

Prefatory Note

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August 6, 2004

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Supplemental Notes

Prepared for the Federal Open Market Committee
by the staff of the Board of Governors of the Federal Reserve System

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Supplemental Notes

The Domestic Nonfinancial Economy

Labor Market Developments

The slowdown in hiring by private nonfarm businesses continued into July; employment rose only 32,000 last month, and the level of employment in June was revised down 51,000.¹ Aggregate hours of production or nonsupervisory workers rose 0.3 percent in July, only partially reversing their June decline.

By industry, manufacturing employment increased 10,000 last month despite a reported drop of 21,000 in the transportation equipment industry, which the BLS attributes to an atypical pattern of summer plant shutdowns.² In the related wholesale trade industry, employment moved up 8,000 last month, in line with gains since the start of the year, but temporary help employment was reported to have edged up only 5,000 after having fallen 11,000 in June. Our contacts in the staffing industry report that demand for workers in light industrial jobs has remained strong, and, in contrast to the weak payroll figures, they have been fairly upbeat about their business prospects going forward. Elsewhere in the goods producing industries, construction employment was little changed for a second month after strong increases earlier this year.

In the services producing sector, employment fell in retail trade (-19,000) and financial activities (-23,000); combined, these industries averaged monthly gains of 39,000 during the first half of this year. The weakness in retail trade was widespread, while a drop off in mortgage refinancing activity was likely responsible for much of the loss in financial activities employment. Employment in leisure and hospitality services was essentially flat last month after average increases of 25,000 in the first half of the year. Elsewhere, employment continued to rise in education and health services (20,000) and professional and business services excluding temporary help (37,000).

Average weekly hours of production or nonsupervisory workers on private nonfarm payrolls rose 0.1 hour to 33.7 hours last month, reversing half of the previous month's decline. With last month's increase, aggregate hours now stand 0.2 percent above their second-quarter average.

Respondents in the household survey reported a more positive picture of labor market developments than the one portrayed by the business report. The

1. The downward revisions to the June level of employment were particularly large in the temporary help and education services industries.

2. Motor vehicle assembly operations during the survey reference week were not evenly distributed across all manufacturers and did not represent a substantial portion of overall monthly output. Only 12 percent of total auto and light trucks assembled in July were produced during that week.

unemployment rate ticked down 0.1 percentage point to 5.5 percent, while the labor force participation rate rose 0.2 percentage point to 66.2 percent. Combining these two measures, the employment to population ratio rose 0.2 percentage point to 66.5 percent, about 1/2 percentage point above the low point reached last September.

Average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls moved up 0.3 percent last month. Over the twelve months ending in July, average hourly earnings increased 1.9 percent compared with an increase of 2.9 percent over the previous twelve months.

Changes in Employment

(Thousands of employees; seasonally adjusted)

| Measure and sector | 2003 | 2004 | | | | |
|---|------------------------|------|------|----------------|------|------|
| | | Q1 | Q2 | May | June | July |
| | Average monthly change | | | Monthly change | | |
| Nonfarm payroll employment (establishment survey) | -5 | 198 | 203 | 208 | 78 | 32 |
| Private | -1 | 195 | 211 | 236 | 93 | 32 |
| Previous | -1 | 195 | 228 | 263 | 117 | ... |
| Manufacturing | -48 | 7 | 17 | 31 | -1 | 10 |
| Construction | 7 | 26 | 20 | 37 | 3 | 4 |
| Wholesale trade | -3 | 8 | 5 | 4 | 2 | 8 |
| Retail trade | -5 | 46 | 14 | 11 | 7 | -19 |
| Transportation and utilities | -5 | 14 | 10 | 14 | 16 | 0 |
| Information | -10 | -2 | 2 | 4 | -2 | -5 |
| Financial activities | 6 | 7 | 11 | 14 | 7 | -23 |
| Professional and business services | 23 | 26 | 71 | 69 | 19 | 42 |
| Temporary help services | 15 | 8 | 20 | 28 | -11 | 5 |
| Nonbusiness services ¹ | 34 | 59 | 59 | 48 | 42 | 11 |
| Total government | -4 | 3 | -8 | -28 | -15 | 0 |
| Total employment (household survey) | 168 | -60 | 244 | 196 | 259 | 629 |
| Memo: | | | | | | |
| Aggregate hours of private production workers (percent change) ² | -0.8 | 2.3 | 2.2 | 0.7 | -0.5 | 0.3 |
| Average workweek (hours) ³ | 33.7 | 33.8 | 33.7 | 33.8 | 33.6 | 33.7 |
| Manufacturing (hours) | 40.4 | 41.0 | 40.9 | 41.1 | 40.8 | 40.9 |

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

2. Establishment survey. Semiannual data are percent changes from Q4 to Q2. Quarterly data are percent changes from preceding quarter at an annual rate. Monthly data are percent changes from preceding month.

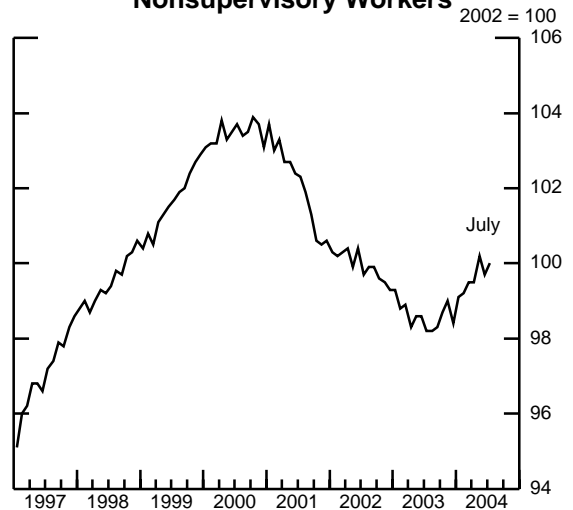
3. Establishment survey.

... Not applicable.

Changes in Private Payroll Employment



Aggregate Hours of Production or Nonsupervisory Workers

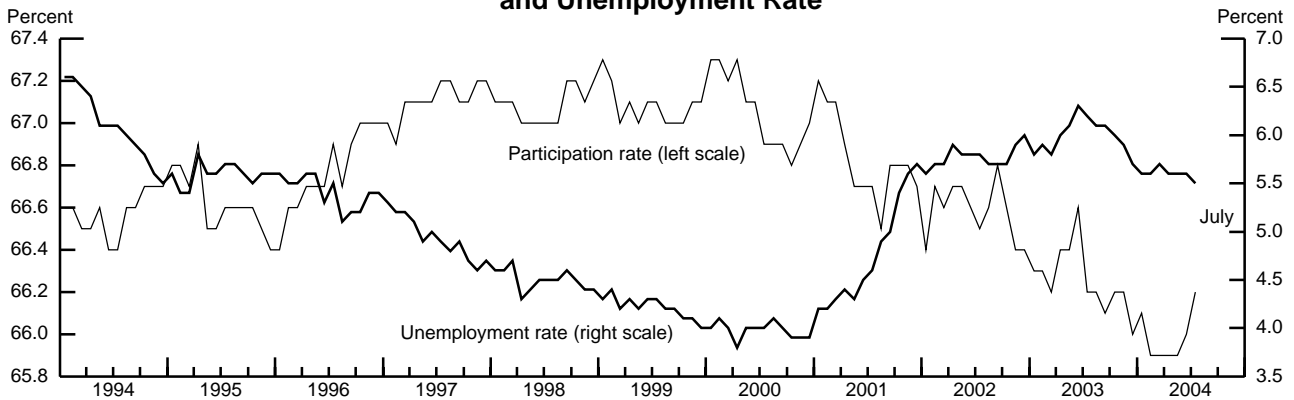


Selected Unemployment and Labor Force Participation Rates

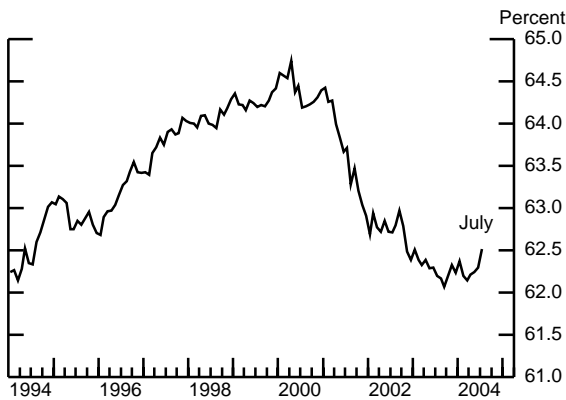
(Percent; seasonally adjusted)

| Rate and group | 2003 | 2004 | | | | |
|---------------------------------------|------|------|------|------|------|------|
| | | Q1 | Q2 | May | June | July |
| <i>Civilian unemployment rate</i> | | | | | | |
| 16 years and older | 6.0 | 5.6 | 5.6 | 5.6 | 5.6 | 5.5 |
| Teenagers | 17.4 | 16.6 | 17.0 | 17.2 | 16.9 | 17.6 |
| 20-24 years old | 10.0 | 9.6 | 9.5 | 9.7 | 9.8 | 9.3 |
| Men, 25 years and older | 5.1 | 4.5 | 4.5 | 4.6 | 4.4 | 4.4 |
| Women, 25 years and older | 4.6 | 4.5 | 4.4 | 4.2 | 4.5 | 4.5 |
| <i>Labor force participation rate</i> | | | | | | |
| Total | 66.2 | 66.0 | 65.9 | 65.9 | 66.0 | 66.2 |
| Teenagers | 44.5 | 43.6 | 43.6 | 43.9 | 43.3 | 44.1 |
| 20-24 years old | 75.4 | 74.7 | 75.1 | 75.0 | 75.1 | 75.2 |
| Men, 25 years and older | 75.5 | 75.4 | 75.2 | 75.2 | 75.3 | 75.4 |
| Women, 25 years and older | 59.6 | 59.2 | 59.3 | 59.2 | 59.4 | 59.5 |

Labor Force Participation Rate and Unemployment Rate

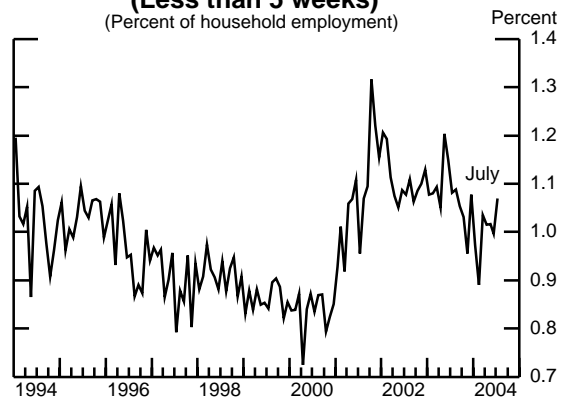


Employment-Population Ratio



Job Losers (Less than 5 weeks)

(Percent of household employment)



Commercial Bank Credit

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

| Type of credit | 2003 | Q1 2004 | Q2 2004 | May 2004 | June 2004 | July 2004 | Level, July 2004 (\$ billions) |
|--------------------------------|------------|-------------|-------------|-------------|--------------|--------------|--------------------------------------|
| Total | | | | | | | |
| 1. Adjusted¹ | 5.9 | 11.2 | 10.7 | 4.3 | 7.8 | .0 | 6,320 |
| 2. Reported | 5.6 | 11.8 | 7.4 | -.6 | 6.6 | 2.7 | 6,480 |
| <i>Securities</i> | | | | | | | |
| 3. Adjusted ¹ | 8.6 | 18.0 | 13.3 | -2.5 | 3.5 | -13.3 | 1,734 |
| 4. Reported | 7.3 | 19.5 | 2.0 | -18.2 | -.1 | -3.1 | 1,893 |
| 5. Treasury and agency | 8.8 | 24.1 | 10.2 | -12.3 | .1 | -6.1 | 1,180 |
| 6. Other ² | 5.0 | 12.4 | -10.7 | -27.8 | -.3 | 1.9 | 714 |
| <i>Loans³</i> | | | | | | | |
| 7. Total | 4.9 | 8.6 | 9.7 | 6.9 | 9.5 | 5.1 | 4,587 |
| 8. Business | -9.3 | -5.0 | -2.0 | -1.5 | 4.9 | 5.0 | 867 |
| 9. Real estate | 11.1 | 10.2 | 19.4 | 15.0 | 5.8 | 4.3 | 2,405 |
| 10. Home equity | 30.8 | 37.8 | 36.7 | 33.7 | 35.3 | 35.4 | 346 |
| 11. Other | 8.8 | 6.3 | 16.7 | 12.0 | 1.2 | -.8 | 2,060 |
| 12. Consumer | 5.6 | 11.8 | 4.8 | 4.3 | 4.5 | 15.7 | 652 |
| 13. Adjusted ⁴ | 6.0 | 10.6 | -1.8 | -8.3 | -.1 | 15.9 | 1,016 |
| 14. Other ⁵ | 6.7 | 19.0 | -3.7 | -8.5 | 33.5 | -1.4 | 663 |

Note. Data are adjusted to remove estimated effects of consolidation related to FIN 46 and for breaks caused by reclassifications. Monthly levels are pro rata averages of weekly (Wednesday) levels. Quarterly levels (not shown) are simple averages of monthly levels. Annual levels (not shown) are levels for the fourth quarter. Growth rates are percentage changes in consecutive levels, annualized but not compounded.

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

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

3. Excludes interbank loans.

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

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

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

| Instrument | 2003 | | 2004 | | Change to Aug. 5 from selected dates (percentage points) | | | |
|---|-------------|---------|---------|---------|--|--|--------------|--------------|
| | June 24 | Dec. 31 | June 29 | Aug. 5 | 2003 June 24 | 2003 Dec. 31 | 2004 June 29 | |
| <i>Short-term</i> | | | | | | | | |
| FOMC intended federal funds rate | 1.25 | 1.00 | 1.00 | 1.25 | .00 | .25 | .25 | |
| Treasury bills ¹ | | | | | | | | |
| 3-month | 0.81 | 0.93 | 1.36 | 1.45 | .64 | .52 | .09 | |
| 6-month | 0.82 | 1.00 | 1.71 | 1.71 | .89 | .71 | .00 | |
| Commercial paper (A1/P1 rates) ² | | | | | | | | |
| 1-month | 0.95 | 1.00 | 1.31 | 1.47 | .52 | .47 | .16 | |
| 3-month | 0.91 | 1.05 | 1.48 | 1.63 | .72 | .58 | .15 | |
| Large negotiable CDs ¹ | | | | | | | | |
| 1-month | 0.96 | 1.06 | 1.32 | 1.53 | .57 | .47 | .21 | |
| 3-month | 0.93 | 1.09 | 1.56 | 1.67 | .74 | .58 | .11 | |
| 6-month | 0.92 | 1.16 | 1.88 | 1.91 | .99 | .75 | .03 | |
| Eurodollar deposits ³ | | | | | | | | |
| 1-month | 0.94 | 1.04 | 1.29 | 1.51 | .57 | .47 | .22 | |
| 3-month | 0.91 | 1.07 | 1.53 | 1.64 | .73 | .57 | .11 | |
| Bank prime rate | 4.25 | 4.00 | 4.00 | 4.25 | .00 | .25 | .25 | |
| <i>Intermediate- and long-term</i> | | | | | | | | |
| U.S. Treasury ⁴ | | | | | | | | |
| 2-year | 1.14 | 1.83 | 2.84 | 2.64 | 1.50 | .81 | -.20 | |
| 10-year | 3.46 | 4.40 | 4.85 | 4.57 | 1.11 | .17 | -.28 | |
| 30-year | 4.53 | 5.22 | 5.50 | 5.31 | .78 | .09 | -.19 | |
| U.S. Treasury 10-year indexed note | 1.70 | 2.00 | 2.19 | 1.96 | .26 | -.04 | -.23 | |
| Municipal revenue (Bond Buyer) ⁵ | 4.89 | 5.04 | 5.37 | 5.24 | .35 | .20 | -.13 | |
| Private instruments | | | | | | | | |
| 10-year swap | 3.67 | 4.66 | 5.22 | 4.89 | 1.22 | .23 | -.33 | |
| 10-year FNMA ⁶ | 3.84 | 4.72 | 5.29 | 4.92 | 1.08 | .20 | -.37 | |
| 10-year AA ⁷ | 4.13 | 5.05 | 5.54 | 5.26 | 1.13 | .21 | -.28 | |
| 10-year BBB ⁷ | 5.16 | 5.74 | 6.14 | 5.87 | .71 | .13 | -.27 | |
| 5-year high yield ⁷ | 8.95 | 7.94 | 8.31 | 8.06 | -.89 | .12 | -.25 | |
| Home mortgages (FHLMC survey rate) ⁸ | | | | | | | | |
| 30-year fixed | 5.21 | 5.81 | 6.25 | 6.08 | .87 | .27 | -.17 | |
| 1-year adjustable | 3.51 | 3.73 | 4.13 | 4.17 | .66 | .44 | .04 | |
| <hr/> | | | | | | | | |
| Stock exchange index | Record high | | 2003 | 2004 | | Change to Aug. 5 from selected dates (percent) | | |
| | Level | Date | Dec. 31 | June 29 | Aug. 5 | Record high | 2003 Dec. 31 | 2004 June 29 |
| Dow-Jones Industrial | 11,723 | 1-14-00 | 10,454 | 10,413 | 9,963 | -15.01 | -4.70 | -4.33 |
| S&P 500 Composite | 1,527 | 3-24-00 | 1,112 | 1,136 | 1,081 | -29.25 | -2.81 | -4.88 |
| Nasdaq | 5,049 | 3-10-00 | 2,003 | 2,035 | 1,822 | -63.92 | -9.07 | -10.48 |
| Russell 2000 | 606 | 4-5-04 | 557 | 588 | 532 | -12.21 | -4.41 | -9.44 |
| Wilshire 5000 | 14,752 | 3-24-00 | 10,800 | 11,084 | 10,472 | -29.01 | -3.03 | -5.52 |

1. Secondary market.
2. Financial commercial paper.
3. Bid rates for eurodollar deposits collected around 9:30 a.m. Eastern time.
4. Derived from a smoothed Treasury yield curve estimated using off-the-run securities.
5. Most recent Thursday quote.
6. Constant maturity yields estimated from Fannie Mae domestic noncallable coupon securities.
7. Derived from smoothed corporate yield curves estimated using Merrill Lynch bond data.
8. For week ending Friday previous to date shown.

NOTES:

June 24, 2003, is the day before the most recent policy easing.
June 29, 2004, is the day before the most recent FOMC meeting.

The International Economy

U.S. International Financial Transactions

Private foreign purchases of U.S. securities (line 4 of the Summary of U.S. International Transactions table) were very strong in June, bringing second quarter inflows to \$128 billion, similar to the elevated pace of the first quarter. In June, private inflows into Treasury securities (line 4a) and corporate bonds (line 4c) were particularly strong while inflows into equities (line 4d) remained tepid. This year's pattern has been rather consistent, with near zero purchases of equities but very strong inflows into corporate bonds and Treasury securities or, alternately, agency bonds (line 4b) .

Net foreign official inflows (line 1) picked up to \$35 billion in June, following inflows of roughly \$20 billion in both April and May.

. Partial data from the Federal Reserve Bank of New York (FRBNY) suggest a slowing of foreign official inflows in July.

Following modest net sales in May, U.S. investors acquired \$15 billion in foreign securities (line 5) in June. As in previous months, purchases of foreign equities were relatively robust, totaling \$9 billion. In a shift, U.S. investors purchased a significant amount of foreign bonds (\$6 billion) for the first time in years.

The banking sector (line 3) recorded modest outflows in June, following similarly sized inflows in May.

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

| | 2002 | 2003 | 2003 | | 2004 | | | |
|--|---------------|---------------|---------------|---------------|---------------|-------------|-------------|-------------|
| | | | Q3 | Q4 | Q1 | Q2 | May | June |
| Official financial flows | 113.0 | 247.3 | 50.1 | 85.9 | 128.6 | 75.2 | 18.8 | 34.8 |
| 1. Change in foreign official assets in the U.S. (increase, +) | 116.7 | 245.8 | 50.8 | 83.7 | 128.0 | 74.0 | 18.6 | 34.7 |
| a. G-10 countries | 30.7 | 115.7 | 15.9 | 47.3 | 95.5 | 45.6 | 15.4 | 20.9 |
| b. OPEC countries | -7.5 | 6.1 | 2.1 | 10.5 | 3.7 | -2.3 | .4 | -4.4 |
| c. All other countries | 93.5 | 124.0 | 32.8 | 25.9 | 28.8 | 30.7 | 2.9 | 18.1 |
| 2. Change in U.S. official reserve assets (decrease, +) | -3.7 | 1.5 | -.6 | 2.2 | .6 | 1.1 | .1 | .2 |
| Private financial flows | 457.2 | 298.5 | 75.9 | 82.8 | 29.7 | n.a. | ... | ... |
| Banks | | | | | | | | |
| 3. Change in net foreign positions of banking offices in the U.S. ¹ | 116.8 | 64.3 | 25.4 | 101.5 | -44.4 | 22.2 | 23.6 | -15.0 |
| Securities² | | | | | | | | |
| 4. Foreign net purchases of U.S. securities (+) | 390.1 | 372.8 | 65.5 | 92.3 | 128.9 | 127.6 | 28.9 | 54.1 |
| a. Treasury securities | 101.5 | 121.2 | 46.7 | 8.8 | 65.8 | 36.0 | 8.3 | 22.6 |
| b. Agency bonds | 84.2 | -14.8 | -31.1 | 2.2 | 6.8 | 38.5 | 12.3 | 6.3 |
| c. Corporate and municipal bonds | 145.7 | 226.1 | 52.5 | 57.6 | 51.3 | 51.5 | 16.2 | 22.9 |
| d. Corporate stocks ³ | 58.8 | 40.3 | -2.5 | 23.6 | 5.0 | 1.7 | -7.8 | 2.4 |
| 5. U.S. net acquisitions (-) of foreign securities | 15.5 | -64.6 | -24.3 | -22.3 | -15.1 | -31.8 | 1.8 | -14.8 |
| a. Bonds | 33.5 | 36.6 | 6.3 | -2.9 | 6.6 | 7.1 | 8.6 | -6.2 |
| b. Stock purchases | -14.8 | -83.7 | -30.6 | -16.6 | -21.7 | -27.8 | -6.8 | -8.6 |
| c. Stock swaps ³ | -3.2 | -17.4 | .0 | -2.8 | .0 | -11.1 | .0 | .0 |
| Other flows (quarterly data, s.a.) | | | | | | | | |
| 6. U.S. direct investment (-) abroad | -134.8 | -173.8 | -45.2 | -53.7 | -57.2 | n.a. | ... | ... |
| 7. Foreign direct investment in U.S. | 72.4 | 39.9 | -2.8 | 10.7 | 18.0 | n.a. | ... | ... |
| 8. Foreign holdings of U.S. currency | 21.5 | 16.6 | 2.8 | 7.5 | -1.8 | n.a. | ... | ... |
| 9. Other (inflow, +) ⁴ | -24.4 | 43.3 | 54.6 | -53.2 | 1.4 | n.a. | ... | ... |
| U.S. current account balance (s.a.) | -473.9 | -530.7 | -131.6 | -127.0 | -144.9 | n.a. | ... | ... |
| Capital account balance (s.a.)⁵ | -1.3 | -3.1 | -.8 | -.3 | -.3 | n.a. | ... | ... |
| Statistical discrepancy (s.a.) | -95.0 | -12.0 | 6.4 | -41.4 | -13.1 | n.a. | | |

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

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

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

3. Includes (4d) or represents (5c) stocks acquired through mergers.

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

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

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