Monetary Policy and Economic Developments

Monetary Policy and the Economic Outlook

The year 2004 was marked by continued expansion in economic activity and appreciable gains in employment. With fiscal policy stimulative, monetary policy accommodative, and financial conditions favorable, household spending remained buoyant and businesses increased investment in capital equipment and inventories, despite the restraint imposed by sizable increases in oil prices. Labor market conditions improved significantly, albeit at an uneven pace, and productivity rose notably further. Consumer price inflation moved higher with the surge in energy prices, but core consumer price inflation (that is, excluding food and energy) remained well contained, and measures of expected inflation over longer horizons held steady or edged lower.

Although economic activity had increased substantially in 2003, the expansion nevertheless appeared somewhat tentative as 2004 opened, in large measure because businesses still seemed to be reluctant to boost hiring. Over the course of the spring, however, it became clearer that the expansion was solidifying. Businesses added appreciably to their payrolls, boosted investment in equipment and software, and started restocking inventories. While household spending growth softened somewhat, residential construction expanded rapidly. Rising energy prices boosted overall consumer price inflation, and core inflation moved up as well. In response to positive economic news and higher inflation during this period, market participants came to anticipate that monetary policy tightening would begin sooner than they had expected, and interest rates increased considerably. With the economic expansion more firmly established and slack in labor and product markets somewhat diminished, the Federal Open Market Committee (FOMC) at its June meeting began to reduce the substantial degree of monetary accommodation that was in place.

The gradual removal of monetary policy stimulus continued in the second half of the year as the economy expanded at a healthy clip on balance. Around midyear, some measures of growth in activity softened, partly because of the drain on income and the rise in business costs created by higher oil prices. The expansion of consumer spending slowed in the spring, and the pace of hiring and gains in industrial production dropped back notably during the summer. Equity prices and longer-term interest rates moved lower over this period as well. In the event, the slowdown in household spending growth proved short lived. Both hiring and increases in factory output stepped up again in the autumn, and these gains were extended early this year. With profits healthy and financial conditions still supportive, capital spending increased at a brisk pace throughout the year. Over the final quarter of 2004, short-term interest rates rose further as monetary policy was firmed at each FOMC meeting, but long-term interest rates were largely unchanged. Equity prices rose appreciably in the fourth

NOTE. The discussion here and in the next section (“Economic and Financial Developments in 2004 and Early 2005”) consists of the text, tables, and selected charts from the Monetary Policy Report submitted to the Congress on February 16, 2005, pursuant to section 2B of the Federal Reserve Act.

quarter, and the dollar depreciated against most other major currencies. The FOMC increased the target federal funds rate 25 basis points again at its meeting this month, bringing the cumulative tightening over the past year to 1½ percentage points.

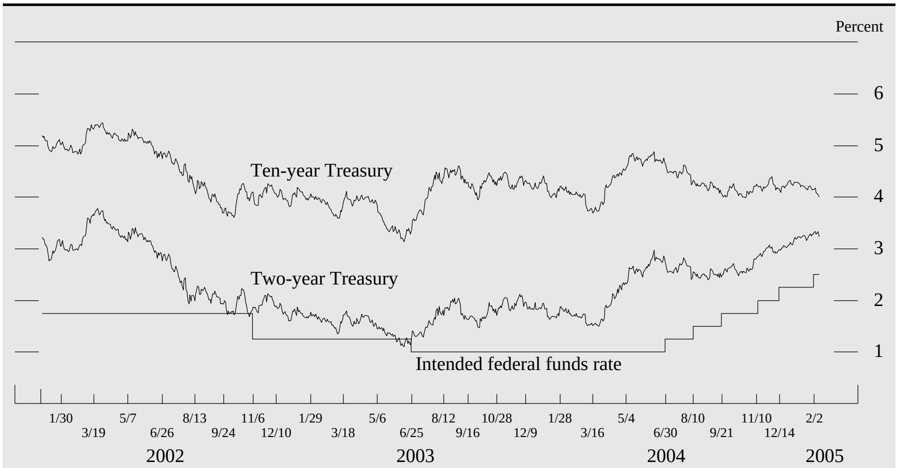
The fundamental factors underlying the continued strength of the economy last year should carry forward into 2005 and 2006, promoting both healthy expansion of activity and low inflation. Monetary policy is still accommodative, and financial conditions more generally continue to be advantageous for households and firms. Profits have been rising briskly, and corporate borrowing costs are low. Household net worth has increased with the continued sharp rise in the value of real estate assets as well as gains in equity prices, and this will likely help support consumer demand in the future. Absent a significant increase in oil prices from current levels, the drag from last year's run-up should wane this year. The lagged effects of the decline in the exchange value of the dollar since the autumn and sustained foreign economic growth are likely to boost the demand for U.S. exports. The prospects for the expansion of aggregate supply also appear to be quite favorable. Gains in structural labor productivity should continue, although not necessarily at the pace of recent years. Economic growth will likely be sufficient to generate notable increases in employment, although any reversal of the decline in labor force participation observed since 2001 would tend to hold up the unemployment rate. Core consumer price inflation has remained low since the larger increases posted in the early months of 2004, and long-term inflation expectations have been similarly well contained. With some slack likely remaining in labor and product markets at present and with the indirect effects of higher oil and import prices diminishing, the prospects for inflation staying low are good. A favorable economic outcome is, of course, not assured, but at the most recent FOMC meeting the Committee again assessed the risks to both output and inflation as balanced. The Committee also reaffirmed that it is prepared to respond to events as necessary in its pursuit of price stability.

Monetary Policy, Financial Markets, and the Economy in 2004 and Early 2005

In early 2004, against the backdrop of stimulative fiscal and monetary policy, continued rapid growth in productivity, and supportive financial market conditions, business outlays appeared to be firming significantly and household spending remained strong. The FOMC became more confident that the economic expansion was likely gaining traction and that the risk of significant further disinflation had been greatly reduced. In these circumstances, it recognized that a highly accommodative stance for monetary policy could not be maintained indefinitely. Nonetheless, the Committee was concerned about the persistently slow pace of hiring and viewed underlying inflation pressures as likely to remain subdued. Accordingly, the Committee left its target for the federal funds rate unchanged at 1 percent at its January and March meetings. However, beginning in January, it modified the language of its policy statement to gain greater flexibility to tighten policy should circumstances warrant by indicating that monetary policy accommodation would eventually have to be removed. At the same time, the Committee suggested that it could be patient in undertaking such actions.

By the time of the May and June FOMC meetings, incoming economic

Selected Interest Rates



NOTE. The data are daily and extend through February 9, 2005. Treasury rates are constant-maturity yields based on the most actively traded securities. The dates on the horizontal axis are those of FOMC meetings.
SOURCE. Department of the Treasury and the Federal Reserve.

data pointed to a broader and more firmly established expansion, with continued strength in housing markets and business fixed investment. Also, the employment reports for March, April, and May had indicated strong and widespread gains in private nonfarm payrolls, and previous reports for January and February were revised upward significantly. Overall consumer price inflation in the first quarter was faster than it had been a year earlier, and core inflation also increased, in part because of the indirect effects of higher energy prices. The Committee maintained its target for the federal funds rate at 1 percent in May, but on the basis of the evolving outlook for economic activity and prices, it revised its assessment of risks to indicate that the upside and downside risks for inflation had moved into balance. The Committee also stated that monetary policy accommodation could "be removed at a pace that is likely to be measured" to communicate its belief, given its economic outlook, that policy would probably soon need to move toward a more neutral stance, though probably not at a rapid pace. The Committee retained this language at the June meeting while raising its target for the federal funds rate from 1 percent to 1¼ percent and noting that it would "respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

The information that the Committee had received by the time of its August meeting indicated that economic growth had softened somewhat earlier in the summer. Although the housing market had remained strong and business outlays had continued to be healthy, consumer spending growth had slowed significantly, and industrial production had begun to level off. Also, the June and July labor market reports revealed that employment growth had slowed considerably. At the same time, core consumer price inflation had moderated in May and June even though sizable increases in food and energy prices continued.

However, the Committee believed that the softness in economic activity was caused importantly by higher prices of imported oil and would prove short lived. With financial conditions remaining stimulative, the economy appeared poised to grow at a pace sufficient to trim slack in resource utilization. In that regard, given the unusually low level of the federal funds rate, especially relative to the level of inflation, policymakers noted that significant cumulative policy tightening would likely be needed to meet the Federal Reserve's long-run objectives of price stability and sustainable economic growth. The Committee's decision at the meeting to raise its target for the federal funds rate 25 basis points, to 1½ percent, and to maintain its assessment of balanced risks with respect to sustainable growth and price stability was largely anticipated by financial markets. However, market participants revised up their expectations for the path of the federal funds rate, reportedly because the announcement conveyed a somewhat more optimistic outlook for the economy than many had anticipated.

By the time of the September FOMC meeting, available information suggested that the economy had regained momentum. Real consumer spending bounced back sharply in July after a weak second quarter, and incoming data on industrial production indicated a modest strengthening. Housing activity had increased further, and business outlays had picked up significantly in the second quarter. In addition, the labor market showed signs of improvement in August, as the unemployment rate edged down and nonfarm payrolls grew moderately. Core consumer price inflation slowed in June and July, and a decline in energy prices from record levels pushed down readings on headline inflation. Although the Committee acknowledged that higher oil prices had damped the pace of economic activity around midyear, it nonetheless saw the expansion as still on solid footing. Consequently, the Committee agreed to increase its target for the federal funds rate another 25 basis points, to 1¾ percent; to reiterate its view that the risks to price stability and to sustainable growth were balanced; and to repeat its indication that the removal of policy accommodation would likely proceed at a "measured" pace. The reaction in financial markets to the policy rate decision and the accompanying statement was muted.

The information in hand at the time of the November FOMC meeting generally suggested that the economy had continued to expand at a moderate rate despite the restraint that higher oil prices imparted to real incomes and consumer confidence. Consumer and business spending stayed firm, and the housing market remained buoyant. However, industrial production was about unchanged, and the news on job growth was uneven—lackluster increases in nonfarm payrolls in September were followed by robust expansion in October. Inflation measures were moderate, although up somewhat from one year earlier. On balance, the Committee saw the economy as growing at a pace that would reduce margins of slack in the utilization of resources. The Committee also judged that inflationary pressures would likely be well contained if monetary policy accommodation were gradually withdrawn. The Committee's decision to raise its target for the federal funds rate from 1¾ percent to 2 percent with minimal change in the language in the accompanying statement was largely anticipated by financial markets and elicited little reaction.

At its December meeting, the Committee viewed available information as continuing to indicate that the pace of the economic expansion was sufficient to further reduce the underutilization of resources, despite elevated oil prices. Consumer spending remained solid, investment spending was strong, and manufacturing production showed modest growth. Also, employment gains in October and November were consistent with gradual improvement in the labor market. Meanwhile, core inflation, while above the unusually low rates of late 2003, remained subdued. Accordingly, the Committee voted to raise its target for the federal funds rate 25 basis points, to 2¼ percent, and to retain the previous statement that the removal of policy accommodation would likely be ''measured.'' Investors had largely anticipated the policy rate decision, but a few market participants had reportedly speculated that the Committee would signal increased concern about inflationary pressures. In the absence of any such signal, implied rates on near-dated futures contracts and longer-term Treasury yields declined a few basis points after the release of the December statement.

Also at its December meeting, the Committee considered an accelerated release of the minutes of FOMC meetings. The Committee's practice had been to publish the minutes for each meeting on the Thursday after the next scheduled meeting. The Committee believed that, because the minutes contain a more nuanced explanation of policy decisions than the statement released immediately after each meeting, publishing them on a timelier basis would help market participants interpret economic developments and thereby better anticipate the course of interest rates. Earlier release would also provide a context for the public remarks of individual FOMC members. It was also recognized, however, that financial markets might misinterpret the minutes at times and that earlier release might adversely affect the Committee's discussions and, perhaps, the minutes themselves. After weighing these considerations, the Committee voted unanimously to publish the FOMC minutes three weeks after the day of the policy decision.

The information that the Committee reviewed at its February 2005 meeting indicated that the economy had continued to expand at a steady pace. The labor market showed signs of further improvement, and consumer spending and the housing market remained robust. Industrial production accelerated, particularly at the end of 2004, and growth of business fixed investment was solid in the fourth quarter. Core inflation stayed moderate, and measures of inflation expectations remained well anchored. Given the solid economic expansion and limited price pressures, the Committee voted to continue its removal of policy accommodation by raising its target for the federal funds rate from 2¼ percent to 2½ percent and to essentially repeat the language of the December statement. Futures market quotes indicated that investors had already priced in a 25 basis point increase in the target federal funds rate at the meeting, and market participants reportedly expected no substantive changes to the accompanying statement. Accordingly, the reaction in financial markets to the announcement was minimal.

Economic Projections for 2005 and 2006

Federal Reserve policymakers expect the economy to expand moderately and inflation to remain low in 2005 and 2006.[1] The central tendency of the fore-

1. As a further step to enhance monetary policy communications, Federal Reserve policymakers

Economic Projections for 2005 and 2006

Percent

Indicator	MEMO: 2004 actual	Federal Reserve Governors and Reserve Bank presidents			
		2005		2006	
		Range	Central tendency	Range	Central tendency
Change, fourth quarter to fourth quarter[1]					
Nominal GDP	6.2	5–6	5½–5¾	5–5¾	5–5½
Real GDP	3.7	3½–4	3¾–4	3¼–3¾	3½
PCE price index excluding food and energy	1.6	1½–2	1½–1¾	1½–2	1½–1¾
Average level, fourth quarter					
Civilian unemployment rate	5.4	5–5½	5¼	5–5¼	5–5¼

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

casts of real GDP growth made by the members of the Board of Governors and the Federal Reserve Bank presidents is 3¾ percent to 4 percent over the four quarters of 2005. The civilian unemployment rate is expected to average about 5¼ percent in the fourth quarter of 2005. For 2006, the policymakers project real GDP to increase about 3½ percent, and they expect the unemployment rate to edge down to between 5 percent and 5¼ percent. With regard to inflation, FOMC participants project that the chain-type price index for personal consumption expenditures excluding food and energy (core PCE) will increase between 1½ percent and 1¾ percent both this year and next—about the same as the 1.6 percent increase posted over 2004. ■

will now provide economic projections for two years, rather than one, in the February Monetary Policy Report.

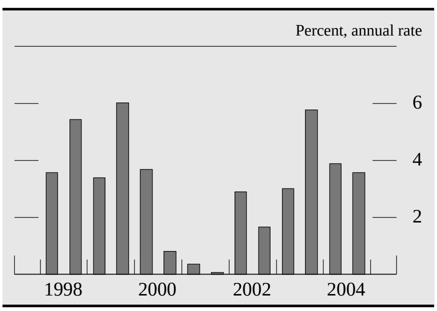
Economic and Financial Developments in 2004 and Early 2005

The economy proved to be sufficiently resilient to maintain solid growth and moderate core inflation in 2004 even as higher oil prices drained consumers' purchasing power and boosted firms' costs. Real GDP rose 3¾ percent last year after having increased 4½ percent in 2003. Activity was supported by continued robust advances in household spending. In addition, capital spending by businesses increased notably. Labor market conditions improved significantly, though at an uneven pace over the course of the year. Private payrolls, which turned up in late 2003, rose 170,000 per month last year, on average, and the unemployment rate declined below 5½ percent by year-end and to 5¼ percent in January 2005—the lowest rates since 2001.

Consumer price inflation was driven higher last year by the sharp rise in energy prices. Although core consumer price inflation moved up somewhat from unusually low levels recorded in 2003, it remained well contained. Price increases were restrained by continuing, though diminishing, slack in labor and product markets, which tended to offset the effects of higher energy and commodity prices, as well as the weaker dollar, on firms' overall costs. In addition, solid productivity gains implied that unit labor costs rose only modestly, even if up from the declines in the preceding two years. The decline in crude oil prices, on balance, since October points to some easing of cost pressures on firms from that source in the period ahead.

Several forces likely contributed to last year's impressive economic performance in the face of the sizable adverse oil shock. The growth of real output continued to be undergirded by gains in structural labor productivity. Moreover, fiscal policy remained stimulative last year through the combination of the lagged effect of earlier cuts in personal

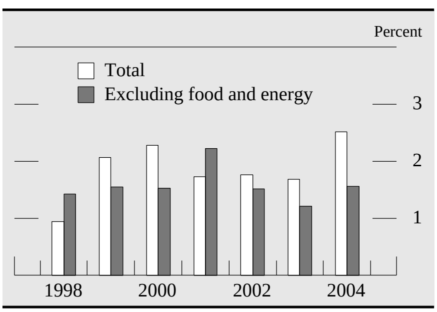
Change in Real GDP



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

SOURCE. Department of Commerce, Bureau of Economic Analysis.

Change in PCE Chain-Type Price Index



NOTE. The data are for personal consumption expenditures (PCE).

SOURCE. Department of Commerce, Bureau of Economic Analysis.

tax rates, the rise in defense spending, and perhaps also the partial-expensing tax incentives for business investment. Monetary policy was highly accommodative in the early part of the year and remained accommodative, though progressively less so throughout the year, and credit remained readily available at favorable terms. Consumer demand was also boosted by the strong increases in asset values during the past two years.

Financial conditions remained stimulative last year even as market participants revised up their expectations for the near-term path of monetary policy. Interest rates on longer-term Treasury securities remained low, risk spreads on corporate bonds narrowed, and commercial banks eased terms and standards on business loans. In this environment, household debt again increased briskly. The borrowing needs of nonfinancial businesses were damped by their strong cash flows. Equity values rose, especially toward the end of the year. At the same time, the exchange value of the dollar declined, on net, over the year as market participants apparently focused on the financing implications of the large and growing U.S. current account deficit.

The Household Sector

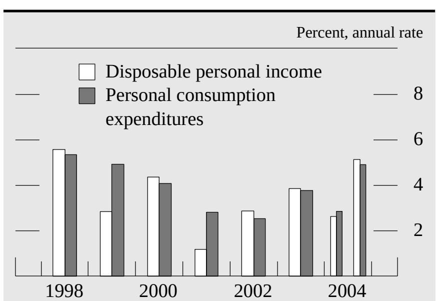
Consumer Spending

Consumer spending grew substantially last year. Personal consumption expenditures (PCE) advanced nearly 4 percent in real terms, about the same as the increase in 2003. Sales of new motor vehicles remained brisk, on average, at 16¾ million units. Excluding motor vehicles, consumer spending on most categories of durable and nondurable goods rose rapidly, as gains in real expenditures for food and clothing both exceeded 5 percent; however, spending on computing equipment increased less in 2004 than in preceding years, and consumers responded to the high cost of gasoline and heating fuel by cutting back on real spending for these items. Real outlays for services also increased rapidly last year, and medical services posted especially large gains.

Real disposable personal income (DPI) rose nearly 4 percent last year, but this figure is exaggerated by Microsoft's $32 billion special dividend payment in December (the bulk of which is estimated to have accrued to U.S. households). If this one-time event is excluded from the calculation, real DPI rose only 2¾ percent in 2004, well below the increase posted in 2003. Faster job growth helped to support increases in households' incomes last year in nominal terms, and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), which brought lower personal tax rates forward into 2003, led to larger refunds and smaller final payments in the spring of 2004. However, real income gains were held down, as higher oil prices siphoned off household purchasing power.

With the growth of real consumption spending outpacing that of real income through most of last year, the personal

Change in Real Income and Consumption



SOURCE. Department of Commerce, Bureau of Economic Analysis.

saving rate moved lower, from 1½ percent, on average, in 2003 to only ½ percent in the third quarter of last year. (The fourth-quarter surge in income associated with the Microsoft dividend payments pushed the saving rate back up to 1¼ percent, but this increase will likely be reversed early this year as dividend income falls back. Because the company's share price declined in step with the dividend payouts, the dividends had no effect on shareholders' overall financial resources and so probably had little effect on consumption.)

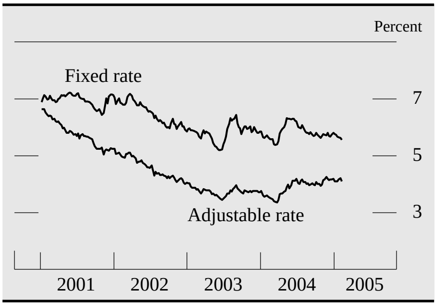
Low interest rates were one factor that helped to support consumption growth—especially for durable goods—despite comparatively slow gains in real income. Higher household wealth was also an important force that propelled consumer spending last year. According to the Federal Reserve's flow of funds accounts, the ratio of household net worth to disposable income rose sharply in 2003, as corporate equity values rebounded and home prices continued to rise. Moreover, although equity values were little changed, on net, through much of 2004 before rising notably in the final quarter, home prices continued to rise throughout the year, and the wealth-to-income ratio moved up further; by the third quarter (the most recent period for which the complete wealth data are available), the ratio had reversed nearly half its decline since the stock market peak in 2000. Because wealth feeds through into household spending over a period of several quarters, the wealth increases in both 2003 and 2004 were important in supporting consumer spending last year. The rise in house prices, together with continued low interest rates, also led consumers to extract additional equity from their homes, in particular through home equity loans. Such actions provided many households with a readily available and relatively low-cost source of funds for financing consumption.

Consumer confidence, which had improved in 2003, remained at generally favorable levels last year, according to surveys by both the Michigan Survey Research Center (SRC) and the Conference Board. Confidence tended to dip at times during the year when energy prices were moving up most rapidly, but it recovered soon after those episodes.

Residential Investment

Residential investment remained robust last year. Real expenditures increased 5¾ percent in 2004—the third straight year of strong gains. Demand for housing was influenced by the same factors that affected household spending more generally, but it was especially supported by nominal mortgage interest rates that have remained near their lowest levels since the late 1960s. Rates on thirty-year fixed-rate mortgages fluctuated between about 5½ percent and 6¼ percent over the past two years; they edged up to the high end of that range during the spring but dropped back to under 6 percent by the end of summer and now stand below 5¾ percent.

Mortgage Rates



NOTE. The data, which are weekly and extend through February 9, 2005, are contract rates on thirty-year mortgages.

SOURCE. Federal Home Loan Mortgage Corporation.

In the single-family sector, housing starts amounted to 1.6 million units last year, a rate faster than the already rapid pace of 1.5 million units started in 2003. In the multifamily sector, starts totaled a solid 350,000 units last year, a figure in line with that of the preceding several years. Sales of both new and existing single-family homes hit new highs last year, and home prices moved up sharply. The repeat-transactions price index for existing homes (limited to purchase transactions only), which is published by the Office of Federal Housing Enterprise Oversight, climbed more than 10 percent over the four quarters ending in the third quarter of last year (the latest quarter for which data are available) and is up a cumulative 65 percent since 1997, when it started to rise notably more rapidly than overall inflation. These price increases have also outstripped by a wide margin the increases in household incomes and rents. Another nationwide price index, the Census Bureau's constant-quality price index for new homes, rose only 6¾ percent last year. Because this index does not adjust for the location of new homes within metropolitan areas, and because new homes constitute only a small fraction of the overall housing stock, this index is probably a less reliable indicator of overall home values than is the repeat-transactions index.

Household Finance

Household debt is estimated to have increased about 9¾ percent in 2004, a touch less than in the previous year. Mortgage debt again paced this advance. The brisk expansion of mortgages reflected continued strong activity in housing markets and rising house prices. However, the growth rate of mortgage debt did not quite match that registered in 2003. Refinancing activity fell off sharply last year, as the pool of outstanding mortgages with interest rates above current market rates shrank considerably. Mortgages with adjustable interest rates, including hybrids that feature both fixed and adjustable interest rate components, were increasingly popular in 2004. Consumer credit continued to expand at a moderate pace by historical standards, restrained in part by the substitution of other forms of debt, such as home equity loans. Higher interest rates on some consumer loans and credit cards in the second half of 2004 may have also damped the growth of consumer credit.

Relatively low interest rates and further gains in disposable personal income limited pressures on household balance sheets in 2004. Measures of aggregate household financial obligations and debt service, which capture pre-committed expenditures relative to disposable income, were little changed last year, on balance, though they remained high by historical standards. Nevertheless, measures of household credit quality either held steady or improved during the course of the year. The latest available data indicate that delinquency rates on credit card loans, consumer loans, and residential mortgages at commercial banks declined, while those on auto loans at captive finance companies were about unchanged at a low level. Household bankruptcy filings ran below the elevated levels of 2003, although they stayed generally above the rates posted in earlier years.

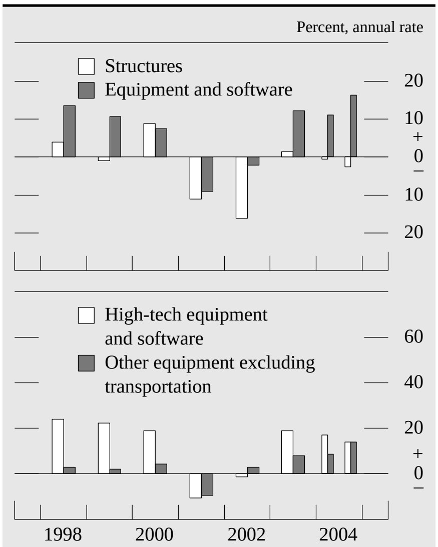
The Business Sector

Fixed Investment

Business fixed investment rose robustly for a second consecutive year in 2004. Real spending on equipment and software (E&S) increased 13½ percent, about as much as in 2003, as firms' final sales continued to increase, profits and cash flow rose further, and many businesses reported a need to replace or upgrade existing equipment and software. Although many firms had little need to seek outside financing given their flush cash situation, those that did generally found financial markets to be receptive—interest rates remained low, and other terms and conditions stayed relatively favorable. The partial-expensing tax incentives, which covered new equipment and software installed by the end of 2004, boosted profits and cash flow and may have also stimulated some investment spending.

Increases in E&S spending were fairly widespread across categories of capital goods. Spending on high-technology equipment increased 15½ percent last year after having risen 19 percent in 2003; these gains followed two years of declines. Although the pattern of spending was uneven over the four quarters of 2004, for the year as a whole, business outlays for computing equipment rose 25 percent in real terms, while spending on software and communications equipment posted increases of 13 percent and 10 percent respectively. Outside of the high-tech sector, business spending on aircraft moved lower for the third consecutive year, as airlines continued to struggle with a highly competitive market environment and high fuel prices. In contrast, business outlays on motor vehicles rose substantially last year, with the demand for trucks exceptionally strong. Investment in equipment other than high-tech and transportation goods—a category that includes industrial machinery and a wide range of other types of equipment—moved up 11 percent last year, the most in more than ten years.

Change in Real Business Fixed Investment



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

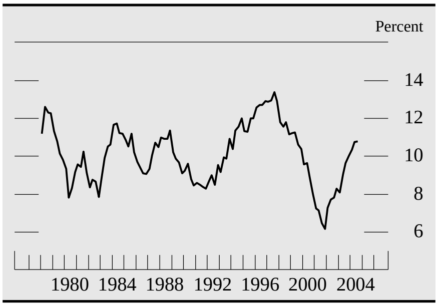
SOURCE. Department of Commerce, Bureau of Economic Analysis.

In contrast to the rebound in equipment spending, real outlays in the nonresidential construction sector were about unchanged for a second year in 2004 and have yet to recover from their sharp downturn during 2001 and 2002. In the office sector, where construction increased rapidly in the late 1990s, spending has remained especially weak; vacancy rates for these properties, although down a touch over the past year, are still quite elevated. Construction of industrial buildings has also remained low as a result of high vacancy rates. In contrast, demand for new retail and wholesale properties has been firmer, reportedly a reflection of the steady increases in consumer spending, and outlays for these types of buildings moved higher last year. In addition, investment in the drilling and mining sector rose last year in response to high prices for natural gas.

Inventory Investment

Businesses added appreciably to inventories last year for the first time since running down their holdings sharply in 2001. As economic activity strengthened during 2002 and 2003, many businesses chose to operate with inventories that were increasingly lean relative to sales. In 2004, when stocks had become quite spare—even after taking into account the ongoing improvements in inventory management that have allowed firms to economize on stockholding—and businesses had apparently grown more confident in the durability of the recovery, businesses accumulated $45 billion of inventories (in real terms), according to preliminary data. The step-up in the pace of stockbuilding contributed about ¼ percentage point to GDP growth last year.

Before-Tax Profits of Nonfinancial Corporations as a Percent of Sector GDP



NOTE. The data are quarterly and extend through 2004:Q3. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.

SOURCE. Department of Commerce, Bureau of Economic Analysis.

Corporate Profits and Business Finance

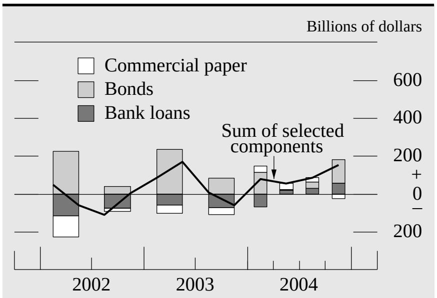
Strong growth of corporate profits again allowed many firms to finance capital spending with internal funds last year. As a result, nonfinancial business debt rose at only a moderate pace. Net equity issuance dropped further into negative territory in 2004, and on balance nonfinancial corporations are estimated to have raised no net funds in credit and equity markets. However, short-term business debt, including commercial paper and commercial and industrial (C&I) loans, expanded last year after three years of contraction, and commercial mortgage debt continued to increase rapidly. The credit quality of businesses remained strong.

Corporate profits held up well in 2004 after surging in the previous year. The ratio of before-tax profits of nonfinancial corporations to that sector's gross value added increased for a second consecutive year. In the fourth quarter of 2004, operating earnings per share for S&P 500 firms were nearly 20 percent above their level four quarters earlier. Analysts' earnings forecasts began to moderate somewhat in the second half of 2004 after several months of strong upward revisions.

In equity markets, net issuance of shares by nonfinancial firms turned more negative in 2004. Although initial public offerings rebounded from the sluggish pace of the past two years, ample profits and sizable cash holdings helped boost share retirements from mergers and repurchases.

Net corporate bond issuance was sluggish in 2004, as firms evidently relied heavily on their considerable profits to fund investment in fixed capital and inventories. The timing of gross bond issuance was influenced by interest rate movements during the year, as firms took advantage of occasional dips in longer-term yields to issue bonds. Firms reportedly used a large portion of the proceeds to pay down existing debt, although some companies used the funds raised in the bond market to

Selected Components of Net Business Financing



NOTE. Seasonally adjusted annual rate for nonfinancial corporate business. The data for the sum of selected components are quarterly. The data for 2004:Q4 are estimated.

SOURCE. Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

repurchase equity shares or to finance mergers.

Short-term business borrowing revived in 2004 after a prolonged contraction. Commercial paper outstanding turned up in the first half of the year, although it flattened out over the second half. Business loans at banks rebounded over the course of last year. According to results from the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, commercial banks eased terms and standards on business loans during the course of 2004 in response to the improved economic outlook and to increased competition from other banks and nonbank lenders. Survey responses also indicated an increase in demand for C&I loans that reflected firms' need to fund rising accounts receivable, inventories, capital expenditures, and merger activity. Concerns over loan quality seemed to diminish further in 2004, as spreads on leveraged deals in the syndicated loan market edged down from already low levels.

Corporate credit quality remained solid in 2004 amid strong earnings, low interest rates, and a further buildup of already substantial cash positions on firms' balance sheets. The delinquency rate on C&I loans declined further, and the twelve-month trailing default rate on corporate bonds fell to historically low levels before edging up late in the year. Net upgrades of bonds by Moody's Investors Service for both investment- and speculative-grade nonfinancial firms increased last year.

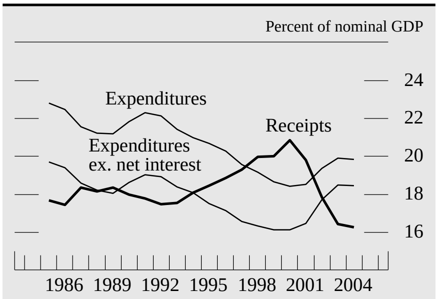
The stock of commercial mortgage debt outstanding grew at a rapid pace in 2004. Some firms reportedly continued to find mortgages an attractive source of long-term funding. The expansion of commercial mortgage credit helped propel issuance of commercial-mortgage-backed securities (CMBS) to near-record levels. Delinquency rates on commercial mortgages on the books of banks and insurance companies remained low throughout the year, and those on loans backing mortgage securities fell. Considerable gains in commercial real estate prices increased owners' equity and largely kept pace with the sizable increase in mortgage debt obligations. Yield spreads of CMBS over comparable Treasury securities remained moderate.

The Government Sector

Federal Government

The federal budget position deteriorated slightly further in 2004, as spending increases and further tax reductions offset the effects of stronger economic growth on revenues. The unified budget deficit widened from $378 billion in fiscal 2003 to $412 billion in fiscal 2004. As a share of GDP, the federal unified deficit stood close to 3½ percent in both years. Receipts increased 5½ percent in fiscal 2004 after two years of declines. Corporate receipts surged more than 40 percent, or $58 billion, reflecting

Federal Receipts and Expenditures



NOTE. The budget data are from the unified budget and are for fiscal years (October through September); GDP is for the year ending in Q3.
SOURCE. Office of Management and Budget.

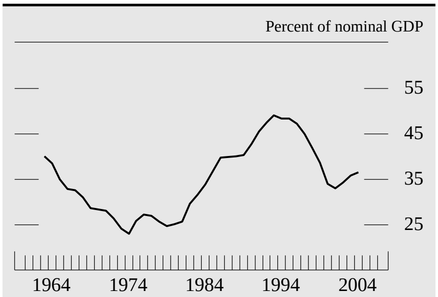
the improvement in corporate profits; individual tax receipts—restrained by JGTRRA, which pulled forward reductions of personal tax rates that had been scheduled for the second half of the decade—rose only about 2 percent. Overall federal receipts increased less rapidly than nominal GDP, and the ratio of receipts to GDP edged down to 16¼ percent, the lowest level in more than forty years.

Meanwhile, nominal federal outlays increased about 6 percent in fiscal 2004. Spending for national defense increased especially sharply, but spending also increased notably for Medicare and Medicaid. Debt service costs, which fell sharply from 1997 through 2003 as a result of reduced debt and declining interest rates, edged higher last year. Federal government purchases of goods and services—the part of spending that is counted in GDP—rose about 4 percent in real terms in 2004 after larger increases in the preceding two years. (Government spending on items such as interest payments and transfers is excluded from GDP because these items do not constitute a direct purchase of final production.)

Regarding legislative initiatives, two new tax bills were enacted in the fall of 2004. First, the Working Families Tax Relief Act extended through 2010 a variety of personal tax reductions that had previously been set to expire earlier. Second, the American Jobs Creation Act replaced the exclusion of extraterritorial income (which the World Trade Organization had declared an illegal export subsidy) with numerous other tax reductions for domestic manufacturers and U.S. multinationals. The first bill is expected to have a ten-year budget cost of around $150 billion, while the second bill was scored as being revenue neutral. As for federal spending in fiscal 2005, the regular appropriations bills provided for sizable increases in spending on defense and homeland security and for modest increases in nondefense discretionary expenditures. In addition, emergency legislation passed in the autumn provided disaster aid for victims of hurricanes and for ranchers and farmers affected by drought conditions.

The recent sizable deficits in the unified budget mean that the federal government, which had been contributing to the pool of national saving from 1997 through 2000, has been drawing on that pool since 2001. Net federal saving—essentially the unified budget balance adjusted to the accounting practices of the national income and product accounts (NIPA)—dropped from positive 2 percent of GDP in 2000 to a level below negative 3 percent of GDP in 2003 and 2004. Personal saving moved lower over this period as well, while business net saving rose with the rebound in corporate profits. In all, net national saving edged up in 2004 but remained near its postwar lows. Because net national saving has fallen increasingly short of net domestic investment over the past several years, the inflow of foreign funds needed to finance that investment has risen. The growing inflow of foreign capital is mirrored in

Federal Government Debt Held
by the Public



NOTE. Through 2003, the data for debt are year-end figures, and the corresponding value for GDP is for Q4 at an annual rate; the final observation is for 2004:Q3. Excludes securities held as investments of federal government accounts.

the widening of the nation's current account deficit. Over time, the low national saving rate could eventually slow the rise in living standards either by increasing the burden of servicing U.S. foreign debt or by impinging on domestic capital formation.

The growth rate of Treasury debt moderated slightly last year after increasing substantially in 2003. Nonetheless, federal debt held by the public as a percentage of GDP continued to edge higher over the course of 2004 and currently stands at about 36½ percent. To help finance substantial budget deficits, the Treasury issued a considerable volume of bills as well as two-, three-, five-, and ten-year nominal notes. In addition, the Treasury expanded its borrowing program in 2004 by adding semiannual auctions of twenty-year inflation-protected bonds and five-year inflation-protected notes.

Various indicators suggested a continued strong appetite for Treasury securities among foreign investors last year. Indirect bidding at Treasury auctions, which includes bidding by the Federal Reserve Bank of New York on behalf of foreign official institutions, remained robust, and Treasury securities held in custody at the Federal Reserve Bank of New York on behalf of such institutions increased just over $200 billion in 2004. Also, data from the Treasury International Capital System showed a substantial increase in holdings of Treasury securities by foreign official and private investors, particularly those in Japan. The proportion of Treasury securities held by foreign investors is estimated to have risen to a record 43½ percent by the third quarter of 2004.

Treasury debt reached its statutory ceiling late last year. To cope with the constraint, the Treasury temporarily resorted to accounting devices, suspended issuance of state and local government series securities, and postponed a four-week bill auction. In mid-November, Congress raised the debt ceiling from $7.4 trillion to $8.1 trillion, and the Treasury subsequently resumed normal financing operations.

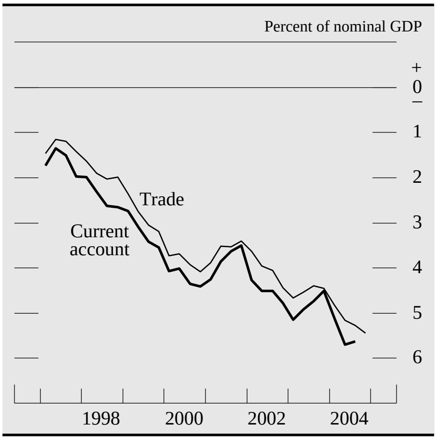
State and Local Governments

Pressures on the budgets of state and local governments have eased as economic activity has strengthened. Tax receipts have been spurred by the increases in household income, consumer spending, and property values. As a result, many states seem to be on track to meet balanced budget requirements in the current fiscal year (which ends June 30 for all but a few states) without using as much borrowing or other extraordinary measures as in recent years. Nevertheless, a number of states still must deal with lingering fiscal problems, particularly depleted reserve funds, the expiration of temporary tax hikes, and rising Medicaid costs. In addition, several states still face serious structural imbalances in their budgets.

Real expenditures by state and local governments as measured in the NIPAs remained about flat for a second year in 2004. Real spending on current operations rose less than 1 percent last year, while real investment spending declined. However, even as they were holding the line on spending increases, states and localities were able to resume net hiring in 2004 after having left employment about unchanged in 2003.

Net issuance of debt by state and local governments edged down from the rapid pace set in 2003, as improved budget positions permitted some contraction in short-term debt. Advance refunding offerings were again strong during the year, as states and municipalities took advantage of low long-term interest rates and moderate credit spreads. Credit quality of tax-exempt borrowers improved in 2004. Rating upgrades of tax-exempt bonds outpaced downgrades, especially later in the year.

U.S. Trade and Current Account Balances



NOTE. The data are quarterly. The trade data extend through 2004:Q4, and the current account data extend through 2004:Q3.
SOURCE. Department of Commerce.

The External Sector

After narrowing in 2003, the U.S. current account deficit widened again last year and was $660 billion (annual rate), or 5.6 percent of GDP, in both the second and third quarters. Much of this widening reflected a considerable increase in the deficit on goods and services trade, as a marked rise in imports more than offset solid increases in exports. The trade deficit expanded from $500 billion during the fourth quarter of 2003 to more than $650 billion, on average, during the second half of 2004.

International Trade

Real exports of goods and services rose an estimated 5½ percent in 2004 despite a deceleration in the fourth quarter. In the first half, exports were supported by the lagged effect of the fall in the dollar's value in 2003. Strong expansion of foreign economic activity also helped boost exports in the first half, but that stimulus diminished in the second half of the year when foreign growth slowed. For the year as a whole, exports of industrial supplies and capital goods posted solid growth. Exports to Canada, Mexico, and western Europe rose smartly in 2004, whereas exports to Japan were relatively weak. Real exports of services increased about 3½ percent through 2004 as a whole.

After increasing at an annual rate of almost 6 percent in the first half of 2004, prices of exported goods moved up at just a 2½ percent rate in the second half. This deceleration was due in large part to a reversal of the run-up in the prices of agricultural products that had occurred in late 2003 and early 2004. Better harvests last year returned prices of agricultural products to levels near those that had prevailed before the spike.

Solid growth in income in the United States spurred growth of real imports of 9½ percent in 2004. The increase primarily reflected higher imports of goods that occurred despite a notable rise in their prices. Real oil imports expanded almost 10 percent in 2004. Imports of capital equipment increased throughout the year, but imports of consumer goods suffered a period of weakness through the middle of the year before rebounding in the fourth quarter. Imports of services moved up only 1¾ percent in 2004.

Prices of imported non-oil goods increased at an annual rate of just over 4 percent in the first half of 2004, but the pace slowed to 2 percent in the second half. This step-down largely reflected a deceleration in the prices of industrial supplies, driven by a leveling off of nonfuel commodity prices at the elevated levels reached in March. Declines in the prices of foods offset continued price increases for metals.

The spot price of West Texas intermediate (WTI) crude oil moved up during most of 2004 and surged temporarily to a record high of $55 per barrel in October. Since then, it has fluctuated somewhat below that peak but still at levels well above $33 per barrel, the price at which it started 2004. Oil prices were driven up by intensified concerns that oil supply would not keep pace with surprisingly strong global demand. Oil consumption in China grew nearly 15 percent in 2004, pushing that economy past Japan as the world's second-largest consumer. As oil prices rose, OPEC increased its oil production, diminishing the cartel's estimated spare capacity to historically low levels. Increased OPEC production damped particularly the rise in prices of heavier, more sulfurous grades of crude oil but had less effect on prices of lighter grades like WTI. Supply disruptions also played a role in the run-up of oil prices. In October, Hurricane Ivan extensively damaged oil and gas production facilities in the Gulf of Mexico, boosting the price of WTI relative to other grades of crude oil. Sabotage of production and distribution facilities in Iraq hindered oil exports from that country, which remain below pre-war levels. In Nigeria, ethnic violence and community protests shut down some production. Russian oil output, however, continued despite the breakup of Yukos, formerly Russia's largest oil company. Late in the year, oil prices declined from their October highs, as production recovered in the Gulf of Mexico and OPEC added new capacity. The price of the far-dated NYMEX oil futures contract (currently for delivery in December 2011) rose about $10 per barrel during 2004, possibly reflecting expectations of greater oil demand in Asian emerging-market economies. The far-dated futures contract averaged about $38 per barrel in January 2005, while the spot price of WTI averaged about $48 per barrel.

The Financial Account

In 2004, the U.S. current account deficit was financed once again largely by foreign purchases of U.S. bonds. Foreign official inflows picked up further last year and were especially strong in the first quarter, reflecting sizable bond purchases by Asian central banks. Private foreign purchases of U.S. bonds rebounded in 2004 from a slight decline in 2003, with especially large purchases coming late in the fourth quarter. In contrast, foreign demand for U.S. equities weakened further in 2004, although this also picked up late in the year. Net purchases of foreign securities by U.S. investors remained strong in 2004, with most of the strength coming in the second half of the year.

U.S. direct investment abroad continued at a strong pace, as reinvested earnings remained sizable. Direct investment into the United States rebounded in the first three quarters of 2004 from its anemic pace in 2003; global mergers and acquisitions revived, and reinvested earnings picked up. Overall, net direct investment outflows continued over the first three quarters of 2004 but at a lower pace than in 2003.

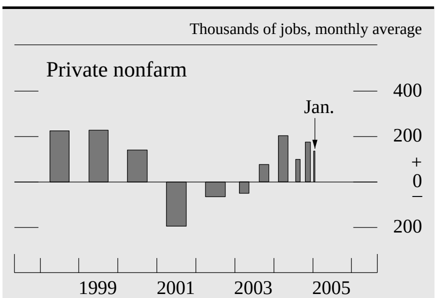
Net inflows of portfolio capital exceeded net outflows of direct investment and represented the financial counterpart to the U.S. current account deficit. These net financial inflows imply a further decline in the U.S. net international investment position, which began 2004 at a reported level of negative $2.4 trillion (22 percent of GDP).

The Labor Market

Employment and Unemployment

The labor market improved notably in 2004. Private payrolls, which began to post sustained increases in late 2003, rose an average of 170,000 per month last year. Progress was not steady over the course of the year, however. Employment growth stepped up sharply in the spring to a pace of almost 300,000 per month in March, April, and May; net hiring then dropped back to subpar rates of about 100,000 per month in June through September. In the four months since then, increases in private payrolls have averaged 165,000 per month.

Net Change in Payroll Employment



SOURCE. Department of Labor, Bureau of Labor Statistics.

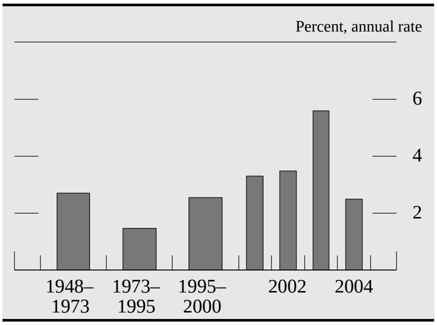
The improved pace of hiring was widespread, as all major industry groups contributed to faster employment growth relative to that of the latter part of 2003. The largest gains were in professional and business services and health services. The construction sector also posted substantial gains. In the manufacturing sector—where employment had declined almost continuously since early 2000—payrolls increased in the spring when overall employment was rising sharply but were about unchanged, on net, over the second half of the year. Employment gains in retail trade and in food services were also brisk over the first half of the year but tapered off in the second half. Meanwhile, state and local governments added substantially to their payrolls last year, especially for education, but civilian employment in the federal government edged lower.

The unemployment rate fell from near 6 percent in late 2003 to less than 5½ percent by late last year; joblessness fell further in January 2005, to 5¼ percent. The decline in the unemployment rate over the past year reflected both the pickup in hiring and a labor force participation rate that remained surprisingly low. From 2001 through 2003, the participation rate declined by more than would have been predicted on the basis of past relationships with indicators of labor demand, and in 2004, when the pace of hiring increased, the participation rate leveled off but failed to rise. These considerations suggest that there may be a persistent component to the recent softness in participation. However, participation had been quite strong through 2000, when the labor market was extremely tight, and the fact that participation turned down at the same time that labor demand weakened suggests that at least some of the recent low participation is cyclical. To the extent that some of this low participation proves to be transitory, the resumption of more-rapid labor force growth will limit the speed at which employment gains further push down the unemployment rate.

Productivity and Labor Costs

Labor productivity rose solidly again last year. Output per hour in the nonfarm business sector increased an estimated 2½ percent over the year. This increase was somewhat below the outsized 4 percent average pace of increase from 2001 through 2003. Those earlier huge productivity gains were not associated with especially large accumulations of new capital equipment, as had been the case during the late 1990s; instead, to a large degree, the gains seem to have been related to more effective use of capital equipment that had been acquired earlier and to one-time organizational innovations induced by firms' earlier reluctance to commit to increased hiring. Still, last year's 2½ percent increase in productivity was impressive by long-run standards: It was in line with the pace of the late 1990s and well above rates that had prevailed during the preceding two decades.

Change in Output per Hour



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

Increases in hourly labor compensation remained moderate last year. As measured by the employment cost index (ECI), which is based on a quarterly survey from the Bureau of Labor Statistics, hourly compensation in private nonfarm businesses increased 3¾ percent in 2004, a bit less than in 2003. An alternative measure is compensation per hour in the nonfarm business sector as derived from compensation data in the NIPAs. This measure of hourly compensation rose 3½ percent last year, an increase similar to that in the ECI but substantially less than the 5½ percent rise in 2003.

As has been the case for several years, the cost of employee benefits rose considerably more than did wages and salaries last year. The benefits component of the ECI increased nearly 7 percent, while the wages and salaries component posted a much more moderate 3 percent increase. The rise in hourly wages and salaries was about the same as increases in the preceding two years; although probably boosted by last year's higher rate of price inflation, wages were likely held down by the continued, though diminishing, labor market slack and also by employers' attempts to offset continued large increases in benefits costs. Health insurance costs continued to rise rapidly. As measured by the ECI, employers' costs of health insurance, which account for about 6 percent of overall compensation costs, rose 7 percent last year after having increased more than 10 percent per year in 2002 and 2003.

Prices

Overall consumer prices rose notably more in 2004 than they did in 2003, and the sharp increase in energy prices accounted for much of the step-up. The chain-type price index for personal consumption expenditures (PCE) rose 2½ percent last year, compared with an increase of 1¾ percent in 2003. The increase in PCE prices excluding food and energy was considerably smaller—only 1½ percent, up a little more than ¼ percentage point from the increase in 2003. Inflation as measured by the market-based component of core PCE prices—which excludes a collection of erratic prices that are unobservable from market transactions and which the Bureau of Economic Analysis began to publish early last year—was in line with overall core PCE inflation last year. The core consumer price index (CPI) rose about 2 percent last year after having increased 1¼ percent in 2003. (The CPI differs from PCE prices in a number of respects, but one factor that boosted CPI inflation relative to PCE inflation last year was a difference in the way the two indexes measure the prices of medical services, especially physicians' services, which rose much more rapidly in the CPI than in the PCE index.) The rise in core consumer prices was largest in the early months of 2004: Core PCE prices increased at an annual rate of nearly 2 percent over the first half of the year and then decelerated to a 1¼ percent rate of increase in the second half.

The price index for GDP was less affected by last year's rise in energy prices than was the PCE measure; much of the energy price increase was attributable to the higher prices of imported oil, which are excluded from GDP because they are not part of domestic production. GDP prices increased 2½ percent last year, ¾ percentage point faster than in 2003. In addition to the rise in PCE prices (excluding the influence of imported oil), GDP prices were affected by a sizable increase in construction prices for residential and nonresidential structures.

Alternative Measures of Price Change

Percent

Price measure	2002	2003	2004
Chain-type			
Gross domestic product	1.6	1.7	2.4
Gross domestic purchases	1.8	1.8	2.9
Personal consumption expenditures	1.8	1.7	2.5
Excluding food and energy	1.5	1.2	1.6
Market-based PCE excluding food and energy	1.4	1.0	1.6
Fixed-weight			
Consumer price index	2.2	1.9	3.4
Excluding food and energy	2.0	1.2	2.1

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

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

The jump in consumer energy prices in 2004 was driven by the run-up in crude oil prices. The prices of both gasoline and fuel oil increased approximately 30 percent over the year, and higher oil costs accounted for the bulk of the increase. Prices of natural gas, which can often substitute for fuel oil in the industrial sector, rose notably as well last year despite the restraining influence of ample inventories. Electricity prices, which tend to reflect fuel costs with a lag, also moved higher through most of the year but dropped back some near year-end.

Consumer food prices rose around 3 percent for a second consecutive year in 2004. Exports of beef dropped sharply last year when most of the largest importing countries placed restrictions on U.S. beef after a case of mad cow disease was discovered. Nevertheless, domestic demand was sufficiently strong to support consumer meat prices last year. Fruit and vegetable prices trended sideways through most of the year but then rose sharply in the fall because of crop damage associated with the series of hurricanes that hit the Southeast in August and September. In addition, prices for food away from home, which are driven more by labor costs than by raw food prices, increased more rapidly last year than in 2003.

Core consumer prices were influenced by a variety of forces last year. Price increases were likely restrained by continuing slack in labor markets and in some product markets, but businesses faced considerable pressure from several sources of increased costs. First, the indirect effects of the large jump in energy prices fed through to businesses throughout the economy and were especially important for firms in energy-intensive industries, such as those that produce plastics and fertilizers. Second, prices were up sharply for a number of other industrial commodities, including lumber and a variety of metals. These price increases reflected strengthening economic activity abroad as well as in the United States. Although these non-oil commodities represent a small part of businesses' overall costs, some businesses likely felt the pinch of sustained price increases in these areas. Third, the declining exchange value of the dollar boosted import prices, including those of many inputs to production. Finally, the deceleration in labor productivity boosted unit labor costs after two years of declines; nevertheless, last year's 1 percent rise in unit labor costs was quite modest.

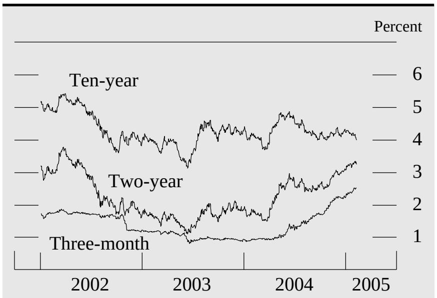
Taken together, these influences left their clearest mark on the prices of goods rather than services. Core goods prices were about unchanged, on average, last year, but this period of stability followed a period of unusually large declines in 2003. In particular, the prices of new motor vehicles leveled off after falling notably in 2003, and the prices of used vehicles reversed some of their sharp 2003 declines. Prices of non-energy PCE services rose about 2 percent in 2004—a smaller increase than in 2003.

Last year's rise in inflation showed through to short-term measures of expected inflation, but longer-term measures remained stable. According to the Michigan SRC, households' median expectations for inflation over the next year moved up considerably in the spring as inflation was rising, but then they eased back and ended the year near 3 percent—up from around 2½ percent in late 2003. In contrast, the median expectation for inflation over the next five to ten years held about steady near 2¾ percent throughout this period. Inflation compensation as measured by spreads between yields on nominal Treasury securities and inflation-indexed securities—another indicator of expected inflation, albeit one that is also influenced by perceptions of inflation risk and perhaps also by the development of the market for inflation-indexed debt—showed a similar pattern. Inflation compensation over the next five years moved up about ½ percentage point during 2004, to 2½ percent, while compensation at the five- to ten-year horizon edged lower, on net, over the year.

U.S. Financial Markets

Domestic financial conditions were supportive of economic growth in 2004. Interest rates on longer-term Treasury securities remained low, corporate risk spreads fell, and stock prices, on balance, registered gains. These developments occurred even as market participants revised up their expectations for the path of the federal funds rate. At the beginning of 2004, futures market quotes implied that investors expected a 1¾ percent target for the federal funds

Interest Rates on Selected
Treasury Securities



NOTE. The data are daily and extend through February 9, 2005.
SOURCE. Department of the Treasury.

rate at year-end, 50 basis points below the target actually established at the FOMC meeting in December 2004. Consistent with the revision in policy expectations, yields on two-year Treasury notes increased about 1¼ percentage points in 2004. Yields on longer-dated Treasury securities, however, ended the year essentially unchanged. Despite the run-up in oil prices, equity prices registered solid gains in 2004 after rising sharply the year before. Risk spreads on investment-grade corporate debt declined a touch, and those on speculative-grade debt fell more noticeably. Moreover, banks appreciably eased terms and standards for lending to businesses.

Interest Rates

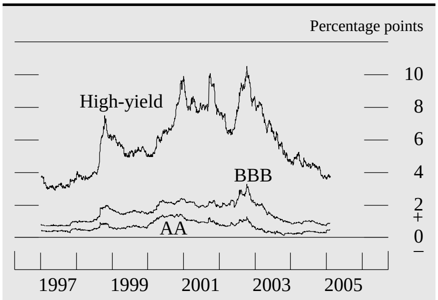
Most market interest rates rose, on balance, over the first half of 2004, particularly at shorter maturities. The FOMC's decision at its January meeting to shift from a statement that monetary policy could remain accommodative for ''a considerable period'' to an indication that it could be ''patient'' in removing policy accommodation prompted a rise in market interest rates. In early February and March, yields fell substantially in response to employment reports that indicated tepid job growth. Prices of federal funds and Eurodollar futures contracts implied that investors placed only small odds on an increase in the target funds rate before late 2004 and that they envisioned only moderate monetary policy tightening thereafter. Longer-term interest rates and the expected path for the federal funds rate were considerably marked up later in the spring in response to data suggesting a pickup in aggregate demand and hiring, readings on core inflation that came in above expectations, and rising oil prices. In the statement released after its May meeting, the Committee indicated that policy accommodation was likely to be removed at a ''measured'' pace. At its June meeting, the Committee raised the target for the federal funds rate from 1 percent to 1¼ percent, but it continued to assess the risks to sustainable growth and to price stability as balanced and reiterated the ''measured pace'' language. Interest rates across the term structure declined somewhat immediately after the announcement, reportedly because some market participants had expected the FOMC to mention upside risks to growth or inflation in its statement.

Chairman Greenspan's congressional testimony in July on monetary policy, which suggested that recent softness in consumer spending would likely prove short lived, sparked a jump in yields on Treasury securities. However, interest rates subsequently moved lower, on balance, as incoming data pointed to weaker spending and employment than investors had expected as well as to more-subdued core inflation. Apart from the August employment report, which seemed to hint that the economy was emerging from its ''soft patch,'' incoming economic news remained somewhat lackluster through the end of the third quarter. However, investors reportedly viewed FOMC statements and comments by FOMC officials as more sanguine on near-term prospects for the economy than they had expected. In particular, the release of the minutes from the August FOMC meeting, which referenced the probable need for ‘‘significant cumulative tightening,’’ prompted investors to mark up their expectations for the near-term path of monetary policy.

Short-term Treasury yields rose a bit further over the fall in association with actual and expected policy tightening, but long-term Treasury yields were little changed on net. Investors' expectations for the path of monetary policy firmed a bit more in the fourth quarter in response to higher-than-anticipated inflation and remarks from Federal Reserve officials that were reportedly interpreted as suggesting that an imminent pause in the tightening cycle was unlikely.

As the economic expansion gathered momentum and measures of corporate credit quality improved, investors' perception of risk seemed to diminish, and their willingness to bear risk apparently increased. Risk spreads on investment-grade corporate debt over comparable Treasuries ended the year slightly below their levels at the end of 2003. Spreads of speculative-grade yields declined further after narrowing sharply during 2003.

Spreads of Corporate Bond Yields over Comparable Off-the-Run Treasury Yields



NOTE. The data are daily and extend through February 9, 2005. The high-yield index is compared with the five-year Treasury yield, and the BBB and AA indexes are compared with the ten-year Treasury yield.

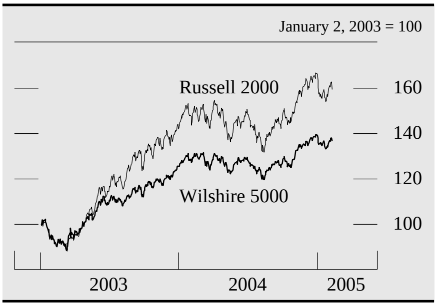
SOURCE. Merrill Lynch AA and BBB indexes and Merrill Lynch Master II high-yield index.

In early 2005, market participants boosted their expectations for the path of the federal funds rate, partly in response to the publication of the minutes of the December FOMC meeting, which investors reportedly interpreted as pointing to greater concerns about inflation than had been expected. Short- and intermediate-term Treasury yields rose along with expectations for the path of monetary policy, but longer-term yields edged lower. Yields on investment- and speculative-grade corporate bonds largely moved with those on comparable Treasury securities, and hence risk spreads remained at low levels.

Equity Markets

After surging as much as 30 percent in 2003, broad stock market indexes climbed modestly over the first half of 2004. The boost to equity prices from robust earnings reports and analysts' upward revisions for future profits during this period was offset in part by rising interest rates in the second quarter, worries about geopolitical developments, and sharply higher oil prices. Stock prices dipped early in the second half in response to softer economic data, further concerns about energy prices, and guidance from corporations that pointed to a less optimistic trajectory for earnings than investors had reportedly been expecting. However, as oil prices pulled back toward the end of 2004 and news on the economy improved, stock prices rebounded to post solid gains

Stock Price Indexes



NOTE. The data are daily and extend through February 9, 2005.

for the year. The increases were led by stocks with comparatively small market capitalizations; the Russell 2000 index climbed 17 percent in 2004 to a record high. The S&P 500 and the technology-laden Nasdaq advanced about 9 percent and 8½ percent respectively. To date in 2005, equity prices have edged lower, on balance, as investors have responded to a rebound in oil prices, lackluster earnings reports, cautious guidance for future profits, and indications of continued monetary policy tightening.

Expected volatility implied by options prices for both the Nasdaq 100 and the S&P 500 declined further in 2004 from already low levels. The difference between the earnings–price ratio and the real ten-year Treasury yield—a crude measure of the premium investors require for holding equity shares—changed little, on balance, remaining close to its average value over the past two decades but above its level during the late 1990s.

Debt, Bank Credit, and M2

The aggregate debt of domestic nonfinancial sectors is estimated to have increased about 7¾ percent in 2004, somewhat faster than nominal income but a bit slower than the pace set the year before. Household and federal debt expanded rapidly. Borrowing by nonfinancial businesses was moderate, although it picked up in the fourth quarter.

Commercial bank credit rose about 9 percent in 2004, a larger advance than in the previous year. Expansion of mortgage and home equity loans on banks' books remained strong, as activity in the housing market stayed robust while mortgage originations shifted somewhat toward adjustable-rate products. After several years of runoffs, business loans began to grow in the second quarter of the year. According to survey evidence, commercial banks eased terms and standards on business loans as the economic outlook improved and competition from other banks and nonbank lenders intensified. Also, banks reported a pickup in demand for business loans that was said to be driven by customers' needs to fund rising accounts receivable, inventories, capital expenditures, and mergers. After adjusting for certain reclassifications of securities as loans, the growth of consumer loans on banks' books remained sluggish. Despite reports of increased competition among banks and nonbank intermediaries, bank profits were again strong in 2004. Banks experienced further improvements in asset quality and, as a result, reduced their provisions for loan losses.

M2 grew at a pace roughly in line with that of nominal GDP during the first half of 2004. A resurgence of mortgage refinancing spurred by the first-quarter decline in mortgage rates likely boosted liquid deposit growth, as proceeds from refinancing were temporarily held in deposit accounts pending disbursement to the holders of mortgage-backed securities. M2 growth slowed in the second half of the year in response to a drop in mortgage refinancing activity and the increased opportunity cost of holding M2 assets, as returns available on market instruments rose more than those on M2 components. For example, yields on retail money market mutual funds moved up more slowly than did short-term market interest rates, and assets of money funds accordingly continued to shrink. Small time deposits, which had contracted over the previous three years, resumed expansion in the second half of the year, as their yields began to rise in association with the increase in other market rates. Currency grew at its slowest rate since 2000, apparently reflecting sluggish demand by both domestic and foreign holders. On balance, M2 growth from the fourth quarter of 2003 to the fourth quarter of 2004 was about 5¼ percent. The velocity of M2 rose 1 percent, on net, roughly in line with the historical relationships among money, income, and opportunity cost.

International Developments

Foreign economic activity expanded in 2004 at a faster pace than in the preceding three years. The pickup in growth was widespread—global manufacturing and trade rebounded across industrial and emerging economies, in part because of strong demand from the United States and China. In the second half of the year, trade and foreign GDP growth slowed, partly as a result of higher oil prices and the appreciation of some foreign currencies against the dollar. The run-up in oil prices and other commodity prices contributed to higher, though still moderate, inflation across industrial and emerging economies.

Monetary policy in many foreign economies tightened over the course of 2004. Citing high rates of capacity utilization and mounting inflationary pressures, the Bank of England raised its target interest rate 100 basis points but has been on hold since August amid signs that housing prices and consumer spending are cooling. After cutting official interest rates earlier in the year, the Bank of Canada raised rates in the fall in response to diminishing slack in the economy. The Bank of Mexico tightened policy throughout the year to resist rising inflation, and Chinese authorities made monetary policy more restrictive to rein in soaring investment demand. In the euro area and Japan, central banks kept policy interest rates unchanged in 2004.

Foreign equity price indexes recorded moderate net gains last year after larger increases in 2003. Equity markets started the year strong, but prices declined in the spring as interest rates rose. The run-up in oil prices between July and October appeared to weigh on foreign equity prices, but the subsequent decline in oil prices helped support a rise in equity prices late in the year. Foreign long-term interest rates declined, on net, during 2004. Rates rose in the second quarter as new data (including reports from the United States) that showed faster growth and higher inflation led market participants to expect more-aggressive monetary tightening. However, foreign long-term interest rates slipped after midyear, when foreign growth slowed and foreign currencies appreciated against the dollar. Over the first half of the year, spreads on internationally issued sovereign debt of emerging-market economies over U.S. Treasuries moved up somewhat from low levels, but spreads more than reversed those increases in the second half.

The path of the exchange rate was uneven over the course of 2004. The dollar rose slightly in the first half of the year on perceptions that monetary policy would tighten more quickly in the United States than abroad. Beginning in

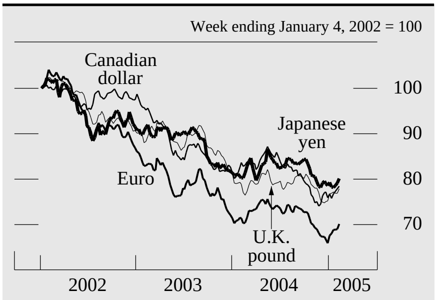
Spread on Internationally Issued Sovereign Debt of Emerging-Market Economies

NOTE. The data are weekly averages. The last observation is the average of trading days through February 9, 2005. The series shown is the spread of the yield of certain dollar-denominated sovereign debt instruments of emerging-market economies over U.S. Treasury securities; over the period shown, the index encompassed nineteen countries.

SOURCE. J.P. Morgan Emerging Market Bond Index Plus (EMBI+).

September, however, the dollar resumed the depreciation that had started in 2002, as market participants focused on the financing implications of the large and growing U.S. current account deficit. In 2004, the dollar depreciated about 7 percent, on net, against the euro, the U.K. pound, and the Canadian dollar. The dollar declined 4 percent, on net, against the Japanese yen and 13 percent against the Korean won, but some other Asian central banks, most notably the People's Bank of China, kept their currencies stable against the dollar. So far in 2005, the dollar has rebounded, with market commentary focusing on the positive differential between U.S. economic growth and that in Europe and Japan.

U.S. Dollar Exchange Rate against Selected Major Currencies



NOTE. The data are weekly and are in foreign currency units per dollar. The last observation for each series is the average of trading days through February 9, 2005.

SOURCE. Bloomberg L.P.

Industrial Economies

After increasing strongly in the first quarter, Japanese GDP growth stagnated in the remainder of 2004. Growth in exports and business investment slowed over the year, and government investment contracted. However, corporate profits and balance sheets improved, and labor market conditions also brightened, with the job-offers-to-applicants ratio rising to a twelve-year high. Consumer prices continued to decline in 2004, though only slightly. In contrast, higher commodity prices helped push twelve-month wholesale price inflation up to 2 percent late in the year, its highest rate since 1990. The yield on the ten-year bellwether government bond rose from its June 2003 record low of about ½ percent to nearly 2 percent in midyear before retreating to about 1½ percent recently. After making substantial sales of yen for dollars in the first quarter, Japanese authorities ceased intervention in mid-March and remained on the sidelines even as the yen appreciated significantly against the dollar in the fall.

Economic conditions in the euro area firmed during the first half of 2004 but weakened in the second half. Private consumption and investment spending continued to rise, but export growth slowed after midyear. German GDP growth slowed to a crawl in the second half, as German consumer spending remained anemic, held down by a weak labor market and low consumer confidence. In contrast, French GDP growth was strong in the fourth quarter. The euro-area unemployment rate has been near 9 percent since rising to that level in early 2003. Inflation for the euro area remained just above the European Central Bank's medium-term goal of less than, but close to, 2 percent.

With the exception of a slowdown in the third quarter, economic expansion in the United Kingdom stayed strong during 2004, largely because of the brisk growth of consumption and government spending. Labor markets remained tight in 2004; the unemployment rate ticked down to its lowest level in almost three decades, and labor earnings posted solid gains. Consumer price inflation over the twelve months ending in December was 1½ percent, below the central bank's official target rate of 2 percent. Housing price rises slowed sharply from rapid rates and were muted during the second half of 2004. Household net mortgage borrowing declined to a level 20 percent below its 2003 peak.

The Canadian economy expanded at a healthy pace throughout 2004. Sizable gains in consumption and investment boosted output throughout the year. Export growth, supported by demand from the United States, was strong in the first half of the year but stagnated in the second half as U.S. manufacturing growth slowed and the Canadian dollar's appreciation hurt Canadian trade. The unemployment rate declined moderately over the year, and employment posted strong gains. Consumer price inflation has settled at about 2 percent, the midpoint of the Bank of Canada's inflation target range, whereas inflation excluding food, energy, and indirect taxes declined to around 1½ percent by year-end.

Emerging-Market Economies

Growth of real GDP in China remained very robust in 2004, supported by strong domestic demand and exports. The Chinese government took steps early in the year to slow investment spending, curbing investment approvals and lending. Investment growth slowed significantly but remained rapid. At the same time, indicators of personal consumption spending strengthened, and Chinese exports and imports continued to soar in 2004. Consumer price inflation peaked at a twelve-month change of more than 5 percent in July but has fallen since then to less than 3 percent, as food prices have moderated. Inflation excluding food is only about 1 percent.

Supported by exports to China, economic growth in other Asian emerging-market economies was generally strong in 2004. Economic expansion in Korea remained heavily dependent on external demand because high levels of consumer debt continued to weigh on consumption spending. Inflation across emerging Asia, though still moderate, was pushed up by higher energy prices and strong aggregate demand.

The Mexican economy grew rapidly in the first half of the year in response to strong demand from the United States. In the third quarter, Mexican GDP growth slowed somewhat, as manufacturing exports stagnated, but domestic demand remained buoyant. Increases in energy and food prices pushed up twelve-month consumer price inflation to more than 5 percent, above the Bank of Mexico's target range of 2 percent to 4 percent. Monetary policy tightened throughout the year, and inflation began to fall near year-end. Oil revenues boosted the Mexican public-sector fiscal surplus and allowed Mexican government spending to provide stimulus while still meeting fiscal targets.

In Brazil, economic activity continued to expand robustly in 2004. Domestic demand was supported by the monetary loosening that occurred in the second half of 2003 and early 2004. Export growth was boosted by demand for commodities and the recovery in Argentina. Brazilian asset prices declined through May on expectations that higher global interest rates would make it more difficult for the Brazilian government to finance its debt, but stock prices have moved up sharply since May, and the currency has appreciated. Concerns over inflation pressures have prompted the central bank to tighten monetary policy since September.

In Argentina, the economic recovery picked up steam last year, as exports were supported by strong demand for commodities. The country continues, however, to grapple with difficult structural problems. After more than three years in default, the government launched a debt swap in January with the goal of restructuring more than $80 billion in defaulted bonds. ■

Monetary Policy Report of July 2004

Monetary Policy and the Economic Outlook

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

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

Monetary policy was very accommodative at the start of 2004 as the Federal Open Market Committee (FOMC) sought to provide continuing support to an economic expansion that had yet to produce a sustained improvement in the labor market and to ensure that the previous year's threat of an unwelcome disinflation would continue to recede. Although real GDP had accelerated sharply in the second half of 2003, the incoming data through the time of the March meeting suggested that employment was growing only slowly, as employers were relying on increased production efficiencies to satisfy considerable gains in aggregate demand. Surging oil prices were boosting overall inflation, while core inflation—though no longer declining—was still low. With subsequent labor market reports suggesting that hiring was on a stronger track, growth in output continuing at a solid pace, and core consumer price

NOTE. The discussion in this section consists of the text and tables from the Monetary Policy Report submitted to the Congress on July 20, 2004; the charts from this report (as well as earlier reports) are available on the Board's web site, at www.federalreserve.gov/boarddocs/hh.

inflation possibly running higher, the FOMC announced in May that it saw the risks to the goal of price stability as having moved into balance. Even so, the Committee stated that it believed that the monetary policy accommodation then in place could be "removed at a pace that is likely to be measured." Indeed, at its June meeting, the FOMC decided that sufficient evidence was in hand to begin moving the federal funds rate back toward a more neutral setting and raised the federal funds rate ¼ percentage point to 1¼ percent, a decision that was widely anticipated by market participants.

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

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

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

At the beginning of 2004, the FOMC was growing more confident that the economic expansion was likely to be self-sustaining, particularly in light of the significant firming of business outlays and the continued strength in household spending. Moreover, stimulative fiscal and monetary policies, in conjunction with receptive financial markets, appeared likely to provide substantial support to economic activity and to ward off any further disinflation. However, the Committee remained concerned about the persistent weakness in the labor market. At its January meeting, the FOMC left the target for the federal funds rate at 1 percent. The Committee generally felt that the apparent slack in labor and product markets and continued strong productivity growth were likely to keep the underlying trend in inflation subdued, but it nevertheless was cognizant that a highly accommodative stance for monetary policy could not be maintained indefinitely. Given these considerations, the Committee modified the language of its policy statement to gain greater flexibility to firm policy should circumstances warrant. The Committee achieved this added flexibility by removing its assessment that monetary policy would be accommodative for ‘‘a considerable period’’ and instead saying that the Committee could be ‘‘patient’’ in removing its policy accommodation.

At the time of the March FOMC meeting, the Committee believed that conditions were mostly in place for further solid economic growth. Industrial production had picked up broadly, and consumer and business spending continued to expand briskly. However, the employment reports for January and February still painted a picture of subdued hiring. With financial markets quite accommodative, the Committee recognized that maintaining the current stance of policy could fuel inflation pressures and perhaps encourage excessive risk-taking by financial market participants. The Committee concluded that the low level of core consumer price inflation and continued evidence of weak hiring argued for the retention of both its 1 percent target for the federal funds rate and the wording in its statement that the Committee could be ‘‘patient’’ with respect to changes in monetary policy.

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

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

Economic Projections for 2004 and 2005

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

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

Economic Projections for 2004 and 2005

Percent

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

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

Economic and Financial Developments in 2004

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

The Household Sector

Consumer Spending

Consumer spending, which had gathered a good bit of steam in the second half of 2003, continued to move higher in the first half of 2004. The growth in spending was spurred by substantial gains in income. In addition, household wealth has risen sharply over the past year, and consumer surveys indicate that individuals are generally upbeat in their assessments of the economy's prospects and of their own situations.

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

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

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

Residential Investment

Activity in the housing sector remained torrid in the first half of 2004. Although starts in the single-family sector faltered a bit early in the year, in part because of unusually adverse weather, they subsequently snapped back and reached an annual rate of more than 1.6 million units in April and May—8½ percent greater than the already rapid pace for 2003 as a whole. Sales of new and existing homes have also been exceptionally strong, and they hit record highs in May. In general, housing activity has been supported by the favorable developments regarding jobs and income and, especially early in the year, by low mortgage rates. Rates on thirty-year fixed-rate mortgages, which had dipped to 5½ percent in March, rose markedly in the spring; they have edged down in recent weeks and now stand at 6 percent, a level still quite low by historical standards.

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

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

Household Finance

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

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

Rapid increases in home prices have continued to buoy household net worth this year. In contrast, stock prices are about unchanged. Although news on earnings and economic activity has generally been favorable, rising oil prices and interest rates and, perhaps, heightened geopolitical concerns have weighed on investor sentiment. Nevertheless, inflows into equity mutual funds have been even stronger thus far in 2004 than they were last year.

The Business Sector

Fixed Investment

For the most part, businesses appear to be shaking off the extraordinary reluctance to undertake new investment projects that was evident in 2002 and 2003. Indeed, although outlays on nonresidential construction have not yet turned up decisively, real spending on equipment and software (E&S) has been advancing briskly. The broadly based growth in E&S spending has been driven by increasingly favorable fundamentals: positive expectations for sales, high levels of corporate profits and cash flow, a desire to replace or upgrade aging equipment after a period of weak investment spending, and the continued low cost of capital.

Real E&S spending rose at an annual rate of more than 15 percent in the second half of last year, and it posted another sizable increase in the first quarter of 2004 despite flat business purchases of motor vehicles and a dip in deliveries of aircraft. Excluding transportation equipment, real spending on E&S rose at an annual rate of 13½ percent in the first quarter. In the high-tech category, real purchases of computers and software remained on the solid uptrend that has been evident for the past couple of years, and real outlays on communications equipment increased further, reaching a level about 20 percent above the low in the fourth quarter of 2002. Spending for equipment other than high-tech and transportation, which accounts for about 40 percent of E&S (measured in nominal terms), also rose markedly in the first quarter. Such spending tends to be particularly sensitive to the prospects for aggregate demand. In addition, it may be receiving a lift from the partial-expensing tax provision, which is especially valuable for equipment with relatively long service lives for tax purposes; that provision is slated to expire at the end of 2004.

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

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

Inventory Investment

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

Corporate Profits and Business Finance

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

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

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

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

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

The Government Sector

Federal Government

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

Over the twelve months ending in June, nominal federal spending was nearly 7 percent higher than during the same period a year earlier and stood at about 20 percent of nominal GDP—virtually the same as in fiscal 2003 but 1½ percentage points above the recent low in fiscal 2000. Spurred by the war in Iraq, defense spending ramped up another 14 percent; outlays for nondefense discretionary programs, which include homeland security, moved up further as well. Spending on the major health programs rose at a rapid clip, in part because the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) temporarily increased grants to the states under the Medicaid program and boosted payments to some Medicare providers. In addition, as noted, net interest payments, which had plummeted between 1997 and 2003, flattened out. Real federal expenditures for consumption and gross investment—the part of government spending that is a component of real GDP—rose at an annual rate of 8½ percent in the first calendar quarter of 2004; that increase reflected a surge in real defense spending, which now stands more than 30 percent above the levels that prevailed, on average, from 1997 to 2000.

Federal receipts in the twelve months ending in June were 1½ percent higher than during the comparable period of the previous year after having fallen markedly between fiscal 2000 and fiscal 2003. Receipts received a substantial boost over the past year from a strong gain in corporate taxes, which were lifted by robust profits. Social insurance taxes, which tend to move in line with wages and salaries, also increased. But individual income taxes were below last year's level: Although taxable incomes rose moderately, collections were reduced by the lower withholding rates in place since mid-2003 and by the effects of JGTRRA on refunds and final settlements this spring.

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

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

State and Local Governments

States and localities have started to see some improvement in their budget positions after having gone through several difficult years. Strong growth in household income and consumer spending has boosted revenues in recent quarters, as have the additional federal grants authorized under JGTRRA. And although rising medical costs and security needs have continued to put upward pressure on spending, state and local governments have generally held the line on hiring and have kept other outlays in check. The restraint on spending, in combination with a drawdown of reserve funds and some increases in taxes, has helped states and localities satisfy their balanced-budget requirements. In fact, between the third quarter of 2003 and the first quarter of 2004, NIPA net saving (excluding social insurance funds) for this sector averaged $21 billion at an annual rate (¼ percent of nominal GDP), compared with negative $7 billion in 2002 and negative $31 billion in the first half of 2003. (Net saving is roughly similar to the surplus or deficit in an operating budget.) Although a few states are still struggling with strained fiscal situations, most have entered fiscal 2005 (which started on July 1 in all but four states) with expectations of respectable growth in revenues and with budgets in place that allow for some increases in spending on high-priority services and some rebuilding of reserve funds.

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

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

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

The External Sector

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

International Trade

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

Real exports of goods and services increased at an annual rate of 7½ percent in the first quarter of 2004, well off the blistering 20 percent pace of the fourth quarter but still above the average for 2003. Solid gains in exports since mid-2003 arose in part from the strong economic performance of many of our major trading partners. In addition, the net decline in the exchange value of the dollar since 2002 continued to make U.S. goods and services more competitive abroad. Increases in exports of U.S. goods were widespread across our major trading partners, with the exception of Japan, and were concentrated in real exports of capital goods, industrial supplies, and consumer goods. Real exports of agricultural products fell sharply, hurt by foreign bans on U.S. beef products following reports of mad cow disease in a U.S. herd. Exports of services rose moderately.

Prices of total exports rose at an annual rate of 5¾ percent in the first quarter, boosted by another jump in agricultural prices along with substantial increases in the prices of other primary commodities and industrial supplies. Prices of U.S. agricultural exports have been pushed up by very strong global demand, particularly from China. For specific products, such as cotton and soybeans, lower production in some countries also contributed to price run-ups. More recently, prices of soybeans and other agricultural products have eased in the face of a slowing in the growth of demand from China and the anticipation of larger harvests. Even so, available data point to continued strong increases in export prices in the second quarter.

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

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

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

The Financial Account

The U.S. current account deficit has continued to be financed largely by foreign flows into U.S. bonds. Foreign official inflows, already sizable in 2003, rose sharply in the first quarter of 2004 and then moderated somewhat. Similarly, private foreign purchases of U.S. bonds, which were significant in 2003, increased sharply in the first quarter and also appear to have moderated in the second quarter. In contrast, foreign demand for U.S. equities was weak in 2003 and has remained so in 2004. Purchases of foreign equities by private U.S. investors appear to be strengthening, but U.S. investors still show no appetite for foreign bonds.

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

The Labor Market

Employment and Unemployment

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

The increases in payrolls over the first half of 2004 were widespread. Especially notable was the turnaround in the manufacturing sector, in which employment bottomed out in January and then rose a cumulative 65,000 jobs through June. The rise in manufacturing jobs was concentrated in the durable goods industries—in particular, those making fabricated metals and other construction-related products, computers and electronic equipment, and machinery. After a long string of declines, employment at producers of nondurable goods was little changed, on net, over the first half. Job gains in virtually all other major sectors have been greater this year than last. In particular, hiring in retail trade, which had been lackluster in 2003, turned up appreciably, and construction employment increased further. The professional and business services sector also posted a sizable rise, in part because the rebound in manufacturing activity lifted hiring at temporary-help firms. A clear indication of the breadth of the employment increases is provided by the six-month diffusion index compiled by the Bureau of Labor Statistics (BLS). The index is equal to the percentage of industries that increased employment over the most recent six months plus one-half the percentage with unchanged employment; in June, the index moved up to its highest level since April 2000.

Productivity and Labor Costs

Gains in labor productivity have slowed somewhat in recent quarters after the spectacular increases of mid-2003. Still, according to the currently published data, output per hour in the nonfarm business sector rose a remarkable 5½ percent over the year ending in the first quarter. Over the past three years, increases in productivity have averaged more than 4 percent per year, compared with average increases of about 2½ percent per year in the second half of the 1990s. During that earlier period, an expansion of the capital stock was an important source of productivity growth. However, in the more recent period, when the business environment—at least until the past few quarters—was characterized by sluggish demand, lean capital budgets, and an extraordinary reluctance of firms to add to payrolls, businesses appear to have raised their productivity mainly through changes in organizational structures and better use of the capital already in place. With hiring having picked up of late, measured productivity growth may slow in coming quarters; but if recent experience is any guide, businesses will continue to focus on achieving structural improvements in the efficiency of their operations. The upswing in investment spending now under way also bodes well for sustained favorable productivity performance in the period ahead.

The rapid productivity growth in recent years has helped to bolster increases in hourly compensation in the face of the soft labor market and the low consumer price inflation in 2003. As a result, increases in the employment cost index (ECI) measure of hourly compensation, which is based on a survey of private nonfarm businesses conducted quarterly by the BLS, have held fairly steady of late. In fact, the rise in the ECI over the twelve months ending in March—at a shade less than 4 percent—was virtually the same as the increases over the preceding two years. Benefit costs, which rose 7 percent over the year ending in March, have continued to be the fastest rising portion of hourly compensation; health insurance costs have remained on a steep uptrend, and employers have boosted their contributions to defined-benefit retirement plans to make up for earlier stock market losses. The rising benefit costs have likely exerted some downward pressure on wages, which rose just 2½ percent over the twelve months ending in March; the twelve-month change in the wage component of the ECI, which was close to 4 percent in 2000 and 2001, has been in the range of 2½ percent to 3 percent since late 2002.

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

Prices

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

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

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

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

A number of factors have contributed to the run-up in core inflation this year. Higher oil prices have doubtless raised the cost of producing other goods and services. So have the steep increases in prices of non-oil commodities such as copper and lumber, which came about as economic activity strengthened worldwide and as industrial capacity utilization both here and abroad tightened. Likewise, the decline in the dollar has boosted non-oil import prices and thus the costs of inputs for many domestic producers. The weaker dollar has also likely lessened the pressure on firms facing foreign competition to hold the line on prices—a consideration that is probably contributing to the widespread perception that firms' pricing power has increased lately. Moreover, unit labor costs have edged up recently after having declined noticeably in 2002 and 2003.

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

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

The upturn in actual inflation has been echoed in some measures of inflation expectations. For example, according to the Michigan Survey Research Center, the median expectation for inflation over the coming year has averaged slightly more than 3 percent since early spring after hovering in the area of 2¼ percent to 2¾ percent in 2003 and early 2004. The median expectation for inflation over the next five to ten years has been running a bit below 3 percent in recent months, a reading similar to the figures for 2002 and 2003. According to the Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia, expectations of inflation over the next ten years held steady in June at 2½ percent. Inflation compensation over the next five years as mea-

Alternative Measures of Price Change

Percent

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

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

sured by the spread between the yield on nominal Treasury securities and their indexed counterparts rose noticeably during the first half of 2004. To be sure, inflation compensation is also influenced by perceptions of inflation risk and the secular increase in demand for inflation-indexed debt, but the rise in near-term inflation compensation likely reflects, at least in part, higher inflation expectations. Similar to the survey-based measures of longer-run inflation expectations, inflation compensation for the period five years to ten years ahead was little changed on net over the first half of the year.

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

U.S. Financial Markets

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

Interest Rates

From the end of 2003 through the end of March, yields on nominal Treasury coupon securities fell, on net, about 30 to 45 basis points. Although interest rates rose immediately after the FOMC's January meeting in response to the Committee's decision to remove its statement that monetary policy could remain accommodative for "a considerable period," the increase proved to be short lived. Weak employment reports released in early February and early March prompted yields to fall amid doubts about the strength of the economic expansion. Federal funds futures contracts at the end of March appeared to indicate that market participants placed small odds on a tightening of monetary policy before late 2004, and contracts also seemed to price in only a gradual increase in the federal funds rate during 2005.

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

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

Equity Markets

Over the first half of 2004, equity prices were subject to the strong crosscurrents of robust earnings reports, rising interest rates, fluctuating fears about geopolitical developments, and sharply higher oil prices. On balance, broad equity price indexes at the end of June had edged about 2½ percent to 3¼ percent above year-end levels after having surged 25–30 percent over the course of 2003. Over the first half, analysts raised their estimates of profits for coming quarters; the upward revision outstripped the more modest increase in equity prices and boosted the ratio of expected year-ahead earnings to stock prices. With real interest rates higher, however, the difference between the earnings–price ratio and the real ten-year Treasury yield—a crude measure of the equity risk premium—changed little to remain close to its average value over the past two decades and above its level during the late 1990s.

Debt and Financial Intermediation

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

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

The M2 Monetary Aggregates

In the first half of 2004, short-term interest rates were stable and M2 grew at an annual rate of 6½ percent—a pace that was roughly in line with estimates of nominal GDP—after contracting at a record rate in the fourth quarter of 2003. Liquid deposits—the largest component of M2—had been depressed late last year by the ebbing of last summer's mortgage refinancing boom. Mortgage refinancings tend to boost M2 as the proceeds are temporarily placed in non-interest-bearing deposit accounts pending disbursement of funds to the holders of mortgage-backed securities. When refinancings slowed last year, the decline in such escrow accounts held down the growth of liquid deposits. In the first half of this year, M2 probably received a boost from the new round of mortgage refinancings that followed the first-quarter decline in mortgage interest rates. The strength in liquid deposits was partly offset, however, by continued weakness in money market mutual funds and small time deposits. Given the recent very low yields on these two components of M2, households likely viewed them as less attractive savings vehicles than other assets.

International Developments

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

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

In foreign financial markets, equity price performance has been more mixed so far in 2004 than during the second half of 2003; sharply rising interest rates over the past few months have weighed on equity valuations, damping the effects of an improved earnings outlook. Since year-end, stock prices in Europe and Canada have changed little, on balance. In contrast, rapidly improving economic conditions in Japan have helped boost Japanese equity prices about 10 percent. Other Asian stock price indexes have fallen, on average, in part because of concerns about the possibility of an acute slowdown in China. Mexican stocks have been bolstered by strong earnings growth of leading Mexican communications firms and, more generally, by the strengthening U.S. expansion. Foreign long-term interest rates rose rapidly in the second quarter as new data (including from the United States) showing faster growth and higher inflation led market participants to expect more-aggressive monetary tightening. Over the first half of the year, the spread on internationally issued sovereign debt of emerging-market economies over U.S. Treasuries moved up somewhat from its very low level.

After depreciating over the previous two years, the value of the dollar rose slightly, on balance, in the first half of 2004. The firming of the dollar has been attributed to perceptions by market participants that near-term monetary tightening in the United States would be faster than such tightening abroad.

Industrial Economies

A broadly based recovery appears to have been established in Japan over the first half of 2004. Real GDP rose at an annual rate of more than 6 percent in the first quarter after an even greater increase in the fourth quarter. Aided by demand from China, growth of Japanese real exports remained robust. Personal consumption and business investment also firmed. More-recent indicators show that domestic strength continued in the spring with large gains in household expenditures and improved labor market conditions. Deflation continued to wane in Japan. Consumer price deflation over the first half of the year was slight, and wholesale prices increased. In financial markets, the stronger economy boosted equity markets and helped drive up the yield on the ten-year bellwether government bond to more than 1¾ percent from its June 2003 record low of about ½ percent. After making substantial sales of yen for dollars in the first quarter, Japanese authorities ceased intervention in mid-March. Even so, the yen depreciated early in the second quarter before appreciating to around ¥109 per dollar.

Economic conditions in the euro area firmed over the first half of 2004, but performance varied across countries, and the region as a whole continues to lag the global upturn. Real GDP in the euro area increased at an annual rate of 2¼ percent in the first quarter; output in France, Spain, and several smaller member countries rose relatively briskly, while growth in Germany and Italy was less robust. In the first quarter, domestic demand firmed noticeably, except in Germany, where growth was due entirely to a spike in exports. German consumer spending remains anemic, held down by a weak labor market and low consumer confidence. Euro-area indicators for the second quarter initially were upbeat, but more-recent data have been mixed. Labor markets have yet to benefit from the recovery, and the average unemployment rate in the region edged up to 9 percent in the spring. Inflation for the euro area over the twelve months ending in June was near 2½ percent, a rate above the European Central Bank's medium-term goal of less than, but close to, 2 percent. Excluding energy, food, alcohol, and tobacco, prices rose slightly less than 2 percent over the same period.

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

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

Emerging-Market Economies

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

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

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

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

The recovery in Argentina has continued at a rapid pace in recent quarters, but limited investment in the energy sector, reflecting a lack of structural reforms, has forced the government to import electricity, natural gas, and fuel oil from neighboring countries. Creditors have shown little enthusiasm for the country's latest debt restructuring plan, and the federal government faces difficult challenges in normalizing its international financial situation and reforming its fiscal relations with the provinces. ■