

## **Prefatory Note**

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January 28, 2005

# CURRENT ECONOMIC AND FINANCIAL CONDITIONS

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## **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

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### The Domestic Nonfinancial Economy

#### Real GDP

According to the BEA's advance release, real GDP rose at an annual rate of 3.1 percent in the fourth quarter, following an increase of 4 percent in the third quarter. The BEA's overall estimate of final sales was, on balance, in line with our expectations, but its estimate of private inventory investment was weaker than ours.

Final sales increased at an annual rate of 2¾ percent in the fourth quarter after a rise of 5 percent in the previous quarter. Consumer spending continued to rise at a robust pace—4½ percent in the fourth quarter following an increase of 5 percent in the third quarter. Expenditures for durable goods posted another strong gain, at an annual rate of 6¾ percent in the fourth quarter, after having surged at an annual rate of 17¼ percent in the preceding quarter. Outlays for equipment and software also continued to rise at a brisk pace, with the gain of 15 percent in the fourth quarter off only slightly from the 17½ percent pace in the third quarter. Residential investment was little changed in the fourth quarter following a small rise in the third quarter. With data on merchandise trade for December still outstanding, the BEA estimated that exports fell at an annual rate of 3.9 percent in the fourth quarter and that imports rose at a rate of 9.1 percent; taken together, net exports subtracted 1.7 percentage points from the estimated change in real GDP. Total government spending rose at an annual rate of 0.9 percent in the fourth quarter after having increased 0.7 percent in the third quarter. Real private inventories are reported to have increased \$11 billion in the fourth quarter, following a \$27 billion decrease in the previous quarter. The swing to accumulation added 0.4 percentage point to the change in real GDP last quarter.

The GDP price index increased at an annual rate of 2 percent in the fourth quarter. PCE prices rose 2.5 percent, and core PCE prices moved up 1.6 percent, a touch higher than we forecast in the January Greenbook. The four-quarter change in core PCE prices was 1.6 percent, up from 1.2 percent over the four quarters of 2003.

On the income side of the accounts, real disposable personal income increased at an annual rate of 8.4 percent in the fourth quarter, boosted about 4½ percentage points by the special Microsoft dividend. The personal saving rate increased to 1.3 percent; excluding the Microsoft dividend, the personal saving rate was close to zero. Real output

**Real Gross Domestic Product and Related Items**  
(Percent change from previous period at a compound annual rate;  
based on seasonally adjusted data, chain-type quantity indexes)

Item	2004:Q2 Final	2004:Q3 Final	2004:Q4 Advance
Gross Domestic Product	3.3	4.0	3.1
Final sales	2.5	5.0	2.7
Consumer spending	1.6	5.1	4.6
Durables	-.3	17.2	6.7
Nondurables	.1	4.7	5.8
Services	2.7	3.0	3.7
Business fixed investment	12.5	13.0	10.3
Nonresidential structures	6.9	-1.1	-4.1
Equipment and software	14.2	17.5	14.9
Residential investment	16.5	1.6	.3
Federal government	2.7	4.8	1.6
State and local government	1.9	-1.7	.6
Exports of goods and services	7.3	6.0	-3.9
Imports of goods and services	12.6	4.6	9.1
<i>ADDENDA:</i>			
Inventory investment <sup>1</sup>	61.1	34.5	45.8
Net exports of goods and services <sup>1</sup>	-580.3	-583.2	-631.9
Nominal GDP	6.6	5.5	5.2
Nominal GDI	6.9	4.3	n.a.
Statistical discrepancy <sup>2</sup>	56.4	90.4	n.a.
Change in economic profits <sup>2</sup>	8.3	-55.9	n.a.
Profit share, excluding FR banks <sup>3</sup>	9.9	9.3	n.a.
Real disposable personal income	2.8	2.0	8.4
Personal saving rate (percent)	1.3	.5	1.3

1. Level, billions of chained (2000) dollars.

2. Billions of dollars.

3. Economic profits as a share of GNP.

n.a. not available.

**Price Indexes for Gross Domestic Product**  
(Based on seasonally adjusted data, chain-type indexes)

Item	2004:Q2	2004:Q3	2004:Q4
	Final	Final	Advance
Gross domestic product	3.2	1.4	2.0
Gross domestic purchases	3.5	1.9	2.7
Personal consumption expenditures	3.1	1.3	2.5
Food and Beverages	3.9	2.6	2.6
Energy	26.5	4.0	16.0
Excluding food and energy	1.7	0.9	1.6
Market-based components	2.1	1.0	1.7
Business fixed investment	1.7	0.9	1.7
Equipment and Software	0.1	-1.6	-0.6
Computers and peripheral equipment	-6.7	-9.7	-11.3
Nonresidential structures	7.6	9.8	10.3
Residential investment	9.1	6.8	2.7
Government consumption expenditures and investment	4.3	3.6	4.0
Exports of goods and services	4.6	1.6	4.1
Imports of goods and services	6.4	5.1	8.1
Nonpetroleum goods	2.8	1.3	3.0
<i>ADDENDA:</i>			
GDP less food and energy	2.7	1.8	2.0
Gross domestic purchases less food and energy	2.5	1.7	1.9

NOTE: Percent change from previous period at compound annual rates

in the nonfarm business sector rose 2.8 percent in the fourth quarter. That estimate implies that productivity in the nonfarm business sector rose at an annual rate of 1.3 percent in the fourth quarter following an increase of 1.8 percent in the third quarter.

### **Shipments and Orders for Durable Goods**

The advance GDP report incorporated the data on shipments of nondefense capital goods that were released on Thursday; those data were, on balance, just a touch stronger than we had expected. Excluding aircraft, shipments rose 2.2 percent in December, more than offsetting the previous month's decline. Shipments of computers and peripheral equipment moved up 1.6 percent in December but deliveries of communications gear dropped 5.7 percent to their lowest level since August 2003. In the non-high-tech category, shipments ramped up 3.4 percent, as shipments in industrial machinery partially recovered from the previous month's plunge and shipments of metalworking machinery posted the second largest gain in the twelve-year history of the series.

New orders for nondefense capital goods excluding aircraft moved up 1.8 percent in December following a 0.9 percent increase in November. Orders of computing equipment rose 8.8 percent while bookings in the volatile communications sector fell 3.8 percent on the heels of an even larger drop in November. Outside of the high-tech sector, bookings increased 1.1 percent, as orders of industrial machinery retraced part of the precipitous drop posted in November and manufacturers of metalworking machinery recorded historically unprecedented gains in orders. The staff's constructed series on real adjusted durable goods orders rose 1.9 percent in December. This series—which strips out nondefense aircraft, defense capital goods, and industries for which reported orders actually equal shipments—has historically been a useful indicator of near-term activity in the industrial sector.

The book value of manufacturing durable goods inventories (which constitute about two-thirds of the total manufacturing inventories) decreased at an annual rate of \$1.4 billion in December, the first decumulation in this category in more than a year. Shipments of total durable goods rose 2.1 percent in December, and the inventory-shipments ratio dropped to 1.38 months.

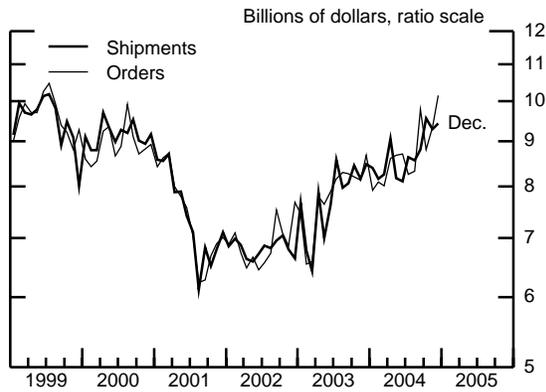
## Orders and Shipments of Nondefense Capital Goods

(Percent change; seasonally adjusted current dollars)

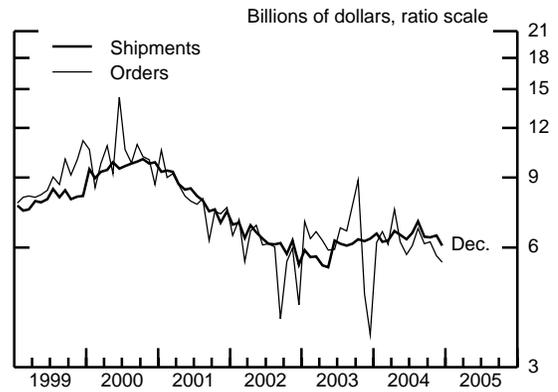
Indicators	2004				
	Q3	Q4	Oct.	Nov.	Dec.
	Annual rate		Monthly rate		
Shipments	14.1	8.1	2.2	-2.5	3.3
Excluding aircraft	15.0	7.9	2.4	-1.8	2.2
Computers and peripherals	10.9	39.3	8.5	-2.9	1.6
Communications equipment	11.8	-18.9	-.4	1.2	-5.7
All other categories	16.2	6.8	1.6	-2.0	3.4
Orders	25.5	2.2	-3.2	7.5	-1.9
Excluding aircraft	14.1	3.5	-4.0	.9	1.8
Computers and peripherals	5.6	32.7	-9.8	5.9	8.8
Communications equipment	-10.9	-27.6	.8	-7.6	-3.8
All other categories	19.7	3.2	-3.4	1.1	1.1
Memo:					
Shipments of complete aircraft <sup>1</sup>	27.8	n.a.	30.3	23.8	n.a.

1. From Census Bureau, Current Industrial Reports; billions of dollars, annual rate.  
n.a. Not available.

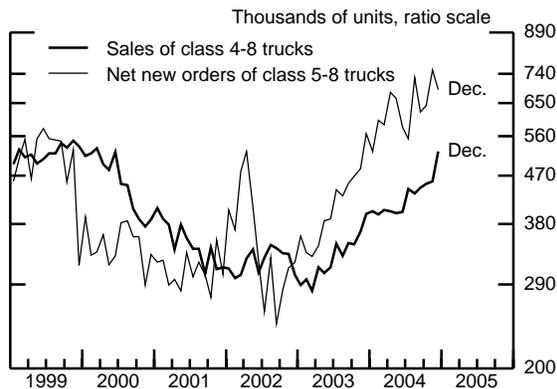
### Computers and Peripherals



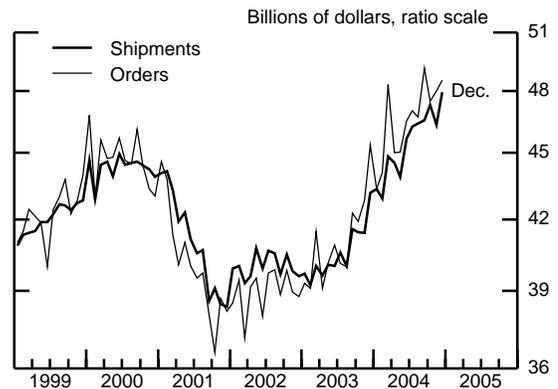
### Communications Equipment



### Medium and Heavy Trucks



### Other Equipment



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

### New Orders for Durable Goods

(Percent change from preceding period except as noted; seasonally adjusted)

Component	Proportion, 2004: H2 (percent)	2004		2004		
		Q3	Q4	Oct.	Nov.	Dec.
		Annual rate		Monthly rate		
<b>Total orders</b>	<b>100</b>	<b>10.3</b>	<b>3.9</b>	<b>-1.0</b>	<b>1.8</b>	<b>.6</b>
Adjusted orders <sup>1</sup>	75.2	6.6	6.7	-2.0	2.0	2.2
Computers	4.6	5.6	32.7	-9.8	5.9	8.8
Communication equipment	3.1	-10.9	-27.6	.8	-7.6	-3.8
Other capital goods	24.2	19.7	3.2	-3.4	1.1	1.1
Other <sup>2</sup>	43.2	1.5	9.1	-.5	2.7	2.5
Memo:						
Real adjusted orders	...	3.3	3.2	-2.3	1.9	1.9
Excluding high tech	...	3.9	1.9	-1.8	1.5	1.3

1. Orders excluding defense capital goods, nondefense aircraft, and motor vehicle parts.
  2. Primary metals; most fabricated metals; most stone, clay, and glass products; household appliances; scientific instruments; and miscellaneous durable goods.
- ... Not applicable.

### Labor Costs

The employment cost index of hourly compensation for private industry workers rose at an annual rate of 3 percent over the three months ending in December, after having posted a 3.5 percent increase over the previous three-month period. For the twelve months ending in December, private-industry hourly compensation advanced 3.8 percent, about ¼ percentage point less than during 2003.

The wages and salaries component of the ECI moved up at an annual rate of 1.5 percent in the three months through December, the smallest quarterly increase since March 1999. Over the twelve months of 2004, wages increased 2.4 percent, ½ percentage point less than during 2003.

Benefits costs increased at an annual rate of 6 percent in the three months of 2004—a pickup from September’s low rate, but still a bit below the average percentage increase over the past two years. Over the twelve months of 2004, benefit costs rose nearly 7 percent, compared with about 6½ percent for 2003. Most benefit categories posted relatively restrained gains last year. In particular, health insurance costs rose 7¼ percent during 2004, down from double-digit increases posted in 2002 and 2003. However,

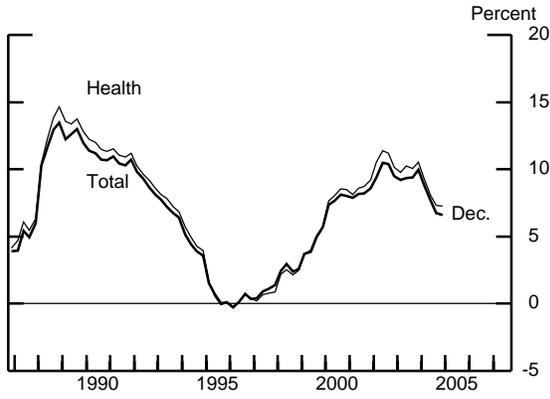
**Change in Employment Cost Index of Hourly Compensation  
for Private-Industry Workers**

Industry and occupational group	2003	2004			
	Dec.	Mar.	June	Sept.	Dec.
	Quarterly change (compound annual rate) <sup>1</sup>				
<b>Total hourly compensation</b>	<b>3.1</b>	<b>4.3</b>	<b>4.0</b>	<b>3.5</b>	<b>3.0</b>
Wages and salaries	2.0	2.5	2.2	3.5	1.5
Benefits	5.6	10.9	7.1	4.0	6.0
<i>By industry</i>					
Construction	3.0	3.5	2.2	2.9	1.2
Manufacturing	2.7	9.4	3.3	5.0	2.3
Transportation and public utilities	2.9	6.1	5.8	2.3	1.4
Wholesale trade	1.9	2.6	2.6	6.6	-.7
Retail trade	4.1	1.7	4.0	1.0	2.5
FIRE	1.6	3.6	2.4	2.6	2.6
Services	3.8	4.3	3.7	3.5	3.7
<i>By occupation</i>					
White collar	3.3	3.8	3.0	4.2	3.2
Blue collar	3.5	6.7	4.1	3.6	3.1
Service occupations	2.7	4.7	3.6	1.9	1.9
Memo: State and local governments	3.2	3.9	4.4	1.9	4.0
	12-month change				
<b>Total hourly compensation</b>	<b>4.0</b>	<b>3.9</b>	<b>4.0</b>	<b>3.7</b>	<b>3.8</b>
Excluding sales workers	4.1	3.9	4.0	3.9	3.9
Wages and salaries Excluding sales workers	3.0	2.6	2.6	2.6	2.4
Benefits	3.1	2.6	2.5	2.5	2.5
Benefits	6.4	7.0	7.3	6.8	6.9
<i>By industry</i>					
Construction	3.4	3.5	3.0	2.9	2.4
Manufacturing	4.1	4.7	4.7	5.0	5.0
Transportation and public utilities	3.3	4.0	4.3	4.3	3.9
Wholesale trade	3.2	2.5	2.7	3.4	2.7
Retail trade	3.3	3.5	4.0	2.7	2.3
FIRE	7.4	3.3	3.0	2.6	2.8
Services	3.6	3.8	4.0	3.8	3.8
<i>By occupation</i>					
White collar	4.1	3.6	3.7	3.6	3.5
Sales	3.2	3.5	3.7	3.5	2.6
Nonsales	4.3	3.7	3.7	3.6	3.8
Blue collar	4.0	4.5	4.6	4.5	4.4
Service occupations	3.2	3.2	3.4	3.1	2.9
Memo: State and local governments	3.3	3.3	3.4	3.4	3.5

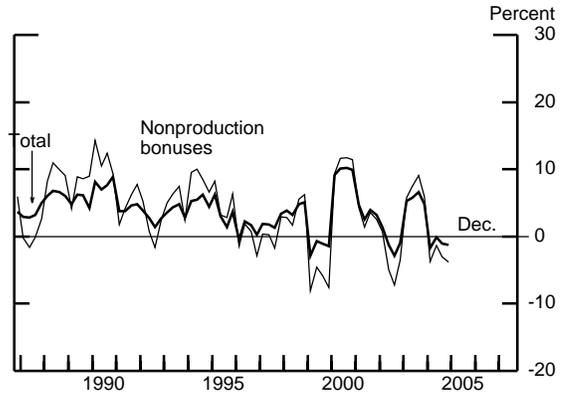
1. Seasonally adjusted by the BLS.

### ECI Benefits Costs (confidential) (Private-industry workers; 12-month change)

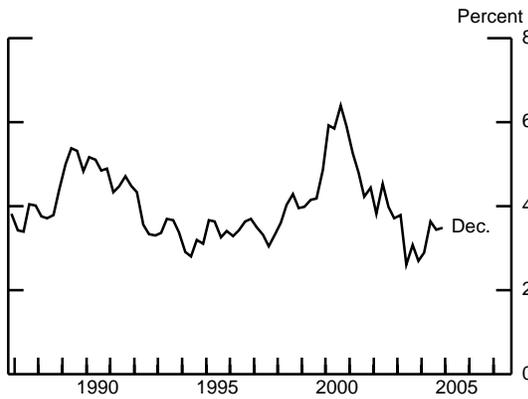
Insurance Costs



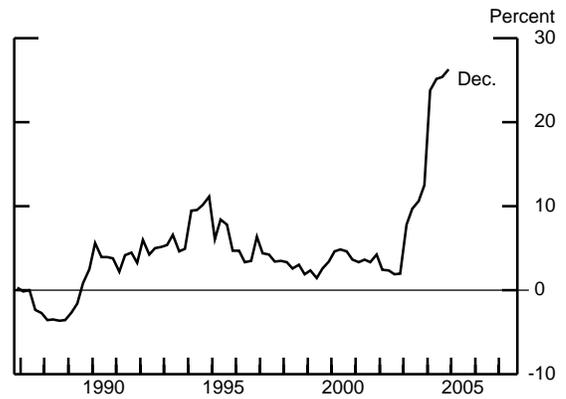
Supplemental Pay



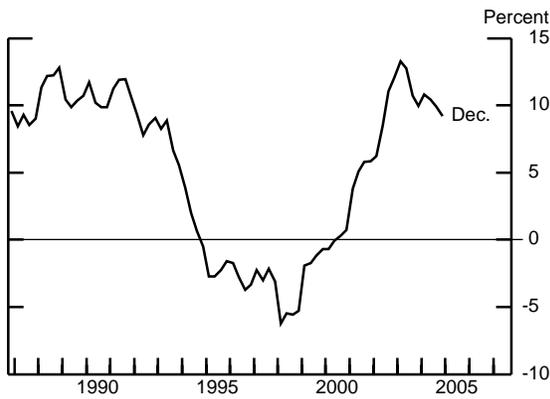
Paid Leave



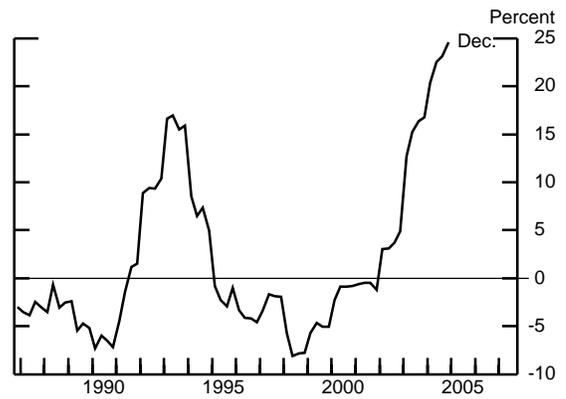
Retirement and Savings



Workers' Compensation Insurance



State Unemployment Insurance



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employer costs for defined benefit pension plans rose sharply last year, boosting the twelve-month change in retirement and savings costs to 26 percent from 12½ percent in 2003.<sup>1</sup>

The advance estimate of compensation included in the GDP release also suggests a slower rate of increase in hourly compensation at the end of 2004. The staff estimates that compensation per hour in the nonfarm business sector rose at an annual rate of 3.6 percent in the fourth quarter of 2004, bringing the change over the four quarters of the year to 3.8 percent.

## **The Domestic Financial Economy**

(Tables attached)

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<sup>1</sup> Because not all companies report their pension costs in the ECI each quarter, some of the rise in pension costs recorded in 2004 might actually have occurred in 2003.

### Hourly Compensation and Unit Labor Costs

(Percent change from preceding period at compound annual rate; based on seasonally adjusted data)

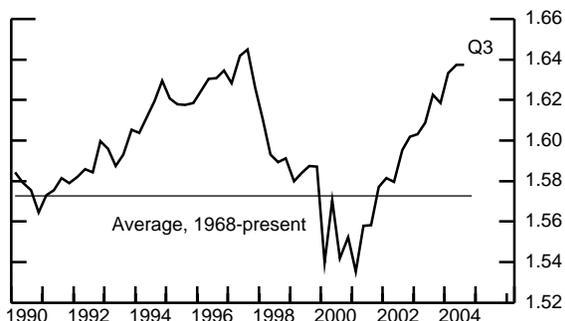
Category	2001	2002	2003	2004			2003:Q4 to 2004:Q4 <sup>e</sup>
				Q2	Q3	Q4 <sup>e</sup>	
<i>Compensation per hour</i>							
Nonfarm business	3.5	2.9	5.4	5.9	3.6	3.6	3.8
Nonfinancial corporations <sup>1</sup>	3.7	2.5	5.0	5.5	4.0	n.a.	n.a.
<i>Unit labor costs</i>							
Nonfarm business	.3	-.6	-.2	1.9	1.8	1.5	.9
Nonfinancial corporations <sup>1</sup>	1.7	-2.4	-1.5	2.2	-.3	n.a.	n.a.

Note. Annual changes are from fourth quarter of preceding year to fourth quarter of year shown.

1. All corporations doing business in the United States except banks, stock and commodity brokers, and finance and insurance companies. The sector accounts for about two-thirds of business employment.

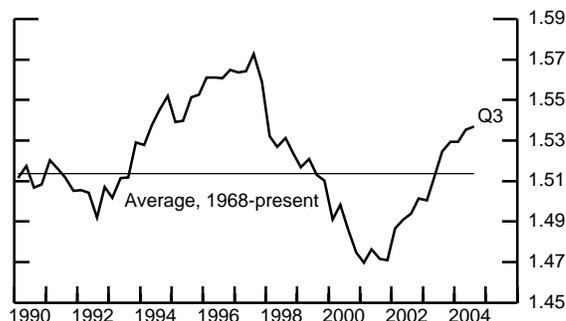
e Staff estimates.

**Markup, Nonfarm Businesses**



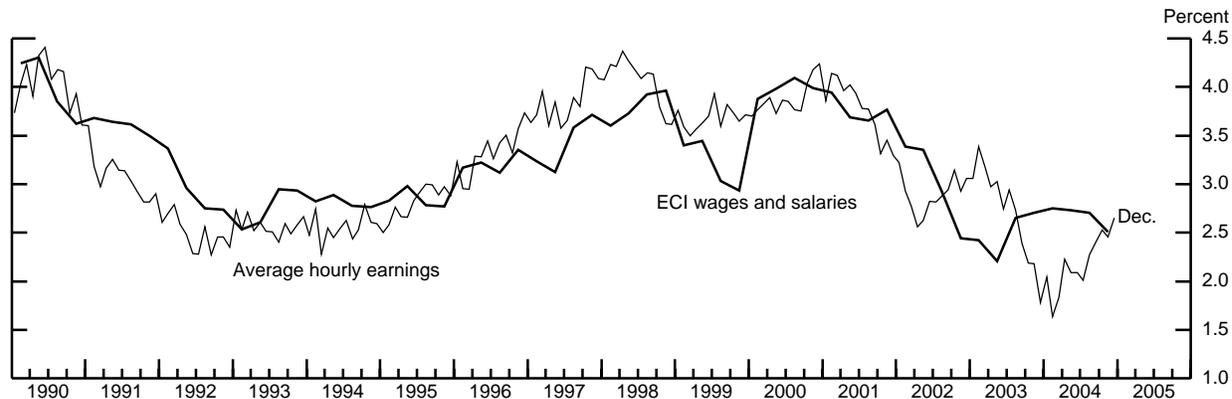
Note. Markup defined as ratio of output price to unit labor costs.

**Markup, Nonfinancial Corporations**



Note. Markup defined as ratio of output price to unit labor costs.

### Labor Costs for Production or Nonsupervisory Workers (12-month change)



### Commercial Bank Credit

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

Type of credit	2003	2004	Q3 2004	Q4 2004	Dec. 2004	Jan. <sup>e</sup> 2005	Level, Jan. 2005 <sup>e</sup> (\$ billions)
<b>Total</b>							
<b>1. Adjusted<sup>1</sup></b>	<b>5.9</b>	<b>8.9</b>	<b>4.9</b>	<b>6.4</b>	<b>3.8</b>	<b>13.5</b>	<b>6,587</b>
2. Reported	5.6	8.3	5.4	6.2	4.1	10.7	6,740
<i>Securities</i>							
3. Adjusted <sup>1</sup>	8.6	6.7	-7.7	2.2	2.5	30.9	1,784
4. Reported	7.3	5.1	-4.8	2.1	3.7	19.6	1,936
5. Treasury and agency	8.8	5.0	-4.0	-10.7	3.3	31.6	1,180
6. Other <sup>2</sup>	5.0	5.2	-6.2	23.4	4.5	1.3	756
<i>Loans<sup>3</sup></i>							
7. Total	4.9	9.6	9.8	7.9	4.2	7.1	4,803
8. Business	-9.4	.7	5.8	4.9	11.0	22.4	906
9. Real estate	11.1	13.6	8.0	12.8	10.6	11.6	2,562
10. Home equity	30.8	43.3	37.1	37.3	15.9	18.4	404
11. Other	8.8	9.5	3.4	8.6	9.7	10.3	2,158
12. Consumer	5.4	8.6	19.6	-1.6	14.6	10.9	680
13. Adjusted <sup>4</sup>	5.8	6.0	12.4	3.0	11.6	11.0	1,061
14. Other <sup>5</sup>	6.7	9.0	11.7	3.6	-37.6	-33.3	656

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.

e Estimated.

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

Instrument	2003	2004		2005	Change to Jan. 27 from selected dates (percentage points)		
	Dec. 31	June 28	Dec. 13	Jan. 27	2003 Dec. 31	2004 June 28	2004 Dec. 13
<i>Short-term</i>							
FOMC intended federal funds rate	1.00	1.00	2.00	2.25	1.25	1.25	.25
Treasury bills <sup>1</sup>							
3-month	.93	1.36	2.21	2.40	1.47	1.04	.19
6-month	1.00	1.74	2.44	2.65	1.65	.91	.21
Commercial paper (A1/P1 rates) <sup>2</sup>							
1-month	1.00	1.28	2.29	2.46	1.46	1.18	.17
3-month	1.05	1.45	2.39	2.65	1.60	1.20	.26
Large negotiable CDs <sup>1</sup>							
1-month	1.06	1.30	2.36	2.54	1.48	1.24	.18
3-month	1.09	1.53	2.45	2.69	1.60	1.16	.24
6-month	1.16	1.82	2.65	2.91	1.75	1.09	.26
Eurodollar deposits <sup>3</sup>							
1-month	1.04	1.29	2.33	2.52	1.48	1.23	.19
3-month	1.07	1.51	2.42	2.67	1.60	1.16	.25
Bank prime rate	4.00	4.00	5.00	5.25	1.25	1.25	.25
<i>Intermediate- and long-term</i>							
U.S. Treasury <sup>4</sup>							
2-year	1.83	2.88	2.98	3.29	1.46	.41	.31
10-year	4.40	4.90	4.27	4.31	-.09	-.59	.04
30-year	5.22	5.55	4.87	4.71	-.51	-.84	-.16
U.S. Treasury 10-year indexed note	2.00	2.23	1.65	1.71	-.29	-.52	.06
Municipal revenue (Bond Buyer) <sup>5</sup>	5.04	5.37	4.99	4.90	-.14	-.47	-.09
Private instruments							
10-year swap	4.66	5.21	4.55	4.59	-.07	-.62	.04
10-year FNMA <sup>6</sup>	4.72	5.30	4.53	4.55	-.17	-.75	.02
10-year AA <sup>7</sup>	5.05	5.59	4.87	4.94	-.11	-.65	.07
10-year BBB <sup>7</sup>	5.74	6.18	5.34	5.36	-.38	-.82	.02
5-year high yield <sup>7</sup>	7.94	8.30	7.29	7.51	-.43	-.79	.22
Home mortgages (FHLMC survey rate)							
30-year fixed	5.85	6.21	5.68	5.66	-.19	-.55	-.02
1-year adjustable	3.72	4.19	4.18	4.18	.46	-.01	.00

Stock exchange index	Record high		2004		2005	Change to Jan. 27 from selected dates (percent)		
	Level	Date	June 28	Dec. 13	Jan. 27	Record high	2004 June 28	2004 Dec. 13
Dow Jones Industrial	11,723	1-14-00	10,357	10,638	10,467	-1.71	1.07	-1.61
S&P 500 Composite	1,527	3-24-00	1,133	1,199	1,175	-23.10	3.64	-2.01
Nasdaq	5,049	3-10-00	2,020	2,149	2,047	-59.45	1.35	-4.72
Russell 2000	655	12-28-04	584	638	617	-5.75	5.62	-3.31
Wilshire 5000	14,752	3-24-00	11,056	11,790	11,563	-21.61	4.59	-1.92

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.

NOTES:

June 28, 2004, is the day before the beginning of the current tightening period.  
 December 13, 2004, is the day before the most recent FOMC meeting.