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# Monetary Policy Report to the Congress

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*Report submitted to the Congress on July 20, 2004,  
pursuant to section 2B of the Federal Reserve Act*

## *MONETARY POLICY AND THE ECONOMIC OUTLOOK*

The economic expansion in the United States became increasingly well established in the first half of 2004, but the pace of inflation picked up from its very low rate in 2003. At the time of the February *Monetary Policy Report to the Congress*, considerable evidence was already in hand indicating that the U.S. economy had made the transition from a period of subpar growth to one of more-vigorous expansion. Nevertheless, job creation remained limited, and gains in investment, although sizable, still seemed restrained by a lingering caution on the part of some businesses. In the event, businesses stepped up their hiring in the spring, and capital spending seems to have continued apace.

Over the first half of this year, energy prices soared; moreover, inflation in core consumer prices—as measured by the price index for personal consumption expenditures excluding the direct effects of movements in food and energy prices—increased from an exceptionally low rate of 1 percent over the four quarters of 2003 to an annual rate of a little more than 2 percent. To some extent, the upturn in core inflation reflected the indirect effects of higher energy prices, but other forces also played a role. Strengthening aggregate demand both at home and abroad induced a surge in the prices of many primary commodities and industrial materials. In addition, the decline in the foreign exchange value of the dollar in 2003 put upward pressure on the prices of imported goods and services. With strong demand in the United States and increased utilization of the productive capacity of the economy, firms were better able to pass on the higher costs of imports, raise the prices of domestically produced items that compete with imports, and in many cases boost their profit margins. Likely in response to the faster rate of price increases experienced this year, surveys suggest that near-term inflation expectations have moved up somewhat; still, expectations for price inflation over the longer term have remained in their recent range.

Monetary policy was very accommodative at the start of 2004 as the Federal Open Market Committee (FOMC) sought to provide continuing support to an economic expansion that had yet to produce a sustained improvement in the labor market and to ensure that the previous year's threat of an unwelcome disinflation would continue to recede. Although real GDP had accelerated sharply in the second half of 2003, the incoming data through the time of the March meeting suggested that employment was growing only slowly, as employers were relying on increased production efficiencies to satisfy considerable gains in aggregate demand. Surging oil prices were boosting overall inflation, while core inflation—though no longer declining—was still low. With subsequent labor market reports suggesting that hiring was on a stronger track, growth in output continuing at a solid pace, and core consumer price inflation possibly running higher, the FOMC announced in May that it saw the risks to the goal of price stability as having moved into balance. Even so, the Committee stated that it believed that the monetary policy accommodation then in place could be “removed at a pace that is likely to be measured.” Indeed, at its June meeting, the FOMC decided that sufficient evidence was in hand to begin moving the federal funds rate back toward a more neutral setting and raised the federal funds rate  $\frac{1}{4}$  percentage point to  $1\frac{1}{4}$  percent, a decision that was widely anticipated by market participants.

Although some of the recent data have been on the soft side, the available information on the outlook for the U.S. economy is, on balance, positive. Households are enjoying a generally improving job market, rising real incomes, and greater wealth, all of which are providing them with the confidence and wherewithal to spend. In the business sector, capital spending apparently is continuing to increase briskly, bolstered by expectations of strong sales as well as by booming profits and supportive financial conditions; investment should also continue to be buoyed by firms' adoption of productivity-enhancing technologies. Moreover, inventories appear to be lean relative to sales even after taking account of the substantial improvements firms have made in managing their stocks, suggesting that stockbuilding may provide some impetus to production in the near term. The

brightening outlook for economic activity abroad suggests that demand for U.S. exports should grow and provide a further lift to domestic production.

The prospects also seem favorable for inflation to remain contained in the period ahead. For one reason, some of the forces that contributed to the upturn in core inflation in the first half of 2004 are likely to prove transitory. In particular, the upward impetus from the rise in energy and commodity prices is likely to lessen in coming quarters. For another reason, the evidence suggests that the productive capacity of the economy is still not being fully used and that the attendant slack is probably exerting some downward pressure on inflation. If—as seems likely—the economy approaches full utilization of its productive capacity only gradually, that downward pressure should persist for a time. Moreover, productivity remains on a solid uptrend and should continue to restrain costs. To date, the gains in productivity have helped to boost profit margins. As firms compete to take advantage of profit opportunities, they may eventually be forced to absorb a portion of any increases in labor and other costs that occur. But history suggests that the absorption of costs has limits. Indeed, unit labor costs have turned up of late, as productivity growth has slowed below the rate of increase in hourly compensation. If increases in those costs were to develop any upward momentum, the well-behaved nature of inflation in recent years could be jeopardized.

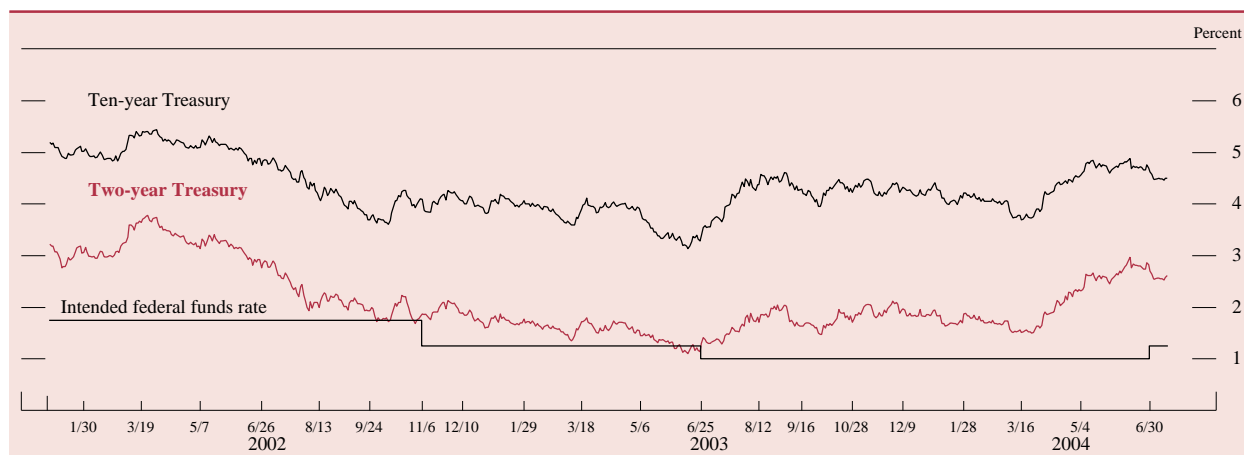
### *Monetary Policy, Financial Markets, and the Economy over the First Half of 2004*

At the beginning of 2004, the FOMC was growing more confident that the economic expansion was

likely to be self-sustaining, particularly in light of the significant firming of business outlays and the continued strength in household spending. Moreover, stimulative fiscal and monetary policies, in conjunction with receptive financial markets, appeared likely to provide substantial support to economic activity and to ward off any further disinflation. However, the Committee remained concerned about the persistent weakness in the labor market. At its January meeting, the FOMC left the target for the federal funds rate at 1 percent. The Committee generally felt that the apparent slack in labor and product markets and continued strong productivity growth were likely to keep the underlying trend in inflation subdued, but it nevertheless was cognizant that a highly accommodative stance for monetary policy could not be maintained indefinitely. Given these considerations, the Committee modified the language of its policy statement to gain greater flexibility to firm policy should circumstances warrant. The Committee achieved this added flexibility by removing its assessment that monetary policy would be accommodative for “a considerable period” and instead saying that the Committee could be “patient” in removing its policy accommodation.

At the time of the March FOMC meeting, the Committee believed that conditions were mostly in place for further solid economic growth. Industrial production had picked up broadly, and consumer and business spending continued to expand briskly. However, the employment reports for January and February still painted a picture of subdued hiring. With financial markets quite accommodative, the Committee recognized that maintaining the current stance of policy could fuel inflation pressures and perhaps encourage excessive risk-taking by financial market

#### Selected interest rates



NOTE. The data are daily and extend through July 14, 2004. The dates on the horizontal axis are those of FOMC meetings.

participants. The Committee concluded that the low level of core consumer price inflation and continued evidence of weak hiring argued for the retention of both its 1 percent target for the federal funds rate and the wording in its statement that the Committee could be “patient” with respect to changes in monetary policy.

At the May FOMC meeting, members noted a distinct improvement in the economic outlook. The labor market figures reported for March had proved to be strong, and the reports for the two previous months had been revised upward significantly. Consumer price inflation in the first quarter of the year was faster than it had been in the previous quarter. Although much of this rise was due to escalating energy costs, core inflation also stepped up, and survey-based measures of near-term inflation expectations had edged higher. In response to the indications of rising aggregate demand and a strengthening job market, yields on Treasury securities had risen appreciably. Accordingly, the Committee was of the view that the expansion would be vigorous and believed that the odds of any further disinflation had been substantially reduced. On the basis of the evolving outlook for economic activity and prices, the Committee revised its assessment of risks to indicate that the upside and downside risks for inflation had moved into balance. To underscore its belief that policy would probably soon need to move toward a more neutral stance while emphasizing that this process was not expected to be rapid, the Committee stated its judgment that monetary policy accommodation “can be removed at a pace that is likely to be measured.”

At the time of the June FOMC meeting, incoming information tended to confirm that the economy was expanding at a solid pace but also indicated that inflation was higher than had been anticipated. Quotes on near-term money market futures and options suggested that market participants were nearly certain of an increase of 25 basis points in the target for the federal funds rate at that meeting and had priced in a cumulative increase of about 2¼ percentage points in the federal funds rate over the next year. The Committee agreed that the current substantial degree of policy accommodation was no longer warranted and decided to increase its target for the federal funds rate 25 basis points. The Committee noted that it considered the risks to both sustainable economic growth and stable prices to be roughly balanced and maintained its appraisal that policy accommodation “can be removed at a pace that is likely to be measured” but also emphasized that it will “respond to changes in economic prospects

as needed to fulfill its obligation to maintain price stability.”

### *Economic Projections for 2004 and 2005*

In conjunction with the FOMC meeting at the end of June, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, were asked to provide economic projections for 2004 and 2005. The central tendency of the FOMC participants’ forecasts for the increase in real GDP is 4½ percent to 4¾ percent over the four quarters of 2004 and 3½ percent to 4 percent in 2005. The civilian unemployment rate is expected to lie between 5¼ percent and 5½ percent in the fourth quarter of 2004 and to decline to between 5 percent and 5¼ percent by the fourth quarter of 2005.

Starting with this report, the Federal Reserve will provide projections for the price index for personal consumption expenditures excluding food and energy (core PCE), which the Committee believes is better as an indicator of underlying inflation trends than is the overall PCE price measure previously featured. Core PCE inflation appears to have run a little above an annual rate of 2 percent in the first half of 2004; for 2004 as a whole, most FOMC participants expect it to lie between 1¾ percent and 2 percent. For 2005, the central tendency of the projections for core PCE inflation is 1½ percent to 2 percent.

#### *Economic projections for 2004 and 2005*

Percent

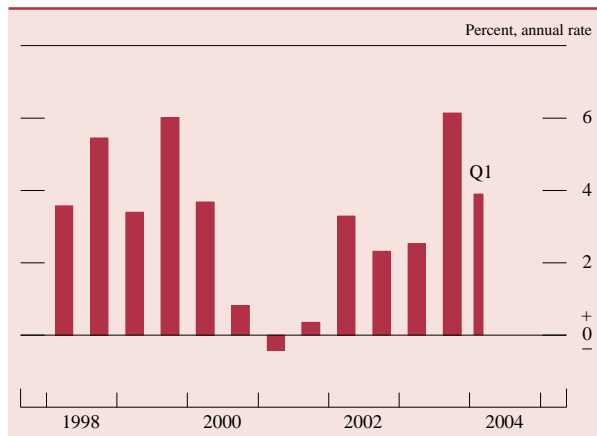
Indicator	Federal Reserve Governors and Reserve Bank presidents	
	Range	Central tendency
	2004	
<i>Change, fourth quarter to fourth quarter<sup>1</sup></i>		
Nominal GDP .....	6–7	6¼–6¾
Real GDP .....	4–4¾	4½–4¾
PCE price index excluding food and energy ....	1½–2	1¾–2
<i>Average level, fourth quarter</i>		
Civilian unemployment rate .....	5¼–5½	5¼–5½
	2005	
<i>Change, fourth quarter to fourth quarter<sup>1</sup></i>		
Nominal GDP .....	4¾–6½	5¼–6
Real GDP .....	3½–4	3½–4
PCE price index excluding food and energy ....	1½–2½	1½–2
<i>Average level, fourth quarter</i>		
Civilian unemployment rate .....	5–5½	5–5¼

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

**ECONOMIC AND FINANCIAL DEVELOPMENTS  
IN 2004**

After having surged in the second half of 2003, economic activity continued to expand at a solid pace in the first half of 2004. In the labor market, payroll employment started to increase last fall after a long string of declines and picked up further during the first half of this year. Headline inflation has been boosted significantly by the jump in energy prices this year, but core inflation has also moved up from the exceptionally low levels of late 2003.

**Change in real GDP**



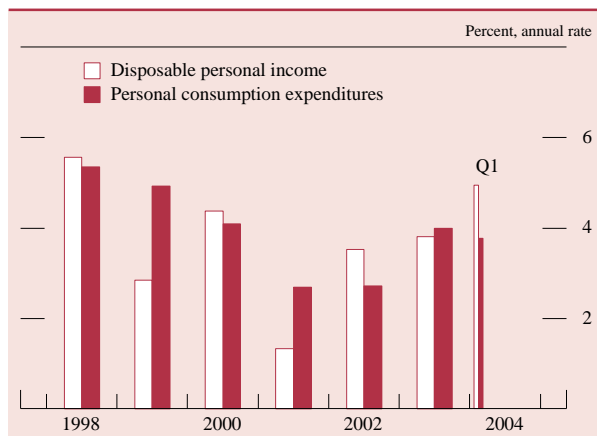
NOTE. Here and in subsequent charts, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period.

**The Household Sector**

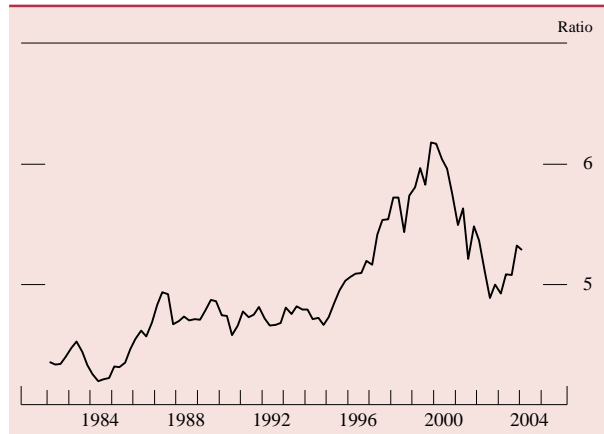
**Consumer Spending**

Consumer spending, which had gathered a good bit of steam in the second half of 2003, continued to move higher in the first half of 2004. The growth in

**Change in real income and consumption**



**Wealth-to-income ratio**



NOTE. The data are quarterly and extend through 2004:Q1. The wealth-to-income ratio is the ratio of household net worth to disposable personal income.

spending was spurred by substantial gains in income. In addition, household wealth has risen sharply over the past year, and consumer surveys indicate that individuals are generally upbeat in their assessments of the economy's prospects and of their own situations.

Personal consumption expenditures rose at an annual rate of 3¾ percent in real terms in the first quarter. Spending on light motor vehicles, which had been supported in late 2003 by aggressive price and financing incentives, slipped somewhat in early 2004. But outlays for goods other than motor vehicles, which had risen 6½ percent in real terms in 2003, posted another huge increase in the first quarter; spending on services also perked up after having advanced only modestly in 2003. The available data point to a much smaller increase in consumer spend-

**Personal saving rate**



NOTE. The data are quarterly; the reading for 2004:Q2 is the average for April and May.

ing in the second quarter; the deceleration mainly reflects a sharp slowing in the growth of outlays on goods other than motor vehicles.

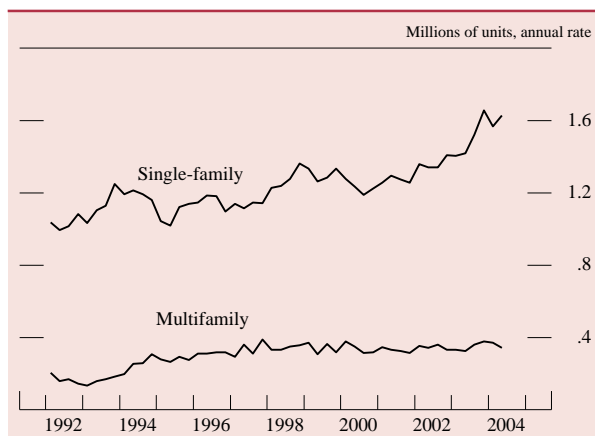
Real disposable personal income (DPI)—that is, after-tax income adjusted for inflation—rose at an annual rate of nearly 4 percent between the fourth quarter of 2003 and May 2004, a gain about in line with its rate of growth last year. To be sure, the rise in energy prices cut into the growth of real income in the first half of the year. However, aggregate wages and salaries, boosted by increases in both employment and earnings, rose appreciably in nominal terms. In addition, last year’s tax legislation, which had already reduced withholding rates in mid-2003, added further to households’ cash flow by increasing refunds and lowering final settlements this spring.

Household wealth increased only about in line with nominal DPI in the first quarter of 2004, and the wealth-to-income ratio was likely little changed in the second quarter as well. Nonetheless, the increase in wealth over the past year has been considerable—and probably large enough to more or less offset any lingering restraint on spending growth from the earlier declines in stock prices. Thus, with wealth approximately a neutral influence on the growth of spending of late, the personal saving rate has held fairly steady. In fact, the average saving rate over the first five months of the year—at 2¼ percent of DPI—was very close to the annual figures for 2002 and 2003.

### Residential Investment

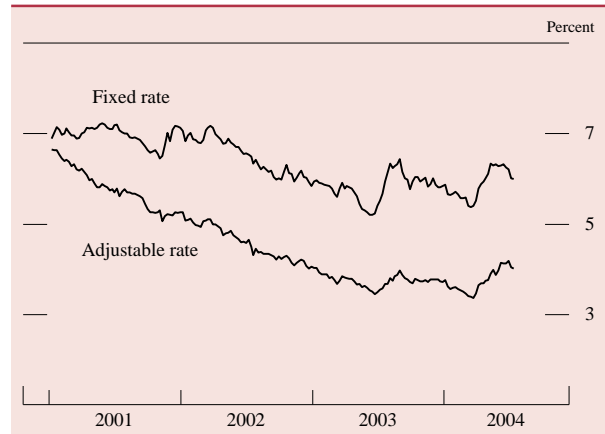
Activity in the housing sector remained torrid in the first half of 2004. Although starts in the single-family

#### Private housing starts



NOTE. The data are quarterly; the readings for 2004:Q2 are the averages for April and May.

### Mortgage rates



NOTE. The data, which are weekly and extend through July 14, 2004, are contract rates on thirty-year mortgages.

SOURCE. Federal Home Loan Mortgage Corporation.

sector faltered a bit early in the year, in part because of unusually adverse weather, they subsequently snapped back and reached an annual rate of more than 1.6 million units in April and May—8½ percent greater than the already rapid pace for 2003 as a whole. Sales of new and existing homes have also been exceptionally strong, and they hit record highs in May. In general, housing activity has been supported by the favorable developments regarding jobs and income and, especially early in the year, by low mortgage rates. Rates on thirty-year fixed-rate mortgages, which had dipped to 5½ percent in March, rose markedly in the spring; they have edged down in recent weeks and now stand at 6 percent, a level still quite low by historical standards.

Home prices have continued to rise rapidly. For example, the national repeat-sales price index from the Office of Federal Housing Enterprise Oversight—which partially adjusts for shifts in the quality of homes sold—rose 7¾ percent over the year ending in the first quarter (the latest available data), a rate similar to the average annual gain since late 2000. By this measure—and many others—house price increases have outstripped gains in incomes as well as in rents in recent years.

Starts in the multifamily sector averaged an annual rate of 360,000 units over the first five months of the year, a pace slightly faster than that of the past several years. Low interest rates have apparently helped maintain the profitability of apartment construction, given that other fundamental determinants of activity in the sector have been weak: In particular, rents have remained soft, and in the first quarter, vacancy rates for multifamily rental properties reached a new high.

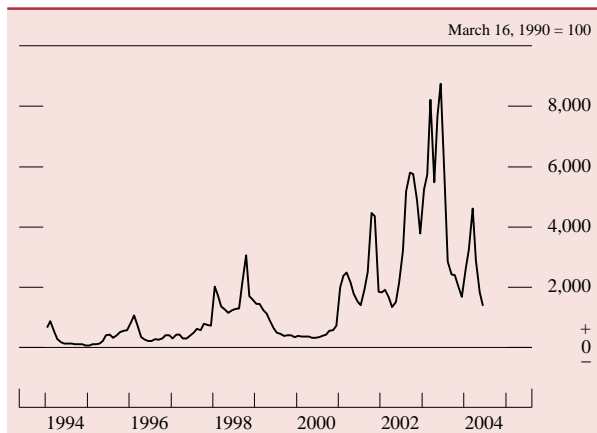
### Household Finance

Household debt rose at an annual rate of about 10¾ percent in the first quarter of 2004. The especially rapid growth of mortgage debt was driven by the strong pace of activity in the housing market and the renewed wave of mortgage refinancing. However, the second-quarter rise in interest rates appears to have slowed the rate of refinancing and, consequently, the amount of equity being extracted from the value of homes through such transactions. Consumer credit—which constitutes the bulk of household debt aside from mortgage borrowing—expanded at an annual rate of about 6 percent over the first quarter of the year and at roughly a 4 percent pace in April and May. The growth of consumer credit likely has continued to be restrained by the substitution toward mortgage debt as a means to finance household expenditures.

Low interest rates, in concert with strong growth in disposable personal income, have helped to keep financial obligations manageable for most households. In the first quarter of the year, the debt service ratio and the financial obligations ratio for the household sector in the aggregate, both of which gauge pre-committed expenditures relative to disposable income, continued to edge down from their peaks in 2001. Other indicators also suggest that the financial well-being of households has stabilized and may be improving. Delinquencies on credit card and auto loans generally declined in the first three months of the year, and bankruptcy rates, while still high, stepped down in the first quarter from their recent peak.

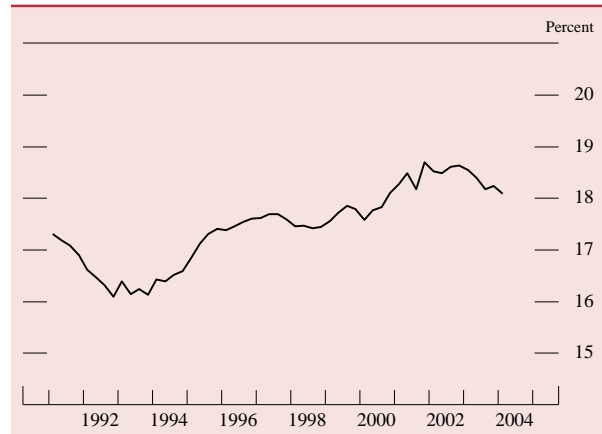
Rapid increases in home prices have continued to buoy household net worth this year. In contrast, stock

### Mortgage refinancing application index



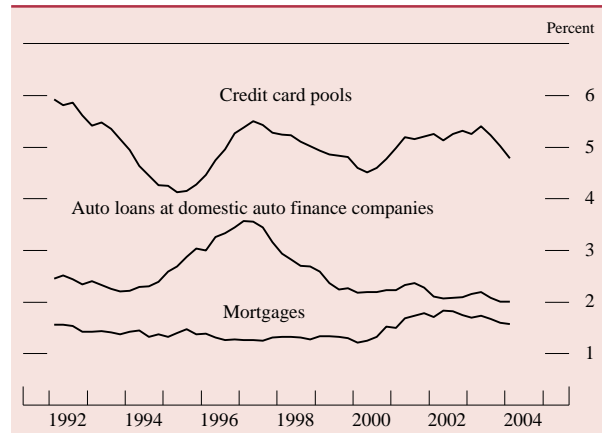
NOTE. The data are monthly and extend through June 2004.  
SOURCE. Mortgage Bankers Association.

### Household financial obligations ratio



NOTE. The data are quarterly and extend through 2004:Q1. The financial obligations ratio equals the sum of required payments on mortgage and consumer debt, automobile leases, rent on tenant-occupied property, homeowners' insurance, and property taxes, all divided by disposable personal income.

### Delinquency rates on selected types of household loans



NOTE. The data are quarterly and extend through 2004:Q1.  
SOURCE. For mortgages, the Mortgage Bankers Association; for auto loans, the Big Three automakers; for credit cards, Moody's Investors Service.

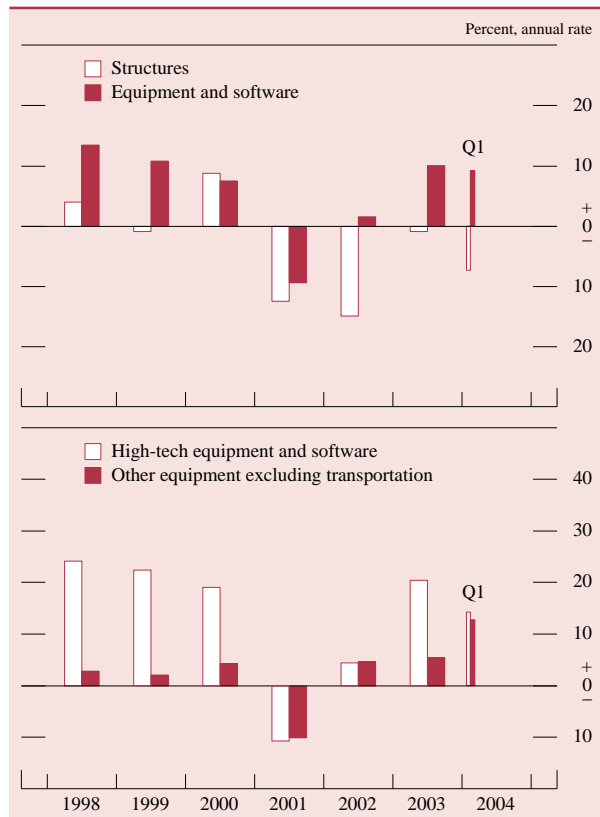
prices are about unchanged. Although news on earnings and economic activity has generally been favorable, rising oil prices and interest rates and, perhaps, heightened geopolitical concerns have weighed on investor sentiment. Nevertheless, inflows into equity mutual funds have been even stronger thus far in 2004 than they were last year.

### The Business Sector

#### Fixed Investment

For the most part, businesses appear to be shaking off the extraordinary reluctance to undertake new investment projects that was evident in 2002 and 2003.

## Change in real business fixed investment



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

Indeed, although outlays on nonresidential construction have not yet turned up decisively, real spending on equipment and software (E&S) has been advancing briskly. The broadly based growth in E&S spending has been driven by increasingly favorable fundamentals: positive expectations for sales, high levels of corporate profits and cash flow, a desire to replace or upgrade aging equipment after a period of weak investment spending, and the continued low cost of capital.

Real E&S spending rose at an annual rate of more than 15 percent in the second half of last year, and it posted another sizable increase in the first quarter of 2004 despite flat business purchases of motor vehicles and a dip in deliveries of aircraft. Excluding transportation equipment, real spending on E&S rose at an annual rate of 13½ percent in the first quarter. In the high-tech category, real purchases of computers and software remained on the solid uptrend that has been evident for the past couple of years, and real outlays on communications equipment increased further, reaching a level about 20 percent above the low in the fourth quarter of 2002. Spending for equipment other than high-tech and transportation,

which accounts for about 40 percent of E&S (measured in nominal terms), also rose markedly in the first quarter. Such spending tends to be particularly sensitive to the prospects for aggregate demand. In addition, it may be receiving a lift from the partial-expensing tax provision, which is especially valuable for equipment with relatively long service lives for tax purposes; that provision is slated to expire at the end of 2004.

Equipment spending appears to have posted another solid increase in the second quarter. Outlays on transportation equipment seem to have rebounded, and the incoming data on high-tech equipment point to robust real expenditures. Some indicators for spending on other nontransportation equipment have been a bit soft recently. But the May level of shipments for this broad category was still above that of the first quarter, and backlogs of unfilled orders, which have risen impressively over the past year, continued to build.

Real nonresidential construction has remained about unchanged, on net, since the steep decline in 2001 and 2002. Construction of office buildings is still running at roughly half the pace of 2000, although vacancy rates have stabilized—albeit at very high levels—and the decline in rents has slowed. Factory construction also remains sluggish. Construction of retail and wholesale facilities, in contrast, has held up fairly well, a performance consistent with the strength in consumer spending. Outlays on buildings for health care and education also have been reasonably well sustained.

## Inventory Investment

Inventory investment has generally remained subdued even as final sales have strengthened. Although real nonfarm inventory investment picked up to an annual rate of \$30 billion in the first quarter, the accumulation occurred almost entirely in the motor vehicle sector, in which sagging sales and a high level of production early in the year created a noticeable bulge in dealer stocks, especially of light trucks. In the second quarter, the automakers reduced assemblies; but with sales running only a little above their first-quarter pace on average, inventories of motor vehicles remained elevated. Outside the motor vehicle industry, nonfarm inventories increased at a meager \$6 billion annual rate in real terms in the first quarter, and the available data point to only a moderate step-up in real stockbuilding, on balance, in April and May. In general, non-auto inventories appear lean relative to sales, even after factoring in the

downward trend in inventory–sales ratios that has accompanied the ongoing improvements in supply-chain and logistics management.

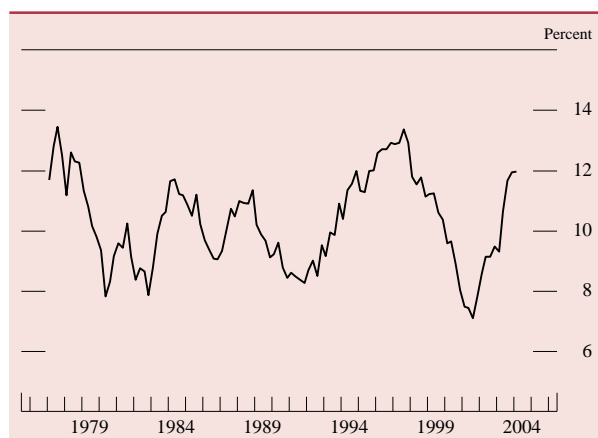
### Corporate Profits and Business Finance

Continuing the gains of last year, profits of the business sector to date have remained strong. In the first quarter of 2004, earnings per share for S&P 500 firms were about 26 percent higher than their level four quarters earlier, and before-tax profits of nonfinancial corporations as a share of GDP from that sector edged up following a steep increase in 2003. A jump in profits in the petroleum and gas industries owing to higher oil prices was responsible for much of the rise in earnings. However, firms across many industries, with the notable exception of telecommunication services, registered solid gains in earnings. In response to this pattern of higher profits, analysts have been steadily marking up their forecasts for earnings in subsequent quarters.

Net equity issuance has remained negative this year. Seasoned offerings have been scarce, the pace of initial public offerings has only inched up, and share retirements have continued to be strong. Corporations have continued to repurchase shares at a rapid rate to manage their cash positions, even as they have increased dividend payments.

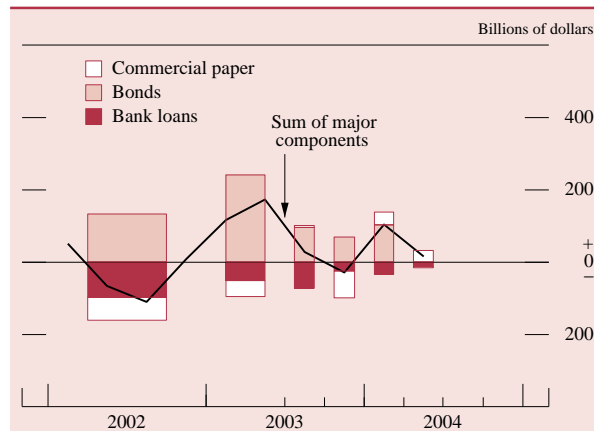
Firms relied heavily on their elevated profits and substantial cash holdings to finance their investment in inventories and fixed capital in the first half of 2004. As a result, the growth of nonfinancial business debt remained modest. Much of the proceeds from

### Before-tax profits of nonfinancial corporations as a percent of sector GDP



NOTE. The data are quarterly and extend through 2004:Q1. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.

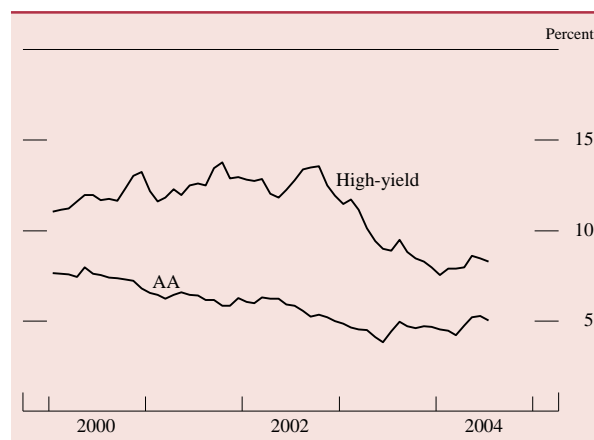
### Major components of net business financing



NOTE. Seasonally adjusted annual rate for nonfinancial corporate business. The data for the sum of major components are quarterly. The data for 2004:Q2 are estimated.

bond issuance was used to pay down higher-cost debt, and the timing of the issuance of investment-grade bonds in particular was influenced by movements in interest rates; issuance spiked in March in the wake of the drop in yields but subsided in April as rates rebounded. Short-term debt financing showed signs of turning around after contracting over the previous three years. Commercial paper outstanding expanded in the first two quarters of 2004. Business loans at banks have fallen on balance so far this year but at a much slower pace than in 2003. The Federal Reserve's Senior Loan Officer Opinion Survey conducted in April 2004 indicated that demand for business loans had begun to expand and that commercial banks had again eased both standards and terms on these loans over the previous three months.

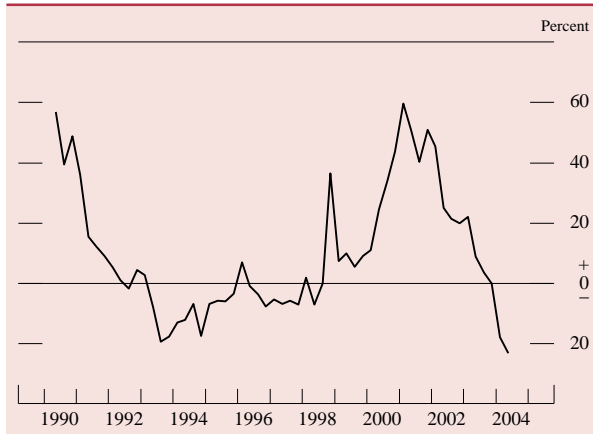
### Corporate bond yields



NOTE. The data are monthly averages of daily data. The final observation is the average of trading days through July 14, 2004. The AA rate is the Merrill Lynch AA index with a remaining maturity of seven to ten years. The high-yield rate is the yield on the Merrill Lynch 175 high-yield index.



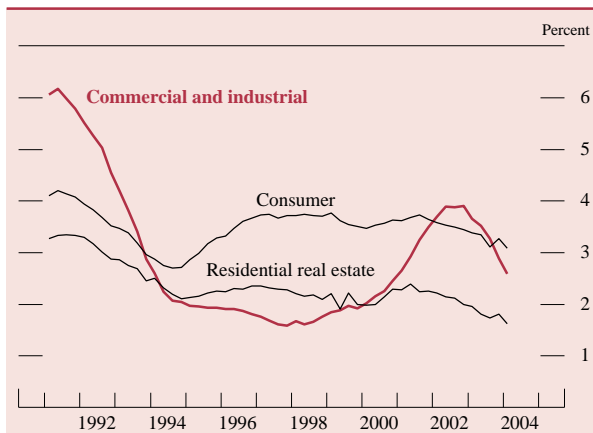
**Net percentage of domestic banks tightening standards on commercial and industrial loans to large and medium-sized firms**



NOTE. The data are based on a survey generally conducted four times per year; the last reading is from the April 2004 survey. Large and medium-sized firms are those with annual sales of \$50 million or more. Net percentage is the percentage reporting a tightening less the percentage reporting an easing.  
SOURCE. Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices.

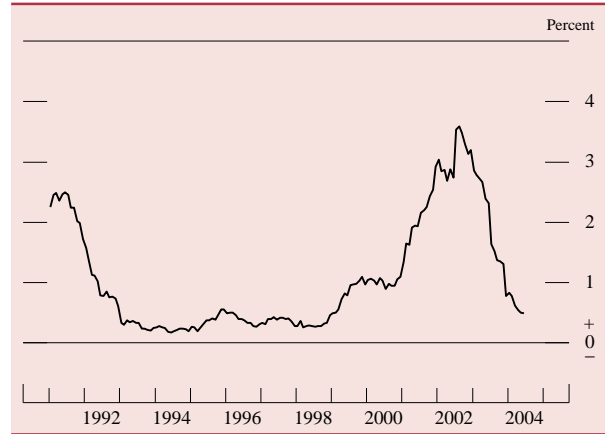
Strong profits, low interest rates, and continued deleveraging helped improve the credit quality of nonfinancial firms over the first half of the year. In the second quarter, the delinquency rate on business loans dropped for the sixth consecutive quarter; the continued decline has reversed a large part of the preceding run-up. Early in the year the twelve-month trailing default rate on outstanding bonds fell into the relatively low range observed over much of the 1990s, and in June it registered another decline. Moreover, in the first part of the year, the pace of upgrades of bond ratings by Moody's Investors Service rose while the pace of downgrades fell.

**Delinquency rates on selected types of loans at banks**



NOTE. The data, from bank Call Reports, are quarterly, are seasonally adjusted, and extend through 2004:Q1.

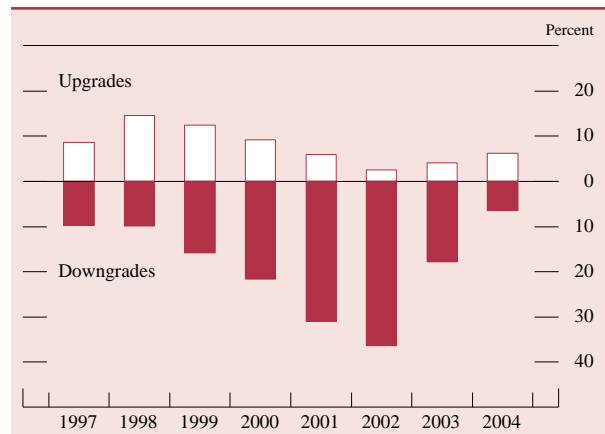
**Default rate on outstanding bonds**



NOTE. The default rate is monthly and extends through June 2004. The rate for a given month is the face value of bonds that defaulted in the twelve months ending in that month divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the twelve-month period.  
SOURCE. Moody's Investors Service.

Borrowing against commercial real estate assets continued at a rapid pace during the first half of this year. Anecdotal reports suggest that some firms were using mortgages on commercial property to lock in low-cost, long-term funding. Despite the persistently high vacancy rates for most types of commercial property, the loans backed by these assets have continued to perform well. Delinquency rates on commercial mortgages held by banks and insurance companies remained very low in the first quarter. A drop in delinquencies on commercial-mortgage-backed securities (CMBS) in recent months has partially reversed last year's rise, and the narrow risk spreads

**Ratings changes of nonfinancial corporate bonds**



NOTE. Data are at an annual rate; for 2004, they are the annualized values of monthly data through May. Debt upgrades and downgrades are expressed as a percentage of the par value of all bonds outstanding.  
SOURCE. Moody's Investors Service.

on CMBS suggest that investors have limited concerns about loan quality.

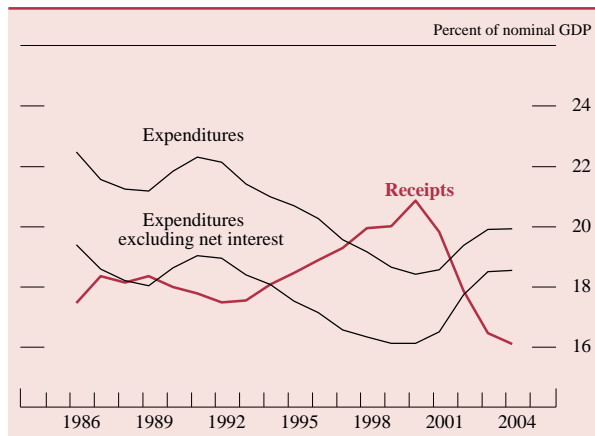
### The Government Sector

#### Federal Government

The deficit in the federal unified budget has continued to widen. Over the twelve months ending in June, the unified budget recorded a deficit of \$431 billion, \$120 billion more than during the comparable period last year and equal to nearly 4 percent of nominal GDP. In large part, the rise in the deficit is attributable to further rapid increases in spending on defense and other programs and the loss of revenues resulting from the tax legislation enacted in recent years. In addition, interest costs, which fell sharply between fiscal 1997 and fiscal 2003 as a result of budget surpluses and declining interest rates, have leveled off and thus are no longer a significant factor helping to restrain the deficit. The primary deficit, which excludes net interest, totaled \$276 billion over the twelve months ending in June, also approximately \$120 billion more than over the year ending in June 2003.

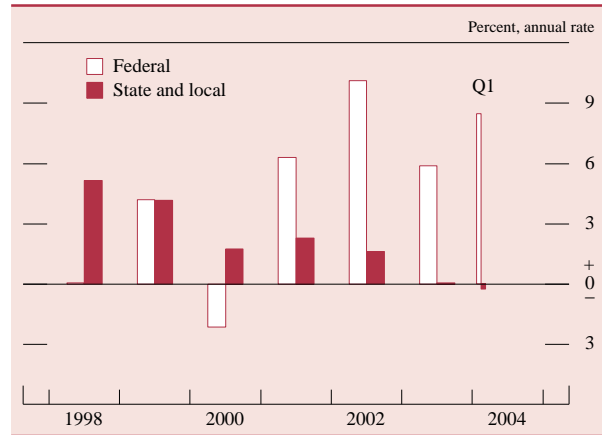
Over the twelve months ending in June, nominal federal spending was nearly 7 percent higher than during the same period a year earlier and stood at about 20 percent of nominal GDP—virtually the same as in fiscal 2003 but 1½ percentage points above the recent low in fiscal 2000. Spurred by the war in Iraq, defense spending ramped up another 14 percent; outlays for nondefense discretionary programs, which include homeland security, moved up

#### Federal receipts and expenditures



NOTE. The budget data are from the unified budget; through 2003 they are for fiscal years (October through September), and GDP is for Q4 to Q3. For 2004, the budget data are for the twelve months ending in June, and GDP is for 2003:Q4 to 2004:Q1.

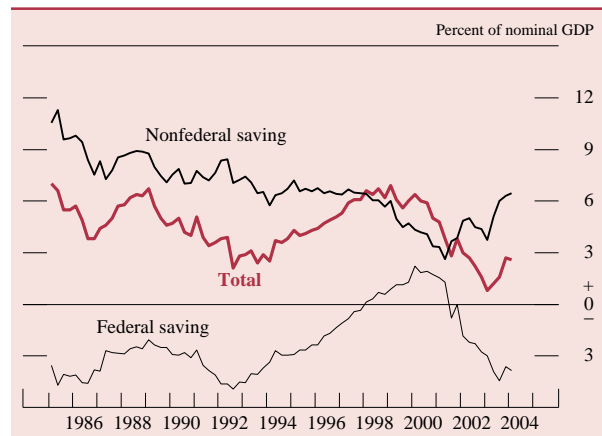
#### Change in real government expenditures on consumption and investment



further as well. Spending on the major health programs rose at a rapid clip, in part because the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) temporarily increased grants to the states under the Medicaid program and boosted payments to some Medicare providers. In addition, as noted, net interest payments, which had plummeted between 1997 and 2003, flattened out. Real federal expenditures for consumption and gross investment—the part of government spending that is a component of real GDP—rose at an annual rate of 8½ percent in the first calendar quarter of 2004; that increase reflected a surge in real defense spending, which now stands more than 30 percent above the levels that prevailed, on average, from 1997 to 2000.

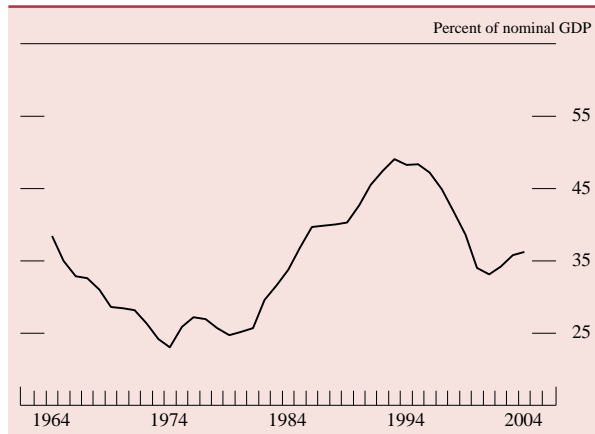
Federal receipts in the twelve months ending in June were 1½ percent higher than during the comparable period of the previous year after having fallen

#### Net saving



NOTE. The data are quarterly and extend through 2004:Q1. Nonfederal saving is the sum of personal and net business saving and the net saving of state and local governments.

### Federal government debt held by the public



NOTE. Through 2003, the data for debt are year-end figures, and the corresponding value for GDP is for Q4 at an annual rate; the final observation is for 2004:Q1. Excludes securities held as investments of federal government accounts.

markedly between fiscal 2000 and fiscal 2003. Receipts received a substantial boost over the past year from a strong gain in corporate taxes, which were lifted by robust profits. Social insurance taxes, which tend to move in line with wages and salaries, also increased. But individual income taxes were below last year's level: Although taxable incomes rose moderately, collections were reduced by the lower withholding rates in place since mid-2003 and by the effects of JGTRRA on refunds and final settlements this spring.

The deterioration in the unified budget since 2000 has been mirrored in a sharp downswing in federal saving—essentially, the unified surplus or deficit adjusted to conform to the accounting practices followed in the national income and product accounts (NIPA). Gross federal saving fell from a high of nearly 3 percent of nominal GDP in 2000 to negative 3 percent of GDP in the first quarter of 2004; measured net of estimated depreciation, federal saving fell from 2 percent of GDP to negative 4 percent of GDP over this period. In the past couple of years, the rise in business saving from the rebound in profits and reductions in corporate taxes has cushioned to some extent the effect of growing budget deficits on national saving. In fact, because of the dramatic increase in business saving in recent quarters, national saving has recovered some from the extreme lows of early 2003. Even so, as of the first quarter of 2004, national saving (measured net of estimated depreciation) was still equal to just about 2½ percent of GDP, compared with a recent high of 6½ percent in 1998. If not reversed over the longer haul, such low levels of national saving could eventually

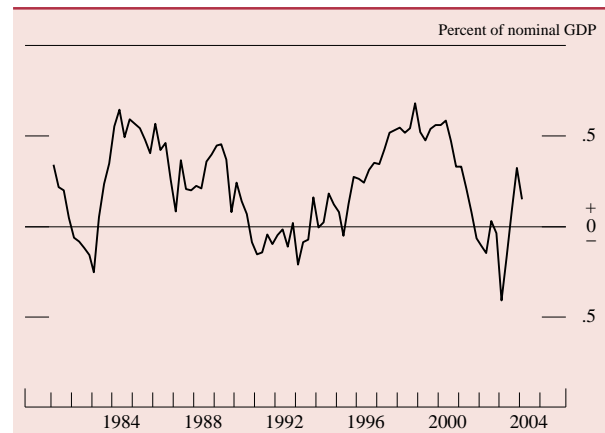
impinge on private capital formation and thus slow the rise of living standards.

Reflecting the need to finance the sizable federal budget deficit, federal debt held by the public expanded at an annual rate of 11¾ percent in the first half of the year. The ratio of this debt to nominal GDP now exceeds 36 percent. The Treasury tilted its issuance toward longer-term and inflation-indexed securities somewhat, and announced semiannual issuance of a twenty-year inflation-protected bond beginning in July and a five-year inflation-protected note beginning in October.

### State and Local Governments

States and localities have started to see some improvement in their budget positions after having gone through several difficult years. Strong growth in household income and consumer spending has boosted revenues in recent quarters, as have the additional federal grants authorized under JGTRRA. And although rising medical costs and security needs have continued to put upward pressure on spending, state and local governments have generally held the line on hiring and have kept other outlays in check. The restraint on spending, in combination with a draw-down of reserve funds and some increases in taxes, has helped states and localities satisfy their balanced-budget requirements. In fact, between the third quarter of 2003 and the first quarter of 2004, NIPA net saving (excluding social insurance funds) for this sector averaged \$21 billion at an annual rate (¼ percent of nominal GDP), compared with negative

### State and local government net saving



NOTE. The data, which are quarterly, are on a national income and product account basis and extend through 2004:Q1. Net saving excludes social insurance funds.

\$7 billion in 2002 and negative \$31 billion in the first half of 2003. (Net saving is roughly similar to the surplus or deficit in an operating budget.) Although a few states are still struggling with strained fiscal situations, most have entered fiscal 2005 (which started on July 1 in all but four states) with expectations of respectable growth in revenues and with budgets in place that allow for some increases in spending on high-priority services and some rebuilding of reserve funds.

Real consumption and investment spending by state and local governments was essentially flat in the first quarter of 2004; available indicators point to a moderate increase in the second quarter. Outlays for consumption items, which were little changed in 2003, appear to have remained subdued throughout the first half of the year. Investment expenditures also were about unchanged in the first quarter, but they turned up sharply in the spring, mainly because of a jump in spending on highways.

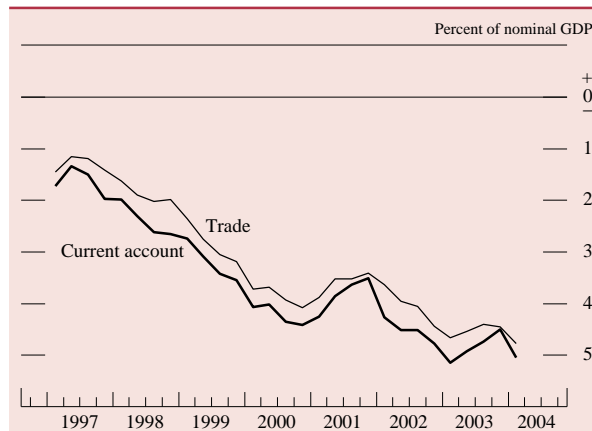
Significant demand for infrastructure spending and favorable interest rates led to robust issuance of state and local government debt to finance capital expenditures and to advance refund higher-cost debt. Nevertheless, over the first half of the year, net issuance edged down from its rapid pace in 2003 to about a 6 percent annual rate. The deceleration reflected a decline in short-term borrowing as improvements in the fiscal positions of state and local governments lessened the need for temporary funding of budget shortfalls.

The credit quality of municipal borrowers has stabilized after two years of deterioration; for the year to date, upgrades and downgrades of credit ratings have been roughly equal. In a marked change from last year's sentiment, rating agencies have begun to express guarded optimism about the credit quality of states because of improvements in state revenue flows and restraint on spending.

### The External Sector

In the first quarter of 2004, the U.S. current account deficit expanded to an annual rate of \$580 billion, or about 5 percent of GDP. As in the past, the widening was driven primarily by a larger deficit in trade of goods and services. The surplus on net investment income declined in the first quarter but remained well above its average value in the previous year. The deficit on net unilateral transfers rose because of a concentration of disbursements of government grants in the first quarter.

### U.S. trade and current account balances



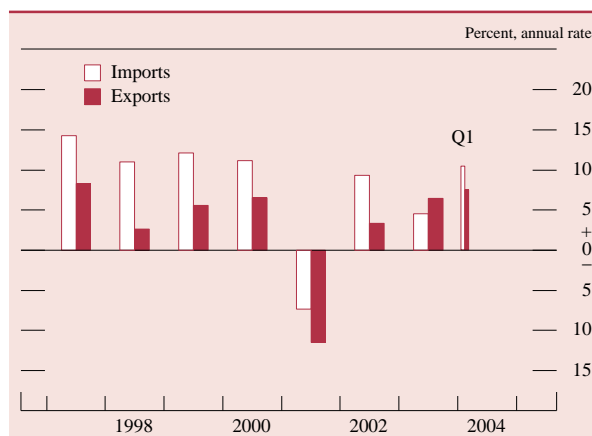
NOTE. The data are quarterly and extend through 2004:Q1.  
SOURCE. Department of Commerce.

### International Trade

The U.S. trade deficit in goods and services registered \$548 billion at an annual rate in the first quarter, about \$46 billion larger than in the fourth quarter of 2003. On average, data for April and May suggest that the trade deficit continued to widen in the second quarter.

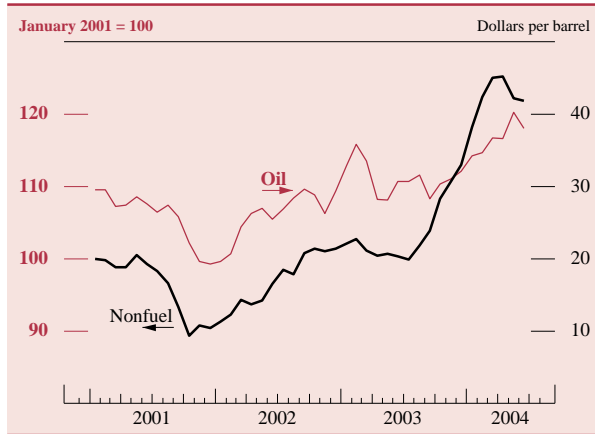
Real exports of goods and services increased at an annual rate of 7½ percent in the first quarter of 2004, well off the blistering 20 percent pace of the fourth quarter but still above the average for 2003. Solid gains in exports since mid-2003 arose in part from the strong economic performance of many of our major trading partners. In addition, the net decline in the exchange value of the dollar since 2002 continued to make U.S. goods and services more competitive abroad. Increases in exports of U.S. goods were wide-

### Change in real imports and exports of goods and services



SOURCE. Department of Commerce.

Prices of oil and of nonfuel commodities

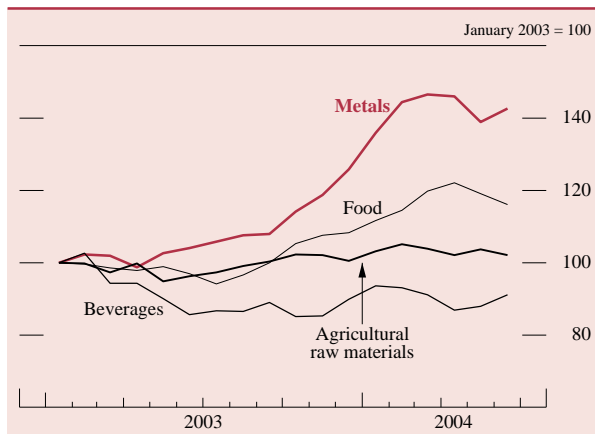


NOTE. The data are monthly and extend through June 2004. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is an index of forty-five primary-commodity prices from the International Monetary Fund.

spread across our major trading partners, with the exception of Japan, and were concentrated in real exports of capital goods, industrial supplies, and consumer goods. Real exports of agricultural products fell sharply, hurt by foreign bans on U.S. beef products following reports of mad cow disease in a U.S. herd. Exports of services rose moderately.

Prices of total exports rose at an annual rate of 5¾ percent in the first quarter, boosted by another jump in agricultural prices along with substantial increases in the prices of other primary commodities and industrial supplies. Prices of U.S. agricultural exports have been pushed up by very strong global demand, particularly from China. For specific prod-

Prices of major nonfuel commodities



NOTE. The data are monthly and extend through June 2004. The metals category includes aluminum, copper, and iron ore; food includes cereals, vegetable oils and protein meals, seafood, and meat; agricultural raw materials consists of timber, cotton, wool, rubber, and hides; beverages consists of coffee, cocoa beans, and tea.

SOURCE. International Monetary Fund.

ucts, such as cotton and soybeans, lower production in some countries also contributed to price run-ups. More recently, prices of soybeans and other agricultural products have eased in the face of a slowing in the growth of demand from China and the anticipation of larger harvests. Even so, available data point to continued strong increases in export prices in the second quarter.

Supported by solid U.S. economic growth, real imports of goods and services rose at an annual rate of 10½ percent in the first quarter. This increase was below the fourth-quarter pace but still roughly double the rate of increase for 2003 as a whole. Real imports of goods were boosted by a sharp increase in oil imports. Gains in imports of non-oil goods were also sizable and widespread across categories. Imports of services grew slightly in the first quarter.

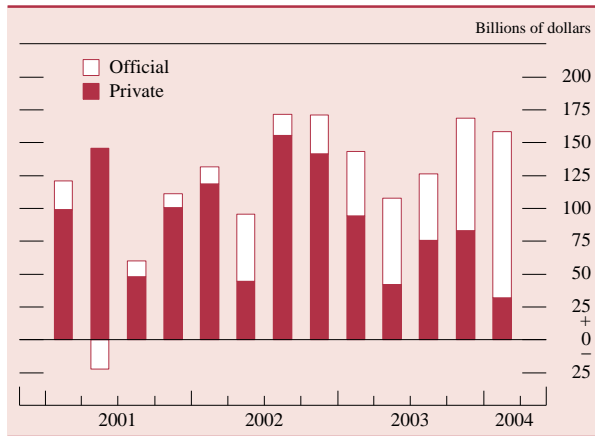
The spot price of West Texas intermediate (WTI) crude oil surged above \$40 per barrel in May and has since fluctuated close to that level. The run-up in the price since the beginning of the year has been driven by surprisingly strong global demand for oil. Supply issues have been important as well. These were mainly continued violence in Iraq, including the sabotage of oil facilities, attacks on foreigners in Saudi Arabia, ongoing unrest in Nigeria, political turmoil in Venezuela, and tax payment difficulties at a major Russian oil company. The recent increase in OPEC production (mainly by Saudi Arabia) has eased the upward pressure on prices a bit, but they have remained elevated.

Prices of imported non-oil goods rose at an annual rate of 5½ percent in the first quarter after minimal increases in the second half of 2003. Prices for imported consumer goods rose at an annual rate of 2¾ percent after being flat in 2003. Skyrocketing global commodity prices last year and early this year boosted prices of imported industrial supplies (especially metals) and of foods, feed, and beverages. The jump in commodity prices reflected strong demand, the net depreciation of the dollar over the past two years, and the limited expansion in supply of many commodities since the 2001 trough in commodity prices. Available data suggest a modest stepdown in the rate of increase of import prices in the second quarter; the move in part reflects a flattening of consumer goods prices.

The Financial Account

The U.S. current account deficit has continued to be financed largely by foreign flows into U.S. bonds. Foreign official inflows, already sizable in 2003, rose

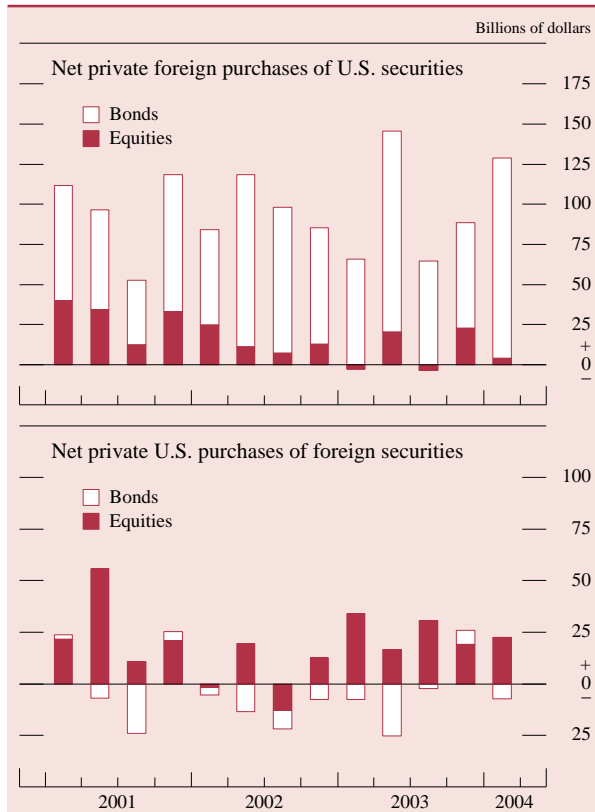
U.S. net financial inflows



SOURCE. Department of Commerce.

sharply in the first quarter of 2004 and then moderated somewhat. Similarly, private foreign purchases of U.S. bonds, which were significant in 2003, increased sharply in the first quarter and also appear to have moderated in the second quarter. In contrast, foreign demand for U.S. equities was weak in 2003 and has remained so in 2004. Purchases of foreign

U.S. net international securities transactions



SOURCE. Department of Commerce and the Federal Reserve Board.

equities by private U.S. investors appear to be strengthening, but U.S. investors still show no appetite for foreign bonds.

Direct investment into the United States in the first quarter continued to be restrained by the slowdown of global mergers and acquisitions since 2002. In contrast, U.S. direct investment abroad was strong in 2003 and in the first quarter of 2004, as the effect of fewer mergers and acquisitions was offset by sizable reinvested earnings.

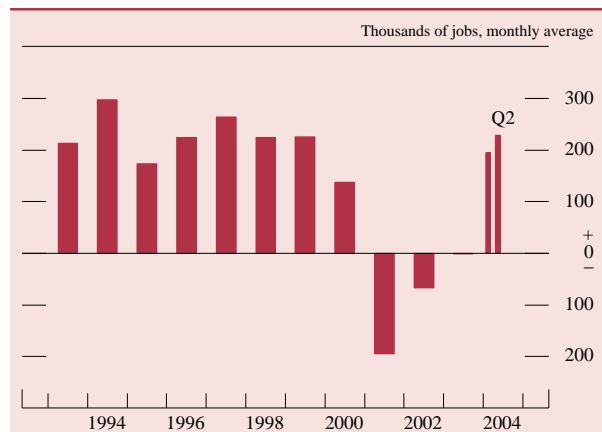
The Labor Market

Employment and Unemployment

The demand for labor turned up in late 2003 after an extended period of weakness, and it has gathered additional steam this year. After averaging about 60,000 per month in the fourth quarter of 2003, gains in private nonfarm payroll employment rose to an average of about 200,000 per month in the first half of 2004. The job gains were especially large in March, April, and May but ebbed somewhat in June. The civilian unemployment rate, which had fallen from a recent peak of 6.3 percent in June 2003 to 5.7 percent in December 2003, was little changed over the first half of the year. In June, it stood at 5.6 percent.

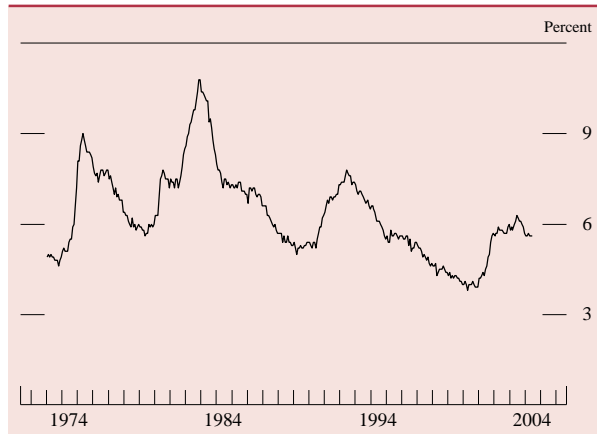
The increases in payrolls over the first half of 2004 were widespread. Especially notable was the turnaround in the manufacturing sector, in which employment bottomed out in January and then rose a cumulative 65,000 jobs through June. The rise in manufacturing jobs was concentrated in the durable goods industries—in particular, those making fabricated metals and other construction-related products,

Net change in payroll employment



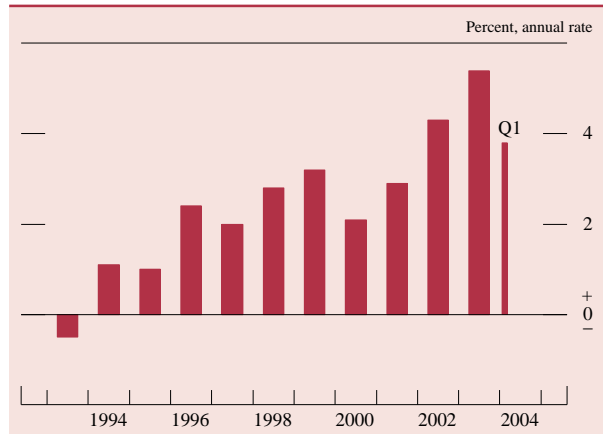
NOTE. Private nonfarm.

Civilian unemployment rate



NOTE. The data are monthly and extend through June 2004.

Change in output per hour



NOTE. Nonfarm business sector.

computers and electronic equipment, and machinery. After a long string of declines, employment at producers of nondurable goods was little changed, on net, over the first half. Job gains in virtually all other major sectors have been greater this year than last. In particular, hiring in retail trade, which had been lackluster in 2003, turned up appreciably, and construction employment increased further. The professional and business services sector also posted a sizable rise, in part because the rebound in manufacturing activity lifted hiring at temporary-help firms. A clear indication of the breadth of the employment increases is provided by the six-month diffusion index compiled by the Bureau of Labor Statistics (BLS). The index is equal to the percentage of industries that increased employment over the most recent six months plus one-half the percentage with unchanged employment; in June, the index moved up to its highest level since April 2000.

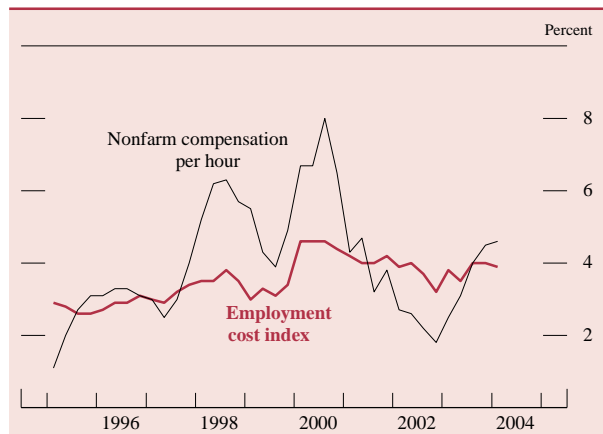
Productivity and Labor Costs

Gains in labor productivity have slowed somewhat in recent quarters after the spectacular increases of mid-2003. Still, according to the currently published data, output per hour in the nonfarm business sector rose a remarkable 5½ percent over the year ending in the first quarter. Over the past three years, increases in productivity have averaged more than 4 percent per year, compared with average increases of about 2½ percent per year in the second half of the 1990s. During that earlier period, an expansion of the capital stock was an important source of productivity growth. However, in the more recent period, when the business environment—at least until the past few quarters—was characterized by sluggish demand,

lean capital budgets, and an extraordinary reluctance of firms to add to payrolls, businesses appear to have raised their productivity mainly through changes in organizational structures and better use of the capital already in place. With hiring having picked up of late, measured productivity growth may slow in coming quarters; but if recent experience is any guide, businesses will continue to focus on achieving structural improvements in the efficiency of their operations. The upswing in investment spending now under way also bodes well for sustained favorable productivity performance in the period ahead.

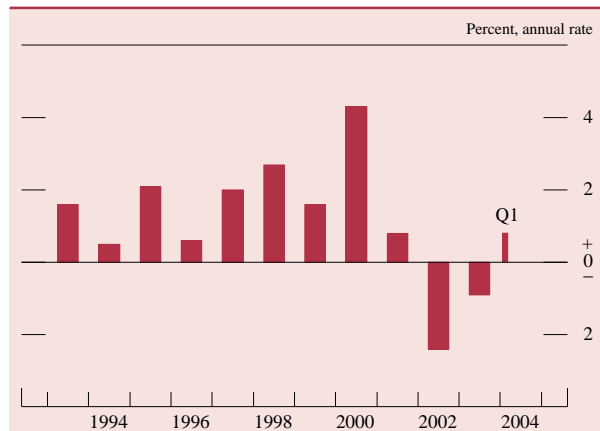
The rapid productivity growth in recent years has helped to bolster increases in hourly compensation in the face of the soft labor market and the low consumer price inflation in 2003. As a result, increases in the employment cost index (ECI) mea-

Measures of change in hourly compensation



NOTE. The data extend through 2004:Q1. For nonfarm compensation, change is over four quarters; for the employment cost index (ECI), change is over the twelve months ending in the last month of each quarter. Nonfarm compensation is for the nonfarm business sector; the ECI is for private industry excluding farm and household workers.

## Change in unit labor costs



NOTE. Nonfarm business sector.

sure of hourly compensation, which is based on a survey of private nonfarm businesses conducted quarterly by the BLS, have held fairly steady of late. In fact, the rise in the ECI over the twelve months ending in March—at a shade less than 4 percent—was virtually the same as the increases over the preceding two years. Benefit costs, which rose 7 percent over the year ending in March, have continued to be the fastest rising portion of hourly compensation; health insurance costs have remained on a steep uptrend, and employers have boosted their contributions to defined-benefit retirement plans to make up for earlier stock market losses. The rising benefit costs have likely exerted some downward pressure on wages, which rose just 2½ percent over the twelve months ending in March; the twelve-month change in the wage component of the ECI, which was close to 4 percent in 2000 and 2001, has been in the range of 2½ percent to 3 percent since late 2002.

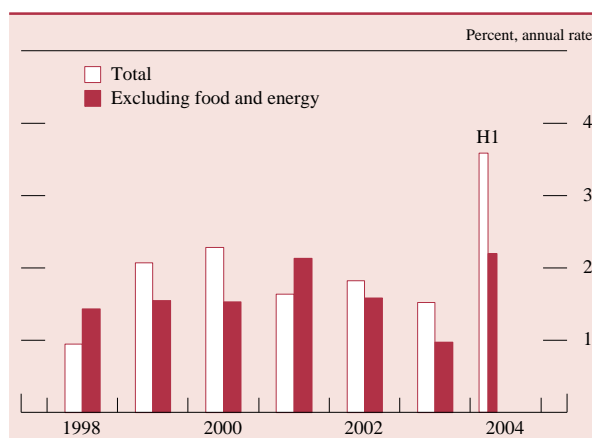
The change in compensation per hour in the nonfarm business (NFB) sector—an alternative measure of hourly compensation based on data constructed for the NIPA—has swung widely in recent years. Fluctuations in the value of stock option exercises, which are excluded from the ECI but included in the NFB measure, likely account for some of the differential movements in the two series. The four-quarter change in the NFB measure bottomed out at a bit less than 2 percent in 2002, when the value of exercised options was dropping; it has moved up steadily since that time and, in the first quarter, stood at 4½ percent—a rate not much different from the increase in the ECI. With productivity growth slowing to a pace below that of NFB hourly compensation, unit labor costs rose in both the fourth and first quarters after having trended down over the preceding two years.

## Prices

Inflation moved higher in the first half of 2004. After rising just 1½ percent over the four quarters of 2003, the price index for personal consumption expenditures (PCE) increased at an annual rate of 3½ percent between the fourth quarter of 2003 and May 2004. In that period, energy prices soared, and increases in core consumer prices picked up to an annual rate of 2¼ percent—more than 1 percentage point faster than the increase in 2003. Data for the consumer price index (CPI) are available through June and show some moderation in the core component of the series. Over the first half of the year, the core CPI rose at an annual rate of 2½ percent, compared with an increase of 1¼ percent over the four quarters of 2003.

Reflecting the surge in crude oil prices, PCE energy prices rose at an annual rate of more than 25 percent in the first quarter; they apparently posted another outsized increase in the second quarter. Gasoline prices increased rapidly through May as crude oil costs rose and as price markups were boosted by strong demand and lean inventories; although gasoline prices have fallen on balance since late May, they are currently nearly 30 percent above their level at the end of last year. As for natural gas, which can often substitute for fuel oil in the industrial sector, spot prices were elevated at the start of the year, fell somewhat in February and March, and trended up over the spring. The higher spot prices for natural gas this spring pushed up prices paid by consumers through June. PCE electricity prices appear to have risen at an annual rate of 3 percent over the first half of the year, a pace similar to that in 2003.

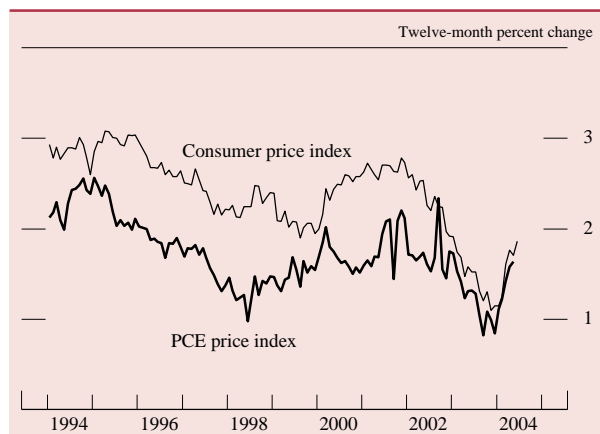
## Change in PCE price index



NOTE. The data are for personal consumption expenditures (PCE). The changes for 2004 are from 2003:Q4 to May 2004.



## Change in consumer prices excluding food and energy



NOTE: The data for the CPI extend through June 2004; for PCE, they extend through May 2004.

Although volatile from month to month, consumer food prices rose moderately on balance over the first half of 2004 after having moved up in late 2003. Robust global demand is imparting upward impetus to food prices, but U.S. producers are in the process of boosting supply, which should help restrain increases in retail food prices in coming quarters.

The step-up in core PCE inflation this year has been especially pronounced in a few categories. In particular, prices of motor vehicles have firmed after a noticeable decrease in 2003. In addition, increases in shelter costs, which were surprisingly low in 2003, are now running more in line with earlier trends. Core inflation has also been lifted this year by substantial increases, on balance, in a number of categories for which prices cannot be derived from market transactions and thus must be imputed by the Bureau of Economic Analysis—for example, prices of financial services provided by banks without explicit charge. These non-market-based prices, which were about flat in 2003, are difficult to estimate, and the imputed figures tend to be volatile.

A number of factors have contributed to the run-up in core inflation this year. Higher oil prices have doubtless raised the cost of producing other goods and services. So have the steep increases in prices of non-oil commodities such as copper and lumber, which came about as economic activity strengthened worldwide and as industrial capacity utilization both here and abroad tightened. Likewise, the decline in the dollar has boosted non-oil import prices and thus the costs of inputs for many domestic producers. The weaker dollar has also likely lessened the pressure on firms facing foreign competition to hold the line on prices—a consideration that is probably contributing to the widespread perception that firms' pricing

power has increased lately. Moreover, unit labor costs have edged up recently after having declined noticeably in 2002 and 2003.

From a cyclical perspective, the sharp upturn in commodity prices is not surprising, given the pickup in the growth of industrial production. In fact, such large increases in commodity prices are typical as economic activity accelerates and capacity utilization rises—especially for products for which the supply is relatively fixed in the short run. Some portion of these increases usually proves transitory. More important, cyclical swings in commodity prices tend to have only a minor effect on overall inflation, both because they account for a small share of total costs and because changes in commodity prices tend to be partly absorbed in firms' profit margins, at least for a time.

The faster rate of inflation this year underscores the difficulty of gauging price pressures. Nevertheless, on the whole, the evidence suggests that slack remains in labor and product markets, which should be exerting some downward pressure on inflation. The unemployment rate—at 5½ percent currently—is not significantly lower than it was through much of 2002 and 2003, when core inflation was trending down. And despite the run-up this year, capacity utilization in the manufacturing sector is still below its longer-run average. In addition, the strong upward trend in productivity is continuing to help keep the rise in labor costs muted, and profit margins are sufficiently wide to give firms scope to absorb cost increases for a while without putting undue upward pressure on prices.

The upturn in actual inflation has been echoed in some measures of inflation expectations. For example, according to the Michigan Survey Research Center, the median expectation for inflation over the coming year has averaged slightly more than 3 percent since early spring after hovering in the area of 2¼ percent to 2¾ percent in 2003 and early 2004. The median expectation for inflation over the next five to ten years has been running a bit below 3 percent in recent months, a reading similar to the figures for 2002 and 2003. According to the Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia, expectations of inflation over the next ten years held steady in June at 2½ percent. Inflation compensation over the next five years as measured by the spread between the yield on nominal Treasury securities and their indexed counterparts rose noticeably during the first half of 2004. To be sure, inflation compensation is also influenced by perceptions of inflation risk and the secular increase in demand for inflation-indexed debt, but

Alternative measures of price change

Percent

Price measure	2002 to 2003	2003 to 2004
<i>Chain-type (Q1 to Q1)</i>		
Gross domestic product .....	1.7	1.8
Gross domestic purchases .....	2.3	1.7
Personal consumption expenditures .....	2.4	1.6
Excluding food and energy .....	1.6	1.3
<i>Fixed-weight (Q2 to Q2)</i>		
Consumer price index .....	2.2	2.8
Excluding food and energy .....	1.5	1.8

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

the rise in near-term inflation compensation likely reflects, at least in part, higher inflation expectations. Similar to the survey-based measures of longer-run inflation expectations, inflation compensation for the period five years to ten years ahead was little changed on net over the first half of the year.

Broader NIPA price measures are available only through the first quarter, and the four-quarter changes in these series do not show the rise in inflation indicated by the monthly data discussed above. In particular, the rate of increase in the price index for GDP over the year ending in the first quarter was just 1¾ percent, the same as over the preceding year. The four-quarter change in the price index for gross domestic purchases—which is defined as the prices paid for purchases of domestic and imported consumption, investment, and government goods and services—dropped from 2¼ percent to 1¾ percent over the same period; the deceleration reflects mainly the effects of energy prices, which rose even more rapidly over the year ending in the first quarter of 2003 than they did over the most recent year.

U.S. Financial Markets

As 2004 opened, financial market conditions were quite accommodative, with low corporate bond yields, narrow risk spreads, and relatively easy terms and standards on bank lending. Although equity prices changed little, and interest rates rose on balance in response to positive economic news and expectations of a tightening of monetary policy, financial conditions in the first half of the year remained supportive of economic growth. Business borrowing nevertheless remained tentative, while increases in the debt of the federal government and of households were sizable.

Interest Rates

From the end of 2003 through the end of March, yields on nominal Treasury coupon securities fell, on

Interest rates on selected Treasury securities

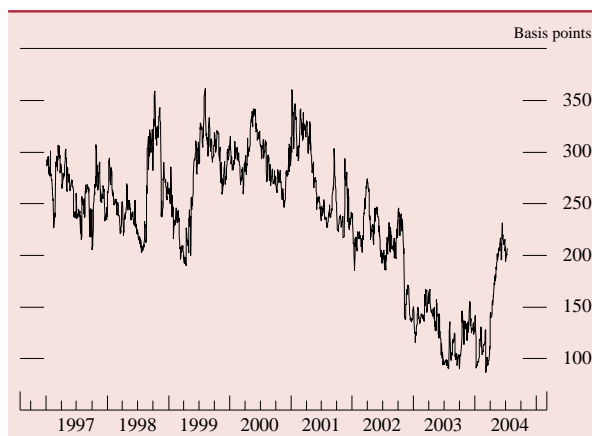


NOTE. The data are daily and extend through July 14, 2004.

net, about 30 to 45 basis points. Although interest rates rose immediately after the FOMC’s January meeting in response to the Committee’s decision to remove its statement that monetary policy could remain accommodative for “a considerable period,” the increase proved to be short lived. Weak employment reports released in early February and early March prompted yields to fall amid doubts about the strength of the economic expansion. Federal funds futures contracts at the end of March appeared to indicate that market participants placed small odds on a tightening of monetary policy before late 2004, and contracts also seemed to price in only a gradual increase in the federal funds rate during 2005.

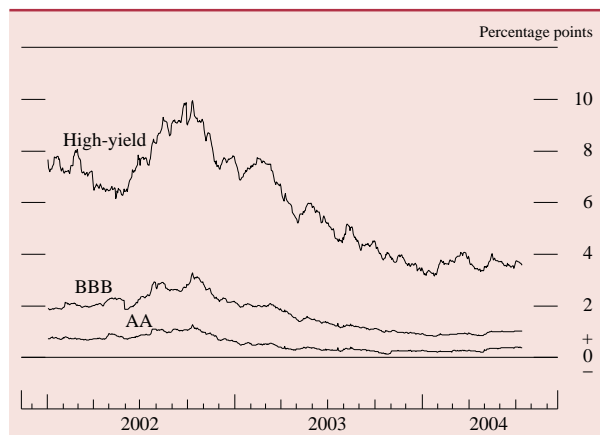
Interest rates backed up in the second quarter as data releases increasingly suggested that the eco-

Implied volatility of short-term interest rates



NOTE. The data are daily and extend through July 14, 2004. The series shown is the implied volatility of the three-month Eurodollar rate over the coming four months, as calculated from option prices.

### Spreads of corporate bond yields over the ten-year Treasury yield



NOTE. The data are daily and extend through July 14, 2004. The spreads compare the yields on the Merrill Lynch AA, BBB, and 175 high-yield indexes with the yield on the ten-year off-the-run Treasury note.

nommic expansion would remain vigorous. Yields on the two-year and ten-year nominal Treasury notes ended the first half of the year 90 and 36 basis points higher, respectively, than at the end of 2003, as markets adjusted to the greater likelihood of an earlier onset and more rapid pace of monetary policy tightening. The surprisingly strong employment reports published in April and May, higher-than-expected readings on core inflation, and surging oil prices all spurred increases in Treasury yields. After the release of the employment report in May, federal funds futures contracts priced in a hike in the target federal funds rate at the June FOMC meeting and a more rapid tightening of monetary policy than had been anticipated. With the evolving outlook for monetary policy, the volatility of short-term interest rates implied by option prices jumped in the first half of the year after staying in a relatively low range in 2003. Near-term interest rates declined a bit after the Committee's decision at its June meeting to raise the intended federal funds rate 25 basis points; the Committee's reaffirmation that policy accommodation likely could be removed at a "measured" pace apparently reassured investors that a steep rise in the federal funds rate probably was not in train.

Yields on investment-grade corporate debt moved roughly in line with those on comparable nominal Treasury securities over the first half of the year, producing little net change in risk spreads from their level at the end of last year. Spreads on speculative-grade debt over Treasury debt declined a bit further after having narrowed sharply during 2003 as the economic expansion was seen as gathering steam.

### Equity Markets

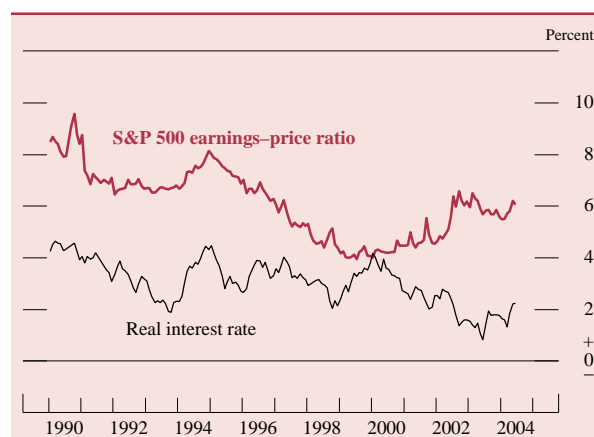
Over the first half of 2004, equity prices were subject to the strong crosscurrents of robust earnings reports, rising interest rates, fluctuating fears about geopolitical developments, and sharply higher oil prices. On balance, broad equity price indexes at the end of June had edged about 2½ percent to 3¼ percent above year-end levels after having surged 25–30 percent over the course of 2003. Over the first half, analysts raised their estimates of profits for coming quarters; the upward revision outstripped the more modest increase in equity prices and boosted the ratio of expected year-ahead earnings to stock prices. With real interest rates higher, however, the difference between the earnings–price ratio and the real ten-year

### Major stock price indexes



NOTE. The data are daily and extend through July 14, 2004.

### S&P 500 forward earnings–price ratio and the real interest rate



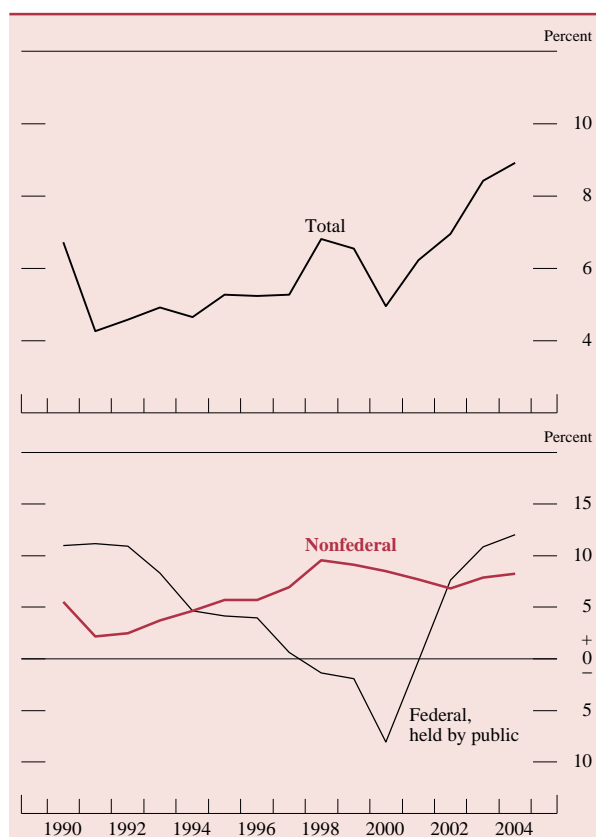
NOTE. The data are monthly and extend through June 2004. The forward earnings–price ratio is based on I/B/E/S consensus estimates of earnings over the coming year. The real interest rate is estimated as the difference between the ten-year Treasury rate and the expected ten-year inflation rate reported in the survey by the Federal Reserve Bank of Philadelphia.

Treasury yield—a crude measure of the equity risk premium—changed little to remain close to its average value over the past two decades and above its level during the late 1990s.

### Debt and Financial Intermediation

Aggregate debt of the domestic nonfinancial sectors expanded at an annual rate of about 8½ percent in the first quarter of 2004, a gain similar to last year's increase. Debt growth in the business sector has remained subdued so far this year, as ample internal funding has limited the need for external finance. In contrast, household debt has continued to expand rapidly, spurred by an elevated pace of home purchases and cash-outs from mortgage refinancing. The large federal budget deficit led to another sharp increase in Treasury debt in the first half of this year. Municipal borrowing moderated somewhat, on

#### Change in domestic nonfinancial debt



NOTE. For 2004, change is from 2003:Q4 to 2004:Q1 at an annual rate. For earlier years, the data are annual and are computed by dividing the annual flow for a given year by the level at the end of the preceding year. The total consists of nonfederal debt and federal debt held by the public. Nonfederal debt consists of the outstanding credit market debt of state and local governments, households, nonprofit organizations, and nonfinancial businesses. Federal debt held by the public excludes securities held as investments of federal government accounts.

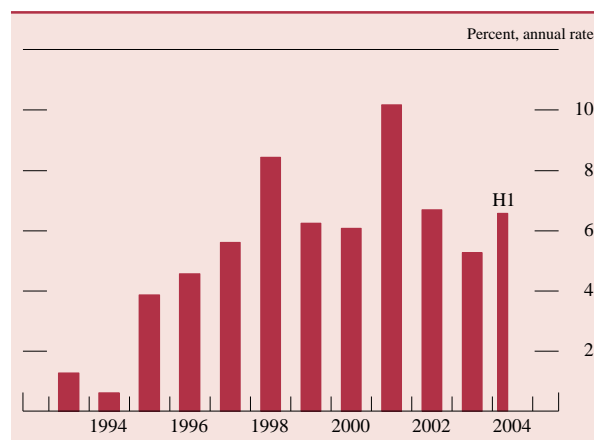
balance, in the first half of the year, as the improving fiscal condition of state and local governments reduced the need for short-term borrowing to cover budget gaps.

The growth of credit on the books of depository institutions picked up to an annual rate of 14 percent in the first quarter of 2004. Financing secured by residential real estate—including home mortgages, home equity loans, and mortgage-backed securities—drove the expansion. In contrast, business loans continued to run off, falling at an annual rate of about 5 percent in the first half of the year after a 10 percent drop in 2003. The deceleration was consistent with some signs that demand for business loans was beginning to recover as well as with an easing of standards and terms on these loans.

### The M2 Monetary Aggregates

In the first half of 2004, short-term interest rates were stable and M2 grew at an annual rate of 6½ percent—a pace that was roughly in line with estimates of nominal GDP—after contracting at a record rate in the fourth quarter of 2003. Liquid deposits—the largest component of M2—had been depressed late last year by the ebbing of last summer's mortgage refinancing boom. Mortgage refinancings tend to boost M2 as the proceeds are temporarily placed in non-interest-bearing deposit accounts pending disbursement of funds to the holders of mortgage-backed securities. When refinancings slowed last year, the decline in such escrow accounts held down the growth of liquid deposits. In the first half of this year, M2 probably received a boost from the new round of

#### M2 growth rate



NOTE. M2 consists of currency, travelers checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds.

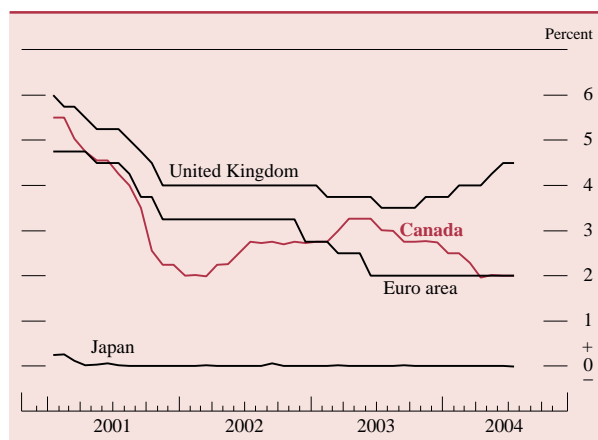
mortgage refinancings that followed the first-quarter decline in mortgage interest rates. The strength in liquid deposits was partly offset, however, by continued weakness in money market mutual funds and small time deposits. Given the recent very low yields on these two components of M2, households likely viewed them as less attractive savings vehicles than other assets.

### International Developments

Foreign economic activity expanded in the first half of this year at a pace only slightly below the rapid increase in the second half of 2003. Global trade has been boosted by strong demand, especially from the United States and China. The run-up in oil and commodity prices has contributed to rising, though still moderate, inflation across the industrial and developing countries.

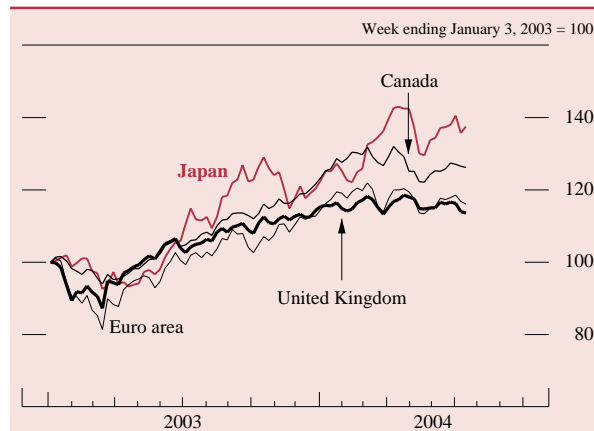
By the end of the first half of this year, monetary policy in most major foreign economies had either tightened or assumed a less accommodative tone. Citing high rates of capacity utilization and mounting inflationary pressures, the Bank of England has raised its target rate 100 basis points since early November. Mexico and China also have tightened policy. Elsewhere, including the euro area, Canada, and Japan, central banks most recently have kept policy unchanged after easing previously. In general, official statements are expressing increasing concern over the inflationary risks associated with stronger economic activity and higher world energy and commodity prices.

### Official interest rates in selected foreign industrial countries



NOTE. The data are as of month-end; the last observation for each series is the average of trading days through July 14, 2004. The data shown are the call money rate for Japan, the overnight rate for Canada, the refinancing rate for the euro area, and the repurchase rate for the United Kingdom.

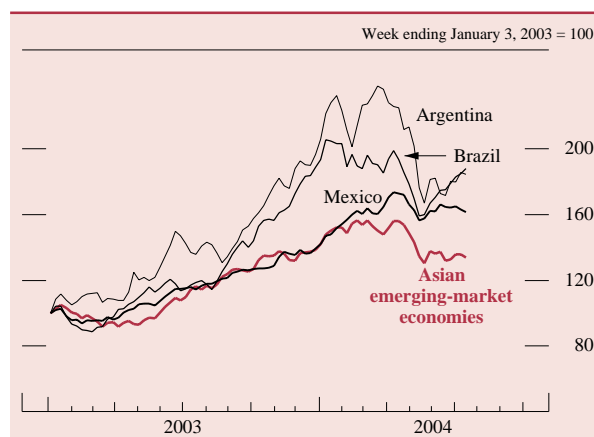
### Equity indexes in selected foreign industrial countries



NOTE. The data are weekly. The last observation for each series is the average of trading days through July 14, 2004.

In foreign financial markets, equity price performance has been more mixed so far in 2004 than during the second half of 2003; sharply rising interest rates over the past few months have weighed on equity valuations, damping the effects of an improved earnings outlook. Since year-end, stock prices in Europe and Canada have changed little, on balance. In contrast, rapidly improving economic conditions in Japan have helped boost Japanese equity prices about 10 percent. Other Asian stock price indexes have fallen, on average, in part because of concerns about the possibility of an acute slowdown in China. Mexican stocks have been bolstered by strong earnings growth of leading Mexican communications firms and, more generally, by the strengthening U.S.

### Equity indexes in selected emerging-market economies



NOTE. The data are weekly. The last observation for each series is the average of trading days through July 14, 2004. The Asian emerging-market economies are China, Hong Kong, India, Indonesia, Malaysia, Pakistan, the Philippines, Singapore, South Korea, Taiwan, and Thailand; the index weight for each of these economies is its market capitalization as a share of the group's total.

### Spread on internationally issued sovereign debt of emerging-market economies

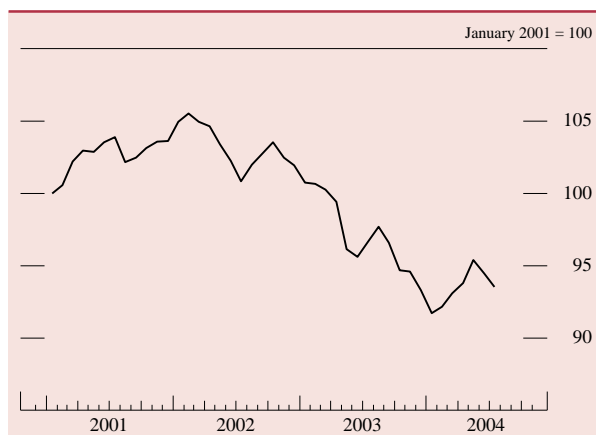


NOTE. The data are weekly averages. The last observation is the average of trading days through July 14, 2004. The series shown is the J.P. Morgan Emerging Market Bond Index Plus (EMBI+), which is the spread of the yield of certain dollar-denominated sovereign debt instruments of emerging-market economies over U.S. Treasury securities; over the period shown, the index encompassed nineteen countries.

expansion. Foreign long-term interest rates rose rapidly in the second quarter as new data (including from the United States) showing faster growth and higher inflation led market participants to expect more-aggressive monetary tightening. Over the first half of the year, the spread on internationally issued sovereign debt of emerging-market economies over U.S. Treasuries moved up somewhat from its very low level.

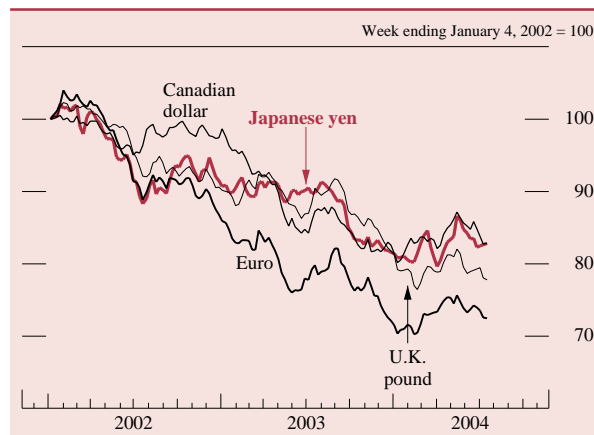
After depreciating over the previous two years, the value of the dollar rose slightly, on balance, in the first half of 2004. The firming of the dollar has been

### U.S. dollar nominal exchange rate, broad index



NOTE. The data are monthly and are in foreign currency units per dollar. The last observation is the average of trading days through July 14, 2004. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.

### U.S. dollar exchange rate against selected major currencies



NOTE. The data are weekly and are in foreign currency units per dollar. The last observation for each series is the average of trading days through July 14, 2004.

attributed to perceptions by market participants that near-term monetary tightening in the United States would be faster than such tightening abroad.

### Industrial Economies

A broadly based recovery appears to have been established in Japan over the first half of 2004. Real GDP rose at an annual rate of more than 6 percent in the first quarter after an even greater increase in the fourth quarter. Aided by demand from China, growth of Japanese real exports remained robust. Personal consumption and business investment also firmed. More-recent indicators show that domestic strength continued in the spring with large gains in household expenditures and improved labor market conditions. Deflation continued to wane in Japan. Consumer price deflation over the first half of the year was slight, and wholesale prices increased. In financial markets, the stronger economy boosted equity markets and helped drive up the yield on the ten-year bellwether government bond to more than 1 $\frac{3}{4}$  percent from its June 2003 record low of about  $\frac{1}{2}$  percent. After making substantial sales of yen for dollars in the first quarter, Japanese authorities ceased intervention in mid-March. Even so, the yen depreciated early in the second quarter before appreciating to around ¥109 per dollar.

Economic conditions in the euro area firmed over the first half of 2004, but performance varied across countries, and the region as a whole continues to lag the global upturn. Real GDP in the euro area increased at an annual rate of 2 $\frac{1}{4}$  percent in the first quarter; output in France, Spain, and several smaller

member countries rose relatively briskly, while growth in Germany and Italy was less robust. In the first quarter, domestic demand firmed noticeably, except in Germany, where growth was due entirely to a spike in exports. German consumer spending remains anemic, held down by a weak labor market and low consumer confidence. Euro-area indicators for the second quarter initially were upbeat, but more-recent data have been mixed. Labor markets have yet to benefit from the recovery, and the average unemployment rate in the region edged up to 9 percent in the spring. Inflation for the euro area over the twelve months ending in June was near 2½ percent, a rate above the European Central Bank's medium-term goal of less than, but close to, 2 percent. Excluding energy, food, alcohol, and tobacco, prices rose slightly less than 2 percent over the same period.

Economic expansion in the United Kingdom continued unabated over the first half of 2004. Labor markets tightened further; the unemployment rate edged down to its lowest level in almost three decades, and labor earnings posted solid gains. Despite the strong economy, consumer price inflation over the twelve months ending in June was 1½ percent, remaining below the central bank's official target rate of 2 percent. Conditions in the U.K. housing market, however, remained red hot, with double-digit price increases, high levels of household mortgage and consumer borrowing, and sizable withdrawals of home equity.

The Canadian economy picked up steam in the first half of 2004 after a year plagued with difficulties including SARS, mad cow disease, and a regional power outage. Sizable gains in consumption and investment boosted output in the first quarter, and indicators are pointing to continued good performance in these sectors. Export growth was strong, as the robust economic performance of the United States appears to have outweighed the negative effect of Canadian dollar appreciation on trade. The unemployment rate was relatively stable over the first half, and employment bounced back in the second quarter from a first-quarter lull. Consumer price inflation decreased early in the year, but energy costs helped drive up the rate to 2½ percent over the twelve months ending in June. Prices excluding food, energy, and indirect taxes have remained more subdued, rising slightly less than 1½ percent over the same period.

### Emerging-Market Economies

Estimates suggest that real GDP in China surged in the first quarter with continued outsized gains in

fixed-asset investment. Fears of overinvestment, particularly in the steel, cement, and aluminum industries, led Chinese officials to intensify their tightening measures early in the second quarter. These measures included increases in reserve requirements and in some interest rates as well as stricter criteria for the approval of investment projects. A sharp slowdown in estimated real GDP for the second quarter suggests that these steps are working. Despite the recent slowing in growth, Chinese exports and imports soared in the first half of the year, and trade was close to balanced.

Growth in the other Asian emerging-market economies slowed only moderately in the first quarter from the fast pace at the end of last year. Exports, which continued to be the driving force behind that growth, were fueled by Chinese demand as well as by the recovery in the global high-tech market and stronger world demand overall. Consumer demand generally rose across the region with the notable exception of Korea, where high levels of consumer debt are weighing on spending. Although still only moderate, inflation across the Asian emerging-market economies is beginning to rise as stronger aggregate demand takes hold and higher energy and commodity prices pass through to prices more generally.

The Mexican economy has been propelled this year by strong demand from the United States. Gains have been broadly based, with sharp increases in industrial production, exports, construction, and retail sales. Employment in the industries most closely linked to U.S. trade also has started to increase. Responding to a rise in twelve-month inflation to slightly above its 2 percent to 4 percent target range, the Bank of Mexico has tightened policy several times so far this year. Elevated oil prices boosted the Mexican public-sector fiscal surplus to a record high during the first five months of the year and facilitated an increase in federal transfers to state governments.

In Brazil, GDP grew robustly in the first quarter, and indications are that economic activity continued to expand in the second quarter with support from strong external demand. Job growth has been robust, although unemployment has remained high. Inflation, however, continues to concern authorities. Asset prices weakened earlier this year, in part because of rising global interest rates but also because of market participants' unease about the direction of structural and fiscal reforms; since then, asset prices have partially rebounded.

The recovery in Argentina has continued at a rapid pace in recent quarters, but limited investment in the energy sector, reflecting a lack of structural reforms, has forced the government to import electricity, natu-

ral gas, and fuel oil from neighboring countries. Creditors have shown little enthusiasm for the country's latest debt restructuring plan, and the federal

government faces difficult challenges in normalizing its international financial situation and reforming its fiscal relations with the provinces. □