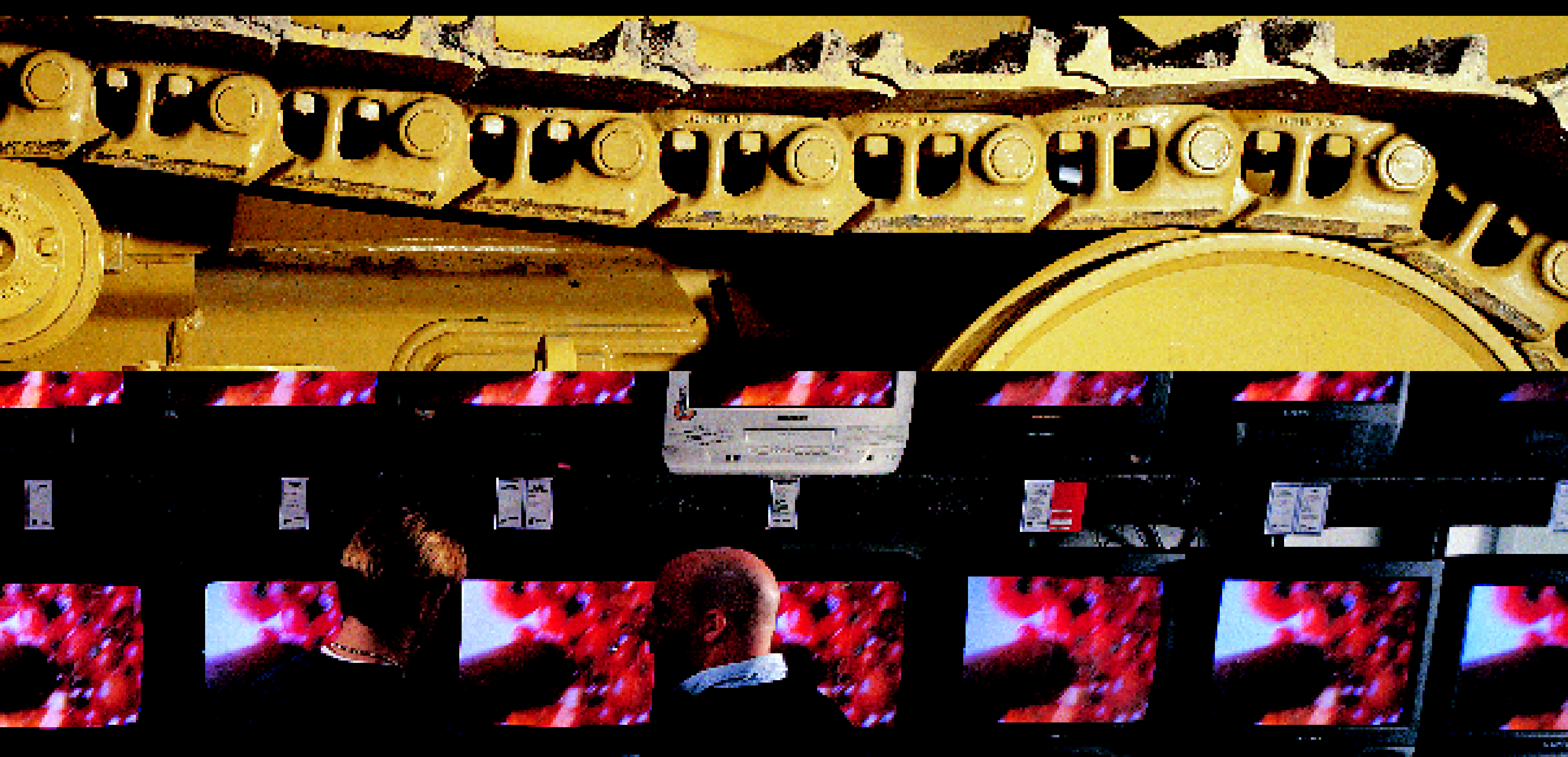
A World of Choices



Our Mission

The Federal Reserve Bank of Chicago is one of 12 regional Reserve Banks across the United States that, together with the Board of Governors in Washington, D.C., serve as the nation's central bank. The role of the Federal Reserve System, since its establishment by an act of Congress passed in 1913, has been to foster a strong economy, supported by a stable financial system.

To this end, the Federal Reserve Bank of Chicago participates in the formulation and implementation of national monetary policy, supervises and regulates state-member banks, bank holding companies and foreign bank branches, and provides financial services to depository institutions and the U.S. government. Through its head office in Chicago, branch in Detroit, regional offices in Des Moines, Indianapolis and Milwaukee, and facility in Peoria, the Federal Reserve Bank of Chicago serves the Seventh Federal Reserve District, which includes major portions of Illinois, Indiana, Michigan and Wisconsin, plus all of Iowa.

Our Vision

Further the public interest by fostering a sound economy and stable financial system

Provide products and services of unmatched value to those we serve

Set the standard for excellence in the Federal Reserve System

Work together, value diversity, communicate openly, be creative and fair

Live by our core values of integrity, respect, responsibility and excellence

Contents

Most Americans would agree that if a factory cannot turn a profit without pouring toxic waste into a community's water supply, that factory should be shut down—even if that means the loss of hundreds of jobs. When it comes to matters of public health, the interests of the many outweigh those of the few.

Regarding the economic health of our nation, however, the American public seems to place the interests of a few above the interests of the majority.

Economists concur that international trade and open markets are directly responsible for greater consumer choice and a higher overall standard of living for the American public. And yet 58 percent of those surveyed in a NBC/*Wall Street Journal* poll taken at the end of 1998 said that foreign trade had been bad for America. Why? Because open markets lead to cheaper imports that, in turn, can cost some individuals their jobs.

How ironic that public resistance to open markets is rising just as our economy is in the longest peace-time expansion in our history and employment is at record levels.

Earlier this decade, I served as deputy U.S. trade representative. Opening markets and expanding international trade was my chief concern as I negotiated trade pacts with the countries of Europe and East Asia, including Japan and China. As confident as I am that more open trade is crucial to the economic health of America as we enter the next century, I am well aware it is not an easy matter to change public opinion on open markets. One trade-related plant closure can dramatically worsen public attitudes toward foreign competition, especially when the closure puts hundreds of people out of work. It is more difficult to convince the public that lower prices, higher-quality products, and resulting higher standards of living are also linked to free trade.

This annual report focuses on the important and complex issue of international trade, examining the costs and benefits of open markets. Our economic well being is increasingly influenced by our ability to reach untapped markets: Nearly four-fifths of world consumption currently occurs outside the U.S. With this new century of increased globalization soon upon us, now is the time to address concerns over the economic and social risks associated with bringing down barriers to trade.

The great strength of the U.S. Constitution, so emulated worldwide, is the careful balancing of the rights of the few with the interests of the many. As the U.S. enters the next century we have the tremendous opportunity to extend these principles to our trade policy. Some short-term job displacement no more justifies holding back our entire economy than it does the operation of a factory that puts our environment at risk. But we must meet the needs of those who are directly affected by foreign competition. We have an obligation to develop programs that help those facing job cuts because of open markets. Only by reducing hardship today can we reduce future backlashes against free trade.

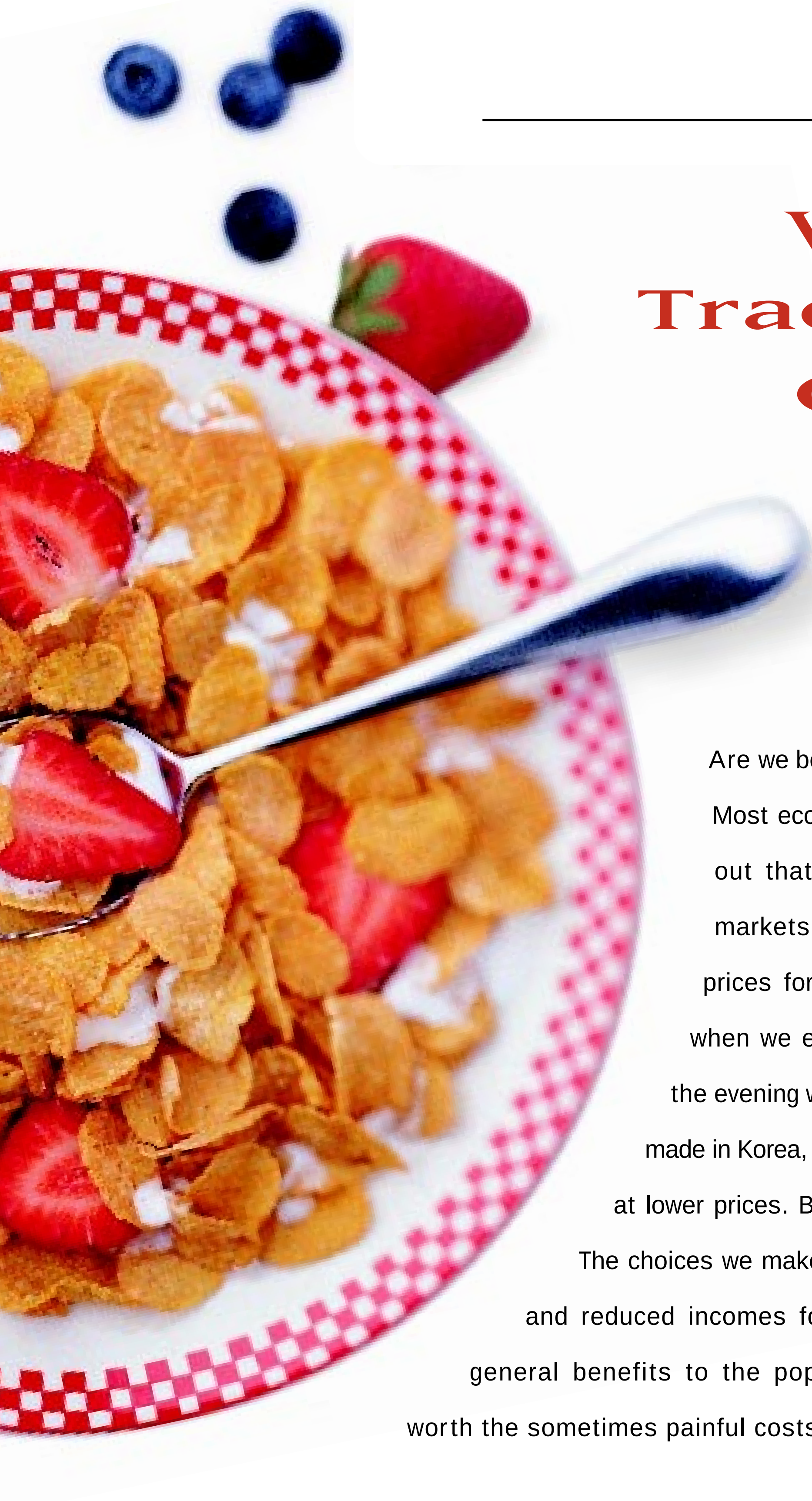
The performance of the U.S. economy in 1998 was extraordinary despite turbulence in foreign markets. Real GDP growth came in at a robust 4.3 percent on a fourth-quarter to fourth-quarter basis. Inflation as measured by the Consumer Price Index slowed to 1.5 percent in 1998. For the first time in 30 years inflation was below 2 percent for two consecutive years. The unemployment rate averaged 4.5 percent for the year, the lowest level since 1969.

In 1999 we expect that real GDP growth will continue at a solid but more sustainable rate, and that inflation and unemployment will continue to be favorable.

On a personal note, I'd like to extend my heartfelt appreciation for the hard work of our dedicated staff, whose accomplishments are highlighted on pages 16 and 17. The achievements of the Federal Reserve Bank of Chicago also reflect the outstanding leadership and counsel of our directors in Chicago and Detroit. Thank you all. A special note of gratitude goes to directors Donald Schneider and Arnold Schultz, who completed their service with the Chicago board in 1998. I would also like to welcome James Keyes and Alan Tubbs, who joined the board at the start of 1999.

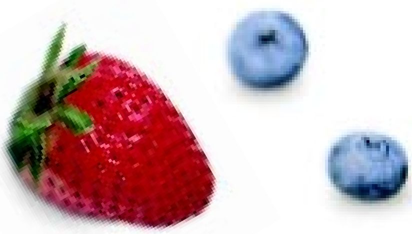
One of the highlights of our achievements this year was ensuring the readiness of our important internal computer applications for Y2K. I am confident that the success of the Federal Reserve and the banking industry this past year will be echoed in 1999 by enhanced consumer confidence in industry preparedness as we approach the millennium.

Michael H. Moskow
President and Chief Executive Officer
March 26, 1999



What's Trade Got to Do with It?

Are we better off with international trade? Most economists would say yes, pointing out that international trade and open markets provide more choices at lower prices for consumers. From the morning when we eat strawberries from Mexico to the evening when we watch a program on a TV made in Korea, we benefit from increased choices at lower prices. But what are the costs? The choices we make can mean lost jobs and reduced incomes for some. Are the general benefits to the population at large worth the sometimes painful costs for some of us?



Strawberries from Mexico, apples from Canada, bananas from Costa Rica and Equador, and grapes from Chile. Many types of fruit flow into the U.S. from a variety of nations. In fact, in 1998 the U.S. imported 8.1 million tons of fruit. And the U.S. exported almost as much, shipping 6.8 million tons in 1998. For example, the U.S. sends grapefruit to Japan and France, peaches and pears to Canada and Mexico, apples to Taiwan, and raisins to the United Kingdom.

The general consensus that open markets provide benefits is rooted in economic theory, specifically the natural efficiency of specialization. Economic theory on the principles of international trade can be traced to 1776, when Adam Smith discussed the importance of specialization in *The Wealth of Nations*. British economist David Ricardo built on Smith's ideas by extending the concept of specialization to trade among nations—the notion of comparative advantage.

The principle of comparative advantage, which applies to both individuals and firms, states that nations should focus on goods and services that they are best at producing and trade for other goods. Such trade is efficient even if the home country can produce all goods more efficiently than its trading partners can. Why? If a nation spends its time producing all goods, rather than those it is best at producing, the result would be fewer and/or lower-quality goods and services. The surest way to achieve the highest efficiency and quality for all goods and services produced by all nations is for each country to exploit its comparative advantages.

Increasing Productivity

Some of the advantages of open markets are as obvious and familiar as the TV in our living room or the fruit on our cereal. Open markets provide more choices for consumers—everything from Italian suits to Japanese cars to Brazilian coffee. Perhaps even more importantly, open markets mean lower prices. If countries focus on their comparative advantage, they do a better job of allocating resources. The cost savings achieved by each nation's producers are passed on to consumers in the form of lower prices. The more efficient allocation of resources fostered by open markets also results in higher quality goods and services. Only the best products at the lowest prices can survive the global winnowing process. Consumers literally have their pick of the best the world has to offer. The result is a higher standard of living for the population at large.

Open markets also raise our standard of living in a more subtle way by boosting productivity growth. This is important because productivity is the key ingredient in raising our standard of living. Open markets foster higher productivity growth by creating stronger incentives for innovation and efficiency. Competition from abroad compels domestic producers to develop more efficient production methods. A case in point is the U.S. auto industry, which was roused from its sleepy complacency during the 1970s by sudden, sharp competition from Japan.

The exchange of information and ideas across borders, such as the adoption by U.S. companies of the Japanese "just-in-time" inventory method, accelerates continual change and improvement. Long-term economic vitality depends on this process of change, described by economist Joseph Schumpeter as "creative destruction," in which competition weeds out inefficient companies and creates opportunities for firms with new ideas, lower prices, and better products.

Costs of Open Markets

While the benefits of open markets are substantial, they come with costs. The distribution of these costs and benefits is often uneven, helping some industries and benefiting some individuals while harming others—especially in the short run.

Export-oriented industries, of course, are helped by open markets. So are the workers employed by these industries. According to the *1998 Economic Report of the President*, jobs in export-oriented industries pay between 5 and 10 percent more than other jobs in the U.S. economy. Other industries are hit hard by foreign competition; some do not survive. Among the U.S. industries hurt by foreign competition was the consumer electronics industry during the 1970s. Open markets also can have a disproportionate effect on certain regions or economic sectors. The downturn in the Midwest in the early 1980s, caused in part by intense foreign competition, resulted in one-fifth of the region's manufacturing workers losing their jobs.

The Asian financial crisis resulted in lower prices for imported steel, helping to keep inflation down in the U.S. At the same time, low prices have hurt domestic steel manufacturers. In fact, several nations have been accused of "dumping" steel on U.S. markets. Selling exports below costs has the potential to distort the efficient allocation of resources as much as erecting barriers to trade.

The effect of job losses can be devastating, regardless of the reason. Workers who are displaced by trade may suffer greater hardship than workers who lose their jobs for other reasons because there is a greater likelihood that an entire industry may be affected, rather than a specific firm. However, the extent of U.S. job losses due to international trade is open to debate. For example, analysis in the *1998 Economic Report of the President* indicates that open markets were not the cause of a large percentage of U.S. job displacement in manufacturing during the 1980s. Most of the job losses in manufacturing during this period occurred because of technological change, according to the *Report*.

Another indication of the effect of open markets is provided by the U.S. Labor Department, which recently reported that 210,000 workers have lost their jobs as a result of the North American Free Trade Agreement (NAFTA) since it became effective in 1994. However, this figure is dwarfed by the 15.3 million total jobs created by the U.S. economy from 1994 to 1998.

Formulating Trade Policy

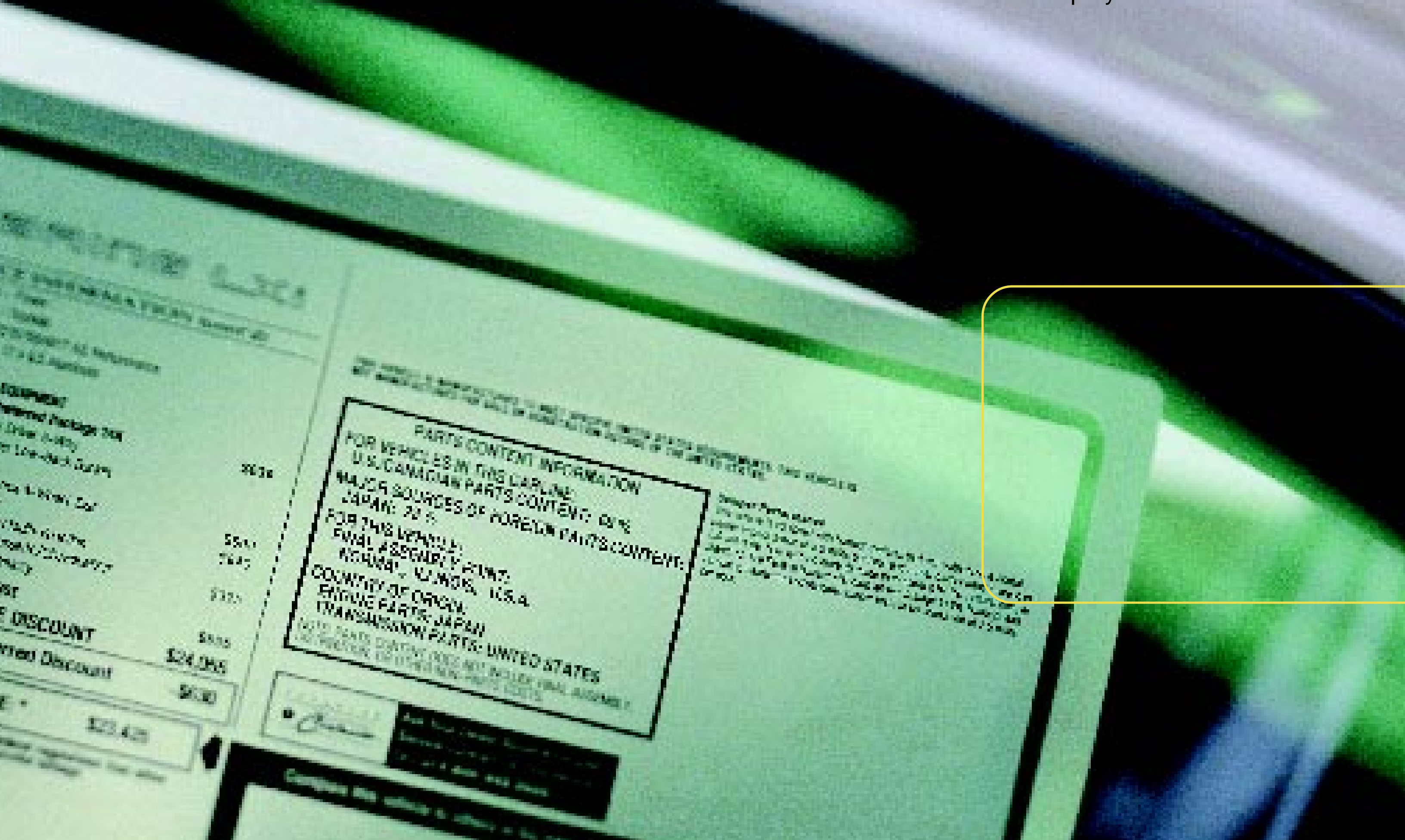
How can the U.S. resolve the difficult tradeoffs between the benefits and costs of open markets in determining future trade policy? Determining trade policy is complicated by the variation in the benefits of open markets for the overall world economy versus individual nations. Open markets provide overall benefits for the world economy. In this way, it is in the best interests of all nations to promote open markets. However, in some cases, it may not be beneficial for a country to open its markets to another country that retains trade barriers. If each country in a region acts on its own—on a unilateral basis—it may be optimal for each country to retain trade barriers. It may take a binding, multi-lateral trade agreement, such as those negotiated under the auspices of the World Trade Organization (WTO), to create a situation in which all countries in a region are better off by jointly removing trade barriers.

One key to formulating effective policy will be to separate the rhetoric from the reality of trade. Often the trade debate has centered on the net effect on jobs, a focus that is reflected in the public's attitude. In a NBC/*Wall Street Journal* poll taken in late 1998, 58 percent of those surveyed said foreign trade has been bad for America because cheap imports have hurt wages and cost jobs.

Yet the key advantages of open markets are fostering lower prices and higher-quality goods and facilitating the efficient allocation of resources. The amorphous nature of these benefits makes them less compelling. The immediate and very real pain resulting from a shuttered factory has a much more visceral effect. But the advantages of open markets are vitally important in raising our standard of living. The ongoing challenge facing policymakers is to balance these important benefits to the population at large with the undeniable costs to some industries and workers.

Have Open Markets Helped the Midwest?

Having U.S. borders open to trade and investment has helped the Midwest regain the economic prowess lost during the downturns of the early 1980s. Midwestern manufacturing has revived in recent years, leading to higher relative standards of living and low unemployment.



The Midwest's revival is partly due to an influx of direct foreign investment to the U.S., which totaled roughly $300 billion in the 1980s and early 1990s. Roughly one-third of that investment was directed at manufacturing-related industries, particularly the auto industry, a Midwestern stronghold.

Productivity-enhancing management practices frequently accompanied the investment. These include procedures such as lean manufacturing and just-in-time inventory practices. Auto and truck manufacturers successfully adopted many of these techniques, finding the Midwest's transportation infrastructure and dense concentration of suppliers and service providers very suitable for these new modes of operation.

Open markets for the sale of Midwestern goods abroad have also contributed to the region's revival. Since 1990, manufacturing goods exports have increased significantly in the Midwest compared with the rest of the country. Certain types of agricultural exports are also up, including processed food products derived from the region's staple crops of corn and soybeans. Total exports from the Midwestern states of Iowa, Illinois, Indiana, Wisconsin and Michigan have increased more than 80 percent since 1990.

Since trade has been beneficial to the region, why do some Midwesterners oppose efforts to open up markets to greater trade? One reason may be a misunderstanding of the reasons behind the industrial upheavals that have dislocated workers and their families.

Trade is often an over-emphasized factor in understanding economic upheavals. Over the course of the 20th century, trade has not been a major factor in changing the concentration of manufacturing in the Midwest. Rather, these changes resulted from a variety of other factors. One is the advent of the interstate highway system, which opened new labor markets in other regions and helped disperse manufacturing throughout the U.S.

Price stickers on new cars illustrate the complex nature of manufacturing, with many autos manufactured in one country using parts produced in another. For example, final assembly of the auto pictured here was in central Illinois, while 23% of the parts came from Japan. It is increasingly difficult to differentiate an export from an import.

Who are our Biggest Trading Partners?

The answer might surprise you. TV pundits or politicians debating trade policy might lead one to guess Japan or possibly Mexico. But our biggest trading partner of goods is up north—Canada. The United States sends more goods there—and receives more in return—than to any other individual nation.

Exports are much more than tangible items such as washing machines or automobiles. Many are services as opposed to goods. One example of a service export is a college education. When a foreigner is educated in the U.S., that's considered an export. Other common services frequently exported are travel-related, or in the financial or legal fields. Overall, the U.S. runs a trade surplus in services, exporting more than it imports.

Where U.S. imports came from and where U.S. exports were sent in 1998

19.1%	Canada	22.9%
19.3	European Union	21.9
10.4	Mexico	11.6
9.4	Asia (NICs*)	9.3
5.6	Central/South America	9.3
13.3	Japan	8.5
7.8	China	2.1
15.1	All other nations	14.4

What goods the U.S. imported or exported in 1998

29.6%	Capital goods	43.8%
21.9	Industrial supplies	21.7
23.6	Consumer goods	11.6
16.5	Autos, etc.	10.6
4.5	Foods, feeds, beverages	6.8
3.9	Other goods	5.4

What services the U.S. imported or exported in 1998

29.5%	Travel	27.3%
6.1	Royalties and license fees	13.4
16.6	Other transportation	9.9
10.3	Passenger fares	7.7
6.8	Military/Defense	6.5
1.6	U.S. government miscellaneous	0.3
29.2	Other private services	35.0

Most equate trade with the exchange of goods. But roughly 28 percent of our exports and 16 percent of our imports are services. If trade in goods and services is combined, the 15 countries that make up the European Union rank ahead of Canada as the largest U.S. trading partner.

While we run a deficit in the trade of goods, we have a relatively large surplus in the trade of services. Traded services include travel, education, or financial services. If consumed by foreigners, these services are considered an export. For example, a Thai student studying at the University of Iowa is buying education. Thus, it's an export. Of all service exports, those related to travel make up about 35 percent. Other private services— including educational, legal and financial services—make up another 58 percent.

What goods do we export? Much of what we export is capital equipment such as machines and the components to make those machines. In fact, capital equipment and components of capital equipment, autos, consumer goods, and other manufactured goods make up more than 70 percent of our goods exports. Nearly 30 percent of our exports is industrial supplies or foods, feeds and beverages. And even for many of the products in those categories, substantial manufacturing or processing is involved.

The flip side is very similar: Slightly more than two-thirds of what we import is capital equipment and components, autos and consumer goods. The remainder includes industrial supplies or foods, feeds and beverages.

Overall, we import more than we export. We hit a record high in the overall trade deficit in 1998, importing $1.1 trillion in goods and services and exporting $931 billion. In services alone, we ran a surplus, exporting $260 billion compared with the $181 billion we imported.

Relative to the size of the total U.S. economy, international trade accounts for a modest but increasing share. The nominal value of exports of goods and services is equivalent to about 11 percent of gross domestic product (GDP), while imports are about 13 percent of GDP. That compares with 5.5 percent and 5.4 percent respectively in 1970.

As for foreign direct investment, the countries that have invested most in the U.S. are the United Kingdom and Japan, followed by the Netherlands, Germany, and Canada. Most of that investment falls in the category of manufacturing, followed by wholesale trade and insurance. The benefits of foreign investment extend beyond the money spent. New ideas and manufacturing techniques often accompany those funds. Most U.S direct investment abroad is in the United Kingdom, followed by Canada and Germany.

Overall, U.S. companies invest far more at home than they do abroad. The vast majority of our trade is "inter-regional," among businesses located in the U.S. And most foreign investment by American companies is in developed nations. In fact, most of our trade is with developed nations.

Why Does the U.S. Have a Trade Deficit?

Simply put, the amount of foreign goods and services purchased by the U.S. is greater than the amount of U.S. goods and services purchased by people abroad. This allows Americans to consume more goods and services than they produce. If Americans buy more than they sell, they must borrow from foreigners to finance the purchases. In other words, foreigners are lending to or investing in the United States.

Most toys imported into the U.S. are duty-free. American kids enjoy a wide variety of high-quality toys made in other countries or with parts manufactured abroad. The U.S. imports many more toys than it exports. U.S. toy manufacturers see great potential for expanding U.S. exports, since more than 96 percent of the world's children live outside the U.S. With the help of regional free trade agreements, toy industry officials look forward to expanded trade and reduced customs tariffs worldwide.

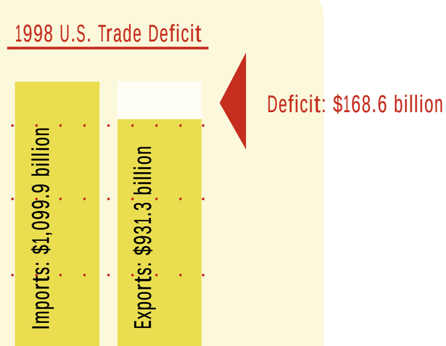
A trade deficit is not inherently undesirable. A variety of economic, social, and demographic factors determines the relationship between a country's goods and services trade and capital flows. For a trade-deficit (net capital inflow) country such as the U.S., the most important issue is not the existence of a deficit. Rather, it's how the imported capital that finances the deficit is used. When there is a trade deficit, there must be an offsetting capital inflow into the U.S. This means that in the current environment Americans are borrowing from abroad to finance some of their foreign purchases.

If the borrowed capital is used to improve productivity and increase output, it can be paid back, and at the same time the nation's real income will have increased. It results in not only an increase in current consumption of imports but also an increase in the standard of living for future generations.

However, if the borrowed capital is used for non-productive endeavors, at some future date the nation may need to reduce consumption to service and pay back the debt. That leads to a lower standard of living than otherwise would have been the case.

The recent increase in the trade deficit is partly the result of the financial crisis abroad and partly the result of strong U.S. economic growth. The financial crisis in Southeast Asia has withered economic growth in the region, reducing its demand for our exports. Strong U.S. economic growth has increased the demand for imports from all markets. In addition, the appreciation of the dollar relative to our Asian trading partners' currencies made their products cheaper for Americans to buy. Both factors resulted in more imports to the U.S. At the same time, weak economic conditions abroad reduced foreign demand for U.S. exports, and the stronger dollar made it relatively more expensive for foreigners to buy U.S. goods and services.

Current conditions have been beneficial in some ways for the U.S. Lower import prices have helped consumers, and have tended to hold down price increases for domestic goods. But lower import prices have made it more difficult for some import-competing domestic industries, such as steel and textiles. And other industries, including agriculture and some capital equipment producers, have faced a decline in exports.



What About Those Left Behind?

American trade is booming. Last year the U.S. exported $931 billion in goods and services, about 50 percent more than just five years ago. Despite the Asian financial crisis, exports now sustain an estimated 12 million American jobs, including one in five in manufacturing industries. Yet many polls indicate that Americans are unsure about the wisdom of maintaining open markets. This may be due to the fact that the benefits are sometimes diffuse and difficult to identify. In addition, open markets have costs. Some workers' jobs are eliminated because of foreign competition. For many Americans, the key question is: What about those left behind?

Policymakers can address the inherent complexities of open markets in two ways: working to ensure the maximum benefits and helping to offset the inevitable costs. The most important step in maximizing the global benefits of open markets is for each nation to resist the temptation to shift to a more protectionist policy. Such policies insulate specific industries against competition, distort resource allocation, discourage innovation, and result in higher prices for consumers.

Tariffs are the best-known type of barrier, but non-tariff barriers are an increasingly important and visible form of trade restriction. This is due in part to the large reductions in tariffs during the post-War period. Technical trade barriers, such as duplicative regulations and unnecessary paperwork, are a notable example of a non-tariff barrier. The growing importance of services in international trade has highlighted non-tariff barriers, such as the lack of a worldwide standard for intellectual property rights, such as patents and copyrights. And even as GATT negotiations have steadily lowered formal barriers, some countries have created hostile environments for outside competitors with informal systems that erode the viability of formal agreements.

The World Trade Organization (WTO) provides a mechanism for resolving disputes and preventing an escalating series of sanctions. Building on the progress in mediating disputes will aid the effort to create a global level playing field.

Reaping the maximum gains of open markets is important, but for many Americans the key question is how to address the inevitable costs. In cases where foreign competition shutters a domestic manufacturing plant, thousands might be out of work. How do policymakers reconcile this difficult tradeoff?

Perhaps the most effective—and difficult—strategy is making high-quality education and training more readily available. Education and training is essential because the Americans most at risk from foreign competition are low-skilled workers who tend to be less productive. In countries such as the U.S., which specialize in high-skill goods and services, such workers are hit especially hard as there are fewer job opportunities for them.

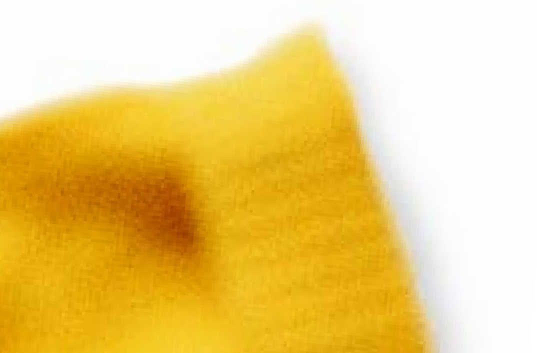
Education and training that upgrade skills would improve productivity and better equip workers for higher-paying, more competitive jobs in a global economy. An important starting point is ensuring high-quality elementary and secondary education. Those already in the workforce need new training methods that better meet the needs of employees and employers.

Another option is to do more to provide immediate, short-term relief for workers displaced by foreign trade. The Trade Adjustment Assistance (TAA) program, in place since 1962, already extends unemployment insurance payments to trade-displaced workers after the six-month limit on regular unemployment benefits expires. The program also provides job search assistance, worker retraining, and relocation expenses. Under legislation implementing NAFTA, TAA benefits are extended to workers displaced by a company moving production to Canada or Mexico.

Once dominant in the textile industry, the U.S. began to feel the pinch of foreign competition in the post-World War II period, losing market share to nations with lower wage costs. But the U.S. is fighting back. Once low-tech and labor intensive, the textile industry is now almost fully automated, particularly in the U.S., Western Europe, and Japan. U.S. firms for years have been investing steadily in capital equipment and computers to improve productivity and efficiency. This is important because all quotas in global trade in textiles are scheduled to be eliminated by 2005.

There are a number of proposals to supplement or replace these existing programs. Brookings Institution economists Bob Litan and Gary Burtless described one such proposal at a recent Chicago Fed conference on global trade. The unemployment insurance program proposed by Litan and Burtless would compensate trade-displaced workers who accept a lower-paying job by providing them with a percentage of their monthly wage loss. The additional payments would be provided only when a displaced worker started on a new job, creating both assistance and an incentive to take a new position as quickly as possible. (See the book *Globaphobia: Confronting Fears about Open Trade* by Gary Burtless, Robert Lawrence, Robert Litan, and Robert Shapiro for more information on the proposal.)

Ultimately, the answer in developing effective trade policy lies in striking a balance between efficiency and equity, preserving the important advantages of efficient resource allocation, while maintaining a sense of fairness in the distribution of the benefits. Determining the appropriate balance is important because of the potential payoff—easing the pain for those left behind in the global economy and increasing the standard of living for the population at large.



Highlights of 1998

First Quarter (January-March)

• The Seventh District Cash Department was rated the Federal Reserve System's best operation in the first quarter, a distinction it earned for the entire year.

• The Bank began a successful year resulting in achievement of its top-priority objectives and expenses well below budget.

• The Chicago Fed launched an initiative to develop strategies for moving to the next generation of electronic payments.

• The Illinois Check Territory set out to improve operations and meet demanding revenue targets, goals that were ultimately accomplished.

• The Bank embarked upon a variety of diversity-related initiatives, including mandatory diversity-awareness sessions for all employees.

• Credit risk, Year 2000 risk, event risk and fair lending are targeted as Supervision and Regulation's top priorities during 1998 exams.

• Supervision and Regulation launched a successful year in which more than 880 inspections, examinations, and risk assessments were carried out.

• The Bank began an effort requiring all employees to create personal development plans.

• The Des Moines Office celebrated 25 years of service.

Second Quarter (April-June)

• The Bank began building renovations to consolidate its statistical reporting functions at one central location at the Chicago Office, a target that was achieved in October.

• Generally regarded as the leading conference of its kind, the 34th annual Conference on Bank Structure and Competition focused on payments systems in the global economy.

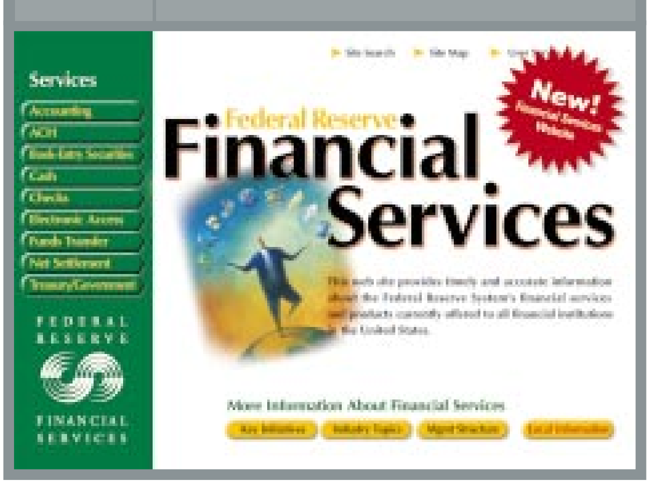
• The Bank held the first meeting of the Community Bank Council, established to promote communication between the Chicago Fed and community banks.

• The Chicago Fed opened its new Conference Center, which during the year accommodated nearly 600 events for employees and visitors.

• The Bank finished the process of ensuring that mission-critical applications that provide electronic services to external customers are ready for the Year 2000.

• A newly designed $20 bill was unveiled with a variety of new security features.

• The Bank committed itself to 72 action steps aimed at improving performance by taking advantage of the organization's diversity.

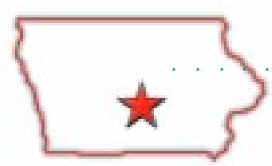


Third Quarter (July-September)

• Banks began to test their electronic connections with the Chicago Fed for any of the financial services provided them.

• The Bank was selected to coordinate the new System Leadership Conference, a forum designed to help develop Federal Reserve System leaders.

• Consumer & Community Affairs coordinated a public hearing in August on the then-proposed merger of First Chicago NBD and Banc One.



• Roughly 60,000 people visited the Bank's booth in August at the Iowa State Fair.

• Foreign graduate students attending the University of Illinois at Urbana-Champaign toured the Bank, counting them in the nearly 12,000 visitors who toured the Chicago Fed during the year.

• Economist Daniel Aaronson explored the effect of neighborhoods on children's educational outcomes in a research paper, one of 20 papers from Economic Research throughout the year accepted for or published in leading scholarly journals.

• Economic Research staff analyzed the competitive considerations of the First Chicago NBD-Banc One merger, one of a record 315 cases reviewed in 1998.

• The Check Department began using imaging technology at its Chicago and Detroit offices to process checks for its commercial customers. The service was previously available at just the Des Moines and Milwaukee offices.

Fourth Quarter (October-December)

• The System's Business Development Office, housed in Chicago, developed a new Web site for all Reserve Banks focusing on the System's financial products and services.

• The Bank successfully ended the year having fully recovered the costs of providing priced financial services, including the cost of taxes and capital and the average level of profit it would incur if it were a private firm.

• Supervision and Regulation finished processing the last of its 650 total applications, one of the highest volumes in the System.

• Research Statistics enjoyed a productive year, having met 100 percent of its report deadlines to the Board of Governors and 99 percent of its report deadlines to the New York Fed.

• The Bank finished certifying all its business-critical computer applications for Y2K readiness, and most are now in production.

• The Research Department hosted an October conference with the International Monetary Fund on the Asian financial crisis.

• The Detroit Branch was recognized for its quality management and performance excellence by the Michigan Quality Leadership Award program.

• The Peoria Office hit a new high in December by increasing check volumes to an annual daily average of 850,000 checks.

• The Bank played a leadership role throughout the year in 23 System committees.

• The Bank closed 1998 having processed 20 percent of the System's ACH volume, as well as the largest commercial ACH volume in the System.

• The System's new "Sell Direct" program located at the Chicago Fed ended the year having processed 16,220 transactions.

Y2K.

The Federal Reserve Bank of Chicago accomplished a great deal in 1998 to prepare for the Year 2000. The Bank's highest-priority objective in 1999 will be to complete preparation of its internal systems and to help prepare the U.S. financial system for Y2K.

The Federal Reserve System is committed to maintaining the stability of the U.S. financial system during the date-change period. Americans have worked together to meet important challenges in the past. Fed officials are confident the financial system will be ready and that the public will keep the Year 2000 in perspective, realizing it is one more challenge that will be met.

Public confidence about the Year 2000 will be strengthened by regular communication from banks, banking supervisors and trade groups. All of these institutions and organizations should be active communicators. The Fed understands the public's need for accurate information and has been communicating about Y2K efforts in a wide variety of ways. The Fed will continue to communicate about the readiness of the banking industry as 1999 progresses.

Following are some questions and answers related to Federal Reserve Year 2000 preparations:

1) How is the Chicago Fed helping financial institutions to which it provides financial services?

The Federal Reserve is doing everything it can to be sure that various methods of payment will continue to work. Banks can test their electronic connections with the Chicago Fed for any of the financial services provided them. Available six days a week, this testing is carried out in an environment that simulates many future dates, but most importantly concentrates on the century date change and leap year dates in the Year 2000. The testing confirms the ability of banks to interact electronically with the Federal Reserve in a future-dated environment. A variety of outreach seminars, bulletins and newsletters promoted the testing and have helped banks assess their Year 2000 readiness. Banks should have completed testing by June 30, 1999, and should have substantially completed implementation of renovated mission-critical systems and contingency planning activities.

2) How many banks have tested so far?

Roughly 825 banks had conducted tests with the Chicago Fed as of March 31, 1999, and roughly 7,900 had tested with Federal Reserve Banks across the country. All in all, testing has gone well, and banks are making good progress. Banks that have not yet completed testing are encouraged to do so as soon as possible. The Chicago Fed is available and ready to meet their needs.

3) How are preparations going from a supervisory standpoint?

The Chicago Fed's examinations during 1998 indicate that institutions are progressing well in their Year 2000 compliance programs. The supervisory agencies have established critical project milestones that institutions must meet. For example, mission-critical system testing must be complete by June 30, 1999. Besides testing, institutions are required to assess Year 2000-related business risks and establish outreach programs to discuss their preparedness with customers. Contingency plans also must be developed to address potential system failures and liquidity management issues. The examination process is focusing on institutions' progress in all of these areas. However, the ultimate responsibility for Year 2000 readiness lies with individual banks. The Chicago Fed can monitor their progress, but individual banks are responsible for being ready.

4) How is the Federal Reserve preparing for demands for currency?

The Fed expects the U.S. financial system to be ready for the Year 2000. Most people should find their money is safe where it is. Some people might decide to hold extra cash during the Year 2000 rollover, but few individuals are expected to hold significantly more than they typically do. As a precaution, the Fed will increase the currency in circulation and in Federal Reserve or commercial banks' vaults to about $700 billion in 1999. That provides a cushion of about $200 billion to meet any increased demand—about $50 billion more than the previous cushion. The Fed will also be taking steps to ensure that depository institutions will be able to obtain currency on a timely basis to meet the demands of their customers. If necessary, Federal Reserve Banks will extend their hours to fill banks' currency orders or take other operational steps to ensure that banks can obtain cash quickly. The Fed will continue to assess public needs, and if necessary, make adjustments in the currency printing order for the fourth quarter.

5) What else is important for consumers to know?

The Year 2000 date change does not affect deposit insurance coverage. Deposits at an FDIC-insured bank or savings institution will continue to be protected up to $100,000 against loss due to the failure of the institution. Banks and savings associations are required to keep backup records for account transactions so they can recover account information in case of an emergency.

6) What are the Fed's internal preparations for the Year 2000?

Much of the Bank's internal preparation has involved making sure all computer systems and applications are ready. The Bank's most important systems were ready for Year 2000 at the end of 1998, and all remaining systems were ready by March 31, 1999. A comprehensive eight-phase process was used to make sure computer hardware and operating systems—as well as systems with embedded chips—were ready. That was followed by testing the processing capabilities of specific business applications in a simulated future-date environment.

7) What will be the Bank's internal focus for the rest of the year?

The rest of the year will be devoted to certifying the readiness of new internal software or software that is changed, as well as to contingency planning.

8) What type of contingency planning is underway?

It focuses on the Chicago Fed's internal readiness and its ability to interact with depository institutions. It's important to remember that the Chicago Fed already has extensive contingency plans that have been routinely tested, and occasionally implemented, during natural disasters and other disruptions. The Bank is building on the plans already in place. Many of these contingency plans will be tested and refined in 1999. The Chicago Fed is developing alternate manual operating procedures for automated business applications where possible, and has a number of other contingency plans in place for a wide variety of other possible problems.

9) What is the Fed doing to assess worldwide readiness?

Although the Federal Reserve can't be responsible for Year 2000 preparations among foreign nations and institutions, it's working to better understand their level of readiness. The Federal Reserve's direct supervisory authority is limited to offices of those foreign banks operating in the U.S., but it will receive information on foreign bank Year 2000 readiness from international supervisory bodies and private sector forums. The Fed will also be working with foreign bank supervisors and other U.S. supervisors to improve the flow and quality of information on foreign Year 2000 readiness.

10) What will be the impact of the Year 2000 problem on the U.S. economy?

The Fed is cautiously optimistic there will be no significant disruptions to the economy as a result of the Year 2000 problem. A recession seems unlikely, but a positive outcome continues to depend on diligent preparation and progress. The economic stakes are very large and the spectrum of possible outcomes very broad, ranging from minimal to very serious. It is impossible to know exactly what will happen, but a reasonable scenario is that the net effect of spending to correct the problem could shave one-tenth or two-tenths of a percent off the growth of U.S. labor productivity and could reduce GDP by one-tenth of a percentage point per year over 1999 and 2000.

11) What about the role of monetary policy?

Monetary policy can do nothing to head off Year 2000 disruptions, but the Fed will be prepared to lend to financial institutions under appropriate circumstances or to provide needed reserves to the banking system. In the unlikely event that serious Year 2000 disruptions resulted in significant longer-term effects on aggregate demand, the Federal Reserve would have an important role to play in countering the downturn.

For more information

Visit the Fed's Year 2000 web site at http://www.frbsf.org/fiservices/cdc/index.html for information on a variety of Year 2000 topics. For information on what banks must do to satisfy the regulatory requirements for the Year 2000, visit the FFIEC's Web site at http://www.ffiec.gov/y2k/default.htm.

These questions and answers have been designated as a Year 2000 Readiness Disclosure.

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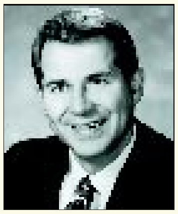

Two new directors joined the board in 1999. They are (left) James H. Keyes, chairman and chief executive officer of Johnson Controls, Inc. in Milwaukee, Wisconsin, and Alan R. Tubbs, president of Maquoketa State Bank and Ohnward Bancshares in Maquoketa, Iowa. They replace Donald Schneider and Arnold Schultz, who served the maximum two terms as directors.

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As of December 31, 1998

Directors

Members of the Federal Reserve Bank of Chicago's board of directors are selected to represent a cross section of the Seventh District economy, including consumers, industry, agriculture, the service sector, labor, and commercial banks of various sizes.

The board consists of nine members. Member banks elect three bankers and three nonbankers. The Board of Governors appoints three additional nonbankers and designates the Reserve Bank chair and deputy chair from among its three appointees.

The Detroit Branch has a seven-member board of directors. The Board of Governors appoints three nonbankers and the Chicago Reserve Bank board appoints four additional directors. The Branch board selects its own chair each year. All Reserve Bank and Branch directors serve three-year terms, with a two-term maximum.

Director appointments and elections at the Chicago Reserve Bank and its Detroit Branch effective in 1998 were:

- Lester H. McKeever, Jr. reappointed to a second three-year term and redesignated Chairman.
- Arthur C. Martinez redesignated Deputy Chairman.
- Jack B. Evans, President of The Hall-Perrine Foundation, Cedar Rapids, Iowa, and Robert R. Yohanan, Managing Director and Chief Executive Officer of First Bank & Trust, Evanston, Illinois, appointed to three-year terms as directors replacing Thomas C. Dorr and Stefan S. Anderson.
- Florine Mark redesignated Branch Chair.
- Timothy D. Leuliette reappointed as Branch director.
- David J. Wagner, Chairman, President, and Chief Executive Officer of Old Kent Financial Corporation and Chairman of Old Kent Bank, Grand Rapids, Michigan, appointed to three-year term as Branch director, replacing Charles R. Weeks.

At year-end 1998 the following appointments and elections to terms beginning in 1999 were announced:

- Lester H. McKeever, Jr. was redesignated to a third term as Chairman.
- Arthur C. Martinez was reappointed to a second three-year term and redesignated Deputy Chairman.
- James H. Keyes, Chairman and Chief Executive Officer, Johnson Controls, Inc., Milwaukee, Wisconsin, was elected to a three-year term, replacing Donald Schneider.
- Alan R. Tubbs, President, Maquoketa State Bank and Ohnward Bancshares, Maquoketa, Iowa, was elected to a three-year term replacing Arnold C. Schultz.
- Florine Mark was redesignated Branch Chair.
- Stephen R. Polk and Richard M. Bell were reappointed to a second three-year term as Branch directors.

Advisory Councils

The Federal Advisory Council, which meets quarterly to discuss business and financial conditions with the Board of Governors in Washington, D.C., is comprised of one banker from each of the 12 Federal Reserve Districts. Each year the Chicago Reserve Bank's board of directors selects a representative to this group. Norman R. Bobins was appointed to serve a second one-year term beginning January 1, 1999.

The Community Bank Council was established in 1998. Members of the Advisory Council on Agriculture, Labor and Small Business, who are selected from nominations by Seventh District organizations, served the second year of their terms in 1998. The councils provide a vital communication link between the Bank and these important sectors.

Officers

The Bank's board of directors acted on the following promotions during 1998:

- William A. Barouski to senior vice president, Information Technology Services.
- Brian D. Egan to vice president, Detroit Branch.
- Douglas D. Evanoff to vice president, Economic Research.
- Charles L. Evans to vice president, Economic Research.
- Frank S. McKenna to vice president, Information Technology Services.
- Jerome D. Nicolas to vice president, Cash.
- Angela D. Robinson to vice president and director of research statistics, Statistics
- Daniel G. Sullivan to vice president, Economic Research.
- William A. Testa to vice president, Economic Research.
- Kathleen H. Williams to vice president, Strategic Marketing and Customer Service.
- Ellen Bromagen to assistant vice president, Accounting.
- Cynthia L. Rasche to assistant vice president, Retail Operations.

New officers appointed by the board in 1998 were:

- Lysette R. Bailey to training and information security officer, Information Technology Services.
- Deirdre A. Grant to cultural transformation leader and EEO officer, Cultural Transformation.
- Michael J. Hoppe to operations officer, Milwaukee Office.
- Katherine McDonald to retail payments officer, Retail Payment Services.
- Linda S. McDonald to operations officer, Detroit Branch.
- Ira R. Zilist to information technology officer, Information Technology Services.

George Coe retired after 37 years of service to the Federal Reserve System.

	Dollar Amount		Number of Items	
	1998	1997	1998	1997
Check & Electronic Payments				
Checks, NOWs, & share drafts processed	1.5 trillion	1.3 trillion	2.0 billion	1.9 billion
Fine sort & packaged checks handled	46.7 billion	64.1 billion	76.0 million	120.3 million
U.S. government checks processed	43.7 billion	41.4 billion	41.8 million	40.7 million
Automated Clearing House (ACH) items processed	2.5 trillion	2.2 trillion	744.3 million	687.1 million
Transfer of funds	46.8 trillion	37.0 trillion	20.5 million	16.8 million
Electronic cash letters processed	–	–	650.2 million	524.3 million
Cash Operations				
Currency received and counted	39.4 billion	39.3 billion	2.8 billion	2.8 billion
Unfit currency destroyed	6.6 billion	10.8 billion	629.6 million	831.2 million
Coin received and counted	858.3 million	759.8 million	8.4 billion	5.0 billion
Securities Services for Depository Institutions				
Safekeeping balance December 31:				
Definitive securities	20.7 billion	12.7 billion	14.4 thousand	23.5 thousand
Book-entry securities	273.4 billion	282.5 billion	–	–
Purchase & Sale	3.4 billion	3.1 billion	7.0 thousand	11.1 thousand
Book-entry government securities	7.4 trillion	7.2 trillion	876.1 thousand	979.4 thousand
Loans to Depository Institutions				
Total loans made during year	2.5 billion	4.0 billion	0.8 thousand	1.6 thousand
Services to U.S. Treasury and Government Agencies				
Redemptions of definitive government securities	33.3 million	37.4 million	0.8 thousand	3.2 thousand
Government coupons paid	2.5 million	3.8 million	9.2 thousand	11.7 thousand
Federal tax deposits processed	11.0 billion	46.8 billion	703.0 thousand	773.2 thousand
Food stamps redeemed	832.3 million	1.5 billion	166.3 million	291.3 million
Sell Direct transactions processed	510.6 million	132.3 million	16.2 thousand	4.2 thousand

Management Assertion

March 5, 1999

To the Board of Directors of The Federal Reserve Bank of Chicago:

The management of the Federal Reserve Bank of Chicago (FRBC) is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 1998 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks, and as such, include amounts, some of which are based on judgments and estimates of management.

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

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

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

Federal Reserve Bank of Chicago

Michael Moskow
President and Chief Executive Officer

Federal Reserve Bank of Chicago

William Conrad
First Vice President and Chief Operating Officer

PRICEWATERHOUSECOOPERS

Report of Independent Accountants

To the Board of Directors of The Federal Reserve Bank of Chicago:

We have examined management's assertion that the Federal Reserve Bank of Chicago ("FRB Chicago") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the Financial Statements as of December 31, 1998, included in the accompanying Management's Assertion.

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

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

In our opinion, management's assertion that the FRB Chicago maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the Financial Statements as of December 31, 1998, is fairly stated, in all material respects, based upon criteria described in "Internal Control - Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

PricewaterhouseCoopers LLP

Chicago, Illinois
March 5, 1999

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
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Chicago, IL 60601-1210
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Report of Independent Accountants

To the Board of Governors of the Federal Reserve System
and the Board of Directors of the Federal Reserve Bank of Chicago

We have audited the accompanying statements of condition of The Federal Reserve Bank of Chicago (the "Bank") as of December 31, 1998 and 1997, and the related statements of income and changes in capital for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on the financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 1998 and 1997, and results of its operations for the years then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

Chicago, Illinois
March 5, 1999

Statement of Condition (in millions) As of December 31,	1998	1997
Assets		
Gold Certificates	$ 998	$ 1,069
Special Drawing Rights Certificates	900	900
Coin	35	52
Items in Process of Collection	794	773
Loans to Depository Institutions	3	13
U.S. Government and Federal Agency Securities, Net	43,841	46,293
Investments Denominated in Foreign Currencies	1,911	1,989
Accrued Interest Receivable	414	438
Interdistrict Settlement Account	1,838	–
Bank Premises and Equipment, Net	141	143
Other Assets	28	87
Total Assets	$ 50,903	$ 51,757
Liabilities and Capital		
Liabilities:		
Federal Reserve Notes Outstanding, Net	$ 44,608	$ 40,531
Deposits:		
Depository Institutions	4,282	3,570
Other Deposits	78	82
Deferred Credit Items	609	679
Surplus Transfer Due U.S. Treasury	56	59
Interdistrict Settlement Account	–	5,705
Accrued Benefit Cost	79	76
Other Liabilities	25	26
Total Liabilities	$ 49,737	$ 50,728
Capital:		
Capital Paid-in	583	527
Surplus	583	502
Total Capital	$ 1,166	$ 1,029
Total Liabilities and Capital	$ 50,903	$ 51,757

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

Statement of Income (in millions) For the years ended December 31,	1998	1997
Interest Income:		
Interest on U.S. Government Securities	$ 2,625	$ 2,696
Interest on Foreign Currencies	43	44
Interest on Loans to Depository Institutions	1	2
Total Interest Income	$ 2,669	$ 2,742
Other Operating Income (Loss):		
Income from Services	95	95
Reimbursable Services to Government Agencies	22	17
Foreign Currency Gains (losses), Net	181	(303)
Government Securities Gains, Net	4	1
Other Income	5	4
Total Other Operating Income (Loss)	$ 307	$ (186)
Operating Expenses:		
Salaries and Other Benefits	129	127
Occupancy Expense	18	20
Equipment Expense	19	18
Cost of Unreimbursed Treasury Services	1	4
Assessments by Board of Governors	53	58
Other Expenses	97	96
Total Operating Expenses	$ 317	$ 323
Net Income Prior to Distribution	$ 2,659	$ 2,233
Distribution of Net Income:		
Dividends Paid to Member Banks	$ 33	$ 32
Transferred to (from) Surplus	81	(10)
Payments to U.S. Treasury as Interest on Federal Reserve Notes	770	–
Payments to U.S. Treasury as Required by Statute	1,775	2,211
Total Distribution	$ 2,659	$ 2,233

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

Statement of Changes in Capital (in millions)

For the years ended Dec. 31, 1998 and Dec. 31, 1997

	Capital Paid-in	Surplus	Total Capital
Balance at January 1, 1997 (10.7 million shares)	$ 537	$ 524	$ 1,061
Net Income Transferred (from) Surplus		(10)	(10)
Statutory Surplus Transfer to the U.S. Treasury		(12)	(12)
Net Change in Capital Stock (Redeemed) (0.2 million shares)	$ (10)	$ –	$ (10)
Balance at December 31, 1997 (10.5 million shares)	$ 527	$ 502	$ 1,029
Net Income Transferred to Surplus		81	81
Net Change in Capital Stock Issued (1.2 million shares)	56	–	56
Balance at December 31, 1998 (11.7 million shares)	$ 583	$ 583	$ 1,166

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

1. Organization

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

Structure

The Bank and its branch in Detroit, Michigan serve the Seventh Federal Reserve District, which includes Iowa and portions of Illinois, Indiana, Michigan, and Wisconsin. In accordance with the Federal Reserve Act, supervision and control of the Bank is exercised by a Board of Directors. Banks that are members of the System include all national banks and any state chartered bank that applies and is approved for membership in the System.

Board of Directors

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

2. Operations and Services

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

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

3. Significant Accounting Policies

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

The financial statements have been prepared in accordance with the Financial Accounting Manual. Differences exist between the accounting principles and practices of the System and generally accepted accounting principles ("GAAP"). The primary differences are the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP, and the accounting for matched sale-purchase transactions as separate sales and purchases, rather than secured borrowings with pledged collateral, as is required by GAAP. In addition, the Bank has elected not to present a Statement of Cash Flows or a Statement of Comprehensive Income.

The Statement of Cash Flows has not been included as the liquidity and cash position of the Bank are not of primary concern to the users of these financial statements. The Statement of Comprehensive Income, which comprises net income plus or minus certain adjustments, such as the fair value adjustment for securities, has not been included because as stated above the securities are recorded at amortized cost and there are no other adjustments in the determination of Comprehensive Income applicable to the Bank. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. Therefore, a Statement of Cash Flows or a Statement of Comprehensive Income would not provide any additional useful information. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

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

a. *Gold Certificates*

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

b. *Special Drawing Rights Certificates*

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

c. *Loans to Depository Institutions*

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

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

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

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

Reserve Banks are authorized by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements, in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires the lending Reserve Bank to take possession of collateral in amounts in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by the lending Reserve Bank on a daily basis, with additional collateral obtained as necessary. The securities loaned continue to be accounted for in the SOMA.

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

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

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

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

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

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

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

e. Bank Premises and Equipment

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

f. Interdistrict Settlement Account

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

g. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents to the Reserve Banks upon deposit with such Agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve Agent must be equal to the sum of the notes applied for by such Reserve Bank. In accordance with the Federal Reserve Act, gold certificates, special drawing rights certificates, U.S. government and agency securities, loans allowed under Section 13, and investments denominated in foreign currencies are pledged as collateral for net Federal Reserve notes outstanding. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, whose collateral value is equal to the par value of the securities tendered. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy its obligation to provide sufficient collateral for its outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides that certain assets of the Reserve Banks are jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents Federal Reserve notes reduced by cash held in the vaults of the Bank of $9,506 million, and $6,589 million at December 31, 1998 and 1997, respectively.

h. Capital Paid-in

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

i. Surplus

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. Payments made after September 30, 1998 represent payment of interest on Federal Reserve notes outstanding.

The Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66, Section 3002) codified the existing Board surplus policies as statutory surplus transfers, rather than as payments of interest on Federal Reserve notes, for federal government fiscal years 1998 and 1997 (which began on October 1, 1997 and 1996, respectively). In addition, the legislation directed the Reserve Banks to transfer to the U.S. Treasury additional surplus funds of $107 million and $106 million during fiscal years 1998 and 1997, respectively. Reserve Banks were not permitted to replenish surplus for these amounts during this time. The Reserve Banks made these transfers on October 1, 1997 and October 1, 1996, respectively. The Bank's share of the 1997 transfer is reported as "Statutory surplus transfer to the U.S. Treasury."

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

j. Cost of Unreimbursed Treasury Services

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

k. Taxes

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

4. U.S. Government and Federal Agency Securities

Securities bought outright and held under agreements to resell are held in the SOMA at the FRBNY. An undivided interest in SOMA activity, with the exception of securities held under agreements to resell and the related premiums, discounts and income, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings. The settlement, performed in April of each year, equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was approximately 9.600% and 10.666% at December 31, 1998 and 1997, respectively.

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

	1998	1997
Par value:		
Federal Agency	$ 32	$ 73
U.S. Government:		
Bills	18,699	21,026
Notes	18,038	18,582
Bonds	6,670	6,337
Total Par Value	**$ 43,439**	**$ 46,018**
Unamortized Premiums	709	661
Unaccreted Discounts	(307)	(386)
Total allocated to Bank	**$ 43,841**	**$ 46,293**

Total SOMA securities bought outright were $456,667 million and $434,001 million at December 31, 1998 and 1997, respectively.

The maturities of U.S. government and federal agency securities bought outright, which were allocated to the Bank at December 31, 1998, were as follows (in millions):

	Par Value		
Maturities of Securities Held	U.S. Government Securities	Federal Agency Obligations	Total
Within 15 days	$ 111	$ –	$ 111
16 days to 90 days	9,517	2	9,519
91 days to 1 year	13,789	7	13,796
Over 1 year to 5 years	10,342	6	10,348
Over 5 years to 10 years	4,303	17	4,320
Over 10 years	5,345	–	5,345
Total	**$ 43,407**	**$ 32**	**$ 43,439**

At December 31, 1998, and 1997, matched sale-purchase transactions involving U.S. government securities with par values of $20,927 million and $17,027 million, respectively, were outstanding, of which $2,009 million and $1,816 million respectively, were allocated to the Bank. Matched sale-purchase transactions are generally overnight arrangements.

5. Investments Denominated in Foreign Currencies

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

Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on F/X swaps and warehousing transactions. This allocation is based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. The Bank's allocated share of investments denominated in foreign currencies was approximately 9.660% and 11.667% at December 31, 1998 and 1997, respectively.

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

	1998	1997
German Marks:		
Foreign currency deposits	$ 1,010	$ 965
Government debt instruments including agreements to resell	229	375
Japanese Yen:		
Foreign currency deposits	64	67
Government debt instruments including agreements to resell	599	572
Accrued interest	9	10
Total	**$ 1,911**	**$ 1,989**

Total investments denominated in foreign currencies were $19,769 million and $17,046 million at December 31, 1998 and 1997, respectively, which include $15 million and $3 million in unearned interest for 1998 and 1997 respectively, collected on certain foreign currency holdings that are allocated solely to the FRBNY.

The maturities of investments denominated in foreign currencies which were allocated to the Bank at December 31, 1998, were as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies	
Within 1 year	$ 1,819
Over 1 year to 5 years	48
Over 5 years to 10 years	44
Total	**$ 1,911**

At December 31, 1998 and 1997, there were no open foreign exchange contracts or outstanding F/X swaps.

At December 31, 1998 and 1997, the warehousing facility was $5,000 million, with zero outstanding.

6. Bank Premises and Equipment

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

	1998	1997
Bank premises and equipment:		
Land	$ 6	$ 6
Buildings	125	122
Building machinery & equipment	18	17
Construction in progress	1	1
Furniture and equipment	100	93
	$ 250	$ 239
Accumulated depreciation	(109)	(96)
Bank premises and equipment, net	**$ 141**	**$ 143**

Depreciation expense was $15 million for each of the years ended December 31, 1998 and 1997.

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

	1998	1997
Bank premises and equipment	$ 3	$ 3
Accumulated depreciation	(1)	(1)
Capitalized leases, net	**$ 2**	**$ 2**

The Bank leases unused space to outside tenants. Those leases have terms ranging from 1 to 13 years. Rental income from such leases was $2 million for each of the years ended December 31, 1998 and 1997. Future minimum lease payments under agreements in existence at December 31, 1998, were (in millions):

1999	$ 2
2000	2
2001	2
2002	2
2003	2
Thereafter	5
	$ 15

7. Commitments and Contingencies

At December 31, 1998, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from 1 to approximately 8 years. These leases provide for increased rentals based upon increases in real estate taxes, operating costs or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $2.3 million and $2.2 million for the years ended December 31, 1998 and 1997, respectively. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 1998, were (in thousands):

	Operating	Capital
1999	$ 1,303	$ 175
2000	1,073	175
2001	847	175
2002	561	175
2003	375	29
Thereafter	998	–
	$ 5,157	**$ 729**
Amount representing interest		(115)
Present value of net minimum lease payments		**$ 614**

At December 31, 1998, the Bank had no other material commitments or long-term obligations in excess of one year outstanding.

Under the Insurance Agreement of the Federal Reserve Banks dated as of June 7, 1994, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of 1% of the capital of the claiming Reserve Bank, up to 50% of the total capital and surplus of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital bears to the total capital of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 1998 or 1997.

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

8. Retirement and Thrift Plans

Retirement Plans

The Bank currently offers two defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank's employees participate in the Retirement Plan for Employees of the Federal Reserve System ("System Plan") and the Benefit Equalization Retirement Plan ("BEP"). The System Plan is a multi-employer plan with contributions fully funded by participating employers. No separate accounting is maintained of assets contributed by the participating employers. The Bank's projected benefit obligation and net pension costs for the BEP at December 31, 1998 and 1997, and for the years then ended, are not material.

Thrift plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled $4.0 million and $3.9 million for the years ended December 31, 1998 and 1997, respectively, and are reported as a component of "Salaries and other benefits."

9. Postretirement Benefits Other Than Pensions and Postemployment Benefits

Postretirement benefits other than pensions

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

The Bank funds benefits payable under the medical and life insurance plans as due and, accordingly, has no plan assets. Net postretirement benefit cost is actuarially determined using a January 1 measurement date.

Following is a reconciliation of beginning and ending balances of the benefit obligation (in millions):

	1998	1997
Accumulated postretirement benefit obligation at January 1	$ 63.3	$ 60.9
Service cost-benefits earned during the period	1.4	1.3
Interest cost of accumulated benefit obligation	4.5	4.3
Actuarial loss (gain)	8.4	(0.3)
Contributions by plan participants	0.3	0.3
Benefits paid	(3.3)	(3.2)
Accumulated postretirement benefit obligation at Dec. 31	**$ 74.6**	**$ 63.3**

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

	1998	1997
Fair value of plan assets at January 1	$ 0.0	$ 0.0
Contributions by the employer	3.0	2.9
Contributions by plan participants	0.3	0.3
Benefits paid	(3.3)	(3.2)
Fair value of plan assets at December 31	$ 0.0	$ 0.0
Unfunded postretirement benefit obligation	$ 74.6	$ 63.3
Unrecognized prior service cost	8.9	9.9
Unrecognized net actuarial (loss)	(12.8)	(4.4)
Accrued postretirement benefit cost	**$ 70.7**	**$ 68.8**

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

The weighted-average assumption used in developing the postretirement benefit obligation as of December 31 is as follows:

	1998	1997
Discount rate	6.25%	7.00%

For measurement purposes, an 8.5% annual rate of increase in the cost of covered health care benefits was assumed for 1999. Ultimately, the health care cost trend rate is expected to decrease gradually to 4.75% by 2006, and remain at that level thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 1998 (in millions):

	1 Percentage Point Increase	1 Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit cost	$ 1.0	$ (1.1)
Effect on accumulated postretirement benefit obligation	**11.8**	**(12.2)**

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

	1998	1997
Service cost-benefits earned during the period	$ 1.4	$ 1.3
Interest cost of accumulated benefit obligation	4.4	4.3
Amortization of prior service cost	(0.9)	(0.9)
Net periodic postretirement benefit cost	**$ 4.9**	**$ 4.7**

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

Postemployment benefits:

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, and disability benefits. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank at December 31, 1998 and 1997, were $8.5 million and $7.4 million, respectively. This cost is included as a component of "Accrued benefit cost." Net periodic postemployment benefit costs included in 1998 and 1997 operating expenses were $1.9 million and $1.6 million, respectively.

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