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Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

July 19, 2006

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Submitted pursuant to section 2B of the Federal Reserve Act

July 19, 2006

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

Washington, D.C., July 19, 2006

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to section 2B of the Federal Reserve Act.

Sincerely,

Ben Bernanke, Chairman

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Monetary Policy Report to the Congress

Report submitted to the Congress on July 19, 2006, pursuant to section 2B of the Federal Reserve Act

Monetary Policy and the Economic Outlook

The U.S. economy continued to expand at a brisk rate, on balance, over the first half of 2006. Spending in the first quarter, which was especially robust, was temporarily buoyed by several factors, including federal spending for hurricane relief and the effects of favorable weather on homebuilding. The pace of the expansion moderated in the spring, to some degree because the influence of these special factors dissipated. More fundamentally, consumer spending slowed as further increases in energy prices restrained the real incomes of households. In addition, home sales and new homebuilding dropped back noticeably from the elevated levels of last summer, partly in response to higher mortgage interest rates. Outside of the household sector, increases in demand and production appear to have been well maintained in the second quarter. Demand for U.S. exports was supported by strong economic activity abroad, and business fixed investment remained on a solid upward trend. Early in the year, as aggregate output increased rapidly, businesses added jobs at a relatively robust pace, and the unemployment rate moved down further. Since April, monthly gains in payroll employment have been smaller but still sufficient to keep the jobless rate steady.

Thus far in 2006, inflation pressures have been elevated. Higher prices for crude oil contributed to a further run-up in domestic energy costs; this year's increases, combined with the steep increases in 2004 and 2005, not only boosted the prices of gasoline and heating fuel but also put upward pressure on the costs of production for a broad range of goods and services. Partly as a result of these cost pressures, the rate of core consumer price inflation picked up. Nevertheless, measures of inflation expectations remained contained, and the rate of increase in labor costs was subdued, having been held down by strong gains in productivity and moderate increases in labor compensation.

Taking a longer perspective, the U.S. economy appears to be in the midst of a transition in which the rate of increase in real gross domestic product (GDP) is moving from a pace above that of its longer-run capacity to a more moderate and sustainable rate. An important element in the transition is the lagged effect of the changes in monetary policy since mid-2004, changes that have been intended to keep inflation low and to promote sustainable economic expansion by aligning real economic activity more closely with the economy's productive potential. Moreover, longer-term interest rates have risen, contributing to increased borrowing costs for both households and businesses. Over time, pressures on inflation should abate as the pace of real activity moderates and, as futures markets suggest, the prices of energy and other commodities roughly stabilize. The resulting easing in inflation should help contain long-run inflation expectations.

Even as the rate of increase in real economic activity moderates, the prospects for sustained expansion of household and business spending appear favorable. Higher energy prices have put strains on household budgets, but once that effect fades, households should experience gains in real income consistent with the ongoing expansion of jobs. Household balance sheets remain generally sound; although some pockets of distress have surfaced, average delinquency rates on mortgages and other consumer debt are still low. Similarly, in the business sector, balance sheets are strong, credit quality is high, and most firms have ready access to funds. Sustained expansion of the global economy, along with the effects of the earlier depreciation of the foreign exchange value of the dollar, should support demand for U.S. exports. The potential for efficiency gains, as well as further declines in the relative cost of capital, are likely to continue to spur capital spending. Indeed, the ongoing advances in efficiency should sustain solid growth of labor productivity, providing support for gains in real wages and income.

As always, considerable uncertainties attend the outlook. Regarding inflation, the margin between production and consumption of crude oil worldwide is quite narrow, and oil markets are especially sensitive to news about the balance of supply and demand and to geopolitical events with the potential to affect that balance; adverse developments could result in yet another surge in energy costs. Indeed, futures markets provide only imperfect readings on the prospects for energy markets, as witnessed by the fact that the surprises in crude oil prices during the past few years have been predominantly to the upside. In addition, a further rise in prices of other, non-energy materials and commodities, if it materializes, could also intensify cost pressures. Another risk is that the effect on imported-goods prices of earlier declines in the foreign exchange value of the dollar, which has been limited to date, could become larger. More broadly, if the higher rate of core inflation seen this year persists, it could induce a deterioration in longer-run inflation expectations that, in turn, might give greater momentum to inflation. However, the risks to the inflation outlook are not entirely to the upside. In the current environment of elevated profit margins, competitive forces, both in domestic markets and from abroad, could impose significant restraint on the pricing decisions of businesses.

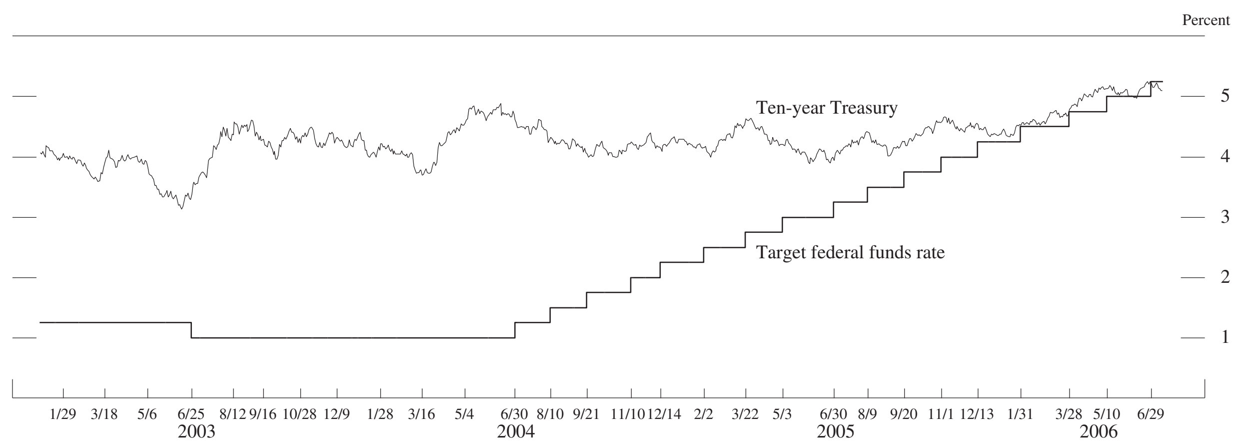
Regarding risks to the outlook for real activity, rates of increase in real GDP have been uneven during the past year, complicating the assessment of whether the pace of the economic expansion is moving into line with its underlying potential rate. One possible risk to the upside is that the softer tone of the recent data on real activity will prove transitory rather than mark a shift to a more sustainable underlying rate of expansion. For example, slower spending and hiring in recent months may represent a shorter-lived adjustment to a higher level of energy prices or to the unusually robust increases in economic activity earlier in the year. In coming months, a sharp rebound in consumer spending accompanied by an acceleration of capital spending could return real activity to a pace that would be unsustainable over the longer run. But downside risks also exist. In particular, the slowing in real estate markets since last summer has been moderate, and the easing of house-price inflation has been gradual. If the softening in the demand for housing and in real estate values becomes more pronounced, the resulting drop in construction activity and the erosion of household wealth could weaken aggregate demand noticeably. Consumer spending might be depressed by the loss of income and wealth, and that effect could be amplified if the downturn is abrupt enough to shake households' confidence about their ability to finance spending or manage their current financial obligations.

The Conduct of Monetary Policy over the First Half of 2006

The Federal Open Market Committee (FOMC) continued to firm the stance of monetary policy over the first half of 2006. At the time of the January meeting, available information suggested that underlying growth in aggregate demand was solid at the turn of the year. The expansion of real GDP in the fourth quarter of 2005 was estimated to have slowed temporarily, in part because of the disruptions associated with last autumn's hurricanes. Core inflation had stayed relatively low, and inflation expectations had remained contained. With rising energy prices and increases in resource utilization having the potential to add to inflationary pressures, the FOMC decided to extend the firming of policy that it had implemented over the previous eighteen months by tightening the policy rate 25 basis points, to 4½ percent. The Committee indicated that some further policy firming might be needed to keep the risks to price stability and to sustainable economic growth roughly in balance.

By March, economic activity appeared to be expanding rapidly, propelled by robust consumer spending and accelerating business investment. Although readings on core inflation for January and February were generally favorable, higher prices for energy and other commodi-

Selected interest rates, 2003–06



NOTE: The data are daily and extend through July 12, 2006. The ten-year Treasury rate is the constant-maturity yield 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.

ties, together with relatively tight labor and product markets, threatened to add to existing inflation strains. Against this backdrop, the Committee raised the target federal funds rate another 25 basis points, to 4¾ percent. The statement released at the end of the meeting continued to point to the possible need for further policy firming.

Data received by the time of the May meeting confirmed that the economy had expanded robustly in the first quarter, though both consumer spending and housing activity appeared to have moderated in late winter. In addition, inflationary pressures had intensified as core consumer prices rose more rapidly in March than in earlier months. Inflation expectations, as measured by some surveys and by comparisons of yields on nominal and inflation-indexed Treasury securities, also rose in April. The Committee still judged those expectations to be contained, but it was mindful that a further increase could impart additional momentum to inflation, as could the surge in energy and other commodity prices and the drop in the foreign exchange value of the dollar that took place in April and early May. To gain greater assurance that inflationary forces would not intensify, the FOMC decided to raise the target federal funds rate another 25 basis points, bringing it to 5 percent. The FOMC also indicated in the policy statement that some further policy firming could be required. However, the Committee was aware that the cumulative effects of past monetary policy actions on economic activity could turn out to be larger than expected. Accordingly, the FOMC stressed that the extent and timing of any further firming would depend importantly on the evolution of the economic outlook as implied by incoming data.

By the time of the June meeting, available data appeared to confirm that economic growth had moderated from the strong pace evident earlier in the year. Consumer spending had softened, and activity in housing markets had continued to cool gradually. Evidence of inflationary pressures was accumulating, however, and core price inflation had increased. In addition, the high levels of resource utilization and of the prices for energy and other commodities had the potential to spur further inflation. Consequently, the FOMC decided to increase the target federal funds rate an additional 25 basis points, to 5¼ percent. The Committee recognized that the moderation in the growth of aggregate demand that appeared to be under way would help to limit inflationary pressures over time, but it judged that, even after its policy action, some upside inflation risks remained. Yet the FOMC made clear that the extent and timing of any additional firming needed to address those risks will depend on the evolution of the outlook for both inflation and economic growth as implied by incoming information.

In recent years, the FOMC has worked to improve the transparency of its decisionmaking process, and it continues to seek further improvements. Between the March and May meetings, the Chairman appointed a subcommittee to help the FOMC frame and organize the discussion of a broad range of communication issues. At the June meeting, the Committee discussed the subcommittee's plans for work in coming months and decided to begin its consideration of communication issues at its August meeting and to lengthen meetings later this year to allow a fuller discussion of these issues.

Economic Projections for 2006 and 2007

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, provided economic projections for 2006 and 2007. In broad terms, the participants expect a sustained, moderate expansion of real economic activity during the next year and a half. The central tendency of the FOMC participants' forecasts for the increase in real GDP is 3¼ percent to 3½ percent over the four quarters of 2006 and 3 percent to 3¼ percent in 2007. The central tendency of their forecasts for the civilian unemployment rate is 4¾ percent to 5 percent in the fourth quarter of this year, and the jobless rate is expected to still be in that range at the end of 2007. For inflation, the central tendency of the forecasts is an increase in the price index for personal consumption expenditures excluding food and energy (core PCE) of 2¼ percent to 2½ percent over the four quarters of 2006; in 2007, the forecast shows

Economic projections for 2006 and 2007

Percent

Indicator	Federal Reserve Governors and Reserve Bank presidents: Range	Federal Reserve Governors and Reserve Bank presidents: Central tendency
2006		
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	5½–6½	6–6¼
Real GDP	3–3¾	3¼–3½
PCE price index excluding food and energy	2¼–3	2¼–2½
Average level, fourth quarter		
Civilian unemployment rate	4½–5	4¾–5
2007		
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4¾–6	5–5½
Real GDP	2½–3¼	3–3¼
PCE price index excluding food and energy	2–2¼	2–2¼
Average level, fourth quarter		
Civilian unemployment rate	4¼–5¼	4¾–5

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

a slower rate of 2 percent to 2¼ percent, which is similar to the rate of core PCE price inflation in 2004 and 2005.

A slowing in activity now appears to be under way in the housing sector, where home sales and residential construction have receded from the elevated levels of last summer. The associated easing in house-price appreciation will likely temper gains in household wealth, which, over time, may be a factor in damping consumer spending. However, households' financial positions should receive a boost from an acceleration of real income if energy prices stabilize as suggested by futures markets. In the business sector, participants view the outlook for fixed investment over the forecast period as positive. Although outlays for new equipment and software may increase a little more slowly with the deceleration in real output, investment opportunities appear to remain attractive: The relative user cost of capital for equipment, particularly high-technology items, is expected to remain favorable, and competitive pressures should maintain strong incentives to exploit opportunities for efficiency gains and cost reduction. At the same time, nonresidential construction seems likely to continue to move up. Finally, the strong performance of the economies of the United States' major trading partners should continue to stimulate U.S. exports of goods and services.

The more moderate pace of expansion and the stability in resource utilization, when coupled with less pressure from the prices of energy and other commodities, should contribute to an environment in which inflation expectations are contained and inflation edges lower. Moreover, ongoing solid gains in productivity should work to limit increases in unit labor costs.

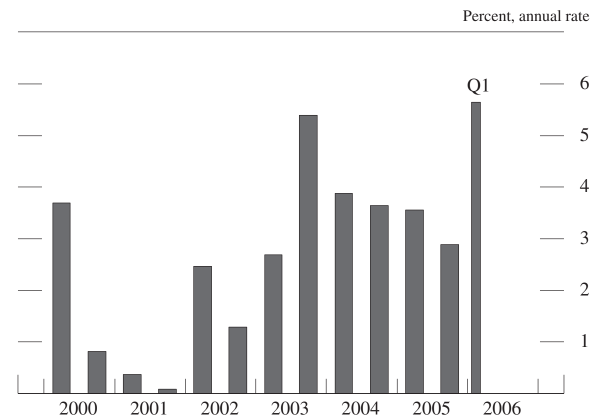
Over the next year and a half, FOMC participants expect the economy to achieve a sustainable rate of economic expansion. That rate will be determined in large part by the rate of increase in productivity. Productivity has been rising at a solid rate over the past two years, albeit more slowly than the especially rapid pace that prevailed during the first three years of the expansion. A strong trend in productivity is likely to be maintained as businesses take advantage of new investment in facilities and equipment, as diffusion of technology continues, and as organizational advancements and business process improvements yield further increases in efficiency.

Economic and Financial Developments in 2006

Although last year's hurricanes caused the pace of aggregate economic activity around the turn of the year to be uneven, real GDP increased at an average annual rate of 3.6 percent in the final quarter of 2005 and first quarter of 2006—about the same pace that prevailed during the preceding year and a half. Over this period, payroll employment posted additional solid gains, and the unemployment rate declined further. In recent months, the incoming information on real activity has suggested that the pace of the expansion is moderating, with the deceleration in spending most apparent in the household sector. Still, as of midyear, resource utilization in labor and in product markets remained high.

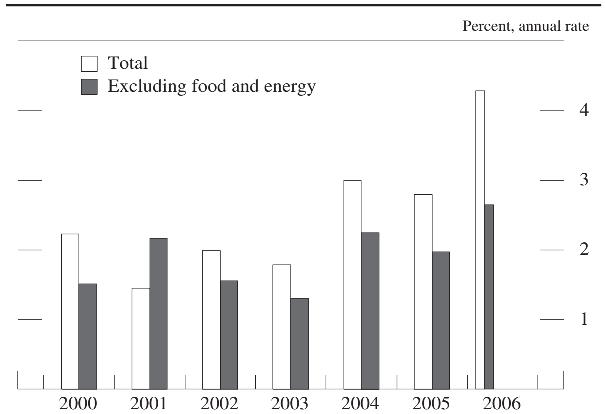
Inflation picked up over the first five months of the year, boosted importantly by the effects of rising energy prices. Long-term inflation expectations fluctuated over the period but remained contained, and increases in unit labor costs were subdued. Although short-term market interest rates rose in line with the FOMC's firming of monetary policy, financial market conditions were still generally supportive of economic expansion in the first

Change in real GDP, 2000–06



Note: Here and in subsequent figures, 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, 2000–06



Note: The data are for personal consumption expenditures (PCE). Through 2005, change is from December to December; for 2006, change is from December to May.
Source: Department of Commerce, Bureau of Economic Analysis.

half of 2006. Long-term interest rates rose but were still moderate by historical standards, and credit spreads and risk premiums stayed narrow.

The Household Sector

Consumer Spending

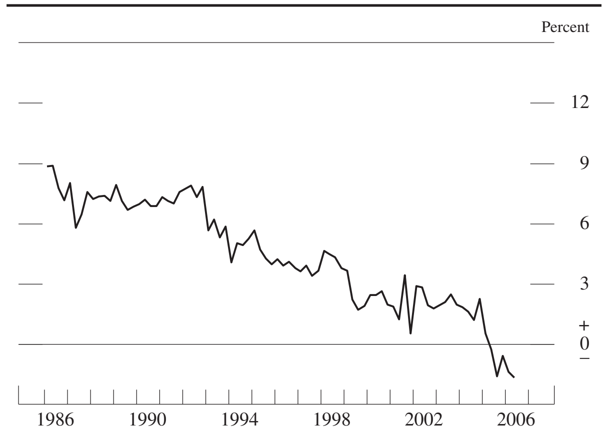
After increasing at a robust rate around the turn of the year, consumer spending has been rising at a more moderate pace in recent months. Over the first half of 2006, rising employment and the lagged effect of increases in wealth continued to provide support for spending by households. However, consumers' purchasing power was restrained by a further run-up in energy costs in the spring.

Sales of new cars and light trucks bounced back sharply at the turn of the year; those sales had slackened in late 2005 after manufacturers ended the special "employee discount" programs that had boosted sales last summer. New light vehicles sold at an annual rate of 16.8 million units between January and April, about the same as the average rate in 2004 and 2005. However, elevated gasoline prices affected the composition of demand, and consumers shifted their purchases away from light trucks and sport-utility vehicles (SUVs) and toward autos. That shift led to an increase in the market share captured by foreign producers. As households' concerns about the higher price of gasoline weighed on their attitudes toward buying vehicles, sales dipped to an annual rate of 16.2 million units in May and June.

Spending for other household goods, such as furniture, electronic equipment, food, and clothing, was quite strong in the first quarter of 2006; real outlays for goods other than motor vehicles increased at an annual rate of 8¾ percent. Some moderation was to be expected after such a surge in spending. Estimates of retail sales, which are available through June, suggest that real expenditures for these goods rose more slowly in the second quarter. In contrast to the uneven pattern of spending for goods, real outlays for consumer services remained on a moderate upward trend over the first half of 2006; they rose at an annual rate of 2½ percent from the fourth quarter of 2005 through May 2006.

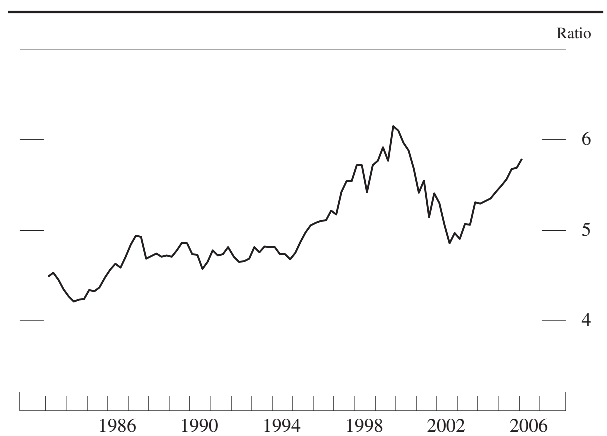
Boosted by gains in nominal wage and salary income, after-tax aggregate personal income rose at an annual rate of 4 percent over the first five months of 2006. However, the acceleration in consumer prices held real income about constant. As a result, the steep decline in the personal saving rate, which began in 2004, extended into 2006. Since 2003, rising household wealth has provided

Personal saving rate, 1986–2006



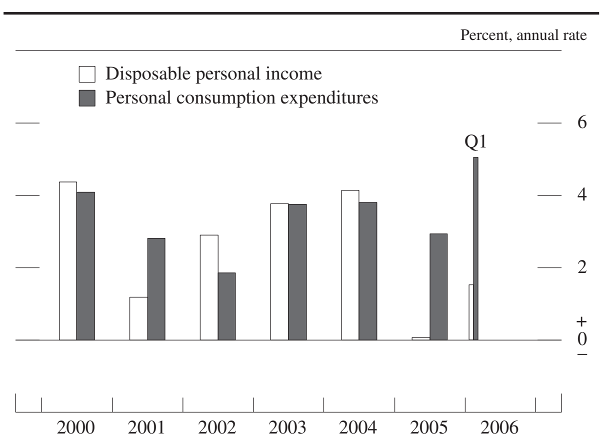
NOTE: The data are quarterly and extend through 2006:Q2; the reading for 2006:Q2 is the average for April and May.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Wealth-to-income ratio, 1983–2006



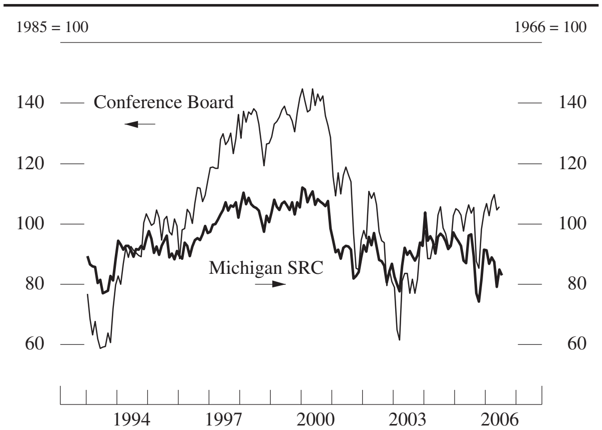
NOTE: The data are quarterly and extend through 2006:Q1. The wealth-to-income ratio is the ratio of household net worth to disposable personal income.
SOURCE: For net worth, Federal Reserve Board, flow of funds data; for income, Department of Commerce, Bureau of Economic Analysis.

Change in real income and consumption, 2000–06



SOURCE: Department of Commerce, Bureau of Economic Analysis.

Consumer sentiment, 1993–2006



NOTE: The Conference Board data are monthly and extend through June 2006. The Michigan SRC data are monthly and extend through a preliminary estimate for July 2006.
SOURCE: The Conference Board and University of Michigan Survey Research Center.

important support for spending, even as gains in real income have been damped by increases in energy prices. In 2005 and the first part of 2006, much of the increase in wealth was the result of the rapid appreciation in the value of homes.

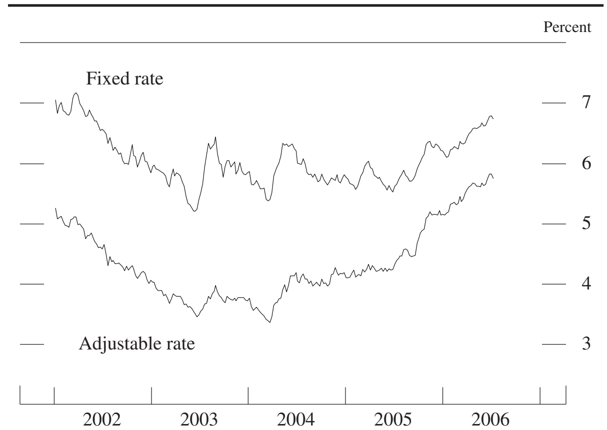
According to the survey by the University of Michigan Survey Research Center (SRC), the run-up in energy prices contributed importantly to the deterioration in consumer confidence this spring. Consumers' pessimism peaked in May and then lessened somewhat, on average, in June and early July. Nonetheless, at midyear, households indicated that they were still concerned about the effect of the high cost of energy on their financial situation. In addition, households' assessments of current and expected business conditions remained considerably less optimistic than they were at the beginning of the year.

Residential Investment

The demand for homes had begun to soften in the summer of 2005, and, by the spring of 2006, starts of new single-family homes were well below the very rapid pace that had prevailed in the preceding two years. The reduced level of activity in real estate markets also led to some easing in house-price appreciation early this year.

Sales of new and existing single-family homes, which had been climbing steadily since 2003, stopped rising during the third quarter of 2005. By May, sales of new and existing homes together were 7¼ percent below their peak in June 2005. The cooling in sales caused inventories of unsold homes to rise. In May, the backlog of unsold new homes equaled 5½ months' supply at that month's selling rate, and the backlog of existing homes

Mortgage rates, 2002–06

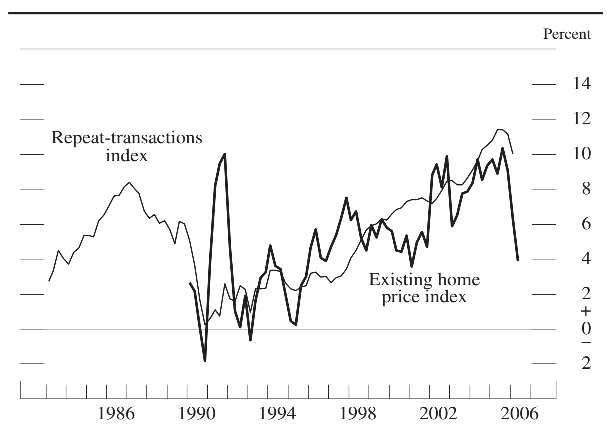


NOTE: The data, which are weekly and extend through July 12, 2006, are contract rates on thirty-year mortgages.
SOURCE: Federal Home Loan Mortgage Corporation.

on the market was 6½ months' supply; in 2005, the stocks of both unsold new and existing homes averaged roughly 4½ months of supply.

An increase in mortgage rates contributed to the slackening in the demand for housing. Since the middle of 2005, the average rate for a thirty-year fixed-rate mortgage has increased about 1 percentage point, to 6¾ percent, and the average for a one-year adjustable-rate mortgage has risen a bit more, to 5¾ percent. According to respondents to the Michigan SRC survey, the rise in borrowing costs has been an important consideration damping their assessment of buying conditions for homes since mid-2005; the rise in home prices has apparently also weighed on consumers' attitudes.

Change in prices of single-family houses, 1983–2006



NOTE: The data are quarterly, and change is from one year earlier. The repeat-transactions index extends through 2006:Q1. For the years preceding 1991, that index includes appraisals associated with mortgage refinancings; beginning in 1991, it includes purchase transactions only. The existing home price index extends through 2006:Q2, and the reading for Q2 is the average for April and May compared with the same period a year earlier.
SOURCE: For repeat transactions, Office of Federal Housing Enterprise Oversight; for existing home prices, National Association of Realtors.

Although recent increases in house prices have been smaller than those that accompanied the robust real estate markets of 2004 and 2005, the deceleration thus far appears to have been modest. The repeat-transactions index of house prices, which is published by the Office of Federal Housing Enterprise Oversight, increased at an annual rate of 7¼ percent in the first quarter of 2006, the smallest quarterly increase since the fourth quarter of 2001; that index attempts to control for the quality of existing single-family homes sold by using prices of homes involved in repeat transactions (excluding refinancings). The first-quarter reading brought the year-over-year change in this measure to 10 percent; in the second and third quarters of 2005, purchase prices according to this index were up 11½ percent from the level of a year earlier. An alternative measure of house prices is the average price of existing single-family homes sold, which is published by the National Association of Realtors. This measure, which does not control for the type of homes sold, showed that the year-over-year change in prices peaked at 11½ percent in August 2005 and then fell to 4 percent in April and May of this year. The greater deceleration in the latter measure suggests that, in addition to some softening in prices, the mix of existing units sold may have shifted toward lower-priced homes.

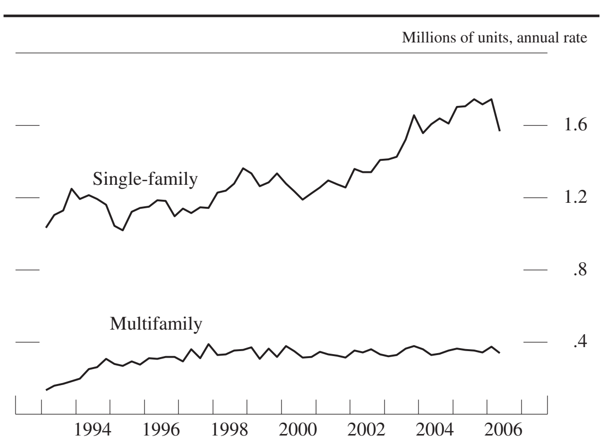
The effect of the slowdown in demand on new construction became apparent during the second half of 2005, when the number of permits issued for new single-family homes began to fall. This year, the decline in permit issuance was relatively steady from January to May. Nonetheless, new single-family homes were started at an exceptionally high annual rate of 1.75 million units during the first quarter, when builders were able to begin work on scheduled projects earlier than normal because of favorable weather conditions. With some starts having been advanced into the first quarter, single-family starts dropped to an average rate of 1.57 million units in April and May. In contrast to the recent trend in the single-family sector, construction of new multifamily homes averaged an annual rate of 360,000 units from January to May, about where it has been for more than four years.

Housing activity, as measured by real expenditures on residential structures, contributed almost ½ percentage point per year to the annual rate of increase in real GDP in 2004 and 2005. In the first quarter of 2006, that contribution dropped to 0.2 percentage point; with the reduced pace of sales and construction since the winter, a decline in residential investment is likely to have held down the rise in real GDP in the second quarter.

Household Finance

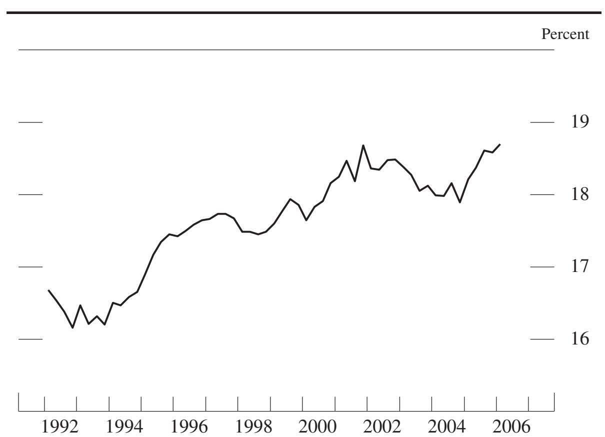
Household debt expanded at an annual rate of about 11½ percent in the first quarter of 2006, about the same pace as in 2005. Despite the rise in mortgage rates and the slowing in housing activity, home mortgage debt expanded rapidly again early in the year as homeowners apparently continued to extract some of the substantial gains in equity that they have accumulated on their homes in the past several years. Indeed, according to industry estimates, although the number of homeowners refinancing their mortgages has remained well below that seen during the refinancing boom of several years ago, a large fraction of homeowners who have refinanced so far this year have chosen to withdraw equity from their homes. As has been the case in recent years, this mortgage-related borrowing likely replaced, in part, some consumer

Private housing starts, 1993–2006



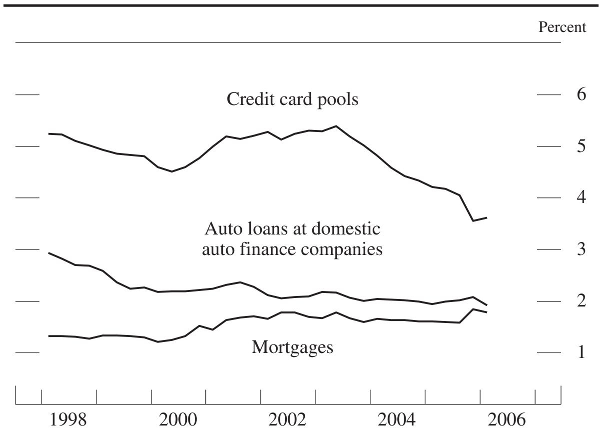
Note: The data are quarterly and extend through 2006:Q2; the readings for 2006:Q2 are the averages for April and May.
Source: Department of Commerce, Bureau of the Census.

Household financial obligations ratio, 1992–2006



Note: The data are quarterly and extend through 2006:Q1. The financial obligations ratio equals the sum of required payments on mortgage and consumer debt, automobile leases, rent on tenant-occupied property, homeowner's insurance, and property taxes, all divided by disposable personal income.
Source: Federal Reserve Board.

Delinquency rates on selected types of household loans, 1998–2006



NOTE: The data are quarterly and extend through 2006:Q1.
SOURCE: For credit cards, Moody's Investors Service; for auto loans, the financing subsidiaries of the three major U.S. automobile manufacturers; for mortgages, Mortgage Bankers Association.

credit borrowing, which, at an annual rate of a bit less than 3 percent, continued to expand modestly in the first five months of 2006.

The ratio of household financial obligations to disposable income rose 0.1 percentage point in the first quarter to about 18¾ percent, narrowly exceeding the top of its historical range. Nonetheless, the evidence points to only limited pockets of financial distress in the household sector. Delinquency rates on residential mortgages were low by historical standards in the first quarter, though they have edged higher since the middle of last year, particularly in the subprime sector. Delinquency rates on consumer debt also continued to be low. Meanwhile, household bankruptcy filings remained subdued in the first half of 2006, running at a pace well below the average of recent years. Bankruptcies have likely been damped this year in part by the decision of some households in the fall of 2005 to accelerate their filings to avoid the implementation of a stricter bankruptcy law in October. More recently, they may also have been restrained by the greater costs of bankruptcy under the new law.

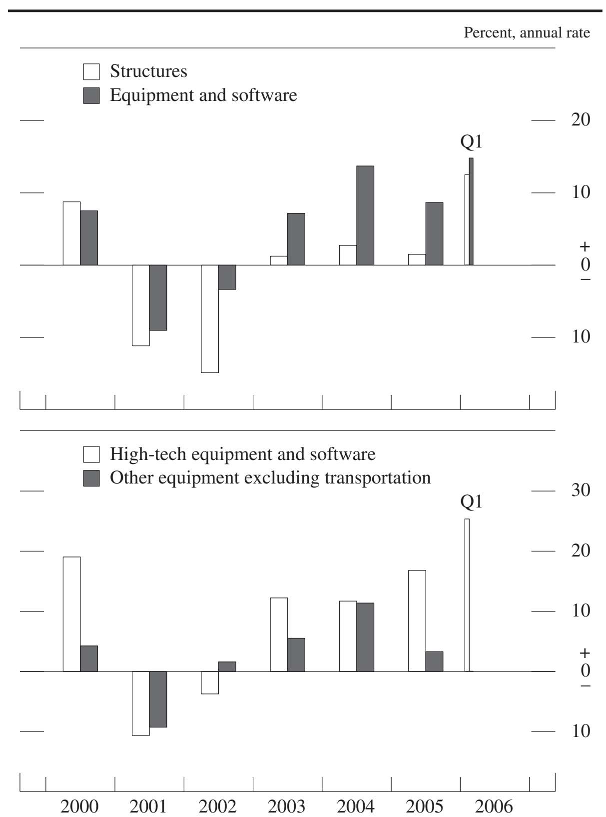
The Business Sector

Fixed Investment

Real business fixed investment increased at a solid rate, on average, during the final quarter of 2005 and the first quarter of 2006. Over that period, real business spending for new equipment and software rose at an annual rate of 9¾ percent, a pace similar to that over the first three quarters of 2005. In addition, investment in nonresidential structures, which had remained weak in 2005, turned up noticeably in early 2006. The underlying determinants of capital spending have stayed quite positive: Businesses have seen steady increases in sales, robust profits, and declining user costs for equipment; they have ample liquid assets; and, despite the rise in interest rates, credit quality is strong.

Real outlays for equipment and software rose at an annual rate of 14¾ percent in the first quarter after having risen at a 5 percent rate in the fourth quarter of 2005. As can often be the case, the timing of spending for a number of types of equipment was uneven between these two quarters. Business purchases of cars and trucks slowed in late 2005, after manufacturers reduced their special discounts on light vehicles, and then recovered in the first quarter. The first-quarter rebound was strengthened by a further acceleration of outlays for medium and heavy trucks. According to industry analysts, businesses have been pulling forward these purchases because the engines in the 2007 models will be required to meet new emission regulations by the Environmental Protection Agency that will make the new vehicles more costly to operate. Deliveries of commercial aircraft to domestic

Change in real business fixed investment, 2000–06



NOTE: High-tech equipment consists of computers and peripheral equipment and communications equipment.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

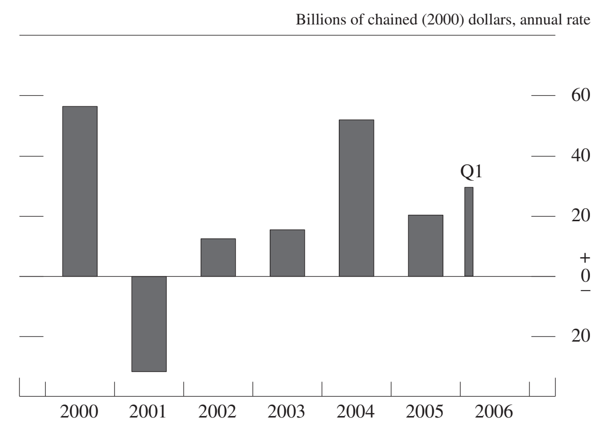
customers also rebounded in the first quarter from a very low level in the fourth quarter.

Demand for high-technology equipment stepped up noticeably in the first quarter because of a sharp jump in outlays for communications equipment. Providers of telecommunications services appear to be investing heavily in fiber-optic networks, which will allow them to offer a wider range of Internet services; the recent spurt likely also includes some replacement demand for equipment damaged by last year's hurricanes. In contrast, business demand for computing equipment, while still increasing at a double-digit pace in real terms, has been relatively modest by historical standards so far this year. Industry analysts suggest that firms may be delaying investment in anticipation of introductions, later this year and in early 2007, of several products that will allow faster and more energy-efficient processing. Spending on equipment other than transportation and high-tech goods continued to trend up at a solid pace, on average, during the fourth and first quarters. Demand was particularly strong for metalworking and general industrial machinery as well as for equipment used in construction, energy extraction, and services industries.

Demand for equipment and software appears to have risen again in the second quarter. The information from U.S. manufacturers on their orders and shipments of nondefense capital goods and the data on imports of capital goods suggest that business spending for equipment other than transportation and high-tech items remained on a strong upward trajectory in April and May. The elevated backlog of unfilled orders at domestic firms likely provided support for factory production of capital equipment in the second quarter. The indicators of demand for high-tech equipment suggest that spending for communications equipment remained at a high level, and real outlays for computing equipment were still rising slowly. Sales of medium and heavy trucks continued to be robust in the second quarter, although they eased slightly from the exceptional rate at the beginning of the year.

Real expenditures for nonresidential construction increased at an annual rate of 12½ percent in the first quarter after having edged up slightly during 2005. Last year, the small net increase in this sector reflected a sharp upturn in spending on structures used in domestic energy exploration; construction of new office and industrial buildings was restrained by elevated vacancy rates. However, vacancy rates for office and industrial properties gradually declined over the course of 2005, and, by the turn of the year, nonresidential construction began to firm. As a result, the increase in nonresidential investment in the first quarter of 2006 was broadly based; it included pickups in outlays in the office, retail, and industrial sectors in addition to another steep rise in spending on structures associated with energy exploration.

Change in real business inventories, 2000–06



SOURCE: Department of Commerce, Bureau of Economic Analysis.

Inventory Investment

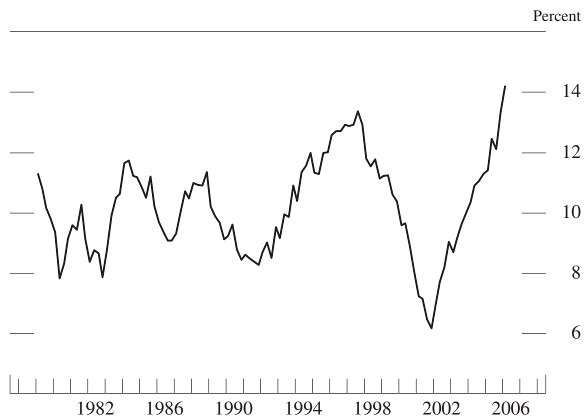
Business inventories appear generally to be well aligned with sales. In surveys taken during the first six months of 2006, about two-thirds of purchasing managers at manufacturing firms who responded characterized the level of their customers' inventories as about right. A similar proportion of respondents at nonmanufacturing firms reported that they were comfortable with their own levels of inventories. However, dealer stocks of new light motor vehicles, particularly trucks (including SUVs), have risen noticeably as sales have slowed; inventories of light trucks reached an uncomfortable 89 days' supply in May. In late June, a number of manufacturers introduced a new round of incentives aimed at reducing dealer stocks in advance of the introduction of their new models this fall.

Corporate Profits and Business Finance

Corporate profits were again strong in the first quarter of 2006, and earnings per share for S&P 500 firms rose about 15 percent from the same time last year. Gains were widespread but were especially large for firms in the energy sector. Before-tax profits of nonfinancial corporations measured as a share of sector GDP rose to about 14 percent in the first quarter, above the previous peak reached in 1997.

The expansion of business debt picked up to an annual rate of nearly 10 percent in the first quarter of this year, and data in hand suggest a robust pace in the second quarter. A substantial fraction of borrowing proceeds reportedly went to finance mergers and acquisitions in the first half of the year. Net bond issuance has been strong so far in 2006. Short-term borrowing by nonfinancial corporations stepped up in the first quarter of 2006 after slowing somewhat in the fourth quarter of last year; it

Before-tax profits of nonfinancial corporations as a percent of sector GDP, 1979–2006

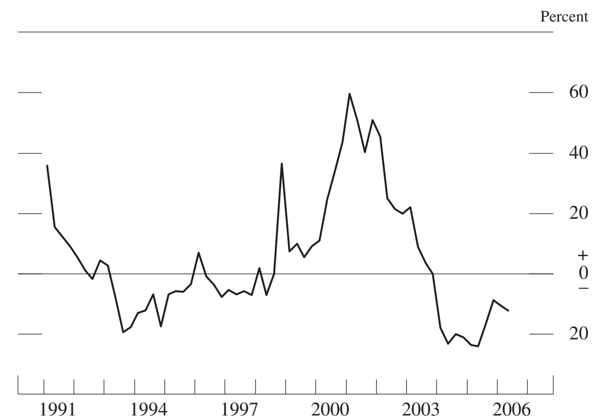


NOTE: The data are quarterly and extend through 2006:Q1. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

appears to have remained strong in the second quarter as well. Commercial paper outstanding started rising again, on balance, after edging lower in 2005. Bank business loans outstanding expanded at an annual rate of 15½ percent in the first quarter. Businesses benefited from a more accommodative lending environment: For example, a significant net fraction of respondents to the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices in April 2006 noted that their institutions had eased both standards and terms on commercial and industrial loans in the first three months of the year. The most commonly cited reasons for the easing of lending policies were more-aggressive competition from other banks and nonbank lenders, increased liquidity in the secondary market for business loans, and increased tolerance for risk.

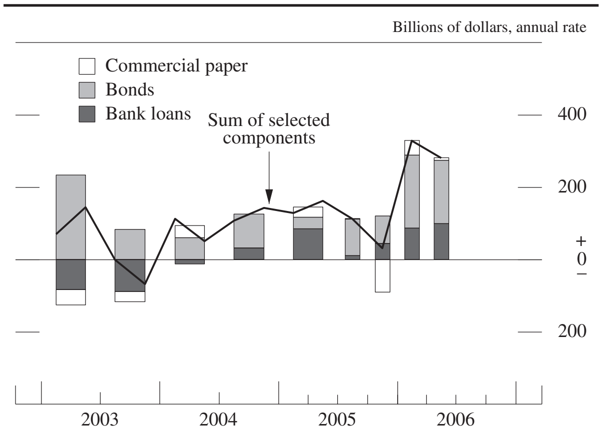
Gross equity issuance has remained moderate so far this year, while an elevated level of cash-financed merg-

Net percentage of domestic banks tightening standards on commercial and industrial loans to large and medium-sized borrowers, 1991–2006



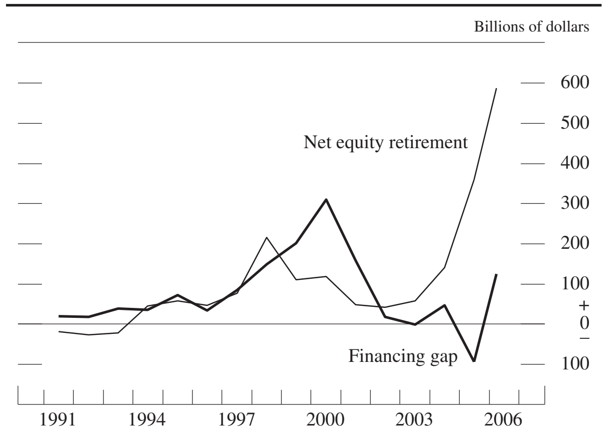
NOTE: The data are drawn from a survey generally conducted four times per year; the last observation is from the April 2006 survey. Net percentage is the percentage of banks reporting a tightening of standards less the percentage reporting an easing. The definition for firm size suggested for, and generally used by, survey respondents is that large and medium-sized firms have sales of $50 million or more.
SOURCE: Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices.

Selected components of net financing for nonfinancial corporate businesses, 2003–06



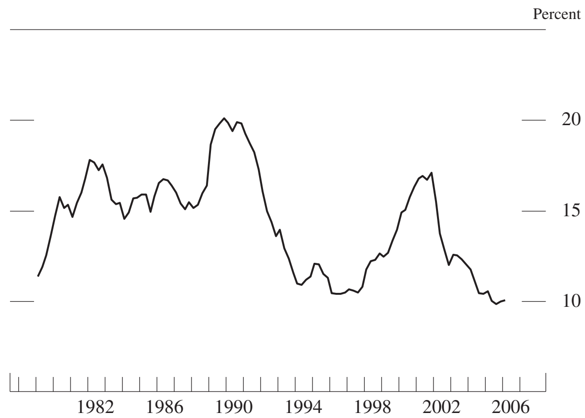
NOTE: The data for the components except bonds are seasonally adjusted. The data for the sum of selected components are quarterly. The data for 2006:Q2 are estimated.
SOURCE: Federal Reserve Board; Securities Data Company; and Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

Financing gap and net equity retirement at nonfinancial corporations, 1991–2006



NOTE: The data are annual through 2005; for 2006, they are as of Q1. The financing gap is the difference between capital expenditures and internally generated funds, adjusted for inventory valuation. Net equity retirement is the difference between equity retired through share repurchases, domestic cash-financed mergers, or foreign takeovers of U.S. firms and equity issued by domestic companies in public or private markets. Equity issuance includes funds invested by venture capital partnerships and stock option proceeds.
SOURCE: Federal Reserve Board, flow of funds data.

Net interest payments of nonfinancial corporations as a percent of cash flow, 1979–2006



NOTE: The data are quarterly and extend through 2006:Q1.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

ers along with record share repurchases has produced further sizable net equity retirements. Taken together, net funds raised by nonfinancial corporations in the credit and equity markets have been slightly negative in 2006, an indication that nonfinancial corporations have financed their increased investment spending with internal funds.

With profitability strong and balance sheets flush with liquid assets, credit quality in the nonfinancial business sector generally has remained quite high. The six-month trailing default rate on corporate bonds dropped after some large firms in the troubled airline and automobile sectors defaulted during the past fall and winter. Delinquency rates on business loans have stayed near the bottom of their historical range.

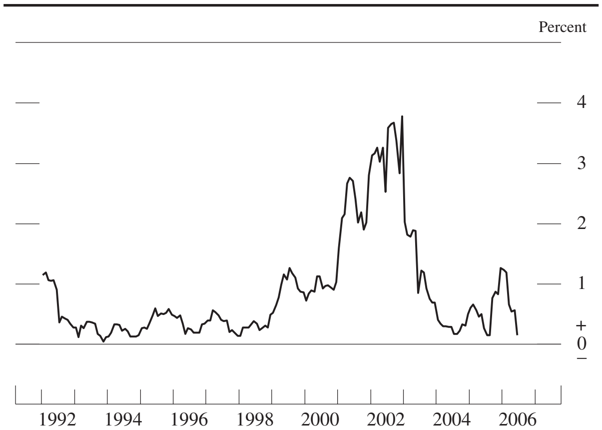
Commercial real estate debt expanded briskly in the first half of 2006, albeit not as quickly as during 2005. Spreads on BBB-rated commercial-mortgage-backed securities have fallen this year. The decline reversed an increase that took place at the end of last year, when issuance surged; these spreads are now back in line with those of comparable-quality corporate bonds. With rents climbing and vacancy rates falling, delinquency rates on commercial real estate loans have been low, and credit quality has remained generally good.

The Government Sector

Federal Government

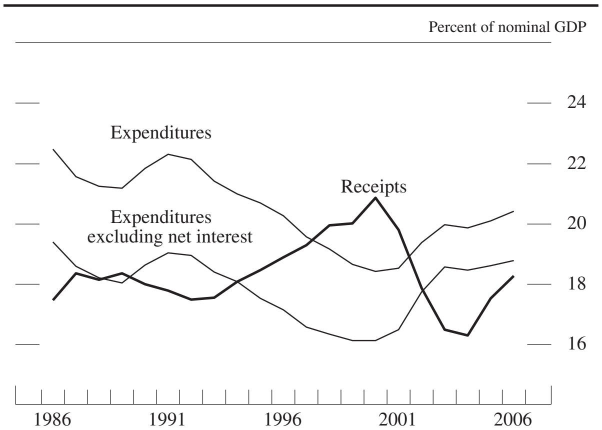
The deficit in the federal unified budget narrowed further during the past year. Over the twelve months ending in June, the unified budget recorded a deficit of $276 billion, about $60 billion less than during the comparable period last year. The federal deficit over the twelve months ending in June was approximately 2 percent of nominal GDP and was significantly lower than its recent fiscal year peak of 3.6 percent of GDP in 2004. Although outlays increased faster than nominal GDP over the past year, the rise in receipts was even larger. Thus, in its recent *Mid-Session Review* of the budget, the Administration estimated that the federal government will finish fiscal 2006 with a deficit of $296 billion; that figure marks a decline from the fiscal 2005 deficit of $318 billion and is much lower than most analysts had projected at the beginning of this year.

Default rate on outstanding corporate bonds, 1992–2006



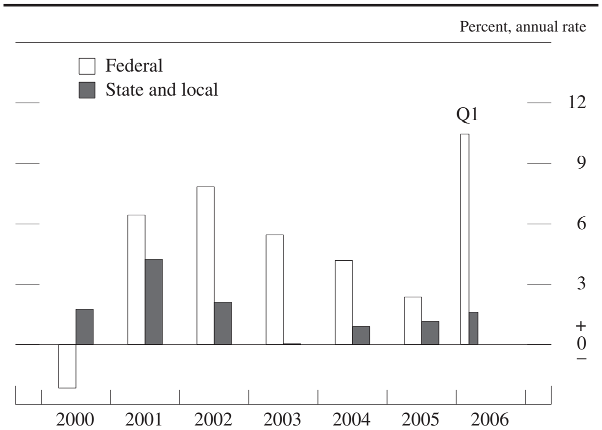
NOTE: The data are monthly and extend through June 2006. The rate for a given month is the face value of bonds that defaulted in the six months ending in that month, multiplied by two to annualize the defaults and then divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the six-month period.
SOURCE: Moody's Investors Service.

Federal receipts and expenditures, 1986–2006



NOTE: Through 2005, the receipts and expenditures data are on a unified-budget basis and are for fiscal years (October through September); GDP is for the four quarters ending in Q3. For 2006, the receipts and expenditures data are for the twelve months ending in June, and GDP is the average of 2005:Q4 and 2006:Q1.
SOURCE: Office of Management and Budget.

Change in real government expenditures on consumption and investment, 2000–06



SOURCE: Department of Commerce, Bureau of Economic Analysis.

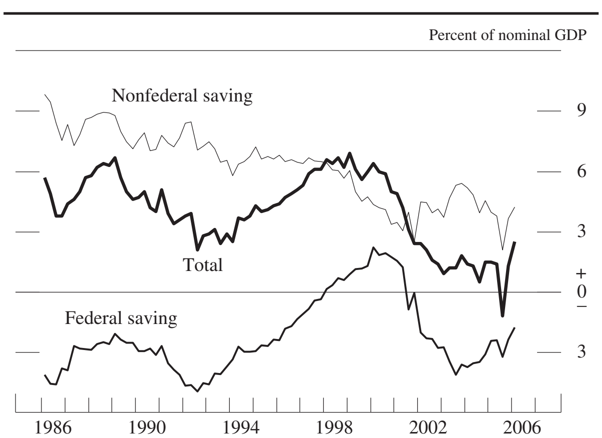
During the twelve months ending in June, federal receipts were 13¼ percent higher than over the same period a year earlier and equivalent to almost 18¼ percent of nominal GDP. Income tax receipts from individuals have outpaced the rise in nominal income; final tax payments on income from 2005 were especially strong in April and May. Corporate tax payments continued to rise at a robust rate, even faster than corporate profits.

Nominal federal outlays rose 9 percent between June 2005 and June 2006 and were about 20½ percent of nominal GDP. The rise in outlays was bolstered by increases in several components of federal spending. Net interest payments increased 20 percent over the year ending in June as federal debt continued to rise and interest rates increased. Medicare outlays were up 14½ percent; since the inception of the new Part D prescription drug program in January, outlays for benefits have added more than $20 billion to spending in this category. Legislative actions related to the hurricanes in the Gulf Coast region last autumn have added significantly to spending for disaster relief over the past ten months. Although defense spending has slowed from the annual double-digit rates of increase from 2002 to 2004, it still has increased about 8 percent per year in the past two years.

As measured in the national income and product accounts (NIPA), real federal expenditures on consumption and gross investment—the part of federal spending that is a direct component of real GDP—increased at an annual rate of 3¾ percent, on average, during the final calendar quarter of 2005 and the first calendar quarter of 2006 and contributed roughly 0.3 percentage point to the annualized change in real GDP over the period. Over these two quarters, real defense purchases were about constant, on average, while spending related to disaster relief from the hurricanes contributed importantly to a rise in real nondefense purchases.

The narrowing of the federal deficit recently has reduced its drain on national saving. However, net national saving excluding the federal government has remained low relative to historical norms. Although the saving rate for private business has moved up during the past two years, the improvement has been offset by the further decline in personal saving. Overall, national saving, net of depreciation, stood at 2½ percent of nominal GDP in the first quarter of 2006. Although the recent rate is a noticeable improvement from the lows of the preceding few years, it has been insufficient to avoid an increasing reliance on borrowing from abroad to finance the nation's capital spending.

Net saving, 1986–2006



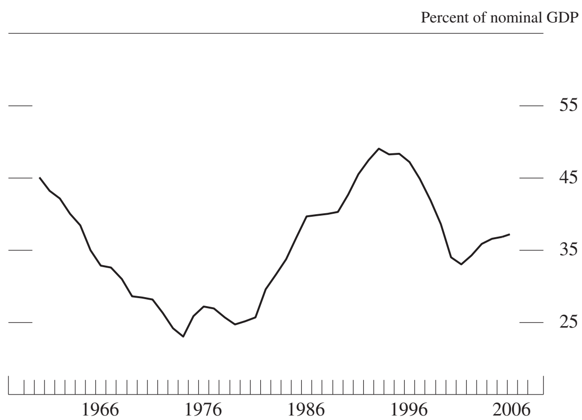
NOTE: The data are quarterly and extend through 2006:Q1. Nonfederal saving is the sum of personal and net business saving and the net saving of state and local governments.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Federal Borrowing

Federal debt rose at an annual rate of 13 percent in the first quarter, a bit less than in the corresponding quarter of 2005. In February, federal debt subject to the statutory limit reached the ceiling of $8.184 trillion, and the Treasury resorted to accounting devices to avoid breaching the limit. The Congress subsequently increased the debt ceiling to $8.965 trillion in March. In the second quarter, federal debt likely declined temporarily because of a surge in tax receipts. On net, the Treasury has raised substantially less cash in the market so far this year than in the comparable period of 2005.

In February, the Treasury conducted an auction of thirty-year bonds for the first time since 2001. The issue generated strong interest, especially from investment funds; foreign investors were awarded only a small fraction of the total. In general, foreign demand for Treasury

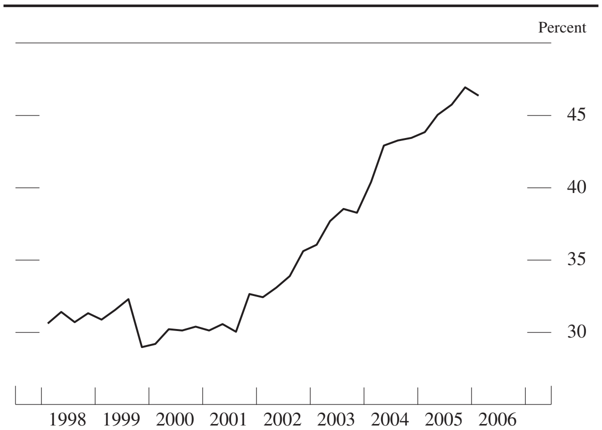
Federal government debt held by the public, 1960–2006



NOTE: The final observation is for 2006:Q1. For previous years, the data for debt are as of year-end, and the corresponding values for GDP are for Q4 at an annual rate. Excludes securities held as investments of federal government accounts.
SOURCE: Federal Reserve Board, flow of funds data.

securities appears to have eased somewhat in 2006. The proportion of nominal coupon securities bought at auction by foreign investors has continued to fall from its peak of 24 percent in 2004; it averaged about 14 percent in the first six months of 2006. Data from the Treasury International Capital system generally suggested subdued demand from both foreign private investors and foreign official institutions over this period. The amount of Treasury securities held in custody at the Federal Reserve Bank of New York on behalf of foreign official and international accounts has changed little since the end of 2005.

Treasury securities held by foreign investors as a share of total outstanding, 1998–2006



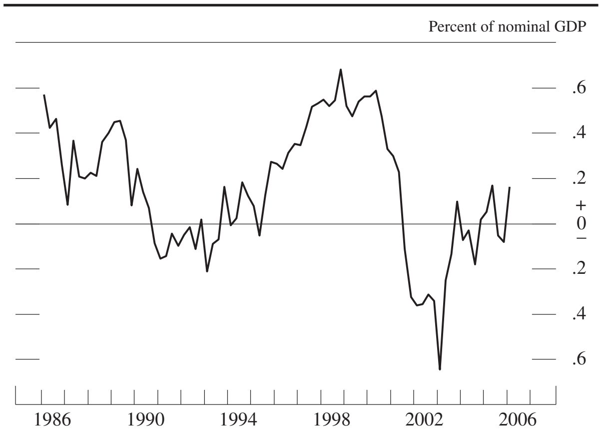
NOTE: The data are quarterly and extend through 2006:Q1.
SOURCE: Federal Reserve Board, flow of funds data.

State and Local Governments

The fiscal positions of states and localities continued to improve through early 2006. In particular, revenues are on track to post a relatively strong gain for a third consecutive year. Tax receipts from sales, property, and personal and corporate income were up 8¼ percent during the year ending in the first quarter of 2006, a rate similar to the increase in the preceding year. The sustained strength in revenues has enabled these jurisdictions to increase their nominal spending somewhat while rebuilding their reserve funds. On a NIPA basis, net saving by state and local governments—a measure that is broadly similar to the surplus in an operating budget—rose to an annual rate of $21½ billion in the first quarter of 2006 after having been close to zero in 2005. Although most states have seen improvement, a number of states are still struggling with structural imbalances in their budgets, and those in the Gulf Coast region are coping with demands related to damage from last year's hurricanes. In addition, local governments may face pressure to hold the line on property taxes after the sharp increases in the past several years, and governments at all levels will have to contend with the need to provide pensions and health benefits to a rising number of retirees in coming years.

Real expenditures by state and local governments on consumption and gross investment, as estimated in the NIPA, rose at an annual rate of 1½ percent in the first quarter of 2006 after having increased roughly 1 percent per year in 2004 and 2005. Real expenditures for investment turned up in the first quarter after having fallen during the second half of 2005. Real outlays for current consumption posted a moderate increase in the first quarter, and that trend appears to have continued into midyear.

State and local government net saving, 1986–2006



NOTE: The data, which are quarterly, are on a national income and product account basis and extend through 2006:Q1. Net saving excludes social insurance funds.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Hiring by state and local governments was slow early in the year but appears to have firmed in the spring. Of the cumulative increase in employment of 100,000 between December and June, 40 percent of the jobs were in education.

State and Local Government Borrowing

Borrowing by state and local governments has slowed thus far in 2006. The deceleration likely reflects the general improvement in budget conditions and a decline in advance refundings, which have dropped below their 2005 pace amid rising interest rates and a dwindling pool of eligible securities. Credit quality in the state and local sector has continued to improve, and upgrades of credit ratings have far outnumbered downgrades. Consistent with the improvement in credit quality, yields on long-dated municipal bonds have increased substantially less than those on comparable-maturity Treasury securities, and the yield ratio has accordingly fallen sharply.

The External Sector

The U.S current account deficit narrowed in the first quarter of 2006 to $835 billion at an annual rate, or about 6½ percent of nominal GDP, from $892 billion in the fourth quarter of 2005. The narrowing resulted from three factors. Unilateral transfer payments to foreigners dropped, largely because of a decrease in government grants. The trade deficit narrowed, primarily because the value of imported oil and natural gas declined. In addition, higher direct investment receipts and lower direct investment payments produced an increase in the investment income balance.

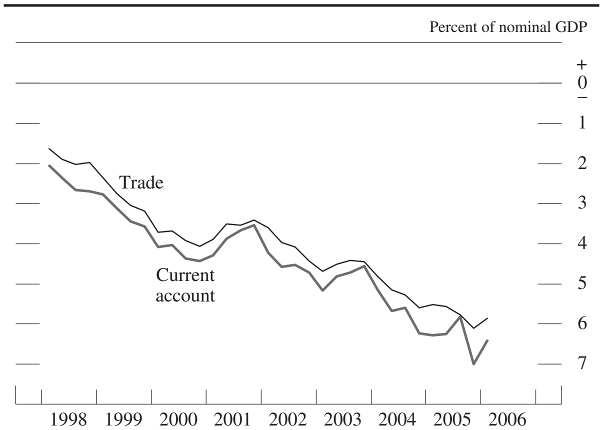
International Trade

Real exports of goods and services increased 14¾ percent at an annual rate in the first quarter of 2006, far faster than the 6½ percent rate recorded in 2005. The surge in export growth in the first quarter resulted in part from a recovery in exports of many types of industrial supplies following a period of hurricane-related disruptions late last year. Exports of capital goods also increased rapidly in the first quarter, with deliveries of aircraft to foreign carriers exhibiting particular strength. The first-quarter increase in exports was widespread across destinations, a sign of robust economic activity in many parts of the world, and exports to Mexico and Canada showed especially large increases. Real exports of services rose at an annual rate of about 6½ percent in the first quarter after increasing just 2¾ percent in 2005. Available data for nominal exports in April and May suggest that the increase in real exports was smaller in the second quarter, held down in part by a drop in aircraft exports after a strong first quarter.

Prices of exported goods increased at an annual rate of 2¾ percent in the first quarter of 2006, a pace somewhat faster than in the second half of 2005. Prices of nonagricultural industrial supplies continued to increase steadily in the first quarter, driven importantly by higher prices for oil and metals. An acceleration in prices for finished goods, especially for capital and consumer goods, contributed to the faster pace of export price inflation in the first quarter. The available data for the second quarter point to further increases in export prices on the strength of additional run-ups in the prices of nonagricultural industrial supplies, especially metals.

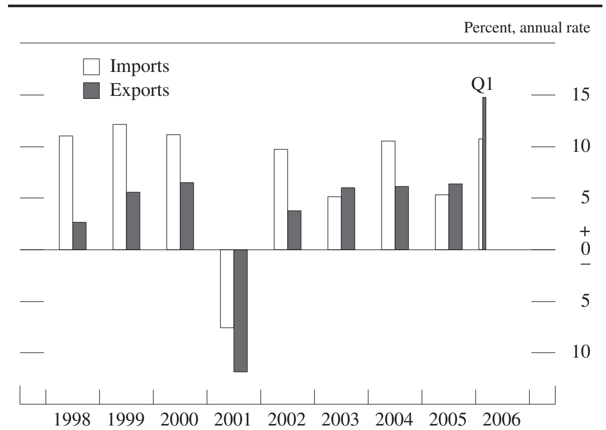
Real imports of goods and services rose at an annual rate of 10¾ percent in the first quarter, slightly slower

U.S. trade and current account balances, 1998–2006



NOTE: The data are quarterly and extend through 2006:Q1.
SOURCE: Department of Commerce.

Change in real imports and exports of goods and services, 1998–2006

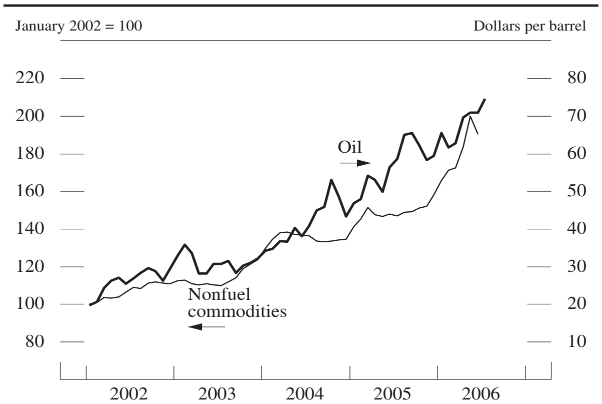


SOURCE: Department of Commerce.

than in the fourth quarter but still considerably faster than the 5¼ percent rate observed for 2005 as a whole. Robust growth of real GDP in the United States supported the first-quarter increase in imports. Among categories of goods, large increases in imports of consumer goods, automotive products, and capital goods, particularly computers, more than offset declines in imports of oil and some other industrial supplies. The rise in imports in the first quarter was widely distributed across countries, and the increases for China and Mexico were especially large. Real imports of services jumped at an annual rate of 8½ percent in the first quarter. Nominal imports in April and May point to an abrupt slowing of real imports in the second quarter from the first quarter's rapid pace.

Prices of imported goods excluding oil and natural gas rose at an annual rate of about 1 percent in the first quarter of 2006, ¾ percentage point faster than the pace in the second half of 2005. Prices of material-intensive goods, such as nonfuel industrial supplies and foods, increased steadily in the last quarter of 2005 and in the first quarter of 2006. Also in the first quarter, prices of finished goods, such as consumer goods and many kinds of capital goods, turned up slightly. Available data for the second quarter indicate that prices of finished goods kept rising at a subdued pace. However, prices of material-intensive goods continued to increase sharply, a development reflecting higher prices for metals. The International Monetary Fund's index of global metals prices rose 46 percent between December 2005 and May 2006, largely because of robust global demand. In June, metals prices retreated about 8 percent, although they remained well above the levels of earlier this year.

Prices of oil and of nonfuel commodities, 2002–06



NOTE: The data are monthly. The last observation for the oil price is the average for July 3 through July 12, 2006. The prices of nonfuel commodities extend through June 2006. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is an index of forty-five primary-commodity prices.

SOURCE: For oil, the Commodity Research Bureau; for nonfuel commodities, International Monetary Fund.

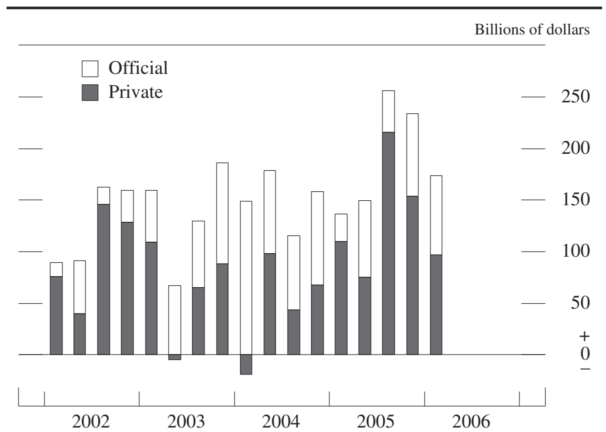
The spot price of West Texas intermediate crude oil increased from around $60 per barrel at the end of last year to more than $75 per barrel in July, higher than the peak that followed last year's hurricanes. Oil prices have been highly sensitive to news about both supply and demand, particularly in light of the narrow margin of worldwide spare production capacity. Global oil demand has continued to grow as the foreign economic expansion has spread, and developing countries have posted the largest increases in oil consumption. Recent events in the Middle East—including concerns over Iran's nuclear program, violence in Iraq, and the recent conflict in Lebanon—have put additional upward pressure on oil prices. In Nigeria, attacks against oil infrastructure have reduced oil production for most of this year. Government intervention in energy markets also raised concerns about supply from some countries: In recent months, Bolivia nationalized its natural gas reserves, and Venezuela and Russia continued to tighten governmental control of their energy industries.

The rise in the price of the far-dated NYMEX oil futures contract (currently for delivery in 2012) to more than $70 per barrel likely reflects a belief by oil market participants that the balance of supply and demand will remain tight over the next several years.

The Financial Account

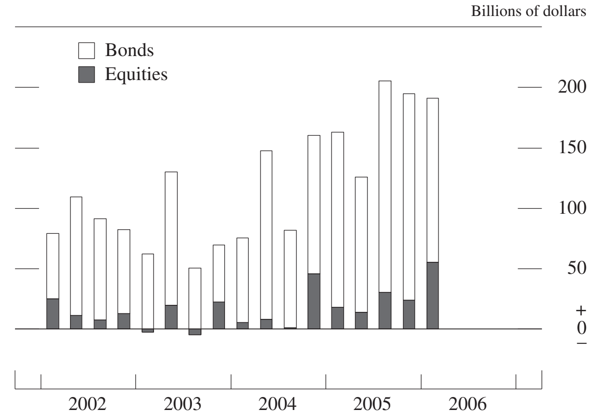
The U.S. current account deficit continues to be financed primarily by foreign purchases of U.S. debt securities. Foreign official inflows in the first quarter maintained the strength exhibited in 2005 but remained below the record levels of 2004. As in recent years, the majority of these official inflows were attributable to Asian central banks and have taken the form of purchases of U.S. government securities.

U.S. net financial inflows, 2002–06



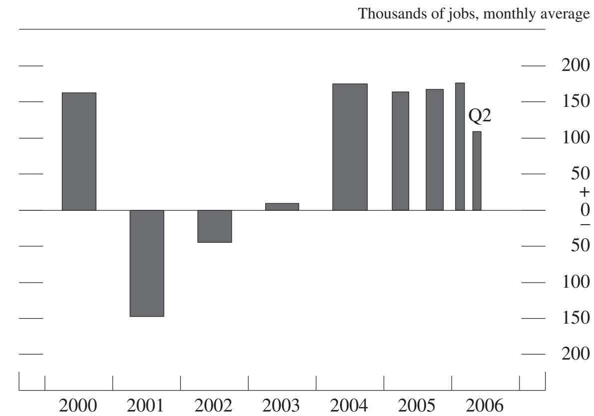
SOURCE: Department of Commerce.

Net private foreign purchases of long-term U.S. securities, 2002–06



SOURCE: Department of Commerce and the Treasury International Capital reporting system.

Net change in payroll employment, 2000–06



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

Foreign private purchases of U.S. securities continued in the first quarter at the extraordinary pace set in the second half of 2005. Although private flows into U.S. Treasury bonds were significantly smaller than in recent quarters, this slowing was more than offset by larger flows into agency bonds and equities. Preliminary data for April and May suggest a slowdown in foreign purchases of U.S. securities relative to the first quarter. Foreign direct investment flows into the United States continued in the first quarter near last year's average levels.

Net purchases of foreign securities by U.S. residents, which represent a financial outflow, strengthened slightly in the first quarter and continued at a solid pace in April and May. In addition, significant outflows were associated with U.S. direct investment abroad, a reversal of some unusual inflows in the second half of 2005. These second-half inflows were prompted by the partial tax holiday offered under the 2004 Homeland Investment Act (HIA), which induced the foreign affiliates of U.S. firms to repatriate a portion of earlier earnings that had been retained abroad. In the first quarter, the foreign affiliates partially unwound the HIA-induced flows by retaining an unusually large portion of their first-quarter earnings. Increased merger activity abroad also boosted direct investment outflows in the first quarter.

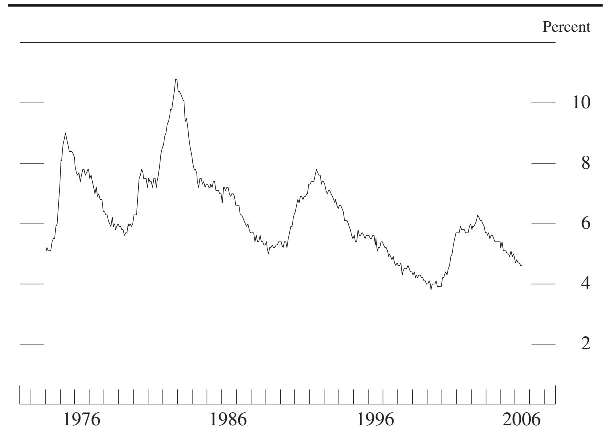
The Labor Market

Employment and Unemployment

Conditions in the labor market continued to improve in the first half of 2006, although the pace of hiring has slowed in recent months. Nonfarm payroll employment increased 176,000 per month during the first quarter, a rate roughly in line with the relatively brisk pace that prevailed during 2004 and 2005. During the second quarter, hiring slowed, and monthly gains in payrolls averaged 108,000 jobs per month. Over the two quarters, the civilian unemployment rate edged down further, to the lowest quarterly level of joblessness in five years.

In the first quarter, with homebuilding quite strong, hiring continued to be particularly robust at construction sites; part of this strength was the result of favorable weather, which allowed more construction activity than is typical during the winter months. Although nonresidential construction activity was firming by the spring, the pullback in housing starts slowed the demand for residential contractors and workers in the building trades. As a result, monthly additions to construction industry payrolls declined from more than 25,000 per month in the first quarter to just 3,000 per month in the second quarter. Cutbacks at retailers also were an important factor holding down the overall gain in employment in the

Civilian unemployment rate, 1974–2006



NOTE: The data are monthly and extend through June 2006.
SOURCE: Department of Labor, Bureau of Labor Statistics.

second quarter. After having been stable early in 2006, employment at retail outlets fell almost 30,000 per month between March and June; most of the cutbacks occurred at general merchandisers.

In other sectors, employment remained on a solid upward trend during the first half of the year. As has been the case since mid-2004, establishments providing education and health services, those offering professional and technical business services, and those involved in financial activities, taken together, added more than 60,000 jobs per month. Employment in manufacturing, which had turned up at the end of 2005, rose further over the first half of 2006. Expanding industrial production was also associated with further job gains in related industries, such as wholesale trade and transportation. In addition, the increase in energy production led to a sustained rise in employment in the natural resources and mining industry over the first half of the year.

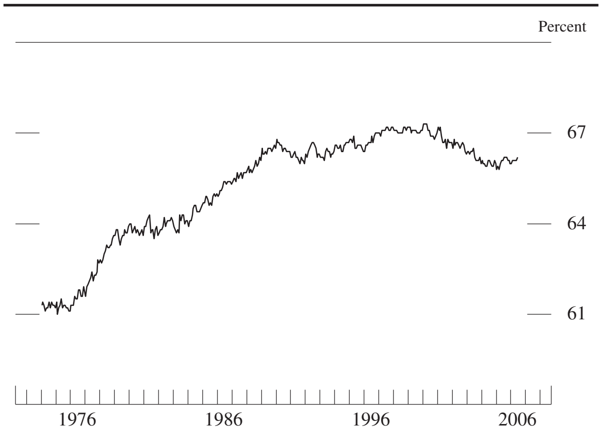
The increase in job opportunities so far in 2006 led to a further reduction in the civilian unemployment rate, from an average of 5.0 percent in the second half of 2005 to 4.7 percent in the second quarter of 2006. Although hiring moderated in the spring, layoffs remained low. New claims for unemployment insurance (UI) dipped below 300,000 per week in January and February and then fluctuated around a still-low level of about 315,000 per week for most of the period from March through early July. Over the first half of 2006, longer-term unemployment (fifteen weeks or more) also moved down, and the proportion of UI claimants who remained on the unemployment rolls until the exhaustion of their benefits continued to recede.

After having edged up during 2005, the labor force participation rate was relatively stable over the first half of 2006 despite the ongoing improvement in labor market conditions. Rates for most broad age groups were little changed from last year's levels. From a longer perspective, developments during the past decade highlight the importance of structural as well as cyclical influences on participation. The rise in the attachment of adult women to the workforce, which was a significant factor in the secular rise in participation over much of the post–World War II period, appears to have leveled off. And the aging of the population is increasing the proportion of the workforce that is 55 years and older; it rose from less than 12 percent in 1996 to 16¾ percent in recent months. Although older workers have tended in recent years to stay in the labor force longer, their participation rate, at 38 percent in the second quarter, was less than half the rate for workers who are age 25 to 54. Thus, the demographic shift to an older population has already begun to reduce the overall rate of labor force participation and has offset part of the rise in participation that has been associated with the cyclical upturn in job creation. The secular forces that are slowing the expansion of the labor force imply that the increase in employment that is consistent with a stable unemployment rate will, over time, be smaller than it was during the period when labor force participation was rising steadily.

Productivity and Labor Costs

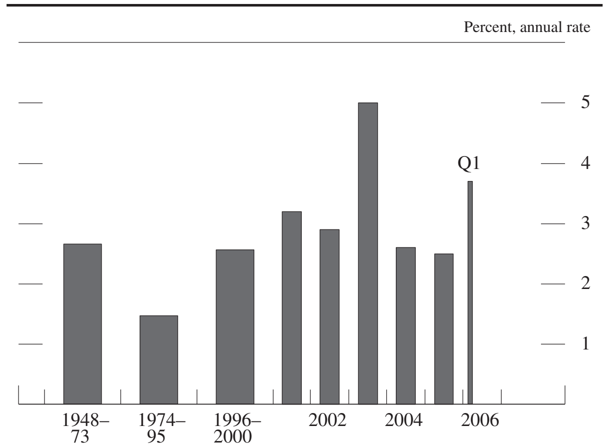
After having advanced at an unusually rapid rate from 2001 to mid-2004, labor productivity in the nonfarm business sector increased at a more moderate annual rate of 2½ percent from mid-2004 to early 2006. Nonetheless, by historical standards, productivity performance recently

Labor force participation rate, 1974–2006



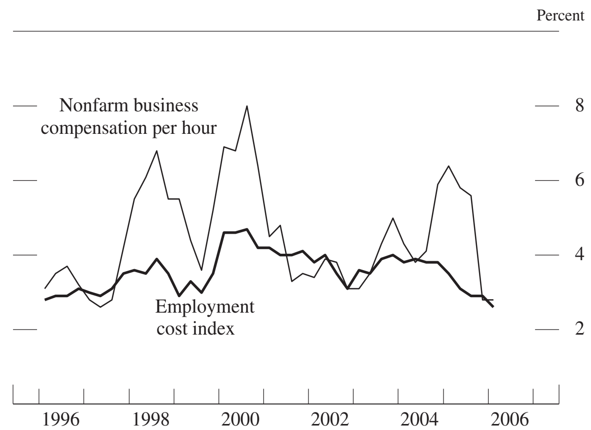
Note: The data are monthly and extend through June 2006.
Source: Department of Labor, Bureau of Labor Statistics.

Change in output per hour, 1948–2006



Note: Nonfarm business sector. Change for each multiyear period is measured from the fourth quarter of the year immediately preceding the period to the fourth quarter of the final year of the period.
Source: Department of Labor, Bureau of Labor Statistics.

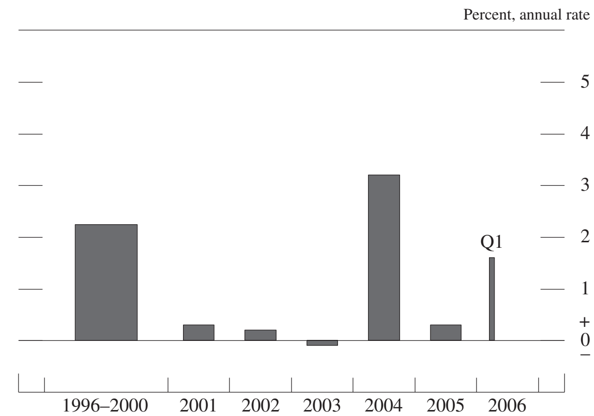
Measures of change in hourly compensation, 1996–2006



NOTE: The data are quarterly and extend through 2006:Q1. For nonfarm business compensation, change is over four quarters; for the employment cost index (ECI), change is over the twelve months ending in the last month of each quarter. The nonfarm business sector excludes farms, government, nonprofit institutions, and households. The sector covered by the ECI used here is the same as the nonfarm business sector plus nonprofit institutions. A new ECI series was introduced for data as of 2001, but the new series is continuous with the old.

SOURCE: Department of Labor, Bureau of Labor Statistics.

Change in unit labor costs, 1996–2006



NOTE: Nonfarm business sector. The change for 1996 to 2000 is measured from 1995:Q4 to 2000:Q4.

SOURCE: Department of Labor, Bureau of Labor Statistics.

has still been solid, with gains at a rate matching those during the second half of the 1990s. In an environment of a sustained expansion of aggregate demand, businesses have gradually adjusted their use of labor, capital, and services to achieve ongoing gains in efficiency. Productivity has continued to benefit importantly from investment in new technologies, organizational changes, and improvements in business processes, although the contribution from capital deepening has been smaller in recent years than it was during the capital investment boom of the late 1990s.

Broad measures of hourly labor compensation, which include both wages and the costs of benefits, posted moderate gains over the year ending in early 2006 despite the run-up in headline price inflation and the further tightening of labor markets. Both the employment cost index (ECI) and the estimate of compensation per hour that uses data from the national income and product accounts increased 2¾ percent between the first quarter of 2005 and the first quarter of 2006.[1] Both series had reported higher rates of change in hourly labor compensation a year earlier.

The deceleration in labor compensation appears to have been associated largely with smaller increases in employers' benefit costs. The benefits component of the ECI was up just 3 percent between March 2005 and March 2006, compared with an increase of 5.5 percent between March 2004 and March 2005. The cost of health insurance, which typically accounts for about one-fourth of overall benefit costs, rose just 4¾ percent during the year ending in March 2006; between 2000 and 2005, these costs increased, on average, 8¾ percent per year. Another likely contributor to the slower rise in benefit costs over the past year was smaller employer contributions to their defined-benefit pension plans; those costs dropped back somewhat after employers made sizable payments to bolster those pension assets in 2004.

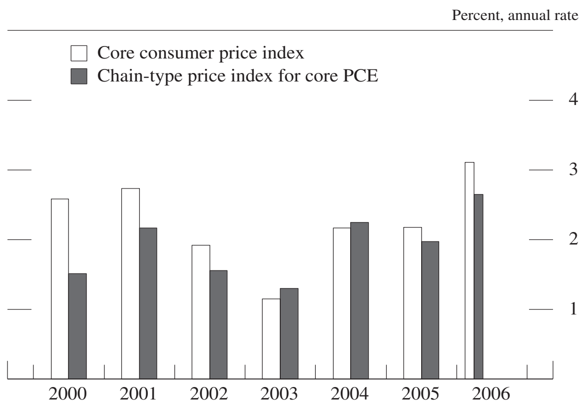
Indicators of the recent trend in the wage component of worker compensation have been providing mixed signals. As measured in the ECI, wages rose 2.4 percent between March 2005 and March 2006, slightly less than in the preceding two years. In contrast, the year-over-year change in average hourly earnings of production or nonsupervisory workers—which refers to a narrower group of private nonfarm employees and has tended to show greater cyclical variation than the ECI—has increased steadily over the past three years. Average hourly earnings rose 3.9 percent over the twelve months ending in June 2006, compared with an increase of 2.7 percent over the twelve months ending in June 2005.

Prices

Inflation pressures were elevated during the first half of 2006. The chain-type price index for personal consumption expenditures (PCE) rose at an annual rate of 4¼ percent between December 2005 and May 2006. Over the same period, core PCE prices increased at an annual rate of 2.6 percent, nearly 0.6 percentage point faster than over the twelve months of 2005.

1. The Bureau of Labor Statistics (BLS) developed a new ECI series and has provided data for the changes in that series beginning in 2001. The BLS considers the new ECI to be continuous with the old series.

Change in core consumer prices, 2000–06



Note: Through 2005, change is from December to December; for 2006, change is from December to May.

Source: For core consumer price index, Department of Labor, Bureau of Labor Statistics; for core PCE price index, Department of Commerce, Bureau of Economic Analysis.

Although energy prices eased temporarily in February, they turned up sharply again from March to May; as a result, the PCE price index for energy increased 13 percent (not at an annual rate) over the first five months of 2006, a rise that marked a continuation of the steep climb in prices that began in 2004. This year, almost the entire rise in energy prices has been associated with higher prices for petroleum-based products. The PCE price index for gasoline and motor fuel, which increased more than 16½ percent last year, climbed another 24 percent (not at an annual rate) by May. Although recent data from the Department of Energy indicate that gasoline prices fell back in June, they moved up again in early July. Retail prices of gasoline this year have risen faster than the cost of crude oil in part because of the additional cost of producing and distributing reformulated product with ethanol. Also, the demand for fuel ethanol has been strong relative to the current capacity to produce it. In contrast, the consumer price of natural gas has turned down this year as inventories have remained relatively high; the price decline between January and May almost completely reversed the steep run-up that occurred last autumn.

Food price inflation remained moderate during the first five months of 2006; between December 2005 and May 2006, the PCE price index for food and beverages increased at an annual rate of 2¼ percent. Retail prices of meat and poultry have fallen so far this year. Domestic supplies of meat have been ample. Production has been expanding at a time when export demand for beef has been soft largely because of bans on imports of U.S. beef by Japan and Korea. Prices of processed food have continued to rise at only a moderate rate despite higher prices for grains; export demand for grains has been strong, and the price of corn has been boosted by demand from producers of ethanol. Prices for food consumed away from home, which typically are influenced heavily by labor and other business costs, have continued to increase relatively rapidly, rising at an annual rate of 3¾ percent over the first five months of the year.

The pickup in core inflation in the first half of 2006 was evident in the indexes for both goods and services. Prices of consumer goods excluding food and energy, which were unchanged in 2005, edged up at an annual rate of ¾ percent this year. Prices of consumer services also accelerated this spring; as a result, the PCE price index for non-energy services increased at an annual rate of 3½ percent between December 2005 and May 2006, compared with a rise of 2¾ percent in 2005. In the three months ending in May, increases in housing rents were especially steep; the rise may reflect, in part, a shift in demand toward rental units because home purchases have become less affordable. Another contributor to the higher inflation rate for consumer services has been the acceleration in the index for nonmarket services to an annual rate of 4 percent over the first five months of the year from 3 percent last year.[2] More broadly, the pickup in core consumer price inflation over the first five months of 2006 likely is the result of the pass-through of higher energy costs to a wide range of goods and services.

The cost pressures from the increase in energy costs during the past three years have been apparent in rising prices of inputs used in the production and sale of final goods and services. The producer price index for intermediate goods, excluding food and energy, rose at an annual rate of 7¼ percent between December 2005 and May 2006; this index rose 4¾ percent in 2005 and 8¼ percent in 2004. In particular, prices of industrial chemi-

2. These are services—such as foreign travel or the financial services provided by banks—for which no prices based on market transactions are available; the Bureau of Economic Analysis must impute or estimate these price indexes.

Alternative measures of price change

Percent

Price measure	2004 to 2005	2005 to 2006
Chain-type (Q1 to Q1)		
Gross domestic product (GDP)	2.8	3.1
Gross domestic purchases	3.1	3.5
Personal consumption expenditures (PCE)	2.7	3.0
Excluding food and energy	2.2	1.9
Market-based PCE excluding food and energy	1.8	1.5
Fixed-weight (Q2 to Q2)		
Consumer price index	3.0	4.0
Excluding food and energy	2.1	2.4

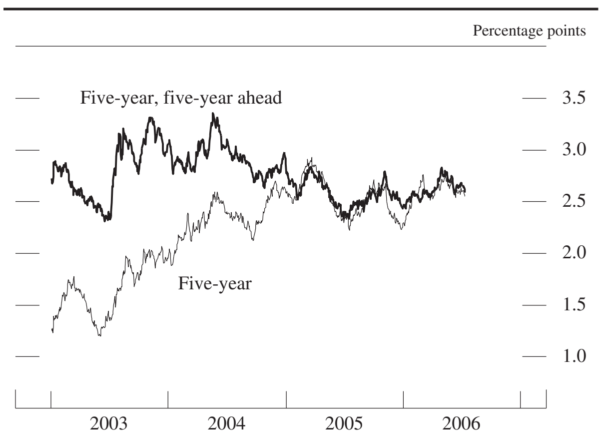
Note: Changes are based on quarterly averages of seasonally adjusted data. For the consumer price index, the 2006:Q2 value is calculated as the average for April and May compared with the average for the second quarter of 2005 and is expressed at an annual rate.

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

cals, fertilizer, and stone and clay products, for which energy represents a relatively high share of the total costs of production, accelerated over the past several years. The costs of a number of important business services, particularly transportation by air, rail, and truck, have also been boosted by higher energy costs. The pass-through of the costs of energy to consumer prices is clear for a few items, such as airfares. For other components of core consumer price indexes, however, the extent of the pass-through is harder to trace. Quantifying the extent of the pass-through is difficult, in part because it is diffused through a wide range of retail goods and services. In addition, the cost of energy is a small share of overall costs—and that share has been declining over time as businesses adopt more energy-efficient technologies and households reduce their consumption of energy. Nonetheless, the cumulative rise in energy costs in recent years has been large enough to show through to pricing of final goods and services even as businesses have seen their labor costs, which represent roughly two-thirds of their costs, remain restrained.

Near-term inflation expectations were also influenced importantly over the first half of 2006 by movements in energy prices, but, as of midyear, they were only slightly higher than they were at the turn of the year. The Michigan SRC survey measure of the median expectation of households for inflation over the next twelve months held steady at 3 percent during the first three months of the year but then rose sharply to 4 percent in May as gasoline prices climbed. By early July, this measure of near-term inflation expectations dropped back to 3.1 percent. Longer-term inflation expectations remained within the ranges in which they have fluctuated in recent years. On average over the first half of 2006, the median respondent to the Michigan SRC survey continued to expect the rate of inflation during the next five to ten years to be just under 3 percent. In June, the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, reported expected inflation at a rate of 2½ percent over the next ten years, an expectation that has been roughly unchanged for the past eight years. Inflation compensation implied by the spread of yields on nominal Treasury securities over their inflation-protected counterparts rose slightly, on net, over the first half of the year; in early July it was just above 2½ percent.

TIPS-based inflation compensation, 2003–06



NOTE: The data are daily and extend through July 12, 2006. Based on a comparison of the yield curve for Treasury inflation-protected securities (TIPS) with the nominal off-the-run Treasury yield curve.

SOURCE: Federal Reserve Board calculations based on data provided by the Federal Reserve Bank of New York and Barclays.

U.S. Financial Markets

U.S. financial markets functioned smoothly in the first half of 2006 against the backdrop of increased volatility in some asset prices. Yields on nominal Treasury coupon securities rose about 70 basis points, on net, through early July as investors came to appreciate that economic conditions and inflation pressures required more monetary policy tightening than they had expected at the end of 2005. Equity prices advanced until mid-May but then reversed those gains. Apparently, evidence of increased inflationary pressures and some softer-than-expected data on economic activity induced market participants to revise down their longer-term outlook for business profits and to perceive greater risks to that outlook. With corporate balance sheets remaining strong and liquid, risk spreads on corporate bonds stayed low, an indication that the revision to the outlook had not sparked broad concerns about credit quality. Firms had ample access to funds, and business-sector debt expanded rapidly in the first quarter. The need to finance brisk merger and acquisition activity was one factor that reportedly induced nonfinancial businesses to tap the credit markets heavily. Bond issuance picked up noticeably, and commercial and industrial loans increased robustly. Banks continued to ease terms and standards on such loans. Household debt expanded further in the first quarter amid rising house prices and brisk cash-out refinancing activity. As was the case in 2005, the M2 monetary aggregate has advanced moderately so far in 2006.

Interest Rates

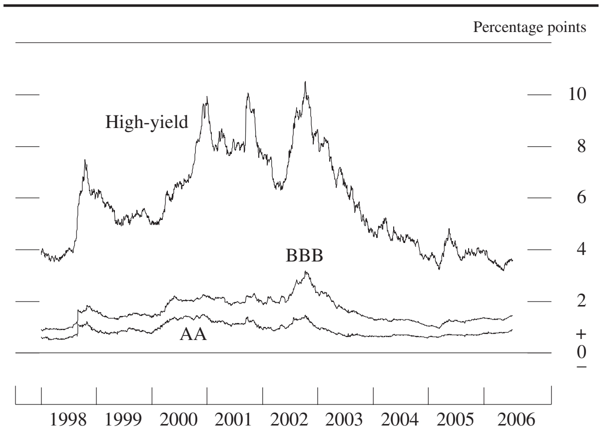
The FOMC increased the target federal funds rate 25 basis points at each of its four meetings this year. These actions brought the rate to 5¼ percent, about 60 basis points above the rate expected at the end of last year for early July. In contrast to the situation earlier in the tightening cycle, when it was evident to investors that consid-

Interest rates on selected Treasury securities, 2003–06

NOTE: The data are daily and extend through July 12, 2006.
SOURCE: Department of the Treasury.

erable monetary policy accommodation was in place and had to be removed, market participants more recently have had to focus to a greater degree on economic data releases and their implications for the outlook for economic growth and inflation to form expectations about near-term policy. Although the information currently available suggests that growth of real output slowed appreciably in the second quarter, incoming price data have pointed to greater-than-expected inflationary pressures throughout the first half of the year. Investors anticipated that the FOMC would act to counter such pressures, and the expected policy path moved upward, on balance, over the first half of 2006. Nevertheless, market participants currently appear to expect the target federal funds rate to ease after the end of the year. Despite investors' apparent awareness that monetary policy decisions increasingly depend on the implications of incoming information for the economic outlook, the implied volatility on short-term Eurodollar rates calculated from option prices has remained near the low end of its historical range.

Spreads of corporate bond yields over
comparable off-the-run Treasury yields, 1998–2006



NOTE: The data are daily and extend through July 12, 2006. 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: Derived from smoothed corporate yield curves using Merrill Lynch bond data.

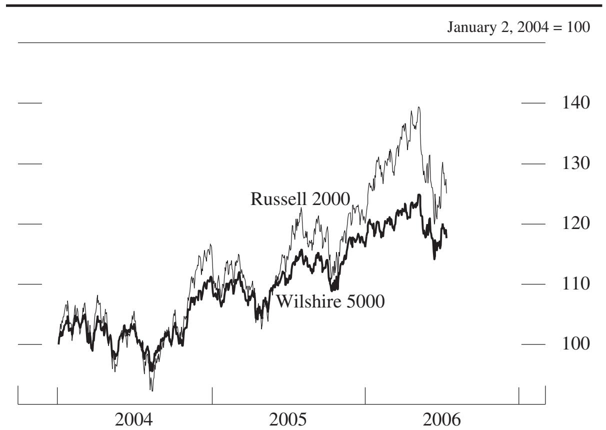
Yields on nominal Treasury coupon securities rose about 70 basis points across the maturity spectrum through early July, in part because of the expectations for firmer policy. In addition, it appears that a modest rebound in term premiums, including investor compensation for inflation risk, may have contributed to the rise in longer-term rates; still, estimated premiums remain low by historical standards. Yields on inflation-indexed Treasury securities rose less than those on their nominal counterparts, leaving inflation compensation at medium- and long-term horizons 20 to 30 basis points higher than at the turn of the year.

In the corporate bond market, yields on investment-grade securities moved about in line with those on comparable-maturity Treasury securities through early July. In contrast, those on speculative-grade securities rose only about 40 basis points; as a result, risk spreads were 30 basis points lower in that segment of the market. The narrowness of high-yield spreads was likely a reflection of investors' sanguine views about corporate credit quality over the medium term, given the strength of business balance sheets and the outlook for continued economic expansion.

Equity Markets

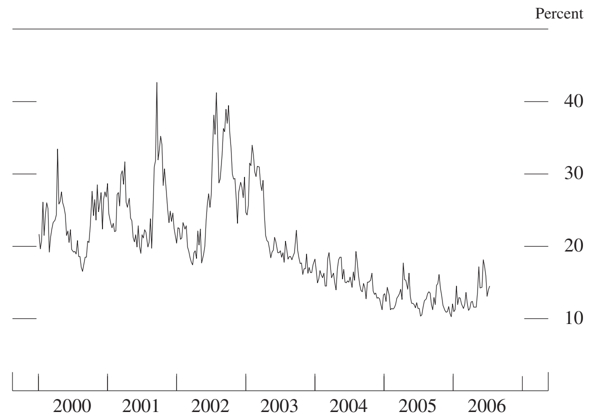
Broad equity indexes changed little, on net, through early July. Stock prices were boosted up to the first part of May

Stock price indexes, 2004–06



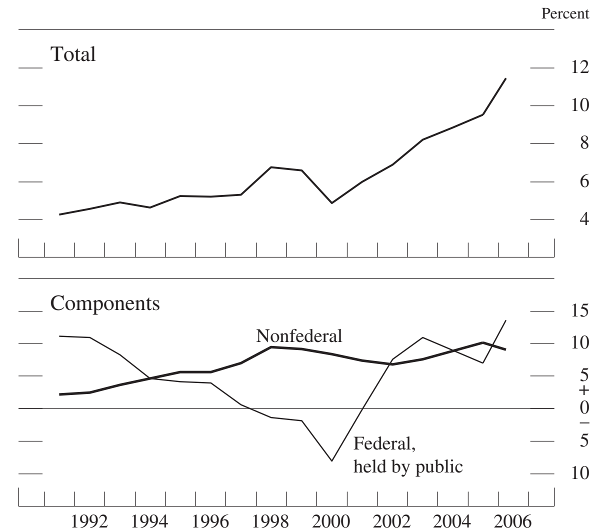
NOTE: The data are daily and extend through July 12, 2006.
SOURCE: Frank Russell Company; Dow Jones Indexes.

Implied S&P 500 volatility, 2000–06



NOTE: The data are weekly and extend through July 12, 2006. The series shown is the implied thirty-day volatility of the S&P 500 stock price index as calculated from a weighted average of options prices.
SOURCE: Chicago Board Options Exchange.

Change in domestic nonfinancial debt, 1991–2006



NOTE: For 2006, change is from 2005:Q4 to 2006:Q1 at an annual rate. For earlier years, the data are annual and are computed by dividing the annual flow for a given year by the level at the end of the preceding year. The total consists of components shown. Nonfederal debt consists of the outstanding credit market debt of state and local governments, households, nonprofit organizations, and nonfinancial businesses. Federal debt held by the public excludes securities held as investments of federal government accounts.
SOURCE: Federal Reserve Board, flow of funds data.

by an upbeat economic outlook and by strong corporate earnings in the first quarter. However, those gains were subsequently reversed as incoming data clouded the prospects for economic growth and continued to point to upward pressures on inflation; the drop in share prices was led by stocks that had logged the largest gains in the previous months, including those of firms with small capitalizations and of firms in cyclically sensitive sectors. A measure of the equity risk premium—computed as the difference between the twelve-month forward earnings–price ratio for the S&P 500 and an estimate of the real long-term Treasury yield—has increased slightly so far this year and remains near the high end of its range of the past two decades. The implied volatility of the S&P 500 calculated from option prices spiked temporarily in late May and early June and remained somewhat elevated compared with its levels earlier in the year.

Net inflows to equity mutual funds were very strong through April, as investors were evidently attracted by the solid performance of the equity market up to that point. In May and June, however, investors withdrew funds as share prices began to sag.

Debt and Financial Intermediation

In the first quarter of 2006, the total debt of domestic nonfinancial sectors expanded at an annual rate of 11 percent. The household, business, and federal government components all increased at double-digit rates, while state and local government debt advanced at about a 6 percent pace. Preliminary data suggest somewhat slower growth of the debt of nonfinancial sectors in the second quarter. The slowdown is particularly noticeable in the federal and state and local government sectors, where strong tax receipts held down borrowing. The available data also point to somewhat reduced growth of nonfinancial business debt in the second quarter.

Commercial bank credit increased at an annual rate of about 11 percent in the first quarter of 2006, a little faster than in 2005, and picked up further to an almost 13 percent pace in the second quarter. A continued rapid increase in business loans was likely supported by brisk merger and acquisition activity, rising outlays for investment goods, ongoing inventory accumulation, and an accommodative lending environment. Growth in commercial mortgages was also strong, as fundamentals in that sector continued to improve. Despite a slowing of housing activity in recent months, residential mortgage holdings expanded robustly. However, higher short-term interest rates likely contributed to a runoff in loans drawn down under revolving home-equity lines of credit. Consumer loans adjusted for securitizations decelerated in the second quarter after rising at a solid pace in the first quarter.

Bank profitability remained solid, and asset quality continued to be excellent in the first quarter. Profits were supported by gains in non-interest income and reductions in loan-loss provisions that more than offset a rise in non-interest expenses. Delinquency and charge-off rates remained low across all loan types. Delinquency rates on residential mortgages on banks' books edged lower in the first quarter after moving up during 2005. Charge-off rates on consumer loans declined to the lowest level seen in recent years after a fourth-quarter surge in charge-offs on credit card loans that was associated with the implementation of the bankruptcy legislation in October of last year.

As the policy debate about the possibility of curbing the balance sheet growth of both Fannie Mae and Freddie Mac continued, the combined size of the mortgage investment portfolios at the two government-sponsored enterprises increased about 1 percent over the first five months of 2006.

The M2 Monetary Aggregate

In the first quarter of 2006, M2 increased at an annual rate of about 6½ percent, but its expansion moderated in the second quarter to a 2¾ percent pace, likely because of some slowing in the growth of nominal GDP. Rising short-term interest rates continued to push up the opportunity cost of holding M2 assets. Growth in liquid deposits, whose rates tend to adjust sluggishly to changes in market rates, was particularly slack. By contrast, the expansion in retail money market funds and, especially, small time deposits was brisk, as the yields on those instruments kept better pace with rising market interest rates. Despite apparently modest demand from abroad, currency growth was strong in the first quarter but has slowed since. The velocity of M2 rose at an annual rate of 2¼ percent in the first quarter and appears to have continued to rise in the second quarter.

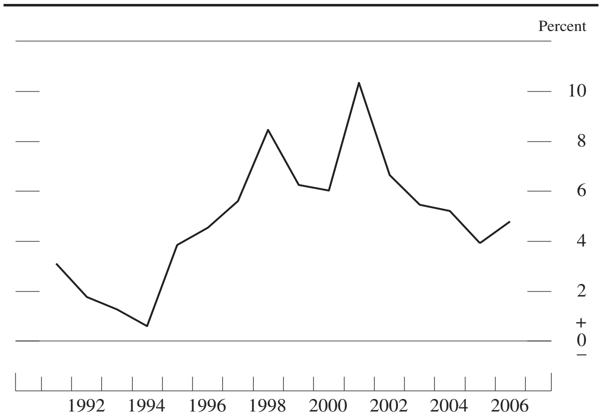
International Developments

Foreign economic growth was strong in the first quarter of 2006 as the expansion spread to all major regions of the world. Accelerating domestic demand boosted growth in the foreign industrial countries, especially Canada and the euro area. Emerging-market economies continued to benefit from rapid export growth, and Chinese economic activity was also spurred by a surge in investment spending. Data for the second quarter suggest continued strong growth abroad but with moderation in some countries. Rising energy prices have pushed up inflation in many countries this year, but upward pressure on core inflation has generally continued to be moderate.

Foreign monetary policy tightened in the first half of this year in the context of solid growth and some heightened inflation concerns. The European Central Bank (ECB) raised its policy rate ¼ percentage point in March and again in June, citing rapid credit growth and the ECB's expectation of above-target inflation. At its July policy meeting, the Bank of Canada kept its target for the overnight rate unchanged at 4¼ percent, but it had increased its target for the overnight rate ¼ percentage point at each of its previous seven policy meetings. On July 14, the Bank of Japan (BOJ) ended its zero-interest-rate policy by raising its target for the call money rate to ¼ percent for the first time since 2001. Earlier, on March 9, the BOJ, announcing an end to its five-year-old policy of quantitative easing, said that it would set policy in the future to control inflation over the medium to long run, defined as one to two years ahead.

Long-term bond yields abroad have risen along with U.S. bond yields on indications of robust global growth

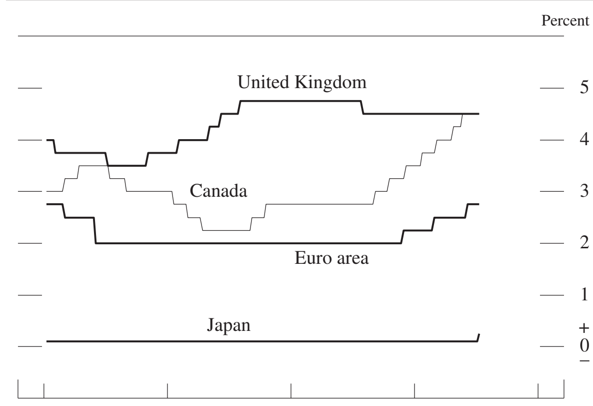
M2 growth rate, 1991–2006



NOTE: Through 2005, the data are annual on a fourth-quarter over fourth-quarter basis; for 2006, change is calculated from 2005:Q4 to 2006:Q2 and annualized. M2 consists of currency, traveler's checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds.

SOURCE: Federal Reserve Board, Statistical Release H.6, "Money Stock Measures" (July 13, 2006).

Official or targeted interest rates in selected foreign industrial countries, 2003–06



NOTE: The data are weekly. The last observation for each series is July 14, 2006. The data shown are the call money rate for Japan, the overnight rate for Canada, the refinancing rate for the euro area, and the repurchase rate for the United Kingdom.

SOURCE: The central bank of each area or country shown.

and expectations of additional tightening of monetary policy. Ten-year sovereign yields have risen roughly 70 basis points in the euro area since the end of last year, while the increases on similar securities in Canada and the United Kingdom have been about 50 basis points. Part of the rise in yields abroad has been increased compensation for possible future inflation as measured by the difference in yield between ten-year nominal and inflation-indexed bonds. Yield spreads of emerging-market bonds over U.S. Treasuries narrowed somewhat early in the year, but that narrowing was more than reversed in the second quarter as investors apparently demanded greater compensation for risk amid uncertainties about economic growth and inflation.

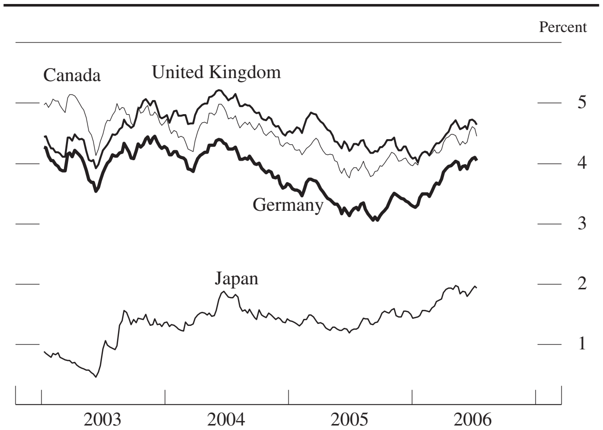
The foreign exchange value of the dollar has declined about 4½ percent, on net, this year against a basket of the currencies of the major industrial countries but is down only about 1 percent, on net, against the currencies of the other important trading partners of the United States. Much of the dollar's downward move occurred at times when the market was focused on concerns about global current account imbalances. The dollar has recovered some ground since early May, as investors reportedly have engaged in flight-to-safety transactions into dollar-denominated assets in conjunction with the volatility in global commodity and asset markets. On net, the dollar has depreciated since the turn of the year about 6½ percent against the euro and sterling, 3 percent against the Canadian dollar, and 1½ percent against the Japanese yen. In contrast, the dollar has risen roughly 4 percent, on balance, against the Mexican peso this year. During the first half of this year, several smaller countries experienced episodes of substantial financial volatility that in some cases involved sharp depreciations in the exchange value of their currencies.

Through the first four months of 2006, a favorable economic outlook and low interest rates supported gains in equity prices in all major foreign countries. During May and early June, however, equity prices registered widespread declines, as market participants grew more concerned about inflation, monetary policy, and global economic growth. More recently, developments in the Middle East have weighed further on stock prices. On net, equity price indexes are up between 1 percent and

U.S. dollar nominal exchange rate, broad index, 2003–06

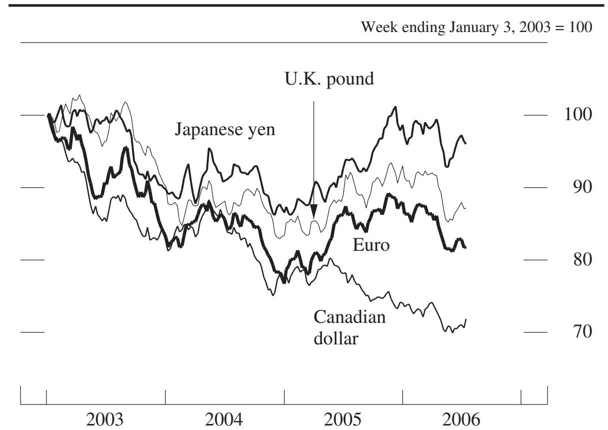
NOTE: The data are weekly and are in foreign currency units per dollar. The last observation is the average for July 10 through July 12, 2006. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.
SOURCE: Federal Reserve Board.

Yields on benchmark government bonds in selected foreign industrial countries, 2003–06



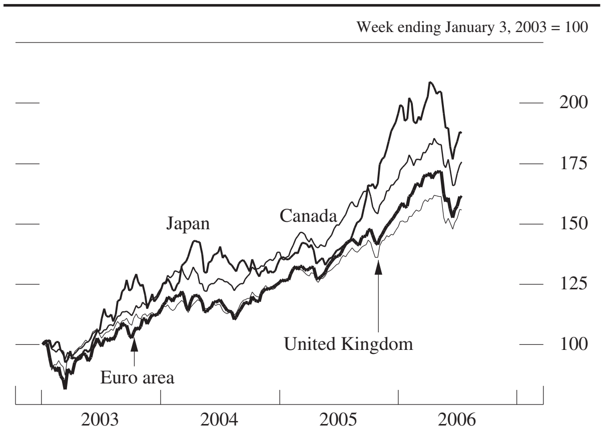
NOTE: The data are for ten-year bonds and are weekly. The last observation for each series is the average for July 10 through July 12, 2006.
SOURCE: Bloomberg L.P.

U.S. dollar exchange rate against selected major currencies, 2003–06



NOTE: The data are weekly and are in foreign currency units per dollar. The last observation for each series is the average for July 10 through July 12, 2006.
SOURCE: Bloomberg L.P.

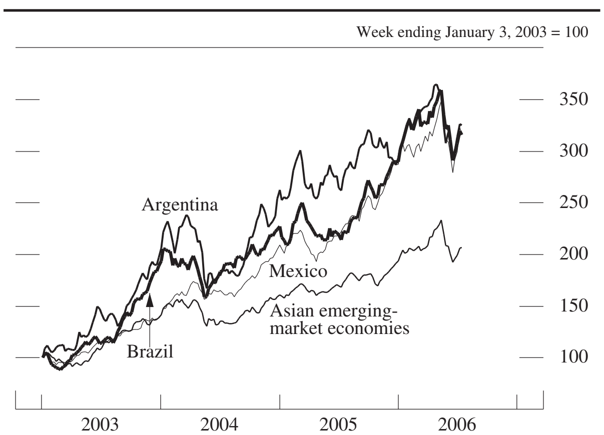
Equity indexes in selected foreign industrial countries, 2003–06



NOTE: The data are weekly. The last observation for each series is the average for July 10 through July 12, 2006.
SOURCE: Bloomberg L.P.

4 percent so far in 2006 in Europe and Canada, but they have fallen roughly 8 percent since year-end in Japan. Latin American and Asian emerging-market equity indexes, which had generally gained more than industrial-country indexes early in the year, have fallen more sharply since early May. Equity indexes in Mexico, Brazil, and Argentina have dropped between 12 percent and 15 percent—leaving them still between 5 percent and 7 percent higher so far this year—while stock prices in Korea have fallen about 9 percent, on net, for the year.

Equity indexes in selected emerging-market economies, 2003–06



NOTE: The data are weekly. The last observation for each series is the average for July 10 through July 12, 2006. The Asian emerging-market economies are China, Hong Kong, India, Indonesia, Malaysia, Pakistan, the Philippines, Singapore, South Korea, Taiwan, and Thailand; each economy's index weight is its market capitalization as a share of the group's total.
SOURCE: For Asian emerging-market economies, Morgan Stanley Capital International (MSCI) index; for others, Bloomberg L.P.

Industrial Economies

The Japanese economy has continued to strengthen this year, although economic growth has stepped down a bit from the comparatively strong rate recorded in 2005. Household consumption maintained a solid rate of growth in the first quarter, and private investment spending rose 11 percent. However, net exports, which previously had been an additional source of strength, did not contribute to growth in the first quarter; the growth of imports increased while export growth remained firm. The labor market in Japan improved further in April and May: The unemployment rate fell to 4 percent, and the ratio of job offers to applicants reached a thirteen-year high. Although the GDP deflator has continued to decline, other signs indicate that deflation is ending. In the first quarter of 2006, land prices in Japan's six largest cities rose 3.8 percent over their year-ago level, the first increase since 1991. Core consumer prices have shown small twelve-month increases over the past several months.

Real GDP in the euro area accelerated in the first quarter, expanding 2½ percent, a rate of growth somewhat above its average in recent years. The acceleration was spurred by strength in domestic demand, especially private consumption spending, which increased in the first quarter at double its pace in 2005. Retail sales were also strong at the start of the second quarter. The revival in household spending has been supported by a small rise in the growth rate of employment and by an improvement in employer and consumer perceptions of employment prospects. Private investment spending has remained strong in the euro area, and business sentiment has continued to brighten in recent months. Energy price increases have pushed euro-area consumer price inflation to about 2½ percent recently, a level above the ECB's 2 percent ceiling, but core inflation has remained near 1½ percent.

In the United Kingdom, real GDP expanded at an annual rate of 3 percent in the first quarter after rising about 1¾ percent in 2005. Consumer spending grew about 1½ percent, the same moderate pace seen last year. House prices, which remained relatively flat during late 2004 and most of 2005, picked up in late 2005 and have continued to rise in the first half of this year. The twelve-month change in consumer prices was 2.2 percent in May. Consumer prices have been boosted importantly by increases in energy prices over the past several months.

In Canada, real GDP grew at an annual rate of nearly 4 percent in the first quarter, an increase led by a jump in spending on consumer durables and housing. Investment in residential structures grew at its fastest rate in more than two years, and business investment continued to exhibit the strength observed in the previous two quarters. Indicators for the second quarter point generally to a deceleration of GDP. Housing starts in the second quarter were significantly below their elevated first-quarter levels; the merchandise trade balance declined, on balance, during the first five months of this year; and in the manufacturing sector, the volume of new orders and of shipments both fell in April. In contrast, in the second quarter, the labor market maintained its strength of the past year, and the unemployment rate has fallen to 6.2 percent, the lowest level in more than thirty years. Consumer prices rose 2.8 percent in the twelve months ending in May.

Emerging-Market Economies

In China, growth of real output was especially robust in the first half. Economic indicators suggest that fixed investment surged and that export growth continued to be strong. The rapid growth of investment prompted the Chinese government to impose a series of new measures to slow capital spending, including controls on credit and land use and stricter criteria for approving investment projects. In addition, to restrain credit, which has soared more than 15 percent over the past year, China's central bank raised the one-year bank lending rate in April and raised banks' reserve requirements ½ percentage point in June. The Chinese trade surplus widened in the first half of this year as exports accelerated. Chinese consumer price inflation is about 1½ percent, slightly above its pace in the second half of last year but well below the more than 5 percent rate seen in 2004.

Economic growth in India, Malaysia, and Hong Kong also was quite strong in the first quarter, although the pace of activity of some of the other Asian emerging-market economies has moderated a bit from last year's rapid rate. Concerns about inflationary pressures have increased, largely because of rising energy prices. In response, monetary policy has been tightened in some countries, including Korea, India, and Thailand.

In Mexico, strong performance in the industrial sector, an expansion in services output, and a recovery in agricultural production propelled real GDP growth to more than 6 percent at an annual rate in the first quarter. In addition, a surge in manufacturing exports boosted Mexico's trade and current account balances noticeably. Industrial production continued to increase early in the second quarter. In June, Mexican inflation was 3.2 percent, just above the center of the Bank of Mexico's target range of 2 percent to 4 percent. After easing policy nine times between August and April, the Bank of Mexico signaled in April that it would leave its policy rate unchanged for a time.

Real GDP growth in Brazil also increased in the first quarter, rising to 5¾ percent, and was supported by very strong performances in manufacturing, mining, and construction. The rate of inflation has been declining from a high of 8 percent reached in April 2005; in June, the twelve-month change in prices edged down to 4 percent. In late May, the central bank reduced its target for the overnight interest rate 50 basis points, to 15¼ percent, bringing the cumulative decline to 450 basis points since the current easing phase began last September. In the minutes of its late-May meeting, the policymaking committee said that the onset of market volatility over the past month had increased its uncertainty about the prospects for inflation and had thus prompted it to ease less than it would have otherwise.

In Argentina, output growth slowed slightly in the first quarter. Amid emerging capacity constraints, inflation rose to about 11 percent, up from 6 percent in 2004. The Argentine government has tried to hold down inflation, with limited success, through voluntary price agreements in several sectors.