

## **Prefatory Note**

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## **Part 2**

October 18, 2006

# **CURRENT ECONOMIC AND FINANCIAL CONDITIONS**

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## **Recent Developments**

October 18, 2006

## **Recent Developments**

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## **Domestic Nonfinancial Developments**

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## Domestic Nonfinancial Developments

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The broad picture of economic activity has not changed appreciably over the past month. Payroll employment has continued to rise moderately on net, and spending on consumption and business fixed investment has held up well. However, the increase in starts in September notwithstanding, the contraction in housing construction remains a significant drag on overall activity, and industrial production has slackened noticeably since midyear, in part because of steep reductions in motor vehicle assemblies. Energy prices dropped sharply in September and fell further in the first half of October, but core consumer price inflation remains elevated relative to readings from a year ago.

### Labor Market

The demand for labor continued to increase in September, although at a slower pace than in previous months according to the first estimate. Private nonfarm payrolls rose 59,000 in September after an upward-revised increase of 162,000 in August. Employment gains in the service-producing sector were generally widespread last month and were again led by an advance in health-care employment. The construction industry also added jobs, on net, with hiring in the nonresidential sector more than offsetting further losses in the residential sector. In contrast, retail trade employment decreased again and now stands more than 100,000 below its year-earlier level. Manufacturing employment also fell again in September, and job losses were widespread across industries. The average workweek was unchanged in September, and aggregate hours of production or nonsupervisory workers during the third quarter as a whole moved up at an annual rate of 0.9 percent.

The unemployment rate ticked down in September for the second consecutive month, to 4.6 percent, the low end of a narrow band that has prevailed since the beginning of the year. Meanwhile, the labor force participation rate remained at 66.2 percent. The number of persons working part time for economic reasons—another indicator of labor market slack—has returned to its low spring level after ticking up this summer.<sup>1</sup> In addition, the number of job losers unemployed less than five weeks (who account for the vast majority of those in transition from employment to unemployment) is very low.

Other indicators do not point to any significant changes in labor market conditions. The four-week moving average of initial claims for unemployment insurance (UI) was

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<sup>1</sup> The category “working part time for economic reasons” measures employees who are working part time because they are unable to find full-time jobs. This indicator reflects economic slack because it captures individuals who would be willing to work more hours in response to employer demand; it is positively correlated with the unemployment rate.

**Changes in Employment**

(Thousands of employees; seasonally adjusted)

Measure and sector	2005	2006					
		Q1	Q2	Q3	July	Aug.	Sept.
	Average monthly change			Monthly change			
Nonfarm payroll employment (establishment survey)	165	176	115	121	123	188	51
Private	152	169	98	108	104	162	59
Natural resources and mining	4	6	5	2	3	2	0
Manufacturing	-6	1	11	-16	-23	-7	-19
Construction	25	26	1	12	5	23	8
Wholesale trade	7	13	8	6	-1	10	9
Retail trade	13	2	-28	-8	1	-14	-12
Transportation and utilities	6	4	9	9	13	0	14
Information	-1	2	-3	-1	-10	8	-2
Financial activities	12	20	11	11	6	10	16
Professional and business services	41	26	40	31	45	37	12
Temporary help services	14	-8	-1	-4	-6	7	-11
Nonbusiness services <sup>1</sup>	51	69	44	64	66	92	33
Total government	14	7	17	12	19	26	-8
Total employment (household survey)	221	287	241	162	-34	250	271
Memo:							
Aggregate hours of private production workers (percent change) <sup>2</sup>	2.3	3.0	2.6	.9	.1	-.1	-.1
Average workweek (hours) <sup>3</sup>	33.8	33.8	33.9	33.8	33.9	33.8	33.8
Manufacturing (hours)	40.6	41.0	41.2	41.3	41.4	41.3	41.1

1. Nonbusiness services comprises education and health, leisure and hospitality, and "other."

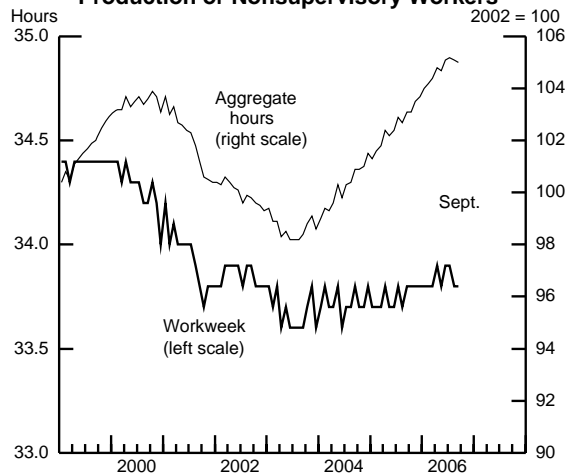
2. Establishment survey. Annual data are percent changes from Q4 to Q4. Quarterly data are percent changes from preceding quarter at an annual rate. Monthly data are percent changes from preceding month.

3. Establishment survey.

**Changes in Private Payroll Employment**



**Aggregate Hours and Workweek of Production or Nonsupervisory Workers**

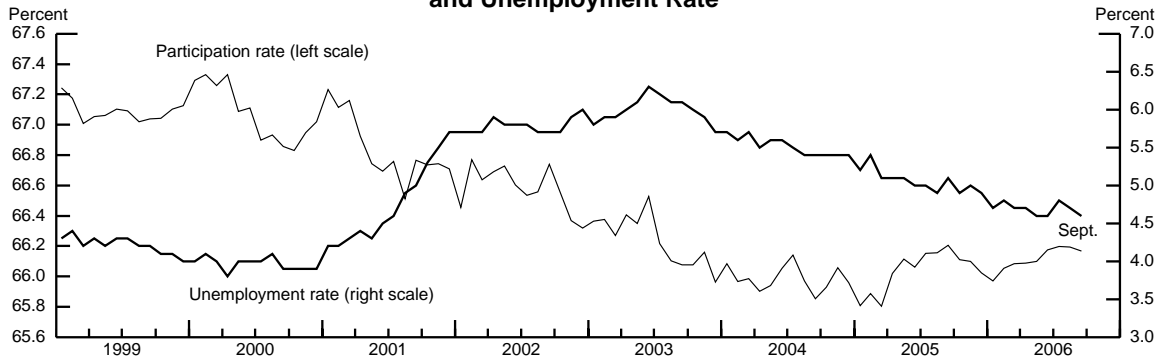


**Selected Unemployment and Labor Force Participation Rates**

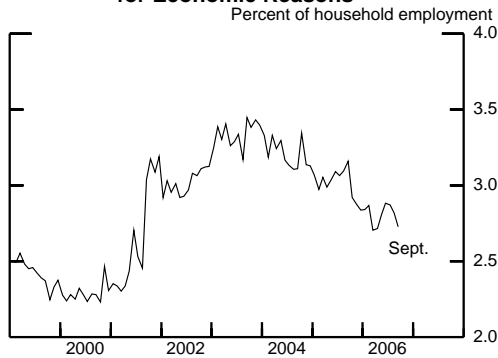
(Percent; seasonally adjusted)

Rate and group	2005	2006					
		Q1	Q2	Q3	July	Aug.	Sept.
<i>Civilian unemployment rate</i>							
Total	5.1	4.7	4.7	4.7	4.8	4.7	4.6
Teenagers	16.6	15.5	14.7	16.1	15.5	16.2	16.4
20-24 years old	8.8	8.1	8.1	8.2	8.5	8.2	8.0
Men, 25 years and older	3.8	3.6	3.6	3.5	3.6	3.5	3.3
Women, 25 years and older	4.2	3.9	3.8	3.8	3.8	3.7	3.8
<i>Labor force participation rate</i>							
Total	66.0	66.0	66.1	66.2	66.2	66.2	66.2
Teenagers	43.7	43.7	43.8	43.6	44.0	43.5	43.3
20-24 years old	74.6	74.0	74.2	74.9	74.5	75.5	74.7
Men, 25 years and older	75.4	75.5	75.5	75.4	75.3	75.3	75.5
Women, 25 years and older	59.4	59.4	59.5	59.8	59.9	59.8	59.7

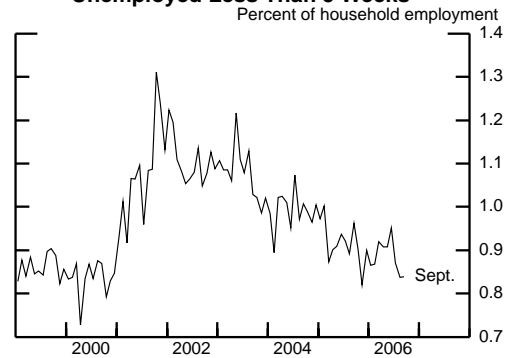
**Labor Force Participation Rate and Unemployment Rate**



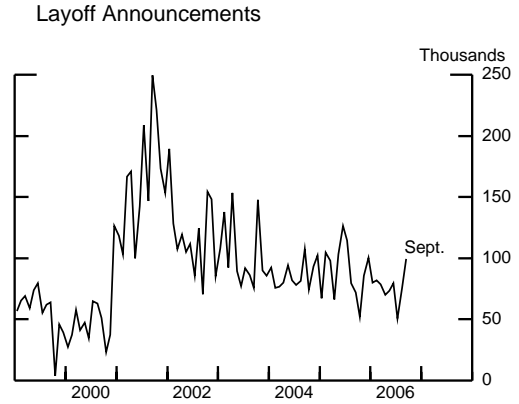
**Persons Working Part Time for Economic Reasons**



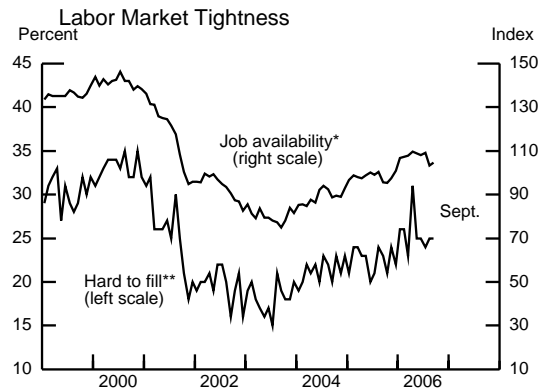
**Job Losers Unemployed Less Than 5 Weeks**



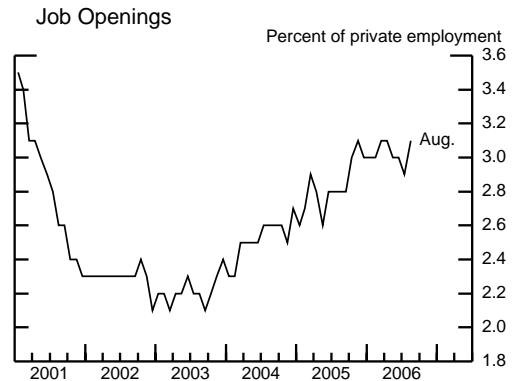
**Labor Market Indicators**



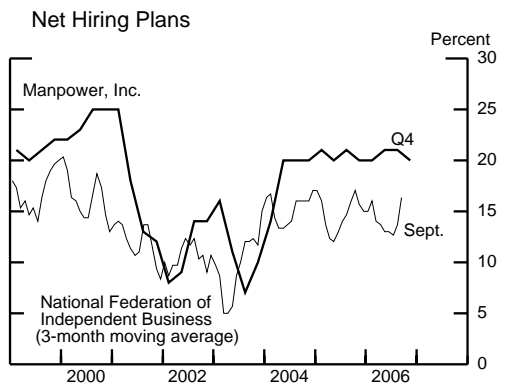
Note. Seasonally adjusted by FRB staff.  
Source. Challenger, Gray, and Christmas, Inc.



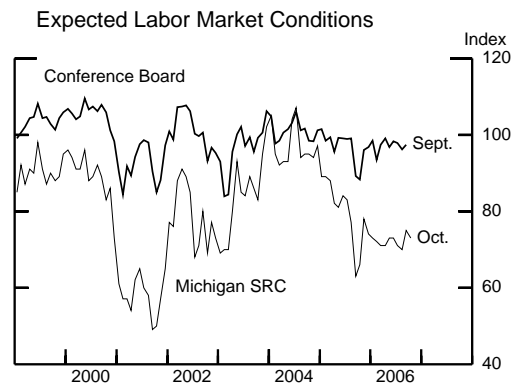
\*Proportion of households believing jobs are plentiful, minus the proportion believing jobs are hard to get, plus 100.  
\*\*Percent of small businesses surveyed with at least one "hard to fill" job opening.  
Source. For job availability, Conference Board; for hard to fill, National Federation of Independent Business.



Source. Job Openings and Labor Turnover Survey.



Note. Percent planning an increase in employment minus percent planning a reduction.



Note. The proportion of households expecting labor market conditions to improve, minus the proportion expecting conditions to worsen, plus 100.



313,000 in the week ending October 7, up just a little from its trough earlier in the year, and the level of insured unemployment has also barely risen from the low levels of the spring. Layoff announcements moved up in September, largely on the news of cutbacks by domestic automobile manufacturers, but many of these job cuts will take place over time or through attrition. According to the Job Openings and Labor Turnover Survey, the rate of job openings has moved sideways this year, and private surveys of hiring plans still suggest that labor demand is rising at a moderate pace. Readings on households' expectations for the labor market remain mixed: Respondents to the Conference Board survey were relatively upbeat through September, while the measure from the Michigan survey remained at a low level in early October.

The Bureau of Labor Statistics (BLS) has released its preliminary estimate of the annual benchmark revision to the establishment survey data, which indicates that the level of total nonfarm payroll employment in March 2006 was 810,000, or 0.6 percent higher than previously reported. This revision, which would be very large by historical standards, will be wedged-in between March 2005 and March 2006 when the BLS revises the employment data next February. All else being equal, the benchmark revision would also boost the change in hours more than ½ percentage point over the four quarters ending in 2006:Q1, and it would therefore lower productivity growth over this period from the currently published 2.7 percent to about 2.1 percent.<sup>2</sup>

### **Industrial Production**

Industrial production (IP) softened over the course of the third quarter after having posted brisk gains through midyear. In September, total IP decreased 0.6 percent after having been unchanged in August. September's decline reflected a sizable weather-related decrease in the output of utilities and a fairly broad-based decline of 0.3 percent in manufacturing output. In contrast, output in the mining sector more than reversed its

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<sup>2</sup> The benchmark revision will not affect the level of compensation in the national income and product accounts (NIPA) because the Bureau of Economic Analysis (BEA) has already incorporated the income-related data from the state UI programs into its estimates. However, the upward revision to hours would reduce compensation per hour. Unit labor costs, which depend on output and compensation but not on hours, would be unaffected.

**Selected Components of Industrial Production**  
(Percent change from preceding comparable period)

Component	Proportion 2005 (percent)	2005 <sup>1</sup>	2006		2006		
			H1	Q3	July	Aug.	Sept.
			Annual rate		Monthly rate		
<b>Total</b>	<b>100.0</b>	<b>3.0</b>	<b>5.9</b>	<b>3.6</b>	<b>.3</b>	<b>.0</b>	<b>-6</b>
Previous	100.0	3.0	5.8	...	.4	-.1	...
Manufacturing	80.8	4.2	5.2	3.8	.4	.2	-.3
Ex. motor veh. and parts	73.7	4.4	5.6	5.4	.9	.1	-.2
Ex. high-tech industries	68.9	2.9	4.8	3.8	.8	-.1	-.3
Mining	9.8	-6.8	18.0	1.8	-.2	-.5	.7
Utilities	9.5	2.9	-.2	4.3	.6	-.9	-4.4
<i>Selected industries</i>							
High technology	4.8	25.7	17.7	28.9	2.1	2.5	1.9
Computers	.8	12.0	13.4	18.0	1.3	1.4	1.4
Communications equipment	1.2	25.4	34.8	7.3	.5	-1.5	2.5
Semiconductors <sup>2</sup>	2.8	29.9	11.7	44.0	3.2	4.8	1.7
Motor vehicles and parts	7.1	2.3	1.0	-12.0	-5.2	1.9	-2.1
<i>Market groups excluding energy and selected industries</i>							
Consumer goods	21.0	2.3	1.8	3.4	.8	.1	-.1
Durables	4.1	2.6	-1.4	2.9	.7	.5	-1.1
Nondurables	16.9	2.2	2.6	3.5	.8	.0	.1
Business equipment	8.0	9.6	10.9	14.0	2.5	.4	-.6
Defense and space equipment	2.0	9.2	5.6	3.8	.6	-.5	.2
Construction supplies	4.4	6.5	.9	.7	.7	-.3	-.5
Business supplies	7.8	2.7	3.7	-.8	.2	-.8	-.5
Materials	24.4	.6	7.0	2.3	.6	-.2	-.5
Durables	13.7	3.6	7.6	3.9	1.0	-.2	-.2
Nondurables	10.7	-3.1	6.1	.1	.2	-.2	-.8

1. From fourth quarter of preceding year to fourth quarter of year shown.

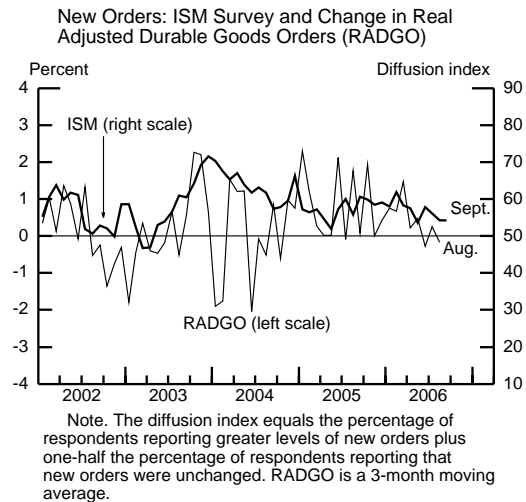
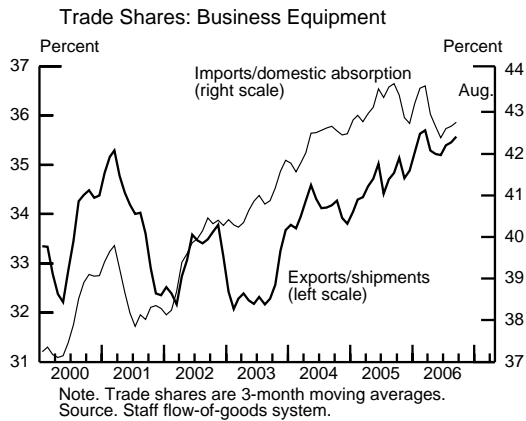
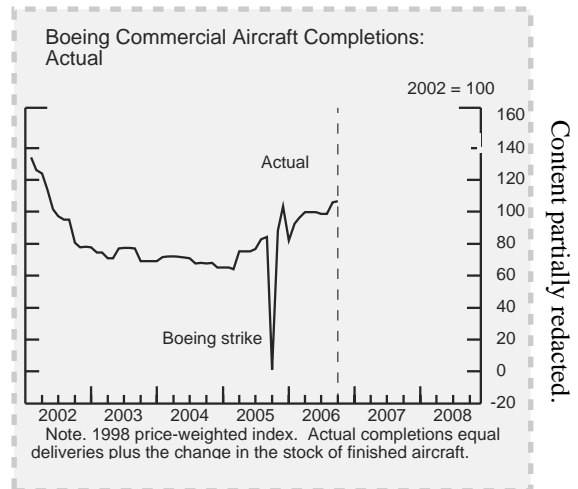
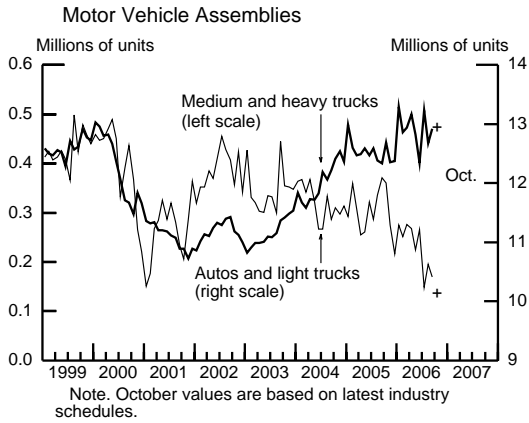
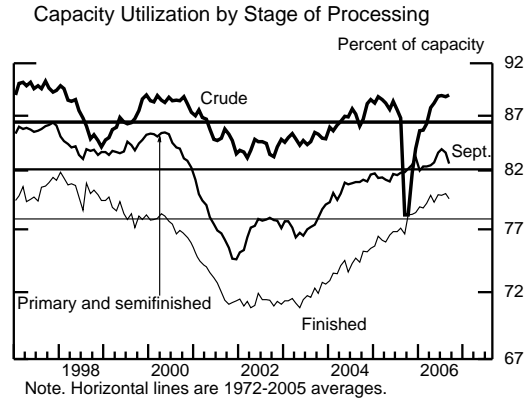
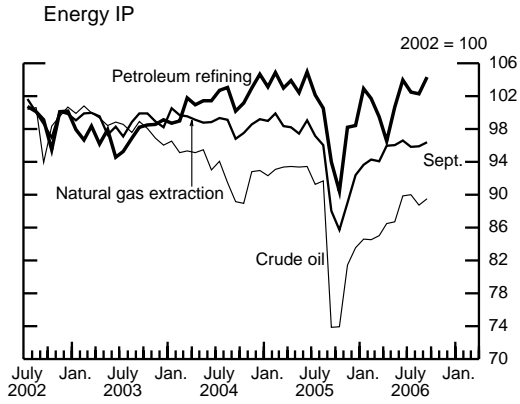
2. Includes related electronic components.

... Not applicable.

**Capacity Utilization**  
(Percent of capacity)

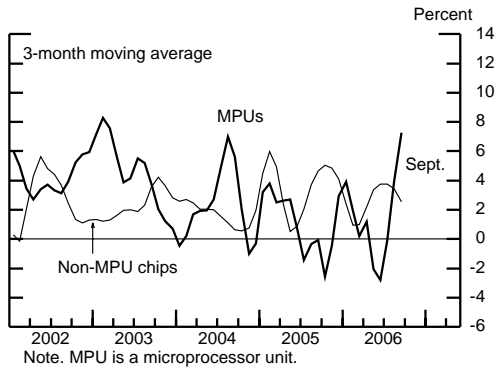
Sector	1972- 2005 average	1994- 2005 high	2001- 02 low	2006				
				Q1	Q2	Q3	Aug.	Sept.
<b>Total industry</b>	<b>81.0</b>	<b>85.0</b>	<b>73.9</b>	<b>81.1</b>	<b>82.0</b>	<b>82.3</b>	<b>82.5</b>	<b>81.9</b>
Manufacturing	79.8	84.5	72.0	80.3	80.8	81.1	81.2	80.8
Ex. motor veh. and parts	79.9	84.3	71.8	80.5	81.0	81.6	81.6	81.3
Mining	87.3	89.0	85.6	87.9	90.4	91.2	90.9	91.6
Utilities	86.7	93.7	83.7	83.5	86.6	87.3	88.3	84.4
<i>Stage-of-process groups</i>								
Crude	86.4	89.4	83.2	85.8	88.2	88.9	88.8	89.0
Primary and semifinished	82.1	88.1	74.6	82.3	82.9	83.4	83.6	82.6
Finished	77.9	80.5	70.8	78.9	79.7	79.8	80.0	79.6

## Indicators of Industrial Activity

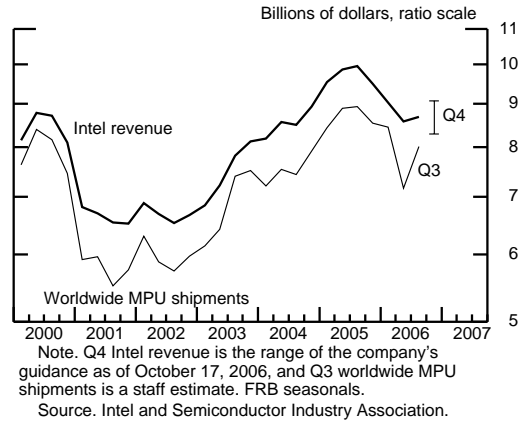


## Indicators of High-Tech Manufacturing Activity

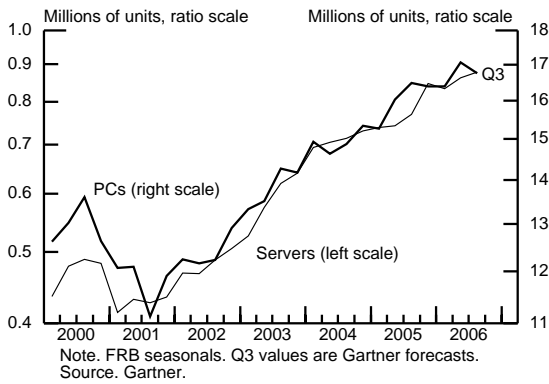
Rate of Change in Semiconductor Industrial Production



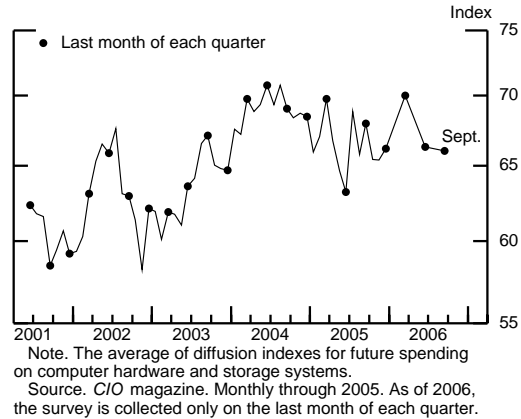
MPU Shipments and Intel Revenue



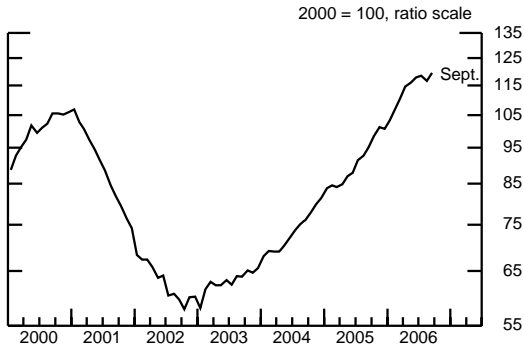
U.S. Personal Computer and Server Sales



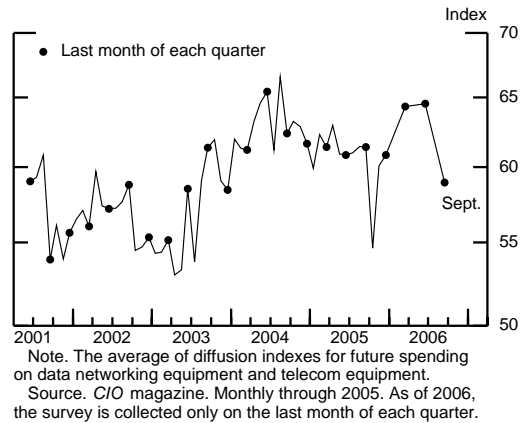
CIO Magazine Computer Hardware and Storage Systems Diffusion Index



IP: Communications Equipment



CIO Magazine Data Networking Equipment and Telecom Equipment Diffusion Index



August drop, largely because of gains in crude oil extraction and in mined construction supplies such as stone, sand, and gravel.<sup>3</sup>

In September, capacity utilization in the manufacturing sector declined 0.4 percentage point to 80.8 percent, but was still 1 percentage point above its average between 1972 and 2005. By stage of process, the utilization rate for industries at the crude stage edged up. The utilization rates for industries at the latter stages of process moved down further from the highs recorded earlier in the summer, though they remained above their 1972-2005 averages.

The output of motor vehicles and parts fell 2.1 percent in September, as automakers continued to trim production of light trucks in response to bloated inventories. For the third quarter as a whole, motor vehicle output was down 12 percent (annual rate) from its second-quarter level. Elsewhere in transportation, commercial aircraft production continued to climb steadily, and orders for Boeing aircraft remain robust. Reflecting a strengthening in domestic demand, this year's orders for Boeing aircraft are tracking only slightly behind the record-breaking pace recorded in 2005. Deliveries of Boeing's single-aisle workhorse, the 737, have increased markedly, and the company is currently starting up production of the new 787 for delivery in mid-2008.

High-tech output increased at an annual rate of nearly 30 percent in the third quarter, a noticeable step-up from the 20 percent rate during the second quarter. The drivers of high-tech output growth switched in the middle of 2006: Communications equipment production flattened out after a second-quarter surge, while semiconductor output accelerated. Semiconductor production rose 1.7 percent in September and was up nearly 45 percent at an annual rate for the quarter as a whole. Intel Corporation's introduction of faster, more energy-efficient microprocessors (MPUs) late this summer led to a jump in their production, which accounted for the bulk of September's increase in overall output of semiconductors. The company's revenue guidance for the fourth quarter—roughly flat in nominal terms—is consistent with another sizable gain in MPU output.

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<sup>3</sup> British Petroleum (BP) brought three of its four eastern Prudhoe Bay pumping stations back on line in September, thereby boosting output at Prudhoe Bay to 90 percent of full capacity. However, weather-related disruptions temporarily cut production during the second week of October. BP expects production to reach full capacity within the next few months once a bypass for the damaged pipelines is complete. Next year, BP plans to replace most of its Prudhoe Bay pipeline with narrower pipe that will maintain the current capacity but will be less prone to corrosion.

The IP index for computers continued to increase at a restrained rate in the third quarter. This estimate is based, in part, on projections from the Gartner Group, which show a continued firming of business demand for servers and a slowing in unit sales of personal computers on the heels of a second-quarter spurt. Meanwhile, the output of communications equipment rose only modestly in the third quarter after having been boosted significantly in the first half of the year by a major capital spending push among telecommunications service providers. Regarding the outlook, *CIO* magazine's diffusion index of plans for future spending on data networking and telecom equipment has dropped noticeably from the elevated readings seen during the first half of the year.

Among market groups excluding energy, motor vehicles and parts, and high-technology products, production was mixed in the third quarter, as downstream categories performed somewhat better than upstream industries. The output of consumer goods quickened in the third quarter, mainly because of a pickup in the production of consumer durables. The output of business equipment, which continues to benefit from both strong domestic orders and growing demand from abroad, advanced at an annual rate of 14 percent in the third quarter after a similar increase in the second quarter. The output of defense and space equipment continued to trend upward despite recent declines in military aircraft production. In contrast, among upstream market groups, materials production decelerated further during the third quarter, and the production of business supplies declined after having risen steadily in the first half of the year. The output of construction supplies edged up during the third quarter but was little changed from its level earlier in the year.

Recent indicators of near-term manufacturing activity have generally been a bit less positive than they were earlier in the year, but they point to continued expansion in the coming months. The Institute for Supply Management's diffusion index for new orders held steady at 54.2 in September, a level consistent with continued modest gains in output. Meanwhile, the three-month moving average of the staff's measure of real adjusted durable goods orders has changed little, on balance, of late. Much of the softening in factory production in the past few months appears to have been associated with the direct and indirect effects of slower homebuilding and, more importantly, with the inventory adjustment now under way in motor vehicle production. More broadly, manufacturing inventories in the staff's flow-of-goods inventory system appear well aligned with demand and provide little indication that other inventory-related production cutbacks are in store for the months ahead.

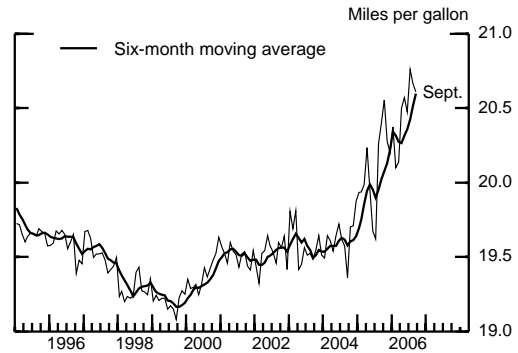
**Sales of Light Vehicles**  
(Millions of units at an annual rate; FRB seasonals)

Category	2005	2006					
		Q1	Q2	Q3	July	Aug.	Sept.
Total	16.9	16.9	16.3	16.6	17.1	16.0	16.6
Autos	7.7	7.8	7.8	7.9	8.2	7.7	7.6
Light trucks	9.2	9.1	8.5	8.7	8.9	8.3	8.9
North American <sup>1</sup>	13.5	13.4	12.6	12.8	13.2	12.4	12.9
Autos	5.5	5.7	5.4	5.4	5.6	5.3	5.3
Light trucks	8.0	7.7	7.1	7.4	7.6	7.1	7.6
Foreign-produced	3.4	3.4	3.7	3.7	4.0	3.6	3.7
Autos	2.2	2.1	2.4	2.5	2.7	2.4	2.3
Light trucks	1.2	1.3	1.3	1.3	1.3	1.2	1.4
Memo: Big Three domestic market share (percent) <sup>2</sup>	56.8	55.8	53.9	52.8	52.1	52.7	53.6

Note. Components may not sum to totals because of rounding.  
 1. Excludes some vehicles produced in Canada that are classified as imports by the industry.  
 2. Domestic market share excludes sales of foreign brands affiliated with the Big Three.

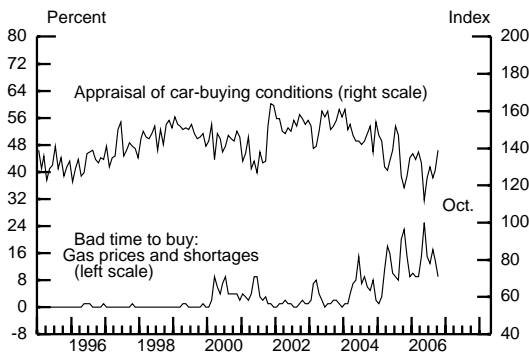


**New Light Vehicle Fuel Economy**

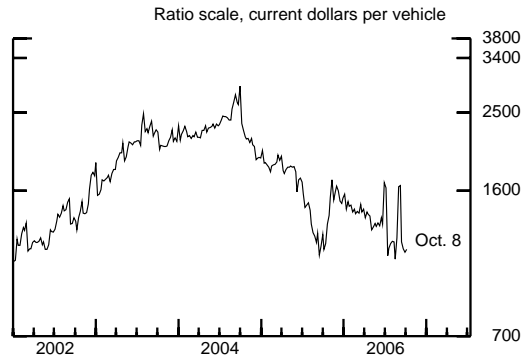


Source. Staff estimate based on a monthly sales-weighted average of city mileage ratings for all new models of light vehicles. Data are seasonally adjusted.

**Michigan Survey Index of Car-Buying Attitudes**



**Average Value of Incentives on Light Vehicles**



Note. Weighted average of customer cash rebate and interest rate reduction. Data are seasonally adjusted.  
 Source. J.D. Power and Associates.

**Production of Domestic Light Vehicles**  
(Millions of units at an annual rate except as noted)

Item	2006							
	Q1	Q2	Q3	Q4	June	July	Aug.	Sept.
U.S. production <sup>1</sup>	11.2	11.1	10.4	10.5	11.2	10.2	10.6	10.4
Autos	4.5	4.3	4.3	4.3	4.1	4.1	4.3	4.5
Light trucks	6.7	6.8	6.2	6.2	7.1	6.2	6.3	6.0
Days' supply <sup>2</sup>	69	75	71	n.a.	75	70	73	70
Autos	53	54	54	n.a.	55	50	53	55
Light trucks	81	90	82	n.a.	90	85	88	81
Inventories <sup>3</sup>	3.01	3.06	2.95	n.a.	3.06	2.99	2.96	2.95
Autos	.99	.95	.95	n.a.	.95	.90	.92	.95
Light trucks	2.03	2.10	2.00	n.a.	2.10	2.09	2.04	2.00
Memo: U.S. production, total motor vehicles <sup>4</sup>	11.7	11.6	10.9	11.0	11.6	10.7	11.1	10.9

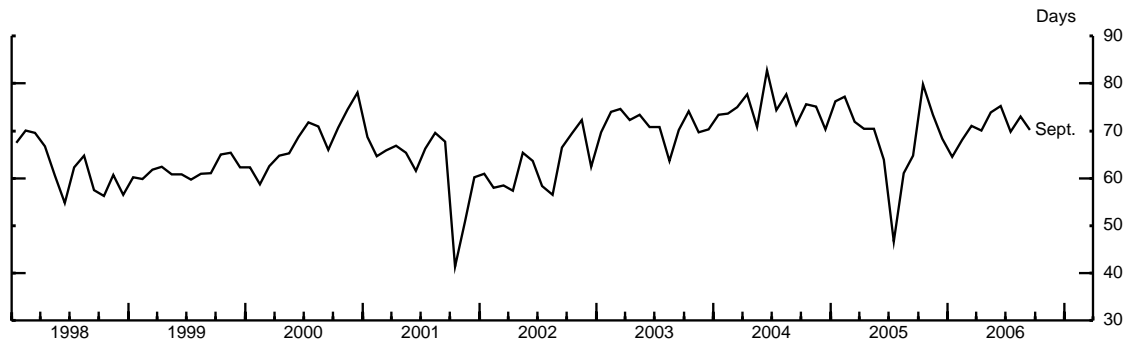
Note. FRB seasonals. Components may not sum to totals because of rounding.

1. Production rate for the fourth quarter reflects the latest industry schedules.
  2. Quarterly values are calculated with end-of-period stocks and average reported sales.
  3. End-of-period stocks.
  4. Includes medium and heavy trucks.
- n.a. Not available.

**Inventories of Light Vehicles**



**Days' Supply of Light Vehicles**





**Light Motor Vehicles**

Sales of light vehicles have continued to run at a moderate pace, while the Big Three manufacturers have slashed production in an effort to reduce bloated inventories. On the sales front, purchases were at an annual rate of 16½ million units in both September and over the third quarter as a whole, a pace slightly above that recorded in the second quarter and in the range that has prevailed for most of the past three years. Because of their ability to deliver more-competitive offerings within the relatively fuel-efficient segments of cars and light sport-utility vehicles, the transplant firms continued to perform well against the Big Three in the third quarter, and the domestic market share has continued to erode.

More recently, sales at the three Japanese transplant firms reportedly picked up a bit in the first ten days of October, while sales at the Big Three may be running a bit below the September pace. Meanwhile, assessments of car-buying conditions in the Michigan survey improved noticeably in early October, in part because of a lessening of concern about the price of gas. No significant changes have been made in cash rebates and other incentive programs in recent weeks.

Light vehicle assemblies dropped in the third quarter by an annual rate of almost 700,000 units, to 10.4 million units—the slowest pace in more than a decade—and are scheduled to remain at about this pace in the fourth quarter. The curtailment of production has been concentrated in light trucks, where inventories remain persistently high, and has helped to lower days' supply of all light vehicles from 75 days in June to 70 days at the end of September. If sales in the fourth quarter match their third-quarter pace, the scheduled assembly rate would reduce days' supply to the neighborhood of 65 days by the end of the year, a number that would be in line with the industry-preferred norm.

**Consumer Spending**

Real personal consumption expenditures regained some steam in September after a lackluster August and appear to have risen at a moderate pace in the third quarter as a whole. In part, the step-up in September reflected the monthly pattern of motor vehicle purchases. In addition, we estimate that real spending on goods excluding motor vehicles increased 0.7 percent last month after having risen only slightly, on net, over the summer; the rise in real spending in September was broadly based and showed particular strength

**Retail and Food Services Sales**

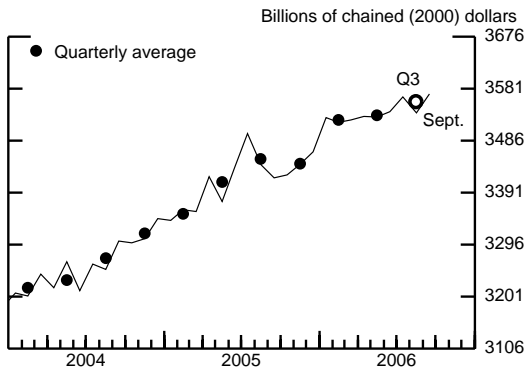
(Percent change from preceding period; seasonally adjusted current dollars)

Category	2006					
	Q1	Q2	Q3	July	Aug.	Sept.
	Annual rate			Monthly rate		
Total sales	13.4	3.3	4.1	1.4	.1	-.4
Retail control <sup>1</sup>	8.9	8.1	4.0	.7	.2	-.6
Ex. sales at gasoline stations	9.4	4.9	5.9	.6	.4	.8
Memo:						
Real PCE control <sup>2</sup>	8.7	1.0	2.3	.2	.0	.7

1. Total sales less outlays at building material and supply stores and automobile and other motor vehicle dealers.

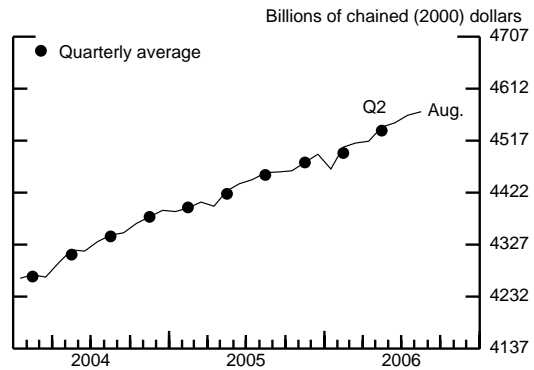
2. Total goods spending excluding autos and trucks. Values for July and August are staff estimates; values for Q3 and September are staff forecasts.

**Real PCE Goods**



Note. Values for July and August are staff estimates; values for Q3 and September are staff forecasts.

**Real PCE Services**



**Personal Saving Rate**



Note. Value for December 2004 excludes the effect on income of the special Microsoft dividend in that month.

in purchases of apparel.<sup>4</sup> Real outlays for consumer services posted a good-sized increase in July as a result of a weather-induced spurt in energy services, but they rose just 0.1 percent in August (the most up-to-date data) as temperatures returned to seasonal norms; cooler-than-normal temperatures likely held down expenditures on energy services in September.

Real disposable personal income (DPI) posted a solid increase in the first half of the year, mainly because of a surge in wages and salaries in the first quarter, and it appears to have moved up further in the third quarter.<sup>5</sup> Real DPI rose moderately in both July and August, reaching a level that was  $\frac{3}{4}$  percent above its second-quarter average, and it likely rose again in September in light of the sharp drop in energy prices in that month. The personal saving rate is currently estimated to have edged up to negative 0.5 percent in August, a value similar to the average over the first half of the year.

Consumer spending continues to draw a good bit of support from the lagged effects of the increases in household wealth over the past two years. As of the second quarter, the ratio of household wealth to disposable income stood at 5.60, well above its historical average; it probably remained in this area in the third quarter after factoring in both the rise in stock values and the apparent deceleration in house prices. Meanwhile, borrowing costs have risen this year, on balance, for both short- and long-term loans.

The fragmentary information on consumer spending in October has been positive. Sales at chain stores in the first half of the month were strong. In addition, the preliminary October report from the University of Michigan points to a considerable improvement in consumer confidence, perhaps because of declining gasoline prices. The sentiment measure from the Conference Board was little changed in September and remained well within the favorable range that has been evident this year.

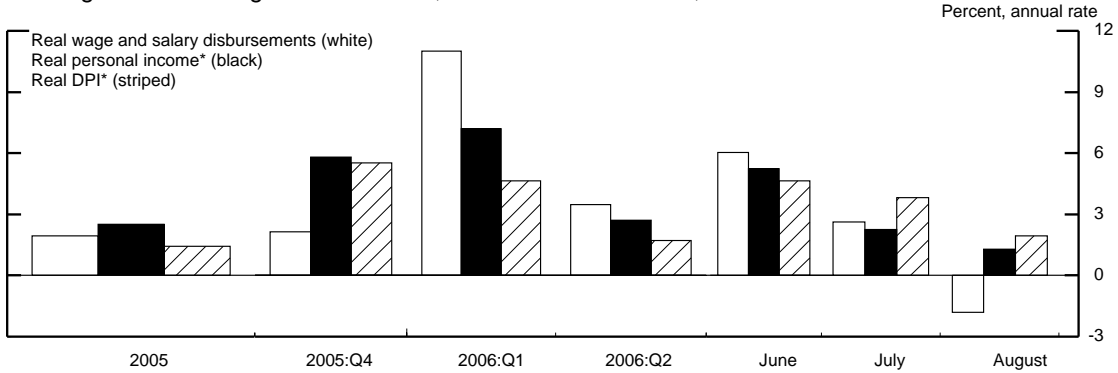
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<sup>4</sup> Although sales at stores in the retail control group—which excludes auto dealers and building material stores—fell 0.6 percent in nominal terms in September, the steep drop in gasoline prices more than accounted for the decline.

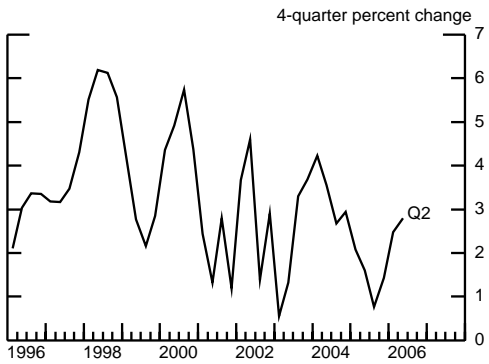
<sup>5</sup> The text refers to the published data on wages and salaries and DPI. Although the anticipated upward revision to payroll employment by the BLS supports the idea that some of the surge in wages and salaries in the first quarter will be permanent, we continue to judge that a substantial fraction reflected transitory factors, such as bonuses and stock options, that are unlikely to be repeated in the subsequent few quarters. The first opportunity for such a reversal to appear in the data will be in late November, when the wage and salary data for the second quarter are benchmarked to UI tax records. In our projection, we have assumed that the reversal will be concentrated in the third quarter.

## Fundamentals of Household Spending

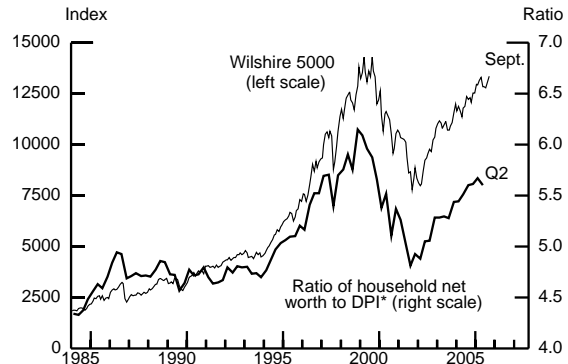
Changes in Real Wages and Salaries, Real Personal Income, and Real DPI



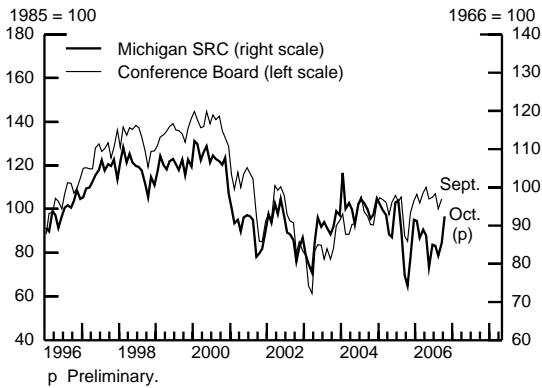
Change in Real DPI



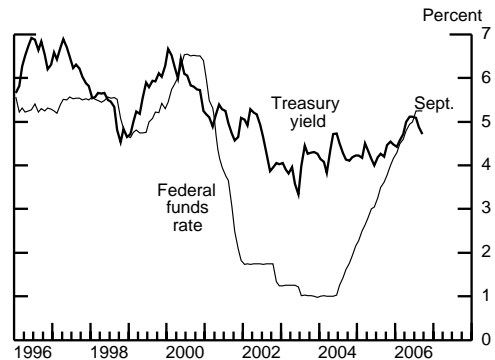
Household Net Worth and Wilshire 5000



Consumer Confidence



Federal Funds Rate and 10-Year Treasury Yield



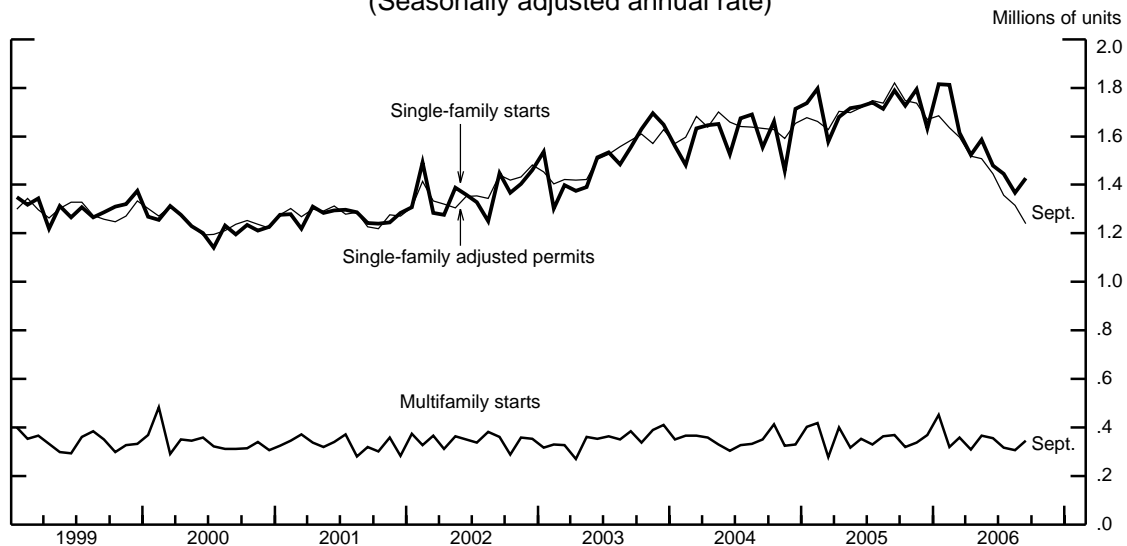
**Private Housing Activity**

(Millions of units, seasonally adjusted; annual rate except as noted)

Sector	2005	2006					
		Q1	Q2	Q3	July	Aug.	Sept.
<i>All units</i>							
Starts	2.07	2.12	1.87	1.74	1.76	1.67	1.77
Permits	2.16	2.14	1.93	1.70	1.76	1.73	1.62
<i>Single-family units</i>							
Starts	1.72	1.75	1.53	1.41	1.45	1.37	1.43
Permits	1.68	1.61	1.46	1.27	1.33	1.28	1.21
Adjusted permits <sup>1</sup>	1.71	1.64	1.49	1.30	1.36	1.32	1.24
Permit backlog <sup>2</sup>	.171	.163	.157	.133	.148	.153	.133
<i>New homes</i>							
Sales	1.28	1.11	1.10	n.a.	1.01	1.05	n.a.
Months' supply <sup>3</sup>	4.43	5.90	6.20	n.a.	7.00	6.60	n.a.
<i>Existing homes</i>							
Sales	6.18	5.96	5.86	n.a.	5.51	5.51	n.a.
Months' supply <sup>3</sup>	4.40	5.20	6.30	n.a.	7.20	7.30	n.a.
<i>Multifamily units</i>							
Starts	.353	.376	.343	.322	.315	.307	.346
Permits	.473	.528	.466	.431	.438	.443	.412
Permit backlog <sup>2</sup>	.060	.066	.068	.067	.069	.069	.067
<i>Mobile homes</i>							
Shipments	.147	.147	.122	n.a.	.111	.109	n.a.
<i>Condos and co-ops</i>							
Existing home sales	.896	.832	.828	n.a.	.822	.793	n.a.

1. Adjusted permits equal permit issuance plus total starts outside of permit-issuing areas.
  2. Number outstanding at end of period. Excludes permits that have expired or have been canceled, abandoned, or revoked. Not at an annual rate.
  3. At current sales rate. The ratio of n.s.a. inventories to n.s.a. sales is seasonally adjusted by the Census Bureau; as a result, the s.a. ratio may not be the same as the ratio of s.a. inventories to s.a. sales. Quarterly and annual figures are averages of monthly figures.
- n.a. Not available.

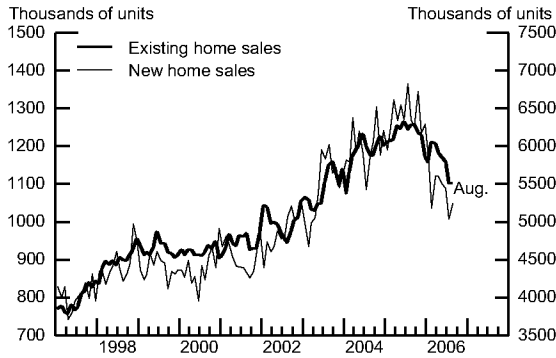
**Private Housing Starts and Permits**  
(Seasonally adjusted annual rate)



Note. Adjusted permits equal permit issuance plus total starts outside of permit-issuing areas.

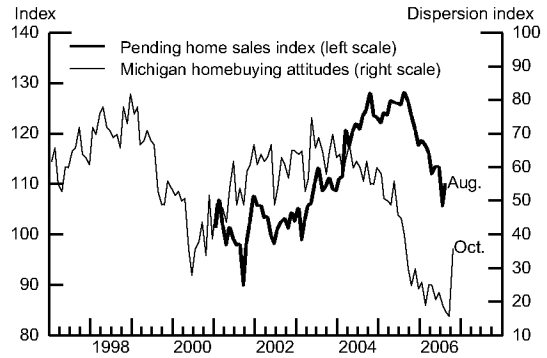
## Indicators of Single-Family Housing

### Home Sales



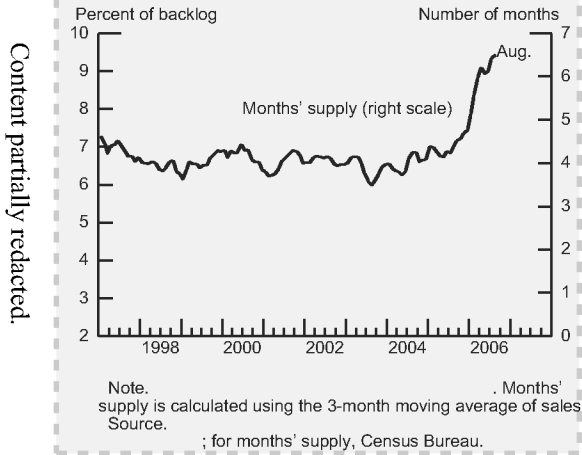
Source. For existing homes, National Association of Realtors; for new homes, Census Bureau.

### Homebuying Indicators

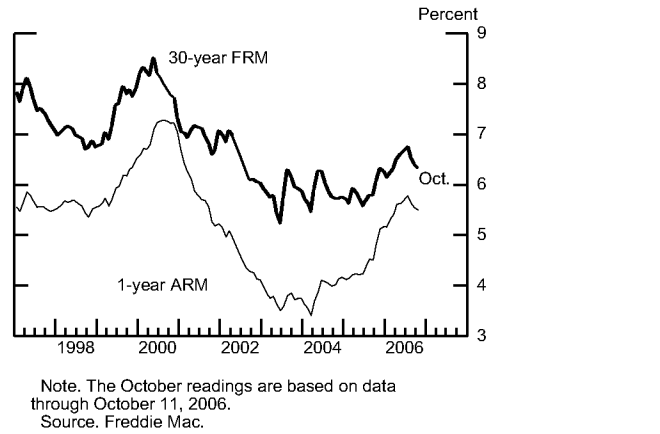


Source. For pending home sales, National Association of Realtors; for homebuying attitudes, Michigan survey.

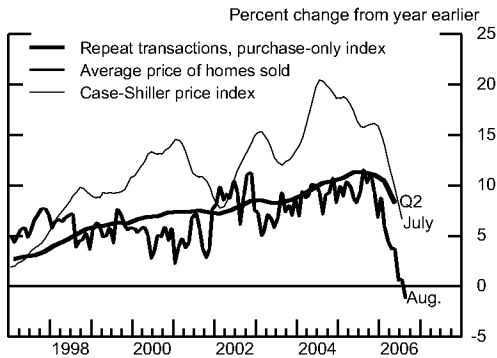
### New Home Sales Months' Supply



### Mortgage Rates

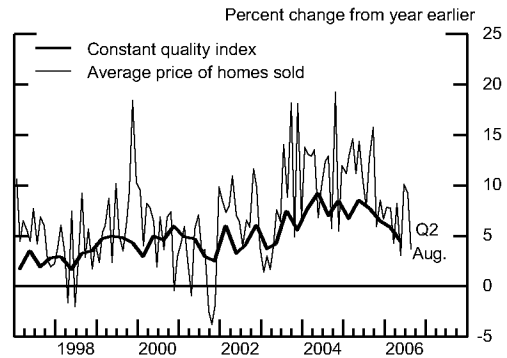


### Prices of Existing Homes



Source. For repeat transactions, OFHEO; for average price, National Association of Realtors; for Case-Shiller, Chicago Mercantile Exchange.

### Prices of New Homes



Note. Average price values have been adjusted by Board staff to take into account new sampling procedures adopted in 2005.  
Source. Census Bureau.

**Housing**

Despite some favorable incoming data, the housing sector remains weak. Although single-family starts rose to an annual rate of 1.43 million units in September, they were still about 20 percent below the peak seen in January. In addition, adjusted permit issuance in this sector, which tends to be a more reliable indicator of the underlying pace of homebuilding, fell 6 percent in September to an annual rate of 1.24 million units, the lowest level in nearly five years. Indeed, the gap between single-family starts and single-family adjusted permits in September was the largest on record and points to a reversal of the September increase in starts. In contrast, construction in the much smaller multifamily sector has continued to fluctuate within the range that has prevailed since 1995.

Sales of both new and existing homes have also dropped sharply since peaking last summer, but sales of existing single-family homes in August held steady at an annual rate of 5.5 million units, and sales of new homes edged up to an annual rate of about 1.1 million units. Moreover, the index of pending home sales—an indicator of future sales of existing homes—increased about 4 percent in August, and the index of homebuying sentiment from the Michigan survey jumped in October to its highest level in more than a year. Recent declines in mortgage rates may provide some support to demand in the coming months: The average rate for thirty-year fixed-rate mortgages has fallen about 35 basis points since July, while the average rate for one-year adjustable-rate mortgages has fallen more than 20 basis points.

Nonetheless, even a significant firming of demand may—in the absence of further cuts in construction—be insufficient to rapidly eliminate the overhang of unsold homes. Reported inventories of unsold new homes have been increasing relative to sales for some time, and the months' supply of new homes for sale is now more than 30 percent higher than the upper bound of the relatively narrow (and historically low) range it occupied from 1997 to 2005. In addition, these published inventory figures likely understate problems in the sector because they do not include the effect of cancellations on the stock of unsold homes.

House-price appreciation has slowed from the elevated rates seen through last year. The purchase-only version of the price index for existing homes calculated by the Office of Federal Housing Enterprise Oversight (OFHEO) increased at an annual rate of just

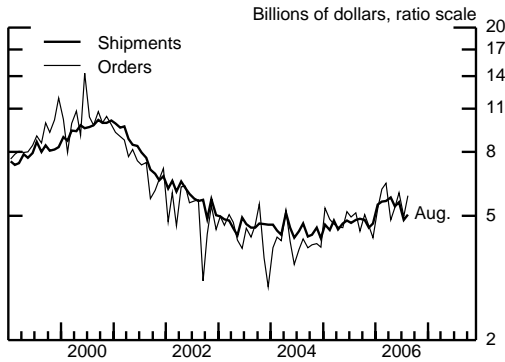
### Orders and Shipments of Nondefense Capital Goods

(Percent change; seasonally adjusted current dollars)

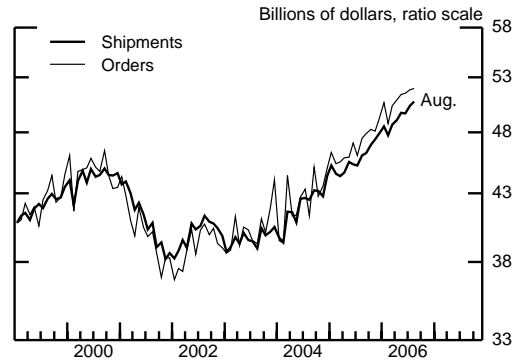
Category	2006				
	Q1	Q2	June	July	Aug.
	Annual rate		Monthly rate		
Shipments	1.4	5.2	-.2	.6	1.3
Excluding aircraft	10.6	5.8	-.2	1.5	.7
Computers and peripherals	-11.7	-18.7	-3.9	15.2	-1.7
Communications equipment	87.7	1.0	2.8	-12.1	3.9
All other categories	7.9	10.1	-.1	1.4	.7
Orders	-25.6	4.6	1.7	-.9	-2.9
Excluding aircraft	16.7	3.7	.9	.6	.4
Computers and peripherals	-16.3	-13.2	-1.7	15.3	-8.6
Communications equipment	159.3	-31.7	11.2	-15.9	16.5
All other categories	12.1	11.1	.2	.7	.1
Memo: Shipments of complete aircraft <sup>1</sup>	33.0	33.8	35.0	32.0	38.0

1. From Census Bureau, Current Industrial Reports; billions of dollars, annual rate.

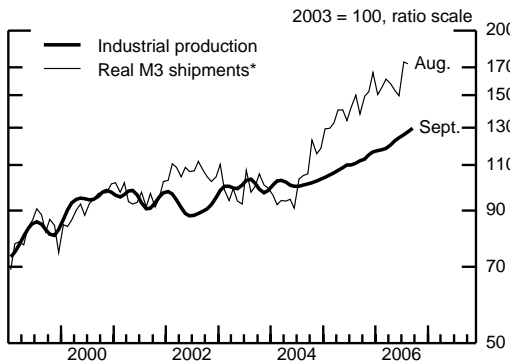
#### Communications Equipment



#### Non-High-Tech, Nontransportation Equipment

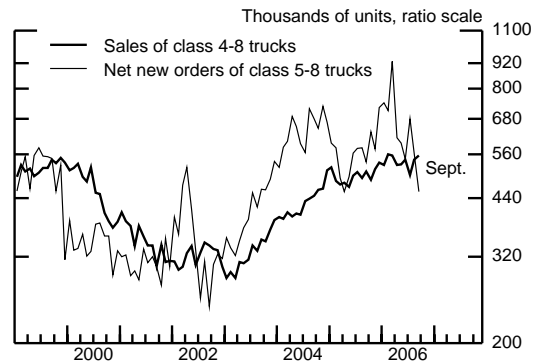


#### Computers and Peripherals



\* Deflated by the staff price index for computers and peripheral equipment, which is derived from BEA's quality-adjusted price indexes.

#### Medium and Heavy Trucks

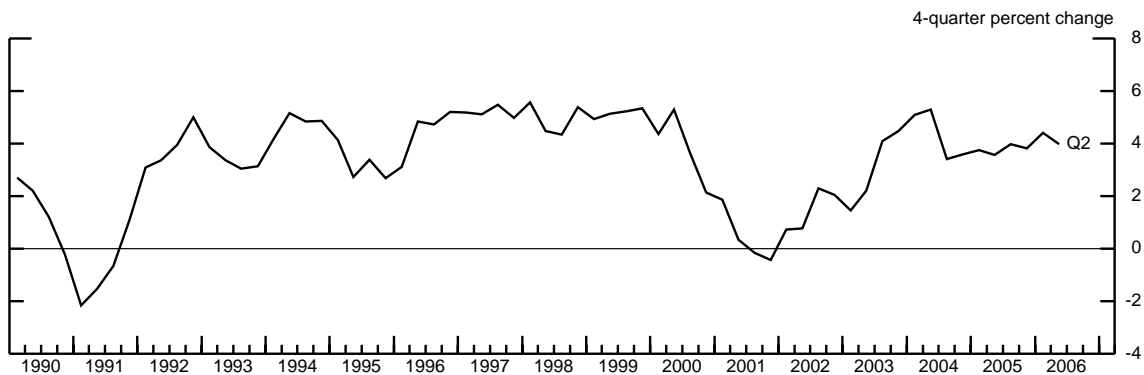


Note. Annual rate, FRB seasonals.  
Source. For class 4-8 trucks, Ward's Communications; for class 5-8 trucks, ACT Research.



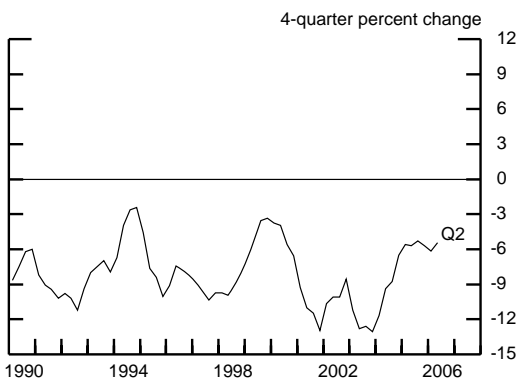
## Fundamentals of Equipment and Software Investment

Real Business Output

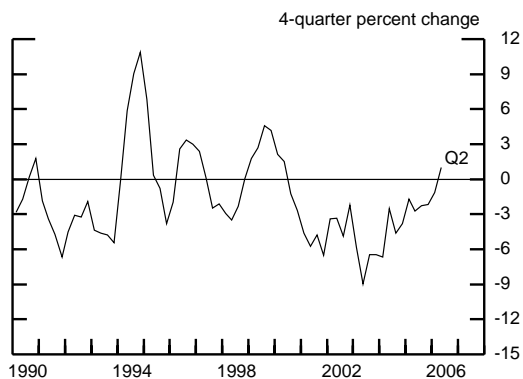


User Cost of Capital

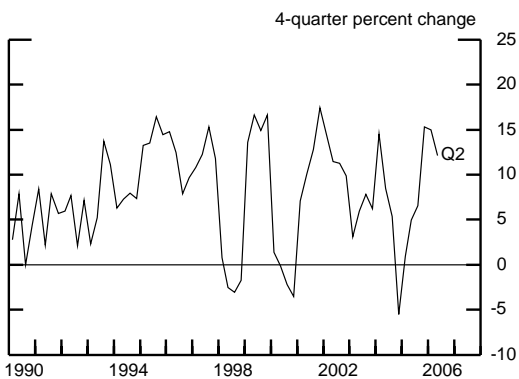
High-Tech



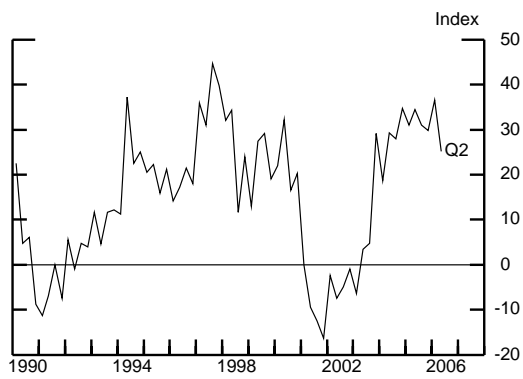
Non-High-Tech



Real Corporate Cash Flow



NABE Capital Spending Diffusion Index



Note. The diffusion index equals the percentage of respondents planning to increase spending minus the percentage of respondents planning to reduce spending.  
Source. NABE Industry Survey.

5 percent in the second quarter, and the increase of 8 percent between the second quarter of 2005 and the second quarter of 2006 was the smallest four-quarter change in nearly three years. More recently, the Case-Shiller home-price index, which covers sales in only ten large U.S. cities, showed roughly no net change, on a seasonally adjusted basis, between January and July, and the average price of existing homes sold posted an outright decline over the twelve months ending in August.<sup>6</sup> However, unlike the OFHEO and Case-Shiller indexes, the series for the average price of existing homes sold does not control for changes in the average characteristics of homes sold. Thus, the abrupt downswing in this measure may reflect, in part, a shift in the composition of sales away from higher-end homes. The rate of appreciation in new home prices has come down as well. Moreover, homebuilders have reportedly stepped up their use of incentives—such as paying closing costs, buying down mortgage rates, and including optional items at no cost—to bolster sales. If so, the deceleration of new home prices may be more pronounced than the reported price data suggest.

### **Equipment and Software**

Real spending on equipment and software appears to have increased at a solid pace during the summer. Shipments and orders of nondefense capital goods excluding aircraft increased in both July and August. And for the most part, the fundamental influences on equipment and software spending continue to look favorable. Corporate financial reserves remain plentiful, and the cost of capital for high-tech goods continues to fall—a trend that seems to have quickened in the third quarter as the pace of computer-price declines sped up and corporate bond rates dropped. That said, the step-down of late in the growth of business output suggests that accelerator effects will be providing less impetus to investment in the future, and some indicators of business conditions, including those from some of the Federal Reserve Banks and from the Institute for Supply Management, have edged down recently.

In the high-tech sector, orders and shipments of communications equipment moved up in August. The increase hinted that real outlays in this sector may be stabilizing after a spectacular first-quarter increase that was only partially unwound in the second quarter. Real computer spending is likely to show a substantial pickup in the NIPA estimate for

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<sup>6</sup> The cities covered by the Case-Shiller index are Boston, Chicago, Denver, Las Vegas, Los Angeles, Miami, New York, San Diego, San Francisco, and Washington.

the third quarter in light of the strong July and August shipments of computers as measured by the M3.<sup>7</sup>

In the transportation sector, real business purchases of motor vehicles have been brisk lately, in part because of a pull-forward of spending on medium and heavy trucks motivated by the Environmental Protection Agency's regulations on truck emissions, which are scheduled to take effect in 2007. Deliveries of these trucks should remain at a high level through year-end, although the decline in orders in recent months points to a drop-off after the turn of the year. Aircraft shipments through August (as estimated by the Census Bureau) and information on Boeing deliveries suggest that domestic aircraft outlays have picked up somewhat from their extremely low second-quarter level.

Real spending on equipment other than high tech and transportation appears to have retained considerable momentum in the third quarter. Shipments in this broad category rose 0.7 percent in August on top of the 1.4 percent increase posted in July, and robust orders in recent months suggest that further increases in shipments are in store for the months ahead.

### **Nonresidential Construction**

Activity in the nonresidential construction sector continued to strengthen in August. The recovery in manufacturing construction that began midway through 2004 has spread to the rest of nonresidential structures, and all the major categories of construction have now shown sustained increases in spending. Nonetheless, the vacancy rate in the retail sector has been essentially flat at a low level for some time now, and vacancy rates remain high in the office and industrial categories.<sup>8</sup> Forward-looking indicators suggest that outlays on nonresidential construction will continue to rise over the next few quarters, although perhaps not as rapidly as they have so far this year. The three-month moving average of the architectural billings index has strengthened significantly in recent months after dipping in the early summer and now shows that more architectural firms are reporting

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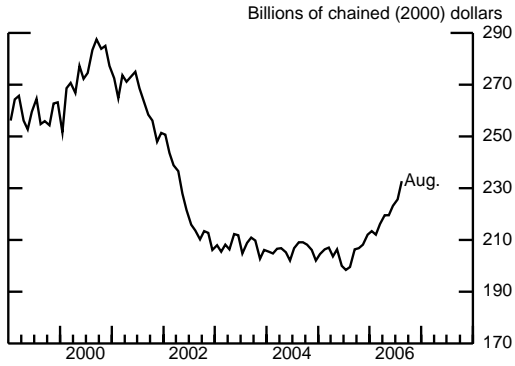
<sup>7</sup> The BEA still puts some weight (25 percent) on the M3 series when measuring computer expenditures, although it now gives the majority of the weight (75 percent) to the IP index for computers. As noted earlier, the IP index of computer production continued to show relatively sluggish growth in the third quarter.

<sup>8</sup> The vacancy rates for the office and industrial sectors plotted in the figure are estimates by Costar. Torto Wheaton Research reported more-significant declines in these vacancy rates than the Costar data indicate, although the levels of the Torto Wheaton series were higher in the second quarter than the Costar estimates. The Torto Wheaton data are based on a larger sample of areas and property types but are much less timely and appear to be of somewhat lower quality than Costar's.

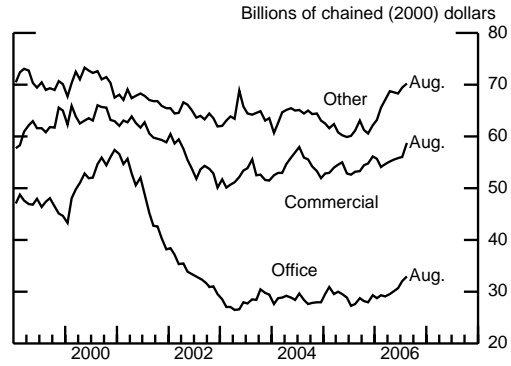
### Nonresidential Construction and Indicators

(All spending series are seasonally adjusted at an annual rate; nominal CPIP deflated by BEA prices through Q2 and by staff projection thereafter)

Total Structures

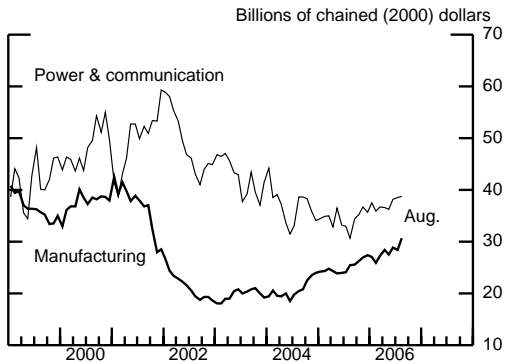


Office, Commercial, and Other

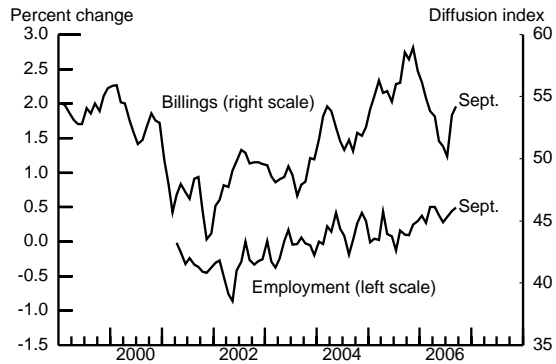


Note. Other includes religious, educational, lodging, amusement and recreation, transportation, and health-care facilities.

Manufacturing and Power & Communication

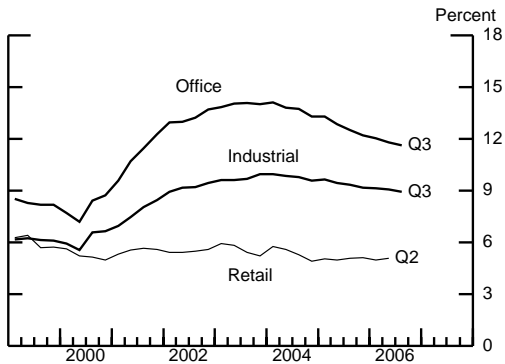


Architectural Billings and Nonresidential Construction Employment

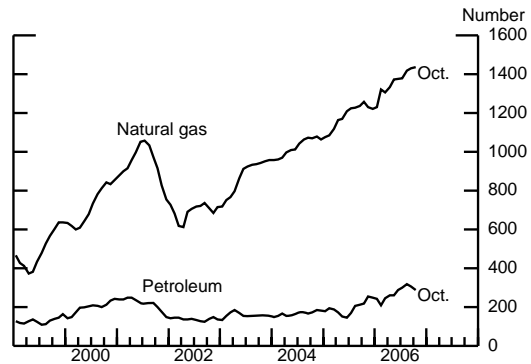


Note. Both series are 3-month moving averages. Employment includes industrial, commercial, and specialty trade construction. Source. For billings, American Institute of Architects; for employment, Bureau of Labor Statistics.

Vacancy Rates



Drilling Rigs in Operation



Note. Industrial space includes both manufacturing structures and warehouses. Source. For office and industrial, CoStar Property Professional; for retail, National Council of Real Estate Investment Fiduciaries.

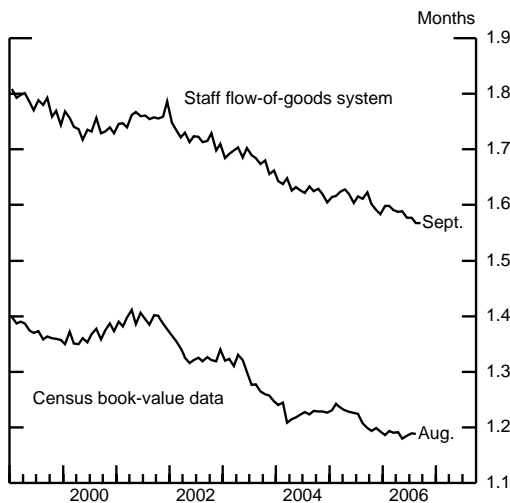
Note. October values are averages through October 13, 2006. Source. DOE/Baker Hughes.

**Nonfarm Inventory Investment**  
(Billions of dollars; seasonally adjusted annual rate)

Measure and sector	2005	2006				
	Q4	Q1	Q2	June	July	Aug.
<i>Real inventory investment (chained 2000 dollars)</i>						
<b>Total nonfarm business</b>	<b>38.6</b>	<b>36.8</b>	<b>52.2</b>	<b>n.a.</b>	<b>n.a.</b>	<b>n.a.</b>
Motor vehicles	23.4	8.5	3.0	n.a.	n.a.	n.a.
Nonfarm ex. motor vehicles	15.2	28.3	49.2	n.a.	n.a.	n.a.
<b>Manufacturing and trade ex. wholesale and retail motor vehicles and parts</b>	<b>16.9</b>	<b>22.7</b>	<b>36.3</b>	<b>33.4</b>	<b>15.1<sup>e</sup></b>	<b>n.a.</b>
Manufacturing	.5	7.6	11.0	9.7	6.3 <sup>e</sup>	n.a.
Wholesale trade ex. motor vehicles & parts	9.9	7.9	18.4	15.1	9.0 <sup>e</sup>	n.a.
Retail trade ex. motor vehicles & parts	6.6	7.2	6.9	8.6	-.2 <sup>e</sup>	n.a.
<i>Book-value inventory investment (current dollars)</i>						
<b>Manufacturing and trade ex. wholesale and retail motor vehicles and parts</b>	<b>56.2</b>	<b>53.3</b>	<b>109.1</b>	<b>110.2</b>	<b>94.4</b>	<b>98.1</b>
Manufacturing	23.3	23.5	48.3	52.6	44.6	21.4
Wholesale trade ex. motor vehicles & parts	20.7	17.9	43.2	38.9	38.1	55.2
Retail trade ex. motor vehicles & parts	12.2	12.0	17.5	18.7	11.7	21.4

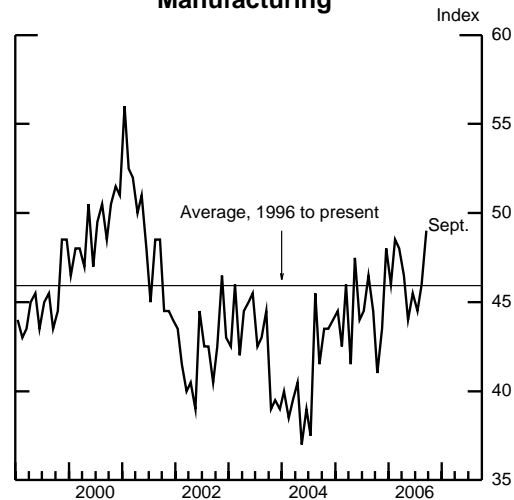
<sup>e</sup> Staff estimate of real inventory investment based on revised book-value data.  
n.a. Not available.  
Source. For real inventory investment, BEA. For book-value data, Census Bureau.

**Inventory Ratios ex. Motor Vehicles**



Note. Flow-of-goods system covers total industry ex. motor vehicles and parts, and inventories are relative to consumption. Census data cover manufacturing and trade ex. motor vehicles and parts, and inventories are relative to sales.

**ISM Customer Inventories: Manufacturing**



Note. A number above 50 indicates inventories are "too high."

### Federal Government Outlays and Receipts

(Unified basis; billions of dollars except as noted)

Function or source	July-September			12 months ending in September		
	2005	2006	Percent change	2005	2006	Percent change
Outlays	618.4	638.9	3.3	2472.1	2654.4	7.4
Financial transactions <sup>1</sup>	-.8	-.7	...	-1.3	-1.0	...
Payment timing <sup>2</sup>	11.9	-17.4	...	11.8	-14.2	...
Adjusted outlays	607.3	657.0	8.2	2461.6	2669.6	8.4
Receipts	549.2	596.9	8.7	2153.3	2406.7	11.8
Payment timing	.0	-6.0	...	6.0	-6.0	...
Adjusted receipts	549.2	602.9	9.8	2147.3	2412.7	12.4
Surplus or deficit (-)	-69.2	-42.0	...	-318.7	-247.7	...
<i>Selected components of adjusted outlays and receipts</i>						
Adjusted outlays	607.3	657.0	8.2	2461.6	2669.6	8.4
Net interest	42.7	57.1	33.6	183.5	226.6	23.5
Non-interest	564.5	599.9	6.3	2278.1	2442.9	7.2
National defense	128.9	134.7	4.5	490.6	524.4	6.9
Social Security	131.8	140.2	6.4	523.3	554.6	6.0
Medicare	77.8	87.4	12.4	295.7	338.2	14.4
Medicaid	43.5	45.3	3.9	181.7	180.6	-.6
Income security	72.0	73.8	2.4	344.6	353.6	2.6
Agriculture	3.2	2.2	...	28.3	30.8	9.1
Other	107.3	116.3	8.4	413.9	460.7	11.3
Adjusted receipts	549.2	602.9	9.8	2147.3	2412.7	12.4
Individual income and payroll taxes	415.9	443.6	6.7	1673.4	1836.4	9.7
Withheld + FICA	361.1	378.0	4.7	1486.6	1590.4	7.0
Nonwithheld + SECA	65.1	74.3	14.0	364.9	432.4	18.5
Less: Refunds	10.3	8.6	-16.1	180.3	186.4	3.4
Corporate	80.4	102.7	27.7	272.3	353.9	30.0
Gross	86.1	107.8	25.2	301.1	380.9	26.5
Less: Refunds	5.7	5.1	-10.8	28.8	27.0	-6.3
Other	52.8	56.6	7.1	201.7	222.3	10.2
Adjusted surplus or deficit (-)	-58.1	-54.0	...	-314.2	-256.9	...

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

1. Financial transactions consist of deposit insurance, spectrum auctions, and sales of major assets.

2. A shift in payment timing occurs when the first of the month falls on a weekend or holiday, or when the first 3 days of a month are nonworking days. Outlays for defense, Social Security, Medicare, income security, and "other" have been adjusted to account for these shifts. In addition, defense outlays for retiree health care have been converted from an annual to a monthly basis. For August 2006, receipts and outlays have been adjusted to reflect a one-time accounting correction by the Treasury that reduced both individual income taxes and Social Security benefits by \$6 billion.

... Not applicable.

Source. Monthly Treasury Statement.

increases in billings than are reporting decreases.<sup>9</sup> In addition, total employment in the nonresidential buildings and nonresidential specialty trade categories has continued to move up in recent months.

In the drilling and mining sector, the increase in the total number of rigs drilling for natural gas or petroleum through the end of September suggests that outlays continued to rise rapidly in the third quarter. The number of active rigs did tick down in early October, but energy prices remain high enough that drilling activity is likely to remain strong.

### **Business Inventories**

The pace of real inventory accumulation outside the motor vehicle sector moved up to an annual rate of nearly \$50 billion in the second quarter, and book-value data through August suggest that the rate of stockbuilding remained substantial in the third quarter. Broad measures of months' supply outside of the motor vehicle sector, including the staff's flow-of-goods inventory system, suggest that inventories are generally well aligned with demand. Although the September survey from the Institute for Supply Management indicated a noticeable rise in the number of respondents who think their customers' inventories are too high, two-thirds of respondents remain comfortable with their customers' inventory positions.

### **Federal Government Sector**

As a result of an exceptionally sharp increase in receipts in September, the unified budget deficit for fiscal year 2006 came in at \$248 billion, down from \$319 billion in the 2005 fiscal year. Outlays rose about in line with nominal GDP in fiscal 2006, but receipts rose much more rapidly, and the deficit fell from 2½ percent of GDP in 2005 to 2 percent of GDP in 2006.

Tax receipts in the July to September period stood 10 percent above the year-earlier level after adjusting for shifts in payment timing. Corporate collections (mainly the estimated payments that were due on September 15) posted another enormous increase, apparently because of both strong gains in corporate profits and other factors, including unusually high settlements of previous years' liability. Nonwithheld individual income and payroll

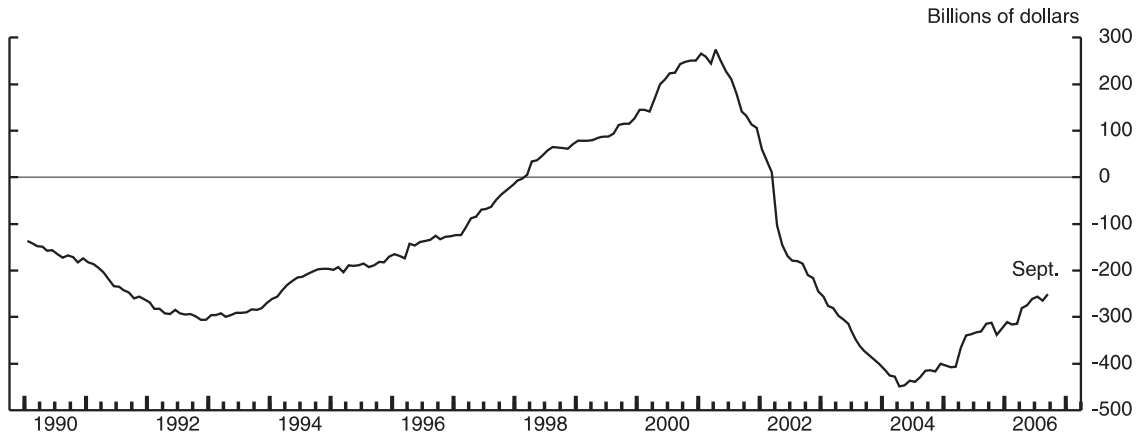
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<sup>9</sup> The architectural billings index includes billings for both nonresidential and residential construction projects, but the lion's share of these projects (about 88 percent) is nonresidential.

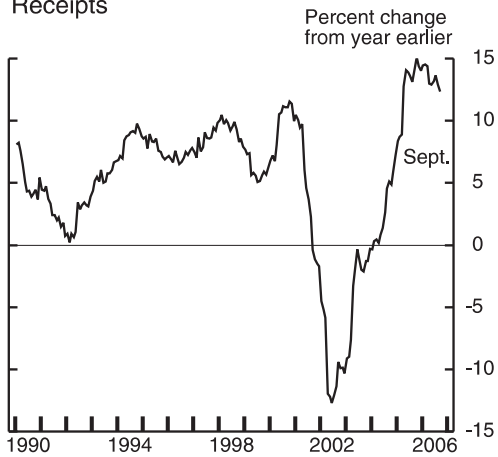
### Federal Unified Budget

(Adjusted for payment-timing shifts; 12-month moving sum)

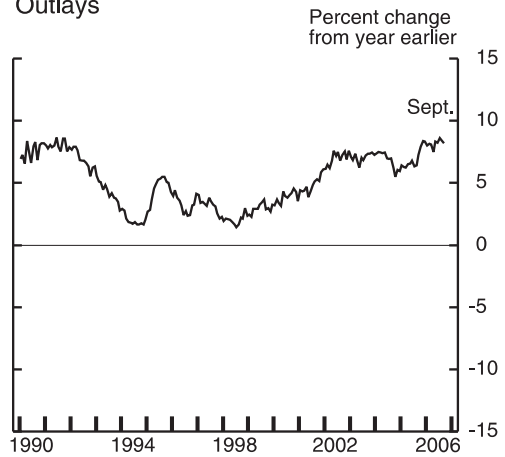
Surplus or Deficit



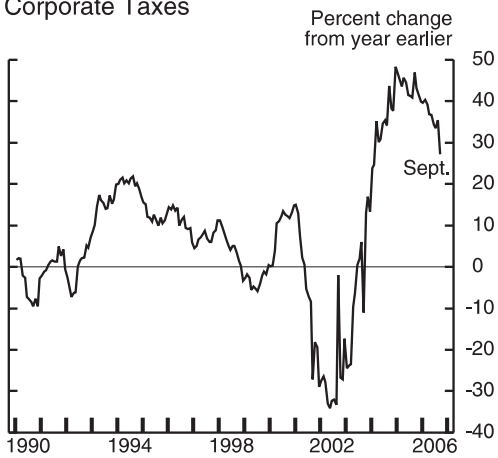
Receipts



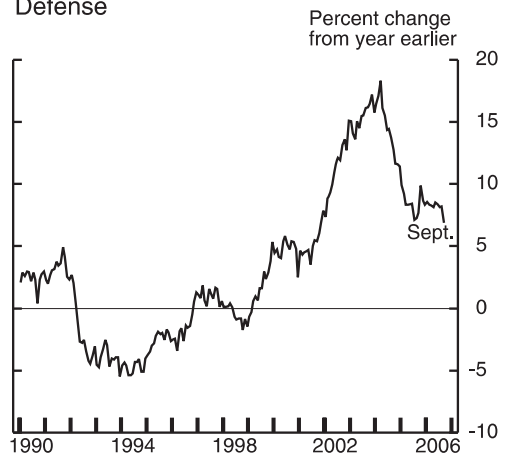
Outlays



Corporate Taxes



Defense



Note. Surplus or deficit, outlays, and defense data exclude Defense Cooperation Account and deposit insurance.



taxes also remained quite strong, while withheld taxes fell a bit short of the gains in wages and salaries over the past year.

Outlays in the July to September period, adjusted for shifts in payment timing, rose 8 percent from the year-earlier comparable period. One factor that boosted spending over this period was a one-time jump of \$12 billion in outlays recorded by the Department of Education in September. The jump stemmed from a re-estimate of the subsidy costs of the student loan program. More generally, though, the underlying rise in outlays appears to have eased a bit of late as increases in defense spending and in Medicare expenditures (after accounting for the prescription drug benefit) have slowed.

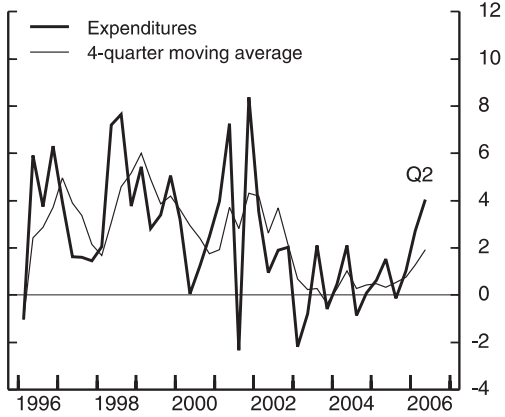
On the legislative front, the Congress has passed just two of the twelve regular appropriations bills: defense and homeland security. The defense appropriation provides \$447 billion in budget authority for fiscal 2007, including \$70 billion of emergency funding (a \$50 billion “down payment” for this year’s spending in Iraq and Afghanistan and \$20 billion for repair and acquisition of equipment). The bill also provides for an increase of 6 percent in non-emergency defense funding. The homeland security bill contains an 8 percent boost in budget authority; this increase is somewhat larger than what the President had requested, mainly because the Congress added emergency funds for border fencing and border-control agents. Before the Congress went into recess on September 29, it passed a continuing resolution to provide funding through November 17 for other programs normally covered under the annual appropriations process. At this point, discretionary spending for fiscal 2007 appears set to exceed the rather stringent limits adopted by the Congress last spring, in part because of the additional \$20 billion for repair and acquisition of military equipment and the \$2 billion in emergency funds for homeland security.

### **State and Local Government Sector**

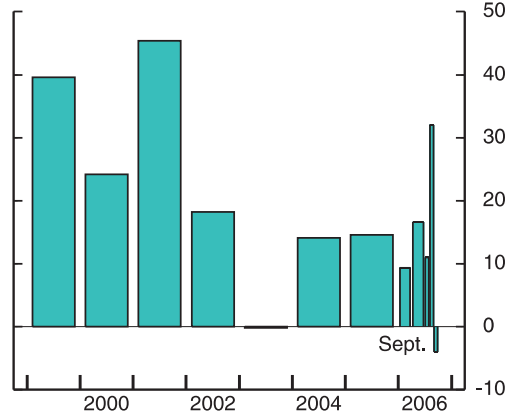
Real purchases by state and local governments appear to have risen just modestly in the third quarter after having posted a sizable increase over the first half of the year. The slowing was concentrated in construction spending, which has been little changed in real terms since midyear after having surged over the first half. Employment growth has been uneven of late, in part because of shifts in hiring around the start of the school year; in general, though, employment has continued to expand at about the gradual pace that has been evident since the start of 2004.

**State and Local Indicators**

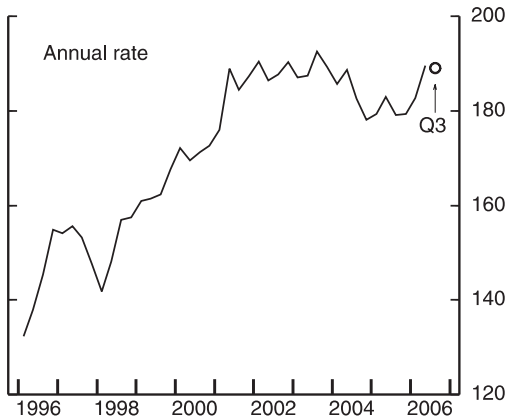
**Real Expenditures on Consumption and Investment**  
Percent change, annual rate



**Net Change in Employment**  
Thousands of jobs, monthly average

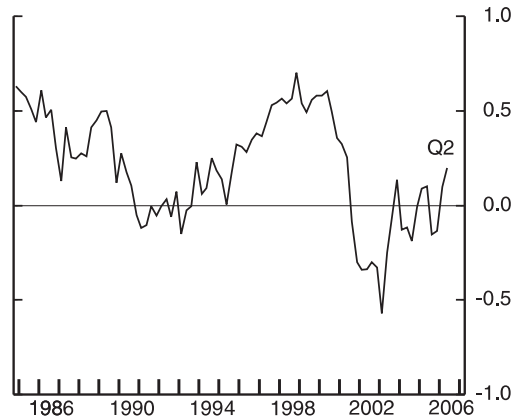


**Real Construction**  
Billions of chained (2000) dollars

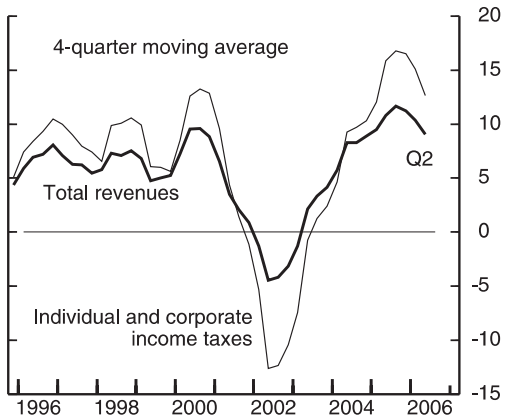


Note. Nominal CIPPI deflated by BEA prices through Q2 and by staff projection thereafter. Q3 is the average for July and August.

**Net Saving**  
Percent of nominal GDP

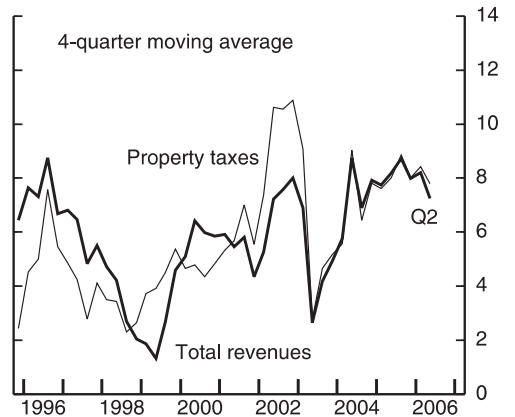


**State Revenues**  
Percent change from year earlier



Source. Census Bureau.

**Local Revenues**  
Percent change from year earlier



Source. Census Bureau.

**Price Measures**  
(Percent change)

Measures	12-month change		3-month change		1-month change	
	Sept. 2005	Sept. 2006	Annual rate		Monthly rate	
			June 2006	Sept. 2006	Aug. 2006	Sept. 2006
<i>CPI</i>						
<b>Total</b>	<b>4.7</b>	<b>2.1</b>	<b>5.1</b>	<b>.8</b>	<b>.2</b>	<b>-.5</b>
Food	2.5	2.5	1.7	3.5	.4	.3
Energy	34.8	-4.3	23.8	-15.6	.3	-7.2
<b>Ex. food and energy</b>	<b>2.0</b>	<b>2.9</b>	<b>3.6</b>	<b>2.7</b>	<b>.2</b>	<b>.2</b>
Core goods	.6	.5	.9	.0	.2	-.1
Core services	2.5	3.9	4.5	3.8	.2	.3
Chained CPI (n.s.a.) <sup>1</sup>	3.7	2.2	...	...	...	...
Ex. food and energy <sup>1</sup>	1.7	2.7	...	...	...	...
<i>PCE prices</i> <sup>2</sup>						
<b>Total</b>	<b>3.8</b>	<b>1.9</b>	<b>3.8</b>	<b>1.0</b>	<b>.2</b>	<b>-.3</b>
Food	2.2	2.5	2.3	2.9	.3	.2
Energy	35.7	-4.7	27.6	-17.6	.3	-7.9
<b>Ex. food and energy</b>	<b>2.1</b>	<b>2.4</b>	<b>2.5</b>	<b>2.2</b>	<b>.2</b>	<b>.2</b>
Core goods	.0	.1	.1	-.1	.2	-.1
Core services	3.0	3.3	3.6	3.2	.2	.3
Core market-based	1.8	2.1	2.5	2.0	.2	.2
Core non-market-based	3.5	n.a.	2.6	n.a.	.2	n.a.
<i>PPI</i>						
<b>Total finished goods</b>	<b>6.9</b>	<b>.9</b>	<b>6.4</b>	<b>-4.4</b>	<b>.1</b>	<b>-1.3</b>
Food	2.0	2.2	3.7	7.6	1.4	.7
Energy	27.7	-1.8	22.3	-24.7	.3	-8.4
<b>Ex. food and energy</b>	<b>2.6</b>	<b>1.2</b>	<b>2.3</b>	<b>-.3</b>	<b>-.4</b>	<b>.6</b>
Core consumer goods	2.8	1.2	2.2	-1.0	-.5	.5
Capital equipment	2.3	1.5	2.5	.5	-.3	.6
Intermediate materials	8.7	4.7	10.3	-1.9	.4	-1.4
Ex. food and energy	3.6	7.4	9.0	5.0	.4	.1
Crude materials	29.7	-7.8	6.4	8.0	2.2	-3.4
Ex. food and energy	6.5	19.7	59.4	-1.9	-2.8	1.0

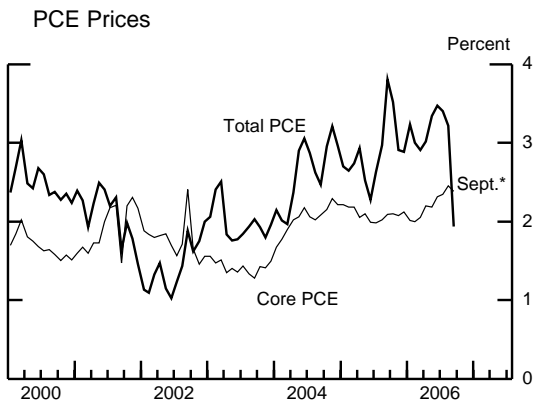
1. Higher-frequency figures are not applicable for data that are not seasonally adjusted.

2. PCE prices in September are staff estimates.

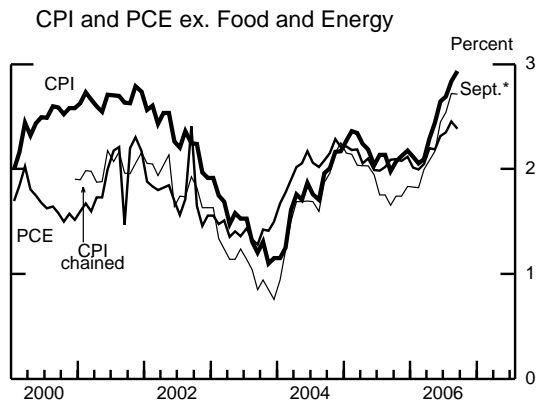
... Not applicable.

n.a. Not available.

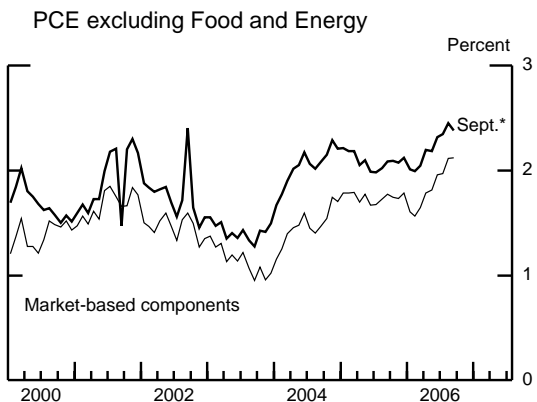
**Consumer Prices**  
(12-month change except as noted)



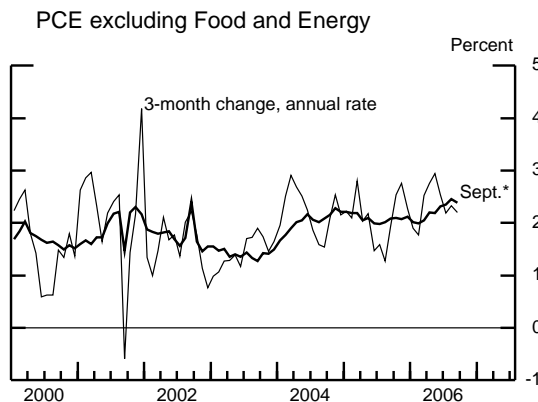
\* Staff estimate.



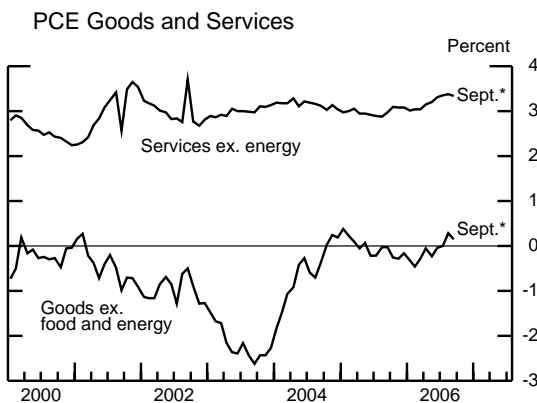
\* PCE for September is a staff estimate.



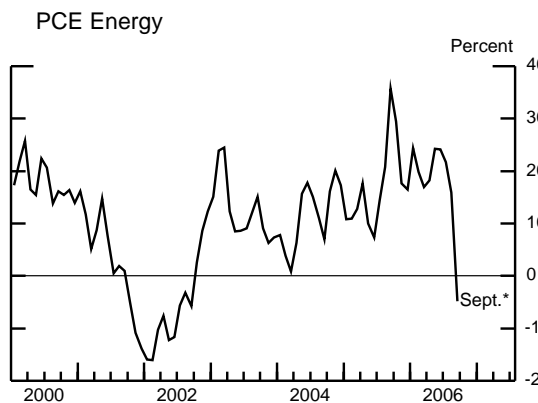
\* Staff estimate.



\* Staff estimate.



\* Staff estimate.



\* Staff estimate.

State and local revenue flows have continued to exhibit considerable vigor. According to the Census Bureau's *Quarterly Summary of State and Local Tax Revenue*, state revenues during the year ending in the second quarter—which was equivalent to fiscal year 2006 for most states—were 9 percent above their year-earlier level. As was the case at the federal level, second-quarter receipts were boosted substantially by both continued strength in corporate income taxes and a large increase in nonwithheld personal income tax payments.<sup>10</sup> Revenues received by local governments rose 7 percent during the year ending in the second quarter, about the same rate as during the comparable period in each of the preceding two years.

### **Prices**

The consumer price index declined 0.5 percent in September as energy prices fell sharply; prices excluding food and energy rose 0.2 percent for the third consecutive month. Given the available data, we estimate that core prices for personal consumption expenditures (PCE) also rose 0.2 percent last month, which leaves the three-month change in September at 2.2 percent at an annual rate—down from a high of 2.9 percent in May. We estimate that core PCE prices increased 2.4 percent over the twelve months ending in September, 0.3 percentage point higher than the increase recorded during the preceding twelve-month period.

The pickup in core PCE inflation over the past year has been concentrated in shelter costs, which have accelerated nearly 2 percentage points.<sup>11</sup> However, shelter costs have slowed considerably in the past few months, rising just 0.3 percent in both August and September after five consecutive months of increases of either 0.4 percent or 0.5 percent. Core goods price inflation was little changed in the past year, as a noticeable acceleration in prices for apparel and a number of other nondurable goods was offset by a deceleration in the prices of a wide variety of durable goods.

We estimate that the PCE price index for food and beverages increased 0.2 percent in September, as a sizable increase in the index for fruits and vegetables was partly offset by a smaller-than-normal rise in the index for food away from home. The spot prices of wheat and corn have risen rapidly of late, but so far these increases have had little effect

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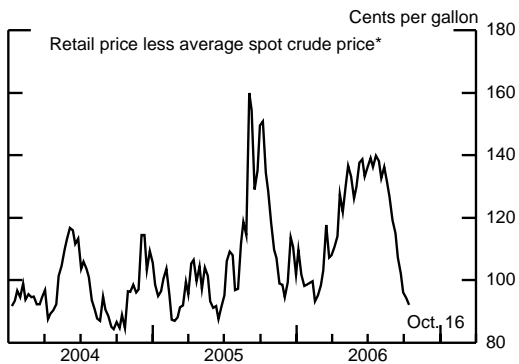
<sup>10</sup> The breakdown of personal income taxes into their withheld and nonwithheld components is provided by the Rockefeller Institute's *State Revenue Report*.

<sup>11</sup> The core CPI has accelerated more than the core PCE price index over the past year, largely because shelter is given a larger weight in the CPI.

## Energy Prices and Inventories

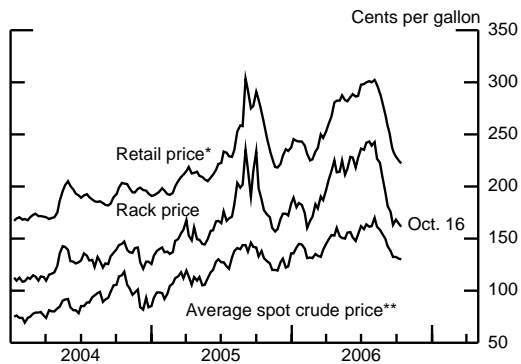
(Data from Energy Information Administration except as noted)

**Total Gasoline Margin**



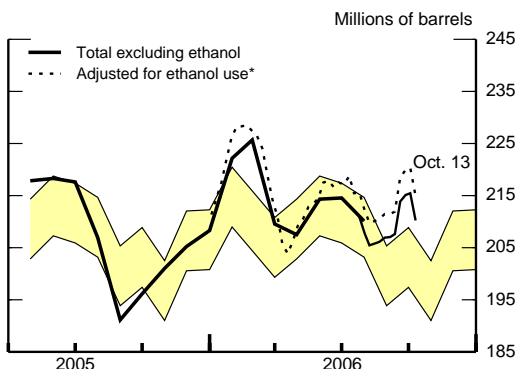
\* Regular grade seasonally adjusted by FRB staff, less average spot crude price: 60% WTI, 40% Maya heavy crude.

**Gasoline Price Decomposition**



\* Regular grade seasonally adjusted by FRB staff.  
\*\* 60% WTI, 40% Maya heavy crude.

**Gasoline Inventories**



Note. Shaded region is average historical range as calculated by DOE. Monthly data through July 2006, weekly data thereafter.

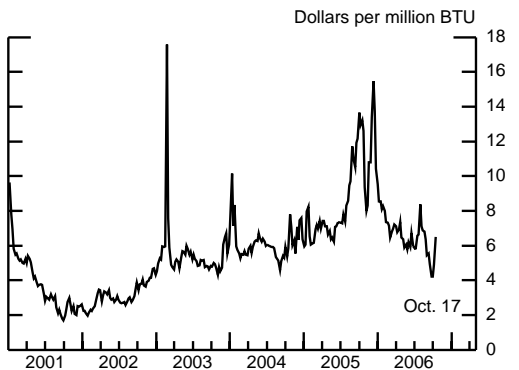
\* Inventories of RBOB gasoline augmented to reflect fuel ethanol to be blended; estimated by FRB staff.

**Ethanol Prices**



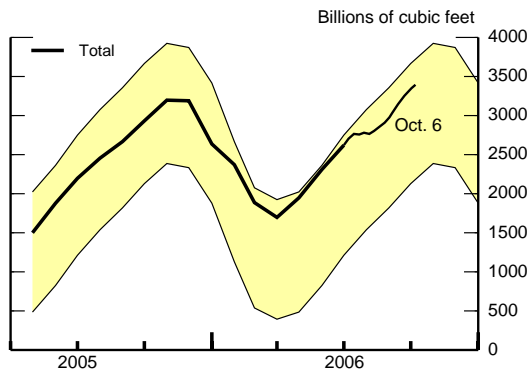
Source. Chicago Board of Trade.

**Natural Gas Prices**



Note. National average spot price.  
Source. Bloomberg.

**Natural Gas Inventories**



Note. Shaded region is historical range for 2000 to 2004 as calculated by FRB staff. Monthly data through June 2006, weekly data thereafter.

on food prices for consumers. Over the past year, food prices have risen 2½ percent, a slightly larger increase than in the previous year.

We estimate that PCE energy prices declined 8 percent in September and stood about 4¾ percent below their year-earlier level. Retail gasoline prices have fallen especially rapidly as a result of both the fall in crude oil costs and a sharp narrowing of the margin between retail gasoline prices and crude oil prices. The narrowing of this margin was caused by a glut of gasoline inventories, which had been accumulated by wholesalers earlier this year as a precaution against possible hurricane-related supply disruptions or distribution problems related to ethanol-based gasoline. However, these disruptions failed to materialize, and in early October gasoline inventories reached a sixteen-year seasonal high, thereby putting downward pressure on retail prices and total margins. In all, retail gasoline prices were down 13 percent in September, and preliminary survey information points to another big drop in October.

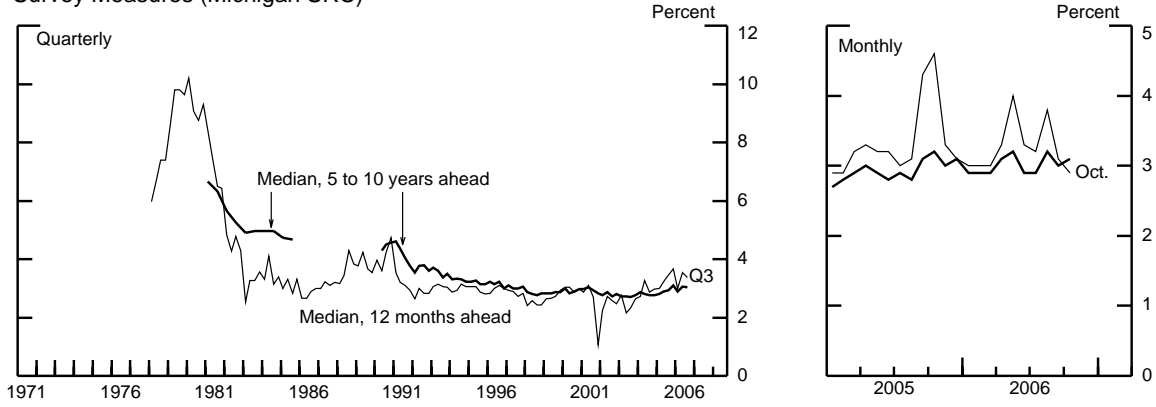
Natural gas inventories also continued to accumulate rapidly through early October and now stand at their highest level in twelve years. This inventory situation has caused spot prices of natural gas to plummet, and by early October they were at a four-year low. Because residential rates (which are typically regulated by state commissions) tend to lag behind changes in the spot price, the drop in spot prices had little effect on consumer prices for natural gas in September, but it should show through more clearly in October.

With the sharp decline in consumer gasoline prices, near-term inflation expectations have eased substantially after spiking up in August. The Michigan Survey Research Center reported that in early October, median one-year inflation expectations moved down to 2.9 percent, while median five- to ten-year expectations edged up 0.1 percentage point, to 3.1 percent—well within the narrow range seen over the past year. As of October 17, inflation compensation implied by rate spreads on nominal and CPI-indexed Treasury bonds was about 2.2 percent for five-year maturities and about 2.6 percent at longer horizons, after adjusting for carry effects. These figures are a shade lower than those in the September Greenbook.

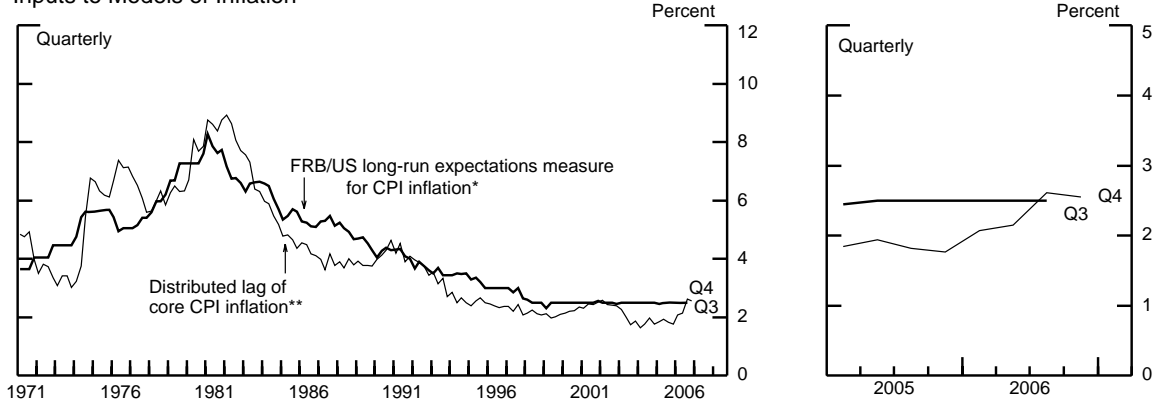
Turning to prices at earlier stages of processing, the producer price index (PPI) for core intermediate materials rose only 0.1 percent in September, well below the 0.7 percent average monthly rate for the preceding twelve months. This reading reflected a drop in

## Measures of Expected Inflation

Survey Measures (Michigan SRC)

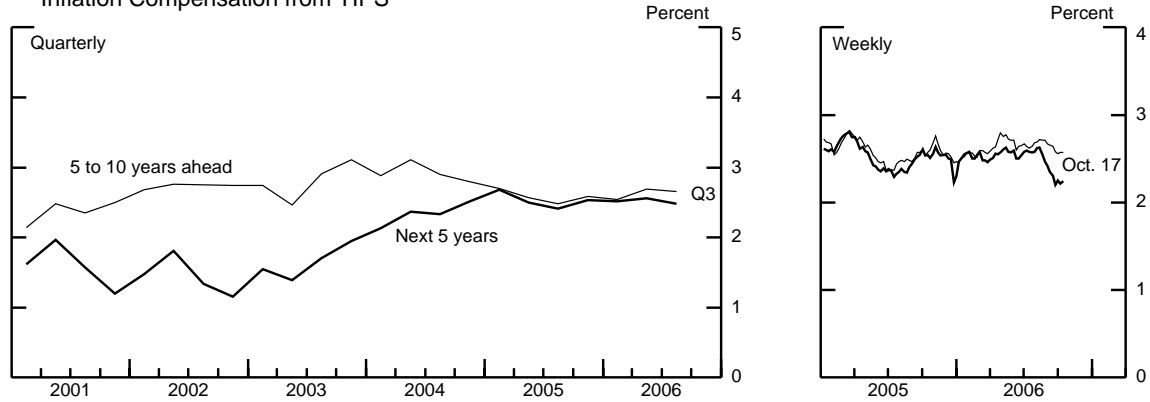


Inputs to Models of Inflation



\* For 1991 forward, the median projection for CPI inflation over the next 10 years from the Survey of Professional Forecasters; for 1981 to 1991, a related survey conducted by Richard Hoey; and for the period preceding 1981, a model-based estimate constructed by Board staff.  
 \*\* Derived from one of the reduced-form Phillips curves used by Board staff.

Inflation Compensation from TIPS



Note. Based on a comparison of an estimated TIPS yield curve with an estimated nominal off-the-run Treasury yield curve, with an adjustment for the indexation-lag effect since March 2004.



**Expected Inflation**

In the September Greenbook, we introduced a new exhibit showing three types of measures of expected inflation. To recap, the top two panels show the median responses to two familiar questions from the Michigan Survey Research Center: one about inflation twelve months ahead and one about inflation five to ten years ahead. The questions are asked of approximately 500 households per month and do not refer to any particular price index. (Specifically, the questions ask, “By about what percent [per year] do you expect prices to go up/down, on the average, during the next twelve months [five to ten years]?”)

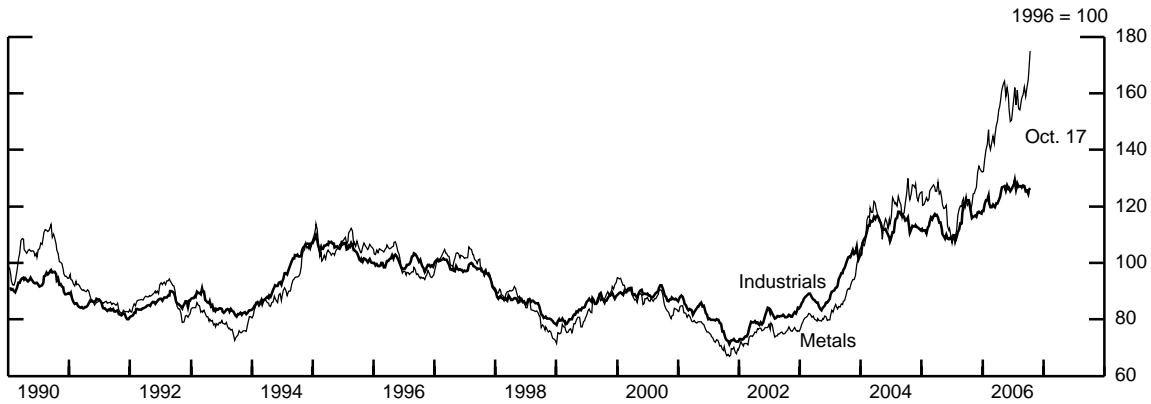
The middle panels show two series that are important inputs into our inflation models: The FRB/US long-run expectations measures for CPI inflation and a distributed lag of core CPI inflation. The FRB/US variable is constructed by splicing together three different series: for 1991 forward, the median projection for CPI inflation over the next ten years from the Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia; for 1981 through 1991, a related survey conducted by Richard Hoey, of Drexel Burnham Lambert; and for years preceding 1981, a model-based estimate constructed by the Board staff. The distributed-lag measure is derived from one of the staff’s reduced-form Phillips curve models of core CPI inflation; multiplying the lagged inflation terms by the estimated coefficients on those terms (which are constrained to sum to 1) generates the measure shown. This distributed lag, although not a direct measure of expected inflation, is highly correlated with actual inflation and likely includes an important expectations component.

Finally, in the bottom pair of panels, we show two series for inflation compensation derived from a comparison of yields on nominal Treasury securities with yields from Treasury inflation-protected securities (TIPS). These series, one for the next five years and one for five to ten years ahead, provide a market-derived measure of expected inflation, albeit one that also includes premiums for liquidity and for inflation risk. Beginning with March 2004, the series on inflation compensation over the next five years is adjusted for the indexation-lag effect.

prices of materials for nondurable manufacturing—including some chemicals that have a high energy content. In addition, the erratic PPI for air transport fell sharply in September. Prices of core crude materials rose 1.0 percent in September, about half the average increase over the previous twelve months. September’s rise in the PPI for core

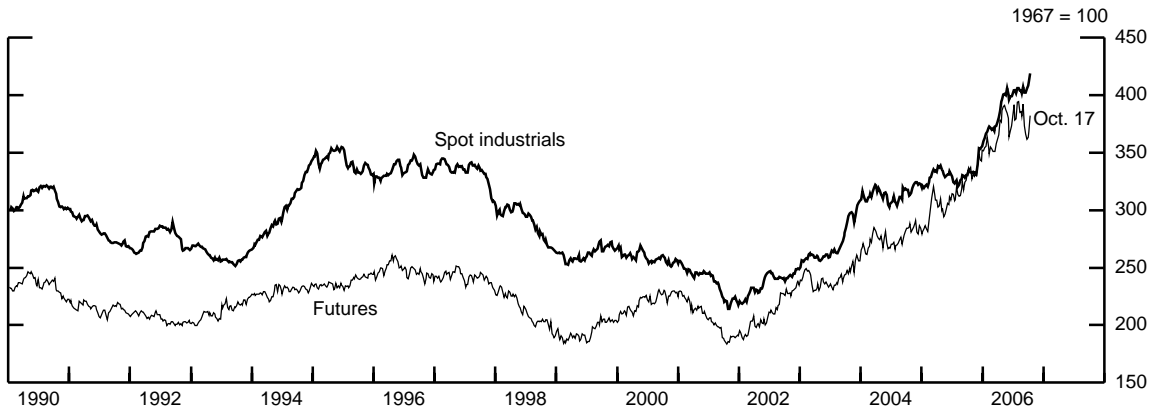
## Commodity Price Indexes

### Journal of Commerce



Note. The *Journal of Commerce* (JOC) industrial price index is based almost entirely on industrial commodities, with a small weight given to energy commodities. Copyright for *Journal of Commerce* data is held by CIBCR, 1994.

### Commodity Research Bureau



Note. The Commodity Research Bureau (CRB) spot industrials index consists entirely of industrial commodities, excluding energy. The CRB futures index gives about a 60 percent weight to food commodities and splits the remaining weight roughly equally among energy commodities, industrial commodities, and precious metals.

### Selected Commodity Price Indexes (Percent change)

Index	2005 <sup>1</sup>	12/27/05 to 9/12/06 <sup>2</sup>	9/12/06 <sup>2</sup> to 10/17/06	52-week change to 10/17/06
JOC industrials	5.3	8.3	-6	4.3
JOC metals	5.8	22.6	7.8	44.2
CRB spot industrials	10.1	13.3	4.2	25.7
CRB spot foodstuffs	-6.1	11.8	-.5	3.3
CRB futures	20.6	8.8	2.4	14.0

1. From the last week of the preceding year to the last week of the year indicated.

2. September 12, 2006, is the Tuesday preceding publication of the September Greenbook.

**Broad Measures of Inflation**

(Percent change, Q2 to Q2)

Measure	2003	2004	2005	2006
<i>Product prices</i>				
GDP price index	2.1	2.9	2.8	3.3
Less food and energy	1.9	2.6	2.9	3.1
Nonfarm business chain price index	1.2	2.3	3.0	3.3
<i>Expenditure prices</i>				
Gross domestic purchases price index	2.1	3.1	3.2	3.6
Less food and energy	1.8	2.6	2.8	2.9
PCE price index	1.8	2.8	2.6	3.3
Less food and energy	1.4	2.1	2.0	2.2
PCE price index, market-based components	1.7	2.4	2.4	3.2
Less food and energy	1.2	1.5	1.7	1.9
CPI	2.2	2.8	3.0	4.0
Less food and energy	1.5	1.8	2.1	2.5
Chained CPI	1.9	2.7	2.6	3.4
Less food and energy	1.2	1.7	2.0	2.2
Median CPI	2.3	2.3	2.3	3.0
Trimmed mean CPI	1.9	2.1	2.2	2.7
Trimmed mean PCE	1.7	2.3	2.2	2.5

**Surveys of Inflation Expectations**

(Percent)

Period	Actual CPI inflation <sup>1</sup>	University of Michigan				Professional forecasters (10 years) <sup>4</sup>
		1 year <sup>2</sup>		5 to 10 years <sup>3</sup>		
		Mean	Median	Mean	Median	
2004:Q4	3.3	3.4	3.0	3.1	2.8	2.5
2005:Q1	3.0	3.6	3.0	3.2	2.8	2.5
Q2	2.9	3.9	3.2	3.3	2.9	2.5
Q3	3.8	4.3	3.5	3.5	2.9	2.5
Q4	3.7	4.6	3.7	3.5	3.1	2.5
2006:Q1	3.6	3.7	3.0	3.3	2.9	2.5
Q2	4.0	4.5	3.5	3.6	3.1	2.5
Q3	3.3	4.0	3.4	3.3	3.0	2.5
2006:July	4.1	3.8	3.2	3.2	2.9	...
Aug.	3.8	4.6	3.8	3.5	3.2	...
Sept.	2.1	3.6	3.1	3.2	3.0	2.5
Oct.	n.a.	3.5	2.9	3.6	3.1	...

1. Percent change from the same period in the preceding year.

2. Responses to the question, By about what percent do you expect prices to go up, on average, during the next 12 months?

3. Responses to the question, By about what percent per year do you expect prices to go up, on average, during the next 5 to 10 years?

4. Quarterly CPI projections compiled by the Federal Reserve Bank of Philadelphia.

... Not applicable.

n.a. Not available.

crude materials reflected a large pickup in prices of aluminum and steel scrap, while prices turned down for crude materials used in construction.

More recently, the *Journal of Commerce* metals index has risen  $7\frac{3}{4}$  percent since the time of the September Greenbook; the jump reflects sizable increases for a number of metals. However, the foodstuffs index from the Commodities Research Bureau fell  $\frac{1}{2}$  percent from its mid-September level, while spot prices of construction materials such as lumber, plywood, and fiberboard have turned down sharply since the September Greenbook.

### **Labor Costs**

The BLS's preliminary estimate of the benchmark revision to payroll employment implies a downward revision of slightly more than  $\frac{1}{2}$  percentage point to the increase in compensation per hour over the four quarters ending in 2006:Q1. Nonetheless, at  $5\frac{3}{4}$  percent, the increase is still large. The only timely information on wages is for average hourly earnings, which rose 0.2 percent in both August and September after a larger increase in July. Average hourly earnings rose 4 percent over the twelve months ending in September, compared with an increase of  $2\frac{3}{4}$  percent over the preceding year.

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## **Domestic Financial Developments**

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III-T-1  
**Selected Financial Market Quotations**  
(One-day quotes in percent except as noted)

Instrument	2004	2005	2006		Change to Oct. 17 from selected dates (percentage points)		
	June 28	Dec. 30	Sept. 19	Oct. 17	2004 June 28	2005 Dec. 30	2006 Sept. 19
<i>Short-term</i>							
FOMC intended federal funds rate	1.00	4.25	5.25	5.25	4.25	1.00	.00
Treasury bills <sup>1</sup>							
3-month	1.36	3.99	4.82	4.96	3.60	.97	.14
6-month	1.74	4.22	4.90	4.95	3.21	.73	.05
Commercial paper (A1/P1 rates) <sup>2</sup>							
1-month	1.28	4.23	5.25	5.24	3.96	1.01	-.01
3-month	1.45	4.37	5.25	5.24	3.79	.87	-.01
Large negotiable CDs <sup>1</sup>							
3-month	1.53	4.49	5.34	5.32	3.79	.83	-.02
6-month	1.82	4.65	5.38	5.34	3.52	.69	-.04
Eurodollar deposits <sup>3</sup>							
1-month	1.29	4.36	5.33	5.32	4.03	.96	-.01
3-month	1.51	4.52	5.39	5.36	3.85	.84	-.03
Bank prime rate	4.00	7.25	8.25	8.25	4.25	1.00	.00
<i>Intermediate- and long-term</i>							
U.S. Treasury <sup>4</sup>							
2-year	2.88	4.43	4.81	4.86	1.98	.43	.05
5-year	3.97	4.35	4.66	4.71	.74	.36	.05
10-year	4.90	4.47	4.81	4.85	-.05	.38	.04
U.S. Treasury indexed notes							
5-year	1.56	2.03	2.41	2.53	.97	.50	.12
10-year	2.25	2.10	2.39	2.48	.23	.38	.09
Municipal general obligations (Bond Buyer) <sup>5</sup>	5.01	4.38	4.30	4.33	-.68	-.05	.03
Private instruments							
10-year swap	5.21	4.92	5.30	5.27	.06	.35	-.03
10-year FNMA <sup>6</sup>	5.38	4.84	5.11	5.16	-.22	.32	.05
10-year AA <sup>7</sup>	5.60	5.27	5.72	5.75	.15	.48	.03
10-year BBB <sup>7</sup>	6.25	5.82	6.28	6.32	.07	.50	.04
10-year high yield <sup>7</sup>	8.41	8.30	8.49	8.39	-.02	.09	-.10
Home mortgages (FHLMC survey rate) <sup>8</sup>							
30-year fixed	6.21	6.21	6.40	6.37	.16	.16	-.03
1-year adjustable	4.19	5.16	5.54	5.56	1.37	.40	.02

Stock exchange index	Record high		2005	2006		Change to Oct. 17 from selected dates (percent)		
	Level	Date	Dec. 30	Sept. 19	Oct. 17	Record high	2005 Dec. 30	2006 Sept. 19
Dow Jones Industrial	11,993	10-18-06	10,718	11,541	11,950	-36	11.50	3.54
S&P 500 Composite	1,527	3-24-00	1,248	1,318	1,364	-1.70	9.27	3.47
Nasdaq	5,049	3-10-00	2,205	2,222	2,345	-53.55	6.33	5.52
Russell 2000	782	5-5-06	673	725	765	-2.16	13.62	5.44
Wilshire 5000	14,752	3-24-00	12,518	13,187	13,691	-7.19	9.37	3.82

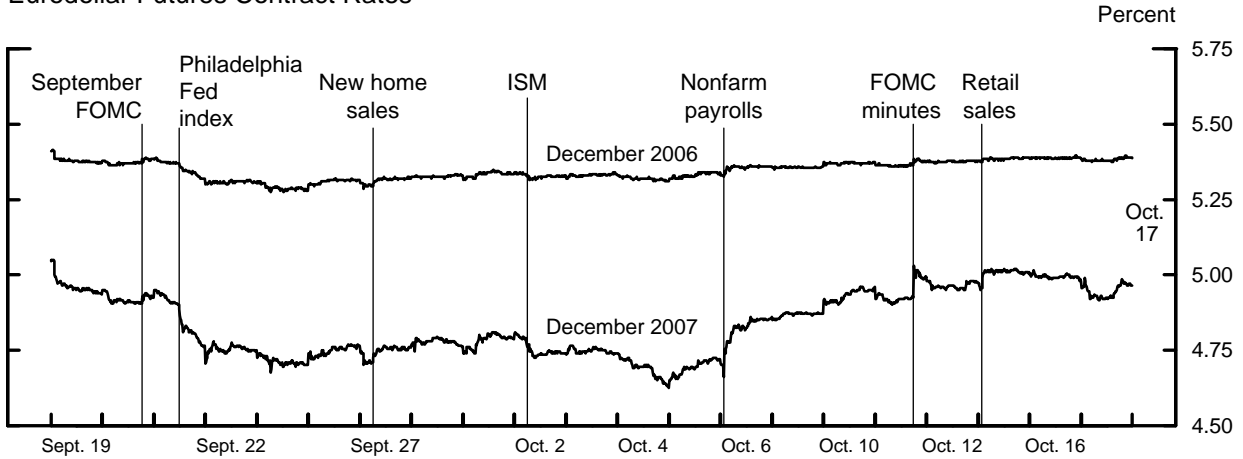
1. Secondary market.
2. Financial commercial paper.
3. Bid rates for Eurodollar deposits collected around 9:30 a.m. eastern time.
4. Derived from a smoothed Treasury yield curve estimated using off-the-run securities.
5. Most recent Thursday quote.
6. Constant-maturity yields estimated from Fannie Mae domestic noncallable coupon securities.
7. Derived from smoothed corporate yield curves estimated using Merrill Lynch bond data.
8. Home mortgage rates for October 17, 2006, are for the week ending October 12, 2006.

NOTES:

June 28, 2004, is the day before the most recent policy tightening began.  
September 19, 2006, is the day before the most recent FOMC announcement.

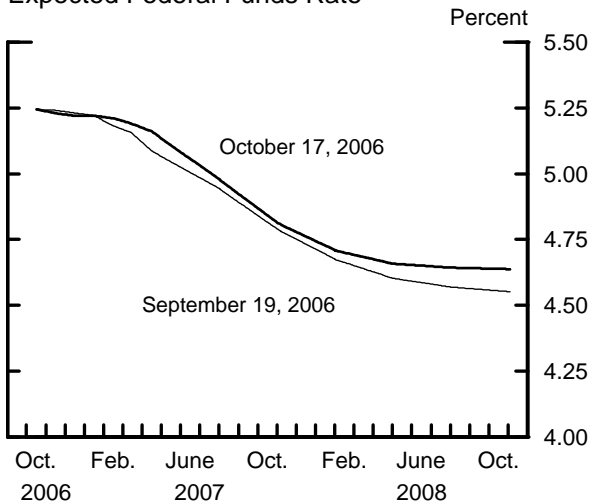
### Policy Expectations and Treasury Yields

Eurodollar Futures Contract Rates



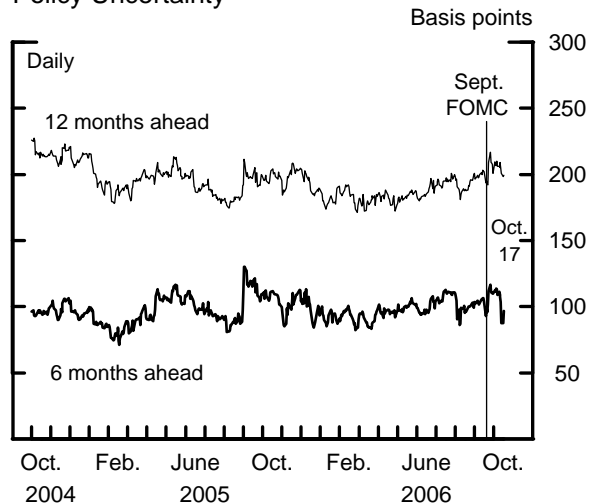
Note. 5-minute intervals.

Expected Federal Funds Rate



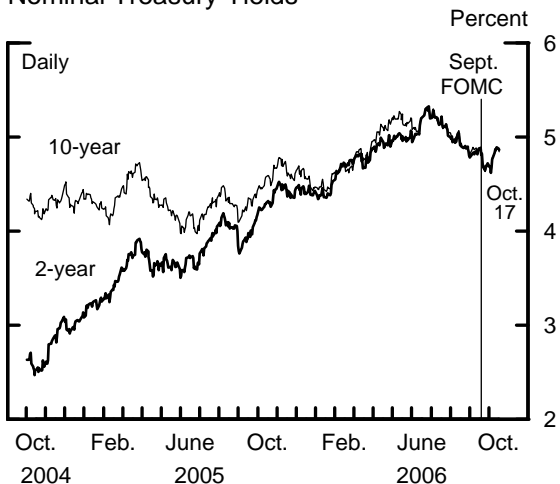
Note. Estimates from federal funds and Eurodollar futures, with an allowance for term premia and other adjustments.

Policy Uncertainty



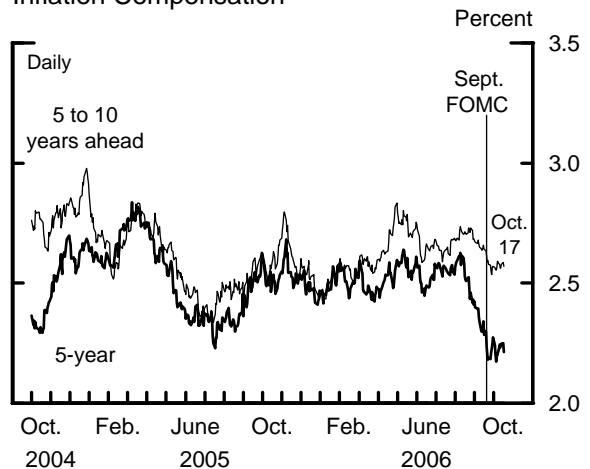
Note. Width of a 90 percent confidence interval for the federal funds rate computed from the term structures for both the expected federal funds rate and implied volatility.

Nominal Treasury Yields



Note. Estimates from smoothed Treasury yield curve based on off-the-run securities.

Inflation Compensation



Note. Estimates based on smoothed nominal and inflation-indexed Treasury yield curves and adjusted for the indexation-lag effect.

## Domestic Financial Developments

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### Overview

Policy expectations were unchanged in the near term, but edged up beyond mid-2007 amid mixed economic news and FOMC communications that were taken to suggest greater concern about inflation risks. Nominal and inflation-indexed Treasury yields both increased a bit on balance, leaving implied measures of inflation compensation little changed. Equity prices rose about 4 percent, boosted by the surprising resilience of corporate profits and perhaps also by the effects of lower spot oil prices on the economic outlook. Risk spreads on investment-grade bonds were about unchanged over the intermeeting period, while speculative-grade spreads narrowed a little. The available indicators suggest that household credit quality remained favorable, on the whole, despite the continuing deceleration in home prices; business credit quality also remained strong.

### Policy Expectations and Interest Rates

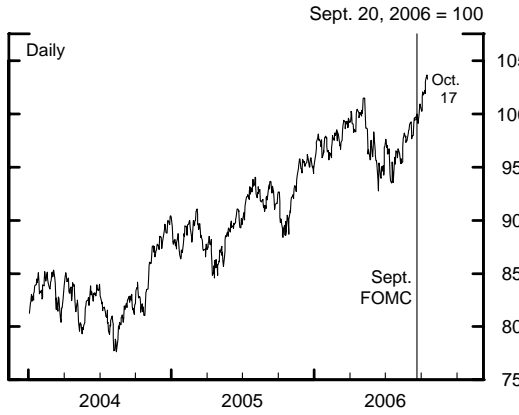
The decision at the September FOMC meeting to leave the target federal funds rate unchanged and to retain the forward-looking language from the previous statement was largely anticipated, and elicited little market reaction. Early in the intermeeting period, some weaker-than-expected data releases pushed the expected path of policy beyond the near term substantially lower. However, this move was subsequently more than reversed, as investors apparently interpreted comments by several FOMC officials and the September FOMC minutes as suggesting that the Committee was more concerned about the risks to the inflation outlook and less worried about a slowdown in economic growth than had been thought. In addition, a few subsequent data releases, including the announcement of an upcoming upward revision to payroll data, boosted policy expectations. Investors continue to expect the Committee to leave the target federal funds rate unchanged through the end of the year. The expected path for policy incorporates about ½ percentage point of policy easing next year, a bit less than was expected at the time of the last FOMC meeting. Measures of uncertainty about the future path of policy, as derived from options on Eurodollar futures contracts, remain near historical lows.

Nominal two-year Treasury yields largely tracked policy expectations, rising 5 basis points, on net, over the intermeeting period; ten-year yields increased 4 basis points. After adjusting for carry effects, yields on Treasury inflation-protected securities (TIPS) rose a bit more, leaving TIPS-based measures of inflation compensation a tad lower, on net, amid a moderate decline in spot oil prices. Near-term inflation compensation remains near the low end of its recent range.



### Corporate Yields, Risk Spreads, and Stock Prices

Wilshire 5000

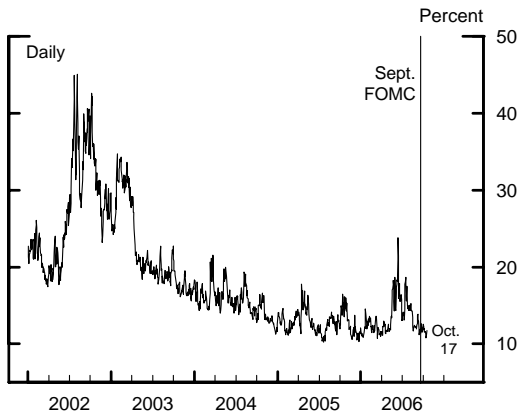


Trend Earnings to Price Ratio for S&P 500 and Long-Run Treasury Yield

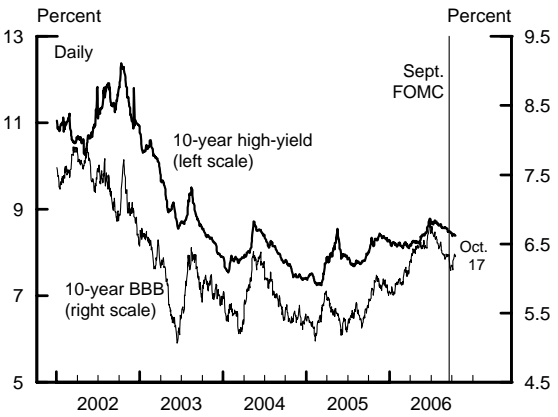


\* Estimated yield on synthetic Treasury perpetuity minus Philadelphia Fed 10-year expected inflation.  
 + Denotes the latest observation using daily interest rates and stock prices and latest earnings data from I/B/E/S.

Implied Volatility on S&P 500 (VIX)

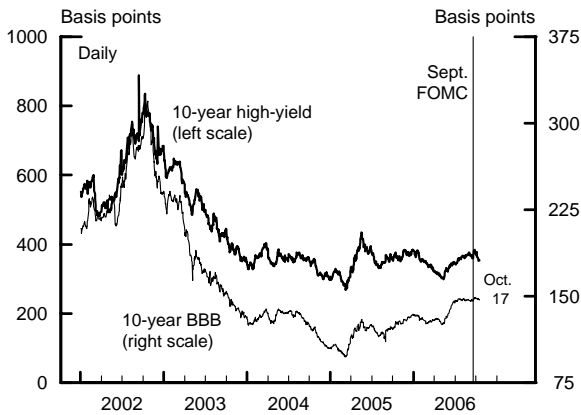


Corporate Bond Yields



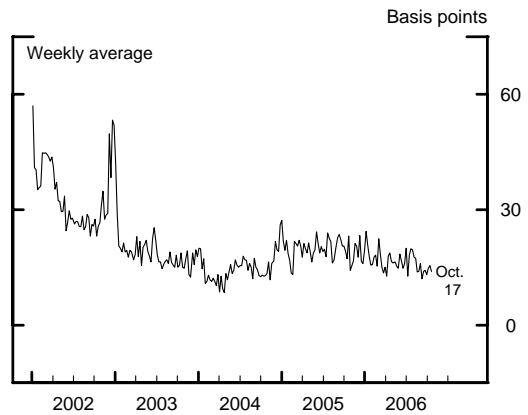
Note. Yields from smoothed yield curves based on Merrill Lynch bond data.

Corporate Bond Spreads



Note. Measured relative to comparable-maturity Treasuries.

Commercial Paper Quality Spread



Note. Measured by the difference between yields on 30-day A2/P2 paper and A1/P1 paper.

**Stock Prices and Corporate Interest Rates**

Broad stock price indexes gained about 4 percent on net, boosted initially by an unusually small number of earnings warnings in advance of the earnings reporting season and later by actual reports, the vast majority of which beat analysts' forecasts. Investors may also have been encouraged by continued declines in spot oil prices. With the rise in stock prices, the twelve-month forward trend-earnings to price ratio for S&P 500 firms inched down, and its spread over a long-run real Treasury yield, a rough measure of the equity risk premium, narrowed a bit. Implied volatility on the S&P 500 index continued to hover close to its historical lows.

Over the intermeeting period, yields on investment-grade corporate bonds moved roughly in line with those on comparable-maturity Treasury securities, leaving risk spreads moderately above their lows in the past couple of years. A small decline in yields on speculative-grade bonds narrowed their spreads a little. Risk spreads on commercial paper, measured by the difference between yields on thirty-day A2/P2 and A1/P1 paper, remained low.

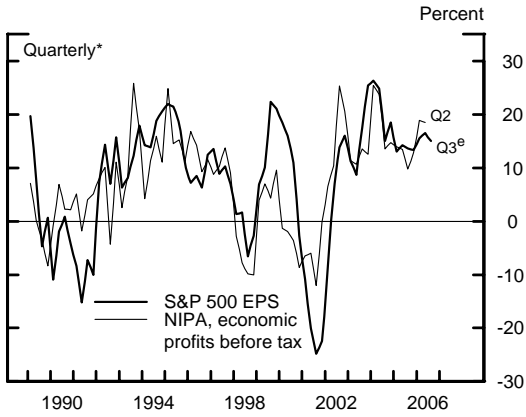
**Corporate Earnings and Credit Quality**

Through mid-October, nearly 100 firms in the S&P 500 had reported third-quarter earnings, and thus far very few have come in short of expectations. On the basis of these reports and analysts' estimates for the remaining firms, we project that third-quarter earnings per share for the S&P 500 have increased about 15 percent from a year earlier, a pace roughly on par with that in the second quarter. Such a result would imply a very modest gain from the second quarter level on a seasonally adjusted basis. Over the past few weeks, analysts' forecasts of year-ahead earnings for S&P 500 firms continued to be revised down, on balance, but this was largely due to reduced energy-sector forecasts.

Overall, the credit quality of nonfinancial firms continued to be solid. Although balance sheet liquidity declined further in the second quarter, it remained high by historical standards, and corporate leverage was unchanged at low levels. Bond rating downgrades during the third quarter were moderate and mainly reflected the July and September downgrades of Ford Motor Company, while bond upgrades were minimal. The realized six-month trailing bond default rate was near zero again in September, and the near-term outlook for credit quality remained favorable, as the forecast of the aggregate year-ahead default rate based on the KMV model hovered around the bottom of its historical range.

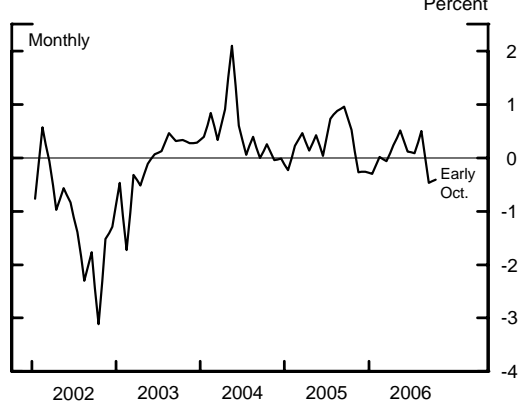
### Corporate Earnings and Credit Quality

Corporate Earnings Growth



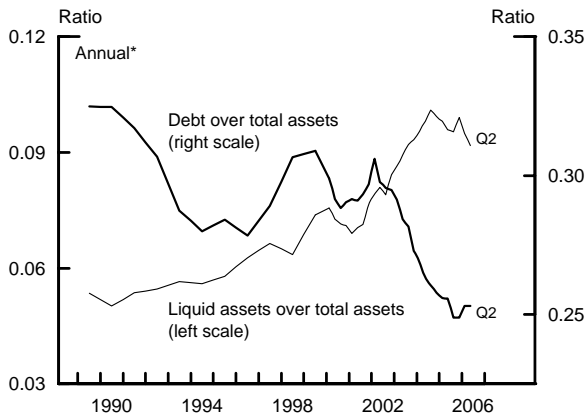
\* Change from 4 quarters earlier.  
e Staff estimate.  
Source: I/B/E/S for S&P 500 earnings per share.

Revisions to Expected S&P 500 Earnings



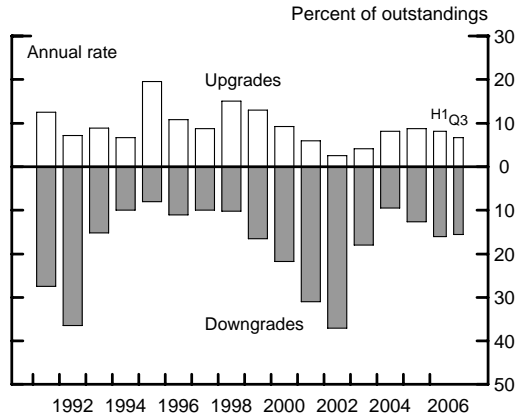
Note. Index is a weighted average of the percent change in the consensus forecasts of current-year and following-year EPS for a fixed sample.

Financial Ratios for Nonfinancial Corporations



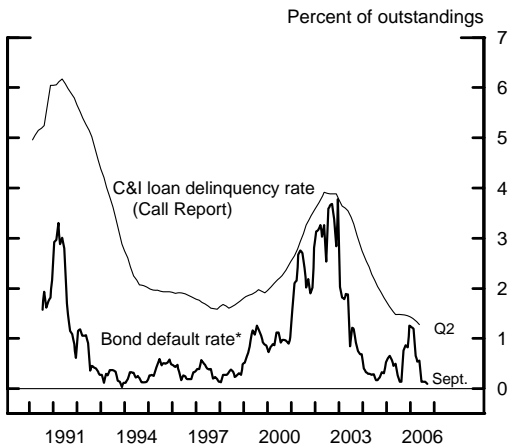
Note. Compustat data.  
\* Data are quarterly starting in 2000:Q1.

Bond Ratings Changes of Nonfinancial Companies



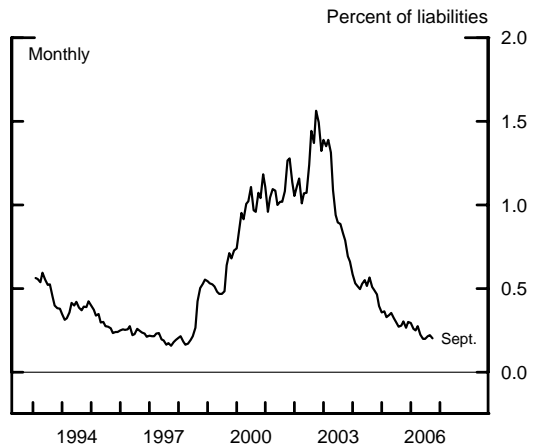
Source. Calculated with data from Moody's Investors Service.

Selected Default and Delinquency Rates



\* 6-month moving average, from Moody's Investors Service.

Expected Year-Ahead Defaults



Note. Firm-level estimates of default weighted by firm liabilities as a percent of total liabilities, excluding defaulted firms.  
Source. Moody's KMV.

**Business Finance**

**Gross Issuance of Securities by U.S. Corporations**

(Billions of dollars; monthly rates, not seasonally adjusted)

Type of security	2002	2003	2004	2005	2006				
					H1	Q3	July	Aug.	Sept.
<i>Nonfinancial corporations</i>									
Stocks <sup>1</sup>	5.2	3.7	5.4	4.6	5.2	2.6	2.0	2.0	3.6
Initial public offerings	.7	.4	1.6	1.7	1.9	.7	.4	.5	1.1
Seasoned offerings	4.4	3.3	3.8	2.8	3.3	1.9	1.6	1.5	2.5
Bonds <sup>2</sup>	24.8	31.6	22.7	19.1	30.5	18.4	11.6	20.0	23.7
Investment grade	15.7	16.0	8.3	8.5	14.5	10.6	6.1	10.6	15.3
Speculative grade	4.8	11.3	9.5	6.4	8.3	4.6	4.6	4.7	4.5
Other (sold abroad/unrated)	4.2	4.3	4.9	4.3	7.8	3.2	1.0	4.7	3.9
<i>Memo</i>									
Net issuance of commercial paper <sup>3</sup>	-5.7	-3.4	1.5	-.4	3.4	-1.2	-3.0	-.6	.0
Change in C&I loans at commercial banks <sup>3,4</sup>	-5.2	-7.7	3.2	10.0	14.6	13.4	17.5	19.5	3.1
<i>Financial corporations</i>									
Stocks <sup>1</sup>	4.0	6.6	6.9	5.0	4.4	5.1	4.9	3.2	7.1
Bonds <sup>2</sup>	87.0	111.1	139.3	176.3	190.2	168.4	114.0	176.0	215.3

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

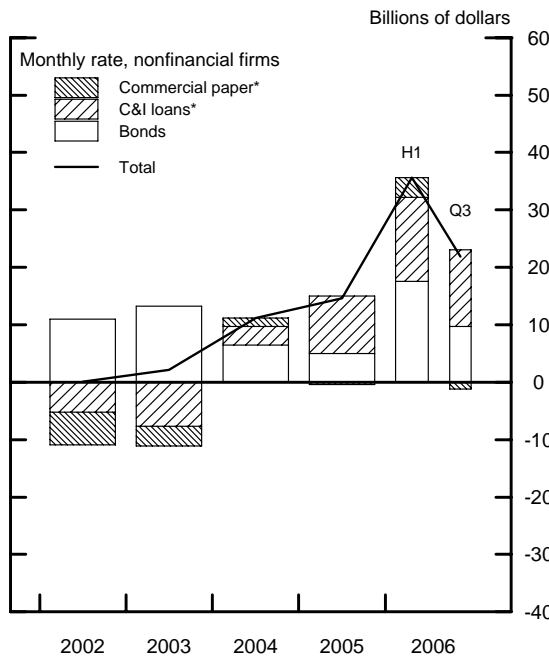
1. Excludes private placements and equity-for-equity swaps that occur in restructurings.

2. Data include regular and 144a private placements. Bond totals reflect gross proceeds rather than par value of original discount bonds. Bonds are categorized according to Moody's bond ratings or to Standard & Poor's if unrated by Moody's.

3. End-of-period basis, seasonally adjusted.

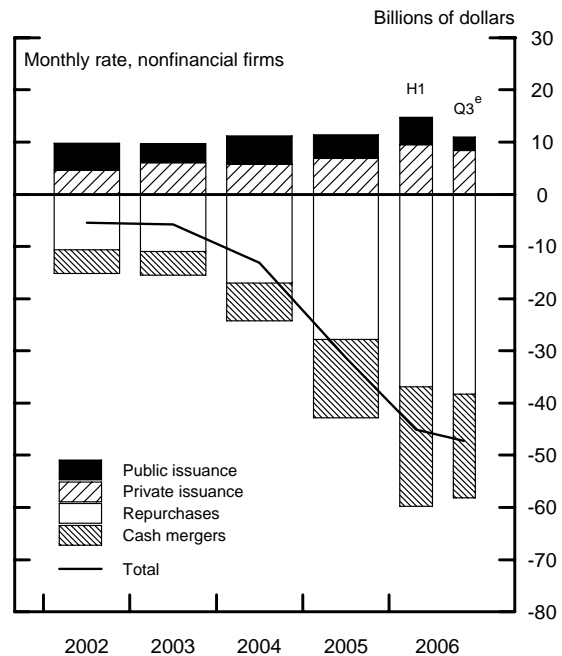
4. Adjusted for FIN 46 effects.

**Selected Components of Net Debt Financing**



\* Seasonally adjusted, period-end basis.

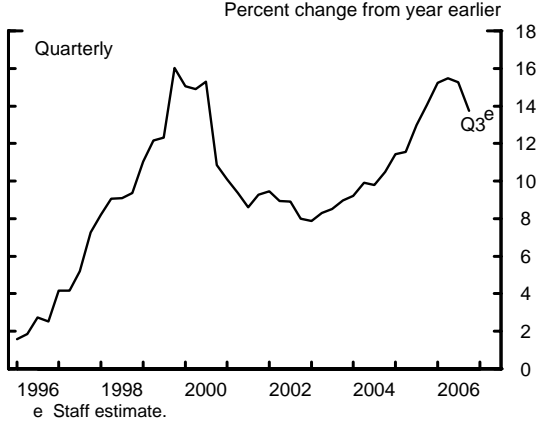
**Components of Net Equity Issuance**



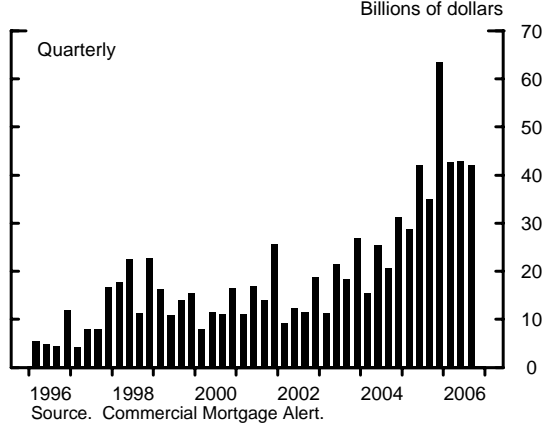
<sup>e</sup> Staff estimate.

### Commercial Real Estate

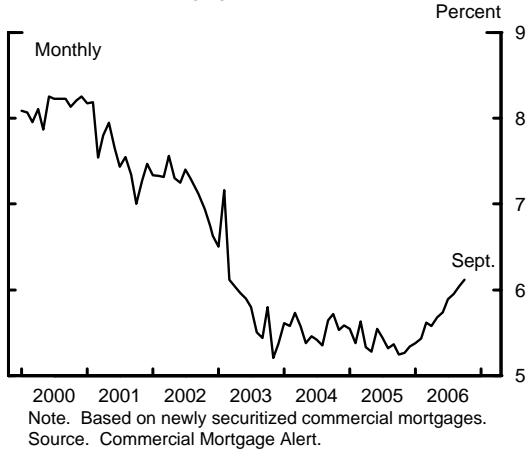
Commercial Mortgage Debt



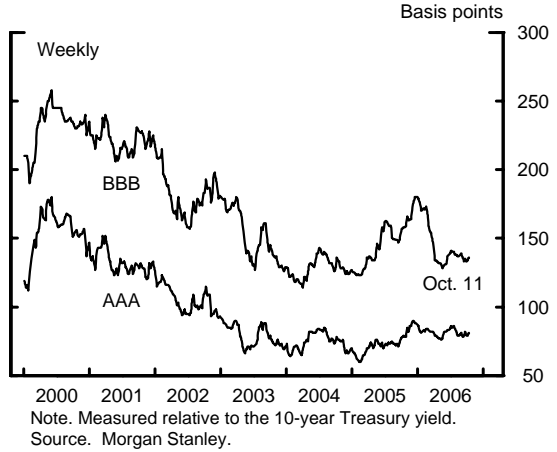
Gross Issuance of CMBS



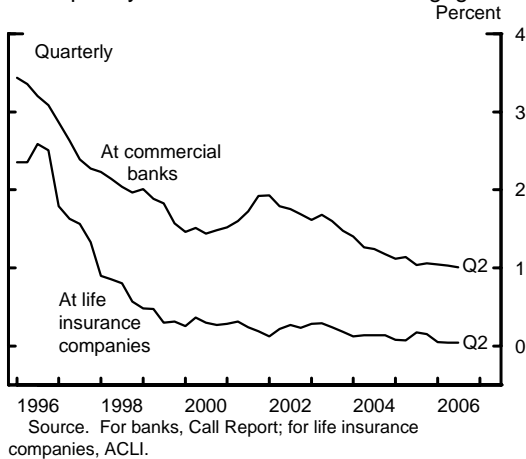
Commercial Mortgage Rates



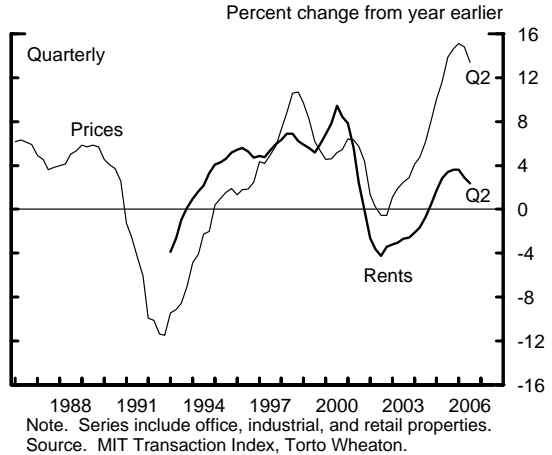
Investment-Grade CMBS Spreads



Delinquency Rates on Commercial Mortgages



Commercial Real Estate Prices and Rents



**Business Finance**

In September and early October, gross bond issuance was robust, but the rate remained below the torrid pace of the first half of the year. Investment-grade firms accounted for about 60 percent of third-quarter issuance. A substantial share of firms continued to report using bond proceeds for refinancings and mergers and acquisitions. C&I loans slowed markedly in September, while commercial paper outstanding was about unchanged. On balance, net debt financing for September and the third quarter as a whole was strong, though well off its very rapid pace in the first half of the year.

After a sluggish summer, both IPOs and seasoned equity offerings picked up a bit in the second half of September and early October, while private equity issuance appears to have remained vigorous due to investments by buyout and venture capital firms. Even so, gross equity issuance continued to be dwarfed by equity retirements, which have been boosted by strong profits and ample cash positions on corporate balance sheets. In the third quarter, retirements from share repurchases and those from cash-financed mergers and acquisitions are estimated to have about matched their extraordinary first-half volumes. Overall, net equity issuance appears to have remained deeply negative.

**Commercial Real Estate**

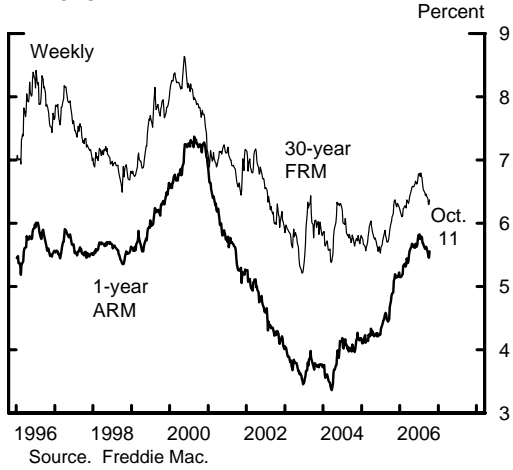
Commercial mortgage borrowing was strong in the second quarter; recent data suggest borrowing eased somewhat in the third quarter, perhaps reflecting the rise in interest rates on commercial mortgages and the net tightening of standards for these loans reported on the October Senior Loan Officer Opinion Survey. Despite this move toward tightening by banks, spreads of yields on investment-grade CMBS over those on comparable-maturity Treasury securities have held steady at low levels in recent months. The credit quality of commercial mortgages has remained strong, with delinquency rates at historic lows in the second quarter. Commercial property prices continued to increase rapidly in the second quarter, and an additional modest rise in rents pointed to continued improvement in market fundamentals.

**Household Finance**

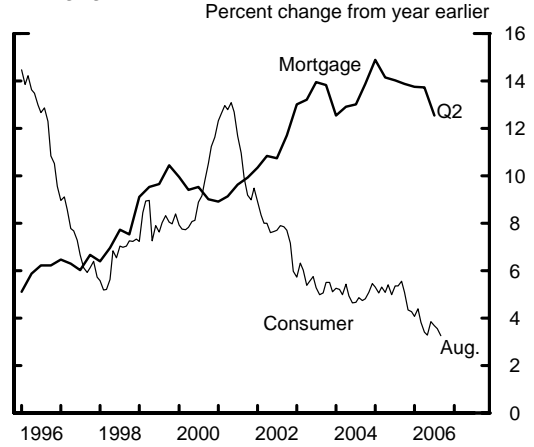
Interest rates on new home mortgages were little changed, on net, over the intermeeting period. In the second quarter, the growth of home mortgage debt from a year earlier slowed further; on a quarter-to-quarter basis, the growth rate was 9 percent at an annual rate, the lowest seen in more than five years. We have little hard data in hand for the third quarter, but we expect some further moderation because of the continued

### Household Liabilities

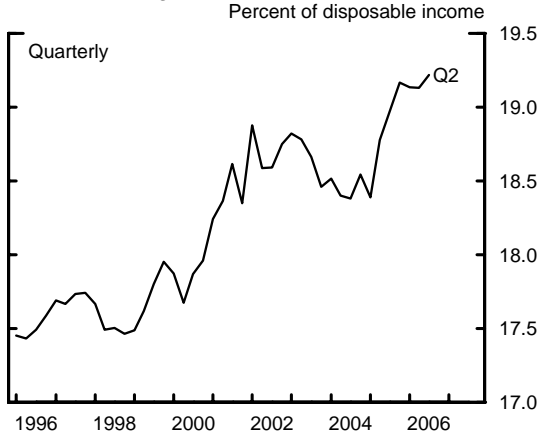
Mortgage Rates



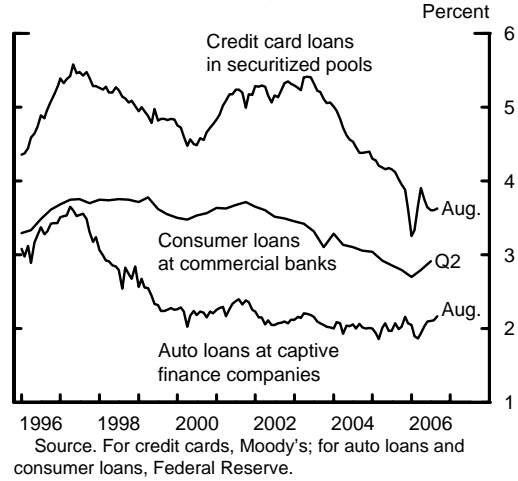
Mortgage Debt and Consumer Credit



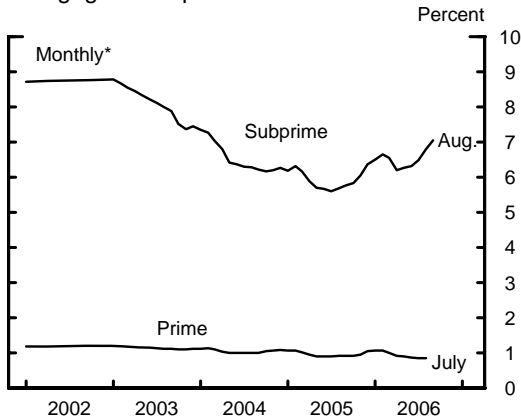
Financial Obligations Ratio



Consumer Credit Delinquencies

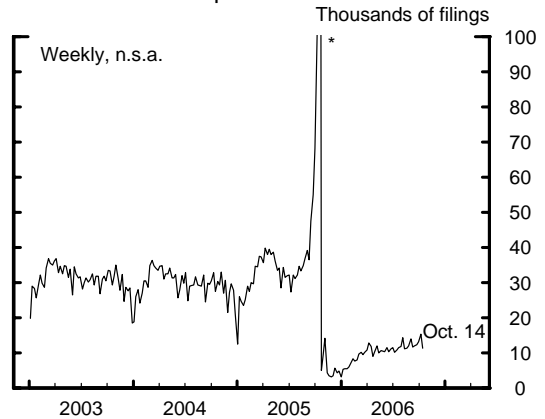


Mortgage Delinquencies



Note. Percent of loans more than 90 days past due or in foreclosure. \* Data are as of year-end before September 2003. Source: LoanPerformance.

Household Bankruptcies



\* 515,017 filings for the week ending Oct. 15, 2005. Source: Lundquist Consulting, Inc.

deceleration of house prices. Meanwhile, year-over-year growth in consumer credit remained modest through August.

Overall household debt expanded more rapidly than disposable income in the second quarter, pushing the financial obligations ratio to another new high. Nonetheless, households generally do not appear to be having trouble meeting their obligations. Delinquency rates on credit cards, auto loans, and prime mortgages remain low; the delinquency rate on subprime mortgages crept up further in August but remained well within the range seen over the past several years. The pace of personal bankruptcy filings continued to be subdued over the intermeeting period.

House prices posted their smallest increase in several years in the second quarter, and monthly indicators imply a further deceleration in the third quarter. Futures quotes continue to imply an outright price decline in coming quarters in ten of the largest markets, but they do not indicate that market participants have become markedly more pessimistic over the intermeeting period. The available data on house prices, stock prices, and income suggest that the ratio of household net worth to disposable personal income was little changed in the third quarter.

### **Treasury and Agency Finance**

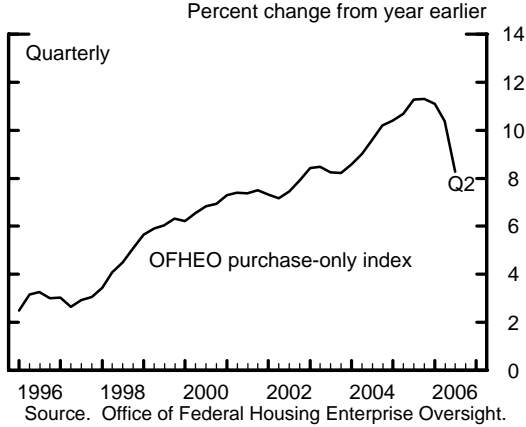
The Treasury auctioned two- and five-year nominal coupon securities and reopened the ten-year TIPS during the intermeeting period. These auctions were reportedly well received, with above-average bid-to-cover ratios suggesting overall strong demand for those securities. Indirect bidding, which may in part reflect demand from foreign official institutions, was also robust. Following strong mid-September tax receipts, issuance of four-week Treasury bills has been lower than expected, but bid-ask spreads in that market were unaffected. Similarly, liquidity in the note and bond markets has continued to be ample, as both bid-ask spreads and trading volumes have remained within their recent ranges.

Net agency debt issuance has been light, as Fannie Mae and Freddie Mac continued to reduce their mortgage portfolios through August. On September 29, the Office of Federal Housing Enterprise Oversight announced that the two government-sponsored enterprises (GSEs) were adequately capitalized as of June 30 and also announced a five-year plan to enhance its supervision of the GSEs. Stock prices of both Fannie Mae and Freddie Mac rose over the intermeeting period, likely boosted in part by Freddie Mac's

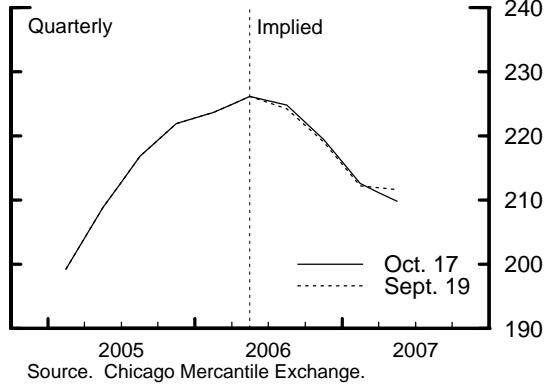


### Household Assets

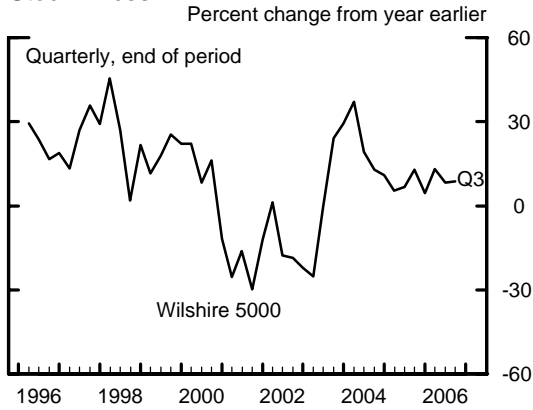
House Prices



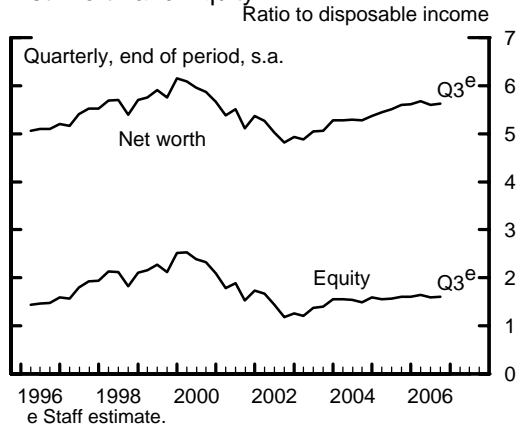
House-Price Path Implied by Futures on 10-City Index  
January 2000 = 100



Stock Prices



Net Worth and Equity



### Net Flows into Long-Term Mutual Funds

(Billions of dollars, monthly rate)

Fund type	2004	2005	2006					Assets
			Q1	Q2	Q3 <sup>e</sup>	Aug.	Sept. <sup>e</sup>	Aug.
<b>Total long-term funds</b>	<b>17.5</b>	<b>16.0</b>	<b>38.9</b>	<b>6.2</b>	<b>11.5</b>	<b>11.7</b>	<b>19.0</b>	<b>7,394</b>
<b>Equity funds</b>	<b>14.8</b>	<b>11.3</b>	<b>31.1</b>	<b>7.0</b>	<b>4.9</b>	<b>4.8</b>	<b>9.3</b>	<b>5,361</b>
Domestic	9.3	2.6	10.7	-2.4	-2.9	-3.7	-1.0	4,222
International	5.6	8.7	20.4	9.4	7.9	8.5	10.3	1,139
<b>Hybrid funds</b>	<b>3.6</b>	<b>2.1</b>	<b>0.4</b>	<b>-0.1</b>	<b>0.3</b>	<b>0.2</b>	<b>0.9</b>	<b>603</b>
<b>Bond funds</b>	<b>-0.9</b>	<b>2.6</b>	<b>7.4</b>	<b>-0.7</b>	<b>6.2</b>	<b>6.7</b>	<b>8.7</b>	<b>1,431</b>
High-yield	-0.8	-1.3	-0.4	-1.4	0.5	0.5	0.5	147
Other taxable	1.0	3.4	5.8	0.7	4.4	4.7	6.3	930
Municipals	-1.1	0.4	2.1	0.1	1.2	1.4	1.9	354

Note. Excludes reinvested dividends.

e Staff estimate based on confidential weekly data.

Source. Investment Company Institute.

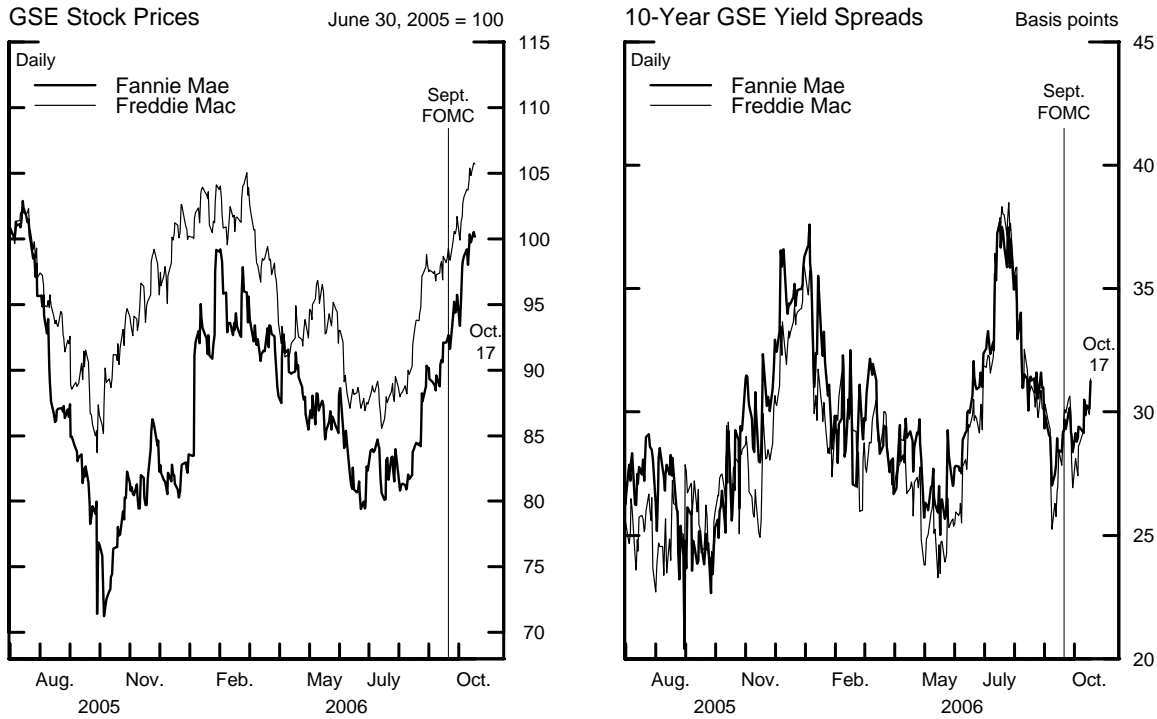
**Treasury Financing**  
(Billions of dollars)

Item	2005		2006				
	Q3	Q4	Q1	Q2	Q3	Aug.	Sept.
<b>Total surplus, deficit (-)</b>	<b>-69.2</b>	<b>-119.7</b>	<b>-183.3</b>	<b>97.4</b>	<b>-42.0</b>	<b>-64.9</b>	<b>56.0</b>
Means of financing deficit							
Net borrowing	72.8	112.2	156.1	-74.8	43.4	62.7	-41.5
Nonmarketable	20.6	21.2	-2.3	17.6	-1.5	-0.7	1.2
Marketable	52.1	91.0	158.5	-92.4	44.9	63.4	-42.8
Bills	-9.3	48.8	78.1	-125.5	-5.3	29.6	-50.8
Coupons	61.4	42.3	80.4	33.1	50.1	33.8	8.0
Decrease in cash balance	-2.5	-0.9	28.4	-37.6	-6.3	21.3	-35.7
Other <sup>1</sup>	-1.1	8.4	-1.3	15.0	5.0	-19.1	21.2
Memo:							
Cash balance, end of period	35.7	36.6	8.2	45.8	52.1	16.4	52.1

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

1. Direct loan financing, accrued items, checks issued less checks paid, and other transactions.

**GSE Market Developments**



Note. GSE yields based on senior unsecured debt. Spreads measured relative to the 10-year Treasury yield.

**State and Local Government Finance**

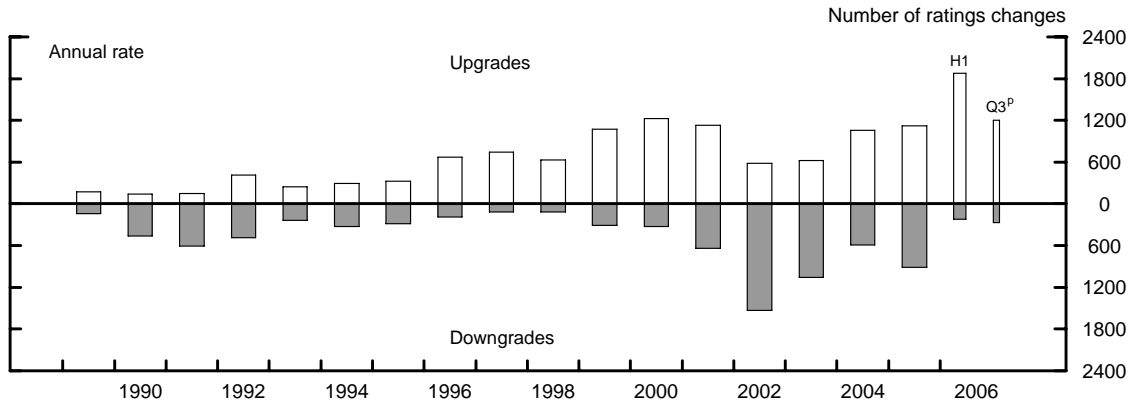
**Gross Offerings of Municipal Securities**

(Billions of dollars; monthly rate, not seasonally adjusted)

Type of security	2002	2003	2004	2005	2006				
					H1	Q3	July	Aug.	Sept.
Total	36.3	37.9	34.7	38.4	32.9	34.6	31.1	39.3	33.3
Long-term <sup>1</sup>	30.3	32.0	29.8	34.1	30.1	29.1	27.3	31.8	28.4
Refundings <sup>2</sup>	10.1	10.0	10.8	15.5	9.7	8.0	4.9	12.1	6.9
New capital	20.2	22.1	19.0	18.7	20.4	21.2	22.3	19.7	21.4
Short-term	6.0	5.8	4.9	4.2	2.8	5.4	3.8	7.5	4.9
Memo: Long-term taxable	1.7	3.5	2.0	2.1	2.8	2.6	3.9	1.4	2.4

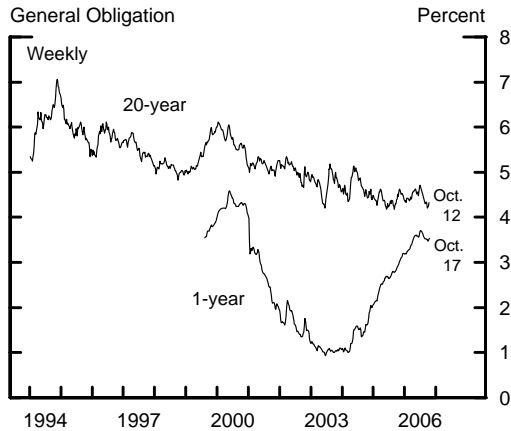
- 1. Includes issues for public and private purposes.
- 2. All issues that include any refunding bonds.

**Ratings Changes**



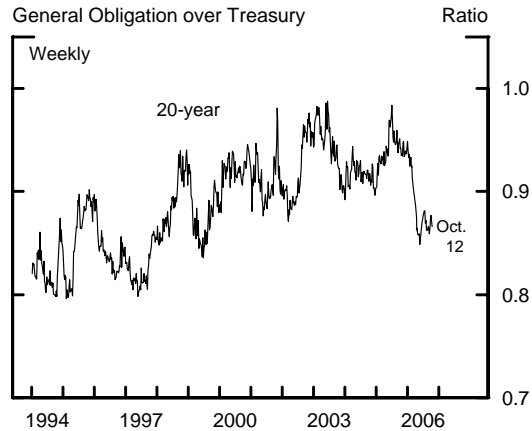
Source: S&P's Credit Week Municipal and Ratings Direct.  
p Preliminary.

**Municipal Bond Yields**



Source: Municipal Market Advisors and Bond Buyer.

**Municipal Bond Yield Ratio**



Source: Bond Buyer.

positive preliminary earnings estimates for the first half of 2006. Agency debt spreads were little changed.

### **State and Local Government Finance**

Gross issuance of long-term municipal bonds declined in September, mainly because of a substantial drop in advance refundings, but issuance for the third quarter as a whole remained robust. Issuance of short-term municipal bonds also declined in September, as it typically does early in the fiscal year.

The credit quality of municipal bonds continued to be solid. During the third quarter, the number of bonds with rating upgrades again far outpaced the number with downgrades, and the ratio of municipal bond yields to Treasuries remained low.

### **Money and Bank Credit**

M2 grew at an annual rate of 3¾ percent during the third quarter. The slow growth is in line with apparently weak nominal GDP growth in the quarter and the lagged effects of rising short-term interest rates earlier in the year. Liquid deposits—rates on which adjust quite sluggishly to changes in market rates—continued to run off last quarter, and the currency component of M2 was flat owing to low foreign demand for U.S. dollars. In contrast, growth of small time deposits and of retail money funds, whose yields tend to rise with market rates, remained strong.

Commercial bank credit decelerated markedly over August and September, trimming third-quarter growth to 8¼ percent, down from the 12 percent annual pace during the first half of the year. The slowdown was due to a run-off in securities and a step-down in the growth of loans late in the quarter. C&I loans—after soaring in July and August—decelerated sharply to a 3¼ percent annual rate in September, with widespread weakness reported across the different bank categories. Commercial real estate loans also slowed over August and September, a pattern consistent with the weakening of demand and the tightening of credit standards for such loans reported in the October Senior Loan Officer Opinion Survey. On the household side, residential real estate loans ran off again in September, while consumer loans originated by banks expanded moderately.

**M2 Monetary Aggregate**  
(Based on seasonally adjusted data)

Aggregate and components	Percent change (annual rate) <sup>1</sup>						Level (billions of dollars), Sept.
	2004	2005	2006				
			H1	Q3	Aug.	Sept.	
M2	5.3	4.0	4.7	3.8	4.2	2.8	6,878
Components <sup>2</sup>							
Currency	5.5	3.5	5.7	-1	1.3	-.3	741
Liquid deposits <sup>3</sup>	10.0	2.0	.8	-3.1	-3.7	-4.4	4,220
Small time deposits	-.3	18.8	17.1	21.8	25.3	22.1	1,124
Retail money market funds	-11.3	-.2	9.9	22.0	20.6	17.3	786
Memo:							
Institutional money market funds	-5.8	5.0	10.5	16.8	24.5	20.8	1,263
Monetary base	5.6	3.5	5.3	-.4	.6	-.4	804

1. For years, Q4 to Q4; for quarters and months, calculated from corresponding average levels.
2. Nonbank traveler's checks are not listed.
3. Sum of demand deposits, other checkable deposits, and savings deposits.

**Commercial Bank Credit**

(Percent change, annual rate, except as noted; seasonally adjusted)

Type of credit	2004	2005	H1 2006	Q3 2006	Aug. 2006	Sept. 2006	Level, <sup>1</sup> Sept. 2006
Total <sup>2</sup>	8.9	10.5	11.9	8.3	5.7	.7	7,780
<i>Loans<sup>3</sup></i>							
Total	9.7	11.6	11.6	10.0	8.7	2.8	5,790
To businesses							
Commercial and industrial	1.2	13.2	16.3	19.1	29.4	3.2	1,149
Commercial real estate	11.7	17.1	15.6	12.9	8.2	7.8	1,398
To households							
Residential real estate	15.6	12.0	7.7	7.4	-6.9	-1.7	1,723
Revolving home equity	43.8	13.3	.0	4.0	-10.4	5.4	449
Consumer	8.8	3.1	6.7	5.8	8.8	-3.3	726
Originated <sup>4</sup>	6.0	.5	7.1	5.5	7.1	4.8	1,106
Other <sup>5</sup>	7.4	8.4	12.0	1.8	15.0	9.1	794
<i>Securities</i>							
Adjusted <sup>2</sup>	6.6	7.6	12.8	3.5	-3.1	-5.6	1,990
Reported	5.2	5.3	13.0	3.2	3.2	-5.1	2,144
Treasury and agency	4.9	.0	8.3	6.1	6.9	-1.4	1,216
Other <sup>6</sup>	5.7	13.3	19.4	-5	-1.8	-9.9	928

Note. Yearly annual rates are Q4 to Q4; quarterly and monthly annual rates use corresponding average levels. Data are adjusted to remove estimated effects of consolidation related to FIN 46 and for breaks caused by reclassifications.

1. Billions of dollars. Pro rata averages of weekly (Wednesday) levels.

2. Adjusted to remove effects of mark-to-market accounting rules (FIN 39 and FAS 115).

3. Excludes interbank loans.

4. Includes an estimate of outstanding loans securitized by commercial banks.

5. Includes security loans and loans to farmers, state and local governments, and all others not elsewhere classified. Also includes lease financing receivables.

6. Includes private mortgage-backed securities, securities of corporations, state and local governments, foreign governments, and any trading account assets that are not Treasury or agency securities, including revaluation gains on derivative contracts.

## Appendix

### Senior Loan Officer Opinion Survey on Bank Lending Practices

The October 2006 Senior Loan Officer Opinion Survey on Bank Lending Practices addressed changes in the supply of, and demand for, bank loans to businesses and households over the past three months. Special questions in the survey queried banks about the extent to which the recent strength in commercial and industrial lending reflected a surge in loans to fund merger and acquisition activity. This appendix is based on responses from fifty-five domestic banks and seventeen foreign banking institutions.

Overall, the respondents noted mixed changes in lending standards and terms over the past three months, while demand for most loan types reportedly declined somewhat. Both domestic and foreign institutions indicated that they had eased lending terms on commercial and industrial (C&I) loans over the previous three months, while credit standards on such loans had changed little. Domestic banks, however, reported that they had tightened lending standards on commercial real estate loans over the previous three months. Demand for C&I loans at domestic institutions was reportedly little changed in the October survey, while demand for commercial real estate loans at these institutions weakened over the past three months. In the household sector, respondents generally reported no change in credit standards on residential mortgage loans over the survey period, while demand for such loans continued to weaken. Standards and terms on credit card and non-credit-card consumer loans were also little changed, but a considerable net fraction of domestic institutions indicated that they had experienced weaker demand for consumer loans over the previous three months.

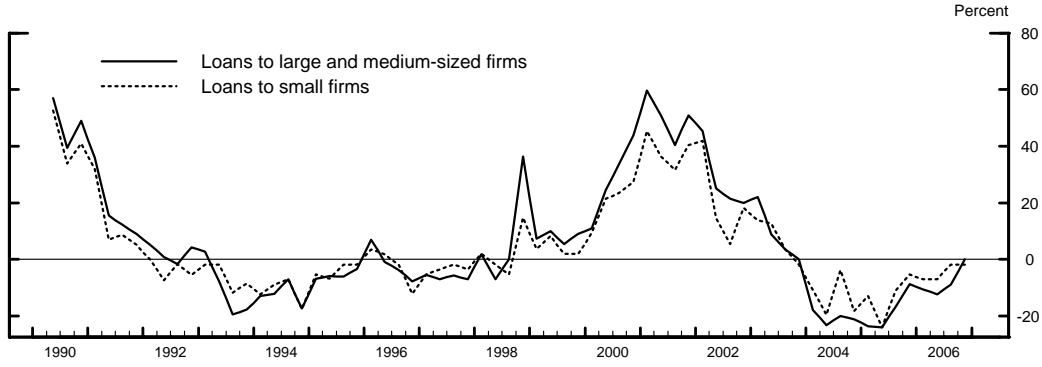
#### **Business Lending**

In the October survey, domestic institutions reported that credit standards on C&I loans to large and middle-market firms were unchanged, on net, over the past three months. On balance, however, domestic respondents indicated that they had further eased terms on C&I loans to such firms over the same period. Almost one-third of respondents—a somewhat smaller net fraction than in the July survey—noted that they had trimmed spreads of loan rates over their cost of funds over the past three months, while nearly one-fifth of banks—about the same net percentage as in the previous survey—reported that they had reduced the costs of credit lines. About 10 percent of domestic respondents, on net, indicated that they had eased loan covenants.

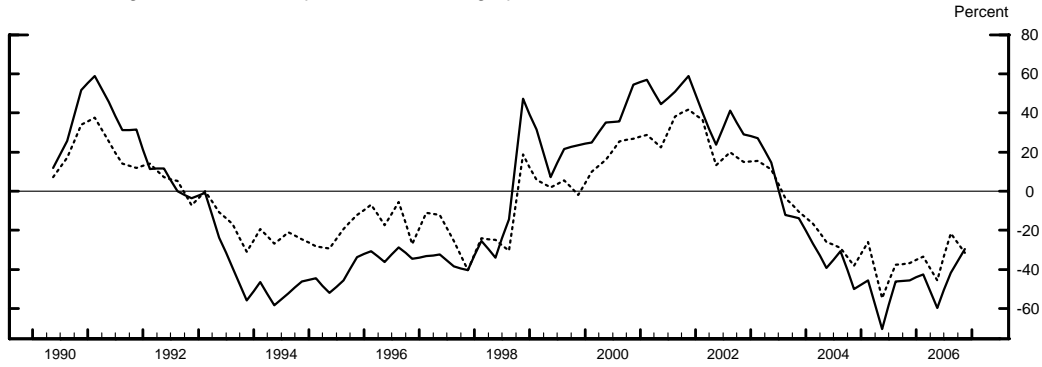
Credit standards on C&I loans to small firms were also reportedly little changed, on net, in the October survey. However, one-third of domestic institutions, on balance, indicated that they had trimmed spreads of loan rates over their cost of funds over the

### Measures of Supply and Demand for C&I Loans, by Size of Firm Seeking Loan

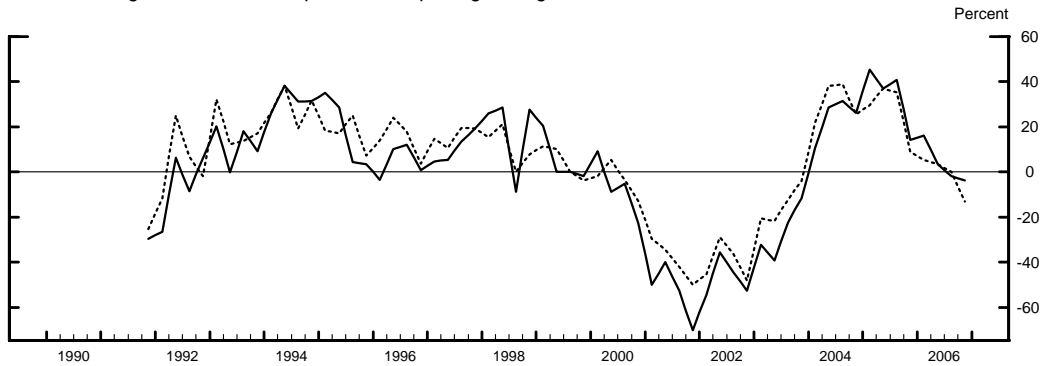
Net Percentage of Domestic Respondents Tightening Standards for C&I Loans



Net Percentage of Domestic Respondents Increasing Spreads of Loan Rates over Banks' Costs of Funds



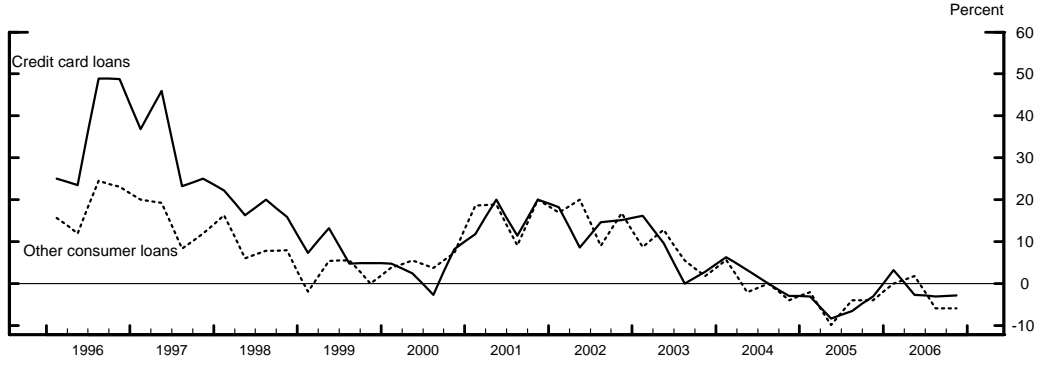
Net Percentage of Domestic Respondents Reporting Stronger Demand for C&I Loans



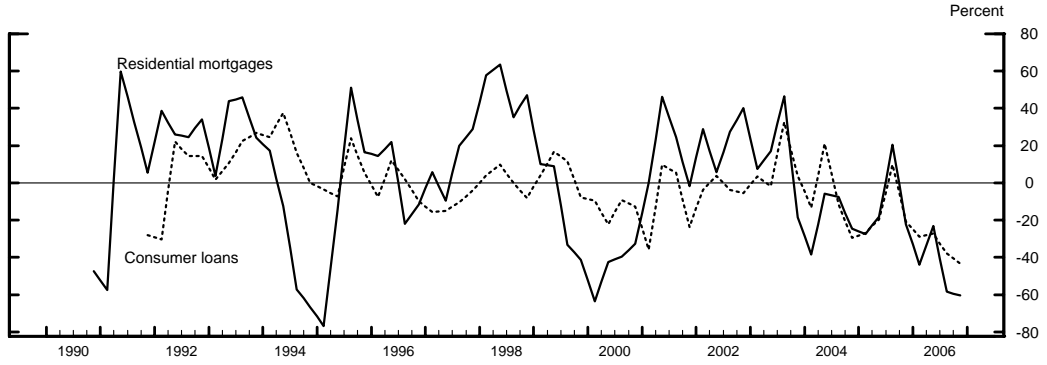


### Measures of Supply and Demand for Loans to Households

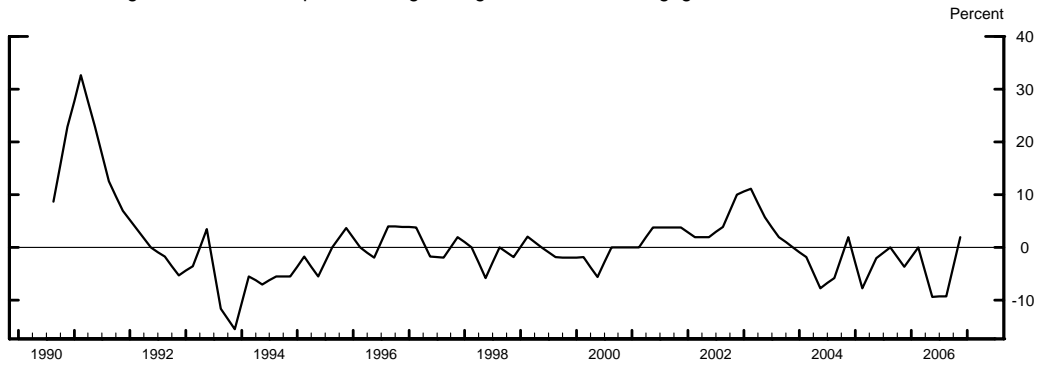
Net Percentage of Domestic Respondents Tightening Standards for Consumer Loans



Net Percentage of Domestic Respondents Reporting Stronger Demand for Loans to Households



Net Percentage of Domestic Respondents Tightening Standards for Mortgages to Individuals



previous three months, and nearly one-fifth of respondents noted that they had reduced the costs of credit lines.

At U.S. branches and agencies of foreign banks, only two institutions reported that they had eased their standards on C&I loans during the survey period. Considerable net fractions of these institutions, however, indicated that they had trimmed spreads of loan rates over their cost of funds and reduced the cost of credit lines.

All domestic and foreign respondents that reported having eased their lending standards or terms in the October survey pointed to more-aggressive competition from other banks or nonbank lenders as the most important reason for having done so. Notable net fractions of domestic institutions also cited increased liquidity in the secondary market for these loans, a more favorable or less uncertain economic outlook, and a reduction in defaults by borrowers in public debt markets as reasons for having eased credit standards or terms on C&I loans.

At domestic banks, demand for C&I loans from large and middle-market firms was reportedly little changed, on balance, in the October survey. About 15 percent of these institutions, on net, indicated that they had experienced weaker demand for such loans from small firms over the previous three months. At U.S. branches and agencies of foreign banks, nearly one-fifth of respondents, on balance, reported that they had seen weaker demand for C&I loans over the same period. All of the domestic institutions that experienced weaker demand for C&I loans attributed the softening, in part, to borrowers' decreased needs to finance investment in plant or equipment. Considerable fractions of respondents also cited borrowers' decreased financing needs for inventories and accounts receivable, as well as increases in customers' internally generated funds, as reasons for weaker loan demand. Among domestic banks that saw stronger demand for C&I loans, three-fourths pointed to a rise in merger and acquisition (M&A) activity as a reason for stronger loan demand, while two-thirds cited borrowers' increased needs to finance inventories.

Regarding future business, about 10 percent of domestic institutions, on net, and nearly 20 percent of foreign respondents reported that the number of inquiries from potential business borrowers had decreased moderately over the previous three months.

Nearly 40 percent of domestic institutions—a notably larger net fraction than in the July survey—indicated that they had tightened lending standards on commercial real estate loans over the previous three months. More than one-fourth of domestic respondents—also a larger net percentage than in the previous survey—reported that they had experienced weaker demand for such loans over the same period. By contrast, both

lending standards and demand for commercial real estate loans at foreign institutions were little changed in the October survey.

The October survey included a set of special questions about the extent to which the recent strength in C&I lending has reflected a surge in loans to fund M&A activity.<sup>1</sup> Holdings of C&I loans originated for M&A-related purposes were generally small for the respondent banks.<sup>2</sup> About one-half of domestic institutions indicated that M&A-related C&I loans accounted for less than 5 percent of the loans currently on their books, and roughly one-third of banks noted that such loans accounted for between 5 percent and 10 percent of their loans. The remainder of banks—except for one institution—reported a share that was between 11 percent and 30 percent.<sup>3</sup> On average, those banks with larger C&I loan portfolios had higher M&A loan concentrations. As a result, when the responses are weighted by the dollar volume of C&I loans at the end of the second quarter, banks that reported an M&A share of less than 5 percent accounted for only about one-third of all C&I loans on the books of banks responding to this special question. At U.S. branches and agencies of foreign banks, more than one-half of respondents indicated that the share of M&A-related C&I loans was 10 percent or less, while almost one-third noted that the share was between 11 percent and 20 percent. The remainder of foreign banks reported a share that was between 21 percent and 40 percent. In contrast to the domestic banks, foreign banks with larger C&I loan portfolios had somewhat smaller M&A loan concentration on average: When the responses are weighted by the dollar volume of C&I loans, foreign institutions that reported an M&A share of 10 percent or less accounted for 65 percent of all C&I loans on the books of respondent institutions.

One-half of domestic respondents and roughly 60 percent of foreign respondents, on balance, reported that the share of M&A-related C&I loans on their books had increased over the past twelve months. When the responses are weighted by C&I loans, these

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<sup>1</sup> The number of domestic banks that responded to these special questions varied from ten to fifty-four depending on the question. According to second-quarter Call Reports, these respondents accounted for between 12 percent and 56 percent of all C&I loans on the books of domestic commercial banks as of June 30, 2006. The number of foreign institutions that responded to these special questions varied from two to seventeen depending on the question. As of June 30, 2006, the foreign respondents accounted for between 10 percent and 48 percent of all C&I loans on the books of U.S. branches and agencies of foreign banks.

<sup>2</sup> In the survey, M&A-related C&I loans were defined as those made to finance leveraged buyouts and other M&A activity.

<sup>3</sup> A similar question regarding the share of C&I loans on banks' books that were merger related was asked in the late 1980s and early 1990s, when M&A activity was strong. On average, the fraction of institutions that reported shares of 10 percent or less was smaller than in the current survey, while the fraction of banks that indicated shares between 11 percent and 20 percent was significantly larger.

institutions accounted for 70 percent and about 85 percent, respectively, of loans outstanding at the end of the second quarter.

Among the domestic institutions that experienced an increase in the share of M&A-related C&I loans over the past twelve months, one-third indicated that this increase reflected to a moderate extent a shift of funding for M&A activity to banks as a result of a reduction in the relative attractiveness of bond finance. Eighty percent of these institutions pointed to relatively more favorable nonprice terms as a reason for the shift of M&A financing out of the bond market, while 60 percent pointed to relatively more favorable pricing in the loan market. Only two of the foreign respondents that experienced an increase in the share of M&A-related C&I loans pointed to a shift of funding for M&A activity from the bond market to banks as a reason for the increase.

Domestic respondents generally reported that the share of M&A-related C&I loans on their books that were used to finance leveraged buyouts was fairly small. Roughly three-fourths of institutions indicated that this share was less than or equal to 10 percent, and only about one-tenth of domestic banks reported that this share was between 51 percent and 75 percent.<sup>4</sup> These fractions are roughly similar if the responses are weighted by the respondents' C&I loans. The shares of C&I loans accounted for by leveraged buyouts were larger on average at the U.S. branches and agencies of foreign banks. Nonetheless, nearly one-half of the foreign respondents reported that the share was less than or equal to 10 percent, and about one-third of respondents indicated that the share was between 11 percent and 50 percent.<sup>5</sup> On average, foreign respondents with larger C&I loan portfolios had somewhat larger fractions of their M&A-related loans devoted to leveraged buyouts.

Domestic respondents generally reported that the share of M&A-related C&I loans on their books that were bridge loans was quite small: Ninety percent of domestic institutions reported that this share was less than or equal to 10 percent.<sup>6</sup> Again, these shares were higher at U.S. branches and agencies of foreign banks, where nearly two-

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<sup>4</sup> In the late 1980s and early 1990s, the share of merger-related C&I loans used to finance leveraged buyouts was reportedly considerably higher. Banks that indicated a share of less than 20 percent accounted for as little as 5 percent of all respondents in February 1989 and for as much as 40 percent in March 1991. Banks that indicated a share of more than 80 percent accounted for as little as 15 percent of all respondents in March 1991 and for as much as 30 percent in February 1988.

<sup>5</sup> Two foreign respondents noted that the share of M&A-related C&I loans on their books that were used to finance leveraged buyouts was more than 75 percent. These institutions, however, accounted for only 1 percent of all C&I loans on the books of the foreign banks that responded to this special question.

<sup>6</sup> In the survey, bridge loans were defined as those loans that banks expected to be paid down with funds raised in capital markets within the next twelve months.

thirds of respondents indicated that the share of such loans was 10 percent or less, while 30 percent of respondents noted that this share was between 11 percent and 50 percent. On balance, about 15 percent of domestic institutions reported that they had tightened credit standards for approving applications for M&A-related C&I loans or credit lines over the past twelve months. These respondents, however, indicated that they had also eased some terms on such loans or credit lines over the same period: Nearly one-third of domestic respondents, on net, indicated that they had trimmed spreads of loan rates over their cost of funds, and 15 percent noted that they had reduced the costs of credit lines. At foreign institutions, about one-fourth of respondents reported that they had eased credit standards for approving applications for M&A-related C&I loans or credit lines over the past twelve months. Notable net fractions of foreign respondents also indicated that they had increased the maximum size of loans or credit lines, reduced the costs of credit lines, and eased loan covenants.

About one-fourth of domestic respondents indicated that they anticipate that the quality of M&A-related C&I loans currently on their books will deteriorate over the next twelve months, and the rest expect that loan quality will likely stabilize around current levels. A somewhat larger net fraction of domestic respondents—about 35 percent—reported that they expect the quality of their C&I loans that were not used to finance M&A activity to deteriorate over the same period.<sup>7</sup> However, when the responses to these two special questions are weighted by the dollar volume of C&I loans at the end of the second quarter, the institutions that anticipated a deterioration in the credit quality accounted for about 45 percent and 35 percent, respectively, of all C&I loans held by respondent banks. At foreign institutions, 35 percent of respondents indicated that they anticipate that the quality of M&A-related C&I loans currently on their books will deteriorate over the next twelve months, while 30 percent indicated that they expect that the quality of their C&I loans that were not used to finance M&A activity will deteriorate over the same period. These shares are broadly similar if the responses are weighted by the respondents' C&I loans outstanding.

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<sup>7</sup> In the late 1980s and early 1990s, banks that had charged off merger-related C&I loans were asked to compare the chargeoff rate on such loans with that on comparably seasoned C&I loans that were not merger related. In the survey conducted in February 1987, a considerable net fraction of banks—about 75 percent—reported that the chargeoff rate on merger-related C&I loans was somewhat or much lower than that on other comparable C&I loans. The net fraction of banks giving a similar answer declined notably over subsequent surveys. In March 1991, about 20 percent of respondents, on net, indicated that the chargeoff rate on merger-related C&I loans was somewhat or much higher than the chargeoff rate on comparably seasoned C&I loans that were not merger related.

**Household Lending**

Domestic respondents indicated that their willingness to make consumer installment loans was about unchanged in the October survey. On net, standards and terms on credit card and non-credit-card consumer loans changed little over the past three months. About 45 percent of domestic respondents reported that they had experienced weaker demand for consumer loans, a somewhat larger net fraction than in the July survey.

Domestic banks reported that credit standards on residential mortgage loans were little changed, on net, over the past three months. Demand for residential mortgage loans weakened further in the October survey: About 60 percent of domestic institutions—roughly the same net fraction as in the July survey—noted that demand for such loans had weakened over the previous three months.

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## **International Developments**

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## International Developments

### U.S. International Transactions

#### Trade in Goods and Services

The U.S. international trade deficit widened to a record \$69.9 billion in August from \$68 billion in July (revised). The widening of the deficit reflected a surge in imports, which more than offset a sizeable jump in exports.

#### Trade in Goods and Services

	2005	Annual rate			Monthly rate		
		2006			2006		
		Q1	Q2	Q3 <sup>e</sup>	June	July	Aug.
Percent change							
<i>Nominal BOP</i>							
Exports	10.8	17.0	14.0	8.5	2.3	-1.3	2.3
Imports	12.6	7.5	11.0	15.6	1.1	.9	2.4
<i>Real NIPA</i>							
Exports	6.8	14.0	6.2	n.a.	...	...	...
Imports	4.9	9.1	1.4	n.a.	...	...	...
Billions of dollars							
<i>Nominal BOP</i>							
Net exports	-716.7	-764.6	-775.3	-827.1	-64.8	-68.0	-69.9
Goods, net	-782.7	-831.9	-842.4	-894.0	-70.0	-73.5	-75.5
Services, net	66.0	67.3	67.1	66.8	5.2	5.5	5.7

e. BOP data are two months at an annual rate.

Source. U.S. Department of Commerce, Bureaus of Economic Analysis and Census.  
n.a. Not available. ... Not applicable.

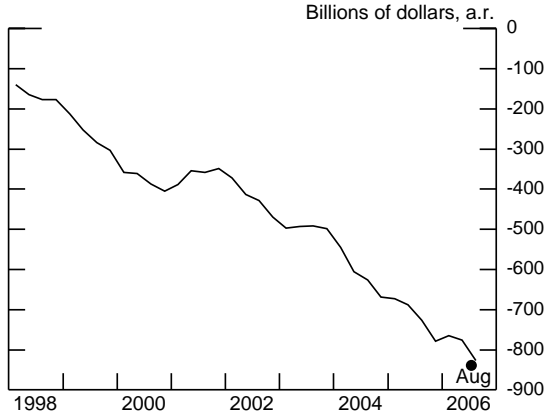
In August, the value of exports of goods and services increased 2.3 percent after declining in July. The increase was led by stronger exports of capital goods, with aircraft, computers, semiconductors, and other machinery all climbing briskly. Exports of industrial supplies also exhibited strong growth, while exports of consumer goods were boosted by a particularly large jump in the volatile category of artwork and antiques. Exports of automotive products fell slightly, whereas services exports expanded modestly.

The average value of exports in July and August increased 8.5 percent (a.r.) from the second quarter. Exports of automotive products, consumer goods, and industrial supplies contributed significantly to the overall increase, whereas services exports were flat.

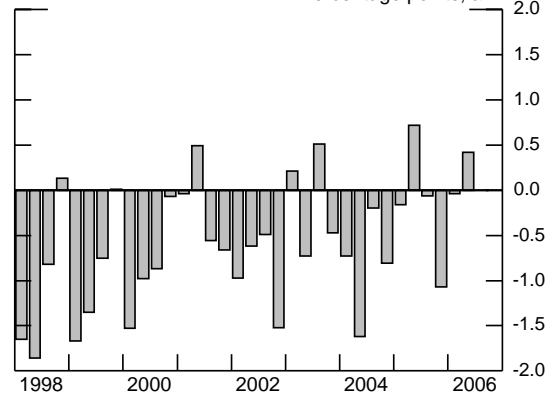


## U.S. International Trade in Goods and Services (Quarterly)

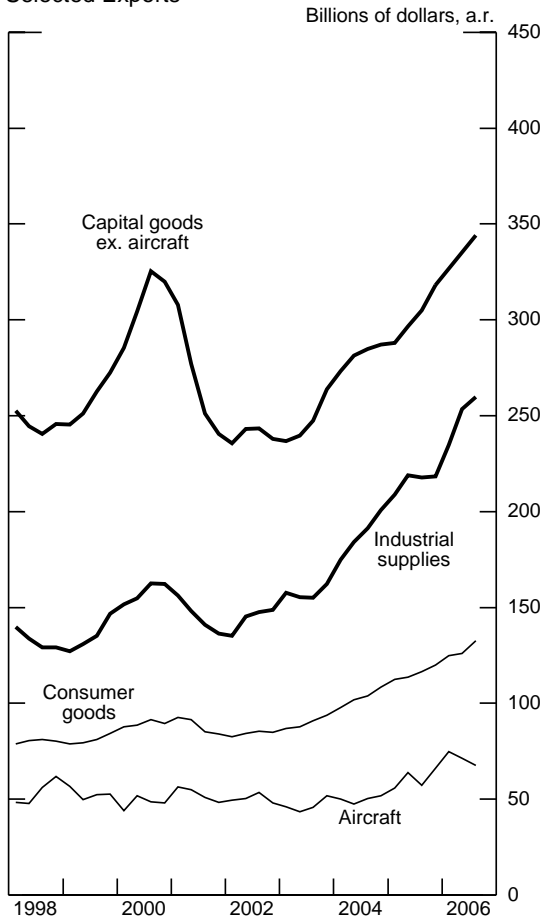
Trade Balance



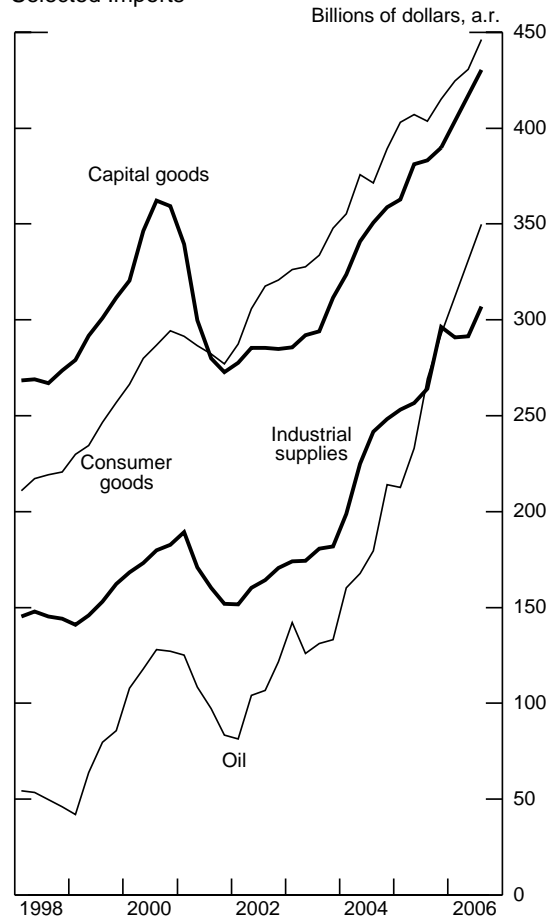
Contribution of Net Exports to Real GDP Growth



Selected Exports



Selected Imports



**U.S. Exports and Imports of Goods and Services**  
(Billions of dollars, a.r., BOP basis)

	Levels				Change <sup>1</sup>			
	2006		2006		2006		2006	
	Q2	Q3 <sup>e</sup>	July	Aug.	Q2	Q3 <sup>e</sup>	July	Aug.
<b>Exports of G&amp;S</b>	<b>1423.5</b>	<b>1452.9</b>	<b>1436.7</b>	<b>1469.1</b>	<b>45.8</b>	<b>29.3</b>	<b>-18.3</b>	<b>32.4</b>
Goods exports	1011.4	1040.6	1025.5	1055.7	33.3	29.2	-18.0	30.2
Gold	8.8	9.0	7.7	10.3	1.2	.2	-2.6	2.7
Other goods	1002.5	1031.6	1017.8	1045.4	32.1	29.1	-15.4	27.5
Capital goods	409.3	411.6	403.9	419.3	8.7	2.3	-15.9	15.4
Aircraft & parts	71.5	67.6	66.2	69.0	-3.4	-3.9	-6.8	2.7
Computers & accessories	47.8	47.1	45.9	48.3	.8	-.7	-5.4	2.4
Semiconductors	54.8	54.4	53.8	54.9	4.0	-.5	-.3	1.1
Other capital goods	235.2	242.5	237.9	247.1	7.4	7.3	-3.3	9.2
Automotive	104.7	114.4	115.2	113.6	-.8	9.8	7.7	-1.6
Ind. supplies (ex. ag., gold)	253.3	259.8	256.5	263.0	18.6	6.4	-3.7	6.4
Consumer goods	126.0	132.5	131.1	134.0	1.2	6.5	1.5	2.8
Agricultural	73.1	76.2	76.0	76.3	3.6	3.1	-.8	.3
All other goods	36.1	37.1	35.0	39.2	.9	1.1	-9.1	4.2
Services exports	412.1	412.3	411.2	413.4	12.5	.1	-.3	2.2
<b>Imports of G&amp;S</b>	<b>2198.8</b>	<b>2280.0</b>	<b>2252.7</b>	<b>2307.3</b>	<b>56.5</b>	<b>81.2</b>	<b>19.9</b>	<b>54.7</b>
Goods imports	1853.8	1934.6	1906.9	1962.2	43.8	80.8	23.3	55.3
Oil	317.2	349.7	343.3	356.2	28.7	32.6	17.3	12.9
Gold	6.2	5.5	5.9	5.0	.4	-.7	-.2	-1.0
Other goods	1530.4	1579.3	1557.6	1601.1	14.8	48.9	6.1	43.5
Capital goods	415.6	430.3	424.5	436.1	11.1	14.8	8.6	11.6
Aircraft & parts	27.7	25.3	25.6	24.9	-.8	-2.4	-4.9	-.6
Computers & accessories	101.4	104.8	103.8	105.8	1.9	3.4	5.0	2.0
Semiconductors	27.0	28.8	28.1	29.5	-.1	1.8	2.4	1.5
Other capital goods	259.5	271.5	267.1	275.9	10.1	12.0	6.1	8.8
Automotive	258.2	254.5	251.4	257.6	-.1	-3.7	-15.2	6.3
Ind. supplies (ex. oil, gold)	291.4	307.1	301.1	313.1	.6	15.7	8.3	12.0
Consumer goods	430.6	446.0	442.0	450.1	6.2	15.4	1.3	8.1
Foods, feeds, bev.	73.2	76.4	75.2	77.7	-.9	3.2	2.8	2.6
All other goods	61.5	65.0	63.5	66.4	-2.2	3.5	.2	2.9
Services imports	345.0	345.4	345.8	345.1	12.7	.4	-3.4	-.7
<i>Memo:</i>								
Oil quantity (mb/d)	13.63	14.04	13.76	14.32	-.69	.42	.04	.56
Oil import price (\$/bbl)	63.67	68.19	68.29	68.09	8.57	4.54	3.25	-.20

1. Change from previous quarter or month. e. Average of two months.

Source. U.S. Department of Commerce, Bureaus of Economic Analysis and Census.

The value of imported goods and services increased 2.4 percent in August. A sharp rise in the value of imported oil and natural gas contributed importantly to the increase. The increase was also supported by stronger imports across most other categories of goods. Imports of capital goods were boosted by robust imports of computers, semiconductors, and telecommunications equipment, while a jump in imports of metals pushed up imports of non-oil industrial supplies. Imports of foods, automotive products, and consumer goods also increased. Imports of services fell back slightly in August, largely on account of a decline in imports of travel services.

The average value of imports in July and August increased 15.6 percent (a.r.) from the second quarter. A large increase in the value of imported oil contributed to the overall increase, but imports of non-oil industrial supplies, capital goods, and consumer goods also exhibited large gains. Imports of automotive products fell, and services imports were flat.

### **Prices of Internationally Traded Goods**

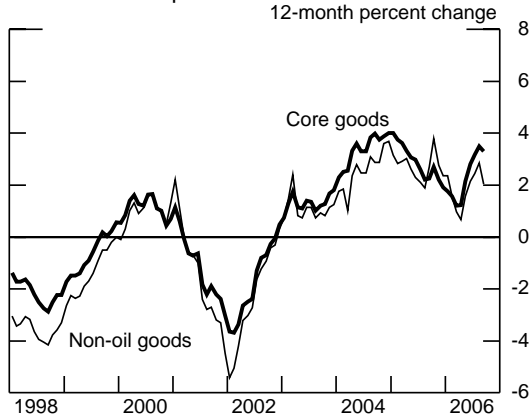
**Non-oil imports.** In September, import prices of non-oil goods and core goods rose 0.1 and 0.2 percent, respectively. These increases primarily reflected a 0.9 percent rise in prices for material-intensive goods. Prices for non-fuel industrial supplies increased 1.0 percent in September, as higher prices for metals were partly offset by falling prices for chemicals. After increasing 2.5 percent in August, food prices were up 0.4 percent in September. In contrast to material-intensive goods, prices for imported finished goods edged up only 0.1 percent. Prices for imported computers fell 0.5 percent, and prices for semiconductors edged down 0.1 percent.

The average level of core import prices in the third quarter was 4½ percent at an annual rate above the second-quarter average, as prices increased in all major sub-categories. Prices for material-intensive goods were up 9¼ percent (a.r.), whereas prices for finished goods increased 2¾ percent (a.r.).

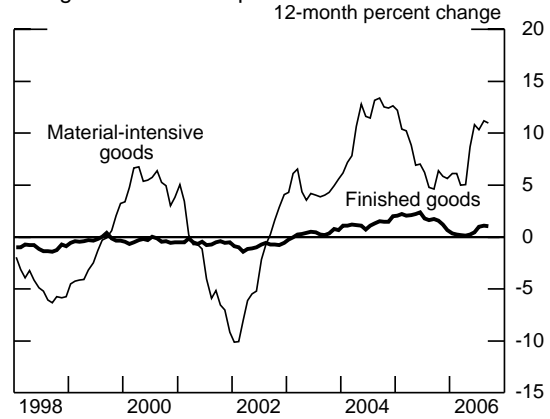
**Oil.** The BLS price index of imported oil plummeted 10.3 percent in September. The spot price of West Texas Intermediate (WTI) crude oil fell from an average of \$73 per barrel in August to an average of \$64 per barrel in September. Thus far in October, the spot price of WTI has fallen further, closing at \$58.94 per barrel on October 17. The sharp drop in the spot price appears to reflect an improved outlook for oil supply.

**Prices of U.S. Imports and Exports**

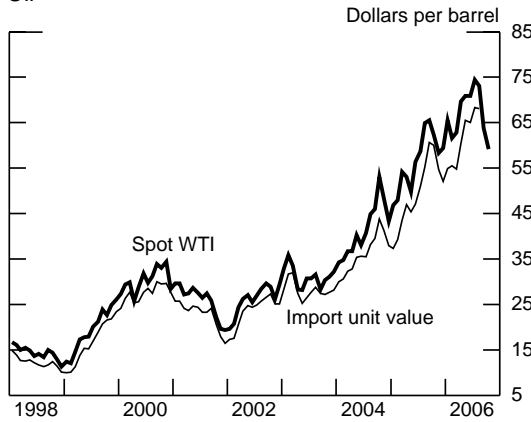
Merchandise Imports



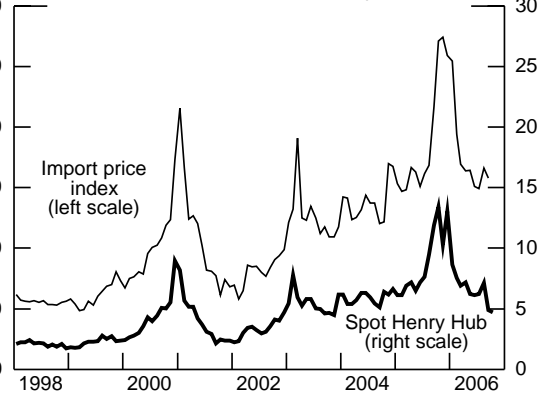
Categories of Core Imports



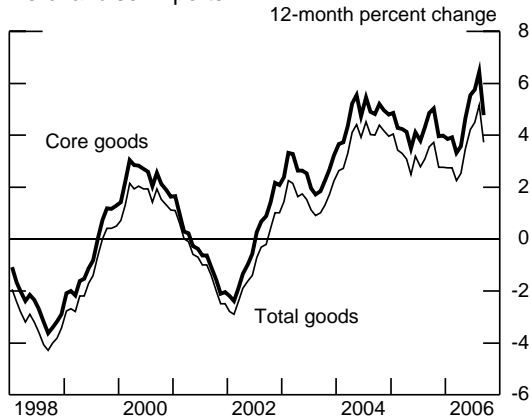
Oil



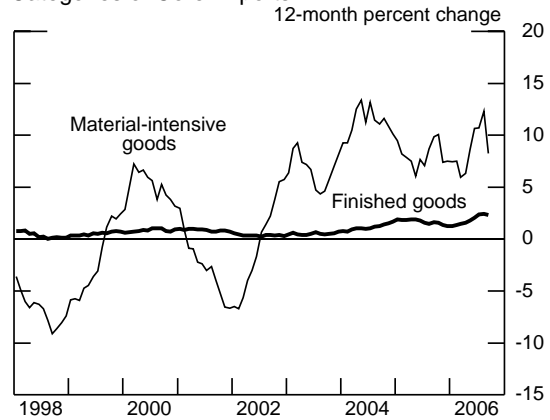
Natural Gas



Merchandise Exports



Categories of Core Exports



**Prices of U.S. Imports and Exports**  
(Percentage change from previous period)

	Annual rate			Monthly rate		
	2006			2006		
	Q1	Q2	Q3	July	Aug.	Sept.
	----- BLS prices -----					
<b>Merchandise imports</b>	.1	12.8	5.2	.8	.8	-2.1
Oil	6.8	79.1	12.5	3.9	2.1	-10.3
Non-oil	-1.2	1.0	3.8	.1	.5	.1
Core goods <sup>1</sup>	2.2	3.9	4.5	.1	.3	.2
Finished goods	.7	.8	2.7	.4	.0	.1
Cap. goods ex. comp. & semi.	1.7	2.5	2.9	.2	.0	.2
Automotive products	-.8	1.0	1.6	.2	.0	.1
Consumer goods	.8	-.4	3.4	.6	.1	.1
Material-intensive goods	9.6	14.9	9.3	-.8	.9	.9
Foods, feeds, beverages	5.5	-.7	9.4	.0	2.5	.4
Industrial supplies ex. fuels	11.8	20.7	9.2	-1.0	.5	1.0
Computers	-6.9	-7.4	-5.2	-.6	.0	-.5
Semiconductors	2.4	-.3	3.7	.8	.0	-.1
Natural gas	-65.2	-63.8	-4.8	-1.1	11.5	-5.2
<b>Merchandise exports</b>	2.9	6.7	4.9	.4	.4	-.5
Core goods <sup>2</sup>	3.6	8.0	6.4	.5	.6	-.6
Finished goods	2.6	2.8	2.4	.3	.1	.1
Cap. goods ex. comp. & semi.	4.0	3.0	2.2	.3	.2	.1
Automotive products	1.0	1.9	1.5	.2	.0	.1
Consumer goods	1.4	3.0	3.1	.3	.1	.1
Material-intensive goods	5.2	15.7	12.6	.7	1.4	-1.6
Agricultural products	-1.4	2.2	18.5	1.9	.9	-.7
Industrial supplies ex. ag.	7.2	20.1	11.3	.5	1.5	-1.8
Computers	1.2	-3.5	-3.1	-.4	-.4	.7
Semiconductors	-7.9	-5.9	-11.9	-1.0	-2.2	-.6
	----- NIPA prices -----					
<b>Chain price index</b>						
Imports of goods & services	-.7	9.8	n.a.	--	--	--
Non-oil merchandise	-1.8	.7	n.a.	--	--	--
Core goods <sup>1</sup>	1.6	3.8	n.a.	--	--	--
Exports of goods & services	2.3	6.1	n.a.	--	--	--
Total merchandise	2.8	6.2	n.a.	--	--	--
Core goods <sup>2</sup>	3.7	6.9	n.a.	--	--	--

1. Excludes computers, semiconductors, and natural gas.

2. Excludes computers and semiconductors.

n.a. Not available. ... Not applicable.

Two recent developments — the return of most of the lost production at Alaska's Prudhoe Bay oil field and a lack of damaging storms this hurricane season — will likely allow for higher than expected U.S. production over the near term. However, a continuing supply disruption in Nigeria and risks to oil production in Iraq and Iran continue to support oil prices at historically elevated levels.

**Exports.** In September, prices of U.S. exports of total goods and core goods fell 0.5 and 0.6 percent, respectively. These were the first declines in these indexes since November 2005. The September decline was driven by a 1.8 percent fall in prices for nonagricultural industrial supplies, reflecting lower prices for petroleum. Chemical prices were also down in September, although metals prices were up. Agricultural export prices fell 0.7 percent. In contrast, export prices for finished goods increased 0.1 percent in September. Prices of exported computers rose 0.7 percent, whereas prices for semiconductors fell 0.6 percent.

The average level of core export prices in the third quarter was 6½ percent at an annual rate above the second-quarter average, as prices increased in all major sub-categories. Much of the increase can be attributed to the 12½ percent increase in the prices of material-intensive goods, as prices of both agricultural products and nonagricultural industrial supplies rose sharply in July and August.

### **U.S. Current Account**

The U.S. current account deficit was \$874 billion (a.r.) in the second quarter of 2006, about \$21 billion wider than recorded in the first quarter of 2006 (revised). The trade deficit widened \$11 billion, as increased exports of goods and services were more than offset by increased imports. A \$4 billion net increase in outflows from unilateral transfers contributed to the widening of the deficit.

The investment income balance was negative \$10 billion (a.r.) in the second quarter, and the first-quarter investment income balance was revised down by \$18 billion to negative \$4 billion. Although interest, dividend, and direct investment income receipts increased in the second quarter, there were even larger increases in interest, dividend, and direct investment payments. As revised, the investment income balance was negative in the past three quarters, suggesting that the large negative net international investment position is finally beginning to add to the financing needs of the current account.

<b>U.S. Current Account</b>				
(Billions of dollars, seasonally adjusted annual rate)				
Period	Goods and services, net	Investment income, net	Other income and transfers, net	Current account balance
<i>Annual</i>				
2004	-611.3	33.6	-87.6	-665.3
2005	-716.7	17.6	-92.4	-791.5
<i>Quarterly</i>				
2005:Q3	-727.2	37.9	-44.3	-733.7
Q4	-779.1	-2.3	-111.0	-892.4
2006:Q1	-764.6	-3.6	-84.7	-852.8
Q2	-775.3	-10.1	-88.3	-873.6
<i>Change</i>				
Q3-Q2	-38.9	23.7	54.7	39.4
Q4-Q3	-51.9	-40.2	-66.7	-158.8
Q1-Q4	14.5	-1.3	26.4	39.6
Q2-Q1	-10.7	-6.5	-3.6	-20.8

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

### **U.S. International Financial Transactions**

The financial flows associated with the current account are highlighted in bold in the Summary of U.S. International Transactions table. Recorded net private financial inflows decreased slightly in the second quarter and, at \$80 billion, were well below the levels recorded in the second half of 2005. Measured official financial inflows were little changed from the first quarter and total financial flows, official and private, were \$154 billion, or \$17 billion less than in the first quarter. The decrease in recorded total net inflows, combined with a small increase in the current account deficit to \$218 billion, increased the size of the statistical discrepancy to an unusually large \$65 billion for the quarter. This positive statistical discrepancy indicates some combination of under-recorded net financial inflows or over-recorded net imports of goods and services and other transactions measured in the current account balance.

The second-quarter reduction in net private financial inflows reflected in part a \$46 billion drop in foreign purchases of U.S. securities (line 4). Foreign private investors continued to acquire agency and corporate securities at a substantial pace (lines 4b and 4c) but showed little interest in Treasuries (line 4a) or equities (line 4d). U.S. purchases of foreign securities (line 5) were little changed from the prior three quarters.

Flows of foreign direct investment into the United States (line 7) remained strong in the second quarter as reinvested earnings remained high. Direct investment inflows from Europe were above their trend level and accounted for more than 75 percent of total inflows in the quarter. U.S. direct investment abroad (line 6), after recording atypical inflows in the second half of last year as foreign earnings were repatriated under the Homeland Investment Act, returned to their normal pattern of outflows in the first half of this year and were roughly equal to the level of foreign direct investment into the United States during the second quarter. Reinvested earnings remained strong in the quarter, but outflows associated with new equity investment slowed from their first-quarter level. As usual, the majority of U.S. direct investment went to Europe and Asia. Foreign acquisition of U.S. currency (line 8) has been unusually low in the past two quarters, primarily because Russia, typically a major purchaser of U.S. currency, was a net seller during the first half of 2006.

In more recent monthly data, net foreign private purchases of U.S. securities rebounded sharply in August (line 4) after unusually modest inflows in July. While there were only small net purchases of U.S. equities (line 4d) during the month, foreign acquisitions of Treasury, agency, and corporate debt securities (lines 4a-c) were all well above their recent norms. Prior to the substantial net purchases in August, foreign private investors had reduced their holdings of Treasuries during the first seven months of the year. U.S. acquisitions of foreign securities decreased sharply from recent levels during the month (line 5), with purchases of debt securities (line 5a) only slightly exceeding net sales of equities (line 5b). Through the first eight months of the year, both foreign private acquisitions of U.S. securities and U.S. acquisitions of foreign securities have maintained paces similar to last year.

Foreign official inflows (line 1) continued at a high level in August and remain on a pace about midway between the record level of 2004 and last year's much smaller total.



holdings at FRBNY indicate very modest foreign official acquisitions during the September to mid-October period;

The volatile banking sector (line 3) recorded modest net inflows during August.

**Summary of U.S. International Transactions**  
(Billions of dollars, not seasonally adjusted except as noted)

	2004	2005	2005		2006			
			Q3	Q4	Q1	Q2	Jul	Aug
<b>Official financial flows</b>	<b>388.2</b>	<b>214.6</b>	<b>40.1</b>	<b>78.5</b>	<b>76.2</b>	<b>73.8</b>	<b>33.0</b>	<b>27.3</b>
1. Change in foreign official assets in the U.S. (increase, +)	385.4	200.5	35.3	73.7	75.7	74.4	32.7	26.7
a. G-10 countries + ECB	161.7	-21.3	-4.0	-4.8	-8.5	-18.2	.4	-4.1
b. OPEC	12.1	7.5	-3.7	10.6	12.0	13.7	4.6	2.8
c. All other countries	211.6	214.4	43.0	67.8	72.2	78.9	27.6	28.0
2. Change in U.S. official reserve assets (decrease, +)	2.8	14.1	4.8	4.8	.5	-.6	.3	.7
<b>Private financial flows</b>	<b>194.3</b>	<b>570.8</b>	<b>216.2</b>	<b>164.2</b>	<b>95.3</b>	<b>80.2</b>	<b>...</b>	<b>...</b>
<b>Banks</b>								
3. Change in net foreign positions of banking offices in the U.S. <sup>1</sup>	-3.8	15.8	15.3	61.3	.9	41.7	27.7	11.3
<b>Securities<sup>2</sup></b>								
4. Foreign net purchases of U.S. securities (+)	489.5	610.4	175.3	184.6	183.5	137.1	12.6	67.7
a. Treasury securities	104.2	178.5	35.7	59.8	-6.6	10.0	-6.8	17.1
b. Agency bonds	67.9	67.1	34.6	16.6	42.0	27.8	-.6	15.4
c. Corporate and municipal bonds	255.0	274.4	73.7	83.2	92.6	98.8	11.2	31.0
d. Corporate stocks <sup>3</sup>	62.4	90.5	31.4	25.0	55.6	.6	8.8	4.2
5. U.S. net acquisitions (-) of foreign securities	-146.2	-197.0	-47.3	-48.7	-54.4	-53.5	-23.4	-4.5
a. Bonds	-60.9	-53.1	-12.1	-5.7	-12.0	-36.1	-19.4	-10.5
b. Stock purchases	-97.6	-139.9	-35.3	-43.0	-38.5	-15.0	-4.0	6.1
c. Stock swaps <sup>3</sup>	12.2	-4.0	.0	.0	-4.0	-2.4	.0	.0
<b>Other flows (quarterly data, s.a.)</b>								
6. U.S. direct investment (-) abroad	-244.1	-9.1	30.3	25.8	-61.3	-47.1	...	...
7. Foreign direct investment in the U.S.	133.2	109.8	44.5	26.5	45.3	48.4	...	...
8. Foreign acquisitions of U.S. currency	14.8	19.4	4.7	9.2	1.9	1.1	...	...
9. Other (inflow, +) <sup>4</sup>	-49.1	21.5	-6.6	-94.5	-20.6	-47.5	...	...
<b>U.S. current account balance (s.a.)</b>	<b>-665.3</b>	<b>-791.5</b>	<b>-183.4</b>	<b>-223.1</b>	<b>-213.2</b>	<b>-218.4</b>	<b>...</b>	<b>...</b>
<b>Capital account balance (s.a.)<sup>5</sup></b>	<b>-2.3</b>	<b>-4.4</b>	<b>-.6</b>	<b>-.5</b>	<b>-1.8</b>	<b>-.9</b>	<b>...</b>	<b>...</b>
<b>Statistical discrepancy (s.a.)</b>	<b>85.1</b>	<b>10.4</b>	<b>-72.2</b>	<b>-19.1</b>	<b>43.4</b>	<b>65.2</b>	<b>...</b>	<b>...</b>

Note. Data in lines 1 through 5 differ in timing and coverage from the balance of payments data published by the Department of Commerce. Details may not sum to totals because of rounding.

1. Changes in dollar-denominated positions of all depository institutions and bank holding companies plus certain transactions between broker-dealers and unaffiliated foreigners (particularly borrowing and lending under repurchase agreements). Includes changes in custody liabilities other than U.S. Treasury bills.

2. Includes commissions on securities transactions and therefore does not match exactly the data on U.S. international transactions published by the Department of Commerce.

3. Includes (4d) or represents (5c) stocks acquired through non-market means such as mergers and reincorporations.

4. Transactions by nonbanking concerns and other banking and official transactions not shown elsewhere plus amounts resulting from adjustments made by the Department of Commerce and revisions in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business.

5. Consists of transactions in nonproduced nonfinancial assets and capital transfers.

n.a. Not available. ... Not applicable.

## Foreign Financial Markets

After moving little on balance during the second half of September, the dollar's weighted-average exchange value against other major currencies moved up in early October; on net, it rose about 1¼ percent over the intermeeting period. The dollar appreciated following speeches by Fed officials that were interpreted by market participants as suggesting a lower likelihood of policy easing in early 2007, following the release of the September U.S. employment report, and following the release of the minutes of the September 20 FOMC meeting. On a bilateral basis, the dollar appreciated 1½ percent against the euro and the yen, and slightly more than 1 percent against sterling and the Canadian dollar. After decreasing in late September, the options-implied volatility of the dollar-euro and yen-dollar exchange rates increased slightly in early October during the period of rapid dollar appreciation, but remains close to historically low levels.

Headline equity indexes rose about 4½ percent in the euro area, the United Kingdom, and Japan. Market participants attributed the rise in share prices in these countries to falling oil prices and a scaling back of expectations of future policy tightening by several central banks. Equity prices in Europe also rose following the release of a better-than-expected IFO German business climate survey on September 26. Beginning on October 3, the Dow Jones Industrial Average index eclipsed its former closing record, set on January 14, 2000, on several successive days. Broader U.S., European, and U.K. stock market indexes, however, are still trading 10 to 20 percent below their early-2000 record highs. The S&P500 and DJ Euro Stoxx indexes began to exceed their early-May year-to-date highs late in the intermeeting period, but the TOPIX still stands about 7 percent below its early-April high. Realized volatilities on headline equity indexes remained low during the intermeeting period.

On October 5, the European Central Bank increased its policy rate 25 basis points, to 3.25 percent, in a move that had been fully anticipated. The Bank of England, the Bank of Japan, and the Bank of Canada all kept their respective policy rates unchanged. Three-month spot interest rates were little changed in Japan, Canada, and increased 8 and 16 basis points in the United Kingdom and Germany, respectively. Ten-year nominal and indexed sovereign yields are up about 10 basis points on balance in Japan and Canada, but are little changed in the United Kingdom and Germany. Long-term interest rates in most major developed countries fell substantially in late September, with fluctuations in foreign yields generally tracking declines in dollar-based yields. The drop in U.S. yields in late September was triggered by a much lower than expected

Philadelphia Fed business activity index, which reportedly raised concerns over a possible U.S. economic slowdown. Nominal and real long-term interest rates in most major developed countries followed U.S. rates up again in early October, in response to speeches by Fed officials, the September employment report, and the release of the FOMC minutes. Realized volatility of ten-year government bonds changed little in most industrial economies over the intermeeting period, and remains very low by recent historical standards.

On September 19, Thailand's military leaders staged a *coup d'état* and ousted the civilian government. In the days that followed, the Thailand headline equity index declined about 2<sup>3</sup>/<sub>4</sub> percent, but the Thai baht depreciated only modestly. Thai share prices have more than retraced and are now almost 2 percent higher since the coup.

Following news that North Korea carried out an underground nuclear test on October 8, the Korean won depreciated 1<sup>1</sup>/<sub>2</sub> percent against the dollar, the Kospi stock index fell almost 2<sup>1</sup>/<sub>2</sub> percent, and the headline Singapore and Hong Kong stock market indexes each fell over 1 percent. Subsequently, share prices in Korea, Singapore, and Hong Kong reversed part or all of these losses. Nevertheless, the Kospi is down 0.9 percent on balance over the intermeeting period. Most other major equity indexes in emerging Asia have, in contrast, risen 3 to 6 percent on balance.

The dollar's trade-weighted exchange value against the currencies of our other important trading partners declined <sup>1</sup>/<sub>2</sub> percent on balance over the intermeeting period. The dollar depreciated 2 percent against the Brazilian *real*, over 1 percent against the Mexican peso, and also depreciated some against the currencies of several East-Asian emerging market economies. The Brazilian Bovespa index and the Mexican Bolsa index rose over 9 and 5 percent, respectively. Brazilian financial indicators outperformed in part on expectations that President Lula will be forced to moderate spending plans to prevail in a runoff vote on October 29 against Alckmin, the opposition candidate. The overall EMBI+ spread rose 22 basis points, to 218 basis points, between September 19 and September 25. Market participants suggested that this was in part due to a general retreat from risk, reflecting both concerns over a potential U.S. economic slowdown and to concerns over current account imbalances and rising political tensions in specific emerging market countries. Following the first round of Brazil's presidential elections, and as concerns over a potential U.S. slowdown moderated, the EMBI+ spread more than retraced the earlier increases, and on balance it is currently down about 10 basis points over the intermeeting period.

On net, the renminbi appreciated  $\frac{1}{4}$  percent against the dollar over the intermeeting period. It reached a high against the dollar on September 28, around the time of Secretary Paulson's visit to China, but it partially retraced this rise subsequently.

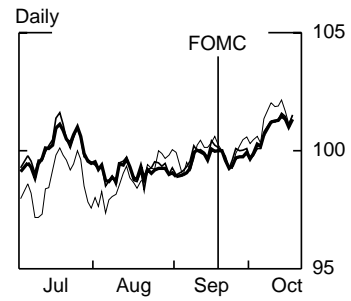
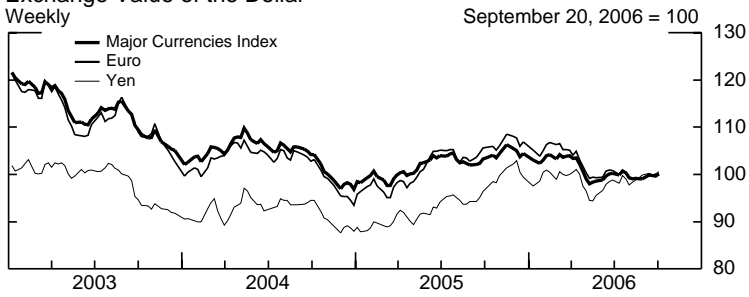
. The Desk did not intervene during the period for the accounts of the System or the Treasury.

**Exchange Value of the Dollar and Stock Market Indexes**

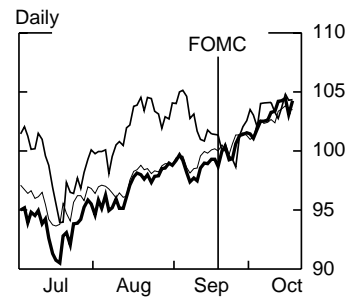
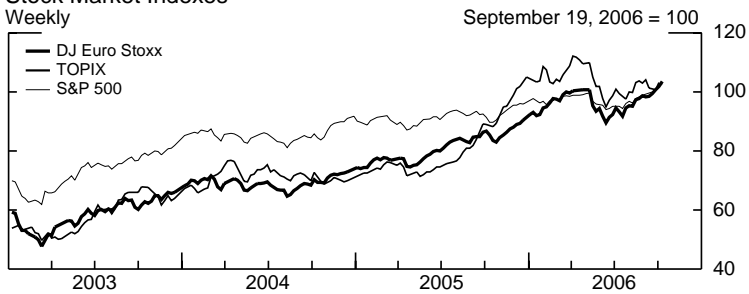
	Latest	Percent change since September FOMC
<i>Exchange rates*</i>		
Euro (\$/euro)	1.2511	1.5
Yen (¥/\$)	119.0	1.5
Sterling (\$/£)	1.8679	1.2
Canadian dollar (C\$/\\$)	1.1400	1.1
<i>Nominal dollar indexes*</i>		
Broad index	108.8	0.5
Major currencies index	83.1	1.3
OITP index	134.6	-0.5
<i>Stock market indexes</i>		
DJ Euro Stoxx	377.7	4.3
TOPIX	1638.7	4.4
FTSE 100	6152.6	4.9
S&P 500	1364.7	3.5

\* Positive percent change denotes appreciation of U.S. dollar.

**Exchange Value of the Dollar**  
Weekly



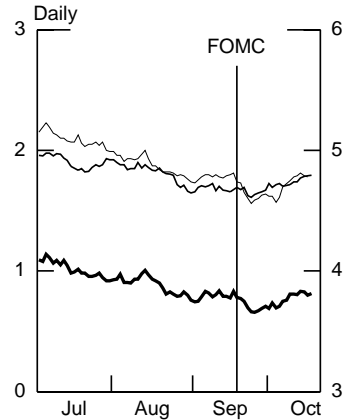
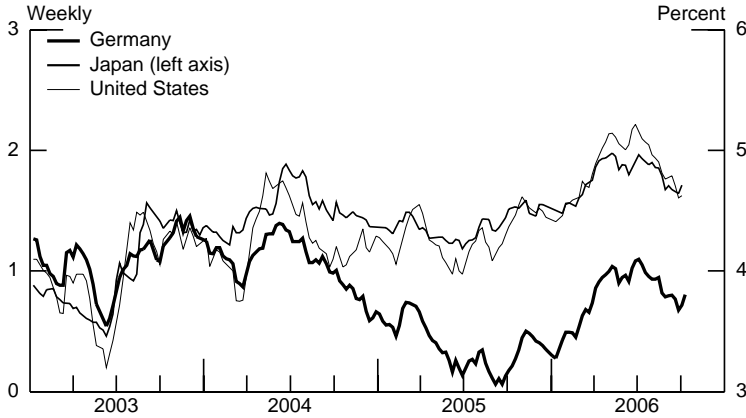
**Stock Market Indexes**  
Weekly



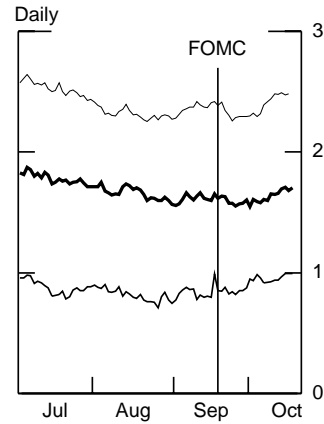
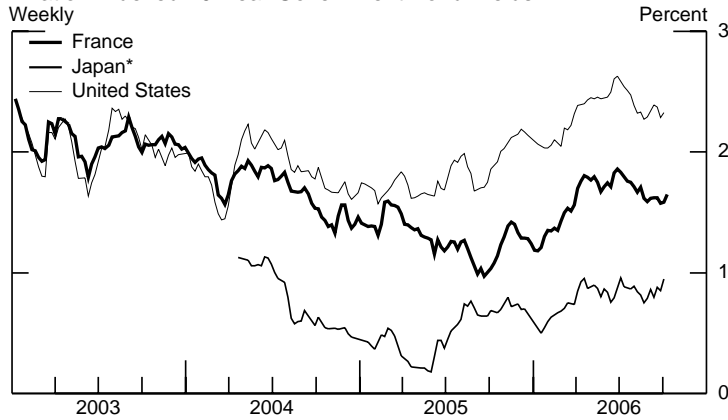
**Industrial Countries: Nominal and Real Interest Rates**

	3-month LIBOR		10-year nominal		10-year indexed		Percent
	Latest	Change since September FOMC	Latest	Change since September FOMC	Latest	Change since September FOMC	
Germany	3.51	0.16	3.81	0.04	1.77	0.05	
Japan	0.44	0.02	1.79	0.12	1.00	0.15	
United Kingdom	5.13	0.08	4.64	0.04	1.65	0.06	
Canada	4.28	-0.01	4.18	0.10	...	...	
United States	5.37	-0.02	4.78	0.04	2.48	0.10	

**Nominal 10-Year Government Bond Yields**



**Inflation-Indexed 10-Year Government Bond Yields**



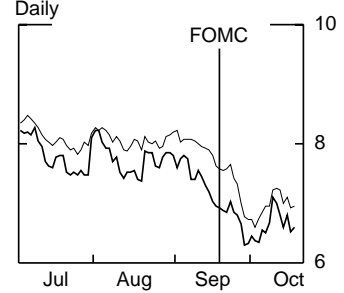
\*Japan first issued inflation-indexed debt in March 2004.

**Measures of Market Volatility**

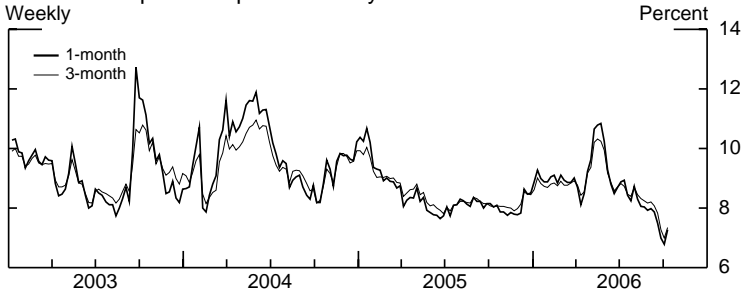
**Dollar-Euro Options-Implied Volatility\***  
Weekly



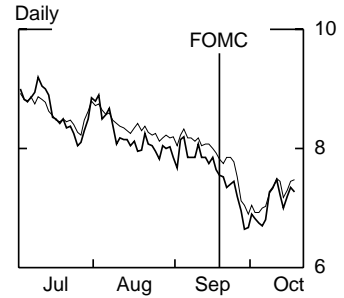
\*Derived from at-the-money options.



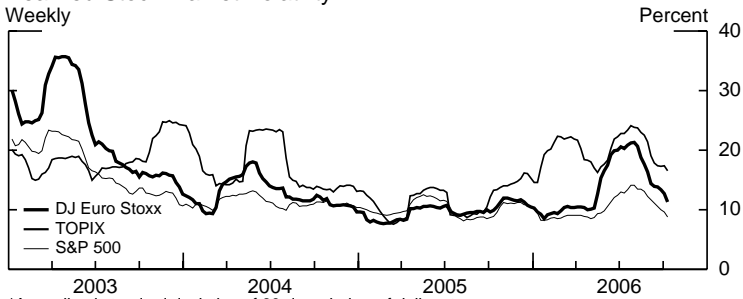
**Yen-Dollar Options-Implied Volatility\***  
Weekly



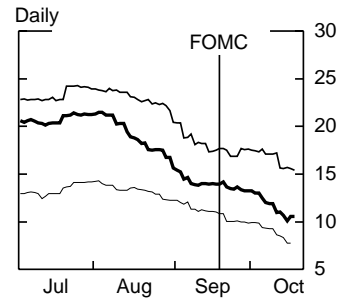
\*Derived from at-the-money options.



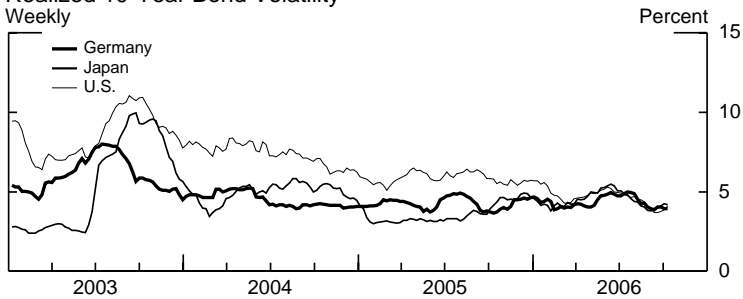
**Realized Stock Market Volatility\***  
Weekly



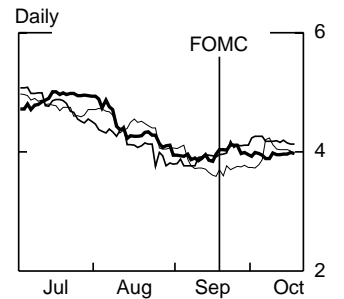
\*Annualized standard deviation of 60-day window of daily returns.



**Realized 10-Year Bond Volatility\***  
Weekly



\*Annualized standard deviation of 60-day window of daily returns.



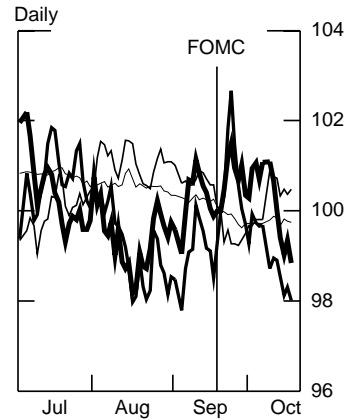
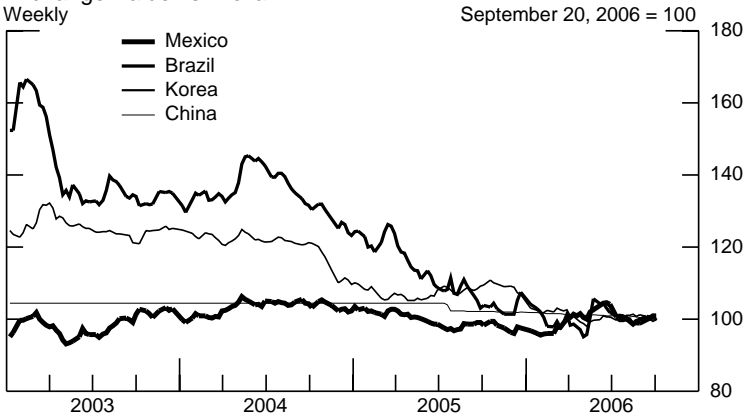


**Emerging Markets: Exchange Rates and Stock Market Indexes**

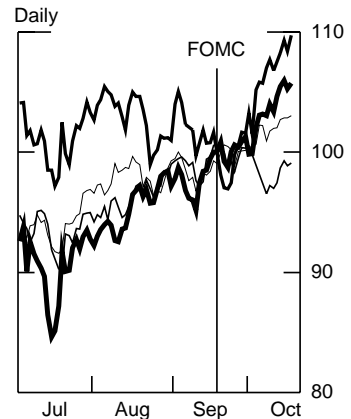
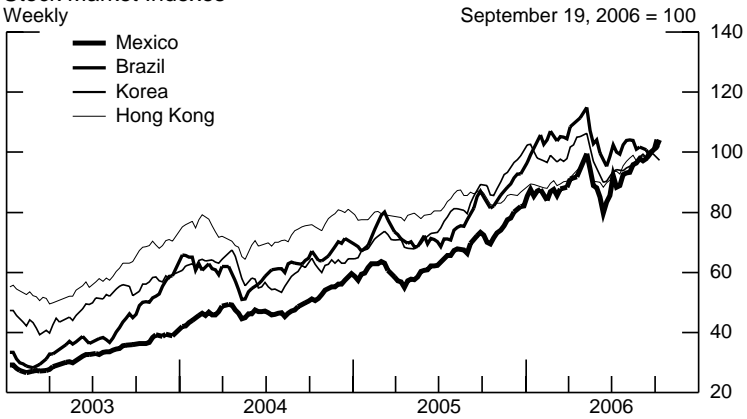
	Exchange value vs. dollar		Stock market index	
	Latest	Percent change since September FOMC*	Latest	Percent change since September FOMC
Mexico	10.8130	-1.2	22901	5.7
Brazil	2.1298	-2.0	39370	9.7
China	7.9066	-0.2	1787	3.2
Hong Kong	7.7848	-0.0	18048	3.1
Korea	955.2	0.5	1354	-0.9
Taiwan	33.18	0.8	7151	4.0
Singapore	1.5762	-0.5	685	4.2
Thailand	37.38	-1.1	719	2.3
India	45.31	-1.1	12858	6.2

\* Positive percent change denotes appreciation of U.S. dollar.

**Exchange Value vs. Dollar**  
Weekly



**Stock Market Indexes**  
Weekly



**Emerging Markets: Short-Term Interest Rates and Dollar-Denominated Bond Spreads**

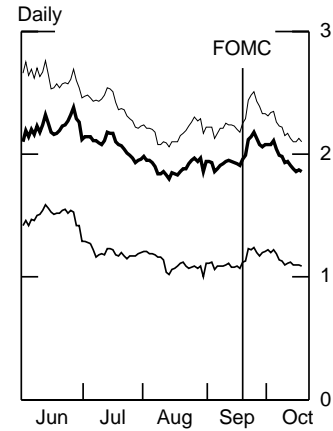
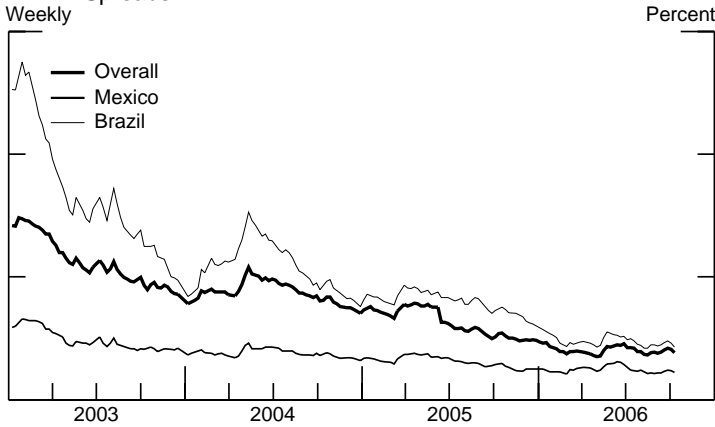
	Short-term interest rates*		Dollar-denominated bond spreads**		Percent
	Latest	Change since September FOMC	Latest	Change since September FOMC	
Mexico	7.07	0.15	1.09	-0.03	
Brazil	13.99	0.01	2.10	-0.15	
Argentina	9.75	-0.19	2.90	-0.33	
China	...	...	0.64	-0.02	
Korea	4.53	-0.03	...	...	
Taiwan	1.82	0.03	...	...	
Singapore	3.50	0.00	...	...	
Hong Kong	4.21	0.15	...	...	

\*One month interest rate except 1-week rate for Korea. No reliable short-term interest rate exists for China.

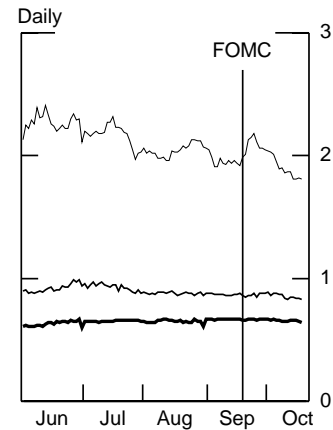
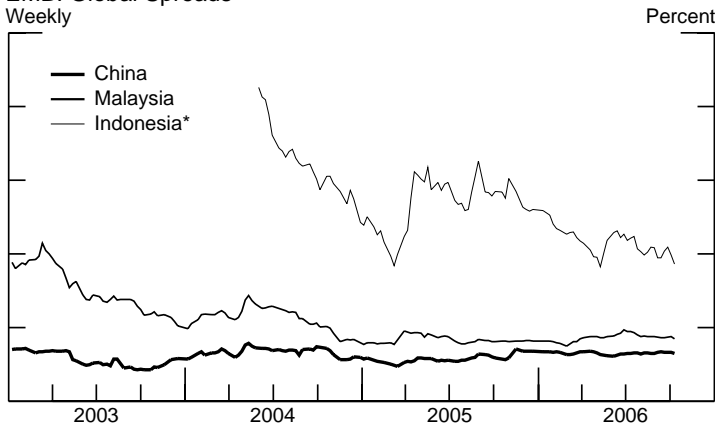
\*\*EMBI+ or EMBI Global Spreads over similar-maturity U.S. Treasuries.

... Korea, Taiwan, Singapore, and Hong Kong have no outstanding dollar-denominated sovereign bonds.

**EMBI+ Spreads**  
Weekly



**EMBI Global Spreads**  
Weekly



\*Begins May 2004.

## **Developments in Advanced Foreign Economies**

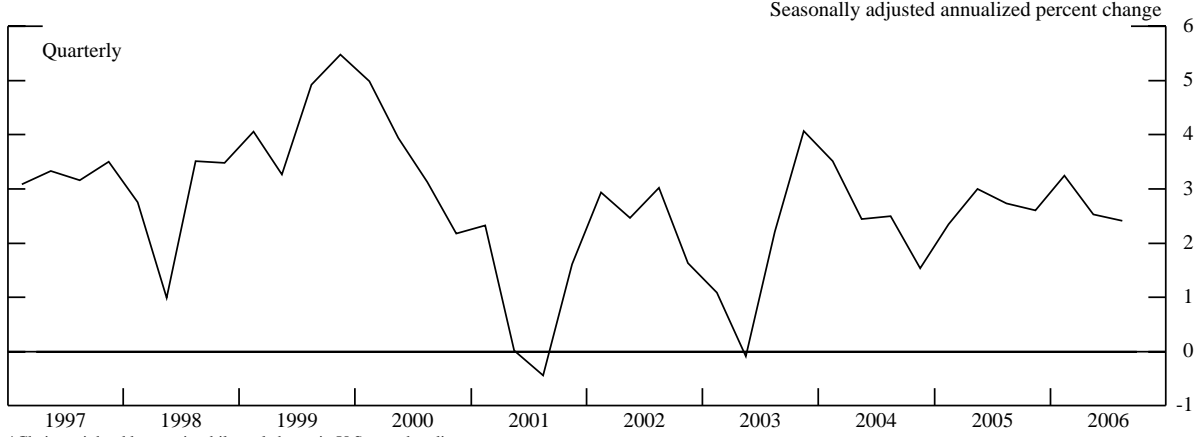
According to incoming data, economic activity in the foreign industrial economies continued to expand at a relatively solid pace in the third quarter. Indicators of investment spending suggest that the Japanese economy accelerated from the very slow second-quarter expansion. Euro-area industrial production and retail sales have exceeded expectations but lower exports probably slowed GDP. In the United Kingdom, business confidence improved while consumer sentiment declined, suggesting that the pace of economic activity remained near trend. Strong import data and a decline in housing starts point to moderate Canadian growth in the third quarter.

The drop in oil prices brought down headline inflation in most advanced foreign economies. In September, twelve-month inflation declined to 1.7 percent and 2.4 percent in the euro area and the United Kingdom, respectively. In Japan, by contrast, a surge in food prices led headline inflation to climb to 0.9 percent in August. As expected, the ECB raised its policy interest rate  $\frac{1}{4}$  percentage point on October 5.

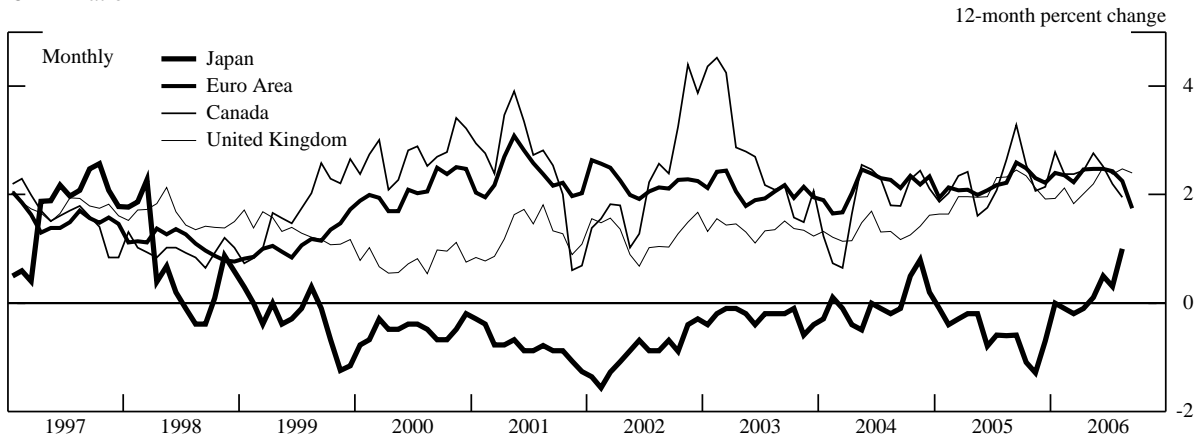
In **Japan**, household demand appears to have weakened in the third quarter. Average real household spending and retail sales for July and August fell 2.2 percent and 0.5 percent, respectively, from their levels in the second quarter despite a sharp rise in the reported real incomes of working households. Although private machinery orders and housing starts also fell on average over the same period, there are indications that investment spending remained solid. Production of capital goods rose 0.6 percent over July and August, and the Bank of Japan's September Tankan survey revealed that firms expect to increase capital spending by 8.3 percent in the current fiscal year, while large manufacturers reported plans to increase investment by 16.9 percent. The external sector also appeared to positively contribute to growth as the average level of real exports over July and August rose 3.4 percent above its level in the second quarter, while real imports fell 0.8 percent over the same period.

### Advanced Foreign Economies

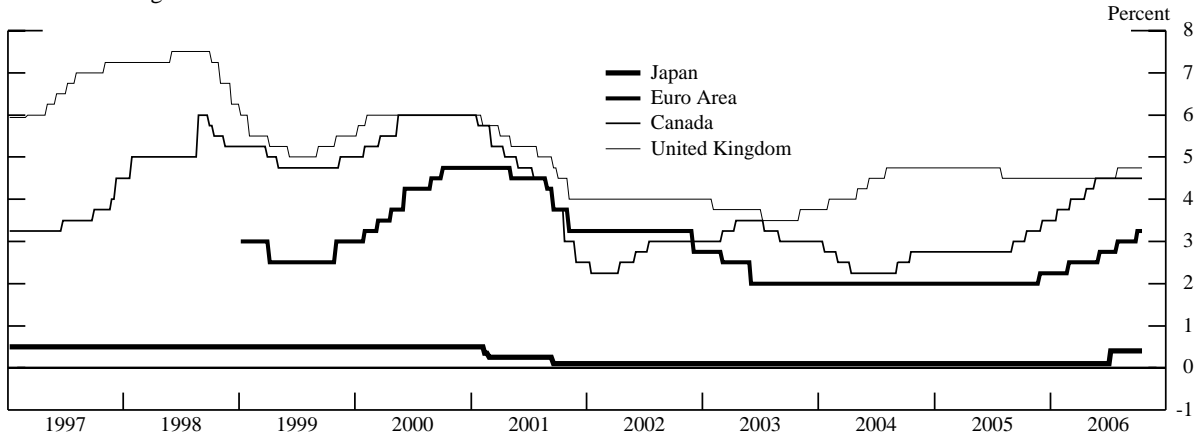
Average Real GDP\*



CPI Inflation



Official or Targeted Interest Rates



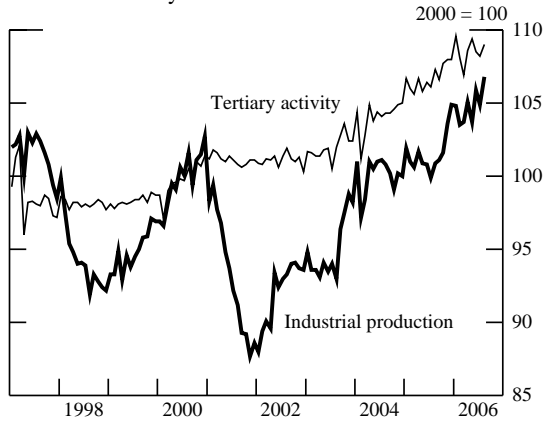
The unemployment rate held steady at 4.1 percent in August as the economy added 80 thousand jobs and the labor force increased by 150 thousand workers. The job openings-to-applications ratio (the number of officially posted job openings relative to the number of officially registered job seekers) fell slightly but remained at an elevated level. The healthy state of the job market was also reflected in the September Tankan survey, in which the number of firms reporting labor shortages increased across all corporate size categories and sectors. Despite these improvements, gross earnings, which include bonuses, fell 0.3 percent in the year to August while contractual earnings declined 0.1 percent.

The headline consumer price index rose 0.6 percent in August and was 1 percent higher than a year earlier. However, this increase was almost entirely due to a jump in food prices. Twelve-month core inflation (excluding fresh food only) was 0.3 percent and consumer prices excluding both fresh food and energy fell 0.4 percent from a year earlier. Year-over-year domestic wholesale goods inflation ticked up to 3.6 percent in August, and the wholesale service price index for August rose 0.3 percent from a year earlier, the first positive reading in eight years.

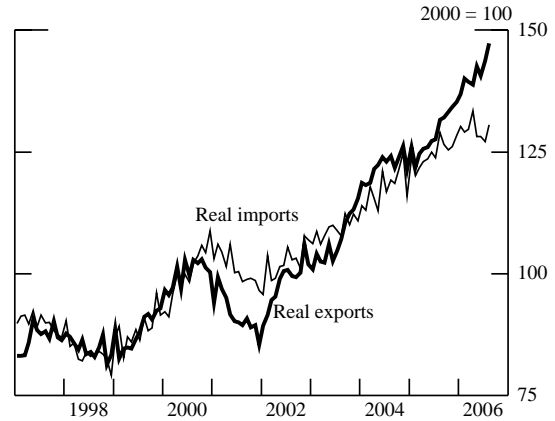
Shinzo Abe was elected Japan's new prime minister on September 26, scoring comfortable majorities in both houses. Abe appointed Yasuhisa Shiozaki, a former senior vice minister for foreign affairs, to the key post of chief cabinet secretary, and also picked Liberal Democratic Party veteran Koji Omi as finance minister and former Cabinet Office official Hiroko Ota as minister in charge of economic and fiscal policy. Minister Omi stated that the government will not begin a full-fledged debate on possible increases in the consumption tax until fall next year, vowing instead to focus on cutting government spending. Although he is expected to concentrate on foreign policy issues in the near term, in his inaugural policy speech to the lower house of Parliament Prime Minister Abe stressed his resolve to continue the structural reform programs initiated by his predecessor, Junichiro Koizumi, and pledged to draw up a long-term strategy to promote technology, innovation, and economic growth.

**Japan**

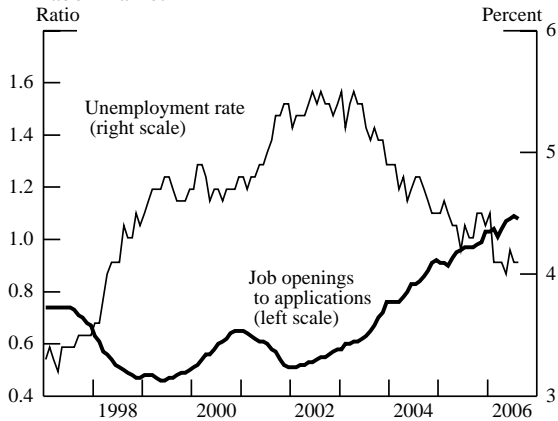
**Economic Activity**



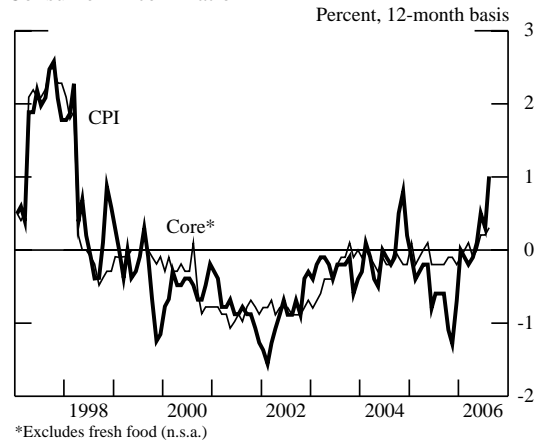
**Real Trade**



**Labor Market Ratio**



**Consumer Price Inflation**



\*Excludes fresh food (n.s.a.)

**Economic Indicators**

(Percent change from previous period except as noted, s.a.)

Indicator	2006			2006			
	Q1	Q2	Q3	June	July	Aug.	Sept.
Housing starts	1.7	2.5	n.a.	-0.9	-5.7	7.2	n.a.
Machinery orders <sup>1</sup>	-0.4	8.9	n.a.	8.5	-16.7	6.7	n.a.
Machinery shipments <sup>1</sup>	-0.2	3.6	n.a.	1.1	1.3	2.1	n.a.
New car registrations	2.7	-3.9	-3.8	2.0	-6.7	4.3	-0.6
Business sentiment <sup>2</sup>	5.0	6.0	6.0	...	...	...	...
Wholesale prices <sup>3</sup>	2.8	3.1	3.5	3.4	3.4	3.5	3.6

1. Private sector, excluding ships and electric power.

2. Tankan survey, diffusion index. Level.

3. Percent change from year earlier, n.s.a.

n.a. Not available. ... Not applicable.

Available indicators suggest that the **euro-area** economy continued to expand at a robust pace in the third quarter, even if a less dynamic external sector likely led to some moderation in the growth rate of overall activity.

In September, the European Commission survey of euro-area economic sentiment rose to its highest level in five and half years, with increased confidence in all sectors. Industrial confidence bounced back from a dip the previous month, with production expectations rebounding sharply and the reported volume of order books rising to within a hair of the previous business cycle peak in June 2000. Consumer confidence was buoyed by improvement in consumers' perceptions of both the general economic situation and their own financial situation. Similarly, Germany's IFO Business Climate Index edged down less than had been expected, to 104.9 in September from 105 in August. The current conditions component of the index reached a fifteen-year peak, indicating a continuation of the robust economic activity in the current quarter, but business expectations for the next six months declined for the third straight month.

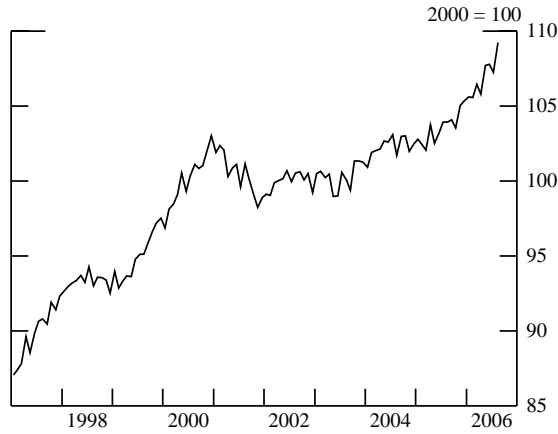
The domestic sector appears to be on relatively solid footing. Euro-area industrial production rose 1.8 percent in August, more than reversing the 0.5 percent fall posted in July. In Germany, the volume of industrial orders surged 3.7 percent in August, the fourth rise in five months and the biggest since April. In addition, euro-area retail sales rose 0.7 percent in August, and average sales for July and August were up 0.9 percent from the second quarter.

By contrast, the merchandise trade deficit in the euro area widened from a monthly average of about \$2.1 billion in the second quarter to an average \$7.4 billion over July and August. After having surged in the first half of the year, exports were flat on average in the first two months of the third quarter with respect to the second-quarter average, while imports grew 1.5 percent over the same period.

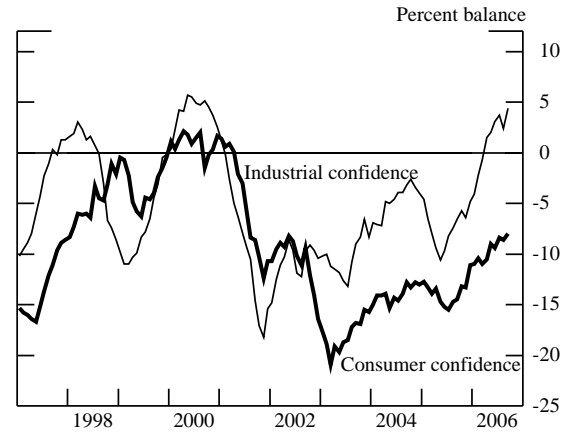
Labor market conditions remain on a gradual improving trend. However, the euro-area unemployment rate ticked up to 7.9 percent in August, as the number of jobless in Germany rose, in part because of the end of the World Cup games.

**Euro Area**

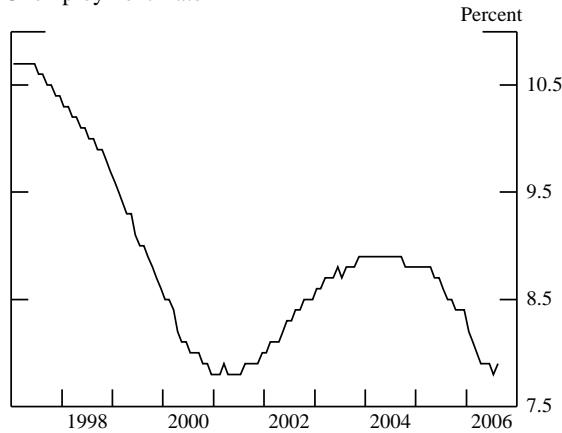
**Industrial Production**



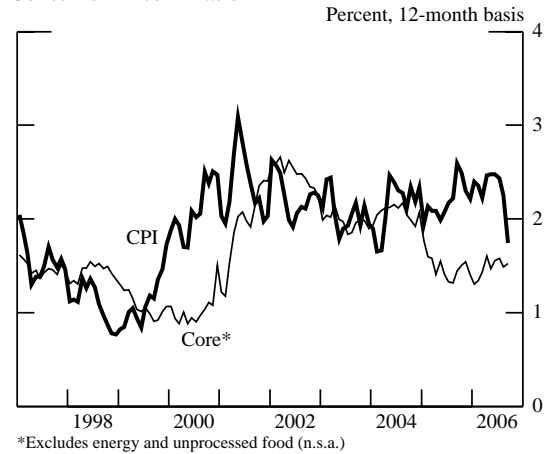
**Economic Sentiment**



**Unemployment Rate**



**Consumer Price Inflation**



**Economic Indicators**

(Percent change from previous period except as noted, s.a.)

Indicator	2006			2006			
	Q1	Q2	Q3	June	July	Aug.	Sept.
Industrial production <sup>1</sup>	1.2	1.2	n.a.	0.1	-0.5	1.8	n.a.
Retail sales volume <sup>2</sup>	0.3	0.6	n.a.	0.3	0.3	0.7	n.a.
Unemployment rate <sup>3</sup>	8.1	7.9	n.a.	7.9	7.8	7.9	n.a.
CPI <sup>4</sup>	2.3	2.5	2.1	2.5	2.4	2.3	1.7
Producer prices <sup>4</sup>	5.2	5.8	n.a.	5.8	6.0	5.7	n.a.
M3 <sup>4</sup>	8.5	8.5	n.a.	8.5	7.8	8.2	n.a.

1. Excludes construction.

2. Excludes motor vehicles.

3. Percent. Euro-area standardized to ILO definition. Includes Eurostat estimates in some cases.

4. Eurostat harmonized definition. Percent change from year earlier.

n.a. Not available. ... Not applicable.



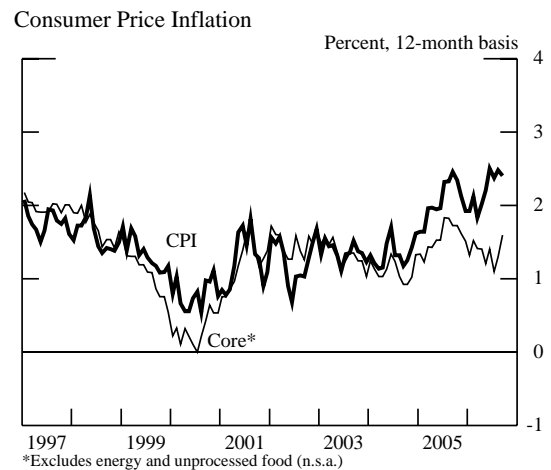
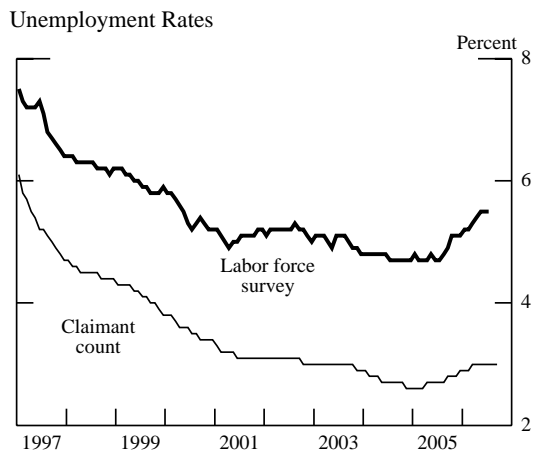
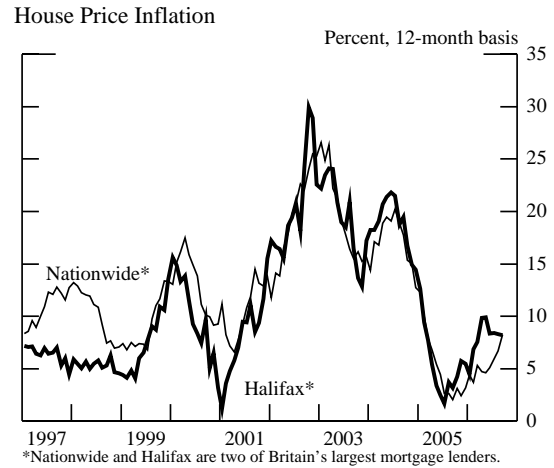
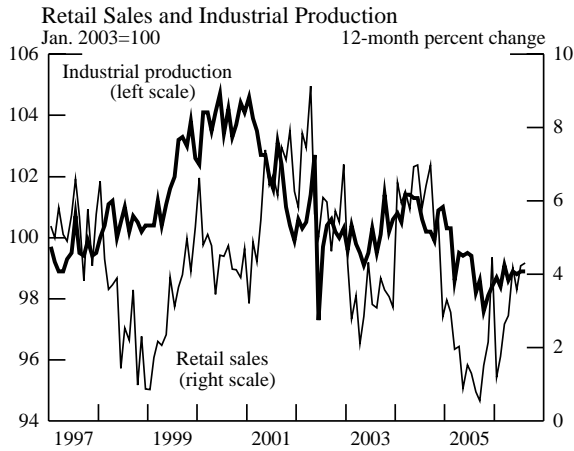
In September, the headline index of consumer prices edged down 0.1 percent from the previous month, and twelve-month rate of inflation dropped to 1.7 percent from 2.3 percent in August, the first reading below 2 percent since May 2005. The sharp decline was mostly due to the combined result of a favorable base effect, given the strong rise in energy prices in September 2005, as well as the recent drop in oil prices. Core inflation (excluding energy and food prices) remained steady at 1.5 percent. As expected, the ECB hiked its policy rate 25 basis points, to 3.25 percent, at its October 5 meeting. In addition, the ECB signaled that it will tighten again in December and used language that hinted at a pause thereafter.

In the **United Kingdom**, most data point to a slowdown of private consumption. Consumer confidence, which hit a three-year low in August, further deteriorated in September. Surveys of businesses providing services to consumers also showed a deterioration of optimism in the third quarter. On a more positive note, retail sales expanded 0.3 percent in August after losing momentum in July.

There are signs that the moderating effects of this slower consumption growth have been partly offset by a mild resurgence in investment. Business confidence continued to improve in the third quarter. In August, new construction orders recorded their second highest level since 1988. Industrial production stayed put in August as the decline in mining and quarrying activities was offset by an overall good performance in the manufacturing sector. According to the Bank of England Agent's Survey, investment intentions ticked up in August in the manufacturing sector, indicating mild growth, while they remained strong in the service sector. The service sector PMI ticked up to 56.7 in September while the manufacturing PMI firmed to 54.4 (where 50 is threshold for expansion), offsetting most of its decline since June. Readings in house prices collected by Nationwide and Halifax, two leading British lenders, both point to 8¼ percent increases in the year to September.

The claimant count as well as the unemployment rate held steady at 3 percent in September and 5.5 percent in August, respectively. A noticeable rise in the participation rate has imparted an upward drift to the Labor Force Survey measure of the unemployment rate since mid-2005, even as employment growth has been relatively solid.

**United Kingdom**



**Economic Indicators**

(Percent change from previous period except as noted, s.a.)

Indicator	2006			2006			
	Q1	Q2	Q3	June	July	Aug.	Sept.
Producer prices <sup>1</sup>	14.5	13.3	7.9	11.1	10.6	7.9	5.1
Average earnings <sup>1</sup>	4.1	4.3	n.a.	5.0	3.9	3.9	n.a.
Business confidence <sup>2</sup>	8.0	12.0	13.0	14.0	14.0	11.0	14.0
Consumer confidence <sup>3</sup>	-3.8	-4.7	-6.0	-5.2	-5.5	-5.8	-6.8
Trade balance <sup>4</sup>	-25.1	-24.5	n.a.	-7.5	-8.2	-8.4	n.a.
Current account <sup>4</sup>	-15.3	-12.8	n.a.	...	...	...	...

1. Percent change from year earlier.  
 2. Confederation of British Industry, percent balance.  
 3. Eurostat, percent balance.  
 4. Level in billions of US Dollars.  
 n.a. Not available. ... Not applicable.

The twelve-month inflation rate declined from 2.5 percent in August to 2.4 percent in September, pushed down by a negative 0.4 percentage point contribution from the fuels and lubricants component. Mounting price pressure remains a concern, however. Core inflation (excluding energy and unprocessed food) was up 0.3 percentage point to 1.6 percent in September. A survey conducted by the British Chambers of Commerce in the third quarter found that 32 percent of manufacturing firms and 28 percent of service firms expected to raise their prices. Moreover, British universities are allowed to charge up to £3,000 a year in tuition fees this academic year, up from the previous level of £1,175. The Bank of England expects this measure, which applies only to incoming cohorts of students, to increase headline inflation  $\frac{1}{4}$  percentage point in October.

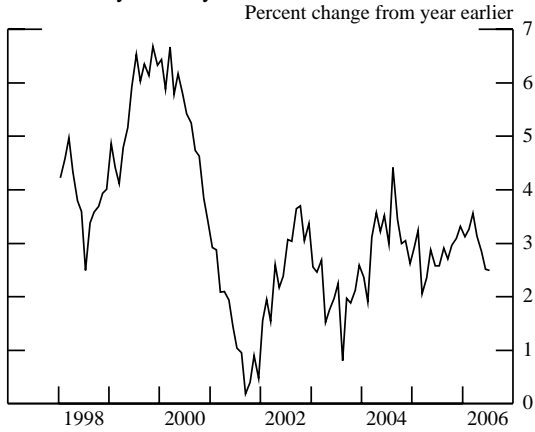
In **Canada**, real GDP by industry rose 2.3 percent (a.r.) in July, as increased activity in the energy, retail trade, and wholesale trade sectors more than offset a third consecutive monthly decline in output of the construction sector. Strong automobile and automotive product sales were behind much of the advances in wholesale and in retail trade. By contrast, sales at home centers and hardware stores were down substantially, consistent with the decline in the construction sector; especially steep was the decline of construction of single-family homes. Output of the manufacturing sector, which has been weak all year, was essentially unchanged from the previous month.

Other indicators also suggest that growth remained somewhat subdued in the third quarter. Housing starts slipped again in September, putting third-quarter housing starts three percent below their second-quarter level. The volume of manufacturing shipments rose in August, but new and unfilled orders both declined. Although the nominal merchandise trade balance expanded in August, its average level in July and August was about 6 percent below the second-quarter average, with nominal exports about 2.5 percent higher than and nominal imports nearly 4 percent higher than their respective second-quarter averages. By contrast, after declining for three straight months, the Ivey Purchasing Managers Index rose in September. In addition, the composite index of leading indicators accelerated in September.

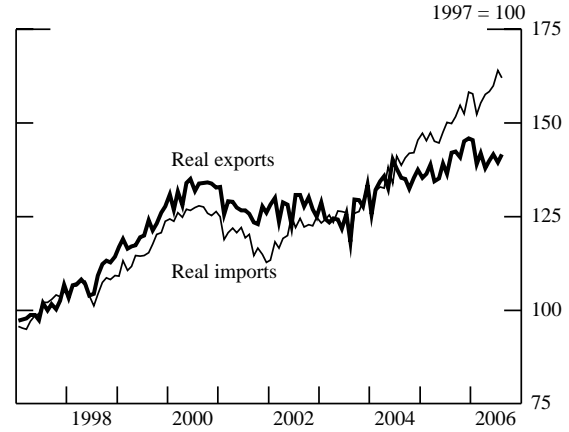
In September, total employment edged up slightly after three months of little change. Full-time employment, which has seen strong growth all year, (even through the recent lull in top-line employment growth) fell a bit in September. The unemployment rate inched down to 6.4 percent in September, but remained a bit higher than the 32-year-low of 6.1 percent touched in June.

**Canada**

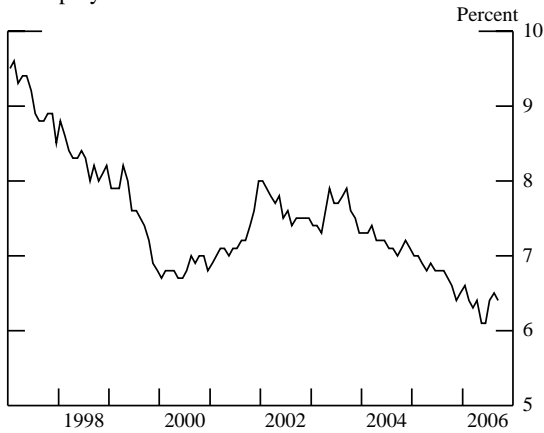
Real GDP by Industry



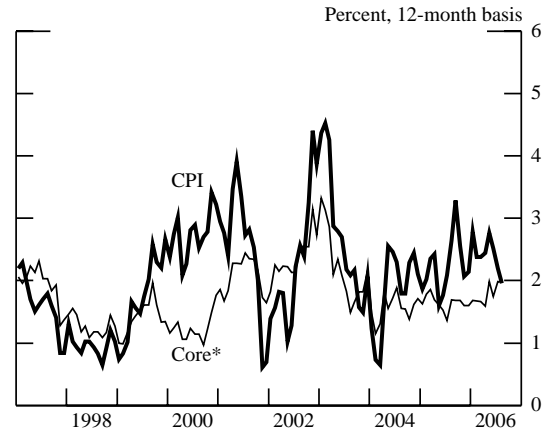
Real Trade



Unemployment Rate



Consumer Price Inflation



\*Excludes 8 volatile components and effects of indirect taxes (n.s.a.)

**Economic Indicators**

(Percent change from previous period except as noted, s.a.)

Indicator	2006			2006			
	Q1	Q2	Q3	June	July	Aug.	Sept.
Industrial production	-0.4	-0.7	n.a.	0.1	0.5	n.a.	n.a.
New manufacturing orders	-1.5	-1.6	n.a.	2.9	0.8	-1.1	n.a.
Retail sales	2.3	2.0	n.a.	0.0	0.4	n.a.	n.a.
Employment	0.4	0.8	0.1	-0.0	-0.0	-0.1	0.1
Consumer attitudes <sup>1</sup>	120.9	122.4	121.0	...	...	...	...
Business confidence <sup>1</sup>	146.0	142.9	n.a.	...	...	...	...

1. 1991=100.

n.a. Not available. ... Not applicable.

The twelve-month rate of consumer price inflation fell to 2 percent in August, the third consecutive month of decline. The recent deceleration of prices is in large part attributable to the retreat of gasoline prices. The twelve-month rate of core inflation (excluding the eight most volatile components and the effects of indirect taxes) held steady at 2 percent in August.

### **Economic Situation in Other Countries**

Across the emerging market economies, incoming data generally point to moderating, but robust, growth in the third quarter. Activity appears to be decelerating in China and Korea, but rebounded in the ASEAN region, notably in Singapore, and remains strong in India. In Latin America, indicators point to a moderation of growth in Mexico and Argentina, and to some pick up of activity in Brazil. Inflation has edged down in Asia but increased in Latin America of late. Emerging market economies appear to be resilient to the recent deterioration of the political environment in some countries.

In **China**, economic activity appears to be decelerating, owing to recent administrative and other measures taken to slow investment. Investment in fixed assets rose 20 percent over the twelve months ended August, down significantly from the growth rates in the range of 26 to 33 percent seen in the previous few months. However, the monthly investment series can be very noisy. The slowdown is also reflected in decreasing twelve-month growth of imports of machinery and transport equipment, and in a modest deceleration of M2 money supply and bank lending in August and September. China's trade surplus for the first nine months of this year amounted to \$160 billion (at an annual rate) compared with a surplus of \$102 billion for all of last year, reflecting a growth rate of exports that was significantly higher than that of imports.

**Chinese Economic Indicators**

(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q2	Q3	July	Aug.	Sept.
Real GDP <sup>1</sup>	9.6	9.9	12.1	n.a.	...	...	...
Industrial production	14.4	17.1	4.2	n.a.	-1.8	2.7	n.a.
Consumer prices <sup>2</sup>	2.5	1.6	1.4	n.a.	.9	1.3	n.a.
Merch. trade balance <sup>3</sup>	32.1	102.0	160.2	187.4	174.1	198.4	189.7

1. Annual rate. Quarterly data estimated by staff from reported four-quarter growth rates. Annual data are Q4/Q4.

2. Percent change from year-earlier period, except annual data, which are Dec./Dec.

3. Billions of U.S. dollars, annual rate. Imports are c.i.f.

n.a. Not available. ... Not applicable.

In **Hong Kong**, recent data suggest a rebound in activity following a lethargic second quarter. The quantity of exports and imports are now growing after falling in the second quarter, a potential indication of rising output growth in this entrepôt economy. The unemployment rate continued to edge down in the third quarter. Twelve-month inflation was 2.5 percent in August, largely reflecting rising food prices and housing rents.

**Hong Kong Economic Indicators**

(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q2	Q3	July	Aug.	Sept.
Real GDP <sup>1</sup>	7.3	7.4	.0	n.a.	...	...	...
Unemployment rate <sup>2</sup>	6.9	5.7	5.0	4.7	4.9	4.8	4.7
Consumer prices <sup>3</sup>	.4	1.3	2.0	n.a.	2.3	2.5	n.a.
Merch. trade balance <sup>4</sup>	-12.0	-10.5	-21.7	n.a.	-4.2	-21.4	n.a.

1. Annual rate. Annual data are Q4/Q4.

2. Percent. Monthly data are averages of the current and previous two months.

3. Percent change from year-earlier period, except annual data, which are Dec./Dec.

4. Billions of U.S. dollars, annual rate. Imports are c.i.f.

n.a. Not available. ... Not applicable.

In **Taiwan**, recent data suggest a moderation in real GDP growth from its strong second-quarter pace. The value of exports and imports fell in the third quarter after registering positive growth in the second. Similarly, the growth rates of industrial production and export orders for electronic products have edged down in the third quarter. Twelve-month inflation remained negative in September. The recent bout of deflation has been largely attributed to declines in food prices (as weather conditions improved this year) and to lower energy prices.

### Taiwan Economic Indicators

(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q2	Q3	July	Aug.	Sept.
Real GDP <sup>1</sup>	2.6	6.5	4.6	n.a.	...	...	...
Unemployment rate <sup>2</sup>	4.4	4.1	3.9	n.a.	3.9	3.9	n.a.
Industrial production	9.8	4.1	.6	n.a.	-.2	1.1	n.a.
Consumer prices <sup>3</sup>	1.6	2.2	1.5	-.3	.8	-.6	-1.2
Merch. trade balance <sup>4</sup>	6.1	7.8	12.7	15.0	14.6	5.3	24.9
Current account <sup>5</sup>	18.5	16.1	18.8	n.a.	...	...	...

1. Annual rate. Annual data are Q4/Q4.

2. Percent.

3. Percent change from year-earlier period, except annual data, which are Dec./Dec.

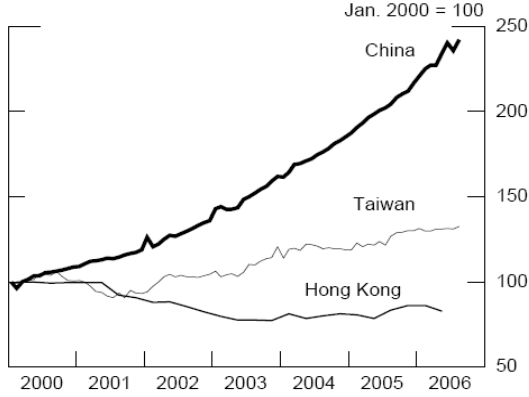
4. Billions of U.S. dollars, annual rate. Imports are c.i.f.

5. Billions of U.S. dollars, n.s.a., annual rate.

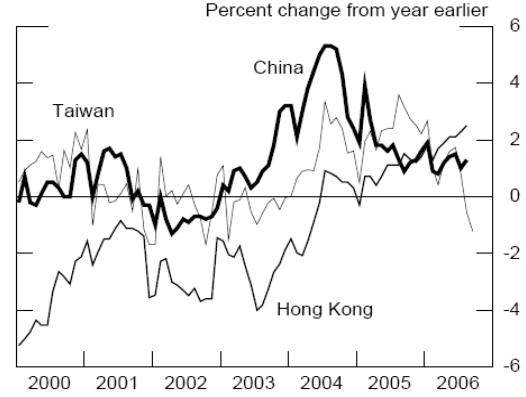
n.a. Not available. ... Not applicable.

**China, Hong Kong, and Taiwan**

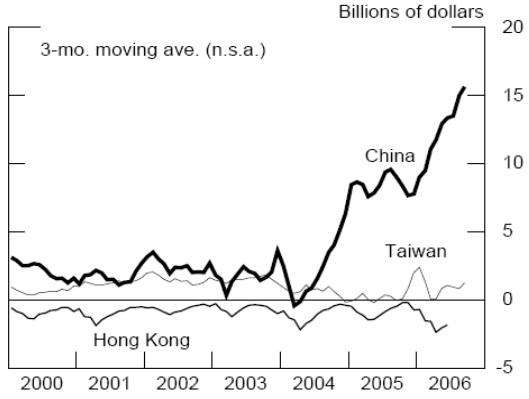
**Industrial Production**



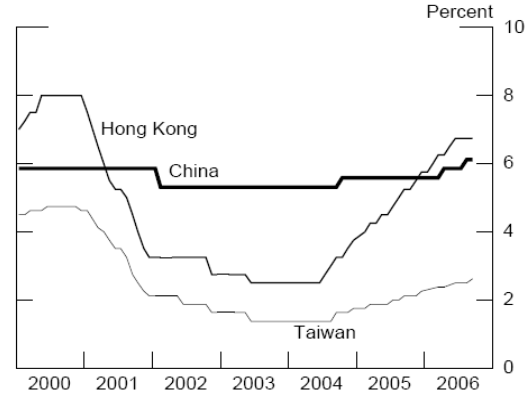
**Consumer Prices**



**Merchandise Trade Balances**



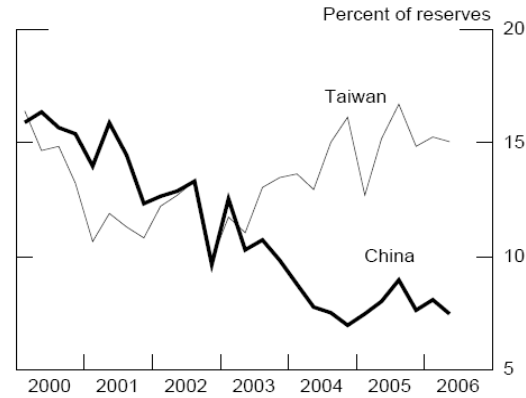
**Benchmark Interest Rates**



**Gross External Debt**



**Short-Term External Debt**





The **Korean** economy has continued to expand at a moderate pace. Industrial production partially rebounded in August after strikes and poor weather depressed July levels. Recent sentiment indicators are up a touch from their earlier lows, but do not yet reflect the impact of North Korea's nuclear test. Although the merchandise trade balance for August improved, the current account balance declined further as the service deficit widened. Consumer price inflation fell back to 2.4 percent over the 12 months ended September, reflecting a dip in food prices following an earlier weather-related spike.

### Korean Economic Indicators

(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q2	Q3	July	Aug.	Sept.
Real GDP <sup>1</sup>	2.9	5.3	3.4	n.a.	...	...	...
Industrial production	10.0	5.9	-4	n.a.	-4.0	3.7	n.a.
Unemployment rate <sup>2</sup>	3.5	3.7	3.5	3.5	3.5	3.5	3.5
Consumer prices <sup>3</sup>	3.0	2.6	2.3	2.5	2.3	2.9	2.4
Merch. trade balance <sup>4</sup>	37.6	33.5	24.9	n.a.	14.1	29.1	n.a.
Current account <sup>5</sup>	28.2	16.6	2.8	n.a.	-4.7	-6.1	n.a.

1. Annual rate. Annual data are Q4/Q4.

2. Percent.

3. Percent change from year-earlier period, except annual data, which are Dec./Dec.

4. Billions of U.S. dollars, annual rate. Imports are c.i.f.

5. Billions of U.S. dollars, n.s.a., annual rate.

n.a. Not available. . . . Not applicable.

**Indian** real GDP growth slowed to 7 percent in the second quarter from its blistering first-quarter pace. Sizable gains in manufacturing and services were tempered by weakness in construction and agriculture, and the trade balance and current account deteriorated significantly. More recently, average industrial production for July and August rose 1.4 percent above the second-quarter level, and the trade deficit has worsened so far in the third quarter. Twelve-month inflation of the closely watched wholesale price index remained near 5 percent in the third quarter. The high level of the central government's fiscal deficit through August suggests that, without a sharp improvement in September, the government will likely violate the mid-year targets set by the Fiscal Responsibility and Budget Management Act, thus requiring corrective measures and an explanatory statement to parliament.

### Indian Economic Indicators

(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q2	Q3	July	Aug.	Sept.
Real GDP <sup>1</sup>	7.0	7.5	6.9	n.a.	...	...	...
Industrial production	8.5	7.9	5.2	n.a.	-2.0	.6	n.a.
Consumer prices <sup>2</sup>	3.8	5.6	5.9	n.a.	6.3	5.0	n.a.
Wholesale prices <sup>2</sup>	6.7	4.4	4.6	4.9	4.8	5.0	4.8
Merch. trade balance <sup>3</sup>	-21.7	-39.8	-42.7	n.a.	-46.2	-39.2	n.a.
Current account <sup>4</sup>	.8	-8.3	-24.4	n.a.	...	...	...

1. Annual rate. Annual data are Q4/Q4.

2. Percent change from year-earlier period, except annual data, which are Dec./Dec.

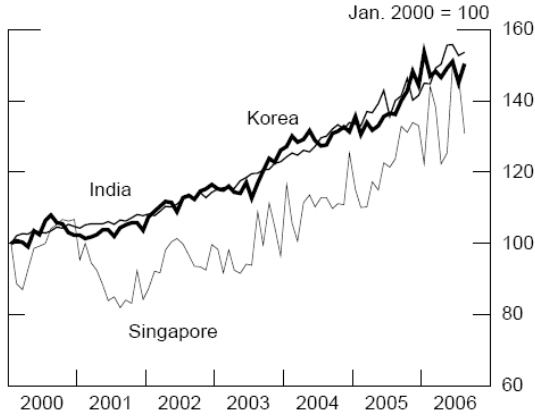
3. Billions of U.S. dollars, annual rate.

4. Billions of U.S. dollars, n.s.a., annual rate.

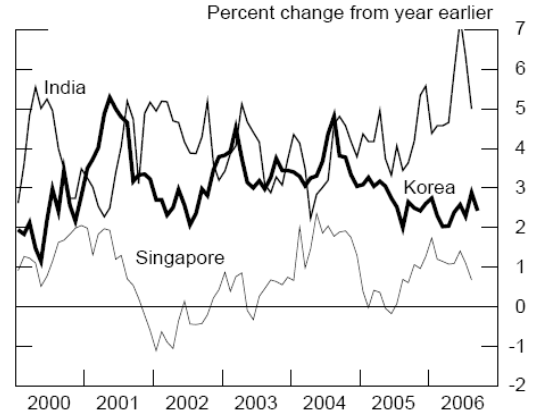
n.a. Not available. ... Not applicable.

### India, Korea, and Singapore

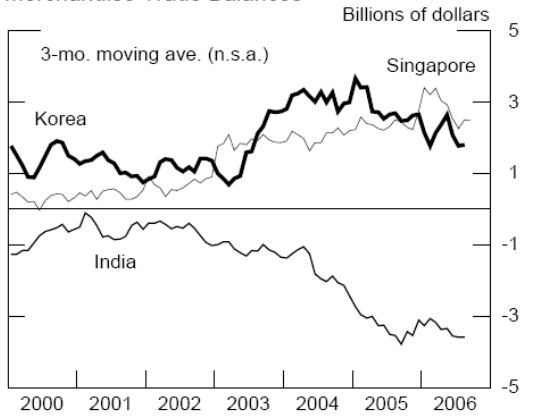
Industrial Production



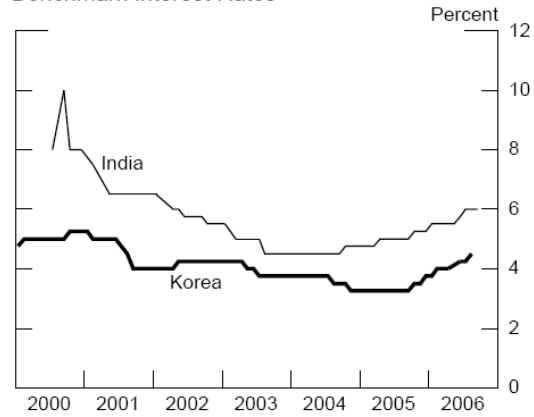
Consumer Prices



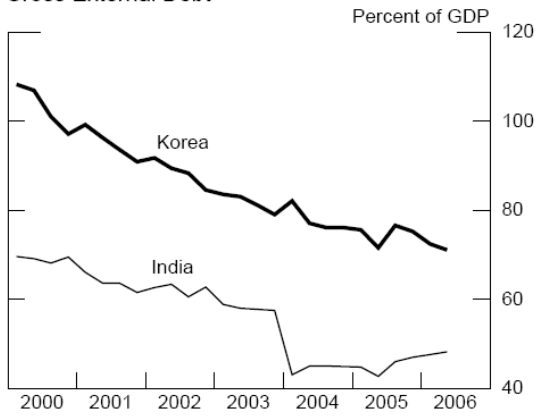
Merchandise Trade Balances



Benchmark Interest Rates



Gross External Debt



Short-Term External Debt



Incoming data for the **ASEAN** region suggest that economic activity expanded at a solid pace in the third quarter. In Singapore, the advance unofficial estimate of third-quarter real GDP growth (not shown) indicate that growth jumped to 6.0 percent, twice the pace in the second quarter, due in part to a rebound of activity in the volatile biomedical sector. Elsewhere in the region, industrial production was up recently and trade balances improved from second-quarter levels in Indonesia, Malaysia, and Thailand.

Twelve-month consumer price inflation in the region continued to decline due in part to waning effects of earlier energy price increases, although previous tightening of monetary policy across the region also contributed. Citing the moderation in inflation and the need to stimulate domestic demand, Bank Indonesia lowered interest rates 50 basis points on October 5, the fifth rate reduction since May. Separately, Bank Indonesia announced on October 11 that it has repaid the remainder of the country's debt to the IMF (around \$3.2 billion), nearly four years ahead of schedule, amid an improved balance of payments and a strengthening of economic fundamentals.

In Thailand, Army Chief General Sonthi Boonyaratkalin led a military coup that ousted Prime Minister Thaksin on September 19. Since then, the Council for National Security (the group of army officers who staged the coup) has appointed retired General Surayud Chulanont as Prime Minister to lead the new government; the central bank governor, Pridiyathorn Devakula, became Deputy Prime Minister and Finance Minister. His deputy governor in charge of the financial institutions stability, Tarisa Watanagase, replaced him on October 17. Following the appointment, she issued a statement indicating continuity in monetary policy going forward. The government is expected to, among other things, administer the 2007 budget, help craft a new constitution, and prepare elections by October of next year. Market reaction to the coup has been benign, with little signs of spillover to other countries in the region, and risks of a financial or economic crisis appear low.

**ASEAN Economic Indicators: Growth**  
(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q1	Q2	June	July	Aug.
<i>Real GDP<sup>1</sup></i>							
Indonesia	7.0	5.0	3.5	7.0	...	...	...
Malaysia	5.9	5.2	10.5	1.4	...	...	...
Philippines	5.5	5.5	4.6	6.8	...	...	...
Singapore	6.6	8.5	7.6	3.0	...	...	...
Thailand	5.4	4.7	3.4	4.2	...	...	...
<i>Industrial production<sup>2</sup></i>							
Indonesia <sup>3</sup>	3.3	1.3	-3.9	8.1	4.3	6.3	n.a.
Malaysia	11.7	4.1	3.9	.2	9.0	-6.6	4.9
Philippines	1.0	2.2	-15.8	1.5	-2.3	-2.5	n.a.
Singapore	13.9	9.5	1.6	-1.7	19.6	-1.9	-11.0
Thailand	11.8	9.0	2.7	1.5	.6	-1.1	2.9

1. Annual rate. Annual data are Q4/Q4.

2. Annual data are annual averages.

3. Staff estimate.

n.a. Not available. . . . Not applicable.

**ASEAN Economic Indicators: Merchandise Trade Balance**  
(Billions of U.S. dollars, s.a.a.r.)

Indicator	2004	2005	2006				
			Q2	Q3	July	Aug.	Sept.
Indonesia	25.1	28.0	34.2	n.a.	40.4	39.1	n.a.
Malaysia	21.2	26.4	27.4	n.a.	34.8	30.1	n.a.
Philippines	-4.4	-6.2	-3.6	n.a.	-4.6	n.a.	n.a.
Singapore	25.1	29.6	30.4	29.9	25.5	30.6	33.6
Thailand	1.5	-8.5	-3.0	n.a.	1.3	5.2	n.a.

n.a. Not available.

**ASEAN Economic Indicators: CPI Inflation**  
(Percent change from year earlier, except as noted)

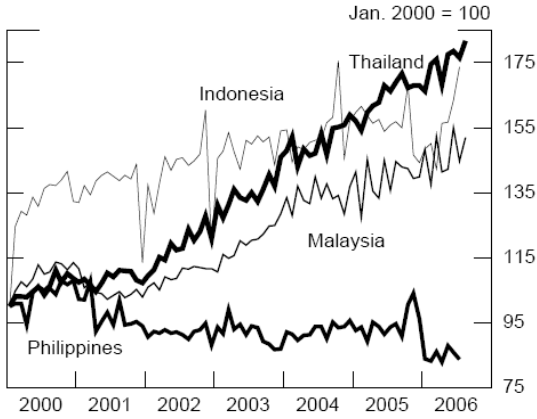
Indicator	2004 <sup>1</sup>	2005 <sup>1</sup>	2006				
			Q2	Q3	July	Aug.	Sept.
Indonesia	6.6	17.0	15.5	14.8	14.9	15.0	14.3
Malaysia	2.2	3.3	4.1	3.6	4.1	3.3	3.3
Philippines	8.6	6.7	6.9	6.1	6.4	6.3	5.7
Singapore	1.3	1.3	1.2	n.a.	1.1	.7	n.a.
Thailand	2.9	5.8	6.0	3.6	4.4	3.8	2.7

1. Dec./Dec.

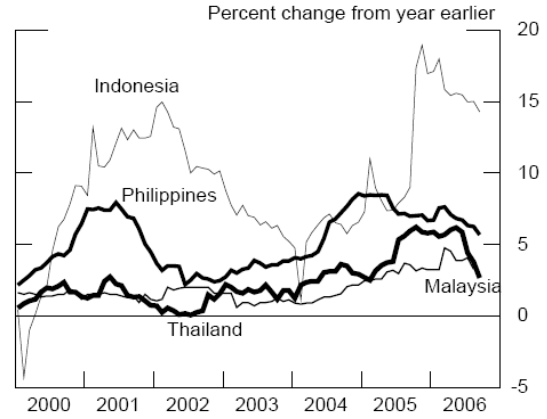
n.a. Not available

**ASEAN-4**

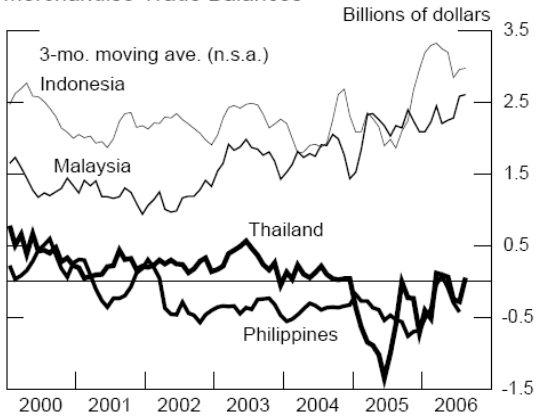
**Industrial Production**



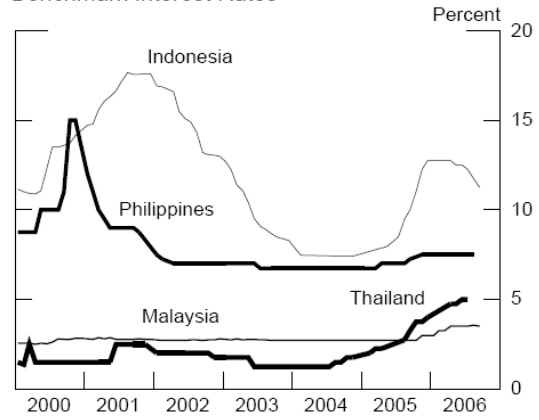
**Consumer Prices**



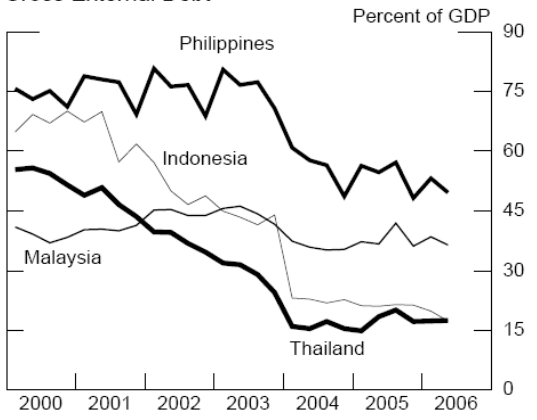
**Merchandise Trade Balances**



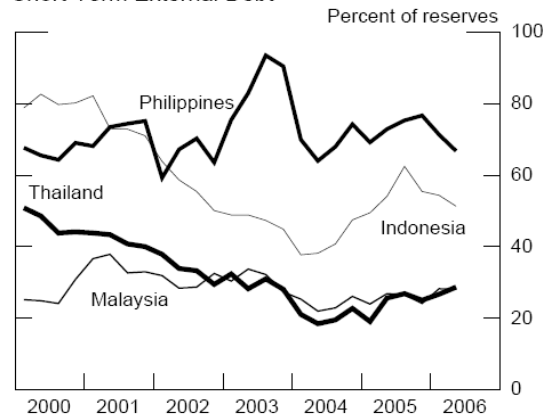
**Benchmark Interest Rates**



**Gross External Debt**



**Short-Term External Debt**



Recent indicators for **Mexico** point to a step-down in growth in the third quarter after two consecutive exceptionally strong quarters. The index of overall economic activity (a monthly proxy for real GDP) rose only 0.2 percent in July from the previous month. Industrial production was down in July and flat in August. Twelve-month headline inflation was 4.1 percent in September, slightly above the target range of 2 to 4 percent. The higher-than-expected inflation reading was the result of some food prices increases, mainly for tomatoes. On the political front, the radical opposition from the losing leftist party to the declaration of conservative Felipe Calderon as president-elect appears to have abated.

### Mexican Economic Indicators

(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q2	Q3	July	Aug.	Sept.
Real GDP <sup>1</sup>	4.8	2.7	6.1	n.a.	...	...	...
Overall economic activity	3.8	3.3	1.0	n.a.	.2	n.a.	n.a.
Industrial production	3.9	1.9	1.3	n.a.	-6	.0	n.a.
Unemployment rate <sup>2</sup>	3.9	3.6	3.4	n.a.	3.6	3.6	n.a.
Consumer prices <sup>3</sup>	5.2	3.3	3.1	3.5	3.1	3.5	4.1
Merch. trade balance <sup>4</sup>	-8.8	-7.6	-5.2	n.a.	-4.4	-5.3	n.a.
Merchandise imports <sup>4</sup>	196.8	221.8	256.7	n.a.	259.8	265.5	n.a.
Merchandise exports <sup>4</sup>	188.0	214.2	251.6	n.a.	255.4	260.2	n.a.
Current account <sup>5</sup>	-6.6	-4.6	4.6	n.a.	...	...	...

1. Annual rate. Annual data are Q4/Q4.

2. Percent; counts as unemployed those working one hour a week or less.

3. Percent change from year-earlier period, except annual data, which are Dec./Dec.

4. Billions of U.S. dollars, annual rate.

5. Billions of U.S. dollars, n.s.a., annual rate.

n.a. Not available. ... Not applicable.

Recent indicators for **Brazil** have been mixed, but generally point to a rebound in activity from a tepid second quarter. Industrial production was up in July and August, and the trade balance improved considerably in the third quarter, but September vehicle sales disappointed. Twelve-month consumer price inflation was 3.7 percent in August and September, well below its 2005 level. Inflation is at its lowest level since inflation targeting was launched in 1999 aided, in recent months, by declines in prices of food and fuel ethanol. In late September, the government removed a requirement that outward investments be intermediated by banks in Brazil, thereby easing controls on outward movement of capital by residents.



In the October 1 presidential election, President Lula fell short of achieving a simple majority, forcing him to go into a runoff against conservative Geraldo Alckmin on October 29. Lula is expected to win the election, but there are concerns that he will have difficulties pushing reform proposals through an uncooperative congress.

### Brazilian Economic Indicators

(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q2	Q3	July	Aug.	Sept.
Real GDP <sup>1</sup>	4.8	1.5	1.8	n.a.	...	...	...
Industrial production	8.3	3.1	.9	n.a.	.7	.7	n.a.
Unemployment rate <sup>2</sup>	11.5	9.8	10.0	n.a.	10.9	10.6	n.a.
Consumer prices <sup>3</sup>	7.6	5.7	4.3	3.8	4.0	3.8	3.7
Merch. trade balance <sup>4</sup>	33.7	44.8	38.7	49.8	59.6	47.2	42.6
Current account <sup>5</sup>	11.7	14.2	5.2	n.a.	36.5	25.1	n.a.

1. Annual rate. Annual data are Q4/Q4.

2. Percent.

3. Percent change from year-earlier period, except annual data, which are Dec./Dec.

Price index is IPCA.

4. Billions of U.S. dollars, annual rate.

5. Billions of U.S. dollars, n.s.a., annual rate.

n.a. Not available. . . . Not applicable.

Indicators for **Argentina** suggest that growth may moderate a bit in the third quarter from the strong pace in the second. Industrial production in July and August was just 1.4 percent on average above its level in the previous quarter. Twelve-month inflation remained elevated in August, but lower than last year, due in part to the voluntary price agreements the government has secured in several sectors.

### Argentine Economic Indicators

(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q2	Q3	July	Aug.	Sept.
Real GDP <sup>1</sup>	9.0	8.9	8.8	n.a.	...	...	...
Industrial production	10.7	7.7	2.5	n.a.	.3	.1	n.a.
Unemployment rate <sup>2</sup>	13.6	11.6	10.4	n.a.	...	...	...
Consumer prices <sup>3</sup>	5.9	12.2	11.4	10.6	10.6	10.8	10.5
Merch. trade balance <sup>4</sup>	12.1	11.4	14.2	n.a.	10.8	13.3	n.a.
Current account <sup>5</sup>	3.4	5.8	10.0	n.a.	...	...	...

1. Annual rate. Annual data are Q4/Q4.

2. Percent; n.s.a.

3. Percent change from year-earlier period, except annual data, which are Dec./Dec.

4. Billions of U.S. dollars, annual rate.

5. Billions of U.S. dollars, n.s.a., annual rate.

n.a. Not available. ... Not applicable.

In **Venezuela**, available information suggests that economic activity has remained strong in the third quarter. Auto sales in September were up 90 percent from a year earlier. Expansionary fiscal and monetary policies lifted twelve-month inflation to 15½ percent in September despite government measures to rein in inflation, including price controls on food.

### Venezuelan Economic Indicators

(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q2	Q3	July	Aug.	Sept.
Real GDP <sup>1</sup>	12.1	10.2	15.2	n.a.	...	...	...
Unemployment rate <sup>2</sup>	15.1	12.2	10.1	n.a.	9.5	n.a.	n.a.
Consumer prices <sup>3</sup>	19.2	14.4	11.2	14.6	13.5	14.9	15.4
Non-oil trade balance <sup>4</sup>	-10.5	-16.5	-26.7	n.a.	n.a.	n.a.	n.a.
Merch. trade balance <sup>4</sup>	21.4	31.5	41.8	n.a.	n.a.	n.a.	n.a.
Current account <sup>5</sup>	13.8	25.4	33.1	n.a.	...	...	...

1. Annual rate. Annual data are Q4/Q4.

2. Percent.

3. Percent change from year-earlier period, except annual data, which are Dec./Dec.

4. Billions of U.S. dollars, annual rate.

5. Billions of U.S. dollars, n.s.a., annual rate.

n.a. Not available. ... Not applicable.

In **Turkey**, incoming data suggest a slowdown in activity from its strong second-quarter pace. Industrial production was down on average in recent months, and the trade and current account balance continued to deteriorate. Twelve-month consumer prices edged up to 10.5 percent in September, opening the possibility of additional interest rate increases. Turkey remains on-track with its IMF program.

### Turkey Economic Indicators

(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q2	Q3	July	Aug.	Sept.
Real GDP <sup>1</sup>	9.0	7.4	7.4	n.a.	...	...	...
Industrial production	9.8	5.4	6.8	n.a.	-5.1	1.1	n.a.
Consumer prices <sup>2</sup>	9.4	7.7	9.6	10.8	11.7	10.3	10.5
Merch. trade balance <sup>3</sup>	-34.4	-43.3	-59.2	n.a.	-49.5	-57.8	n.a.
Current account <sup>4</sup>	-15.6	-23.1	-35.5	n.a.	-30.9	-34.4	n.a.
Unemployment rate	10.3	10.3	9.7	n.a.	...	...	...

1. Percent change from year-earlier period. Annual data are annual averages.

2. Percent change from year-earlier period, except annual data, which are Dec./Dec.

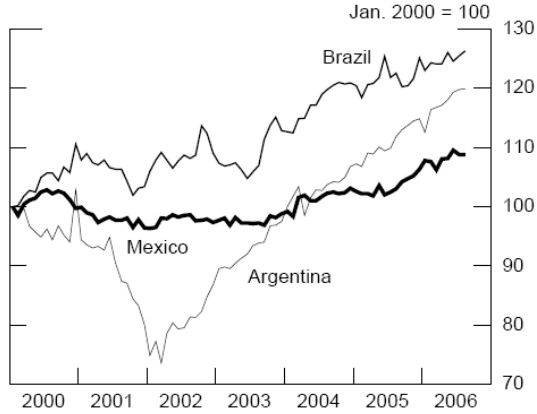
3. Billions of U.S. dollars, annual rate. Imports are c.i.f.

4. Billions of U.S. dollars, n.s.a., annual rate.

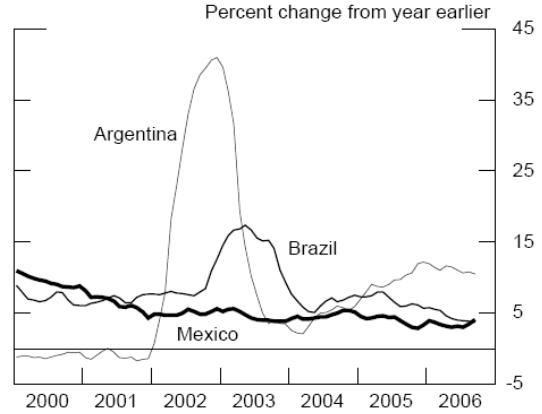
n.a. Not available. ... Not applicable.

Latin America

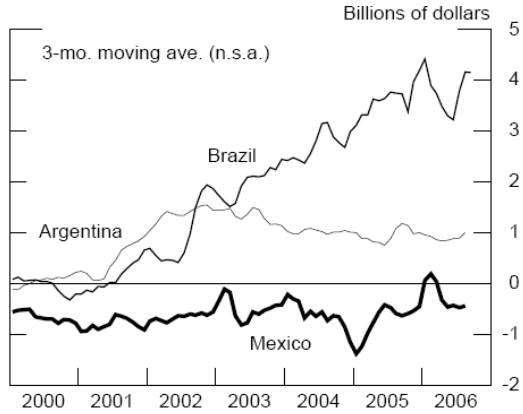
Industrial Production



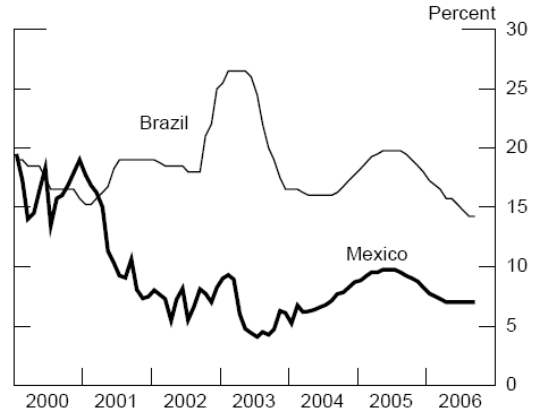
Consumer Prices



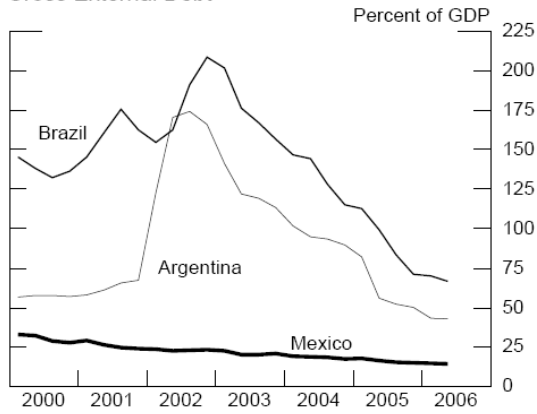
Merchandise Trade Balances



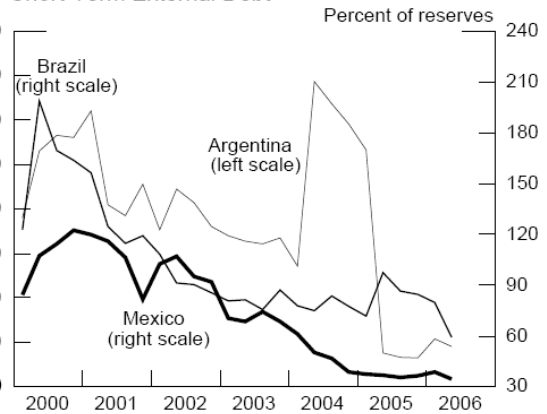
Benchmark Interest Rates



Gross External Debt



Short-Term External Debt



In **South Africa**, real GDP rose nearly 5 percent in the second quarter, due mostly to a rebound in government expenditures that more than offset a contraction in the external sector. More recently, average production was up from second-quarter levels, notably in the mining sector, but the trade balance continues to deteriorate due to excess growth of imports over exports. Twelve-month consumer price inflation has been rising of late, reaching 5.1 percent in August. The higher inflation owes to a weakening currency, rising food prices, and strong consumer spending, and has raised concern that it might exceed the central bank's 3-6 percent target range in coming months. Citing the need to contain inflation, the South African Reserve Bank raised its key interest rate 50 basis points to 8.5 percent on October 12.

The current account has widened significantly in the first half of this year, mostly reflecting a deterioration of the trade balance, but also large dividend payments to foreign shareholders. The wider current account deficit, among other factors, has put pressure on the currency, which has depreciated about 20 percent against the US dollar since January of this year.

### South African Economic Indicators

(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q1	Q2	June	July	Aug.
Real GDP <sup>1</sup>	5.6	4.3	4.0	4.9	...	...	...
Manuf. Production	4.2	3.6	1.0	1.5	1.7	-4	-7
Mining Production	3.7	1.2	-1.0	3.4	5.8	-4.3	3.1
Consumer Prices <sup>2</sup>	4.3	4.1	4.4	4.3	4.9	5.0	5.1
Merch. trade Balance <sup>3</sup>	-1.3	-2.9	-9.9	-9.7	-12.8	-11.6	-9.0
Current Account <sup>3</sup>	-7.5	-10.1	-14.2	-16.9	...	...	...

1. Annual Rate. Annual data are Q4/Q4.

2. Percent change from year-earlier period for the CPIX, except annual data, which are Dec./Dec.

3. Billions of U.S. dollars, n.s.a., annual rate.

... Not applicable.