

## **Prefatory Note**

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January 27, 2006

# CURRENT ECONOMIC AND FINANCIAL CONDITIONS

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## **Supplemental Notes**

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

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## Supplemental Notes

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### The Domestic Nonfinancial Economy

#### Real Gross Domestic Product (GDP)

According to the BEA's advance estimate, real GDP rose at an annual rate of 1.1 percent in the fourth quarter after having increased at a rate of 4.1 percent in the third quarter. The slowdown in the fourth quarter reflected decelerations in most major categories of spending with the notable exception of private inventory investment. Real PCE increased at an annual rate of 1.1 percent following an increase at a 4.1 percent rate in the third quarter; the deceleration was the result of a sharp drop in purchases of durable goods, as spending on motor vehicles fell. Total government spending decreased 2.4 percent in the fourth quarter; a small increase in state and local government expenditures was more than offset by a large decline in federal spending. Business fixed investment rose at an annual rate of 2.8 percent in the fourth quarter, down from the 8.5 percent pace in the third quarter; spending on both equipment and software and nonresidential structures decelerated. In the foreign sector, the BEA estimated that real exports rose at a moderate rate for a second quarter but that real imports accelerated; as a result, the arithmetic contribution of net exports to the change in real GDP was -1.2 percentage points last quarter compared with just -0.1 percentage point in the third quarter. In contrast, real private inventories are reported to have increased \$25.7 billion in the fourth quarter, adding 1.5 percentage points to the change in real GDP; in the third quarter, the change in private inventory investment held down the change in real GDP by about ½ percentage point.

Real output in the nonfarm business sector rose at an annual rate of 0.9 percent in the fourth quarter. Based on the data currently available, the staff estimates that productivity in the nonfarm business sector fell at an annual rate of 0.4 percent last quarter following an increase at a 4.4 percent rate in the third quarter. These estimates put the four-quarter change in nonfarm business productivity for 2005 at just under 2½ percent.

On the income side of the accounts, real disposable personal income rebounded at an annual rate of 7.0 percent in the fourth quarter after having been severely restrained in the third quarter by the effects of the hurricane. The personal saving rate edged up a bit, but remained below zero. The staff currently estimates that compensation per hour increased at an annual rate of 3.2 percent in the fourth quarter, implying an increase of just under ½ percent from the fourth quarter of 2004.

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

Item	2005:Q2 Final	2005:Q3 Final	2005:Q4 Advance
Gross Domestic Product	3.3	4.1	1.1
Final sales	5.6	4.6	-.3
Consumer spending	3.4	4.1	1.1
Durables	7.9	9.3	-17.5
Nondurables	3.6	3.5	5.1
Services	2.3	3.3	3.2
Business fixed investment	8.8	8.5	2.8
Nonresidential structures	2.7	2.2	.7
Equipment and software	10.9	10.6	3.5
Residential investment	10.8	7.3	3.5
Federal government	2.4	7.4	-7.0
State and local government	2.6	.2	.4
Exports of goods and services	10.7	2.5	2.4
Imports of goods and services	-.3	2.4	9.1
<i>ADDENDA:</i>			
Inventory investment <sup>1</sup>	-1.7	-13.3	25.7
Net exports of goods and services <sup>1</sup>	-614.2	-617.5	-650.3
Nominal GDP	6.0	7.6	4.2
Nominal GDI	4.7	8.0	n.a.
Statistical discrepancy <sup>2</sup>	78.3	66.5	n.a.
Change in economic profits <sup>2</sup>	59.3	-54.5	n.a.
Profit share, excluding FR banks <sup>3</sup>	10.6	10.0	n.a.
Real disposable personal income	.2	-2.0	7.0
Personal saving rate (percent)	-.2	-1.8	-.4

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

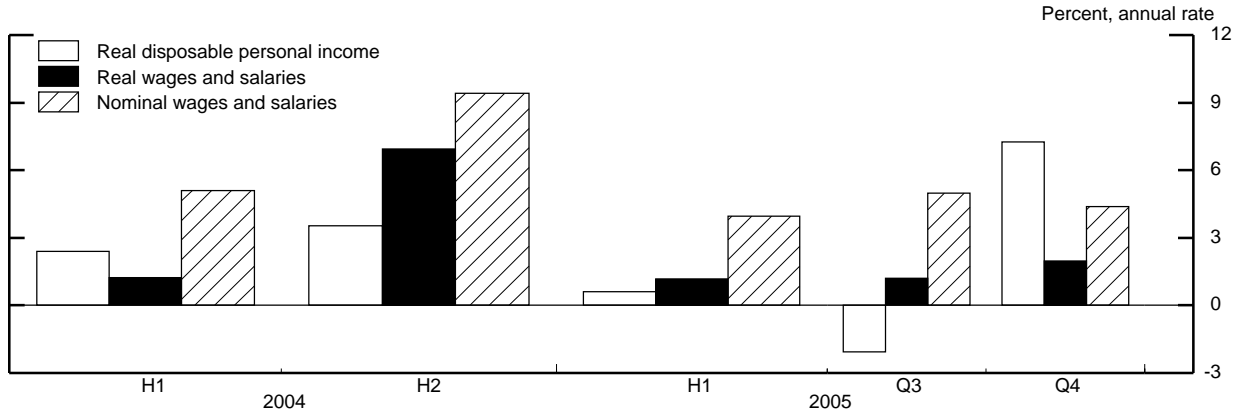
2. Billions of dollars.

3. Economic profits as a share of GNP.

n.a. not available.

## Household Indicators

### Changes in DPI and Wages and Salaries



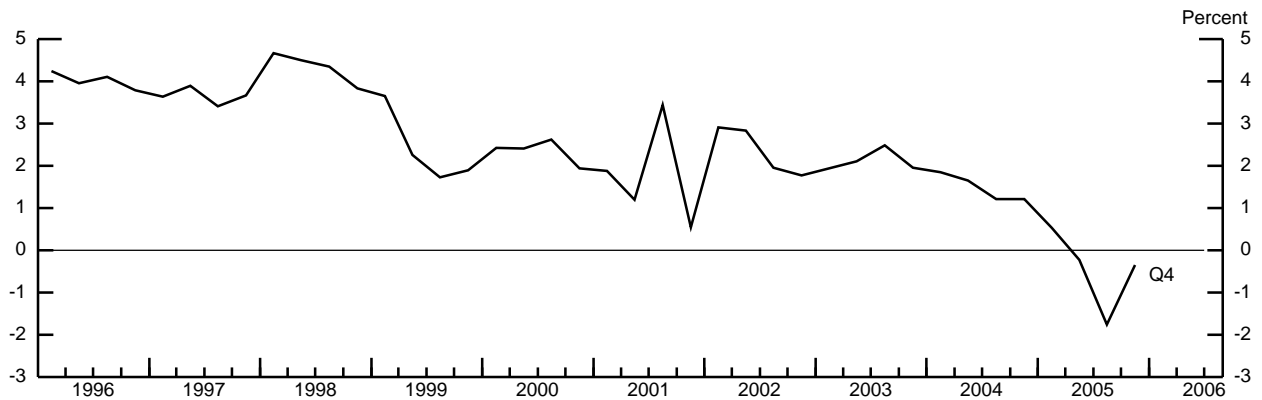
Note. Microsoft dividend is excluded.

### Household Net Worth and Wilshire 5000



\* Value for 2004:Q4 excludes the effect on income of the one-time Microsoft dividend in December. Value for 2005:Q4 is a staff estimate.

### Personal Saving Rate



Note. Value for 2004:Q4 excludes the effect on income of the one-time Microsoft dividend in December.

### **GDP Prices**

The GDP price index increased at an annual rate of 3.0 percent in the fourth quarter after having risen at a 3.3 percent rate in the preceding quarter. A fairly sharp increase in construction prices boosted the overall GDP price index, but was more than offset by a deceleration in energy prices. The slowing in energy prices also contributed to the deceleration in PCE prices, which rose at an annual rate of 2.6 percent in the fourth quarter compared with a rate of 3.7 percent in the third quarter. Core PCE prices increased 2.2 percent last quarter after having moved up at a 1.4 percent rate in the third quarter; the price index for GDP excluding food and energy also accelerated in the fourth quarter.

### **Manufacturers' Orders, Shipments, and Inventories**

New orders for nondefense capital goods excluding aircraft rose 3.5 percent in December following an upward-revised increase of 0.2 percent in November. Orders for non-high-tech equipment shot up 4.6 percent after having changed little in November, and orders for computers and peripherals rose strongly for a second month; in contrast, orders for communications equipment posted their second straight large decline.

Shipments of nondefense capital goods excluding aircraft jumped 3.2 percent in December following an increase of 0.6 percent in November. Increases in shipments were broad-based across categories of equipment last month. The increase of 3.8 percent in shipments of communications equipment retraced about half of the cumulative decline posted over the preceding two months while shipments of computers and other capital equipment remained on their strong upward trajectories.

The book value of inventories held by manufacturers of durable goods (which constitute about two-thirds of total manufacturing inventories) increased at an annual rate of \$0.7 billion in December. Shipments of total durable goods increased 3.5 percent, and the inventory-shipments ratio fell to 1.29 months.

### **Sales of New Homes**

Sales of new homes moved up 3 percent in December to an annual rate of 1.27 million units on the heels of a decline of 9¼ percent in November. Sales in December were up sharply in the West and the Midwest, which more than offset declines in the South and the Northeast. All told, the level of sales in the fourth quarter was about in line with the average level during the first three quarters of 2005. The stock of new homes for sale continued to edge up in December and represented 4.9 months of sales at December's

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

Item	2005:Q2	2005:Q3	2005:Q4
	Final	Final	Advance
Gross domestic product	2.6	3.3	3.0
Gross domestic purchases	3.3	4.2	3.3
Personal consumption expenditures	3.3	3.7	2.6
Food and Beverages	3.5	1.3	2.6
Energy	28.6	50.0	9.0
Excluding food and energy	1.7	1.4	2.2
Market-based components	1.5	1.1	1.8
Business fixed investment	1.9	2.5	3.7
Equipment and Software	-0.7	-1.8	-1.2
Computers and peripheral equipment	-14.9	-14.4	-13.3
Nonresidential structures	9.9	16.5	19.5
Residential investment	4.3	6.5	7.1
Government consumption expenditures and investment	3.7	6.7	4.9
Exports of goods and services	3.7	2.9	2.9
Imports of goods and services	8.2	9.4	5.1
Nonpetroleum goods	1.6	-0.0	5.5
<i>ADDENDA:</i>			
GDP less food and energy	2.4	2.8	3.1
Gross domestic purchases less food and energy	2.1	2.5	2.9

NOTE: Percent change from previous period at compound annual rates



**Broad Measures of Inflation**  
(Percent change, Q4 to Q4)

Measure	2002	2003	2004	2005
<i>Product prices</i>				
GDP price index	1.7	2.0	2.9	3.0
Less food and energy	1.9	1.7	2.8	2.8
Nonfarm business chain price index	1.1	1.1	2.7	3.1
<i>Expenditure prices</i>				
Gross domestic purchases price index	1.9	2.0	3.4	3.4
Less food and energy	1.7	1.7	2.7	2.6
PCE price index	1.8	1.7	3.1	3.0
Less food and energy	1.6	1.3	2.2	1.9
PCE price index, market-based components	1.7	1.6	2.8	3.0
Less food and energy	1.4	1.0	1.7	1.7
CPI	2.2	1.9	3.4	3.7
Less food and energy	2.1	1.2	2.1	2.1
Chained CPI	1.8	1.7	2.9	3.0
Less food and energy	1.7	.8	1.8	1.7
Median CPI	3.0	2.0	2.3	2.4
Trimmed mean CPI	2.1	1.7	2.2	2.5

**Surveys of Inflation Expectations**  
(Percent)

Period	Actual CPI inflation <sup>1</sup>	University of Michigan				Professional forecasters (10-year) <sup>4</sup>
		1 year <sup>2</sup>		5 to 10 years <sup>3</sup>		
		Mean	Median	Mean	Median	
2004:Q1	1.8	3.1	2.7	3.4	2.9	2.5
Q2	2.9	4.0	3.3	3.3	2.8	2.5
Q3	2.7	3.3	2.9	3.1	2.8	2.5
Q4	3.3	3.4	3.0	3.1	2.8	2.5
2005:Q1	3.0	3.6	3.0	3.2	2.8	2.5
Q2	2.9	3.9	3.2	3.3	2.9	2.5
Q3	3.8	4.3	3.5	3.5	2.9	2.5
Q4	3.7	4.6	3.7	3.5	3.1	2.5
Sept.	4.7	5.5	4.3	3.8	3.1	2.5
Oct.	4.3	5.5	4.6	3.8	3.2	...
Nov.	3.5	4.1	3.3	3.3	3.0	...
Dec.	3.4	4.1	3.1	3.5	3.1	2.5
2006:Jan.	n.a.	3.5	3.0	3.3	2.9	...

1. Percent change from the same period in the preceding year.
  2. Responses to the question: By about what percent do you expect prices to go up, on average, during the next 12 months?
  3. Responses to the question: By about what percent per year do you expect prices to go up, on average, during the next 5 to 10 years?
  4. Quarterly CPI projections compiled by the Federal Reserve Bank of Philadelphia.
- ... Not applicable.  
n.a. Not available.

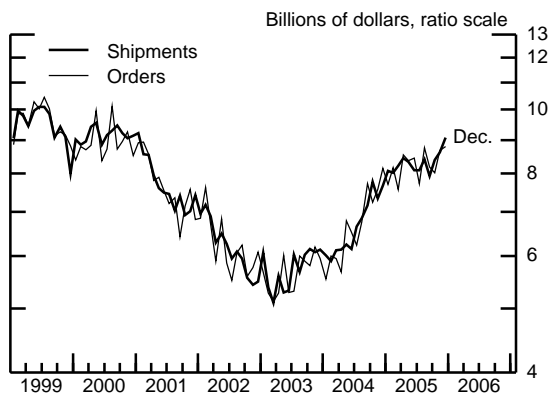
## Orders and Shipments of Nondefense Capital Goods

(Percent change; seasonally adjusted current dollars)

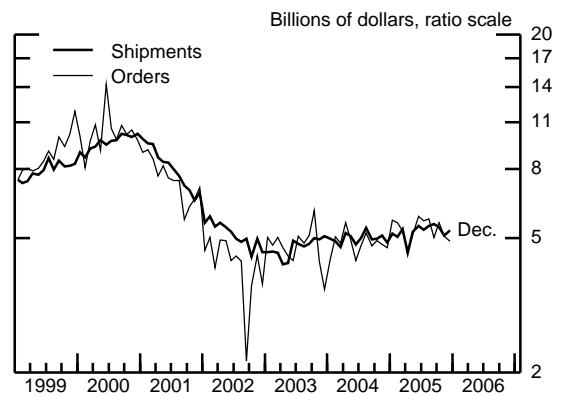
Indicators	2005				
	Q3	Q4	Oct.	Nov.	Dec.
	Annual rate		Monthly rate		
Shipments	1.8	34.3	4.5	3.4	4.6
Excluding aircraft	3.2	14.9	1.7	.6	3.2
Computers and peripherals	-6.6	29.5	5.7	2.7	5.3
Communications equipment	30.8	-11.5	-2.2	-5.5	3.8
All other categories	2.3	15.8	1.5	.9	2.8
Orders	-15.6	83.7	6.7	22.2	-.6
Excluding aircraft	4.0	10.3	1.1	.2	3.5
Computers and peripherals	-10.7	14.2	-2.0	8.1	1.5
Communications equipment	23.2	-19.0	10.8	-8.9	-3.6
All other categories	4.8	13.3	.7	-.1	4.6
Memo:					
Shipments of complete aircraft <sup>1</sup>	26.2	n.a.	28.8	26.6	n.a.

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

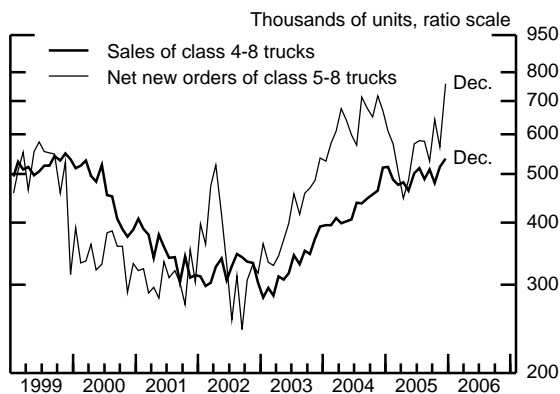
### Computers and Peripherals



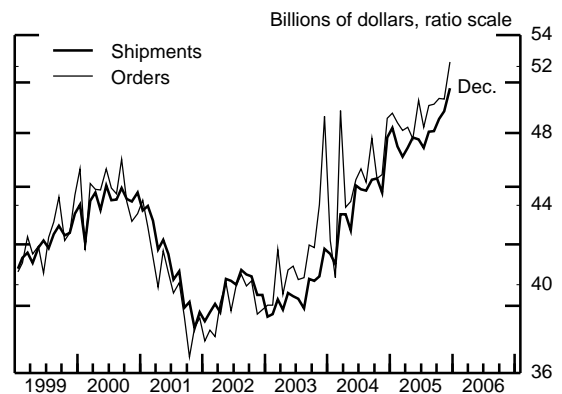
### Communications Equipment



### Medium and Heavy Trucks



### Other Equipment



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

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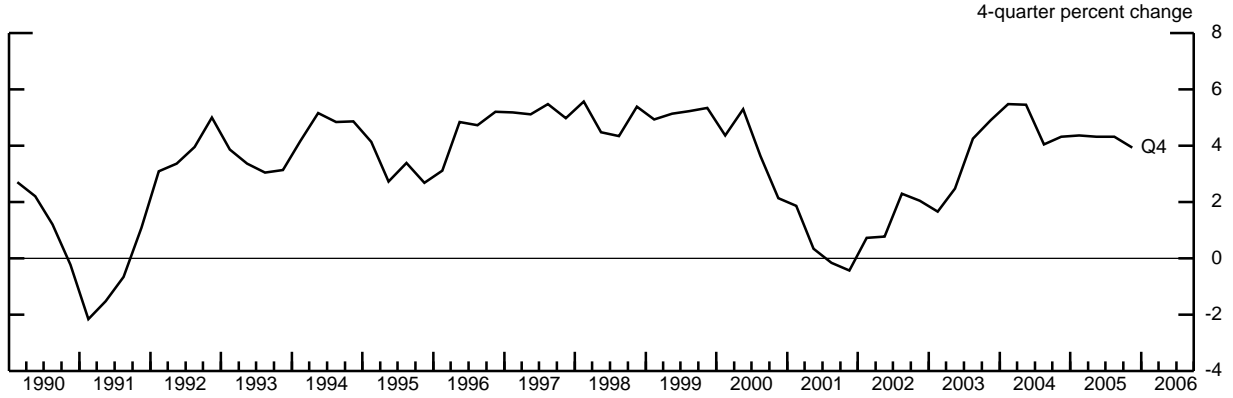
sales pace. The average price of new homes was 4 percent lower in December than a year earlier, and the median price of new homes in December was down 3½ percent from the previous year.<sup>1</sup>

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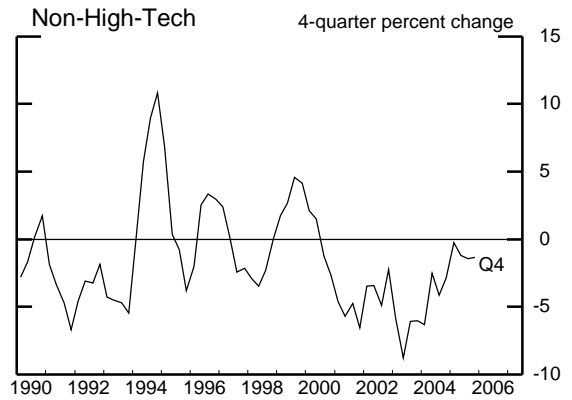
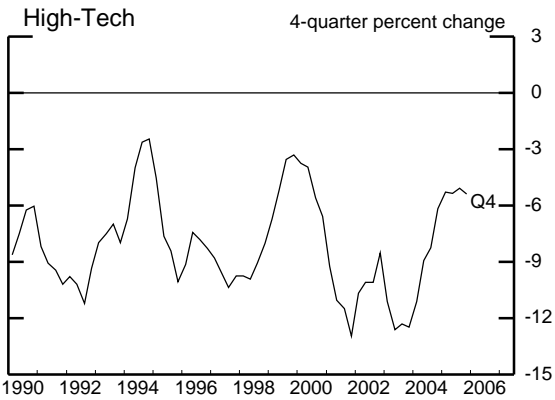
<sup>1</sup> These estimated rates of change should be interpreted cautiously because the Census Bureau began using a new sample frame in January 2005 which has characteristics that differ considerably from the previous year.

## Fundamentals of Equipment and Software Investment

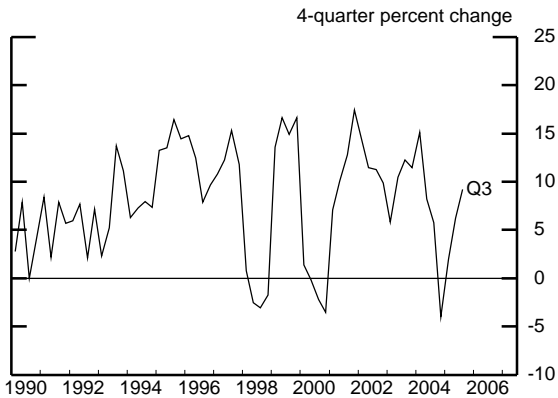
Real Business Output



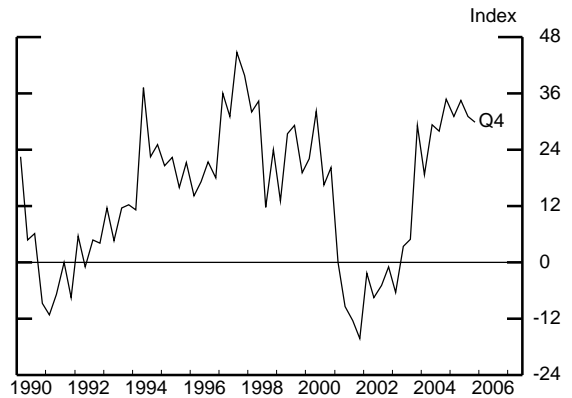
User Cost of Capital



Real Corporate Cash Flow



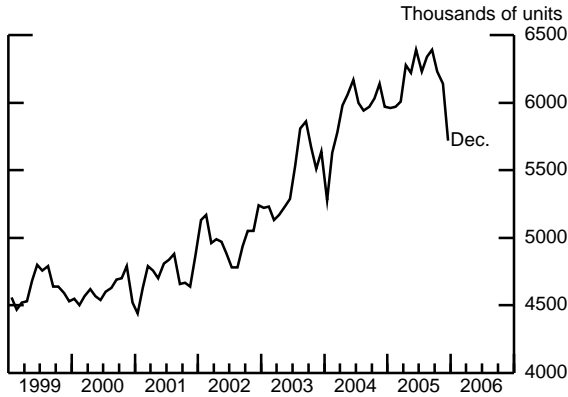
NABE Capital Spending Diffusion Index



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

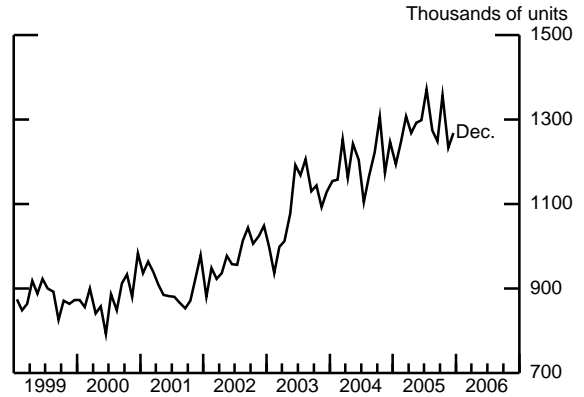
## Indicators of Single-Family Housing

### Existing Home Sales



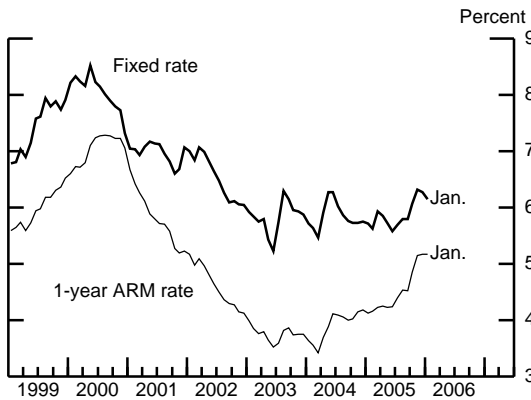
Source. National Association of Realtors.

### New Home Sales



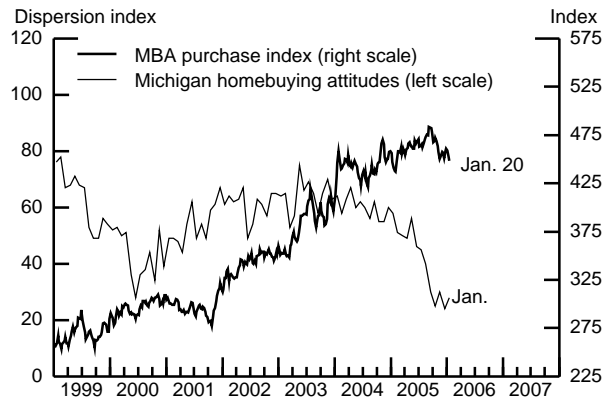
Source. Census Bureau.

### Mortgage Rates



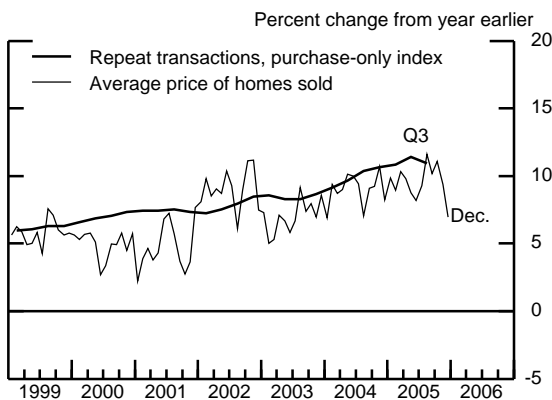
Note. The January readings are based on data through January 25, 2006.  
Source. Freddie Mac.

### Homebuying Indicators



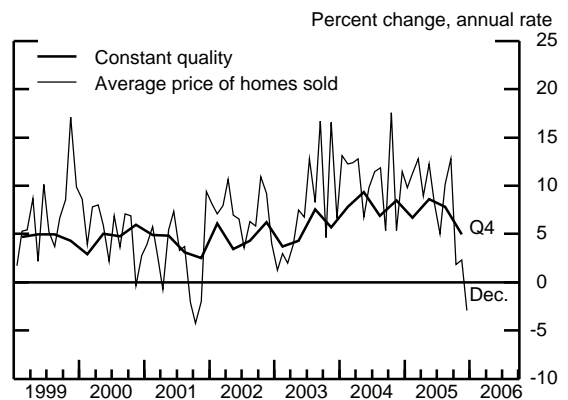
Note. MBA index is a 4-week moving average.  
Source. Mortgage Bankers Association and Michigan Survey.

### Prices of Existing Homes



Source. For repeat transactions, OFHEO; for average price, National Association of Realtors.

### Prices of New Homes



Note. Average price is a 12-month moving average with a missing value in January 2005. Constant quality price index is a 4-quarter moving average. Both series are seasonally adjusted by Board staff.  
Source. Census Bureau.

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**The Domestic Financial Economy**

### Commercial Bank Credit

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

Type of credit	2004	2005	2005: Q3	2005: Q4	Dec. 2005	Jan. <sup>e</sup> 2006	Level (\$ billions), Jan. 2006 <sup>e</sup>
<b>Total</b>							
<b>1. Adjusted<sup>1</sup></b>	<b>8.9</b>	<b>10.4</b>	<b>9.6</b>	<b>5.8</b>	<b>8.5</b>	<b>5.9</b>	<b>7,242</b>
2. Reported	8.4	9.7	9.7	5.3	7.5	6.2	7,382
<i>Securities</i>							
3. Adjusted <sup>1</sup>	6.6	7.4	.5	-.7	-5.4	1.9	1,852
4. Reported	5.2	5.1	1.7	-2.0	-7.9	3.5	1,992
5. Treasury and agency	4.9	-.3	-5.4	-9.7	-9.1	9.5	1,142
6. Other <sup>2</sup>	5.6	13.4	12.0	8.8	-6.0	-4.5	851
<i>Loans<sup>3</sup></i>							
7. Total	9.8	11.5	12.9	8.1	13.3	7.3	5,390
8. Business	1.2	13.5	11.8	9.5	14.7	22.0	1,034
9. Real estate	14.0	14.0	17.0	8.3	10.6	7.7	2,916
10. Home equity	43.8	11.1	10.9	-1.9	-1.6	-4.7	435
11. Other	9.8	14.5	18.2	10.2	12.8	9.9	2,482
12. Consumer	8.8	3.0	4.9	-4.5	-8.3	7.5	691
13. Adjusted <sup>4</sup>	5.9	.4	3.4	-4.9	7.9	3.3	1,055
14. Other <sup>5</sup>	7.9	8.2	6.4	17.3	42.5	-14.1	749

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

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

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

3. Excludes interbank loans.

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

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

e Estimated.

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

Instrument	2004		2005	2006	Change to Jan. 26 from selected dates (percentage points)		
	June 28	Dec. 31	Dec. 12	Jan. 26	2004 June 28	2004 Dec. 31	2005 Dec. 12
<i>Short-term</i>							
FOMC intended federal funds rate	1.00	2.25	4.00	4.25	3.25	2.00	.25
Treasury bills <sup>1</sup>							
3-month	1.36	2.18	3.83	4.34	2.98	2.16	.51
6-month	1.74	2.52	4.19	4.38	2.64	1.86	.19
Commercial paper (A1/P1 rates) <sup>2</sup>							
1-month	1.28	2.29	4.26	4.47	3.19	2.18	.21
3-month	1.45	2.28	4.37	4.54	3.09	2.26	.17
Large negotiable CDs <sup>1</sup>							
3-month	1.53	2.50	4.46	4.62	3.09	2.12	.16
6-month	1.82	2.72	4.61	4.75	2.93	2.03	.14
Eurodollar deposits <sup>3</sup>							
1-month	1.29	2.32	4.35	4.55	3.26	2.23	.20
3-month	1.51	2.49	4.47	4.65	3.14	2.16	.18
Bank prime rate	4.00	5.25	7.00	7.25	3.25	2.00	.25
<i>Intermediate- and long-term</i>							
U.S. Treasury <sup>4</sup>							
2-year	2.88	3.08	4.48	4.51	1.63	1.43	.03
5-year	3.97	3.63	4.47	4.46	.49	.83	-.01
10-year	4.90	4.34	4.67	4.61	-.29	.27	-.06
U.S. Treasury indexed notes							
5-year	1.56	1.03	2.11	1.97	.41	.94	-.14
10-year	2.25	1.65	2.20	2.09	-.16	.44	-.11
Municipal general obligations (Bond Buyer) <sup>5</sup>	5.01	4.49	4.49	4.42	-.59	-.07	-.07
Private instruments							
10-year swap	5.21	4.65	5.09	5.04	-.17	.39	-.05
10-year FNMA <sup>6</sup>	5.30	4.61	4.97	4.92	-.38	.31	-.05
10-year AA <sup>7</sup>	5.59	4.98	5.39	5.38	-.21	.40	-.01
10-year BBB <sup>7</sup>	6.18	5.38	6.00	5.96	-.22	.58	-.04
5-year high yield <sup>7</sup>	8.30	7.34	8.33	8.20	-.10	.86	-.13
Home mortgages (FHLMC survey rate)							
30-year fixed	6.21	5.77	6.30	6.12	-.09	.35	-.18
1-year adjustable	4.19	4.10	5.15	5.20	1.01	1.10	.05

Stock exchange index	Record high		2004	2005	2006	Change to Jan. 26 from selected dates (percent)		
	Level	Date	Dec. 31	Dec. 12	Jan. 26	Record high	2004 Dec. 31	2005 Dec. 12
Dow Jones Industrial	11,723	1-14-00	10,783	10,768	10,809	-7.79	.25	.39
S&P 500 Composite	1,527	3-24-00	1,212	1,260	1,274	-16.60	5.11	1.06
Nasdaq	5,049	3-10-00	2,175	2,261	2,283	-54.78	4.94	.98
Russell 2000	728	1-26-06	652	690	728	.00	11.80	5.65
Wilshire 5000	14,752	3-24-00	11,971	12,655	12,874	-12.73	7.54	1.73

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

NOTES:

June 28, 2004, is the day before the most recent policy tightening began.  
December 12, 2005, is the day before the most recent FOMC meeting.