551	$ 277,589
Accounts payable due to the Council	$ 54,870	$ 104,864

(12) Federal Reserve Banks

The Board performs certain functions for the Reserve Banks in conjunction with its responsibilities for the Federal Reserve System, and the Federal Reserve Banks provide certain administrative functions to the Board. Activity related to the Board and Reserve Banks for 2006 and 2005 is summarized in the following table:

	2006	2005
Board paid to the Reserve Banks:		
Assessments for employee benefits	$ 2,380,474	$ 2,072,595
Data processing and communication	2,161,298	2,106,850
Contingency site	1,087,429	956,476
Total Board paid to the Reserve Banks	$ 5,629,201	$ 5,135,921
Reserve Banks paid to the Board:		
Assessments for currency costs	$491,962,202	$477,087,471
Assessments for operating expenses of the Board	301,013,500	265,742,100
Data processing	731,999	516,433
Total Reserve Banks paid to the Board	$793,707,701	$743,346,004
Accounts receivable due from Federal Reserve Banks	$ 854,142	$ 145,142
Accounts payable due to Federal Reserve Banks	$ 12,417	$ 0

(13) Noncash Financing Activities

In 2005, the Board billed a federal government agency $1,096,557 for rent and leasehold improvements. In 2006, the federal government agency provided equipment, software, and services valued at $392,301 to the Board and paid the balance of $704,256 in 2006. In 2006, the Board billed the same agency $143,772 for rent, and the agency provided telecommunication equipment and services valued at $124,720 to the Board and paid the balance of $19,052 in 2006.

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Internal Control over Financial Reporting

To the Board of Governors of the Federal Reserve System:

We have audited the balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2006 and 2005, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows (hereinafter referred to as "financial statements") for the years then ended, and have issued our report thereon dated April 17, 2007.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the Board is responsible for establishing and maintaining effective internal control. In planning and performing our 2006 audit, we considered the Board's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards*. The objective of our audit was not to express an opinion on the effectiveness of the Board's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Board's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Board's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Board's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Board's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the third paragraph above and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.

In our 2006 audit, we noted a matter described in Exhibit I involving internal control over financial reporting that we consider to be a significant deficiency. We believe that this significant deficiency is not a material weakness. Exhibit II presents the status of the prior year finding.

KPMG

The Board's response to the findings identified in our audit is presented in the Exhibit I. We did not audit the Board's response and, accordingly, we express no opinion on it.

We noted certain additional matters that we have reported to the management of the Board in a separate letter dated April 17, 2007.

This report is intended solely for the information and use of the Board's management, the Office of Inspector General, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

April 17, 2007

Exhibit I

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Significant Deficiency
December 31, 2006

Improvement is needed in Internal Controls over Financial Reporting

Management is responsible for developing and maintaining effective internal controls to provide reasonable assurance that the Board has the ability to initiate, authorize, record, process, and report financial data reliably in accordance with generally accepted accounting principles. Internal controls help ensure that reliable and timely information is obtained, maintained, reported, and used for decision making.

Appropriate internal controls should be integrated into each policy and procedure established by the Board to direct and guide its operations. Monitoring the effectiveness of internal controls should occur in the normal course of business throughout the year. Periodic reviews, reconciliations, or comparisons of data should be included as part of staff's regularly assigned duties. In addition, periodic assessments should be integrated into management's continuous monitoring of internal controls to help provide assurance that weaknesses in the design or operation of internal control, which could adversely affect the Board's ability to meet its financial reporting objectives, are prevented or detected in a timely manner.

Board management is committed to improving its internal control environment as demonstrated by its ability to resolve prior year findings.

The following paragraphs discuss weaknesses noted in the Board's internal control over financial reporting that could adversely affect the Board's ability to produce accurate and timely financial statements. None of these deficiencies individually would be considered a significant deficiency. However, the combination of these deficiencies is considered to be a significant deficiency.

Recording Accounts Payable, Accrued Liabilities, and Prepaid Expenses

During 2006, the Management Division identified and processed transactions and journal entries to reclassify/and or correct several transactions that were initially coded to a different general ledger account or recorded in a different accounting period. We noted that the original transactions were initially reviewed and approved by a supervisor, and all the required changes were not identified during this initial review as follows.

- Two disbursements totaling $11,230, of the 115 disbursement transactions tested totaling $18,473,927, were initially recorded in different general ledger accounts or were 2007 transactions that were recorded as 2006 transactions. One transaction for $5,980 was identified and adjusted during management's review prior to year end, and one transaction for $5,250 was corrected as a post closing entry.
- Two accounts payable transactions totaling $45,709, of the 21 accounts payable invoices tested totaling $2,969,595, were received in 2006 for services to be provided in 2007. These were initially recorded as accounts payable in 2006. Both transactions were corrected as a post closing entry.
- One prepaid expense totaling $11,927, of the 19 prepaid expenses tested totaling $1,758,579, was a 2007 invoice that was paid in 2006 and was initially recorded as 2006 expense. This was subsequently identified and adjusted during management's review prior to year end.

We commend the Board for identifying most of these entries prior to year end. However, the Board should strengthen its procedures for posting and reviewing all entries to ensure initial posting to the proper accounts and accounting period.

Posting Accrued Annual Leave

We noted that the annual leave accrual was overstated by $301,600 at December 31, 2006, because the annual leave report did not reflect the proper year end information for all employees. The Board subsequently recorded a post closing entry to reflect the appropriate amounts.

Billing of Accounts Receivable

We noted that the Board did not record a year-end receivable from the Bank for International Settlements (BIS) for $157,317 representing services performed in 2006. Although the invoice for the 2006 services was not finalized, recorded, and submitted until 2007, this amount should have been recorded as a receivable at December 31, 2006. As a result of our audit, the Board recorded a post closing entry for this amount.

Monitoring Miscellaneous Receivables

During our audit, we noted that the Board does not have specific policies and procedures for monitoring miscellaneous receivables related to relocation expenses to determine if amounts are considered collectible and appropriately recorded. As a result of our audit, the Board recorded post closing entries to write off three accounts receivables amounting to $105,599 for relocation expenses that were not considered collectible.

Recording Property Transactions

During our audit of property and equipment, we noted that the Board inappropriately processed property and equipment additions and adjustments as follows.

- Two assets purchased for $113,016 in 2006 were recorded at an acquisition value of $109,259. As a result, the asset was overstated by $3,757.
- Three assets valued at $329,375 were put into service with the incorrect in-service dates. As a result, the 2006 depreciation expense was overstated by $25,700.
- One asset was placed in service on March 1, 2006 for $811,756, but did not have any depreciation recorded in 2006. As a result, the Board's depreciation expense was understated by $20,294.
- Three adjustments related to 22 assets acquired via trade-in were overstated on the depreciation schedule in 2005. As a result, depreciation for 2005 was overstated by $27,294 and correspondingly understated by the same amount in 2006.

During our physical inspection test work of property and equipment, we noted that one of the 22 items inspected, valued at $76,744, was included on the asset listing for the Board's contingency site, although it was physically located in the Board's Washington, DC, facility. Our inspection also found that the asset tag number for one item valued at $7,042 was not identified in the Board's financial system.

Recording Financial Statement Disclosures

During our audit, we noted instances where the Board needs to improve its preparation and review process for the financial statements as follows.

- Assets traded in for other assets were incorrectly recorded as *Proceeds from Disposals* and *Capital Expenditures* in the Statement of Cash Flows. The entries, totaling $159,519, represent non-cash transactions and should not have been included in the *Proceeds from Disposals* or the *Capital Expenditures* sections of the Statement of Cash Flows.
- In Footnote 4, *Property and Equipment,* Construction in Process was initially reported as zero, and in the corresponding roll-forward schedule, the balance was $360,966.
- In Footnote 7, *Accumulated Postemployment Benefit Plan,* the Board initially understated the accrued postemployment benefits costs for FY2006. The Board originally reported $1,828,000. However, this amount did not reflect the external actuary's revised calculation, which resulted in an upward adjustment of $134,000.

The Board subsequently made all necessary adjustments in the financial statements.

Recommendations

To strengthen internal controls over financial reporting, we recommend that the Board:

- Strengthen the control process over the initial input and review of disbursement transactions to ensure that they are properly coded and recorded in the general ledger. We also recommend that management conduct periodic training for all relevant personnel, including end users, to help ensure the proper use of general ledger accounts.
- Enhance the process for determining the accrued annual leave to ensure that the reports generated include the appropriate amounts as of the end of the reporting period. The process should include matching a selection of employees' leave balances and other information included in the report to data in the Board's Human Resources system.
- Implement policies and procedures that require the calculation and reconciliation of amounts due from BIS on a regular basis. Once amounts due are determined, the applicable adjustments should be promptly recorded in the general ledger.
- Enhance its policies and procedures to include a documented periodic review and analysis of all accounts receivables, to determine if an allowance is required or if the amounts should be written off. Further, management should also review the accounting treatment required for all transactions.
- Strengthen its policies and procedures to improve communication between the divisions and the accounting staff to ensure the appropriate accounting entries for property transactions are recorded timely in the general ledger. The communications should include, but not be limited to: when the asset was placed in service, the cost of the asset, the asset's location and tag number, and any additional information necessary for the accounting division to make the appropriate entries. The Board should also enhance its review and approval procedures over property transactions to ensure that the appropriate entries have been recorded.
- Strengthen its process over the preparation and review of the financial statements to ensure information is accurately reported.

Management's Response

KPMG offers six recommendations aimed at strengthening the Board's internal controls over financial reporting. In its discussion of these recommendations and the supporting audit findings, KPMG does not consider any individual finding to be a significant deficiency. In combination, however, KPMG concludes that the audit findings represent a significant deficiency. While management does not concur with this conclusion, we do agree that KPMG's recommendations will strengthen the Board's system of internal controls, and we will implement the recommended actions.

Exhibit II

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
STATUS OF PRIOR YEAR REPORTABLE CONDITION

December 31, 2006

Reported Issue	Prior Year Recommendation	2006 Status
Improvement is needed in Internal Control over Financial Reporting		
Control over accounts payable and accrued liabilities	1. Establish policies and procedures for processing year-end accounts payables and accruals to include the requirements for management to review and approve all entries and supporting documents before they are recorded. Management should also perform a review of the year-end accounts payable listings and subsequent disbursements to ensure that the transactions reported at year end are appropriately stated. Further, a reconciliation of the GSA account should be performed timely, to identify any discrepancies on the invoices received.	Significant Deficiency (see revised comment in Exhibit I).
Control of Census Data	2. Confirm the data used by the actuary in the pension liability calculation prior to recording the entries in the general ledger.	Completed.
	3. Implement recommendations made by the OIG in their report titled *"Evaluation of Service Credit Computations."* This would include performing periodic reconciliations of the census data between the Board's system and the data used by the actuary; reducing or eliminating the number of data transcriptions; requiring automated verifications for all census data transmissions; and updating the existing service credit form to clearly document all prior government service.	Substantially resolved. See revised comment in the 2006 management letter.

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Compliance and Other Matters

To the Board of Governors of the Federal Reserve System:

We have audited the balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2006 and 2005, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows (hereinafter referred to as "financial statements") for the years then ended, and have issued our report thereon dated April 17, 2007.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the Board is responsible for complying with laws, regulations, and contracts applicable to the Board. As part of obtaining reasonable assurance about whether the Board's financial statements are free of material misstatement, we performed tests of the Board's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contracts applicable to the Board. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests of compliance described in the preceding paragraph, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Board's management, the Office of Inspector General, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

April 17, 2007

Federal Reserve Banks Combined Financial Statements

The combined financial statements of the Federal Reserve Banks were audited by PricewaterhouseCoopers LLP, independent auditors, for the years ended December 31, 2006 and 2005.

PRICEWATERHOUSECOOPERS

REPORT OF INDEPENDENT AUDITORS

To the Board of Governors of the Federal Reserve System
and the Board of Directors of the Federal Reserve Banks:

We have audited the accompanying combined statements of condition of the Federal Reserve Banks (the "Reserve Banks") as of December 31, 2006 and 2005, and the related combined statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These combined financial statements are the responsibility of the Reserve Banks' management. Our responsibility is to express an opinion on these combined financial statements based on our audits.

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

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

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the combined financial position of the Reserve Banks as of December 31, 2006 and 2005, and the combined results of their operations for the years then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

March 30, 2007
Washington, D.C.

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CONDITION

(in millions)

	December 31, 2006	December 31, 2005
Assets		
Gold certificates	$ 11,037	$ 11,039
Special drawing rights certificates	2,200	2,200
Coin	801	686
Items in process of collection	3,486	5,930
Loans to depository institutions	67	72
Securities purchased under agreements to resell	40,750	46,750
U.S. government securities, net	783,619	750,202
Investments denominated in foreign currencies	20,482	18,928
Accrued interest receivable	6,761	5,874
Bank premises and equipment, net	2,376	2,252
Other assets	1,785	3,394
Total assets	$873,364	$847,327
Liabilities and Capital		
Liabilities		
Federal Reserve notes outstanding, net	$783,019	$758,359
Securities sold under agreements to repurchase	29,615	30,505
Deposits		
Depository institutions	18,699	19,043
U.S. Treasury, general account	4,708	4,573
Other deposits	349	393
Deferred credit items	3,813	5,039
Interest on Federal Reserve notes due to U.S. Treasury	908	1,784
Accrued benefit costs	1,314	913
Other liabilities	291	281
Total liabilities	842,716	820,890
Capital		
Capital paid-in	15,324	13,536
Surplus (including accumulated other comprehensive loss of $1,849 million at December 31, 2006)	15,324	12,901
Total capital	30,648	26,437
Total liabilities and capital	$873,364	$847,327

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

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF INCOME

(in millions)

	For the years ended December 31, 2006	2005
Interest income		
Interest on U.S. government securities	$36,452	$28,959
Interest on investments denominated in foreign currencies	369	283
Interest on loans to depository institutions	12	7
Total interest income	36,833	29,249
Interest expense		
Interest expense on securities sold under agreements to repurchase	1,342	809
Net interest income	35,491	28,440
Other operating income (loss)		
Income from services	908	901
Reimbursable services to government agencies	426	396
Foreign currency gains (losses), net	1,186	(2,723)
Other income	144	131
Total other operating income (loss)	2,664	(1,295)
Operating expenses		
Salaries and other benefits	1,880	1,709
Occupancy expense	240	228
Equipment expense	212	198
Assessments by the Board of Governors	793	743
Other expenses	835	747
Total operating expenses	3,960	3,625
Net income prior to distribution	$34,195	$23,520
Distribution of net income		
Dividends paid to member banks	$ 871	$ 781
Transferred to surplus	4,272	1,271
Payments to U.S. Treasury as interest on Federal Reserve notes	29,052	21,468
Total distribution	$34,195	$23,520

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

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CHANGES IN CAPITAL
for the years ended December 31, 2006 and 2005

(in millions)

	Capital paid-in	Surplus: Net income retained	Surplus: Accumulated other comprehensive loss	Surplus: Total surplus	Total capital
Balance at January 1, 2005 (238 million shares)	$11,914	$11,630	$ . . .	$11,630	$23,544
Net change in capital stock issued (32 million shares)	1,622	. . .	. . .	. . .	1,622
Transferred to surplus	. . .	1,271	. . .	1,271	1,271
Balance at December 31, 2005 (270 million shares)	$13,536	$12,901	$ . . .	$12,901	$26,437
Net change in capital stock issued (36 million shares)	1,788	. . .	. . .	. . .	1,788
Transferred to surplus	. . .	4,272	. . .	4,272	4,272
Adjustment to initially apply FASB Statement No. 158	. . .	. . .	(1,849)	(1,849)	(1,849)
Balance at December 31, 2006 (306 million shares)	$15,324	$17,173	$ (1,849)	$15,324	$30,648

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

Notes to the Combined Financial Statements of the Federal Reserve Banks

(1) Structure

The twelve Federal Reserve Banks ("Reserve Banks") are part of the Federal Reserve System ("System") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act"), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics.

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

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

(2) Operations and Services

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

The FOMC, in the conduct of monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and annually issues authorizations and directives to the FRBNY for its execution of transactions. The FRBNY is authorized and directed by the FOMC to conduct operations in domestic markets, including the direct purchase and sale of U.S. government securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY executes these open market transactions at the direction of the FOMC and holds the resulting securities, with the exception of securities purchased under agree-

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

ments to resell, in the portfolio known as the System Open Market Account ("SOMA").

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

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

During 2005, the Federal Reserve Bank of Atlanta ("FRBA") was assigned the overall responsibility for managing the Reserve Banks' provision of check services to depository institutions and, as a result, recognizes total System check revenue on its Statements of Income. Because the other eleven Reserve Banks incur costs to provide check services, a policy was adopted by the Reserve Banks in 2005 that required that the FRBA compensate the other Reserve Banks for costs incurred to provide check services. In 2006 this policy was extended to the ACH services, which are managed by the FRBA, as well as to Fedwire funds transfer and securities transfer services, which are managed by the FRBNY. The FRBA and the FRBNY compensate the other Reserve Banks for the costs incurred to provide these services.

(3) SIGNIFICANT ACCOUNTING POLICIES

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

Differences exist between the accounting principles and practices in the Financial Accounting Manual and generally accepted accounting principles in the United States of America ("GAAP"), primarily due to the unique nature of the Reserve Banks' powers and responsibilities as part of the nation's central bank. The primary difference is the presentation of all securities holdings at amortized cost, rather than using the fair value presentation required by GAAP. Amortized cost more appropriately reflects the Reserve Banks' securities holdings given their unique responsibility to conduct monetary policy. While the application of current market prices to the securities holdings may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio may involve transactions that result in gains or losses when holdings are sold prior to maturity. Decisions regarding securities and foreign currency transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such securities and currencies are incidental to the open market operations and do not motivate these activities or policy decisions.

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

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

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

(A) *Gold and Special Drawing Rights Certificates*

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

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

SDR certificates are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDR certificates serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding year. There were no SDR transactions in 2006 or 2005.

(B) *Loans to Depository Institutions*

Depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations issued by the Board of Governors, have borrowing privileges at the discretion of each of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Outstanding loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Bank, subject to review and determination by the Board of Governors.

(C) *U.S. Government Securities and Investments Denominated in Foreign Currencies*

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

Activity related to U.S. government securities, including the premiums, discounts, and realized and unrealized gains and losses, is allocated to each of the Reserve Banks on a percentage basis derived from an annual settlement of interdistrict clearings that occurs in April of each year. The settlement equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding in each District. Activity related to investments denominated in foreign currencies is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31.

(D) *Securities Purchased under Agreements to Resell, Securities Sold under Agreements to Repurchase, and Securities Lending*

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

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

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

Activity related to securities sold under agreements to repurchase and securities lending is allocated to each of the Reserve Banks on a percentage basis derived from the

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

annual settlement of interdistrict clearings. Securities purchased under agreements to resell are allocated to the FRBNY and not to the other Reserve Banks.

(E) *FX Swap Arrangements and Warehousing Agreements*

FX swap arrangements are contractual agreements between two parties, the FRBNY and an authorized foreign central bank, to exchange specified currencies, at a specified price, on a specified date. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to the foreign currencies it may need to intervene to support the dollar and give the authorized foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the FX swap arrangements can be initiated by either party acting as drawer, and must be agreed to by the drawee party. The FX swap arrangements are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. The FRBNY will generally invest the foreign currency received under an FX swap arrangement in interest-bearing instruments.

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

FX swap arrangements and warehousing agreements are revalued daily at current market exchange rates. Activity related to these agreements, with the exception of the unrealized gains and losses resulting from the daily revaluation, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. Unrealized gains and losses resulting from the daily revaluation are allocated to the FRBNY and not allocated to the other Reserve Banks.

(F) *Bank Premises, Equipment, and Software*

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

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

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

(G) *Federal Reserve Notes*

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

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

The Board of Governors may, at any time, call upon a Reserve Bank for additional collateral for the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes issued to all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, Federal Reserve notes are obligations of the United States and are backed by the full faith and credit of the United States government.

"Federal Reserve notes outstanding, net" in the Statements of Condition represents Federal Reserve notes outstanding, reduced by the currency issued to the Reserve Banks but not in circulation, of $175,661 million and $148,152 million at December 31, 2006 and 2005, respectively.

At December 31, 2006, all Federal Reserve notes were fully collateralized. All gold certificates, all special drawing right certificates, and $769,782 million of domestic securities and securities purchased under agreements to resell were pledged as collateral. At December 31, 2006, no loans or investments denominated in foreign currencies were pledged as collateral.

(H) *Items in Process of Collection and Deferred Credit Items*

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

(I) *Capital Paid-In*

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

(J) *Surplus*

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

Accumulated other comprehensive income is treated as a component of surplus in the Statements of Condition and the Statements of Changes in Capital. The balance of accumulated other comprehensive income is comprised of expenses, gains, and losses related to defined benefit pension plans and other postretirement benefit plans that under accounting principles are included in comprehensive income but excluded from net income. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 8, 9, and 10.

(K) *Interest on Federal Reserve Notes*

The Board of Governors requires the Reserve Banks to transfer excess earnings to the U.S. Treasury as interest on Federal Reserve notes, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. This amount is reported as a component of "Payments to U.S. Treasury as interest on Federal Reserve notes" in the Statements of Income and is reported as a liability in the Statements of Condition. Weekly payments to the U.S. Treasury may vary significantly.

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

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

Due to the substantial increase in capital paid-in at one Reserve Bank, surplus was not equated to capital at December 31, 2005. The amount of additional surplus required due to these events exceeded the Bank's earnings in 2005.

(L) *Income and Costs Related to U.S. Treasury Services*

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

(M) *Assessments by the Board of Governors*

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

(N) *Taxes*

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property and sales taxes on certain construction projects. Real property taxes were $33 million and $32 million for the years ended December 31, 2006 and 2005, respectively, and are reported as a component of "Occupancy expense."

(O) *Restructuring Charges*

In 2003, the Reserve Banks began the restructuring of several operations, primarily check, cash, and U.S. Treasury services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in some locations. These restructuring activities continued in 2004 through 2006.

Note 11 describes the restructuring and provides information about the Reserve Banks' costs and liabilities associated with employee separations and contract terminations. The costs associated with the impairment of certain of the Reserve Banks' assets are discussed in Note 6. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all of the Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8. Costs and liabilities associated with enhanced post-retirement benefits are discussed in Note 9.

(P) *Implementation of FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*

The Reserve Banks initially applied the provisions of FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, at December 31, 2006. This accounting standard requires recognition of the overfunded or underfunded status of a defined benefit postretirement plan in the Statements of Condition, and recognition of changes in the funded status in the years in which the changes occur through comprehensive income. The transition rules for implementing the standard require applying the provisions as of

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

the end of the year of initial implementation with no retrospective application. The incremental effects on the line items in the Statement of Condition at December 31, 2006, were as follows (in millions):

	Before Application of Statement 158	Adjustments	After Application of Statement 158
Other Assets	$ 3,277	$ (1,492)	$ 1,785
Total assets	$874,856	$ (1,492)	$873,364
Accrued benefit costs	957	357	1,314
Total liabilities	$842,359	$ 357	$842,716
Surplus	17,173	(1,849)	15,324
Total capital	$ 32,497	$ (1,849)	$ 30,648

(4) U.S. GOVERNMENT SECURITIES, SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL, SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE, AND SECURITIES LENDING

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA.

Total securities held in the SOMA at December 31, were as follows (in millions):

	2006	2005
Par value		
U.S. government		
Bills	$277,019	$271,270
Notes	402,367	380,118
Bonds	99,528	92,827
Total par value	778,914	744,215
Unamortized premiums	8,708	8,813
Unaccreted discounts	(4,003)	(2,826)
Total	$783,619	$750,202

At December 31, 2006 and 2005, the fair value of the U.S. government securities held in the SOMA, excluding accrued interest, was $795,900 million and $767,472 million, respectively, as determined by reference to quoted prices for identical securities.

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

The maturity distribution of U.S. government securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase, that were held in the SOMA at December 31, 2006, was as follows (in millions):

	U.S. government securities (Par value)	Securities purchased under agreements to resell (Contract amount)	Securities sold under agreements to repurchase (Contract amount)
Within 15 days	$ 40,588	$40,750	$29,615
16 days to 90 days	180,893	...	...
91 days to 1 year	185,132	...	...
Over 1 year to 5 years	224,177	...	...
Over 5 years to 10 years	67,645	...	...
Over 10 years	80,479	...	...
Total	$778,914	$40,750	$29,615

At December 31, 2006 and 2005, U.S. government securities with par values of $6,855 million and $3,776 million, respectively, were loaned from the SOMA.

At December 31, 2006 and 2005, the total contract amount of securities sold under agreements to repurchase was $29,615 million and $30,505 million, respectively. At December 31, 2006 and 2005, securities sold under agreements to repurchase with a par value of $29,676 million and $30,559 million, respectively, were outstanding. The contract amount for securities sold under agreements to repurchase approximates fair value.

(5) INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

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

Total investments denominated in foreign currencies, including accrued interest, and valued at current foreign currency market exchange rates at December 31, were as follows (in millions):

	2006	2005
European Union euro		
Foreign currency deposits	$ 6,242	$ 5,424
Securities purchased under agreements to resell	2,214	1,928
Government debt instruments	4,074	3,561
Japanese yen		
Foreign currency deposits	2,601	2,618
Government debt instruments	5,351	5,397
Total	$20,482	$18,928

At December 31, 2006 and 2005, the fair value of the total System investments denominated in foreign currencies, including accrued interest, was $20,434 million and $18,965 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government securities discussed in Note 4, unrealized gains or losses have no effect on the ability of a Reserve Bank, as a central bank, to meet its financial obligations and responsibilities.

The maturity distribution of investments denominated in foreign currencies at December 31, 2006, was as follows (in millions):

	European euro	Japanese yen	Total
Within 15 days	$ 4,359	$2,601	$ 6,960
16 days to 90 days	2,378	1,208	3,586
91 days to 1 year	2,442	2,213	4,655
Over 1 year to 5 years	3,351	1,930	5,281
Over 5 years to 10 years	...	...	...
Over 10 years	...	...	...
Total	$12,530	$7,952	$20,482

At December 31, 2006 and 2005, there were no material open foreign exchange contracts.

At December 31, 2006 and 2005, the warehousing facility was $5,000 million, with no balance outstanding.

(6) BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	2006	2005
Bank premises and equipment		
Land	$ 306	$ 295
Buildings	1,817	1,787
Building machinery and equipment	393	387
Construction in progress	220	86
Furniture and equipment	1,156	1,162
Subtotal	3,892	3,717
Accumulated depreciation	(1,516)	(1,465)
Bank premises and equipment, net	$2,376	$2,252
Depreciation expense, for the year ended December 31	$ 186	$ 175

The Federal Reserve Bank of Kansas City (FRBKC) is constructing a new building to replace its head office. Approximately $29 million of costs associated with the acquisition of land and site preparation for the new building are included in the "Land" account, and approximately $114 million of costs associated with the construction of the new building are included in the "Construction in progress" account. In July 2005, the FRBKC completed the sale and leaseback of its head office, and will lease the space from the purchaser until the new building is completed in 2008.

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

	2006	2005
Leased premises and equipment under capital leases	$12	$10
Accumulated depreciation	(6)	(5)
Leased premises and equipment under capital leases, net	$ 6	$ 5

Certain of the Reserve Banks lease space to outside tenants with remaining lease terms ranging from one to fourteen years. Rental income from such leases was $25 million and $23 million for the years ended December 31, 2006 and 2005, respectively, and is reported as a component of "Other income." Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2006, are as follows (in millions):

2007	$ 23
2008	23
2009	22
2010	21
2011	18
Thereafter	70
Total	$177

The Reserve Banks have capitalized software assets, net of amortization, of $155 million and $162 million at December 31, 2006 and 2005, respectively. Amortization expense was $66 million and $55 million for the years ended December 31, 2006 and 2005, respectively. Capitalized software assets are reported as a component of "Other assets" and the related amortization is reported as a component of "Other expenses."

Several of the Reserve Banks have impaired assets as a result of the System's restructuring plan, as discussed in Note 11. Impaired assets include software, buildings, leasehold improvements, furniture, and equipment. Asset impairment losses related to the check and cash restructurings of $15 million and $50 million for the periods ending December 31, 2006 and 2005, respectively, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

(7) COMMITMENTS AND CONTINGENCIES

At December 31, 2006, the Reserve Banks were obligated under noncancelable leases for premises and equipment with remaining terms ranging from one to approximately seventeen years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $31 million and $26 million for the years ended December 31, 2006 and 2005, respectively. Certain of the Reserve Banks' leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with remaining terms of one year or more, at December 31, 2006 are as follows (in millions):

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

	Operating
2007	$ 12
2008	9
2009	8
2010	8
2011	7
Thereafter	102
Future minimum rental payments	$146

At December 31, 2006, the Reserve Banks had other commitments and long-term obligations extending through the year 2017 with a remaining amount of $336 million. As of December 31, 2006, commitments of $219 million were recognized. Purchases of $92 million and $98 million were made against these commitments during 2006 and 2005, respectively. These commitments are for goods and services to maintain currency machines, for software licenses and maintenance, for services related to check processing equipment and transportation, and have variable and/or fixed components. The variable portion of the commitments is for additional services above fixed contractual service limits. The fixed payments for the next five years under these commitments are as follows (in millions):

	Fixed commitment
2007	$30
2008	36
2009	32
2010	28
2011	29

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

(8) Retirement and Thrift Plans

Retirement Plans

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

The System Plan is a multi-employer plan with contributions funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. No separate accounting is maintained of assets contributed by the participating employers. The FRBNY acts as the sponsor of the System Plan and the costs associated with the Plan are not redistributed to other participating employers.

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

	2006	2005
Estimated actuarial present value of projected benefit obligation at January 1	$4,785	$4,524
Service cost—benefits earned during the period	134	123
Interest cost on projected benefit obligation	278	263
Actuarial loss	132	125
Contributions by plan participants	3	3
Special termination benefits loss	3	6
Benefits paid	(254)	(259)
Plan amendments	66	. . .
Estimated actuarial present value of projected benefit obligation at December 31	$5,147	$4,785

Following is a reconciliation of the beginning and ending balance of the System Plan assets, the funded status, and the prepaid pension benefit costs (in millions):

	2006	2005
Estimated fair value of plan assets at January 1	$5,868	$5,887
Actual return on plan assets	713	237
Contributions by the employer	. . .	. . .
Contributions by plan participants	3	3
Benefits paid	(254)	(259)
Estimated fair value of plan assets at December 31	$6,330	$5,868
Funded status	$1,183	$1,083
Unrecognized prior service cost		149
Unrecognized net actuarial loss		1,496
Prepaid pension benefit costs		$2,728
Amounts included in accumulated other comprehensive loss (in millions)		
Prior service cost	(191)	
Net actuarial loss	(1,301)	
Total accumulated other comprehensive loss	$(1,492)	

Prepaid pension benefit costs are reported as "Other assets" in the Statements of Condition.

The accumulated benefit obligation for the System Plan, which differs from the estimated actuarial present value of the projected benefit obligation because it is based on current rather than future compensation levels, was $4,522 million and $4,162 million at December 31, 2006 and 2005, respectively.

The weighted-average assumptions used in developing the projected pension benefit obligation for the System Plan as of December 31 were as follows:

	2006	2005
Discount rate	6.00%	5.75%
Rate of compensation increase	4.50%	4.50%

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Net periodic benefit expenses are actuarially determined using a January 1 measurement date. The weighted-average assumptions used in developing net periodic benefit expenses for the System Plan for the years at January 1 were as follows:

	2006	2005
Discount rate	5.75%	5.75%
Expected asset return	8.00%	8.25%
Rate of compensation increase	4.50%	4.25%

Discount rates reflect yields available on high-quality corporate bonds that would generate the cash flows necessary to pay the plan's benefits when due. The expected long-term rate of return on assets was based on a combination of methodologies including the System Plan's historical returns, surveys of other plans' expected rates of return, building a projected return for equities and fixed income investments based on real interest rates, inflation expectations, equity risk premiums, and, finally, surveys of expected returns in equity and fixed income markets.

The components of net periodic pension benefit expense (credit) for the System Plan for the years ended December 31 are shown below (in millions):

	2006	2005
Service cost—benefits earned during the period	$ 134	$ 123
Interest cost on projected benefit obligation	278	263
Amortization of prior service cost	23	24
Amortization of actuarial loss	75	49
Expected return on plan assets	(460)	(476)
Net periodic pension expense/ (credit)	50	(17)
Special termination benefits losses	3	6
Total periodic pension expense/ (credit)	$ 53	$ (11)

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic pension expense in 2007 (in millions):	
Prior service cost	$ 29
Actuarial loss	66
Total	$ 95

The recognition of special termination benefits losses is the result of enhanced retirement benefits provided to employees during the restructuring described in Note 11.

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

	Expected benefit payments
2007	$ 260
2008	270
2009	281
2010	294
2011	306
2012–2016	1,764
Total	$3,175

The Federal Reserve System's pension plan weighted-average asset allocations at December 31, by asset category, were as follows:

	2006	2005
Equities	64.3%	66.2%
Fixed income	34.4%	31.7%
Cash	1.3%	2.1%
Total	100.0%	100.0%

The System's Committee on Investment Performance (CIP) contracts with investment managers who are responsible for implementing the System Plan's investment policies. The managers' performance is measured against a trailing 36-month benchmark of 60 percent of a market value weighted index of predominantly large capitalization stocks trading on the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers Automated Quotation National Market System and 40 percent of a broadly diversified investment-grade fixed income index (rebalanced monthly). The managers invest plan funds within CIP-established guidelines for investment in equities and fixed income instruments. Equity investments can range between 40 percent and 80 percent of the portfolio. Investments, however, cannot be concentrated in particular industries and equity securities holdings of any one company are limited. Fixed income securities must be investment grade and the effective duration of the fixed income portfolio must remain within a range of 67 percent and 150 percent of a broadly diversified investment-grade fixed income index. CIP guidelines prohibit margin, short sale, foreign exchange, and commodities trading as well as investment in bank, bank holding company, savings and loan, and government securities dealers' stocks. In addition, investments in non-dollar denominated securities are prohibited; however, a small portion of the portfolio can be invested in American Depositary Receipts/Shares and foreign-issued dollar-denominated fixed income securities.

Contributions to the System Plan may be determined using different assumptions than those required for financial reporting. The System does not expect to make a cash contribution to the System Plan during 2007.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

The Reserve Banks' projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2006 and 2005, and for the years then ended, are not material.

Thrift Plan

Employees of the Reserve Banks may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Reserve Banks' Thrift Plan contributions totaled $66 million and $63 million for the years ended December 31, 2006 and 2005, respectively, and are reported as a component of "Salaries and other benefits" in the Statements of Income. The Reserve Banks match employee contributions based on a specified formula. For the years ended December 31, 2006 and 2005, the Reserve Banks matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

(9) POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits Other Than Pensions

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

The Reserve Banks fund benefits payable under the medical and life insurance plans as due and, accordingly, have no plan assets.

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

	2006	2005
Accumulated postretirement benefit obligation at January 1	$ 947	$869
Service cost—benefits earned during the period	27	32
Interest cost of accumulated benefit obligation	54	49
Actuarial loss	188	45
Contributions by plan participants	13	11
Benefits paid	(60)	(59)
Plan amendments	(5)	. . .
Accumulated postretirement benefit obligation at December 31	$1,164	$947

At December 31, 2006 and 2005, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.75 percent and 5.50 percent, respectively.

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

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

	2006	2005
Fair value of plan assets at January 1	$ . . .	$ . . .
Contributions by the employer	47	48
Contributions by plan participants	13	11
Benefits paid	(60)	(59)
Fair value of plan assets at December 31	$ . . .	$ . . .
Unfunded postretirement benefit obligation	$1,164	$947
Unrecognized prior service cost		105
Unrecognized net actuarial loss		(277)
Accrued postretirement benefit costs		$775
Amounts included in accumulated other comprehensive loss (in millions):		
Prior service cost	$ 85	
Net actuarial loss	(443)	
Deferred curtailment gain	1	
Total accumulated other comprehensive loss	$ (357)	

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

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

	2006	2005
Health care cost trend rate assumed for next year	9.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2012	2011

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2006 (in millions):

	One percentage point increase	One percentage point decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit expense	$ 12	$ (10)
Effect on accumulated postretirement benefit obligation	128	(111)

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

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

	2006	2005
Service cost—benefits earned during the period	$ 27	$ 32
Interest cost on accumulated benefit obligation	54	49
Amortization of prior service cost	(23)	(21)
Amortization of actuarial loss	22	13
Total periodic expense	80	73
Curtailment gain	. . .	(5)
Net periodic postretirement benefit expense	$ 80	$ 68

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic benefit expense in 2007 (in millions):	
Prior service cost	(22)
Actuarial loss	45
Total	$ 23

Net postretirement benefit expense is actuarially determined using a January 1 measurement date. At January 1, 2006 and 2005, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit expense were 5.50 percent and 5.75 percent, respectively.

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

The 2005 service cost contains an adjustment by one Reserve Bank that resulted from a review of plan terms and assumptions. A plan amendment that modified the credited service period eligibility requirements created curtailment gains in 2005. A deferred curtailment gain, which was recorded in 2006 as a component of accumulated other comprehensive loss, is expected to be recognized in net income in 2008 when the related employees terminate employment.

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

The Reserve Banks account for the Medicare subsidies as a reduction to benefits payments. The Reserve Banks expect to receive approximately $4 million in subsidies in the year ending December 31, 2007 that relate to benefit payments made in the year ended December 31, 2006.

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

	Without subsidy	With subsidy
2007	$ 63	$ 58
2008	68	62
2009	73	68
2010	79	72
2011	84	77
2012–2016	476	430
Total	$843	$767

Postemployment Benefits

The Reserve Banks offer benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2006 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Reserve Banks at December 31, 2006 and 2005 were $126 million and $124 million, respectively. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2006 and 2005 operating expenses was $20 million and $14 million, respectively, and is recorded as a component of "Salaries and other benefits" in the Statements of Income.

(10) ACCUMULATED OTHER COMPREHENSIVE INCOME

Following is a reconciliation of beginning and ending balances of accumulated other comprehensive loss:

	Amount Related to Defined Benefit Retirement Plans	Amount Related to Post-retirement Benefits Other than Pensions	Total Accumulated Other Comprehensive Loss
Balance at December 31, 2005	$ . . .	$ . . .	$ . . .
Adjustment to initially apply FASB Statement No. 158	(1,492)	(357)	(1,849)
Balance at December 31, 2006	$ (1,492)	$ (357)	$ (1,849)

Additional detail regarding the classification of accumulated other comprehensive income is included in notes 8 and 9.

(11) BUSINESS RESTRUCTURING CHARGES

In 2003, several Reserve Banks announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2004 through 2006, additional consolidation and restructuring

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

initiatives were announced in the check, cash, purchasing, and Treasury operations. These actions resulted in the following business restructuring charges (in millions):

	Total estimated costs
Employee separation	$49
Contract termination	1
Other	1
Total	$51

	Accrued liability 12/31/05	Year-ended 12/31/2006 Total charges	Total paid	Accrued liability 12/31/06
Employee separation	$17	$9	$(12)	$14
Contract termination	. . .	. . .	. . .	. . .
Other	. . .	. . .	. . .	. . .
Total	$17	$9	$(12)	$14

Adjustments to the accrued liability due to changes in the estimated restructuring costs were offset against total charges. Without these offsets, total charges would have been $10 million in 2006.

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 1,949, including 286 and 292 staff reductions related to restructuring announced in 2006 and 2005, respectively. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of "Salaries and other benefits" in the Statements of Income. Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of "Other expenses." Other costs include the continuation of a noncancelable lease agreement and associated facility maintenance and are shown as a component of "Occupancy expenses."

Restructuring costs associated with impairment of certain Reserve Bank assets, including software, buildings, leasehold improvements, furniture, and equipment, are discussed in Note 6. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8. Costs associated with enhanced postretirement benefits are disclosed in Note 9.

Future costs associated with the announced restructuring plans are estimated at $4 million.

The Reserve Banks anticipate substantially completing their announced plans in 2008.

Office of Inspector General Activities

The Board of Governors' Office of Inspector General (OIG) functions in accordance with the Inspector General Act of 1978, as amended. In addition to retaining an independent auditor each year to audit the Board's financial statements, the OIG plans and conducts audits, reviews, and investigations relating to the Board's programs and operations and its delegated functions at the Federal Reserve Banks. The OIG also reviews existing and proposed legislation and regulations for their impact on the economy and efficiency of the Board's programs and operations. It recommends policies, and it supervises and conducts activities to promote economy and efficiency and to prevent and detect waste, fraud, and abuse in Board and Board-delegated programs and operations, as well as in activities administered or financed by the Board. The OIG keeps the Congress and the Chairman of the Board of Governors fully informed about serious abuses and deficiencies and about the status of any corrective actions.

During 2006, the OIG completed eight audits, reviews, and other assessments and conducted a number of follow-up reviews to evaluate action taken on earlier recommendations. The OIG also closed eight investigations and performed numerous legislative and regulatory reviews.

OIG Audits, Reviews, and Assessments Completed during 2006

Report title	Month issued
External Quality Control Review of the National Science Foundation Inspector General Audit Organization	February
Audit of the FFIEC's Financial Statements (Year Ended December 31, 2005)	March
Inspection of the Board's Security Services Unit	March
Audit of the Board's Implementation of Electronic Authentication Requirements	March
Audit of the Board's Financial Statements (Year Ended December 31, 2005)	May
Audit of the Board's Information Security Program	September
Security Control Review of the Common Document and Text Repository System (Internal Report)	October
Audit of the Board's Payroll Process	December

Government Accountability Office Reviews

Under the Federal Banking Agency Audit Act (Public Law 95–320), most Federal Reserve System operations are under the purview of the Government Accountability Office (GAO). In 2006, the GAO completed six reports on selected aspects of Federal Reserve operations (table). In addition, seven projects concerning the Federal Reserve were in various stages of completion at year-end (table). The Federal Reserve also provided information to the GAO during the year on numerous other GAO investigations.

The reports are available directly from the GAO.

Reports Completed during 2006

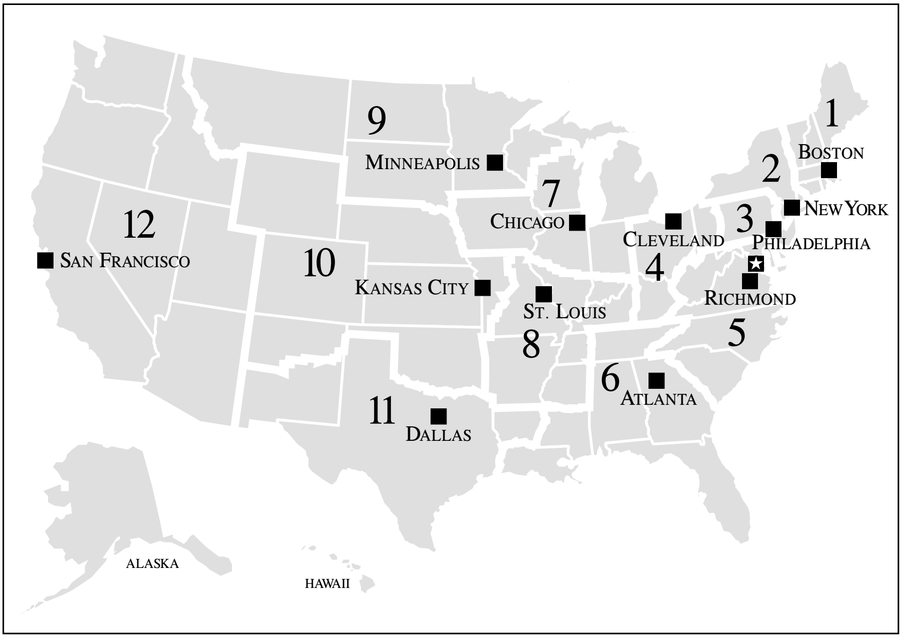
Report title	Report number	Month issued (2006)
Credit Cards: Customized Minimum Payment Disclosure Would Provide More Information to Consumers, but Impact Could Vary	GAO-06-434	April
Bank Secrecy Act: Opportunities Exist for FinCEN and the Banking Regulators to Further Strengthen the Framework for Consistent BSA Oversight	GAO-06-386	May
Information Security: Federal Reserve Needs to Address Treasury Auction Systems	GAO-06-659	August
Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved	GAO-06-1021	September
Minority Banks: Regulators Need to Better Assess Effectiveness of Support Efforts	GAO-07-6	October
Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers	GAO-06-929	October

Projects Active at Year-End 2006

Subject of project	Month initiated
Consolidated supervision of financial institutions	November 2005
Prompt Corrective Action (PCA) program	March 2006
Basel II Capital Accord	March 2006
Financial markets preparedness	March 2006
Financial regulatory agencies' performance pay systems	May 2006
Financial regulatory agencies' compensation programs	May 2006
Hedge funds and federal regulatory oversight	October 2006

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

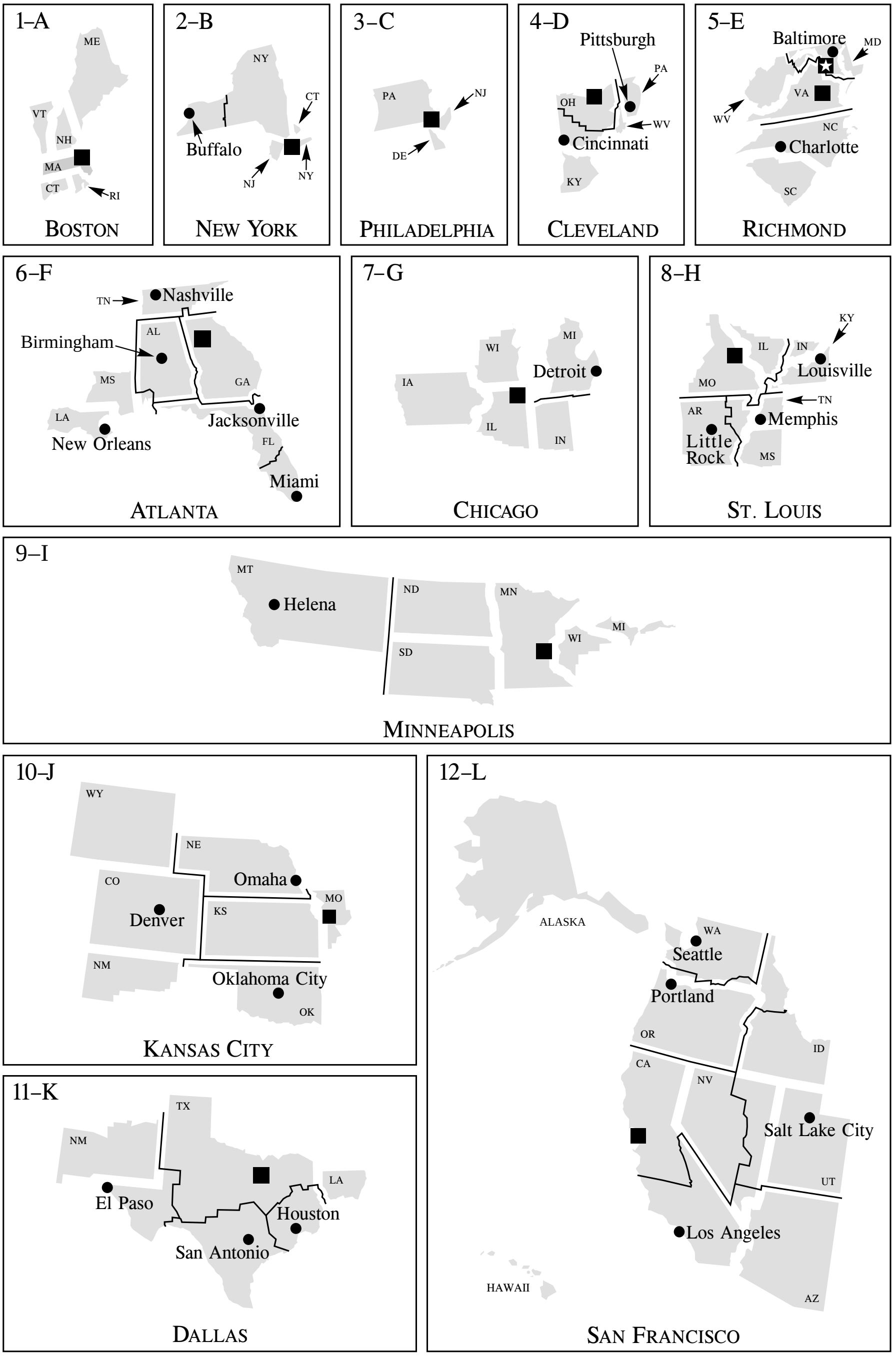
- • Federal Reserve Branch city
- — Branch boundary

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 2006.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