Report from the President

RESPONDING TO SEPTEMBER 11 AND FUTURE PROSPECTS FOR THE NEW YORK REGIONAL ECONOMY

This has been an extraordinarily sad year for our nation and our city. The events of September 11 have left no one untouched. The attacks on the World Trade Center in New York and the Pentagon in Washington, D.C., have become a defining moment in our nation's history. The loss of human life and the destruction to two of our country's landmarks are as unspeakable as they are unimaginable. Tragic as these events were, they did nothing to dampen the strength of the human spirit and the resolve of our nation.

The *2001 Annual Report* of the Federal Reserve Bank of New York pays tribute to those here at the Bank and throughout the New York business and financial community who worked under exceptionally difficult circumstances to maintain order and continuity in the U.S. financial system on September 11 and in the days and weeks that followed. In my report, I describe the role played by Federal Reserve Bank of New York staff in ensuring that payments operations and other critical banking and financial activities continued. I also look at some of the collaborative and outreach efforts that our institution undertook during this period. Finally, I comment on how these terrible events have affected our outlook for the New York regional economy.

Countless individuals throughout our Bank and the New York business and financial community worked tirelessly on September 11 to see that essential trading and payments operations continued. The basic dollar payments systems never closed. Although the money and foreign exchange markets were seriously disrupted, they also remained open. Trading in government securities did effectively stop on September 11 and 12, but settlement continued. Within forty-eight hours of the attack on the World Trade Center, our markets were once again serving their crucial function in our country's economy. By Monday, September 17, the U.S. equities markets and other corporate securities markets had reopened. The rapid reestablishment of our capital markets was a testament not only to the fundamental resiliency of the financial system, but also to the dedication and quiet valor of many workers at our Bank and at other financial and business institutions throughout New York.

Why was the functioning of the U.S. financial markets put at risk on September 11? In part, the tragic destruction that day created unprecedented challenges for financial firms seeking to continue or resume business. But of special interest to the Federal Reserve, the events also put enormous pressure on the payments and securities settlement system that lubricates and underpins the financial markets and enables them to allocate capital in the most effective and efficient ways.

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More specifically, the World Trade Center buildings housed several wholesale brokers and large securities trading operations that played important roles in the financial markets. Moreover, the collapse of the towers disrupted the communications network and the primary operations of many payments service providers not housed in the Trade Center itself. Fire, debris, and water destroyed or damaged much of the power, telecommunications, and transportation infrastructure serving lower Manhattan's financial district.

Because most securities settlements and larger payments today are in electronic form, the payments and securities settlement system depends on an extensive communications network to maintain transaction flow. Any blockage in one segment of the payments system can potentially cause gridlock throughout the network and have spillover effects on the financial markets and eventually on the real economy. One of our missions at the Federal Reserve is to try to ensure that such gridlock does not occur.

In the chaos that followed the attack on the World Trade Center, workers in the vicinity were forced to evacuate their buildings immediately. Usual business operations were broken off suddenly, and a large number of institutions lost access to their premises and were obliged to activate contingency plans. These firms had to arrange to transport staff to backup sites even as the city closed access to lower Manhattan and to bridges, tunnels, and highways to facilitate the rescue effort and protect the city.

In the immediate aftermath of the attack, our first concern at the New York Fed—given our proximity to the World Trade Center—was for the safety of our staff and the need to tend to injured people on the street. Once the attack occurred, we relocated many employees to the lobby and below-ground levels. Outside, panicked and confused pedestrians were everywhere as the thick dust and smoke in the streets made breathing and seeing exceedingly difficult. Our protection officers, medical staff, and human resources staff were available to treat not only our own employees but also pedestrians and emergency workers who were brought into the Bank.

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One of our initial decisions on September 11 was to turn off the Bank's ventilation system so as to protect as fully as possible the air quality within our building. Throughout the day, our food services staff provided continuous beverage service and snacks. Our housekeeping staff immediately began vigorous cleanup efforts to ensure the health and safety of our employees and to enable the cafeteria to reopen by lunchtime. Our automation staff activated their contingency plans and made certain that the Bank's network and central data centers functioned as smoothly as possible.

Even before the first tower collapsed, our protection staff had locked our vaults, secured the perimeters of our building, and cleared a passageway through Maiden Lane so that emergency vehicles could more easily move from east to west toward the World Trade Center complex. In addition, special frequency radios were activated so that our staff could have uninterrupted communications with our operations center in New Jersey.

Because our building was so close to the World Trade Center, we encouraged our staff to remain in the Bank until there was some assurance that it was safe for them to leave the building and until it was clear that some public transportation had been restored. We also provided masks to all employees for their protection.

A core group of employees stayed on at the Bank to carry out essential market and payments functions and to maintain around-the-clock communication with our central bank colleagues throughout the world. Late on September 12, however, these employees were forced to leave the building because of concern that a nearby building at One Liberty Plaza might collapse.

Within hours of the attack, the Board of Governors of the Federal Reserve System announced over the System's Internet sites and through the wire services that the Federal Reserve was functioning and that the discount window was available to assist depository institutions with their funding needs. In addition, we at the New York Fed worked with the office of New York Governor George E. Pataki to invoke procedures in New York State's General Construction Law declaring an emergency condition. A proclamation was issued at 4:00 p.m. on September 11 allowing banks to close at their discretion.

Throughout the day, our Markets Group contacted many government securities dealers to assess operating conditions and capacity. The Bank conducted its normal securities lending operation at noon but altered its usual limits to provide maximum benefit to the primary dealer community. Since only a very small number of dealers had reliable electronic communication lines, much business was conducted on the telephone and recorded manually instead of through the usual automated channels that day and for several weeks thereafter. Other staff within our Markets Group prepared the file that would permit Treasury bills to be issued as normal that Thursday.

Banks were urged to take into account their access to the discount window in making decisions about how they could accommodate the liquidity needs of their customers, even if those customers already had large overdrafts. The discount window team answered questions about lending and liquidity positions and later made loans. In the wake of the September 11 events, banks deposited approximately $20 billion in additional collateral at our Bank in readiness for borrowing at the window.

At the same time, senior managers in the Bank Supervision Group contacted some of the major supervised institutions to determine what problems they were experiencing. Many banks were encouraged to provide liquidity to the markets and to help their customers to the degree that this could be done safely. Bank Supervision Group managers also made calls to some banks reminding them of the availability of the discount window in case they needed additional liquidity.

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The New York Fed kept its wholesale payments system, Fedwire, functioning without interruption on September 11. On that day, the payments operations were being managed by staff at our backup facility, an exercise that we undertake regularly. Thus, primary Fedwire operations staff here in New York were free to concentrate on helping bank customers resolve problems. The other major dollar payments system, CHIPS (Clearing House Interbank Payments System), was also spared the direct effects of the attack in lower Manhattan and continued operating on September 11.

Nonetheless, sustaining payments activity in light of the extensive and largely unprecedented damage to communications channels on September 11 proved exceedingly difficult. Although Fedwire and CHIPS functioned continuously, there were significant strains on each of the systems. Moreover, virtually all firms with trading or payments operations in lower Manhattan faced difficulties. For example, largely because of communications problems, redemptions and rollovers of commercial paper were temporarily disrupted on September 11 and 12.

Once staff was in place at contingency sites, the reestablishment of voice and data communications linkages was necessary to keep the payments system operational. The large-scale relocation of firms and the disruption of communications made the process of simply finding counterparts at other financial institutions very difficult. Initially, industry associations facilitated the distribution of updated contact information.

Connectivity between computer systems was a related problem. The simultaneous activation of individual contingency plans by many firms meant that for the first time, one firm's backup site needed to connect to another firm's backup site. Up to this time, standard plans envisioned that only one firm would be incapacitated at any given time. On September 11, however, the untested connections among multiple firms' backup sites sometimes presented problems that had to be worked through. Technicians from our Automation Group worked with banks to ensure connectivity.

Throughout the week of September 11, senior members of the Wholesale Payments Product Office were in constant touch with firms having difficulty completing the processing of securities transactions. To deal with some of the exceptional pressures in these initial days, we took the extraordinary step of reopening the securities wire after its already extended closing time. The late close of Fedwire was also intended to facilitate the ability of CHIPS and individual institutions to complete their daily payments.

Despite the enormous scale of destruction and damage to phone lines and communications on September 11, the U.S. dollar payments and settlement system performed well. Fedwire and CHIPS were able to ensure the continuous flow of dollar and securities transfers. Securities transfers started clearing as early as September 11 itself, and the customary three-day processing cycle was maintained for equities trades made before September 11.

By September 12, a concern had arisen about cash shortages at automated teller machines, with all bridges and tunnels into and out of New York City closed. To meet these shortages, our Cash and Protection Functions made special arrangements with New York City police and New Jersey state troopers to deliver more than $425 million in cash from New Jersey to local banks.

At the same time, our Check Division recognized that disruptions were occurring in check processing. With the halt of commercial aircraft and the restrictions placed on ground transportation into and out of New York City, the Bank published a legal notice announcing delays in the collection and return of cash items. Together with the Retail Product Office at the Atlanta Reserve Bank and the Board of Governors of the Federal Reserve System, we decided to give banks immediate credit for deposited checks even if we could not get these checks paid in timely fashion by the banks on which they were drawn. This practice resulted in a large amount of float in the payments system for a short period of time.

It is important to keep in mind that the payments system is not only a transaction-processing system but also a complex liquidity-management system. Trillions of dollars in transactions are processed each day through the payments system, yet the base of liquidity used to facilitate these funds transfers is a fraction of that volume.

In one of our systems, Fedwire, temporary imbalances are accommodated through intraday credit. Some market participants can periodically end up with excess funds while others experience shortages. If imbalances are very large and persistent, the Federal Reserve may lend funds against collateral. But if liquidity is not forthcoming from correspondent banks or the Federal Reserve, a single blockage can trap liquidity in one corner of the payments network, and this disruption can quickly spill across the entire financial industry.

We faced such a situation on September 11, but on an unprecedented scale. Problems in settling government securities and processing funds transfers that day led to large imbalances, some involving many billions of dollars. These imbalances persisted all week as a result of connectivity problems and other operational difficulties.

The strong financial condition of U.S. banks and securities firms made it clear that the imbalances resulting from difficulties settling government securities and other payments disruptions reflected liquidity problems and not credit strains. This was an important element in the success of the payments system's recovery after September 11—namely, that this was a true liquidity rather than a solvency problem. We could all deal constructively with counterparties knowing that temporary liquidity problems were not going to develop into significant credit issues.

To meet liquidity needs in the week following the attack, the New York Fed injected tens of billions of dollars into the financial system through discount window loans and open market operations. On September 11, we made discount window loans totaling

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$18.3 billion to seventeen depository institutions and had overnight overdrafts totaling $1.7 billion to fourteen depository institutions. On September 12, the New York Fed arranged open market transactions of $38 billion; the Federal Reserve System had $46 billion outstanding at the discount window. Daily open market operations peaked at $81 billion on September 14 as we provided funds to primary dealers.

On the international front, the Federal Reserve took further measures. Many of our staff were in contact with other central banks and foreign counterparties virtually around the clock.

To cope with potential shortages of dollar liquidity outside the United States that could not be met through the correspondent banking network, the Federal Reserve System entered into temporary swap arrangements with the European Central Bank and the Bank of England. The Federal Reserve also temporarily augmented its existing swap arrangement with the Bank of Canada. The European Central Bank was the only institution to draw on its swap line during the week of September 11, with the amount outstanding peaking at $19 billion.

The Federal Reserve System made additional adjustments to facilitate liquidity. For example, charges for intraday overdrafts and penalty charges for overnight overdrafts were suspended. Only the effective federal funds rate was charged. Rules on the volume of government securities that the Fed would lend to the market from its portfolio were relaxed. As a result, securities lent reached record levels, peaking at $13.4 billion. This step added critical liquidity to the Treasury securities market. Moreover, banks were told that temporary declines in their capital ratios would not be subject to regulatory criticism if their balance sheets expanded.

In addition, on September 17, in an early morning telephone conference call, the Federal Open Market Committee (FOMC) reduced the federal funds rate target 50 basis points, to 3 percent. In taking this action, the FOMC recognized that the actual federal funds rate might be below its target on occasion in these unusual circumstances. In a related action, the Board of Governors of the Federal Reserve System approved requests by the boards of directors of the New York Fed and other Reserve Banks to lower the discount rate by 50 basis points to 2 ½ percent. An additional cut of 50 basis points in interest rates took place at a regularly scheduled meeting of the FOMC on October 2.

It also became clear in the days immediately after the attack that some depository institutions might need to extend credit to a securities affiliate, given the difficult conditions in government securities and money markets. Staff from the Bank Supervision Group and the Legal Group worked with the institutions to allow appropriate flexibility while ensuring that the objective of section 23A of the Federal Reserve Act—that a bank not be harmed by transactions with an affiliate—was satisfied.

I am very proud of the role that the Federal Reserve Bank of New York and the Federal Reserve System played in responding to the liquidity needs of the financial system and in staving off a potential liquidity crisis that could have posed a systemic risk had it not been quickly addressed. The effectiveness of the Federal Reserve in responding to the events of September 11 also owed much to the collective problem solving and ongoing dialogue that take place among financial institutions and regulators on virtually a daily basis.

One of the primary examples of such collaborative effort related to the decision to reopen the major U.S. stock exchanges on September 17. After extensive discussions that included some of our senior officers, industry officials sensibly decided to keep the exchanges closed through the weekend following the attack. The delayed reopening gave the exchanges time to reconnect literally thousands of telephone lines and to test their operations in preparation for the return to business. On that Monday, when the markets reopened, payments and securities settlements were flowing sufficiently smoothly to accommodate the largest volume of trading that has ever occurred on a single day in New York Stock Exchange history. Some 2 billion shares changed hands that day, largely without a problem.

This, to me, is what builds confidence in markets—when people are able to buy or sell in volumes they want in a normal way. Given the physical destruction in lower Manhattan on September 11, the reopening of Wall Street on September 17 represents a superb achievement by thousands of people in New York.

Collective problem solving was also evident in the actions of industry associations such as the Bond Market Association and advisory groups such as the Foreign Exchange Committee, which is sponsored by the Federal Reserve Bank of New York. These organizations have traditionally been important in supporting infrastructure and identifying and addressing issues related to market practices. In the days after September 11, telephone meetings and coordination efforts led by these organizations were critical in providing market-wide status reports and in identifying emerging problems.

For example, the Bond Market Association held multiple daily conference calls to share information on market and payments system conditions. The Association sought to ease strains in the settlement of government securities by recommending that firms temporarily extend the normal settlement cycle from one day to five days. This adjustment allowed firms more time to work through operational problems, even though it meant doubling up on processing loads when the market reverted to one-day settlement. Similarly, the Foreign Exchange Operations Committee, a subcommittee of the Foreign Exchange Committee, made daily conference calls to members to determine the status of their foreign exchange operations.

As part of our interactions with the broader New York financial community, the New York

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Fed reached out to other institutions in this time of crisis. We provided office space for New York State Banking Department staff whose offices were located near the World Trade Center complex. Checks normally exchanged through the New York Clearing House were instead exchanged through our Bank, where the volume of these exchanges tripled in the week following the attack. In addition, we established an on-line connection for the Depository Trust Company for securities processing. This on-line connection also allowed billions of dollars in commercial paper outstanding to be redeemed.

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I am especially proud that our Bank reached out to those directly involved in the rescue effort that followed the tragedy. In the days and weeks after the attack, our Bank offered free meals in our cafeteria daily to New York City police, fire department workers, the National Guard, and other rescue workers in addition to our own staff. It was very moving for me and my staff to witness so closely the incredible dedication of these workers. The New York Fed also opened its doors to POPPA (Police Organization Providing Peer Assistance), a trauma counseling service for the New York City police, by offering this very important group office space in our main building.

The Bank has long been a proponent of careful contingency planning. A factor that helped all of us in the financial community respond more effectively to the attack than would otherwise have been possible was the progress we had made in contingency planning during the run-up to the century date change, Y2K, only two years earlier. As a result of preparations for Y2K, we and our colleagues throughout the financial industry had already analyzed how potential system failures would affect core business processes and what types of services it was critical to restore and in what order. Moreover, because of this earlier planning effort, we had in place lists of contact phone numbers for all financial institutions, regulators, and key infrastructure providers.

To be sure, the preparation of backup sites, the testing of contingency plans, and the simulations of disasters helped many firms grapple initially with extraordinarily terrible circumstances. Still, the size, the scope, and the suddenness of the disaster challenged all of the regularly used scenarios that we and others had devised. September 11 required, in short, a totally new mindset and a significant rethinking of the priorities embodied in standard contingency plans. That work goes on.

So where do we go from here? Today's management of payments risk reflects in substantial part the accumulated learning from past experience. Yet the lessons learned from September 11 have not yet been fully absorbed. Ultimately, I believe, these lessons will take contingency and liquidity planning to a new level that will ensure continuity of business and financial operations in the event of a crisis of similar severity.

Within a week of the destruction of the World Trade Center, the public and private sectors began to assess how financial institutions and the payments system responded to the crisis. The courage displayed on September 11 and the enormous numbers of lives lost that day made all too clear that people and their knowledge are the most important contributors to the financial business. As a practical matter, the loss of access to premises highlighted the value of having contingency sites far enough away from the primary site so that financial institutions could continue to do business. "Hot" sites that continuously replicated transactions from the primary site proved especially valuable in the days and weeks following September 11.

These assessment efforts recently culminated in a financial industry summit hosted by our Bank. The meeting was cosponsored by the Board of Governors of the Federal Reserve System, the New York Fed, the New York State Banking Department, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission and was attended by senior officials of the principal financial institutions active in the U.S. markets. The regulatory and financial industry participants agreed that, until now, business continuity strategies have not fully taken into account the potential for wide-area disruptions, the loss or inaccessibility of critical staff, and the extent to which financial institutions depend on one another as they carry out essential activities.

The emerging consensus is that major financial institutions will need to ensure the rapid resumption of critical activities in the face of large-scale or regional disruptions as well as loss or inaccessibility of key staff. In addition, these institutions will need to foster a high degree of confidence, through ongoing use or robust testing of contingency plans, that continuity arrangements within and across firms will be effective and compatible. Our common goal is to make certain that the payments and financial systems continue to operate at an adequate level, even in a severe emergency.

The crisis of September 11 has made us all more aware of the vulnerabilities in modern payments and financial systems. In the short run, strengthening these systems will invariably involve costs. A key question for the financial industry in the near term will be how best to balance costs and risks in reducing vulnerabilities. I am confident that financial sector managers will take into account the importance of payments services to their profitability and their special duty to maintain the safety of the payments and financial systems when making these investment decisions.

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THE IMPACT OF THE ATTACK ON THE NEW YORK REGIONAL ECONOMY

The attack on the World Trade Center on September 11 shattered lower Manhattan. Most devastating was the tragic loss of almost 3,000 lives, the impact of which no economic or financial measure can capture. As for what can be measured, the attack destroyed more than 13 million square feet of office space—equivalent to about 3.5 percent of Manhattan's total office space—and damaged another

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20 million square feet. The cost of cleaning up and restoring the site for potential reuse has been estimated to be about $10 billion. Replacing the destroyed structures, equipment, inventory, utilities, and retail space is estimated to total an additional $20 billion.[1] An estimated 100,000 employees in almost 1,300 businesses were displaced.

In economic and financial terms, the largest and most immediate effects of the attack were felt in the financial, retail, and travel and tourism sectors in New York City. Retail activity was sharply curtailed in the immediate area of the attack, with more than one hundred stores destroyed. Sales at many businesses were hurt by the drop-off in foot traffic and the restrictions placed on access to lower Manhattan. Many stores were obliged to remain closed, typically for two to six weeks, and others reported little or no business.

The travel and tourism sector was also hard hit. Restrictions on air travel in the immediate aftermath of the attack and sharply lower air traffic in subsequent weeks helped keep visitors away from the city, especially the many international tourists who rely on air transportation. Related businesses were equally hurt—not only hotels, which had their lowest recorded occupancy rates ever for the months of September and October, but also retail stores that cater to visitors.

The financial sector suffered potentially the sharpest blow. The World Trade Center had been occupied primarily by financial sector firms, all of which had to find alternative locations. Although the financial sector directly employs about 13 percent of New York City's workforce, it typically generates more than 30 percent of the city's earnings each year. Any sizable loss of jobs and income in this sector, therefore, even if temporary, can have significant ripple effects on the numerous firms that supply services to the industry, on the retail firms that benefit from the income generated in the sector, and on state and city income and corporate tax revenues.

The most visible measure of the short-term impact of the World Trade Center attack on New York and the regional economy appears in fourth-quarter 2001 employment data. The October jobs report showed a loss of more than 50,000 private-sector jobs in New York City. These losses were followed by further declines of 10,000 jobs in both November and December (Chart 1).

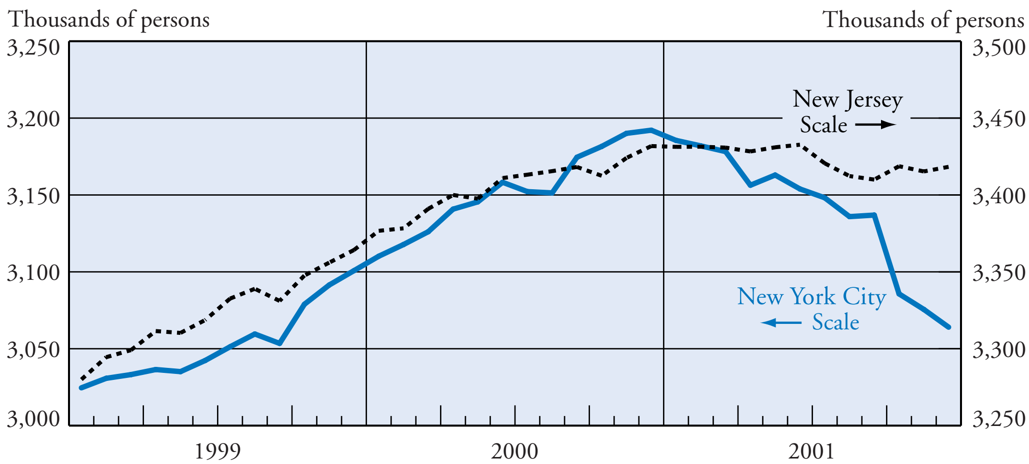
Thus, in the fourth quarter alone, the city's total private-sector job count had declined by more than 70,000. Not surprisingly, the job declines were particularly severe in the sectors most affected by the attack. In the financial sector, part of this employment falloff reflected the net gain of about 13,000 workers in New Jersey (Chart 2). However, these gains in New Jersey appear to have been a onetime event, as the run-up in financial sector employment there peaked in October.

In addition to directly affecting employment in New York City, the World Trade

[1]Capital loss estimates are taken from New York City Partnership and Chamber of Commerce, *Economic Impact Analysis of the September 11 Attack*, November 2001.

Chart 1

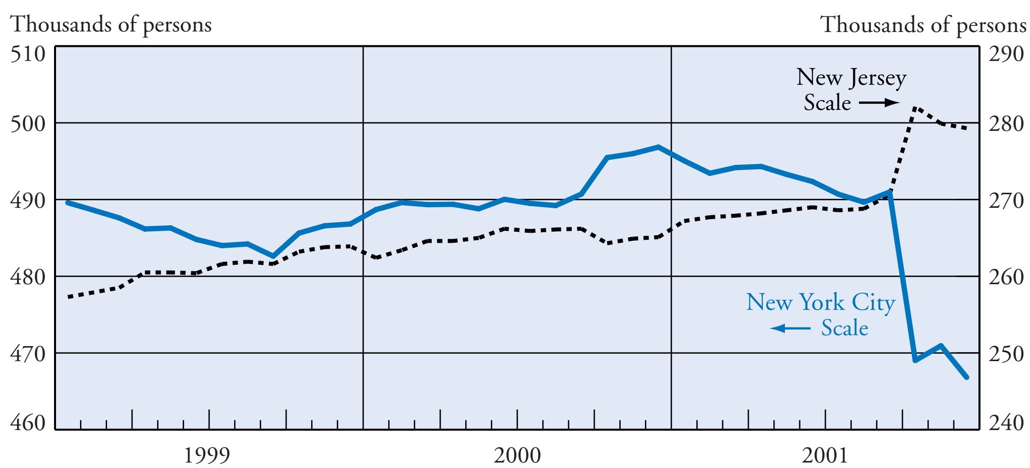
PRIVATE-SECTOR EMPLOYMENT
Seasonally Adjusted Data



Source: U.S. Department of Labor, Bureau of Labor Statistics.

Chart 2

FINANCE, INSURANCE, AND REAL ESTATE EMPLOYMENT
Seasonally Adjusted Data



Source: U.S. Department of Labor, Bureau of Labor Statistics.

Center attack also accentuated an economic slowdown that was already occurring in the New York regional economy. A weakening financial sector and a shakeout in the new media sector were among the key causes of this slowdown.

In fact, indexes of coincident economic indicators for New York City, New York State, and New Jersey developed by our Bank staff[2] show that economic activity throughout the region had peaked somewhat before the national economy hit its high and well before the attack in 2001. Activity in New York City and New York State peaked in January 2001, and in New Jersey in February 2001; it then contracted steadily, but modestly, in subsequent months (Charts 3A-3C).

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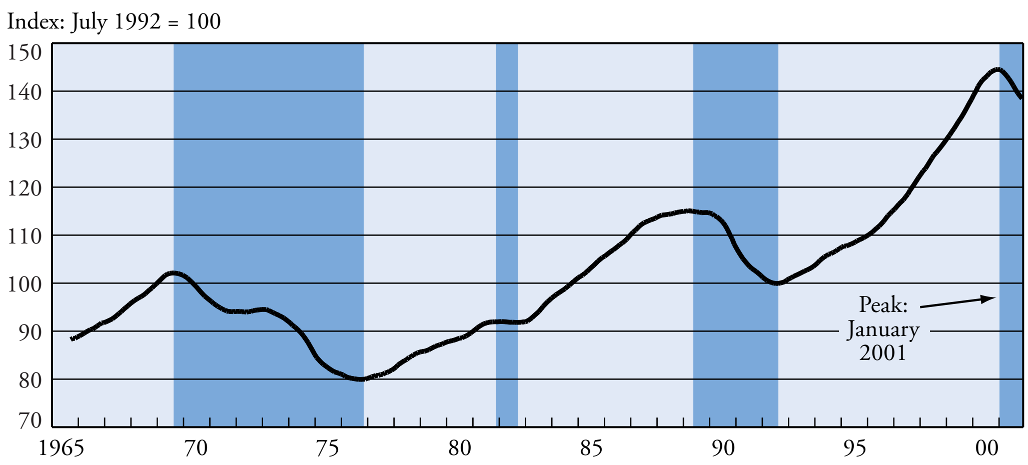
Despite the clearly negative short-run employment effects of the World Trade Center attack, the region's economy has shown resilience. Within a few weeks of the attack, most displaced financial firms took advantage of alternative locations—mostly in midtown Manhattan and northern New Jersey. While some of these firms substantially reduced operations, few appear to have moved major parts of their operations outside of the New York metropolitan area entirely.

Moreover, the moderation, by year-end, in the level of new claims for unemployment

Chart 3A

NEW YORK CITY COINCIDENT ECONOMIC INDEX



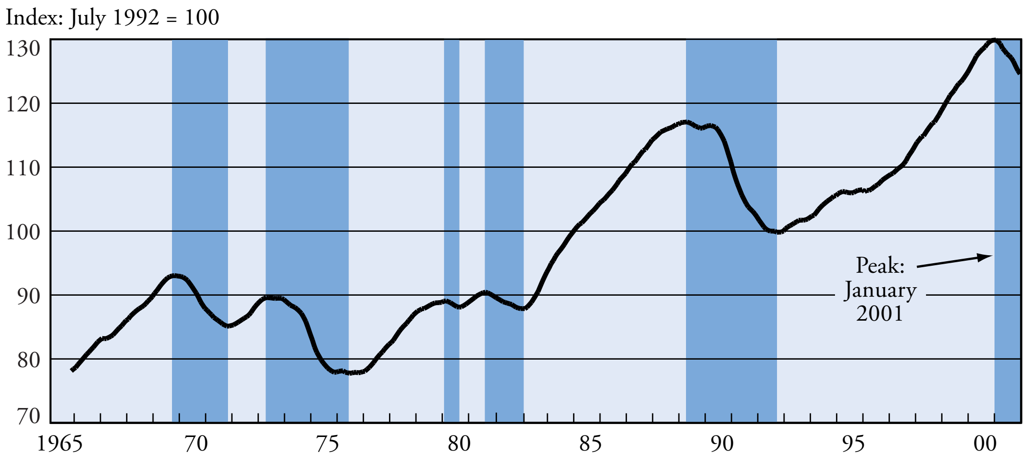
Source: Federal Reserve Bank of New York staff calculations.

Note: Shading indicates city recessionary episodes.

[2]James Orr, Robert Rich, and Rae Rosen, "Two New Indexes Offer a Broad View of Economic Activity in the New York–New Jersey Region," Federal Reserve Bank of New York *Current Issues in Economics and Finance* 5, no. 14 (October 1999).

Chart 3B

NEW YORK STATE COINCIDENT ECONOMIC INDEX

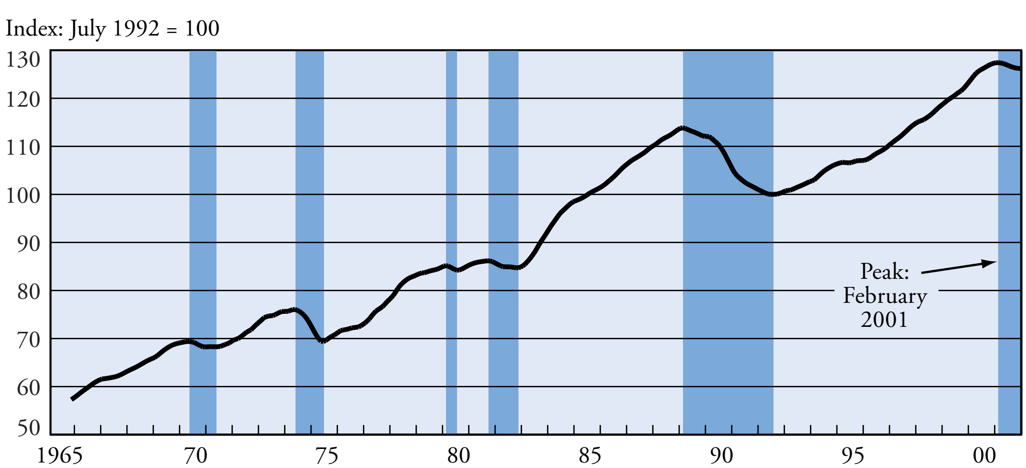


Source: Federal Reserve Bank of New York staff calculations.

Note: Shading indicates state recessionary episodes.

Chart 3C

NEW JERSEY COINCIDENT ECONOMIC INDEX



Source: Federal Reserve Bank of New York staff calculations.

Note: Shading indicates state recessionary episodes.

insurance to roughly pre-attack levels in both New York State and New Jersey supports the view that further employment disruptions relating directly to the attack are unlikely (Chart 4). Moreover, the rebound in hotel occupancy rates in recent months and a leveling off of the decline in retail employment suggest that tourists are returning to New York.

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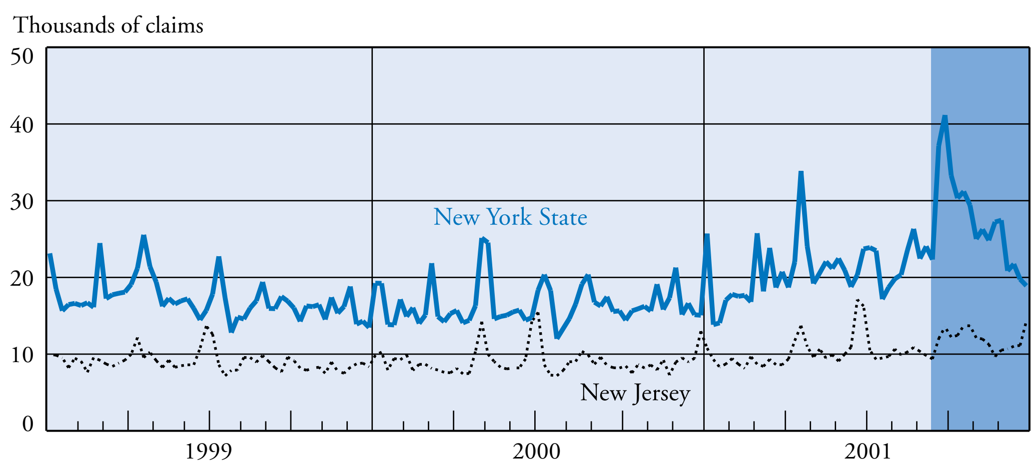
Indeed, we need only look to New York's own recent history to be confident about the city's and the region's ability to overcome the devastation of September 11. As New York City emerged from the deep recession of the early 1990s, crime fell, immigration rose, and new businesses were created. As Chart 3A shows, the peak signaled by the coincident indicators in 2001 significantly exceeded the previous peak in 1989.

Moreover, in the second half of the 1990s, there was an almost unprecedented surge of job creation in the city and metropolitan area. During this period, the private-sector employment growth rate roughly matched or exceeded the corresponding rate for the nation and produced the longest sustained period of high job growth in half a century. New businesses were spawned in a variety of service industries, including health care, education, new media, motion pictures, and business services. The city's services sector became much more diversified.

Still, New York City and the metropolitan area remain first and foremost a global financial center and, as such, depend greatly on the evolution of the finance, insurance, and real estate (FIRE) sector. Although New York's share

Chart 4

INITIAL JOBLESS CLAIMS
Seasonally Adjusted Data



Source: U.S. Department of Labor, Bureau of Labor Statistics.

Note: Shading indicates the post-attack period.

of nationwide employment in the FIRE sector has drifted down over the past two decades, its share of nationwide earnings has held constant or even risen modestly (Chart 5). This finding reflects the high value-added of the financial activities in the New York area.

There are many reasons to believe in New York's continued preeminence as a financial center. First, the financial sector has been undertaking significant restructuring efforts over the past few decades. These efforts, of course, have led to some sizable job losses, particularly in the period following the October 1987 stock market crash and extending through the national recession in the early 1990s. They have also prompted some firms to relocate certain functions—generally those that are more mechanized and routine, such as call centers, credit cards, and some niche operations—to other areas of the country or even abroad. At the same time, however, it has been this very restructuring that has helped to strengthen the competitiveness of the FIRE sector in the New York regional economy and contributed to the resilience that this sector demonstrates today.

A second reason for optimism about New York's continued preeminence as a financial center relates to the desirability of having firms located close to one another. Over the

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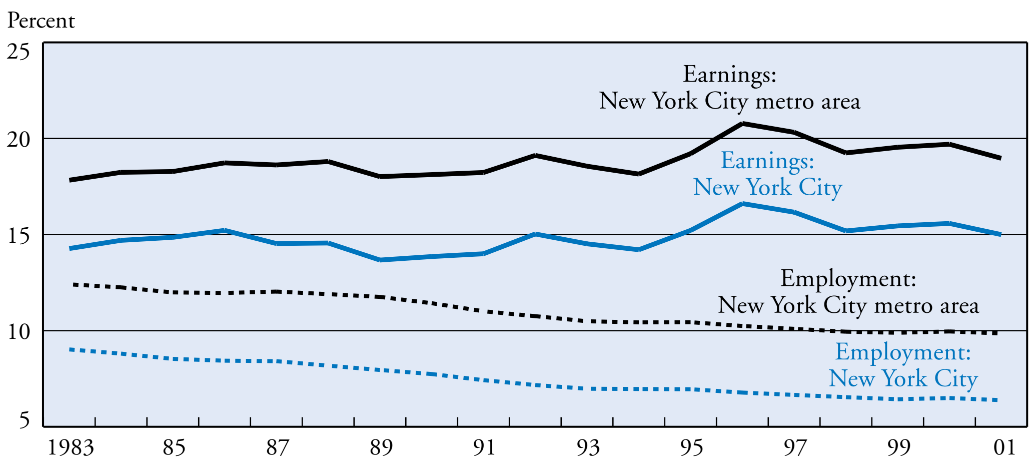
Chart 5

NEW YORK'S SHARE OF NATIONWIDE EARNINGS AND EMPLOYMENT IN THE FINANCE, INSURANCE, AND REAL ESTATE SECTOR



Sources: For 1983-99 earnings data, U.S. Department of Commerce, Bureau of Economic Analysis; for 2000-2001 earnings data, Federal Reserve Bank of New York staff estimates; for 1983-2001 employment data, U.S. Department of Labor, Bureau of Labor Statistics.

Note: The New York City metro area comprises the following primary metropolitan statistical areas: New York, N.Y.; Nassau-Suffolk, N.Y.; Bergen-Passaic, N.J; and Jersey City, N.J.

Evidence suggests that high-value-added functions and their complement of skilled professionals will continue to find the city a competitive location for their activities.

decades, New York City and the surrounding metropolitan area have greatly benefited from the historical tendency of financial firms to "cluster." The efficiencies arising from the large presence of an industry in one location are clearly important in maintaining large segments of the financial industry, including a large international presence, in New York City.

A third reason for optimism about New York City's continued status as a financial capital is the fact that the city possesses a well-developed financial infrastructure that effectively supports the smooth operation of the banking and securities sectors both in the city and nationwide. This infrastructure comprises multiple financial clearinghouses, the world's largest securities depository, five major exchanges, major domestic and international bank and nonbank financial institutions, and numerous financial support services. Financial firms in New York City thus offer a deep and extensive capital market for businesses, governments, and consumers, and virtually all major forms of financial transactions can be executed in the city.

This huge financial infrastructure is a key source of the economies that derive from a location in the city. The institutions that make up this infrastructure for the most part survived the World Trade Center attack and are unlikely to leave the city. Consequently, they should continue to attract other major financial institutions and financial support services to the area.

The fourth and perhaps most important reason that the New York City metropolitan area will retain its status as a center of financial activity over the long run is the nature of its labor force. The metropolitan area possesses an ethnically diverse and skilled workforce. It includes a concentration of talented senior-level managers together with such related business professionals as lawyers, accountants, consultants, advertisers, and other specialists.

The workforce also includes large numbers of people from other parts of the nation and the world who come to New York for the opportunity to strive for a better future. Those who worked in the World Trade Center and those who died there included many such people. Not only did the World Trade Center symbolize the promise of a better future, but it also housed thousands of workers who had begun to realize their aspirations. Hundreds of thousands of similar workers can be found in the office towers, operations centers, and other buildings of New York and the metropolitan area.

Therefore, on balance, evidence suggests that high-value-added functions and their complement of skilled professionals will continue to find the city a competitive location for their activities. In addition, I believe that the area's extensive financial infrastructure combined with the city's proven ability to tap into a national and international pool of skilled labor will support the competitiveness of our city and our region as a center of financial activity for years to come.

We at the Federal Reserve Bank of New York are committed to remaining an integral part of this city's financial infrastructure, an active participant in its daily life, and a major presence in downtown Manhattan. What seems most important to me as we go forward is that we also commit ourselves to addressing the challenges that lie ahead with the same strength of human spirit we witnessed on September 11 and in the weeks and months that followed. In this way, we honor the memory of those whose lives were lost on that tragic day.

January 14, 2002

To the Board of Directors of the
Federal Reserve Bank of New York:

The management of the Federal Reserve Bank of New York (FRBNY) 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, 2001 (the "Financial Statements"). The Financial Statements have been prepared in conformity with 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 Federal Reserve Banks, and as such, include amounts, some of which are based on judgments and estimates of management.

The management of the FRBNY 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 effective internal controls, no matter how well designed, have inherent limitations—including the possibility of human error and costs versus benefits considerations—and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements.

The management of the FRBNY assessed its 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 FRBNY believes that the FRBNY maintained an effective process of internal controls over financial reporting, including the safeguarding of assets as they relate to the Financial Statements.

William J. McDonough	Jamie B. Stewart, Jr.
President	First Vice President

Report of Independent Accountants

PricewaterhouseCoopers L.L.P.

To the Board of Directors of the
Federal Reserve Bank of New York:

We have examined management's assertion that the Federal Reserve Bank of New York ("FRBNY") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the Financial Statements as of December 31, 2001, included in the accompanying Management's Assertion. The assertion is the responsibility of FRBNY management. Our responsibility is to express an opinion on the assertions based on our examination.

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 FRBNY maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the Financial Statements as of December 31, 2001, is fairly stated, in all material respects, based upon criteria described in the "Internal Control–Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

PricewaterhouseCoopers LLP

New York, New York
March 4, 2002