Prefatory Note

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Class III FOMC - Internal (FR)

Part 2

August 3, 2006

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Recent Developments

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

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Domestic Nonfinancial Developments

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Economic activity expanded at a more restrained pace in the second quarter than in the first quarter and less rapidly than in 2005. The moderation was most evident in the household sector, where consumer spending posted a smaller increase and residential investment turned down more noticeably. In the business sector, investment spending decelerated sharply in the second quarter after expanding rapidly earlier in the year, but high-frequency indicators—such as orders and shipments—generally remained favorable. Industrial production increased at a robust rate in June and in the second quarter as a whole, with gains spread widely across industries, and the capacity utilization rate moved up further. Meanwhile, the unemployment rate held steady in June while the pace of hiring continued on its recent more-subdued track. Consumer prices accelerated in the second quarter, led by rising energy prices, and core consumer prices also increased more rapidly.

Labor Market Developments

The pace of hiring stepped down in the second quarter relative to the several preceding quarters. Private payroll employment rose 90,000 in June, bringing the average monthly gain in the second quarter to 86,000, down noticeably from the 169,000 per month pace in the first quarter. Although employment in the services sector expanded steadily in recent months, hiring in the construction and retail trade sectors slackened markedly. Aggregate hours of production or nonsupervisory workers rose at an annual rate of 2.3 percent in the second quarter, down from 3.0 percent in the first quarter.

At 4.6 percent, the unemployment rate was unchanged in June from its May level, while the labor force participation rate edged up to 66.2 percent, its highest level since last year. In contrast, the percentage of people working part time for economic reasons turned up of late. In addition, the proportion of individuals who quit work to search for a new job fell, which may suggest that employed workers are becoming less optimistic about alternative employment prospects.

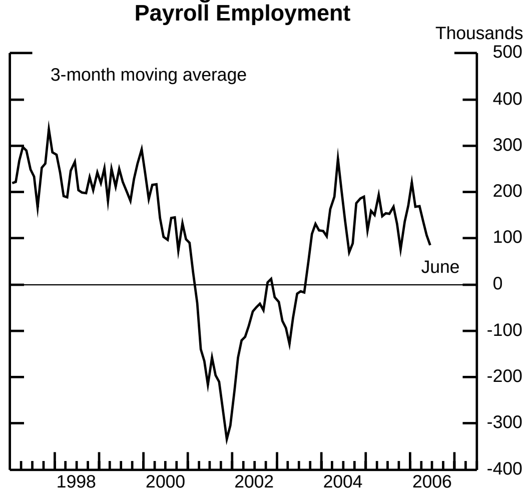
Other labor market indicators point to further moderate growth in labor demand. The four-week moving average of initial claims for unemployment insurance was 314,000 in the week ending July 29, in the same general range of the past several months. Similarly, the exhaustion rate indicates that the pace at which claimants are finding jobs before their benefits run out has, on net, been moving sideways. In addition, according to the Job Openings and Labor Turnover Survey (JOLTS), the rate of job openings has been about flat since the end of 2005. Moreover, various surveys of households and businesses

Changes in Employment
(Thousands of employees; seasonally adjusted)

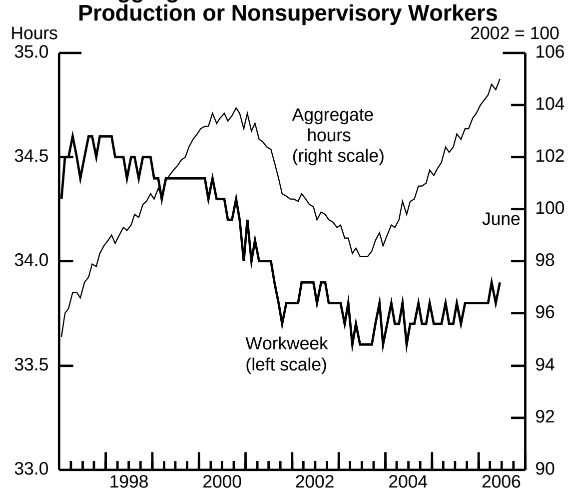
Measure and sector	2005	2005 Q4	2006 Q1	2006 Q2	2006 Apr.	2006 May	2006 June
		Average monthly change			Monthly change		
Nonfarm payroll employment (establishment survey)	165	179	176	108	112	92	121
Private	152	171	169	86	93	74	90
Natural resources and mining	4	4	6	5	9	1	4
Manufacturing	-6	12	1	9	19	-8	15
Construction	25	30	26	3	10	4	-4
Wholesale trade	7	7	13	9	10	11	7
Retail trade	13	11	2	-29	-46	-33	-7
Transportation and utilities	6	6	4	11	15	8	11
Information	-1	-2	2	-4	-2	-9	-1
Financial activities	12	17	20	13	26	9	3
Professional and business services	41	41	26	27	12	45	25
Temporary help services	14	18	-8	-4	-8	3	-8
Nonbusiness services[1]	51	44	69	41	41	47	36
Total government	14	8	7	23	19	18	31
Total employment (household survey)	221	115	287	241	47	288	387
Memo:							
Aggregate hours of private production workers (percent change)[2]	2.3	2.1	3.0	2.3	.4	-.2	.4
Average workweek (hours)[3]	33.8	33.8	33.8	33.9	33.9	33.8	33.9
Manufacturing (hours)	40.6	40.9	41.0	41.2	41.2	41.2	41.3

1. Nonbusiness services comprises education and health, leisure and hospitality, and "other."
2. Establishment survey. Annual data are percent changes from Q4 to Q4. Quarterly data are percent changes from preceding quarter at an annual rate. Monthly data are percent changes from preceding month.
3. Establishment survey.

Changes in Private Payroll Employment



Aggregate Hours and Workweek of Production or Nonsupervisory Workers

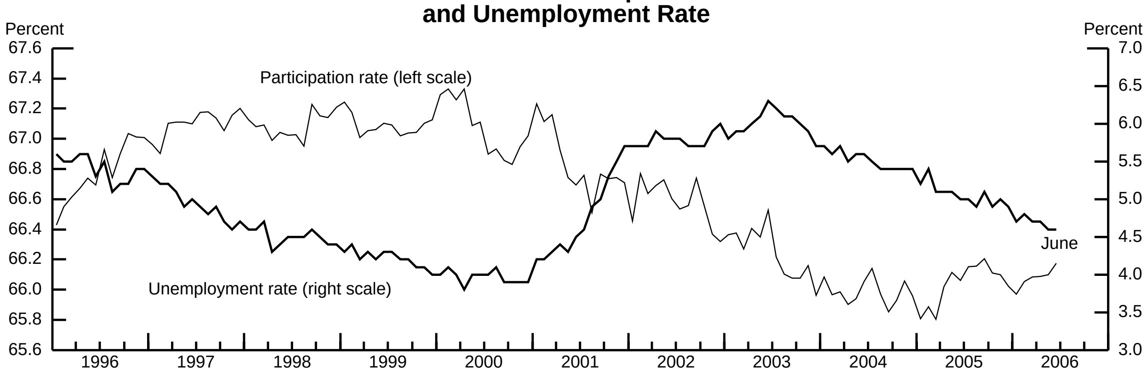


Selected Unemployment and Labor Force Participation Rates

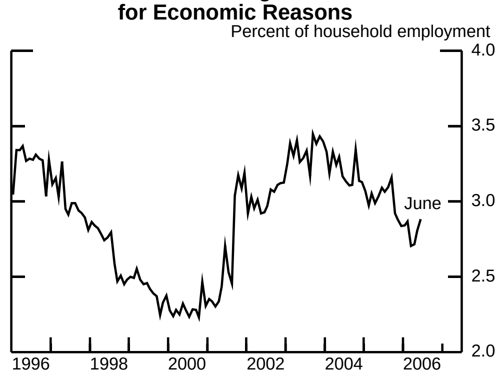
(Percent; seasonally adjusted)

Rate and group	2005	2005 Q4	2006 Q1	2006 Q2	2006 Apr.	2006 May	2006 June
Civilian unemployment rate							
Total	5.1	5.0	4.7	4.7	4.7	4.6	4.6
Teenagers	16.6	16.1	15.5	14.7	14.6	14.0	15.4
20-24 years old	8.8	8.5	8.1	8.1	8.2	8.1	7.9
Men, 25 years and older	3.8	3.7	3.6	3.6	3.6	3.7	3.5
Women, 25 years and older	4.2	4.2	3.9	3.8	3.9	3.8	3.7
Labor force participation rate							
Total	66.0	66.1	66.0	66.1	66.1	66.1	66.2
Teenagers	43.7	43.4	43.7	43.8	43.4	43.5	44.5
20-24 years old	74.6	74.8	74.0	74.2	74.1	74.5	74.1
Men, 25 years and older	75.4	75.3	75.5	75.5	75.6	75.5	75.4
Women, 25 years and older	59.4	59.6	59.4	59.5	59.4	59.4	59.7

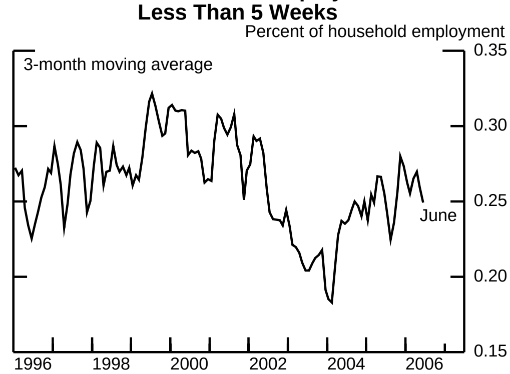
Labor Force Participation Rate and Unemployment Rate



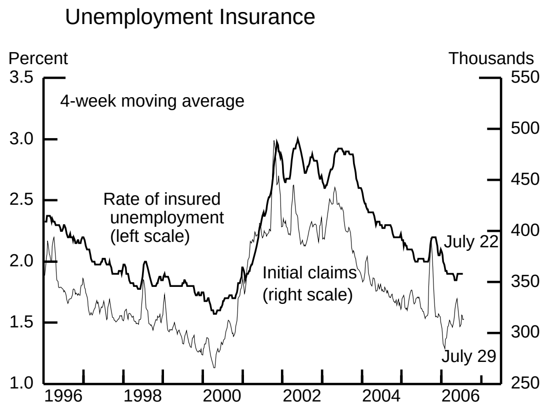
Persons Working Part Time for Economic Reasons

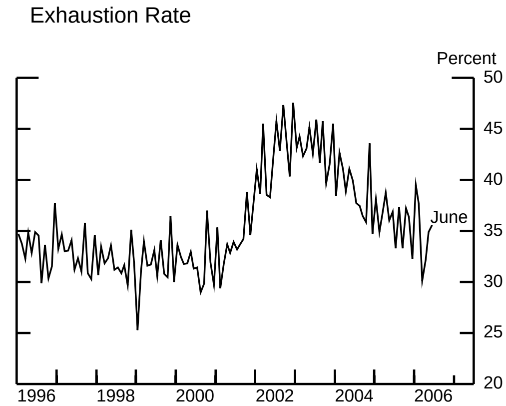


Job Leavers Unemployed Less Than 5 Weeks

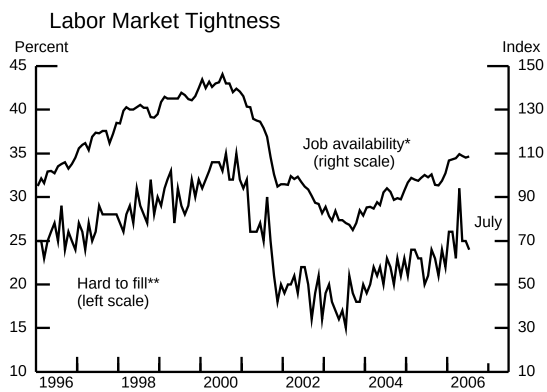


Labor Market Indicators

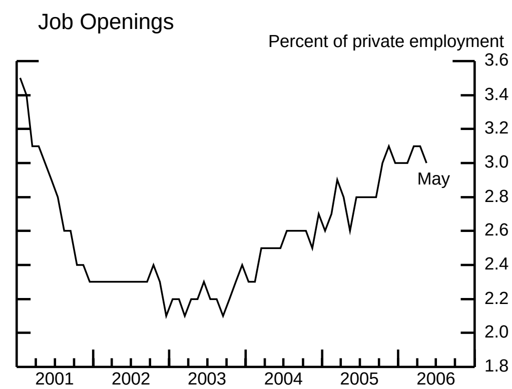




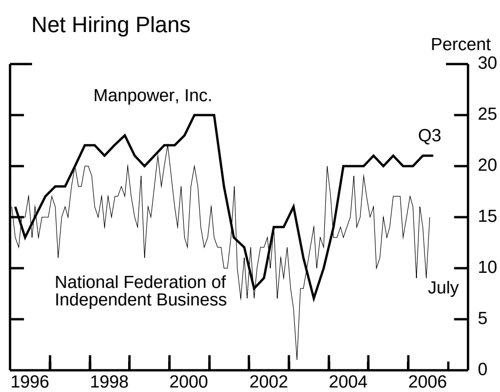
Note. The exhaustion rate is calculated as the number of individuals who were receiving unemployment insurance benefits but reached the end of their potential eligibility expressed as a percent of all individuals who began receiving such benefits six months earlier.



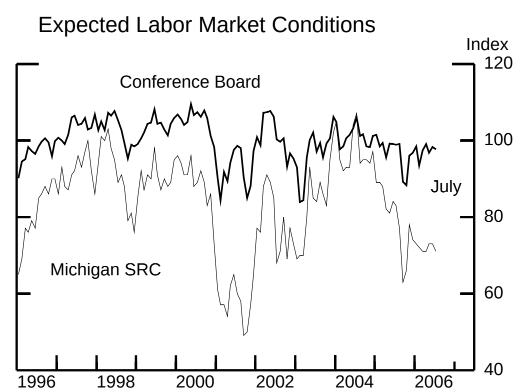
*Proportion of households believing jobs are plentiful, minus the proportion believing jobs are hard to get, plus 100.
**Percent of small businesses surveyed with at least one "hard to fill" job opening.
Source. For job availability, Conference Board; for hard to fill, National Federation of Independent Business.



Source. Job Openings and Labor Turnover Survey.



Note. Percent planning an increase in employment minus percent planning a reduction.



Note. The proportion of households expecting labor market conditions to improve, minus the proportion expecting conditions to worsen, plus 100.

generally indicate perceptions that the demand for labor continues to increase at a modest pace.

Based on the latest national income and product accounts (NIPA) data, the staff estimates that productivity in the nonfarm business sector increased at an annual rate of 4.0 percent in the first quarter and 2.2 percent in the second quarter. Over the four quarters ending in the second quarter of 2006, productivity rose an estimated 2.6 percent, a step up from the 1.7 percent pace in the preceding four quarters.

Output per Hour [1]
(Percent change from preceding period at an annual rate;
seasonally adjusted)

Sector	2004:Q2 to 2005:Q2	2005:Q2 to 2006:Q2	2005		2006	
			Q3	Q4	Q1	Q2
Nonfarm business						
All persons	1.7	2.6	4.4	-.1	4.0	2.2
All employees[2]	2.0	2.3	3.3	-.7	4.9	1.8

1. Staff estimates.
2. Assumes that the growth rate of hours of non-employees equals the growth rate of hours of employees.

Industrial Production

Total industrial production rose 0.8 percent in June and increased at a robust annual rate of 6.6 percent for the second quarter as a whole. Activity in the manufacturing sector strengthened in June and expanded 5.4 percent for the quarter; gains were widespread among industries. Mining output increased 9 percent in the second quarter, supported by continued, though waning, hurricane-related recovery efforts in the energy-extraction industries. The output at utilities jumped more than 15 percent in the second quarter, an increase that largely reversed a weather-related drop in the first quarter.

The utilization of industrial capacity in June stood at its highest level in six years. Over the past 3½ years, utilization rates have risen fairly steadily at all stages of processing. In June, the operating rate among industries in the crude stage was nearly 3 percentage points above its 1972–2005 average. Among primary and semifinished producers, the operating rate was 1.2 percentage points above average, and for industries in the finished stage, the operating rate was 1.8 percentage points above average. Moreover, the increase in the rate of capacity utilization in recent years has been widespread across manufacturing industries.

Selected Components of Industrial Production
(Percent change from preceding comparable period)

Component	Proportion 2005 (percent)	2005[1]	2006 Q1	2006 Q2	2006 Apr.	2006 May	2006 June
			Annual rate		Monthly rate		
Total	**100.0**	**3.0**	**5.1**	**6.6**	**.8**	**.1**	**.8**
Previous	100.0	3.0	5.3	...	.8	-.1	...
Manufacturing	80.8	4.2	5.3	5.4	.8	.1	.7
Ex. motor veh. and parts	73.7	4.4	5.9	5.7	.9	.2	.5
Ex. high-tech industries	68.9	2.9	5.2	4.8	.9	.1	.5
Mining	9.8	-6.8	26.3	9.0	1.4	.3	1.2
Utilities	9.5	2.9	-14.3	15.3	.3	.2	.7
Selected industries							
High technology	4.8	25.7	15.2	18.8	1.6	2.0	1.1
Computers	.8	12.0	10.6	7.3	.7	.7	.5
Communications equipment	1.2	25.4	30.5	38.6	3.6	1.4	1.0
Semiconductors[2]	2.8	29.9	10.0	13.5	.9	2.6	1.2
Motor vehicles and parts	7.1	2.3	-.2	2.3	-.3	-1.3	3.3
Market groups excluding energy and selected industries							
Consumer goods	21.0	2.3	.9	2.6	.7	-.2	.0
Durables	4.1	2.6	-2.5	.4	.3	.0	-.2
Nondurables	16.9	2.2	1.7	3.2	.8	-.3	.1
Business equipment	8.0	9.6	8.4	12.7	2.4	-.2	.7
Defense and space equipment	2.0	9.2	6.7	7.0	1.0	.4	.9
Construction supplies	4.4	6.5	3.1	-1.1	.2	-.6	.4
Business supplies	7.8	2.7	3.7	3.9	.9	-.1	.6
Materials	24.4	.6	9.7	4.9	.8	.2	.6
Durables	13.7	3.6	9.0	6.7	1.1	.2	.8
Nondurables	10.7	-3.1	10.6	2.4	.5	.3	.3

1. From fourth quarter of preceding year to fourth quarter of year shown.
2. Includes related electronic components.
... Not applicable.

Capacity Utilization
(Percent of capacity)

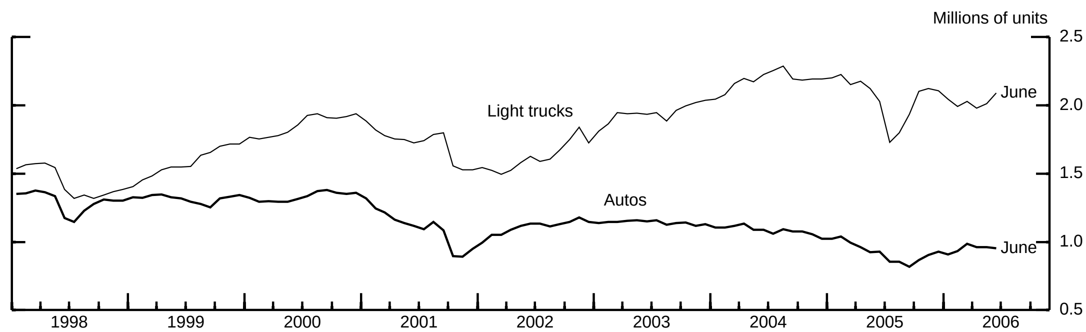
Sector	1972-2005 average	1994-2005 high	2001-02 low	2005 Q4	2006 Q1	2006 Q2	2006 May	2006 June
Total industry	**81.0**	**85.0**	**73.9**	**80.5**	**81.1**	**82.0**	**81.8**	**82.4**
Manufacturing	79.8	84.5	72.0	79.8	80.3	80.9	80.7	81.1
Mining	87.3	89.0	85.6	82.7	87.9	90.1	89.9	91.1
Utilities	86.7	93.7	83.7	86.9	83.5	86.4	86.3	86.8
Stage-of-process groups								
Crude	86.4	89.4	83.2	81.3	85.8	88.4	88.3	89.3
Primary and semifinished	82.1	88.1	74.6	82.6	82.3	83.0	82.8	83.3
Finished	77.9	80.5	70.8	78.3	78.9	79.6	79.4	79.7

Production of Domestic Light Vehicles
(Millions of units at an annual rate except as noted)

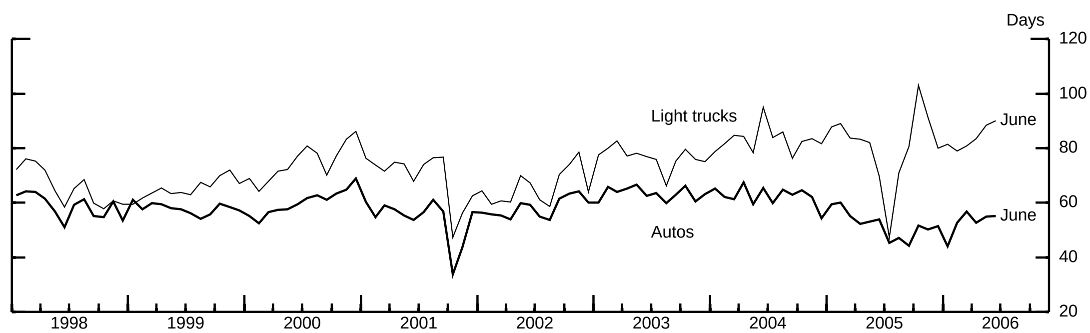
Item	2005	2006 Q1	Q2	Q3	May	June	July	Aug.
U.S. production[1]	11.5	11.2	11.1	11.3	10.9	11.3	11.3	11.1
Autos	4.3	4.5	4.3	4.5	4.3	4.1	4.5	4.4
Light trucks	7.2	6.7	6.8	6.8	6.5	7.1	6.8	6.7
Days' supply[2]	69	69	74	n.a.	74	75	n.a.	n.a.
Autos	52	53	54	n.a.	55	55	n.a.	n.a.
Light trucks	81	80	90	n.a.	88	90	n.a.	n.a.
Inventories[3]	3.04	3.01	3.05	n.a.	2.98	3.05	n.a.	n.a.
Autos	.93	.99	.95	n.a.	.96	.95	n.a.	n.a.
Light trucks	2.11	2.03	2.09	n.a.	2.01	2.09	n.a.	n.a.
Memo: U.S. production, total motor vehicles[4]	12.0	11.7	11.6	11.6	11.3	11.6	11.7	11.5

Note. FRB seasonals. Components may not sum to totals because of rounding.
1. Production rates for the third quarter reflect the latest industry schedules.
2. Annual and quarterly values are calculated with end-of-period stocks and average reported sales.
3. End-of-period stocks.
4. Includes medium and heavy trucks.
n.a. Not available.

Inventories of Light Vehicles

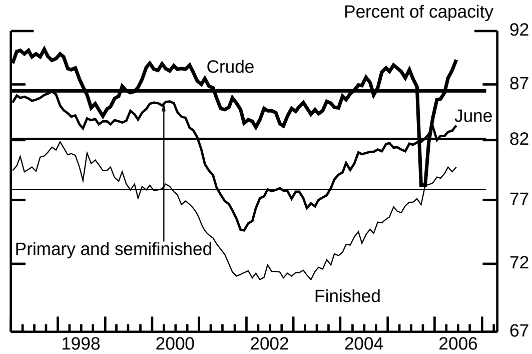


Days' Supply of Light Vehicles



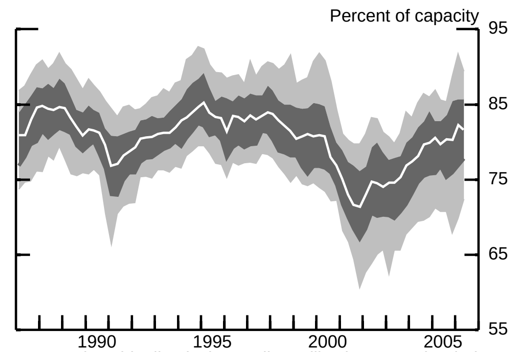
Indicators of Industrial Activity

Capacity Utilization by Stage of Processing



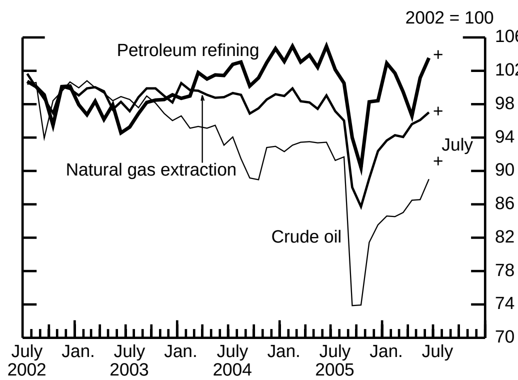
Note. Horizontal lines are 1972-2005 averages.

Distribution of Industry-Level Manufacturing Utilization Rates



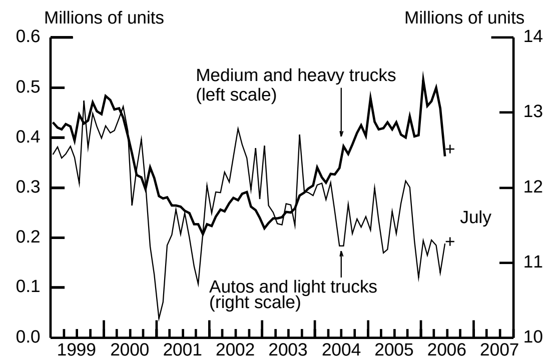
Note. The white line is the median utilization rate. The darker shade represents the utilization rates between 25th and 75th percentiles. The lighter shade represents utilization rates between the 10th and 25th and the 75th and 90th percentiles. Series-specific means removed. Data extend through 2006:Q2.

Energy IP



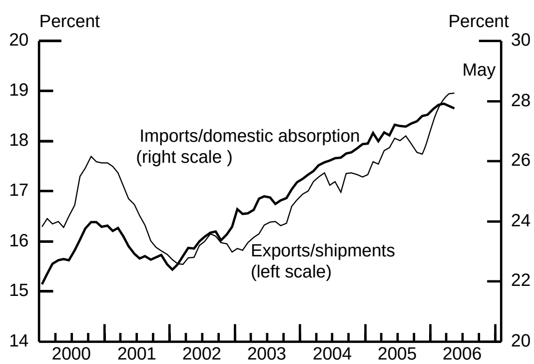
Note. July values are based on available weekly data and estimates of facilities that remain off line.

Motor Vehicle Assemblies



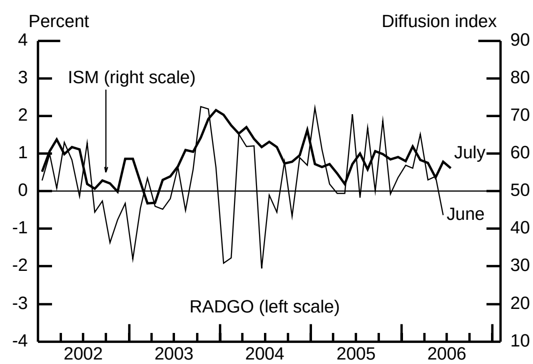
Note. July values are based on latest industry schedules.

Trade Shares



Note. Trade shares are 3-month moving averages.

New Orders: ISM Survey and Change in Real Adjusted Durable Goods Orders (RADGO)



Note. The diffusion index equals the percentage of respondents reporting greater levels of new orders plus one-half the percentage of respondents reporting that new orders were unchanged. RADGO is a 3-month moving average.

As the pace of hurricane-related recovery abated in the second quarter, the gains in crude oil and natural gas production moderated. However, the available weekly data point to a jump in crude oil production in July. In the Gulf of Mexico, the crude oil and natural gas platforms that are still not operating account for less than 2 percent of domestic oil and gas extraction capacity. Separately, about 2 percent of domestic petroleum-refining capacity is off line because of hurricane-related and other reasons. Refinery output dropped sharply in March and April because of the switch to ethanol-blended gasoline, but it bounced back by the end of June and appears to have been little changed in July. However, even during the switchover to ethanol-based blends of gasoline, refineries were operating at above-average rates of utilization.

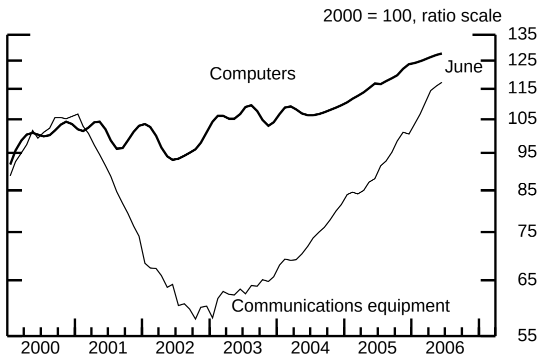
Motor vehicle production moved up in June to an annual rate of 11.6 million units, which was the same as the average rate of production in the second quarter. Over the first half of the year, production of cars increased a little relative to the average pace in 2005, while production of light trucks was notably lower. However, inventories of light trucks were elevated at the end of June because of sluggish sales during the first half of the year. Overall days' supply for light vehicles at the end of the second quarter stood at 75 days, well above the industry-preferred norm of about 65 days. For July, industry assembly schedules suggest that the rate of production was about unchanged. For the third quarter as a whole, production is also scheduled to hold steady at a rate of about 11.6 million units.

Output in the high-technology sector increased 1.1 percent in June and rose at an annual rate of nearly 19 percent for the second quarter as a whole. This increase, which is relatively modest by historical standards, obscures an appreciable divergence among the components of total high-technology output. The output of communications equipment jumped at an annual rate of nearly 40 percent in the second quarter after a 30 percent rate of increase in the first quarter. Production of communications equipment in the first half of 2006 was elevated by robust business spending on voice and data-networking equipment.[1] In addition, telecommunication service providers have been upgrading their networks to build-out the infrastructure needed to provide households with combined voice, data, and television service over a single high-speed Internet connection.

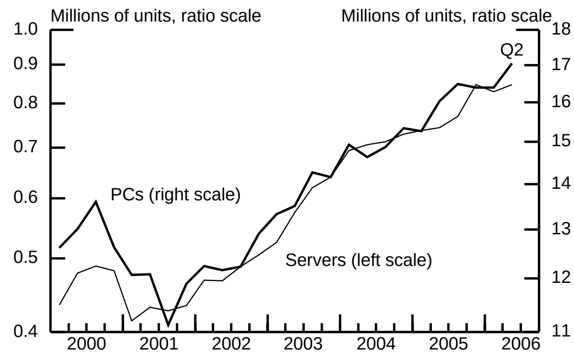
[1] In particular, the demand for voice-switching equipment necessary to support Internet-based voice communications—so-called voice-over-Internet protocol, or VOIP—has been an important driver of recent business spending on communications equipment.

Indicators of High-Tech Manufacturing Activity

Communications Equipment and Computer IP

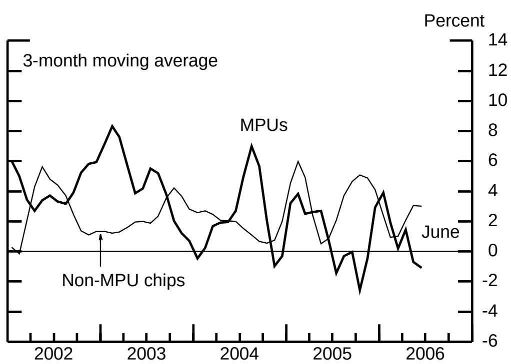


U.S. Personal Computer and Server Sales



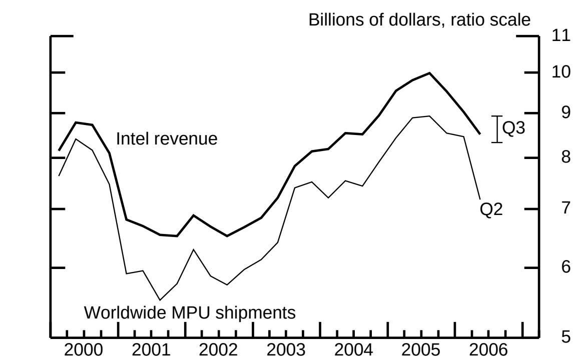
Note. FRB seasonals.
Source. Gartner.

Rate of Change in Semiconductor Industrial Production



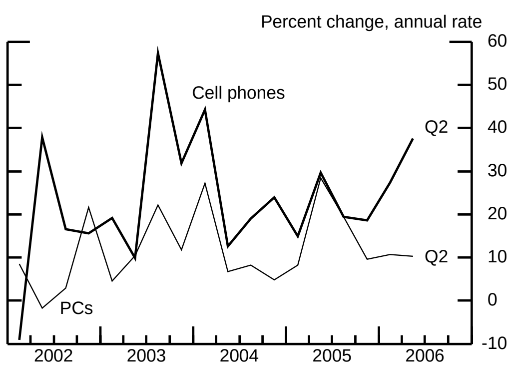
Note. MPU is a microprocessor unit.

MPU Shipments and Intel Revenue



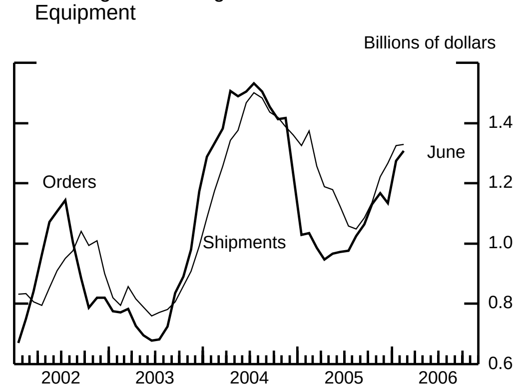
Note. Q3 is the range of Intel's revenue guidance as of July 19, 2006. FRB seasonals.
Source. Intel and Semiconductor Industry Association.

Worldwide Unit Sales of Personal Computers and of Cell Phones



Note. FRB seasonals. Q2 worldwide sales figure is the midpoint of estimates by Nokia and Motorola.
Source. Gartner.

Bookings and Billings for Semiconductor Equipment



Note. FRB seasonals.
Source. Semiconductor Equipment and Materials International.

In contrast, computer production remained relatively restrained last quarter despite an increase in units produced. Unit sales of personal computers (PCs) turned up in response to price cuts, but anecdotal evidence indicates that part of the increase in demand was directed toward lower-end PCs that have a relatively smaller impact on industrial production. Unit sales of servers appear to have reversed a small decline in the first quarter but were essentially unchanged from the fourth quarter, suggesting some softness in commercial sales. The production of microprocessors (MPUs), which are principally used in computers, has been weak recently, and Intel's revenue guidance for the third quarter points to only a modest increase in production in the near term. However, Intel is continuing to roll out new chips that are considerably faster and more energy-efficient—attributes that are likely to be highly valued by corporate customers. Industry analysts expect that demand for these new chips will increase Intel's market share, which would tend to boost IP later this year.[2] The output of chips other than MPUs has been well maintained and is being supported by demand for cell phones and other consumer electronics and by business spending on communications equipment.

Among market groups excluding energy, motor vehicles and parts, and high-technology products, output gains were generally strong in June. All of the major market groups posted solid increases with the exception of consumer goods, which were unchanged in June but still up at an annual rate of 2½ percent for the second quarter. The output of business equipment advanced in the second quarter at an annual rate of more than 12½ percent, and the output of defense and space equipment climbed at an annual rate of 7 percent. The output of materials rose at an annual rate of almost 5 percent, and the production of business supplies increased at an annual rate of about 4 percent. Construction supplies declined at an annual rate of about 1 percent after having been at a level elevated by favorable weather in the first quarter.

In general, domestic production appears to have benefited from brisk foreign demand, which has been boosted by the lagged effects of a lower exchange value of the dollar and strong foreign output growth. Indeed, the manufacturing export share—defined as the ratio of nominal exports of manufactured goods to nominal shipments—moved up in recent months, while the nominal import share leveled off.

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[2] Intel's main competitor—Advanced Micro Devices (AMD)—does not yet produce in the United States, and therefore changes in market share can have a significant effect on domestic semiconductor production. However, AMD has announced plans to build a $3 billion semiconductor fabrication facility in upstate New York that will likely begin production between 2013 and 2015.

Sales of Light Vehicles
(Millions of units at an annual rate; FRB seasonals)

Category	2005	2005 Q4	2006 Q1	2006 Q2	2006 May	2006 June	2006 July
Total	16.9	15.9	16.9	16.3	16.1	16.1	17.1
Autos	7.7	7.5	7.8	7.8	7.8	7.7	8.2
Light trucks	9.2	8.3	9.1	8.5	8.3	8.4	8.9
North American[1]	13.5	12.6	13.4	12.6	12.4	12.5	13.2
Autos	5.5	5.4	5.7	5.4	5.4	5.3	5.6
Light trucks	8.0	7.2	7.7	7.1	7.0	7.2	7.6
Foreign-produced	3.4	3.3	3.4	3.7	3.7	3.7	4.0
Autos	2.2	2.1	2.1	2.4	2.4	2.4	2.7
Light trucks	1.2	1.2	1.3	1.3	1.3	1.2	1.3
Memo: Big Three domestic market share (percent)[2]	56.8	53.4	55.8	53.9	52.7	55.5	52.1

Note. Components may not sum to totals because of rounding.
1. Excludes some vehicles produced in Canada that are classified as imports by the industry.
2. Domestic market share excludes sales of foreign brands affiliated with the Big Three.

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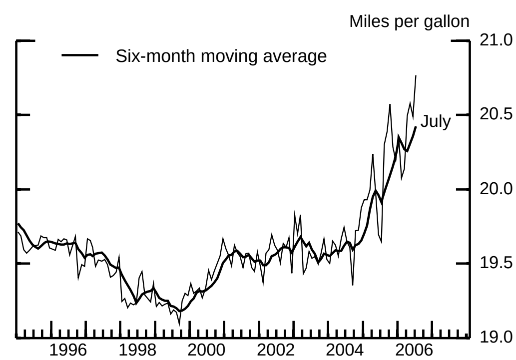
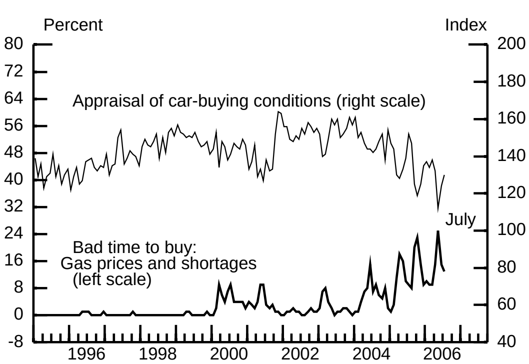
New Light Vehicle Fuel Economy

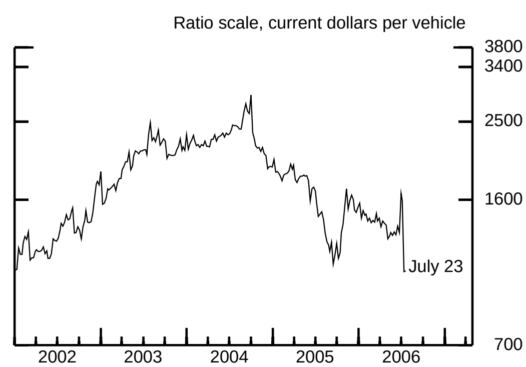


Source. Staff estimate based on a monthly sales-weighted average of city mileage ratings for all new models. Data are seasonally adjusted.

Michigan Survey Index of Car-Buying Attitudes



Average Value of Incentives on Light Vehicles



Note. Weighted average of customer cash rebate and interest rate reduction. Data are seasonally adjusted.
Source. J.D. Power and Associates.

Near-term indicators of production have generally remained favorable. The latest reading of the new orders diffusion index from the Institute for Supply Managements is consistent with moderate gains in manufacturing output in coming months. The new orders indexes from the various regional surveys also point to further increases in near-term production.

Motor Vehicles

Sales of light vehicles picked up in July to a 17.1 million unit annual rate from the soft reading of 16.1 million units in June. Sales were boosted by a step-up in incentives that began in late June, and industry anecdotes indicate that sales shot up over the long Independence Day weekend. A new round of incentives was introduced later in July after sales fell back, with some targeted specifically at large and midsize SUVs.[3] Sales of light trucks rebounded somewhat in June and July after having fallen back sharply in April and May. Despite the increase in light-truck sales, the average fuel economy for light vehicles sold moved up in July, and the average market share for the Big Three automakers moved further below its already low level from earlier in the year.

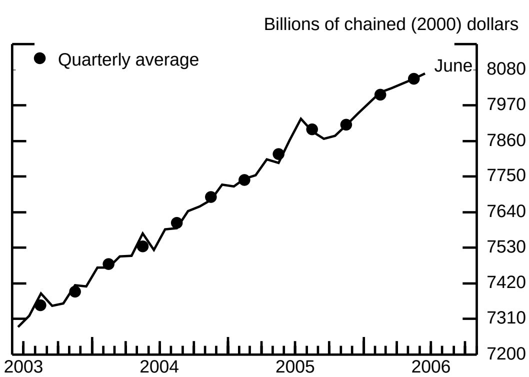
Recent indicators of motor vehicle sentiment are consistent with a gradual strengthening in retail demand for motor vehicles. According to the University of Michigan's Survey of Consumer Attitudes, consumer assessments of car-buying conditions improved in June and edged up further in July, mostly reflecting a reported decline in consumers' anxiety over gas prices. The percentage of households in the survey reporting that it was a bad time to buy a car because of high gasoline prices fell back in July to 13 percent, down from the record-high level of 25 percent observed in May. However, the recent surge in gasoline prices may have occurred too late to have been fully reflected in the July survey.

[3] According to J.D. Power and Associates, the average value of incentives received by new car purchasers increased $84 in June and climbed an additional $216 through the week including July 4. This measure then plummeted after the temporary promotions expired, even though the automakers continued to offer generous cash rebates, gas cards, and zero-interest financing. Industry anecdotes suggest that the promotions at the beginning of July pulled many sales forward. Subsequently, prospective buyers who had not yet purchased may have been waiting for incentives to increase again near the end of the month.

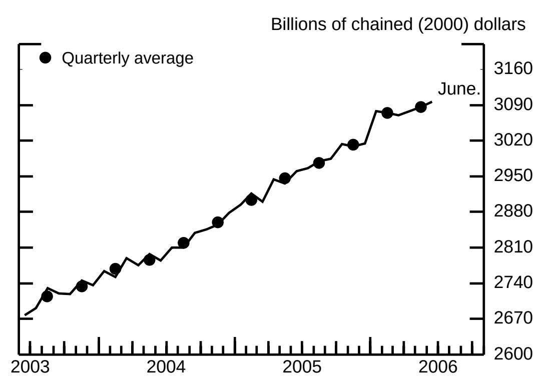
Real Personal Consumption Expenditures
(Percent change from the preceding period)

	2005		2006				
	H1	H2	Q1	Q2	Apr.	May	June
	Annual rate				Monthly rate		
Total real PCE	3.5	2.3	4.8	2.5	.2	.2	.2
Durable goods	7.4	-2.2	19.8	-.5	-.3	-.6	.5
Motor vehicles	2.9	-15.2	18.9	-3.1	-.2	-2.5	.6
Excluding motor vehicles	11.2	8.7	20.5	1.5	-.3	.7	.5
Nondurable goods	5.1	3.7	5.9	1.7	.4	.2	.3
Energy	.5	-4.1	-1.3	.8	1.1	-.6	-.6
Other	5.7	4.8	6.9	1.8	.3	.3	.4
Services	2.0	2.6	1.6	3.5	.2	.4	.1
Energy	-.1	2.0	-29.7	15.0	-2.7	3.7	-.4
Other	2.0	2.6	3.2	3.1	.3	.2	.1

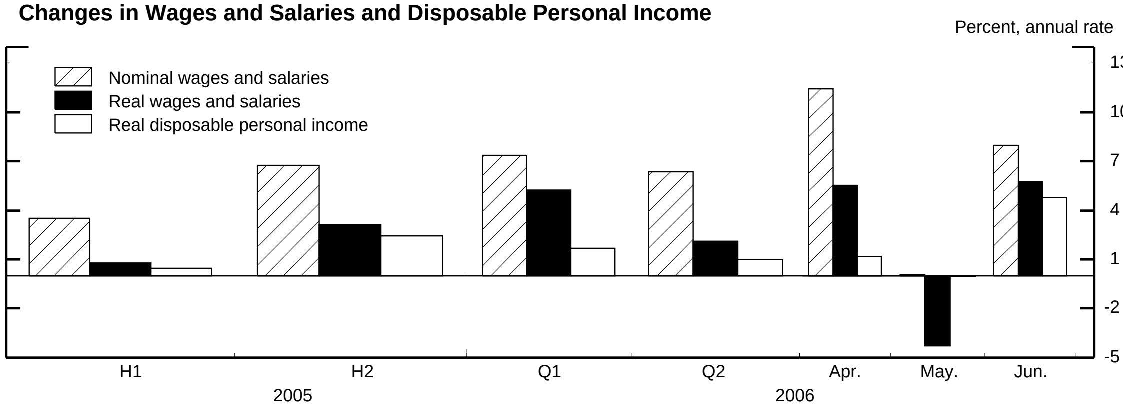
Real PCE



Real PCE Goods Excluding Motor Vehicles



Changes in Wages and Salaries and Disposable Personal Income



Note. Values for 2005:H1 exclude the effect of the special December 2004 Microsoft dividend payment on real DPI growth.

Looking ahead, most of our industry contacts anticipate that the recent improvements in sales will continue through the third quarter, although they also expect sales for 2006 as a whole to come in a bit below the 16.9 million units sold in 2005. Model year-end promotions aside, General Motors continues to assert that its use of incentives will be more restrained than in recent years, and several automakers are counting on their new 2007 model introductions to maintain sales momentum this fall. Because the mix of sales continues to shift toward vehicles with higher fuel economy, many of the new models are in the increasingly popular crossover market segment.[4]

Consumer Spending

The growth of consumer spending slowed considerably in the second quarter after the surge in purchases around the turn of the year. Real consumer spending moved up 0.2 percent in June after similar modest gains in April and May. Excluding motor vehicles, spending for goods perked up in June after remaining flat, on average, over the previous four months. Consumer spending on services, which had been trending up this year, decelerated in June and was held back by a drop in real outlays for energy services and financial services (specifically, brokerage fees).

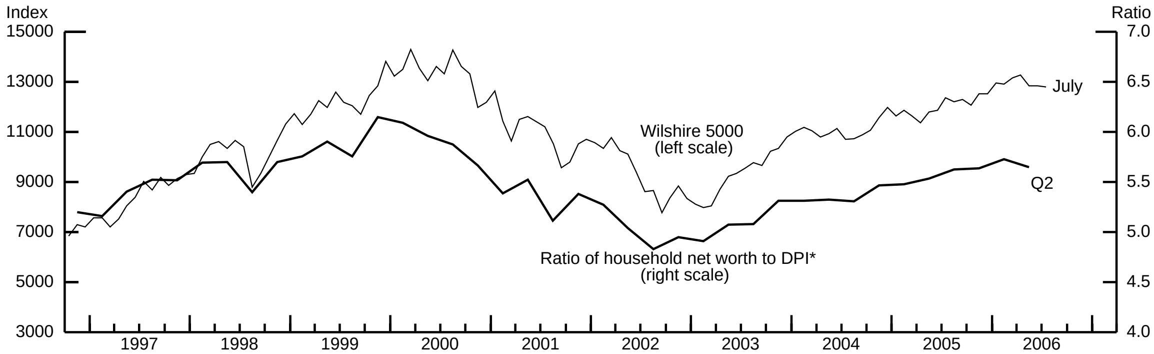
The slower pace of consumer expenditures this spring was accompanied by a moderation in real income growth and continued increases in borrowing costs. Although nominal compensation rose briskly in the first half of the year, real gains were damped by rising consumer price inflation. In June, real disposable personal income increased 0.4 percent after no change, on average, over the previous five months. However, consumer spending continues to be supported by past gains in household wealth, particularly from the earlier rapid rise in home prices. Increases in outlays have outpaced gains in disposable income, on average, since late last year, and the personal saving rate has declined, reaching negative 1½ percent in June.

Recent readings on consumer confidence have been mixed. The July index from the Michigan survey edged down a bit and is consistent with continued subpar gains in household spending. In contrast, confidence as measured by the Conference Board remained somewhat more upbeat.

[4] Crossovers resemble small SUVs but are built on car platforms, which are more fuel efficient than the truck platforms used for traditional SUVs. Nonetheless, crossovers are classified as light trucks by the industry.

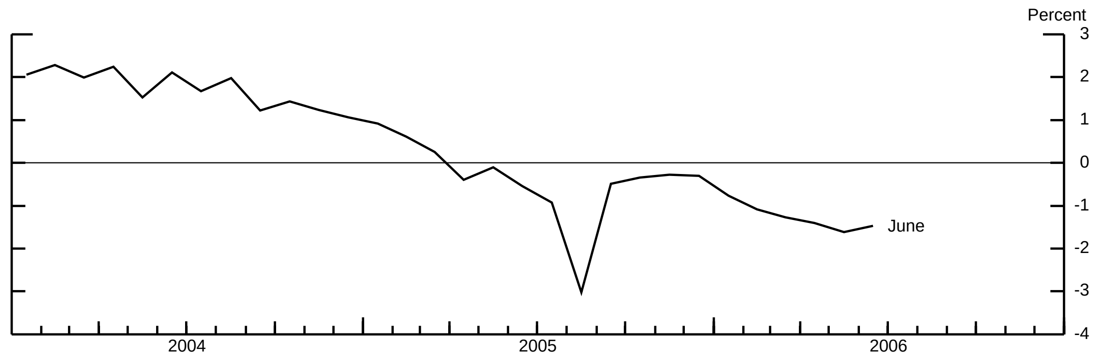
Household Indicators

Household Net Worth and Stock Prices



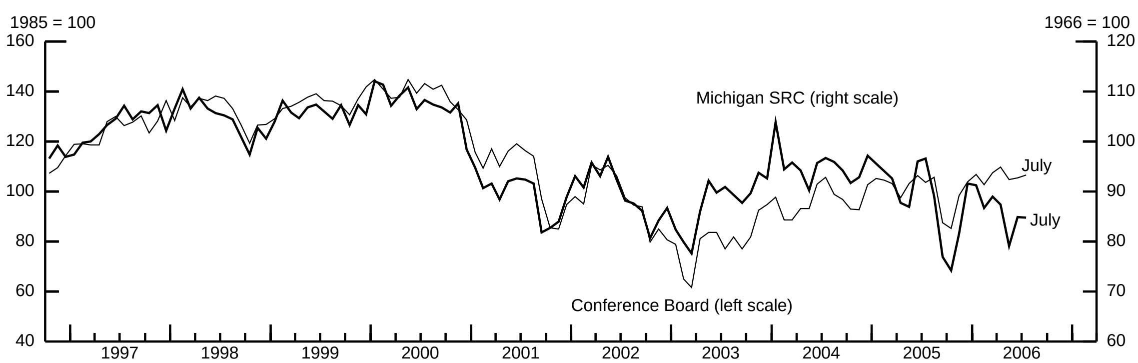
* Value for 2004:Q4 excludes the effect on income of the one-time Microsoft dividend in December.

Personal Saving Rate



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

Consumer Confidence



Housing

Residential construction activity has continued to recede over the past few months. Single-family starts fell to an annual rate of 1.49 million units in June, and adjusted permit issuance in the single-family sector—a more reliable indicator of the underlying pace of housing construction than starts—has trended down since last fall. With the 3¾ percent decline in June, the number of permits issued slumped to a level 15 percent below its average in the second quarter of last year. The backlog of unused permits also has dropped after peaking late last year. In contrast, construction in the multifamily sector has not shown any signs of slowing. Multifamily starts in June were at an annual rate of 364,000 units—well within the typical range seen since 1995—and the rate of permits issued in this sector has remained steady.

The pace of home sales has also weakened over the past year. Sales of existing single-family homes in June were at an annual rate of 5.81 million units, down 8¼ percent from their peak in June 2005. After gaining some ground in recent months, new home sales fell 3 percent in June to a pace 17¼ percent lower than the record high posted in July 2005.

Near-term indicators suggest that housing activity will slow further in the months ahead. Inventories of both new and existing homes have been trending up relative to sales for some time, and pending home sales—a leading indicator of existing home sales at one- and two-month horizons—have remained at low levels in recent months. In addition, the Michigan index of homebuying attitudes has moved down considerably over the past year. Survey respondents have pointed to higher mortgage rates as the primary reason for the deterioration in homebuying conditions. Since home sales peaked last summer, the average rate for thirty-year fixed-rate mortgages has risen about 1 percentage point, while the average rate for one-year adjustable-rate mortgages has climbed almost 1½ percentage points.

House-price appreciation has slowed from the elevated rates of recent years. The rate of appreciation shown by the Case-Shiller repeat-sale price index, which controls for the quality of homes sold but is confined to sales in ten large U.S. cities, has moved down

Private Housing Activity

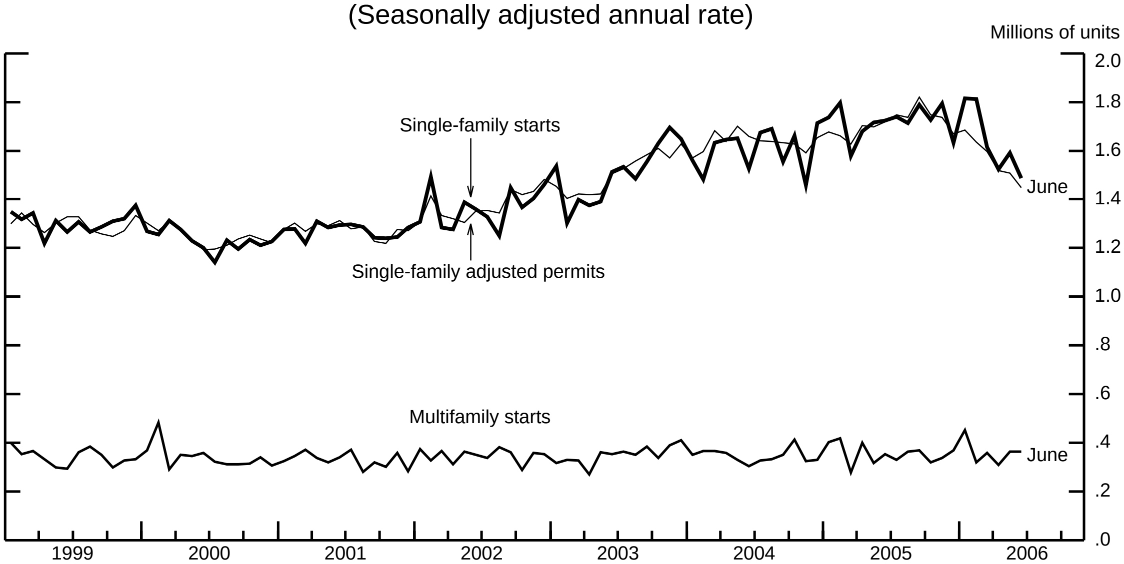
(Millions of units, seasonally adjusted; annual rate except as noted)

Sector	2005	2006				
		Q1	Q2	Apr.	May	June
All units						
Starts	2.07	2.12	1.88	1.83	1.95	1.85
Permits	2.16	2.14	1.93	1.97	1.95	1.87
Single-family units						
Starts	1.72	1.75	1.53	1.52	1.59	1.49
Permits	1.68	1.61	1.46	1.50	1.49	1.40
Adjusted permits[1]	1.71	1.64	1.49	1.52	1.51	1.45
Permit backlog[2]	.17	.16	.15	.16	.16	.15
New homes						
Sales	1.28	1.11	1.15	1.16	1.17	1.13
Months' supply[3]	4.43	5.90	6.00	6.00	5.90	6.10
Existing homes						
Sales	6.18	5.96	5.86	5.91	5.86	5.81
Months' supply[3]	4.40	5.20	6.20	5.90	6.20	6.60
Multifamily units						
Starts	.35	.38	.35	.31	.36	.36
Permits	.47	.53	.47	.48	.46	.47
Permit backlog[2]	.06	.07	.07	.07	.07	.07
Mobile homes						
Shipments	.15	.15	n.a.	.13	.13	n.a.
Condos and co-ops						
Existing home sales	.90	.83	.83	.84	.85	.81

1. Adjusted permits equal permit issuance plus total starts outside of permit-issuing areas.
2. Number outstanding at end of period. Excludes permits that have expired or have been canceled, abandoned, or revoked. Not at an annual rate.
3. At current sales rate. The ratio of n.s.a. inventories to n.s.a. sales is seasonally adjusted by the Census Bureau; as a result, the s.a. ratio may not be the same as the ratio of s.a. inventories to s.a. sales. Quarterly and annual figures are averages of monthly figures.
n.a. Not available.

Private Housing Starts and Permits

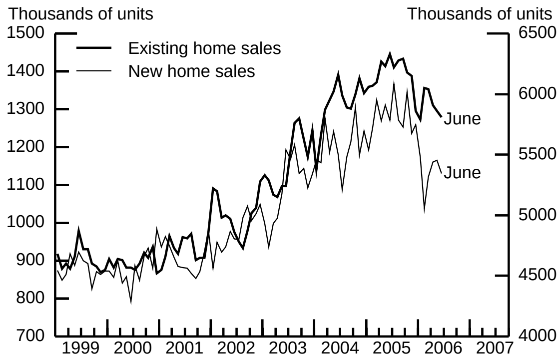
(Seasonally adjusted annual rate)



Note. Adjusted permits equal permit issuance plus total starts outside of permit-issuing areas.

Indicators of Single-Family Housing

Home Sales



Source. For existing homes, National Association of Realtors; for new homes, Census Bureau.

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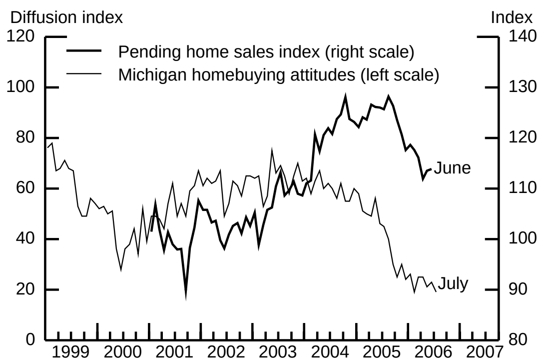
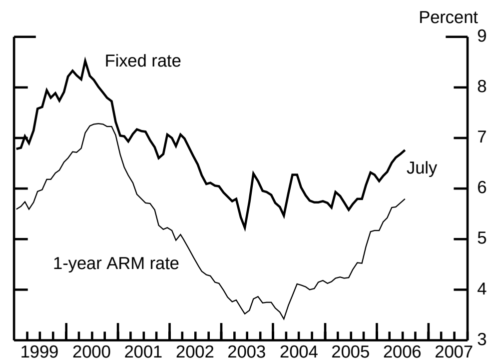
Homebuying Indicators



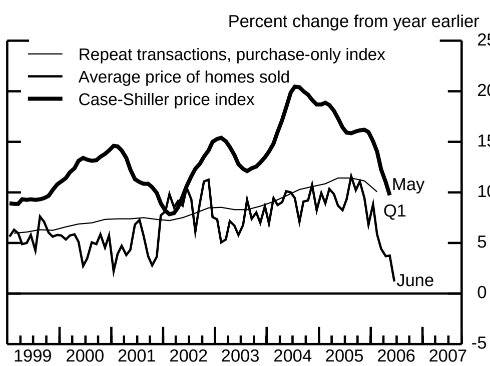
Source. National Association of Realtors and Michigan survey.

Mortgage Rates



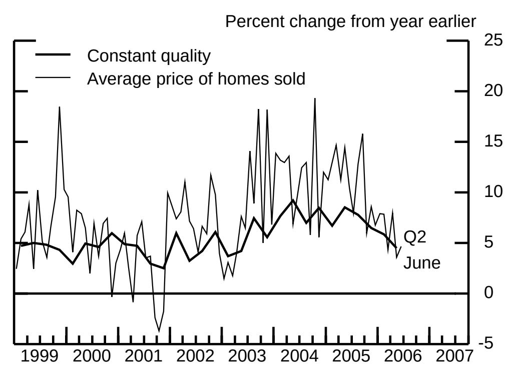
Note. The July readings are based on data through July 26, 2006.
Source. Freddie Mac.

Prices of Existing Homes



Source. For repeat transactions, OFHEO; for average price, National Association of Realtors; for Case-Shiller, Chicago Mercantile Exchange.

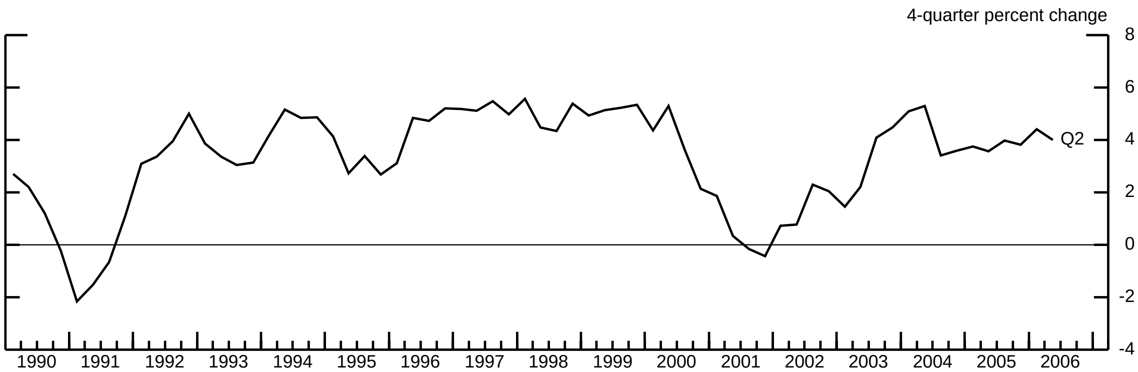
Prices of New Homes



Note. Although average price values have been adjusted by Board staff to take into account new sampling procedures adopted in 2005, they may still not be directly comparable to earlier periods.
Source. Census Bureau.

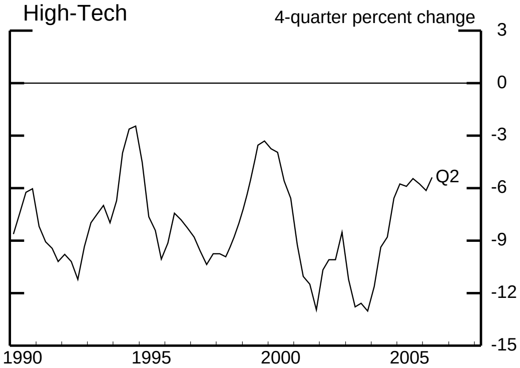
Fundamentals of Equipment and Software Investment

Real Business Output

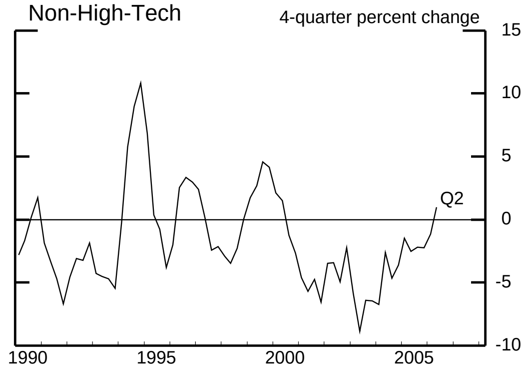


User Cost of Capital

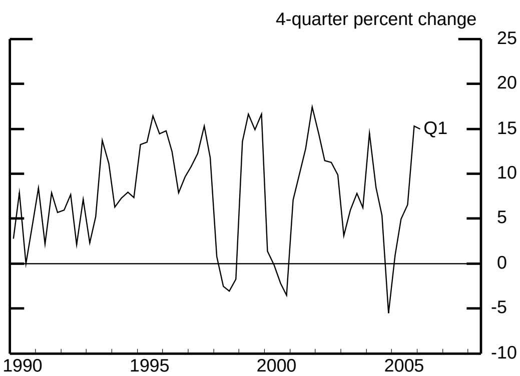
High-Tech



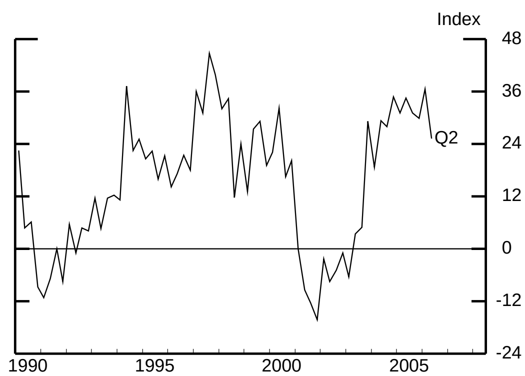
Non-High-Tech



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.

markedly this year to 10 percent over the twelve months ending in May, approximately the same rate of appreciation posted in the first quarter by the purchase-only version of the existing-homes price index calculated by the Office of Federal Housing Enterprise Oversight (OFHEO).[5] In June, the average price of existing homes, which has broad market coverage but is not quality adjusted, was up only 1¼ percent from the level of twelve months earlier, and, on a seasonally adjusted basis, this series has hovered around the same level since last October. The rate of appreciation in new-home prices has also slowed of late. The constant-quality price index for new homes—which is the most reliable measure of quality-adjusted price appreciation in the new home market—was 4½ percent higher in the second quarter than in the same period last year, its smallest four-quarter change since the spring of 2003.

Equipment and Software

The gain in real outlays for equipment and software has been solid, on average, so far this year, and is similar to its rate of expansion during 2005. In the second quarter, real outlays for equipment and software edged down at an annual rate of 1 percent after surging 15½ percent in the first quarter. The slower rate of investment spending in the second quarter primarily reflected downward swings in real expenditures on communications and transportation equipment that reversed much of the large run-up in the first quarter.

Underlying fundamentals continue to be supportive of increased business investment. The expansion in business output remains solid. Decreases in relative prices continue to drive down the cost of capital for high-tech goods, although not by as much as a few years ago. And, robust growth in profits has furnished the corporate sector with ample financial reserves. Furthermore, surveys of executive sentiment are consistent with these solid fundamentals; for example, the capital spending diffusion index derived from the National Association for Business Economics survey remains at a level suggestive of further strong growth in capital spending.

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[5] The cities covered by the Case-Shiller index are Boston, Chicago, Denver, Las Vegas, Los Angeles, Miami, New York, San Diego, San Francisco, and Washington. The OFHEO price index for existing homes—which we think is, on balance, the most reliable overall gauge of house-price appreciation—also controls for differences in quality and covers a broader geographic market than the Case-Shiller index. However, the OFHEO index does not reflect the highest and lowest ends of the market because it excludes sales financed using jumbo mortgages and mortgages backed by the Department of Veterans Affairs and the Federal Housing Administration, while the Case-Shiller index includes such purchases.

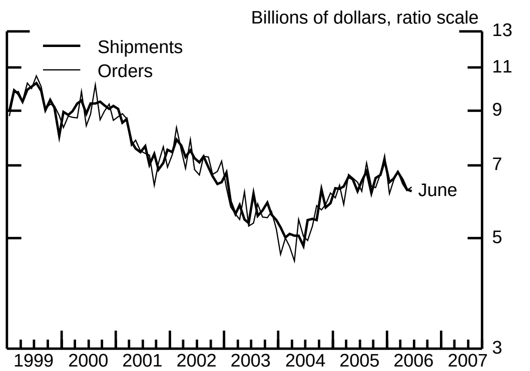
Orders and Shipments of Nondefense Capital Goods

(Percent change; seasonally adjusted current dollars)

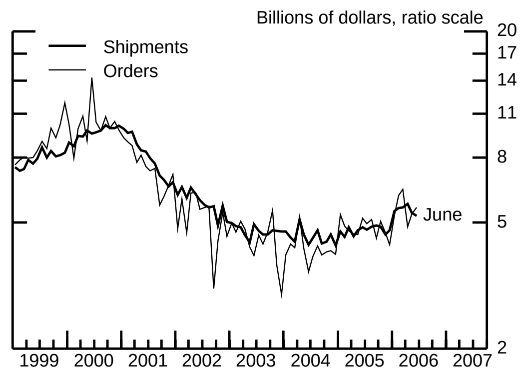
Category	2006				
	Q1	Q2	Apr.	May	June
	Annual rate		Monthly rate		
Shipments	1.4	4.8	-1.4	2.1	-.5
Excluding aircraft	10.6	5.4	.4	.0	-.5
Computers and peripherals	-11.7	-15.3	-3.6	-4.1	-.9
Communications equipment	87.7	-5.4	2.3	-6.1	-2.3
All other categories	7.9	9.8	.8	1.3	-.3
Orders	-25.6	3.9	-6.5	-2.0	1.3
Excluding aircraft	16.7	3.0	-2.1	1.3	.4
Computers and peripherals	-16.3	-9.5	-5.6	-3.0	1.5
Communications equipment	159.3	-37.2	-23.7	9.7	5.0
All other categories	12.1	10.5	1.0	1.0	-.2
Memo:					
Shipments of complete aircraft[1]	33.1	n.a.	33.1	33.4	n.a.

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

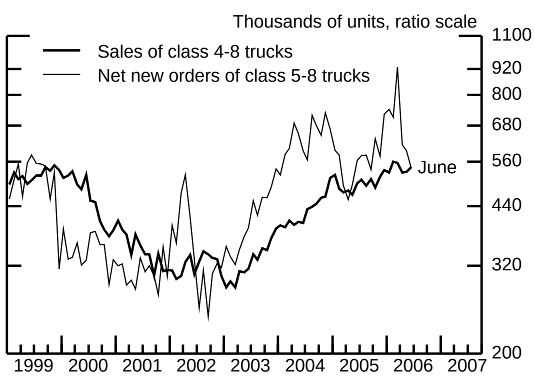
Computers and Peripherals



Communications Equipment

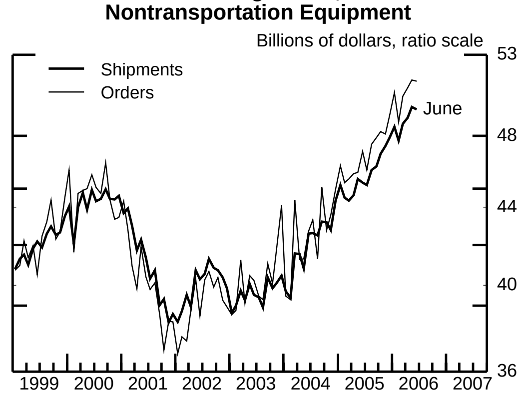


Medium and Heavy Trucks



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

Non-High-Tech, Nontransportation Equipment



Real investment in transportation equipment decreased at an annual rate of 22½ percent in the second quarter, after an increase of 27½ percent in the first quarter. Fleet sales of new autos and light trucks stepped down to more-normal levels in the second quarter from the lofty pace of the first quarter and declined further in July. In contrast, sales of medium and heavy trucks increased in June and have remained at high levels throughout the first half of the year. The current elevated demand for medium and heavy trucks appears to stem from new Environmental Protection Agency regulations on truck engines that are scheduled to take effect in 2007. There is a large backlog of orders for these trucks, and new orders have fallen sharply in recent months as manufacturers have reached their capacity to deliver new trucks before the new regulations take effect. Domestic outlays on aircraft declined in the second quarter after their sizable increase in the first quarter.

Real spending on high-tech equipment and software declined at annual rate of 6 percent in the second quarter, after their extraordinary increase in the first quarter. This reversal was led by outlays on communications equipment, which fell at an annual rate of 28 percent in the second quarter after they soared at annual rate of 71 percent in the first quarter. A significant fraction of the swing in communications equipment spending between the first and second quarters likely reflects this year's mild winter, which permitted the outdoor installation of more capital in the first quarter than is possible under more typical seasonal conditions. In addition, spending to replace communication infrastructure damaged in the hurricanes last autumn probably began to unwind in the second quarter. Nevertheless, the level of spending on communications equipment was still relatively elevated in the second quarter, buoyed by outlays by telecommunications service providers on fiber-optic networks. In July, respondents to the *CIO Magazine* quarterly tech poll reported that they plan to increase spending on communications equipment over the next twelve months, an indication that outlays will remain elevated in the months ahead. Meanwhile, real computer spending increased at a tepid 6 percent annual rate in the second quarter; some purchases of computers and peripherals probably were postponed in anticipation of the release of several new hardware products. These products include faster and more energy-efficient servers and significantly enhanced dual-core processor chips. The growth of real software spending in the second quarter was weak as well, increasing at an annual rate of only 2½ percent.

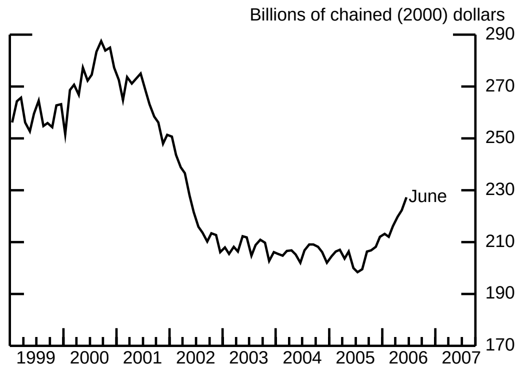
Real business spending on equipment outside of the high-tech and transportation categories has expanded erratically so far this year. Outlays in this broad investment

Nonresidential Construction and Indicators

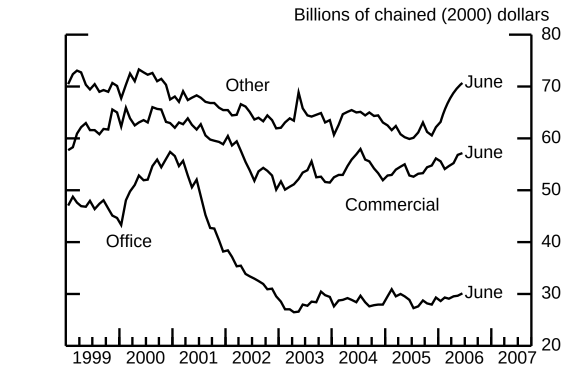
Real Construction

(All spending series are seasonally adjusted, annual rate; nominal CPIP deflated by BEA prices through Q1 and by staff projection thereafter)

Total Structures

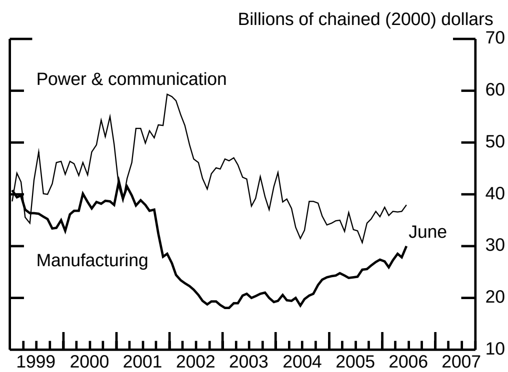


Office, Commercial, and Other

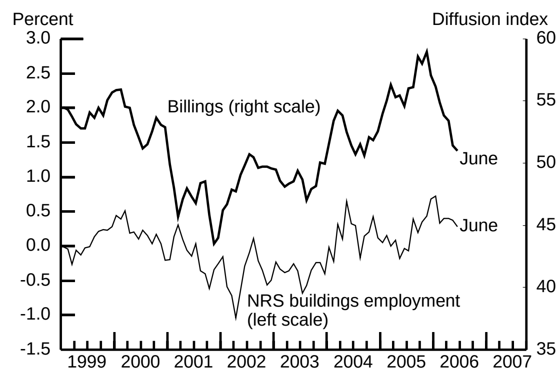


Note. Other includes religious, educational, lodging, amusement and recreation, transportation, and health-care facilities.

Manufacturing and Power & Communication

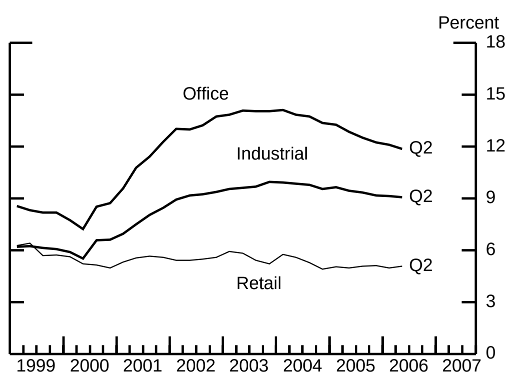


Architectural Billings and Nonresidential Buildings Employment



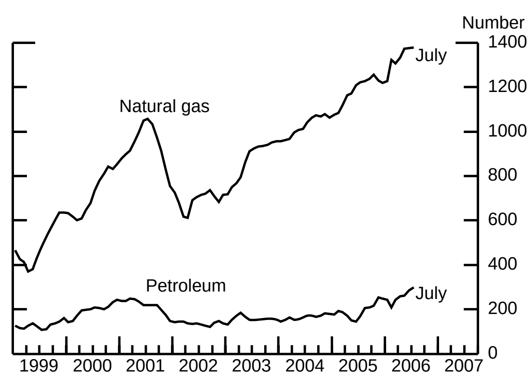
Note. Both series are 3-month moving averages.
Source. For billings, American Institute of Architects; for nonresidential buildings employment, Bureau of Labor Statistics.

Vacancy Rates



Source. For office and industrial, CoStar Property Professional; for retail, National Council of Real Estate Investment Fiduciaries.

Drilling Rigs in Operation



Note. July values are averages through July 28, 2006.
Source. DOE/Baker Hughes.

category expanded slowly in the first quarter before jumping at an annual rate of 13 percent in the second quarter; the gains in the second quarter were widespread throughout the category. The already elevated level of unfilled orders for equipment in this category, which moved up further in June, suggests that outlays will increase solidly in the coming months.

Nonresidential Construction

Outlays for the construction of nonresidential buildings have moved up at a solid pace so far this year, although activity remains well short of the level seen before the last recession. Spending on office construction has gained some traction as vacancy rates in this sector continue to trend downward. The commercial construction sector has, on balance, posted spending gains in recent months, and vacancy rates in this sector remain low by historical standards. Despite only small decreases in vacancy rates in the industrial sector, expenditures on manufacturing structures have strengthened considerably over the past two quarters. The "other" category of construction—which includes construction outlays on health-care, lodging, and educational structures—has registered strong growth recently.

Forward-looking indicators suggest that outlays for the construction of nonresidential buildings, excluding drilling and mining structures, will continue to rise over the next few quarters but possibly at a more moderate rate than that seen in the first half of the year. The three-month moving average of the architectural billings index—a diffusion index from the American Institute of Architects—has moved down considerably since its highs of last summer and now shows that the number of firms reporting decreases is about equal to the number reporting increases.[6] The level of the index is well correlated with nominal expenditure growth in the nonresidential construction sector and, as the index has a lead time of about two quarters, suggests a leveling-off near the end of the year. However, employment for the construction of nonresidential buildings has increased during the first six months of the year, a gain that may point to a more sustained pace of construction spending in the months ahead.

Outlays on drilling and mining structures have continued to climb in response to high projected energy prices. In the first half of 2006, real spending in this sector grew at an annual rate of 15 percent after increasing 14 percent over the four quarters of 2005. The number of rigs drilling for natural gas and petroleum has increased at a good clip in

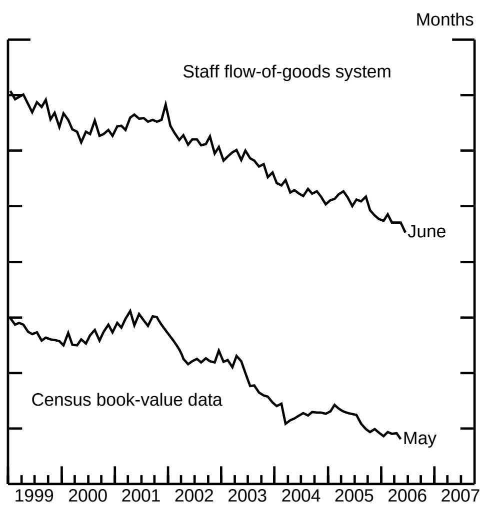
[6] The architectural billings index includes billings for both nonresidential and residential construction projects, but a large majority of these projects—about 88 percent—is nonresidential.

Nonfarm Inventory Investment
(Billions of dollars; seasonally adjusted annual rate)

Measure and sector	2005 Q4	2006 Q1	2006 Q2	2006 Apr.	2006 May	2006 June
Real inventory investment (chained 2000 dollars)						
Total nonfarm business	**38.6**	**36.8**	**57.5** e	**n.a.**	**n.a.**	**n.a.**
Motor vehicles	23.4	8.5	.0 e	n.a.	n.a.	n.a.
Nonfarm ex. motor vehicles	15.2	28.3	57.5 e	n.a.	n.a.	n.a.
Manufacturing and trade ex. wholesale and retail motor vehicles and parts	**16.9**	**22.7**	**n.a.**	**41.3** e	**52.5** e	**n.a.**
Manufacturing	.5	7.6	n.a.	26.6 e	9.0 e	n.a.
Wholesale trade ex. motor vehicles & parts	9.9	7.9	n.a.	17.5	24.4	n.a.
Retail trade ex. motor vehicles & parts	6.6	7.2	n.a.	-2.8	19.1	n.a.
Book-value inventory investment (current dollars)						
Manufacturing and trade ex. wholesale and retail motor vehicles and parts	**56.2**	**53.3**	**n.a.**	**100.9**	**113.7**	**n.a.**
Manufacturing	23.3	23.5	46.1	52.7	39.7	45.9
Wholesale trade ex. motor vehicles & parts	20.7	17.9	n.a.	42.2	43.9	n.a.
Retail trade ex. motor vehicles & parts	12.2	12.0	n.a.	5.9	30.0	n.a.

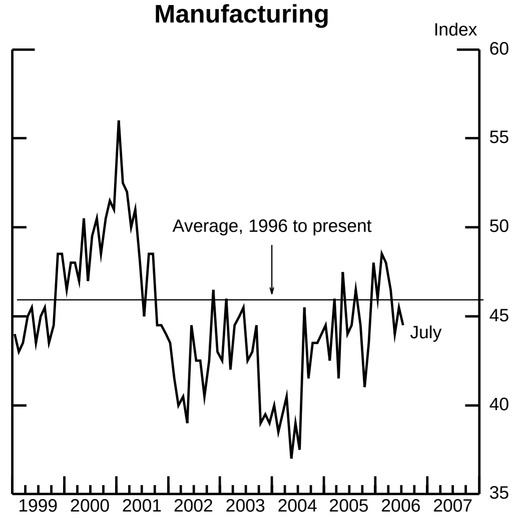
e Staff estimates of real inventory investment based on revised book-value data.
n.a. Not available.
Source. For real inventory investment, BEA. For book-value data, Census Bureau.

Inventory Ratios Ex. Motor Vehicles



Note. Flow-of-goods system covers total industry ex. motor vehicles and parts, and inventories are relative to consumption. Census data cover manufacturing and trade ex. motor vehicles and parts, and inventories are relative to sales.

ISM Customer Inventories: Manufacturing



Note. A number above 50 indicates inventories are "too high."

recent months, an indication that the sector is poised to continue its rapid pace of growth in the current quarter.

Business Inventories

On the basis of available data, we estimate that real nonfarm inventories apart from the motor vehicle sector increased at an annual rate of $58 billion in the second quarter, up slightly from a real increase of $28 billion in the first quarter.[7] The ratio of book-value inventories to sales in the manufacturing and trade sector—excluding motor vehicles—edged down in May after having remained relatively steady over the previous three months, and in June the manufacturing inventory-to-sales ratio ticked up. Data from the staff's flow-of-goods inventory system suggest that—excluding motor vehicles and parts—months' supply moved lower, on balance, during the first half of the year. Except for paper products, inventories appear to be well aligned with demand. Moreover, business surveys indicate that firms continue to view the level of their customers' inventories as being within a comfortable range.

Federal Government Sector

The federal budget deficit continued to improve as a result of robust growth in tax receipts. According to the Monthly Treasury Statement, the deficit over the twelve months ending in June, after routine adjustments for payment-timing shifts and financial transactions, was $262 billion, compared with an adjusted deficit of $335 billion over the preceding twelve months.

Tax receipts have been rising faster than nominal income. Total receipts in June were 13 percent above their year-earlier level. Individual income and social insurance tax receipts were 11 percent greater than they were last June, largely because of strong nonwithheld taxes that are mostly quarterly estimated payments on this year's individual tax liability. Corporate tax payments in June, which primarily reflect estimated quarterly payments of corporate tax liability for this year, were 18 percent above the year-earlier level. For July, the Daily Treasury Statements indicate that withheld individual and social insurance tax receipts were about 10 percent above their level of a year ago.

Outlays have also been increasing at a rate greater than nominal GDP growth but not as quickly as receipts. Federal outlays in June, adjusted for payment-timing shifts and

[7] This estimate of inventory accumulation in the second quarter is $9 billion higher than the advance estimate by the Bureau of Economic Analysis (BEA) for the quarter because it incorporates data for manufacturing inventories in June that were released after the BEA's estimate was calculated.

Federal Government Outlays and Receipts

(Unified basis; billions of dollars except as noted)

Function or source	June 2005	June 2006	June Percent change	12 months ending in June 2005	12 months ending in June 2006	12 months ending in June Percent change
Outlays	211.9	243.9	15.1	2418.8	2634.4	8.9
Financial transactions[1]	.1	.1	...	-.9	-1.1	...
Payment timing[2]	.0	15.0	...	1.3	14.7	...
Adjusted outlays	211.8	228.8	8.0	2418.4	2620.8	8.4
Receipts	234.8	264.4	12.6	2083.7	2358.9	13.2
Payment timing	.0	.0	...	.0	.0	...
Adjusted receipts	234.8	264.4	12.6	2083.7	2358.9	13.2
Surplus or deficit (-)	22.9	20.5	...	-335.1	-275.5	...
Selected components of adjusted outlays and receipts						
Adjusted outlays	211.8	228.8	8.0	2418.4	2620.8	8.4
Net interest	16.9	21.4	26.9	176.8	212.3	20.1
Non-interest	194.9	207.4	6.4	2241.6	2408.6	7.4
National defense	42.8	47.0	9.7	481.0	518.6	7.8
Social Security	47.8	50.7	6.1	516.1	546.1	5.8
Medicare	26.8	33.0	23.2	287.0	328.6	14.5
Medicaid	18.0	16.9	-6.0	180.2	178.9	-.7
Income security	22.0	22.5	2.5	343.0	352.0	2.7
Agriculture	.7	.5	...	26.4	31.8	20.7
Other	36.8	36.7	-.2	407.9	452.5	10.9
Adjusted receipts	234.8	264.4	12.6	2083.7	2358.9	13.2
Individual income and payroll taxes	163.7	181.8	11.0	1635.8	1808.7	10.6
Withheld + FICA	121.5	130.9	7.7	1461.5	1573.5	7.7
Nonwithheld + SECA	45.2	54.5	20.6	352.9	423.2	19.9
Less: Refunds	3.0	3.7	23.7	180.7	188.0	4.0
Corporate	56.5	67.3	19.1	246.9	331.6	34.3
Gross	57.7	68.2	18.1	276.8	359.3	29.8
Less: Refunds	1.3	.9	-28.2	29.9	27.6	-7.6
Other	14.6	15.4	5.2	201.0	218.6	8.7
Adjusted surplus or deficit (-)	23.0	35.6	...	-334.7	-261.9	...

Note. Components may not sum to totals because of rounding.

1. Financial transactions consist of deposit insurance, spectrum auctions, and sales of major assets.

2. A shift in payment timing occurs when the first of the month falls on a weekend or holiday, or when the first 3 days of a month are nonworking days. Outlays for defense, Social Security, Medicare, income security, and "other" have been adjusted to account for these shifts. In addition, defense outlays for retiree health care have been converted from an annual to a monthly basis.

... Not applicable.

Source. Monthly Treasury Statement.

financial transactions, were 8 percent above their year-earlier level. Net interest outlays were 27 percent higher; greater debt and higher interest rates, including larger inflation adjustments on Treasury inflation-protected securities, boosted debt service costs relative to those of a year ago. Non-interest outlays rose 6 percent from their level last June; the increase was led by spending for defense and particularly for Medicare, which includes payments for new Part D prescription drug benefits. In contrast to the sharp rise in Medicare outlays, Medicaid spending declined, in part because some of the outlays previously made on behalf of Medicaid beneficiaries are now included in Medicare Part D but also because overall Medicaid spending has been notably restrained during the past year. In addition, spending by the Federal Emergency Management Agency (FEMA) for disaster relief and flood insurance payments—included in the "other" outlays category—was only a bit above $1 billion in June, well below the $4½ billion monthly average since September.[8]

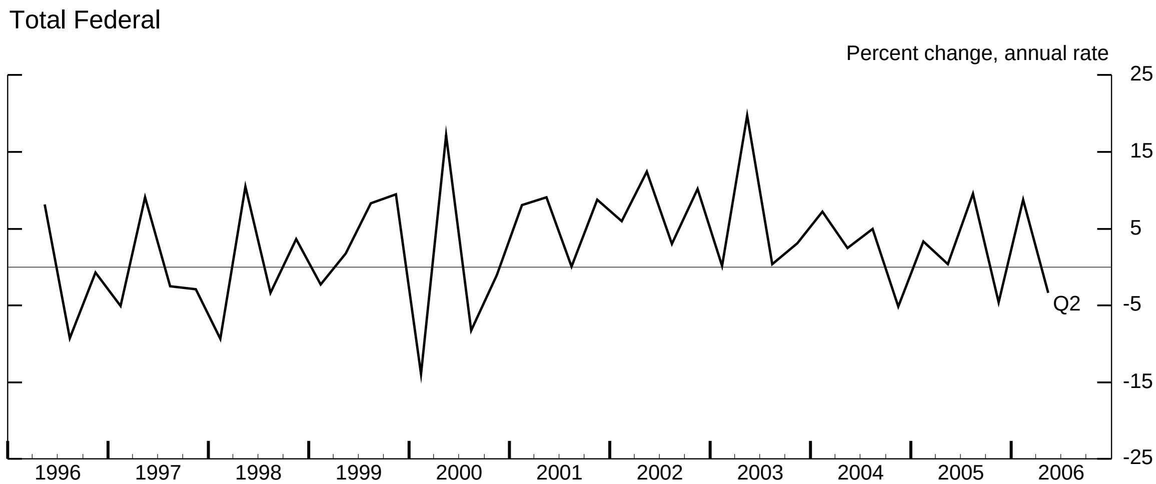
In the NIPA data, total real federal purchases declined at an annual rate of 3 percent in the second quarter. Real defense purchases were only slightly lower in the second quarter than in the first quarter. However, real nondefense purchases declined at an annual rate of 8 percent, primarily because of a step-down in the component of spending by FEMA for disaster relief that is included in NIPA federal purchases.

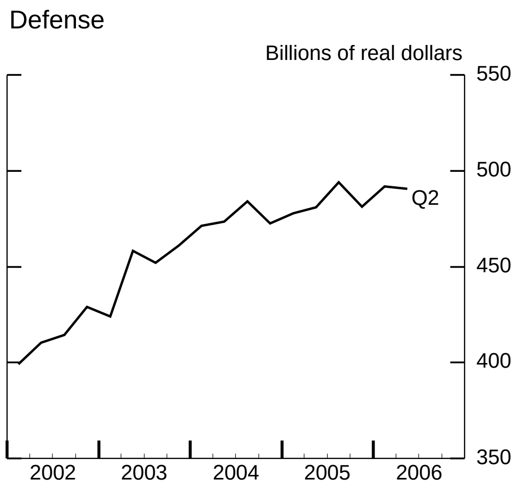
In July, the Office of Management and Budget (OMB) released its *Mid-Session Review* of the budget, which presented an improved outlook for federal deficits relative to the February budget projection. This improvement is primarily due to greater-than-expected individual and corporate tax receipts this spring and to the OMB's assumption that a sizable portion of the upward revision will persist in coming years. The OMB now projects the fiscal year 2006 deficit at $296 billion, or 2.3 percent of nominal GDP, down a little from last year's deficit. For fiscal 2007, the OMB projects that the deficit will increase to $339 billion, or 2.4 percent of GDP. Thereafter, the OMB projects that deficits will decline to $127 billion, or 0.7 percent of GDP, in fiscal 2011. The most significant policy development indicated in the *Mid-Session Review* is the Administration's plan to request $110 billion in funding for operations in Iraq and Afghanistan in fiscal 2007.

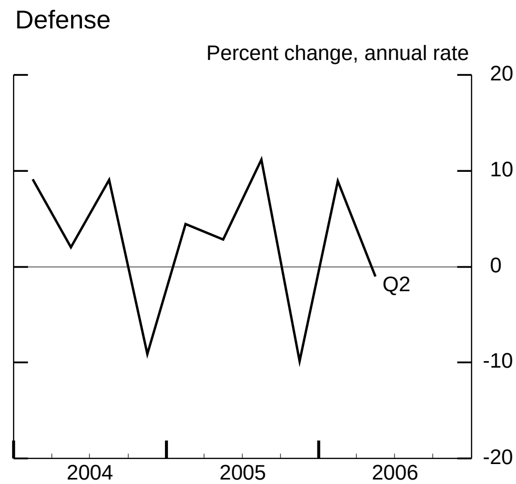
[8] Hurricane-related outlays by FEMA during the twelve months ending in June were about $30 billion higher than in the preceding twelve months.

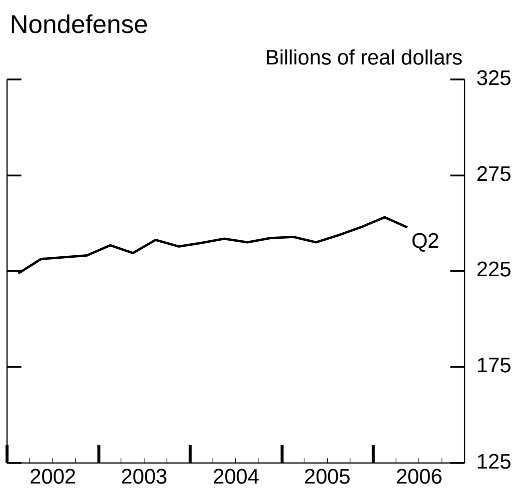
Federal Purchases in the National Income and Product Accounts

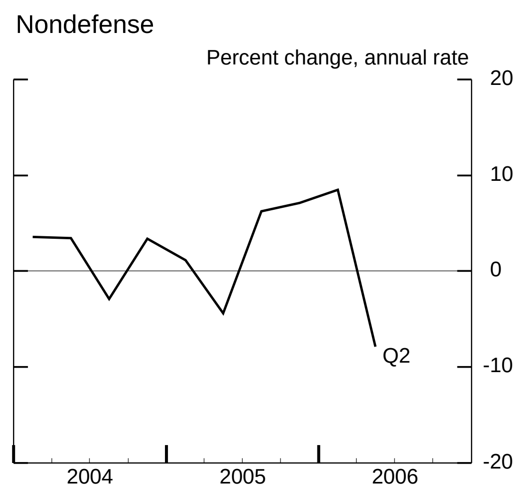
(Billions of real dollars)











State and Local Government Sector

On the basis of the available data, the staff estimates that real purchases by state and local governments increased at an annual rate of about 4½ percent in the second quarter, a notably faster pace than in the first quarter.[9] Construction spending shot up in June, and as a result we now estimate that real state and local construction outlays increased at an annual rate of 17 percent during the second quarter. State and local spending also was boosted by increases in employment averaging about 25,000 per month during the second quarter, somewhat above the average monthly pace seen during the previous two years. Most of the hiring continued to be done by local governments, but state governments contributed modestly to the increases in employment in the second quarter after several years of almost no growth.

As with the tax collections of the federal government, the growth of tax receipts by state and local governments has been robust and has helped improve the general fiscal position of the sector.[10] The Census Bureau's *Quarterly Summary of State and Local Government Tax Revenue* indicates that total revenues continued to increase at a rapid pace in the first quarter.[11] Personal and corporate tax revenues have soared over the past three quarters and have exceeded the high growth rates experienced in the late 1990s and in 2000.

Prices

Consumer price inflation has continued to move up, on balance, in recent months. The overall PCE price index rose at an annual rate of 3.9 percent during the first six months of the year, 1 percentage point faster than in the twelve months of last year. While rising energy prices have been a major source of the increase in overall consumer price inflation, the prices of core goods and services—particularly housing rents but also other core prices—have accelerated as well. Core PCE prices increased at an annual rate of 2.7 percent during the first half of this year, which is more than ½ percentage point higher than during 2005.

Although consumer energy prices declined 0.9 percent in June, PCE energy prices surged at an annual rate of about 25 percent over the first half of this year, up from the

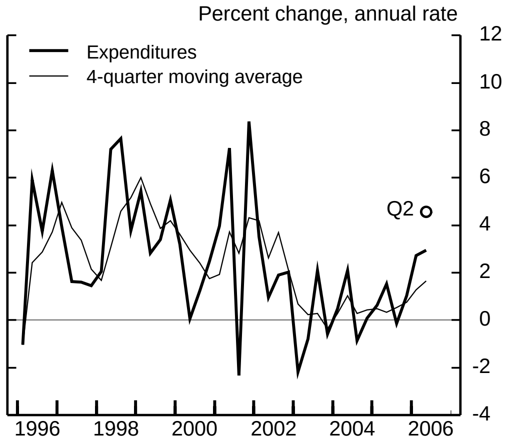
[9] The June data on state and local construction were released after the BEA's advance GDP estimate for the second quarter. We estimate that, after incorporating the June data, real state and local purchases grew 1.6 percentage points more than the BEA's advance second-quarter estimate.

[10] However, the BEA's annual revision revised down NIPA estimates of state and local net saving, suggesting that the sector's fiscal position in recent years was not as strong as it had appeared previously.

[11] The Census Bureau's revenue estimates corroborate data from other sources, such as the National Association of State Budget Officers and the Rockefeller Institute's *State Revenue Report*.

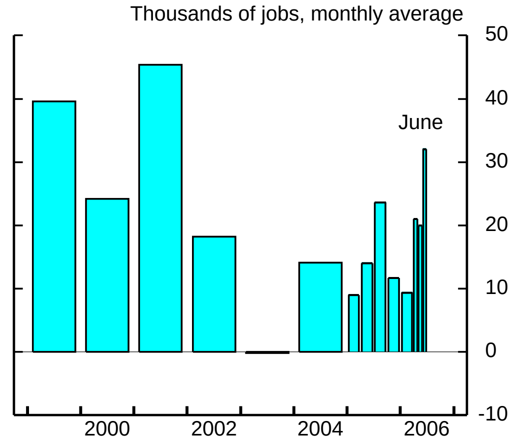
State and Local Indicators

Real Expenditures on Consumption and Investment

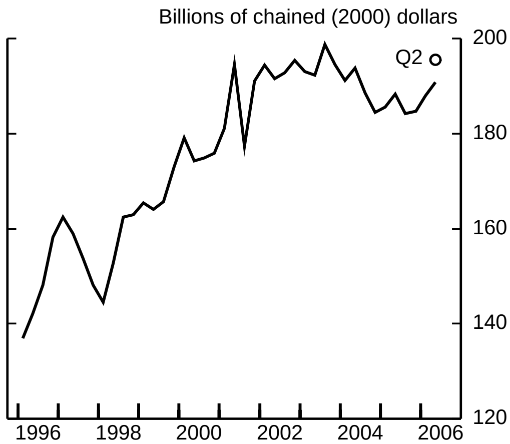


Note. Hollow circle is staff estimate of the expected revision to the published BEA estimate.

Net Change in Employment

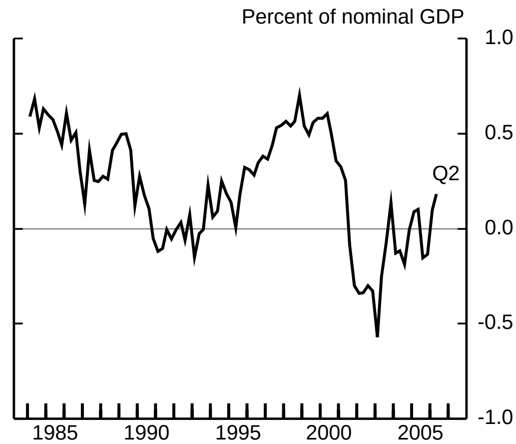


Real Structures



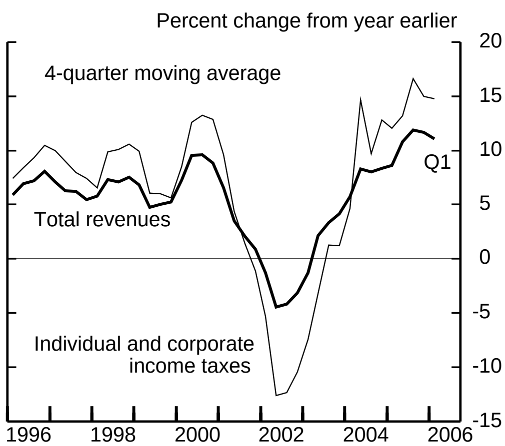
Note. Hollow circle is staff estimate of the expected revision to the published BEA estimate.

Net Saving



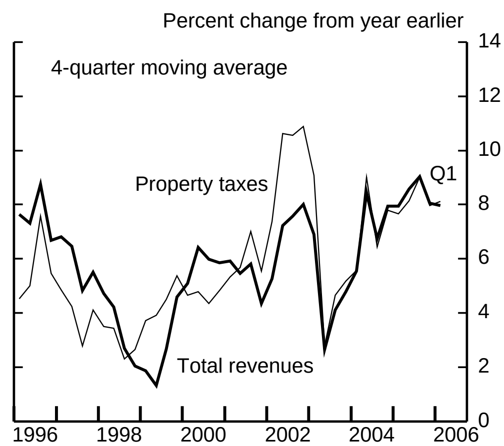
Note. 2006:Q2 is a staff estimate.

State Revenues



Source. Census Bureau.

Local Revenues



Source. Census Bureau.

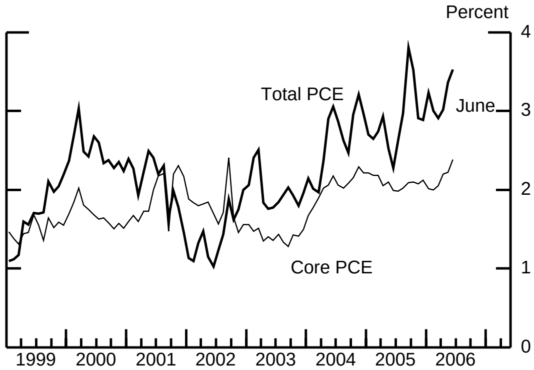
Price Measures
(Percent change)

Measures	12-month change		3-month change		1-month change	
			Annual rate		Monthly rate	
	June 2005	June 2006	Mar. 2006	June 2006	May 2006	June 2006
CPI						
Total	**2.5**	**4.3**	**4.3**	**5.1**	**.4**	**.2**
Food	2.2	2.2	2.5	1.7	.1	.3
Energy	7.3	23.3	21.8	23.8	2.4	-.9
Ex. food and energy	**2.0**	**2.6**	**2.8**	**3.6**	**.3**	**.3**
Core goods	.4	.5	1.4	.9	.1	.1
Core services	2.7	3.5	3.4	4.5	.4	.4
Chained CPI (n.s.a.) [1]	2.3	3.7	...	...	...	...
Ex. food and energy [1]	1.9	2.4	...	...	...	...
PCE prices						
Total	**2.3**	**3.5**	**3.7**	**4.1**	**.4**	**.2**
Food	2.0	2.3	2.7	2.3	.2	.3
Energy	7.3	24.2	23.4	27.6	2.6	-.9
Ex. food and energy	**2.0**	**2.4**	**2.5**	**2.8**	**.2**	**.2**
Core goods	-.2	.0	.8	.1	.0	-.1
Core services	2.9	3.4	3.3	4.0	.3	.4
Core market-based	1.7	2.0	2.1	2.6	.2	.2
Core non-market-based	3.4	4.3	4.6	4.0	.2	.4
PPI						
Total finished goods	**3.7**	**4.9**	**-2.2**	**6.7**	**.2**	**.5**
Food	.3	.6	-8.6	4.5	-.5	1.4
Energy	13.2	19.1	-11.4	22.3	.4	.7
Ex. food and energy	**2.4**	**1.9**	**3.9**	**2.3**	**.3**	**.2**
Core consumer goods	2.4	1.9	4.4	1.9	.2	.2
Capital equipment	2.2	1.8	3.1	3.0	.3	.3
Intermediate materials	6.2	9.3	2.3	11.1	1.1	.7
Ex. food and energy	4.9	7.3	5.7	9.8	1.1	.8
Crude materials	2.5	8.6	-38.2	5.7	2.0	-1.7
Ex. food and energy	7.1	33.2	15.2	63.1	6.2	1.7

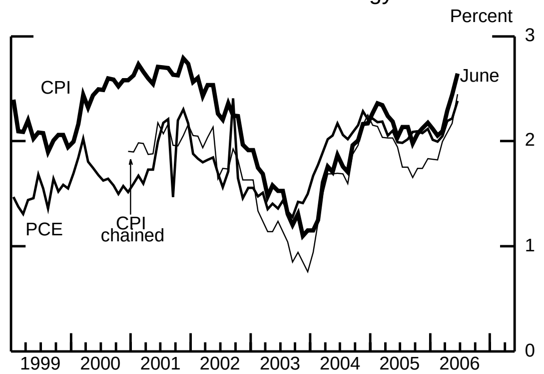
1. Higher-frequency figures are not applicable for data that are not seasonally adjusted.
... Not applicable.

Consumer Prices
(12-month change except as noted)

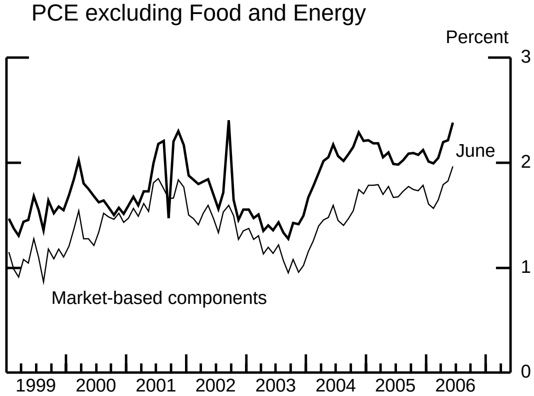
PCE Prices



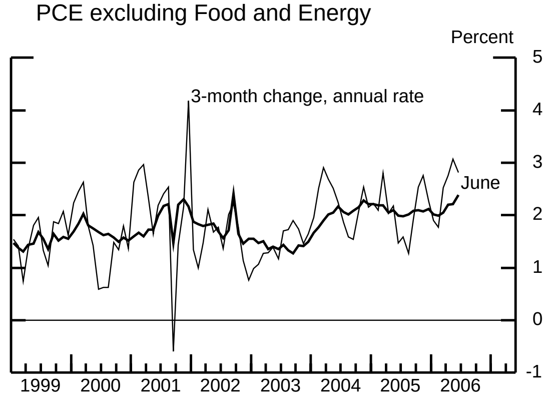
CPI and PCE ex. Food and Energy



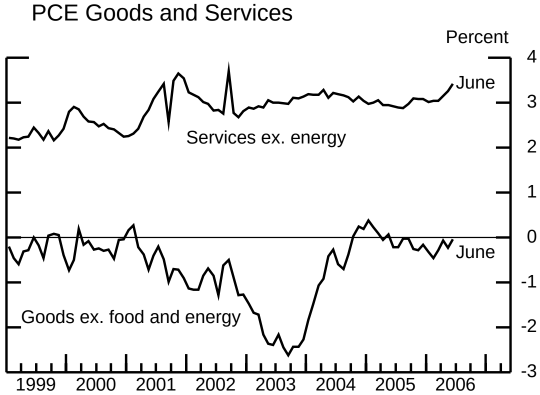
PCE excluding Food and Energy



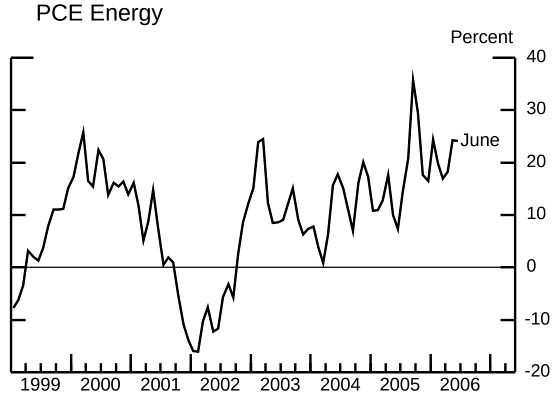
PCE excluding Food and Energy



PCE Goods and Services



PCE Energy



17 percent increase posted in 2005. Furthermore, the downturn in energy prices in June was transitory: Spot prices for crude oil moved back up during July to a level near the peak for the year; weekly survey data on gasoline point to an increase of about 5 percent in July in the PCE price index for gasoline, a rise that would more than reverse the decline in June. Although most of the recent increase in gasoline prices reflected the higher cost of crude oil, the margin between retail gasoline prices and crude prices has moved up somewhat from an already high level despite a 35 percent decline since late June in the price of ethanol used for reformulated gasoline.[12] The unusually wide margin for gasoline has persisted even though gasoline inventories currently stand near the upper end of their seasonal range. This relatively high level of gasoline inventories may reflect some precautionary demand by wholesalers concerned that the hurricane season this year could significantly disrupt gasoline production as it did last year.

Prices for natural gas turned up in July after falling sharply in the first half of the year. Abundant supplies caused natural gas prices to plummet earlier this year, and the steep decline had more than offset the huge run-up in these prices that followed the hurricanes last autumn. However, the heat wave experienced by much of the country in July boosted the use of natural gas to generate electricity for cooling, and natural gas prices have moved up considerably in the past few weeks. Despite the recent surge in demand, however, inventories of natural gas still remain near the high end of their historical range for the season.

Consumer food prices rose 0.3 percent in June, a somewhat larger increase than those recorded since January. The increase in food prices primarily reflected a surge in the volatile price index for fresh fruits and a rebound in prices for poultry and eggs. Although the demand for crops and livestock seems to have been fairly robust, ample supplies held down price increases for these commodities. Current estimates by the U.S. Department of Agriculture (USDA) indicate that output of meats and poultry will expand more than 3 percent this year, and crop ratings indicate that corn and soybean crops are currently in good shape. In contrast, the USDA estimates that the wheat harvest this year will probably be about 15 percent less than in 2005 because of poor growing conditions. However, the small share of wheat in the overall cost of producing cereal and bakery products should limit the upward pressure on consumer food prices.

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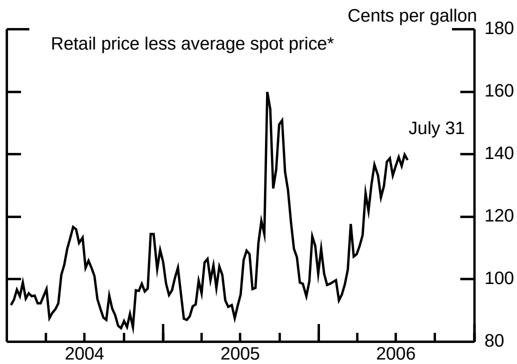
[12] Reformulated gasoline, which is required in many urban areas, contains about 10 percent ethanol. While the price of ethanol has declined, the price of reformulated gasoline remains about 15 cents per gallon more than the price of conventional gasoline because transport and blending costs are higher for gasoline-ethanol mixes than for conventional gasoline.

Energy Prices and Inventories

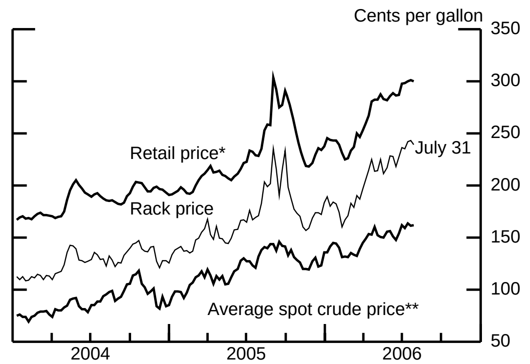
(Data from Energy Information Administration except as noted)

Total Gasoline Margin



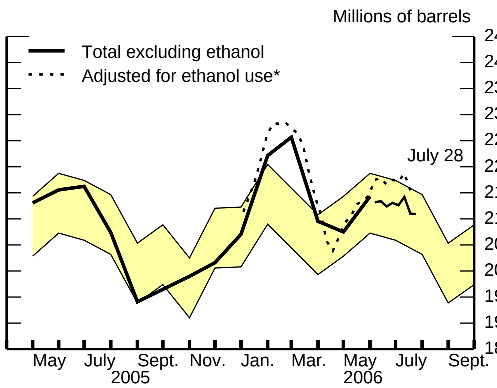
* Regular grade seasonally adjusted by FRB staff, less average spot crude price: 60% WTI, 40% Maya heavy crude.

Gasoline Price Decomposition



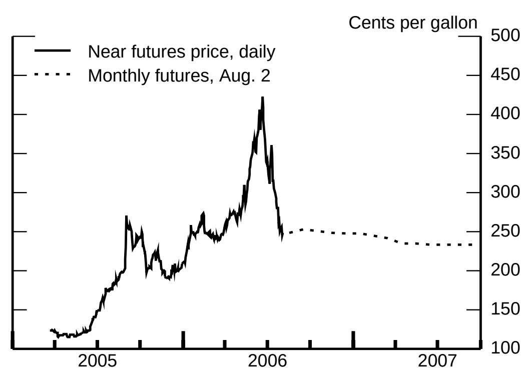
* Regular grade seasonally adjusted by FRB staff.
** 60% WTI, 40% Maya heavy crude.

Gasoline Inventories



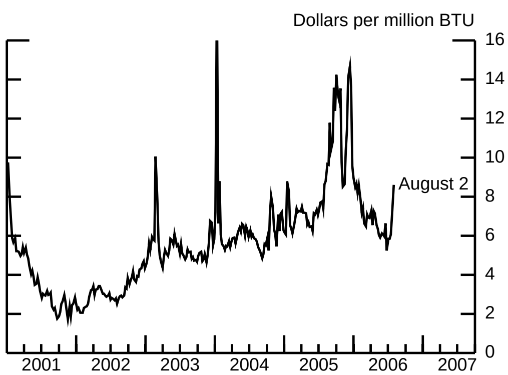
Note. Shaded region is average historical range as calculated by DOE. Weekly data as of June 2006.
* Inventories of RBOB gasoline augmented to reflect fuel ethanol to be blended; estimated by FRB staff.

Ethanol Prices



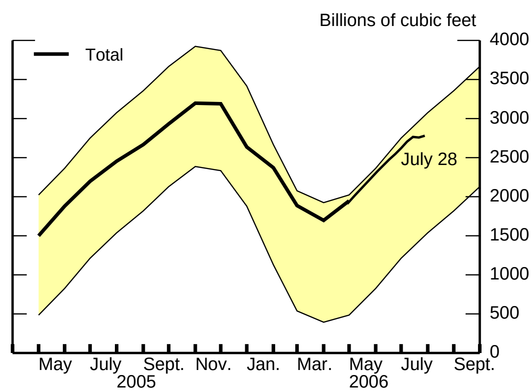
Source. Chicago Board of Trade.

Natural Gas Prices



Note. National average spot price.
Source. Bloomberg.

Natural Gas Inventories



Note. Shaded region is historical range for 2000 to 2004 as calculated by FRB staff. Weekly data as of May 2006.

Excluding food and energy, core consumer prices accelerated in the first half of this year. Some of the recent pickup in core PCE price inflation came from core goods prices, which advanced at an annual rate of about ½ percent over the first six months of this year after edging down in 2005. Core service prices also contributed importantly to the upturn in core PCE price inflation, mostly because of hefty increases in prices of housing services—both tenant-occupied and particularly owner-occupied—over recent months.[13] Price increases for core consumer services excluding housing rents have picked up only a little since last year; these prices rose at an annual rate of 3.3 percent in the first six months of this year after increasing 3.2 percent in 2005.

It is difficult to estimate how much the pass-through of higher petroleum prices has contributed to the recent acceleration in core consumer price inflation. Input costs are undoubtedly higher for many businesses, and higher energy prices have clearly boosted producer prices for energy-intensive intermediate goods and services, such as industrial chemicals, gypsum, concrete, fertilizers, and transportation. In core consumer prices, increases in the prices of transportation services, for which energy costs constitute a relatively large share of total input costs, have been particularly sharp. More broadly, energy costs contribute to the overall cost of a wide range of goods and services, making it difficult to identify the specific contribution of energy to price inflation.

Most broad measures of price inflation also picked up over the past year. In the four quarters ending last quarter, GDP prices accelerated ½ percentage point from the year-earlier pace. Excluding food and energy items, GDP prices have increased about 3 percent over the past four quarters, an acceleration of about ¼ percentage point relative to the year-earlier pace.

After rising notably in April and May, survey-based measures of inflation expectations reversed much of their rise in June and July. According to the Michigan Survey Research Center's final reading for July, median inflation expectations for the coming year moved down 0.1 percentage point, to 3.2 percent, which is about ¾ percentage point below its recent peak in May.[14] Median five- to ten-year inflation expectations were 2.9 percent in

[13] The increase in the measure of owners' equivalent rent in June remained well above its pace earlier in the year, but it was below the very large increase recorded in May. In addition, measures of rents for both tenant-occupied and owner-occupied dwellings advanced at comparable rates in June. In contrast, housing rents in predominantly owner-occupied neighborhoods had been increasing faster than rents in other areas during April and May.

[14] However, the Michigan survey's final reading in July was 0.1 percentage point higher than its preliminary reading.

Broad Measures of Inflation
(Percent change, Q2 to Q2)

Measure	2003	2004	2005	2006
Product prices				
GDP price index	2.1	2.9	2.8	3.3
Less food and energy	1.9	2.6	2.9	3.1
Nonfarm business chain price index	1.2	2.3	3.0	3.3
Expenditure prices				
Gross domestic purchases price index	2.1	3.1	3.2	3.6
Less food and energy	1.8	2.6	2.8	2.8
PCE price index	1.8	2.8	2.6	3.3
Less food and energy	1.4	2.1	2.0	2.3
PCE price index, market-based components	1.7	2.4	2.4	3.2
Less food and energy	1.2	1.5	1.7	1.9
CPI	2.2	2.8	3.0	4.0
Less food and energy	1.5	1.8	2.1	2.5
Chained CPI	1.9	2.7	2.6	3.4
Less food and energy	1.2	1.7	2.0	2.2
Median CPI	2.3	2.3	2.3	3.0
Trimmed mean CPI	1.9	2.1	2.2	2.7
Trimmed mean PCE	1.7	2.3	2.2	2.6

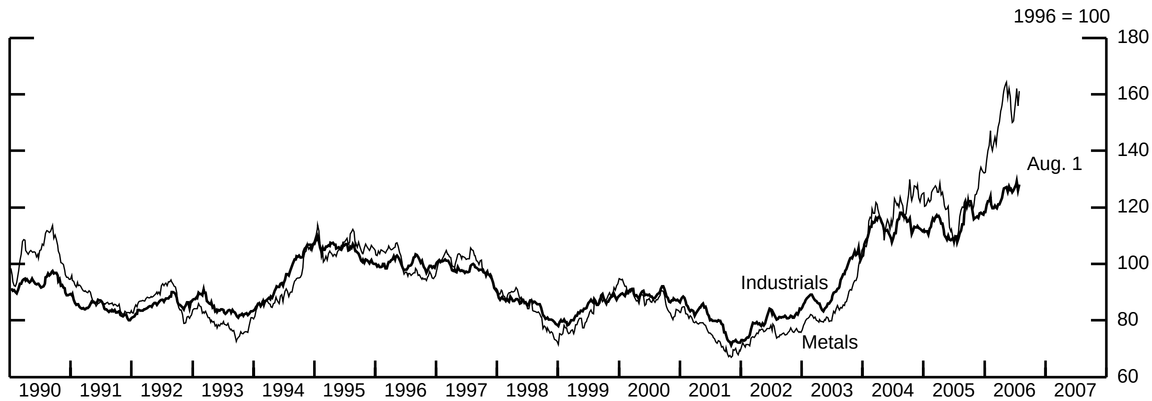
Surveys of Inflation Expectations
(Percent)

Period	Actual CPI inflation[1]	University of Michigan: 1 year[2] Mean	University of Michigan: 1 year[2] Median	University of Michigan: 5 to 10 years[3] Mean	University of Michigan: 5 to 10 years[3] Median	Professional forecasters (10 years)[4]
2004: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
2006:Q1	3.6	3.7	3.0	3.3	2.9	2.5
Q2	4.0	4.5	3.5	3.6	3.1	2.5
Mar.	3.4	3.8	3.0	3.3	2.9	2.5
Apr.	3.5	4.4	3.3	3.6	3.1	...
May	4.2	4.7	4.0	3.8	3.2	...
June	4.3	4.4	3.3	3.4	2.9	2.5
July	n.a.	3.8	3.2	3.2	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.

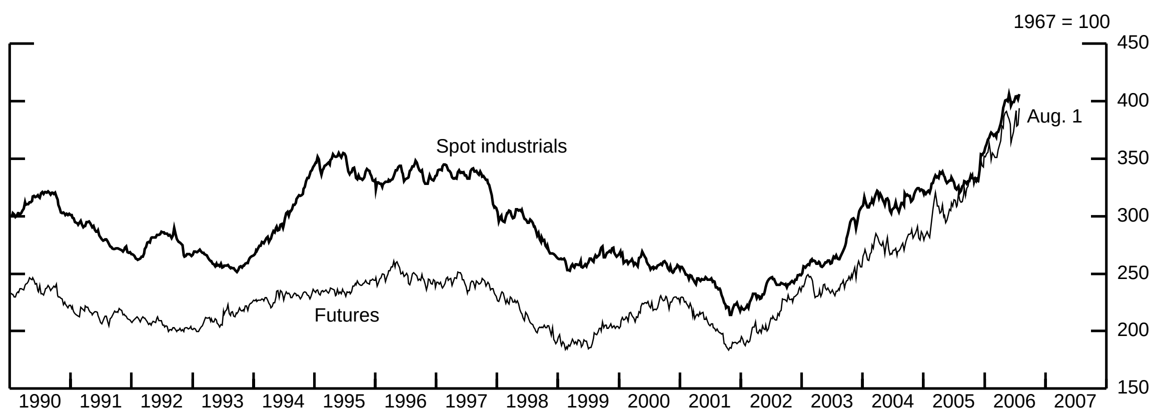
Commodity Price Indexes

Journal of Commerce



Note. The *Journal of Commerce* (JOC) industrial price index is based almost entirely on industrial commodities, with a small weight given to energy commodities. Copyright for *Journal of Commerce* data is held by CIBCR, 1994.

Commodity Research Bureau



Note. The Commodity Research Bureau (CRB) spot industrials index consists entirely of industrial commodities, excluding energy. The CRB futures index gives about a 60 percent weight to food commodities and splits the remaining weight roughly equally among energy commodities, industrial commodities, and precious metals.

Selected Commodity Price Indexes
(Percent change)

Index	2005[1]	12/27/05 to 6/20/06[2]	6/20/06[2] to 8/1/06	52-week change to 8/1/06
JOC industrials	5.3	6.8	2.3	17.6
JOC metals	5.8	13.5	7.3	44.7
CRB spot industrials	10.1	12.3	1.9	24.7
CRB spot foodstuffs	-6.1	6.6	2.0	3.6
CRB futures	20.6	7.5	6.8	23.1

1. From the last week of the preceding year to the last week of the year indicated.
2. June 20, 2006, is the Tuesday preceding publication of the June Greenbook.

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

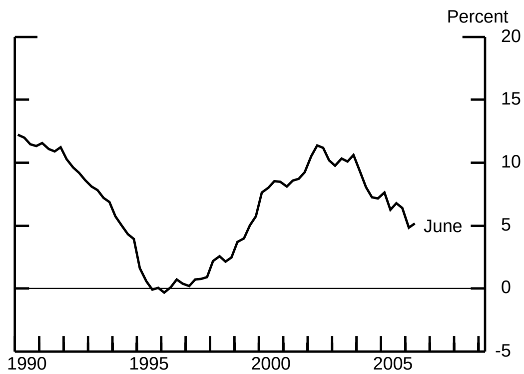
Measure	2005 June	2005 Sept.	2005 Dec.	2006 Mar.	2006 June
	Quarterly change (compound annual rate)[1]				
Total hourly compensation	**2.5**	**2.9**	**2.8**	**2.4**	**3.2**
Wages and salaries	2.1	2.5	2.8	2.8	3.6
Benefits	3.3	3.3	3.3	1.6	2.8
	12-month change				
Total hourly compensation	**3.1**	**2.9**	**2.9**	**2.6**	**2.8**
Wages and salaries	2.5	2.3	2.5	2.4	2.8
Benefits	4.7	4.5	4.0	3.0	2.7

1. Seasonally adjusted by the Bureau of Labor Statistics.

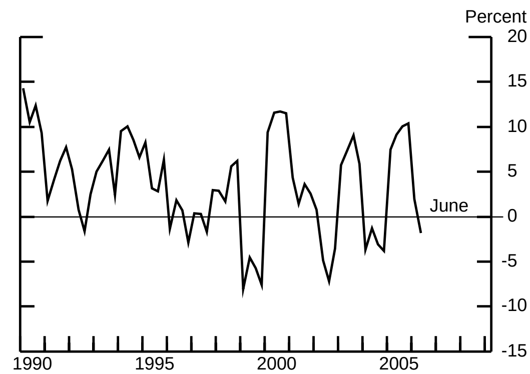
ECI Benefits (confidential)

(Private-industry workers; 12-month change)

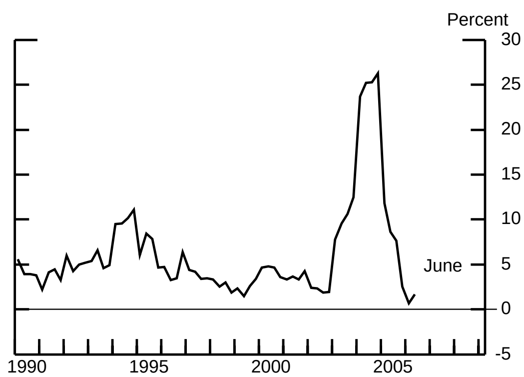
Health Insurance



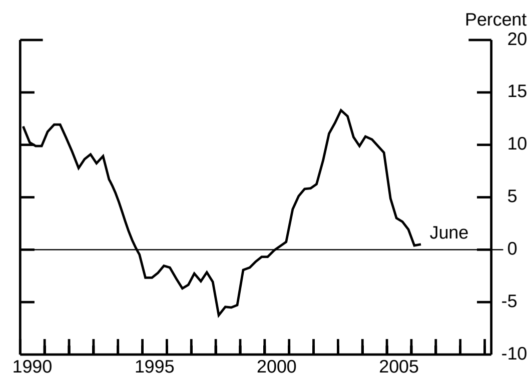
Nonproduction Bonuses



Retirement and Savings



Workers' Compensation Insurance



July, down ¼ percentage point from the rate recorded in May. The upswing through May, as well as the subsequent decline in these measures of expectations, is broadly consistent with the large, energy-related swings in top-line inflation so far this year. By comparison, as of August 2, inflation compensation implied by the rate spreads between nominal and CPI-indexed Treasury bonds was a bit above 2½ percent for both five- and ten-year maturities, roughly the same as at the times of the May and June Greenbooks.

At earlier stages of processing, the producer price index (PPI) for core intermediate materials rose 0.8 percent in June after having moved up 1.1 percent in the preceding month. Over the six months ending in June, core intermediate materials prices rose at an annual rate of 7¾ percent, compared with an increase of 4¾ percent in 2005. Energy prices undoubtedly account for a substantial part of these increases in core intermediate materials prices, but rising import prices, higher domestic rates of capacity utilization, and strong global demand for many of these materials have probably also contributed to the acceleration in prices of core intermediate materials.

The PPI for core crude materials rose at an annual rate of 37 percent in the first half of this year, compared with an increase of 5¼ percent in 2005. Since the PPI pricing date in mid-June, commodity prices have moved up a bit further. Most notably, prices for industrial metals have continued to rise in recent weeks, with the *Journal of Commerce* (JOC) metals index up 7 percent since the time of the June Greenbook. Among the broad commodity indexes, the JOC industrial index, which includes a substantial energy component, and the Commodity Research Bureau spot industrials index, which excludes energy items, have both increased about 2 percent since the time of the June Greenbook.

Labor Costs

Over the three months ending in June, the employment cost index (ECI) for hourly compensation of private industry workers rose at an annual rate of 3.2 percent, a pickup of 0.8 percentage point from the gain reported in the preceding three-month period. However, the twelve-month change in the ECI was 2.8 percent in June, about ¼ percentage point less than the increase over the preceding twelve months.

The wages and salaries component of the ECI rose 2.8 percent during the twelve months ending in June, ¼ percentage point more than the increase over the year-earlier period. In contrast, benefit costs rose 2.7 percent during the twelve months ending in June, a slowdown of about 2 percentage points since the previous year. Much of the slowdown in benefit costs reflects a substantially smaller increase in firms’ contributions to

Hourly Compensation and Unit Labor Costs

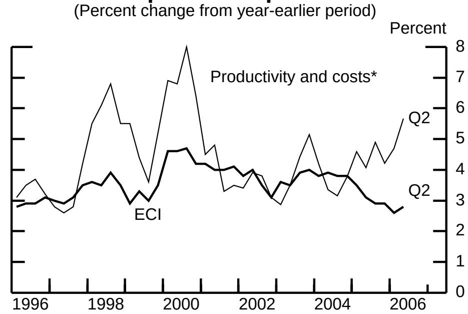
(Percent change from preceding period at compound annual rate; based on seasonally adjusted data)

Category	2004:Q2 to 2005:Q2	2005:Q2 to 2006:Q2	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2
Compensation per hour							
Nonfarm business	4.1	5.7	1.6	8.0	2.9	6.4	5.4
Unit labor costs							
Nonfarm business	2.3	3.1	-.8	3.4	3.0	2.3	3.6

Note. Staff estimates. Output and compensation are derived from the annual revision to the national income and product accounts. However, output and compensation for the second quarter of 2006 and hours for the fourth quarter of 2005 and the first and second quarters of 2006 are staff estimates. Before the fourth quarter of 2005, the level of hours is published data.

Compensation per Hour

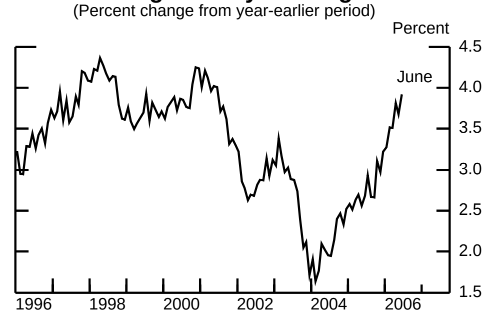
(Percent change from year-earlier period)



* Values after 2002 are staff estimates.

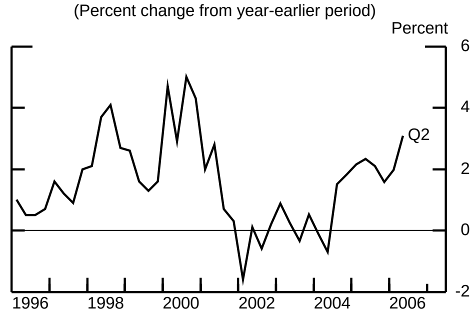
Average Hourly Earnings

(Percent change from year-earlier period)



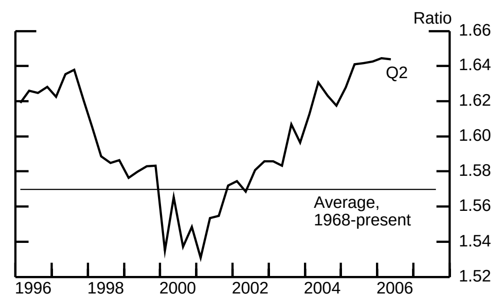
Unit Labor Costs

(Percent change from year-earlier period)



Note. Values after 2002 are staff estimates.

Markup, Nonfarm Business



Note. The markup is the ratio of output price to unit labor costs. Values after 2002 are staff estimates.

retirement and saving programs and a decline in nonproduction bonuses. In addition, increases in employer costs for health insurance slowed to 5.2 percent over the twelve months ending in June from 6.3 percent during the previous year.

Using the most recent NIPA data, the staff estimates that compensation per hour in the nonfarm business sector rose at annual rates of about 5½ percent in the second quarter and 5¾ percent over the past four quarters. This four-quarter change is up considerably from the revised gain of 4 percent posted in the preceding year. Unit labor costs are estimated to have moved up at an annual rate of about 3½ percent in the second quarter, a bit faster than the 3 percent increase posted over the past year.

Appendix

Annual Revision of the National Income and Product Accounts

The annual revision of the national income and product accounts (NIPA), released on July 28, affected data back to the beginning of 2003. Although this year's revision mainly reflected the incorporation by the Bureau of Economic Analysis (BEA) of more-comprehensive source data, including data from tax records and economic surveys, the BEA also introduced three noteworthy methodological changes. First, the BEA began using the Board's industrial production index for computers as an input for constructing estimates of computer investment in the years after the latest available Annual Survey of Manufacturers (ASM), which is currently for 2004. This adjustment was intended to address the large downward revisions to computer investment that occurred in the current and last several annual revisions. Second, the BEA now includes hospitals and nursing homes among the categories in PCE services that use the Quarterly Services Survey as source data. Finally, the BEA began estimating the value of new light trucks using data from J.D. Power and Associates on actual transaction prices.

On a four-quarter-change basis, the growth rate of real GDP was revised down 0.3 percentage point in 2003, 0.4 percentage point in 2004, and 0.1 percentage point in 2005. Personal consumption expenditures (PCE) were revised down slightly, on average, but the largest downward revisions were to investment outlays for equipment and software and to government expenditures. The downward revisions to spending on equipment and software were the result of updated information from the ASMs for 2003 and 2004 and were concentrated in spending on computers and peripheral equipment. The downward revisions to real government spending reflected updates from various data sources and affected both federal and state and local expenditures. Partially offsetting these downward revisions were small upward revisions to residential investment and the arithmetic contribution of net exports to real GDP growth.

The BEA also revised its price indexes. The average change in the GDP price index was revised up 0.2 percentage point per year from the fourth quarter of 2002 to the fourth quarter of 2005. Core PCE inflation was revised up 0.1 percentage point in 2003, was unchanged in 2004, and was revised up 0.1 percentage point in 2005. Core market-based PCE inflation was unchanged in 2003 and 2004 and was revised up 0.1 percentage point in 2005. In 2003, the upward revision to core PCE inflation was the result of changes in nonmarket prices (specifically, health insurance). In 2005, revisions to both core indexes primarily reflected new estimates of prices of hospital and nursing home services that resulted from incorporating revisions to the producer price indexes for these components.

On the income side of the accounts, the growth rate of gross domestic income from the fourth quarter of 2002 to the first quarter of 2006 was revised down, on average, by approximately the same amount as was the average growth rate of GDP. As a result, in the first quarter of 2006, the statistical discrepancy was little changed. The growth rate of real disposable personal income was revised up slightly, on average, over the same period, in part because of upward revisions to dividend income. Furthermore, personal outlays were revised down—largely because of downward revisions to PCE—and thus the personal saving rate was revised up 0.4 percentage point in the first quarter of this year. Corporate economic profits were revised down, on average, over the three-year period of the revision, although the contour of rising profits over this period was maintained. The downward revisions to profits were due primarily to larger estimates of economic depreciation.

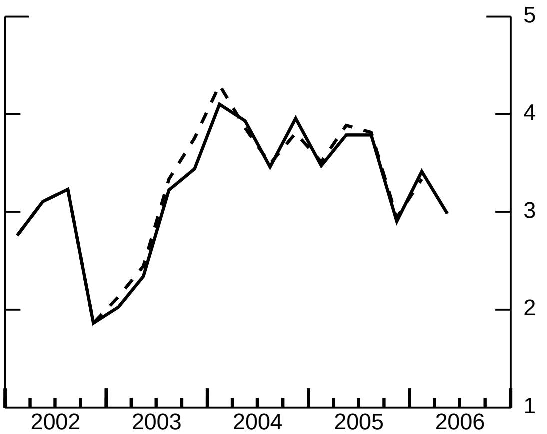
The annual revision also provided information about the magnitude of upcoming revisions to measures of productivity and compensation per hour in the nonfarm business sector. We estimate that the four-quarter change in real output per hour will be revised down 0.4 percentage point in 2003 and 0.7 percentage point in 2004 and will be revised up 0.1 percentage point in 2005. In addition, we estimate that the change in compensation per hour from the fourth quarter of 2002 to the fourth quarter of 2005 will be little changed, on average, but that the pattern of growth will be much smoother. Most notably, we estimate that, instead of a sharp deceleration in compensation per hour from 2004 to 2005, the revised data will show compensation per hour increasing at about 4 percent in both years.[1] Together, these revisions also imply a smoother pattern of growth in unit labor costs in 2004 and 2005, with revised estimates showing increases of about 1-¾ percent in both years.

[1] Expected revisions to the 2004 and 2005 four-quarter growth rates of compensation per hour stem largely from revisions to the BEA's estimates of wages and salaries, which derive in turn from a change in the BEA's seasonal adjustment procedures to take into account the number of Fridays—the most popular payday—in a quarter. For example, the presence of fourteen Fridays in the fourth quarter of 2004 meant that wages and salaries were likely boosted by the higher-than-typical number of paydays in the quarter. By taking this source of increase into account, the BEA reduced the seasonally adjusted increase in compensation per hour in that quarter, lowering the 2004 four-quarter change and raising the four-quarter change in 2005.

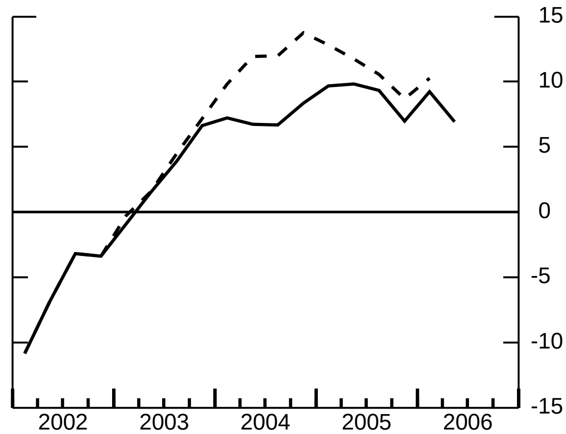
Annual Revision to the National Income and Product Accounts
(4-quarter percent change)

Real GDP

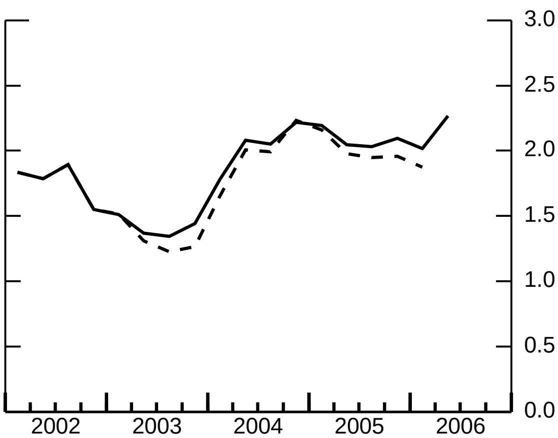
Real Personal Consumption Expenditures



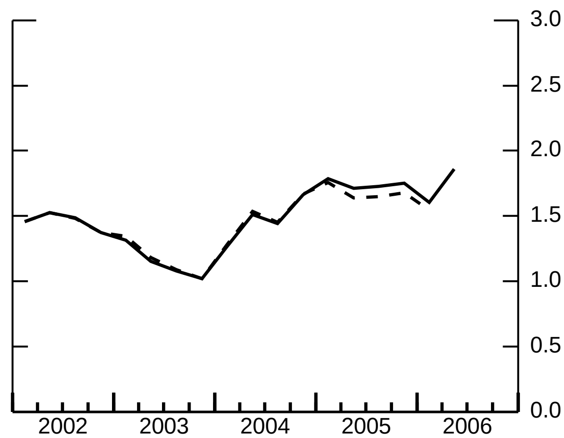
Real Equipment and Software



Core PCE Prices

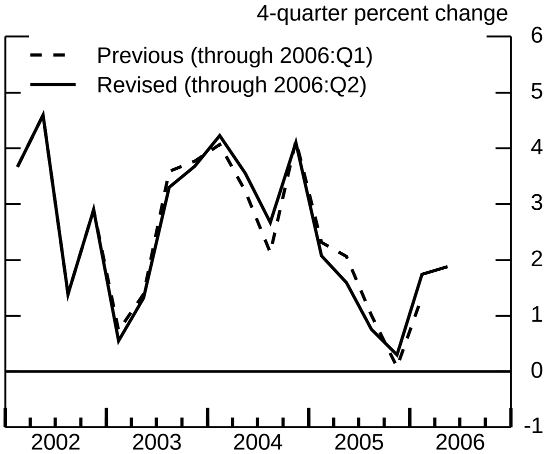


Market-Based Core PCE Prices

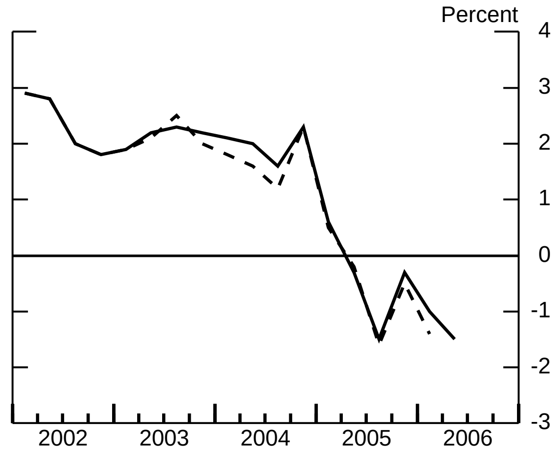


Annual Revision to the National Income and Product Accounts

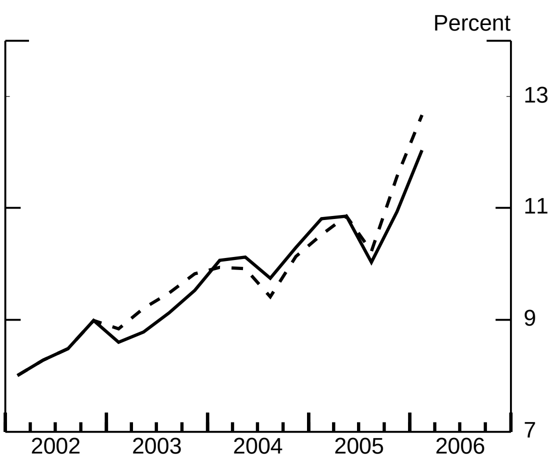
Real DPI



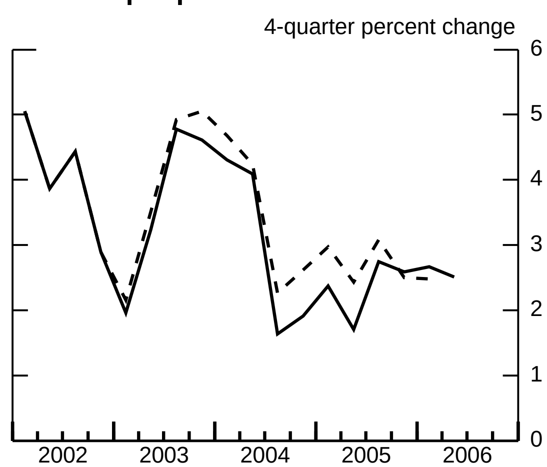
Personal Saving Rate



Profits as a Share of GNP

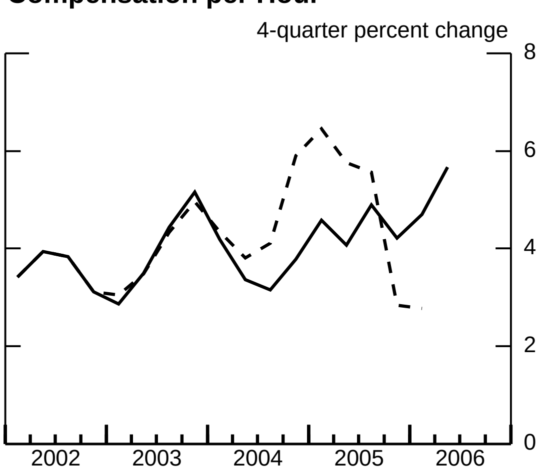


NFB Output per Hour



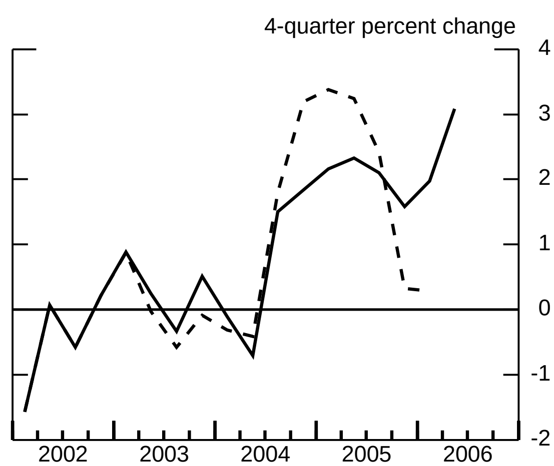
Note. Staff estimates.

Compensation per Hour



Note. Staff estimates.

Unit Labor Costs



Note. Staff estimates.

Domestic Financial Developments

III-T-1

Selected Financial Market Quotations

(One-day quotes in percent except as noted)

Instrument	2004 June 28	2005 Dec. 30	2006 June 28	2006 Aug. 2	Change to Aug. 2 from selected dates (percentage points) 2004 June 28	2005 Dec. 30	2006 June 28
Short-term							
FOMC intended federal funds rate	1.00	4.25	5.00	5.25	4.25	1.00	.25
Treasury bills[1]							
3-month	1.36	3.99	4.88	4.97	3.61	.98	.09
6-month	1.74	4.22	5.10	4.98	3.24	.76	-.12
Commercial paper (A1/P1 rates)[2]							
1-month	1.28	4.23	5.26	5.32	4.04	1.09	.06
3-month	1.45	4.37	5.37	5.35	3.90	.98	-.02
Large negotiable CDs[1]							
3-month	1.53	4.49	5.47	5.44	3.91	.95	-.03
6-month	1.82	4.65	5.58	5.50	3.68	.85	-.08
Eurodollar deposits[3]							
1-month	1.29	4.36	5.34	5.38	4.09	1.02	.04
3-month	1.51	4.52	5.48	5.45	3.94	.93	-.03
Bank prime rate	4.00	7.25	8.00	8.25	4.25	1.00	.25
Intermediate- and long-term							
U.S. Treasury[4]							
2-year	2.88	4.43	5.32	4.98	2.10	.55	-.34
5-year	3.97	4.35	5.20	4.86	.89	.51	-.34
10-year	4.90	4.47	5.32	5.02	.12	.55	-.30
U.S. Treasury indexed notes							
5-year	1.56	2.03	2.60	2.28	.72	.25	-.32
10-year	2.25	2.10	2.68	2.39	.14	.29	-.29
Municipal general obligations (Bond Buyer)[5]	5.01	4.38	4.68	4.55	-.46	.17	-.13
Private instruments							
10-year swap	5.21	4.92	5.80	5.55	.34	.63	-.25
10-year FNMA[6]	5.30	4.82	5.55	5.37	.07	.55	-.18
10-year AA[7]	5.59	5.25	6.19	5.91	.32	.66	-.28
10-year BBB[7]	6.18	5.84	6.76	6.47	.29	.63	-.29
5-year high yield[7]	8.30	8.28	8.81	8.62	.32	.34	-.19
Home mortgages (FHLMC survey rate)[8]							
30-year fixed	6.21	6.21	6.78	6.72	.51	.51	-.06
1-year adjustable	4.19	5.16	5.82	5.78	1.59	.62	-.04

Stock exchange index	Record high Level	Record high Date	2005 Dec. 30	2006 June 28	2006 Aug. 2	Change to Aug. 2 from selected dates (percent) Record high	2005 Dec. 30	2006 June 28
Dow Jones Industrial	11,723	1-14-00	10,718	10,974	11,200	-4.46	4.50	2.06
S&P 500 Composite	1,527	3-24-00	1,248	1,246	1,279	-16.30	2.42	2.61
Nasdaq	5,049	3-10-00	2,205	2,112	2,079	-58.82	-5.74	-1.56
Russell 2000	782	5-5-06	673	688	697	-1.87	3.50	1.27
Wilshire 5000	14,752	3-24-00	12,518	12,554	12,793	-13.27	2.20	1.91

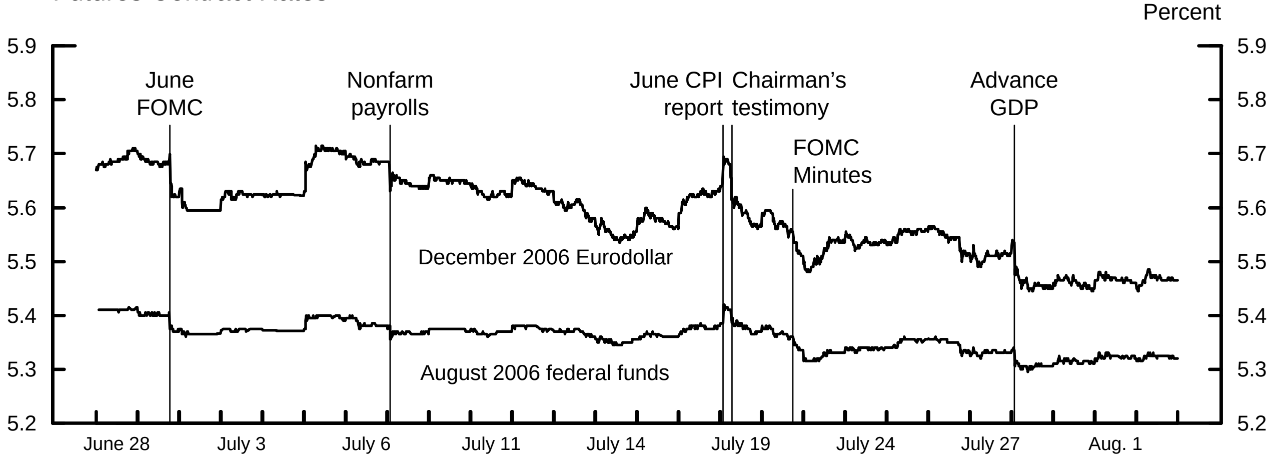
1. Secondary market.
2. Financial commercial paper.
3. Bid rates for Eurodollar deposits collected around 9:30 a.m. eastern time.
4. Derived from a smoothed Treasury yield curve estimated using off-the-run securities.
5. Most recent Thursday quote.
6. Constant-maturity yields estimated from Fannie Mae domestic noncallable coupon securities.
7. Derived from smoothed corporate yield curves estimated using Merrill Lynch bond data.
8. Home-mortgage rates for August 2, 2006, are for the week ending July 27, 2006.

NOTES:

June 28, 2004, is the day before the most recent policy tightening began.
June 28, 2006, is the day before the most recent FOMC announcement.

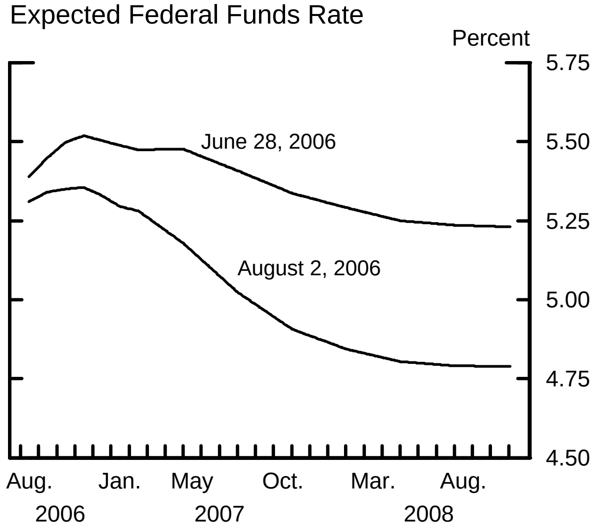
Policy Expectations and Treasury Yields

Futures Contract Rates



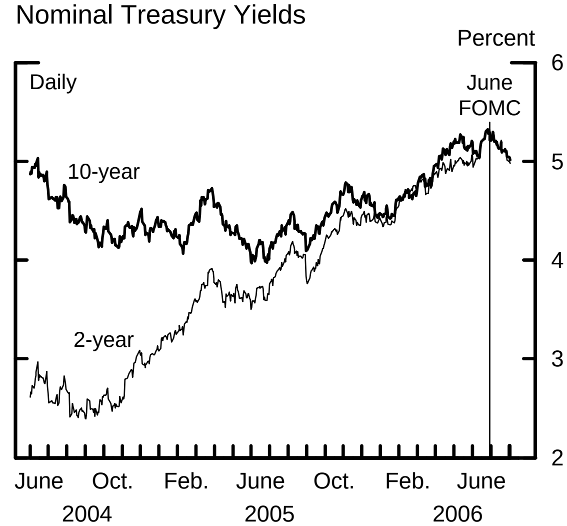
Note. 5-minute intervals.

Expected Federal Funds Rate



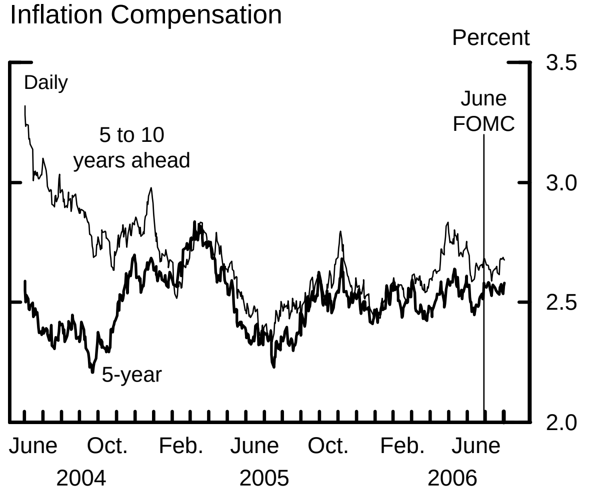
Note. Estimates from federal funds and Eurodollar futures, with an allowance for term premia and other adjustments.

Nominal Treasury Yields



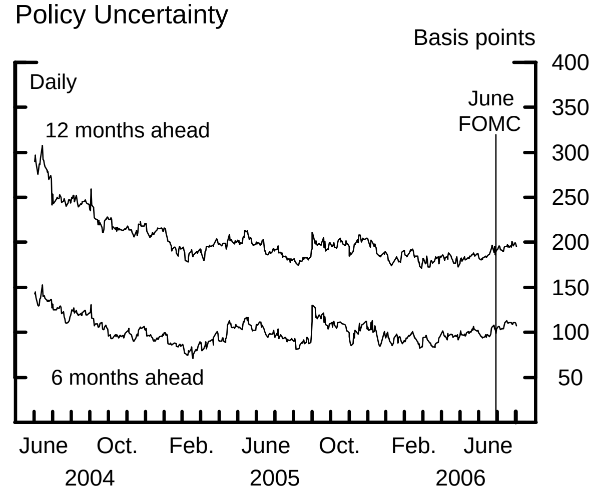
Note. Estimates from smoothed Treasury yield curve based on off-the-run securities.

Inflation Compensation



Note. Estimates based on smoothed nominal and inflation-indexed Treasury yield curves and adjusted for the indexation-lag effect.

Policy Uncertainty



Note. Width of a 90 percent confidence interval for the federal funds rate computed from the term structures for both the expected federal funds rate and implied volatility.

Domestic Financial Developments

Overview

The expected path of the federal funds rate shifted down over the intermeeting period. Market participants apparently interpreted FOMC communications, some softer-than-expected economic readings, heightened geopolitical tensions, and higher oil prices as portending a more appreciable moderation in economic growth. Nominal Treasury yields dropped in line with the decline in policy expectations. Inflation-indexed yields fell by amounts similar to their nominal counterparts, despite somewhat higher-than-expected readings on consumer prices, so that inflation compensation implied by Treasury yields was little changed over the intermeeting period. Equity prices moved up slightly, buoyed by greater prospects for a near-term end to policy tightening. Spreads for speculative-grade corporate bonds inched higher, but corporate bond spreads generally remained low, as indicators of near-term corporate credit quality continued to be favorable. Recent data suggest that household financial conditions have also remained solid.

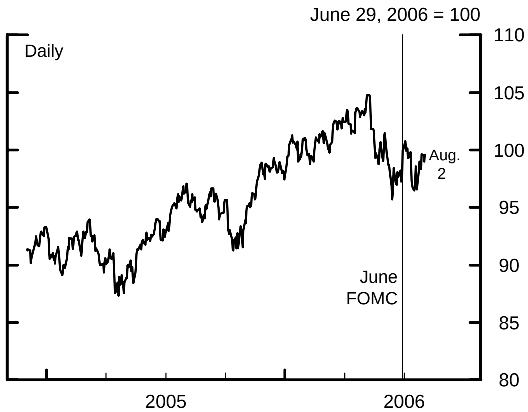
Policy Expectations and Interest Rates

The decision at the June FOMC meeting to increase the target federal funds rate 25 basis points was largely anticipated by market participants. However, the accompanying statement stressing the dependence of policy decisions on incoming economic data and the release of the June meeting minutes—which noted that the Committee saw inflation as likely to edge lower—reportedly led market participants to revise down their expectations for the path of monetary policy. The Chairman’s monetary policy testimony prompted a further downward revision, as investors reportedly focused on references to “moderation” in economic growth, lags in the effects of previous policy actions, and the dependence of future policy decisions on incoming data. The odds of a quarter-point rate hike at the August FOMC meeting fell, on net, from nearly 70 percent to about 30 percent over the intermeeting period. The Desk’s survey indicates that primary dealers see closer to even odds of a hike in August. The expected level of the nominal federal funds rate at the end of this year shifted down about 15 basis points and moved down even more further out. Policy uncertainty, as inferred from Eurodollar-implied volatilities, moved up slightly over the intermeeting period but remained low by historical standards.

On net, two- and ten-year nominal Treasury yields declined 34 and 30 basis points, respectively, over the intermeeting period. (Relative to the June Greenbook, Treasury yields fell less—25 and 21 basis points, respectively.) Despite the higher-than-expected June CPI data, yields on Treasury inflation-protected securities moved about in line with those on their nominal counterparts, leaving inflation compensation little changed. The short- and long-term measures of inflation expectations from the Michigan survey—

Corporate Yields, Risk Spreads, and Stock Prices

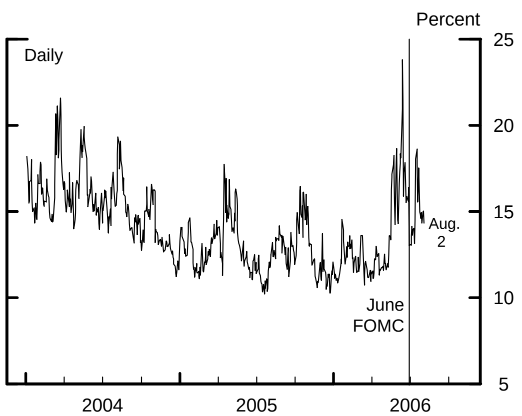
Wilshire 5000



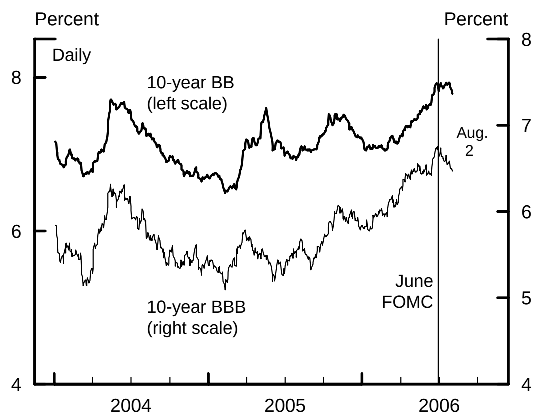
Trend Earnings-Price Ratio for S&P 500 and
Long-Run Treasury Yield

* Yield on synthetic Treasury perpetuity minus Philadelphia Fed 10-year expected inflation.
+ Denotes the latest observation using daily interest rates and stock prices and latest earnings data from I/B/E/S.

Implied Volatility on S&P 500 (VIX)

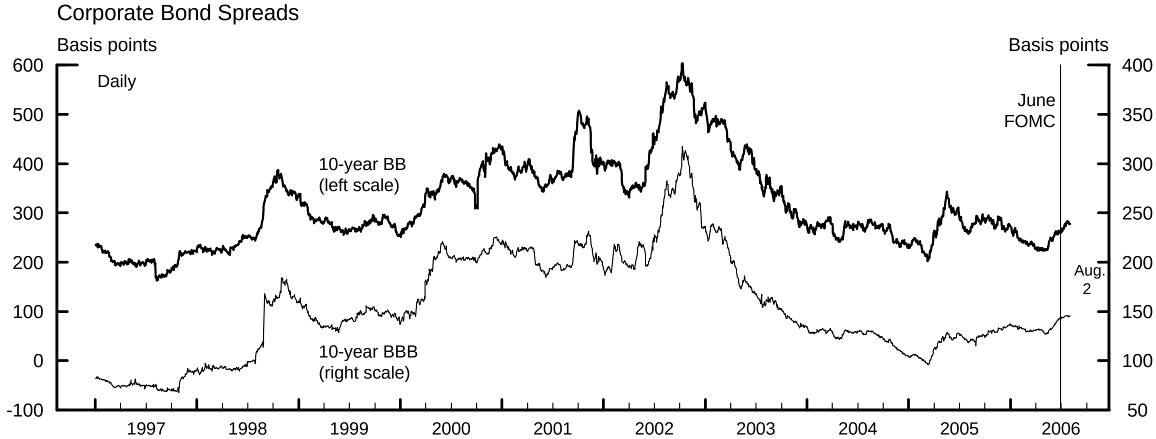


Corporate Bond Yields



Note. Yields from smoothed yield curves based on Merrill Lynch bond data.

Corporate Bond Spreads



Note. Measured relative to comparable-maturity Treasuries.

while little changed from their June values—were down significantly from the May readings.

Stock Prices and Corporate Interest Rates

Over the intermeeting period, heightened geopolitical tensions and the associated rise in oil prices appeared to weigh on equity markets. However, these effects were countered by investor reaction to FOMC communications, particularly the June FOMC statement and the Chairman's congressional testimony, which were taken as suggesting reduced odds of further monetary policy tightening. Despite some notable negative earnings surprises that induced sizable stock price declines for a handful of prominent firms, second-quarter earnings reports were not accompanied by much in the way of negative guidance, and, on balance, were about a wash for the stock market. Broad equity market indexes rose about 2 to 3 percent, on net, over the intermeeting period.

The equity risk premium—measured by the spread between the twelve-month forward trend earnings-price ratio for S&P 500 firms and a real long-run Treasury yield—widened slightly but remained near 3 percentage points. Implied volatility on the S&P 500 declined slightly, on net, over the intermeeting period, but remained above the extraordinarily low average levels of the past year.

Yields on investment-grade corporate bonds generally fell in line with Treasury rates over the intermeeting period, implying little change in their spreads. Yields on speculative-grade bonds fell by less, leaving their spreads over comparable-maturity Treasury rates a bit higher but still relatively low by historical standards. Risk spreads on commercial paper, measured by the difference between yields on thirty-day A2/P2 paper and A1/P1 paper, remained low.

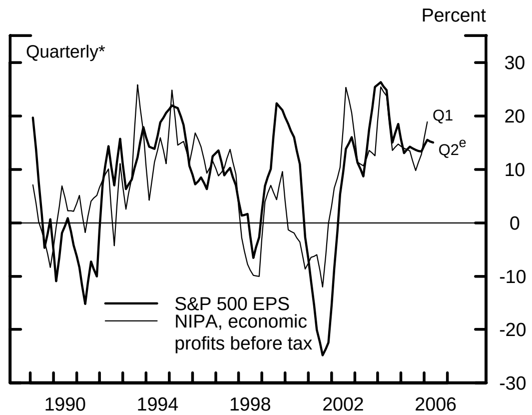
Corporate Earnings and Credit Quality

With about three quarters of S&P 500 firms having reported to date, second-quarter earnings per share are estimated to have increased about 15 percent from a year earlier, a pace similar to that of the past several quarters. While the energy sector again logged the largest gains, four-quarter gains continued to be spread among all major sectors. Through mid-July, analysts' revisions to forecasted year-ahead earnings for the S&P 500 companies were offsetting, leaving the year-ahead revisions index near zero.

Overall, the credit quality of nonfinancial firms remained solid. Boosted by continued robust earnings, balance sheet liquidity has stayed high, while corporate leverage has

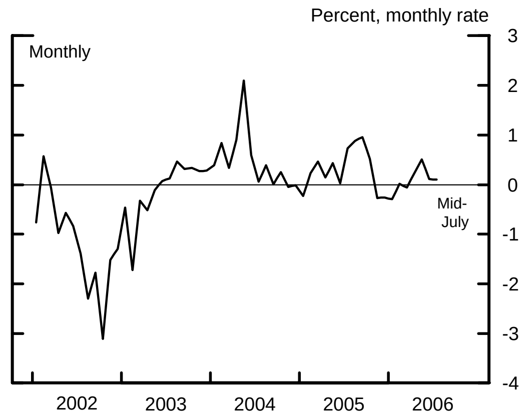
Corporate Earnings and Credit Quality

Corporate Earnings Growth



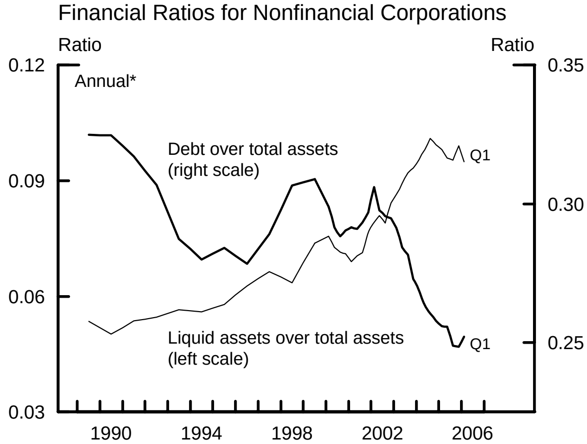
* Change from four quarters earlier.
e Staff estimate.
Source. I/B/E/S for S&P 500 EPS.

S&P 500 EPS Revisions Index



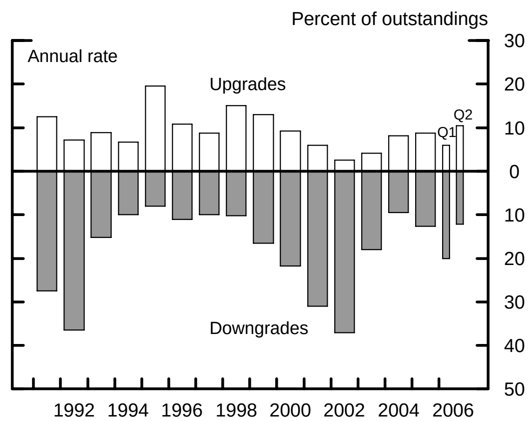
Note. Index is a weighted average of the percent change in the consensus forecasts of current-year and following-year EPS for constant sample.

Financial Ratios for Nonfinancial Corporations



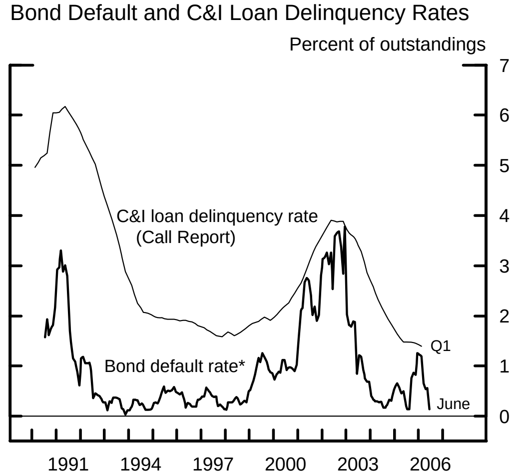
Note. Compustat data.
* Data are quarterly starting in 2000:Q1.

Bond Ratings Changes of Nonfinancial Companies



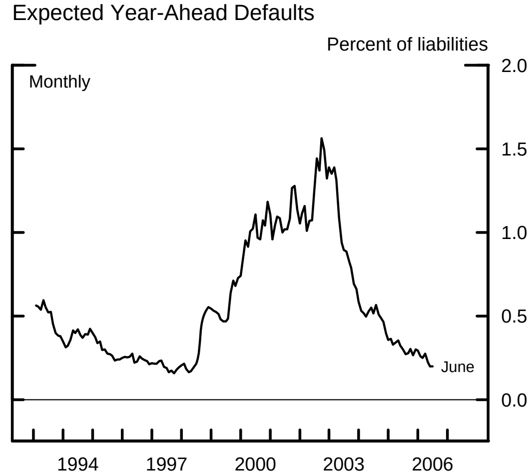
Source. Calculated with data from Moody's Investors Service.

Bond Default and C&I Loan Delinquency Rates



* 6-month moving average, from Moody's Investors Service.

Expected Year-Ahead Defaults



Note. Firm-level estimates of default weighted by firm liabilities as a percent of total liabilities, excluding defaulted firms.
Source. Moody's KMV.

Business Finance

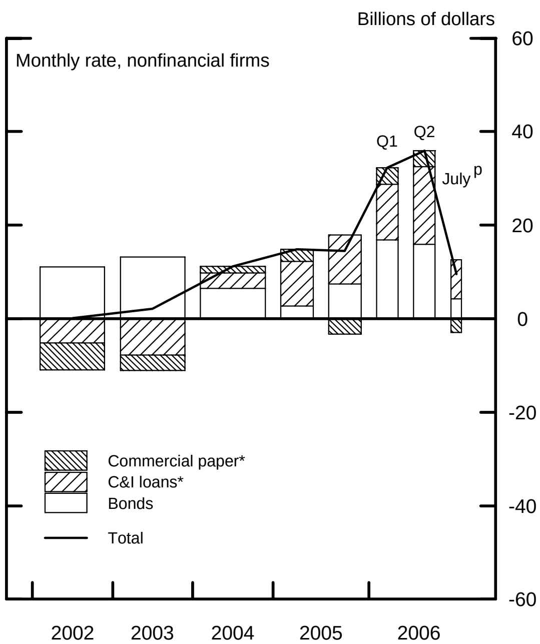
Gross Issuance of Securities by U.S. Corporations

(Billions of dollars; monthly rates, not seasonally adjusted)

Type of security	2002	2003	2004	2005 H1	2005 H2	2006 Q1	2006 Q2	2006 June	2006 July p
Nonfinancial corporations									
Stocks[1]	5.2	3.7	5.4	3.8	5.3	5.6	4.9	5.3	1.9
Initial public offerings	.7	.4	1.6	1.6	1.8	1.7	2.1	1.9	.4
Seasoned offerings	4.4	3.3	3.8	2.1	3.5	3.9	2.7	3.5	1.6
Bonds[2]	24.8	31.6	22.8	18.1	20.3	29.1	29.6	28.6	11.6
Investment grade	15.7	16.0	8.3	7.9	9.0	15.7	13.3	10.1	6.1
Speculative grade	4.8	11.3	9.5	6.2	6.5	6.8	9.7	14.4	4.6
Other (sold abroad/unrated)	4.2	4.3	4.9	4.0	4.8	6.6	6.6	4.1	1.0
Memo									
Net issuance of commercial paper[3]	-5.7	-3.4	1.5	2.6	-3.4	3.5	3.3	10.3	-3.0
Change in C&I loans at commercial banks[3,4]	-5.2	-7.7	3.3	9.5	10.5	11.9	16.7	20.1	8.3
Financial corporations									
Stocks[1]	4.0	6.6	6.9	5.3	4.8	3.6	5.1	4.6	4.9
Bonds[2]	87.0	111.1	139.4	167.3	185.7	180.1	194.6	237.0	54.3

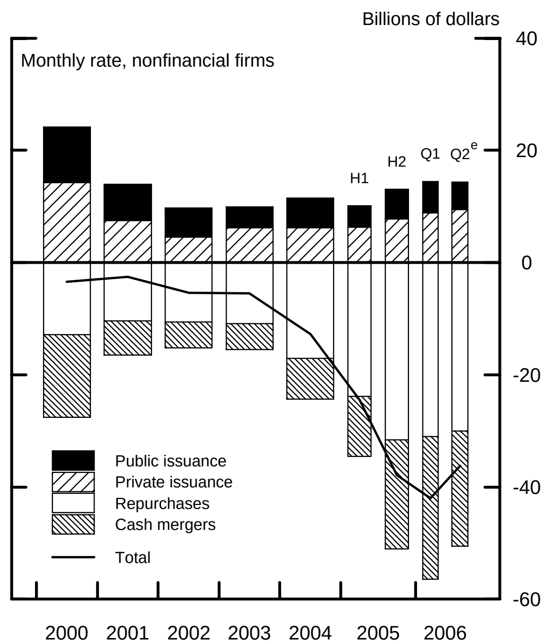
Note. Components may not sum to totals because of rounding.
1. Excludes private placements and equity-for-equity swaps that occur in restructurings.
2. Data include regular and 144a private placements. Bond totals reflect gross proceeds rather than par value of original discount bonds. Bonds are categorized according to Moody's bond ratings, or to Standard & Poor's if unrated by Moody's.
3. End-of-period basis, seasonally adjusted.
4. Adjusted for FIN 46 effects.
p Preliminary.

Selected Components of Net Debt Financing



* Seasonally adjusted, period-end basis.
p Preliminary.

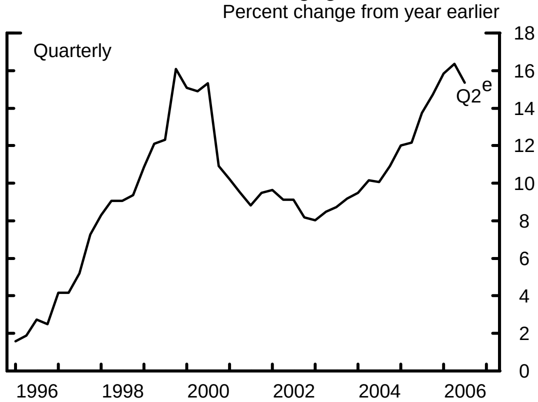
Components of Net Equity Issuance



e Staff estimate.

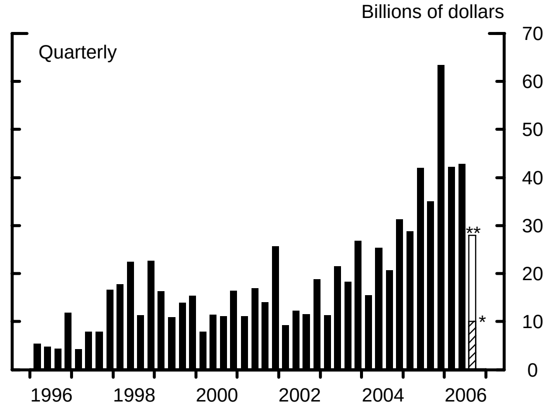
Commercial Real Estate

Growth of Commercial Mortgage Debt



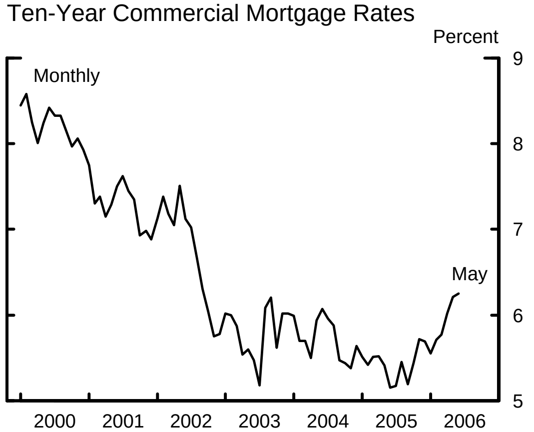
e Staff estimate.

Gross Issuance of CMBS



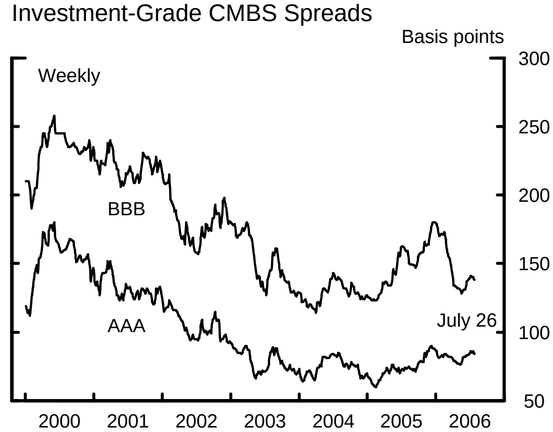
* Through August 2.
** Staff estimate for Q3.
Source. Commercial Mortgage Alert.

Ten-Year Commercial Mortgage Rates



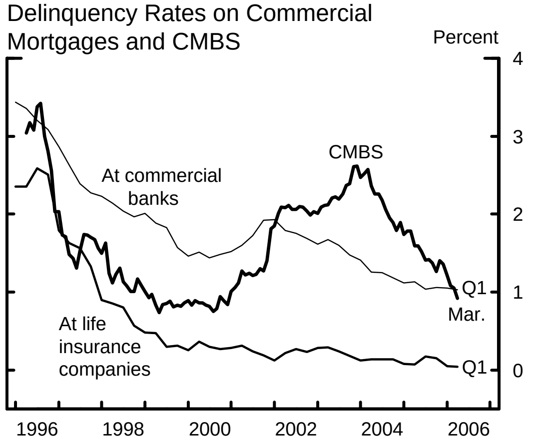
Source. Barron's/Levy.

Investment-Grade CMBS Spreads



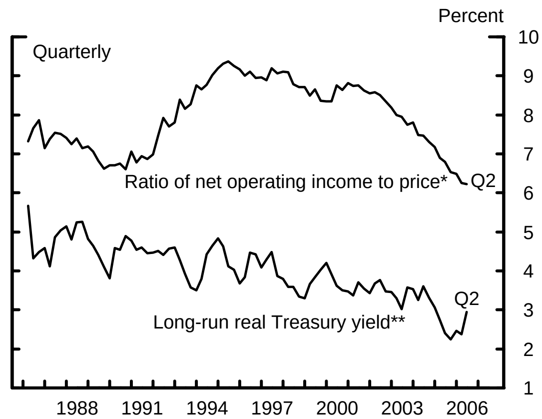
Note. Measured relative to the 10-year Treasury yield.
Source. Morgan Stanley.

Delinquency Rates on Commercial Mortgages and CMBS



Source. Call Report, ACLI, Morgan Stanley.

Commercial Real Estate Valuation



* Staff calculation from NCREIF data, annual rate.
** Yield on synthetic Treasury perpetuity minus Philadelphia Fed 10-year expected inflation.

remained very low. Despite $28 billion of GM bonds being downgraded, the pace of bond rating upgrades nearly matched that of downgrades in the second quarter. The six-month trailing bond default rate fell again in June, to a very low level. Meanwhile, expected year-ahead defaults, based on the KMV model, were unchanged and quite low, an indication that strong aggregate credit quality is viewed as likely to persist over the near term.

Business Finance

Gross bond issuance by nonfinancial firms, boosted by especially strong speculative-grade issuance, remained robust in June but slowed some in July. Outstanding commercial paper and C&I loans also increased at a rapid clip in June, then slowed last month. In sum, net debt financing has been strong in recent months, on average, despite the dip in July. Reported uses of bond proceeds and responses to July's Senior Loan Officer Opinion Survey on Bank Lending Practices indicate that firms have borrowed largely to finance mergers and acquisitions and investment in plant and equipment.

In June, both seasoned equity offerings and IPOs were in line with the past year's moderate pace, but IPOs dried up in July when several issues were withdrawn. However, the backlog of filings suggests that IPOs could resume their modest pace. Moreover, our indicators suggest that private equity issuance, which includes equity investments by buyout firms and venture capital, has continued to outpace public issuance.

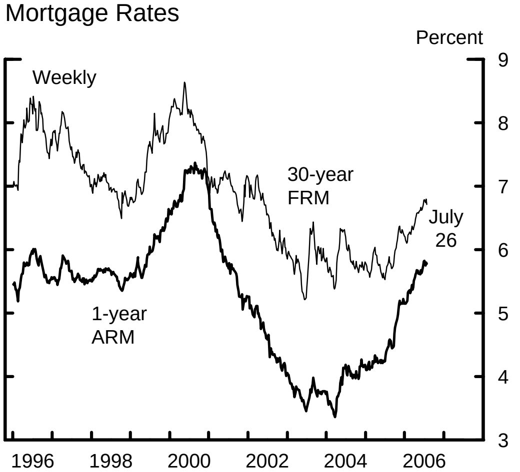
Still, the amount of gross issuance pales in comparison with the pace of equity retirements, resulting in a sharp contraction of net equity issuance. In the second quarter, retirements from cash-financed mergers and acquisitions, boosted by leveraged buyouts, were not far off the scorching first-quarter pace, and share repurchases seem to have remained near the record pace set in the fourth quarter—trends supported by continued strong profits, favorable debt financing terms, and ample cash on corporate balance sheets. With recent announcements indicating that both share repurchases and cash mergers are not about to abate, net equity is likely to continue contracting rapidly.

Commercial Real Estate

Commercial mortgage borrowing remained strong in the second quarter, leaving the level of commercial mortgage debt 15 percent above its year-ago reading. The issuance calendar for commercial mortgage-backed securities (CMBS) suggests a moderation in the pace of borrowing in the third quarter. This slowing is probably due to rising interest rates for commercial mortgages, which climbed in May to their highest level since mid-

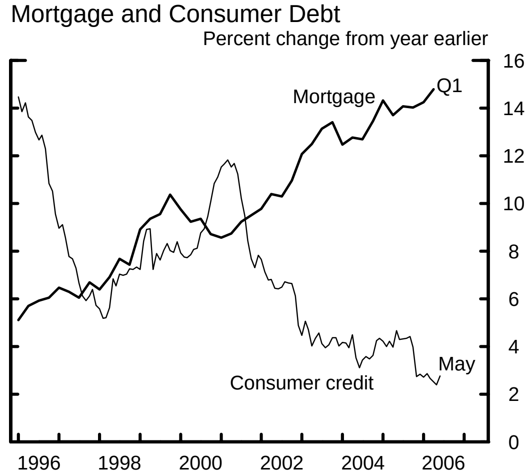
Household Liabilities

Mortgage Rates

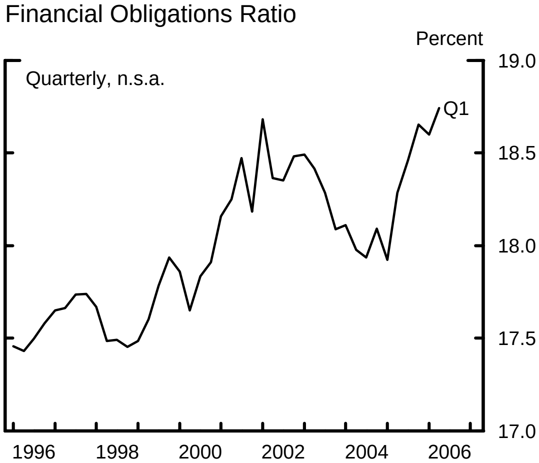


Source. Freddie Mac.

Mortgage and Consumer Debt

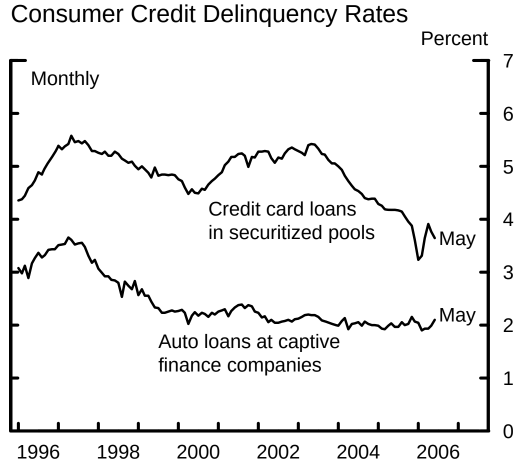


Financial Obligations Ratio



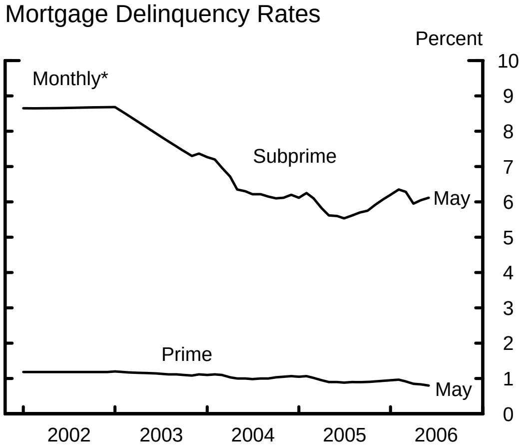
Note. Adjusted to reflect the effects of the NIPA revision on disposable personal income and other financial obligations.

Consumer Credit Delinquency Rates



Source. For credit cards, Moody's; for auto loans, Federal Reserve.

Mortgage Delinquency Rates

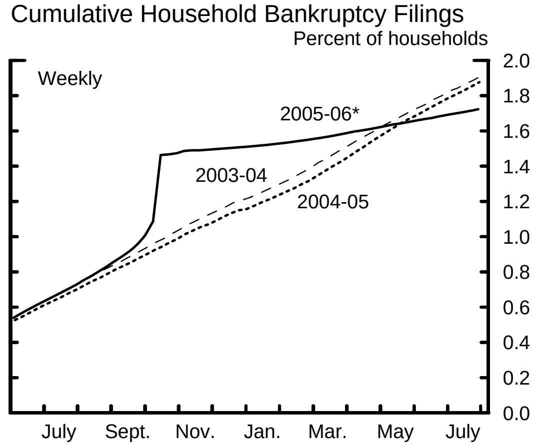


* Data are as of year-end before September 2003.

Note. Serious delinquencies are equally weighted and have been adjusted to exclude the effects of Hurricane Katrina.

Source. LoanPerformance.

Cumulative Household Bankruptcy Filings



* Through July 29.

Source. Lundquist Consulting, Inc.

2002. Spreads of rates on investment-grade CMBS over those on comparable-maturity Treasuries held steady over the intermeeting period and remained quite narrow. Delinquency rates on commercial mortgages, including those backing CMBS, remained low by historical standards through the first quarter. A decline in vacancy rates and some firming in rents in the current quarter indicate continued improvement in market fundamentals.

The ratio of net operating income to property prices, an indicator of the rate of return on commercial real estate properties, declined slightly in the second quarter. The spread of this ratio over the real perpetuity Treasury yield, a rough measure of the risk premium on commercial real estate assets, narrowed somewhat to its lowest reading since 1992.

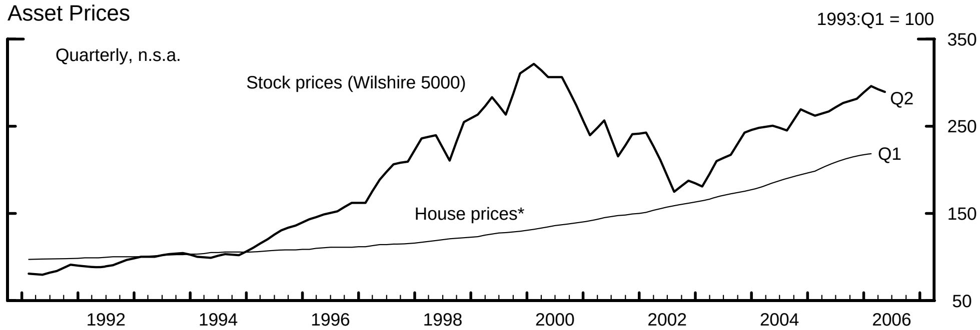
Household Finance

Average interest rates on both thirty-year fixed-rate and one-year adjustable-rate mortgages decreased slightly over the intermeeting period but remained well above the levels posted earlier this year. Household mortgage debt expanded rapidly in the first quarter, but the higher mortgage rates and a cooling housing market suggest that borrowing likely decelerated a bit in the second quarter. In May, consumer credit was only modestly above its year-earlier level, as nonrevolving consumer credit has remained particularly sluggish.

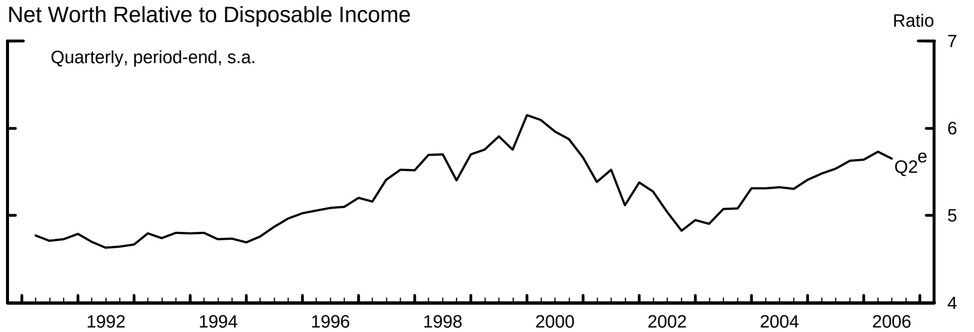
The financial obligations ratio edged up in the first quarter to a level just above the top of its historical range. Nonetheless, the evidence to date suggests that most households are not having problems meeting those obligations. Delinquency rates on credit cards, auto loans, and prime residential mortgages have stayed low in recent months. However, delinquency rates on subprime mortgages—especially those with variable rates—have risen, on net, since the middle of last year. The pace of bankruptcy filings remained damped over the intermeeting period—perhaps because the new regime imposes higher costs on filers.

Stock prices and the available information on home prices suggest a slight decline in the ratio of net worth to disposable personal income last quarter. Reflecting low stock returns of late, domestic equity mutual funds recorded net redemptions the past three months, while inflows to international equity funds moderated substantially in June and July.

Household Assets



* Source. Office of Federal Housing Enterprise Oversight (OFHEO) purchase-only house-price index.



Note. Adjusted to reflect the effects of the NIPA revision on disposable personal income.
e Staff estimate.

Net Flows into Long-Term Mutual Funds
(Billions of dollars, monthly rate)

Fund type	2004	2005		2006					Assets
		H1	H2	Q1	Q2	May	June	July[e]	June
Total long-term funds	**17.5**	**18.3**	**13.7**	**38.9**	**6.3**	**0.5**	**-9.2**	**2.4**	**7,220**
Equity funds	**14.8**	**12.3**	**10.3**	**31.1**	**7.0**	**3.2**	**-8.4**	**-1.6**	**5,249**
Domestic	9.3	4.1	1.0	10.7	-2.4	-5.9	-9.3	-6.7	4,169
International	5.6	8.2	9.2	20.4	9.4	9.0	0.9	5.1	1,080
Hybrid funds	**3.6**	**3.4**	**0.9**	**0.4**	**-0.1**	**-0.2**	**-0.4**	**-0.2**	**585**
Bond funds	**-0.9**	**2.5**	**2.6**	**7.4**	**-0.7**	**-2.5**	**-0.3**	**4.2**	**1,386**
High-yield	-0.8	-1.6	-1.0	-0.4	-1.4	-2.2	-1.8	0.4	142
Other taxable	1.0	3.7	3.1	5.8	0.7	-0.7	1.1	3.2	899
Municipals	-1.1	0.4	0.4	2.1	0.1	0.3	0.3	0.5	344

Note. Excludes reinvested dividends.
e Staff estimates based on confidential ICI weekly data.
Source. Investment Company Institute.

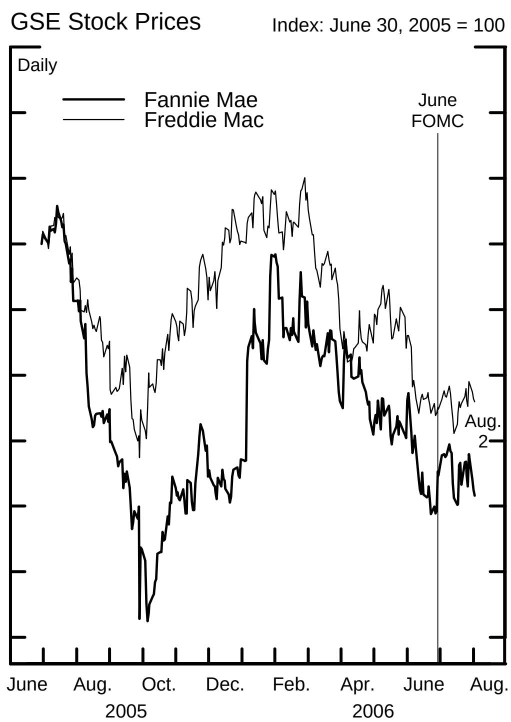
Treasury Financing

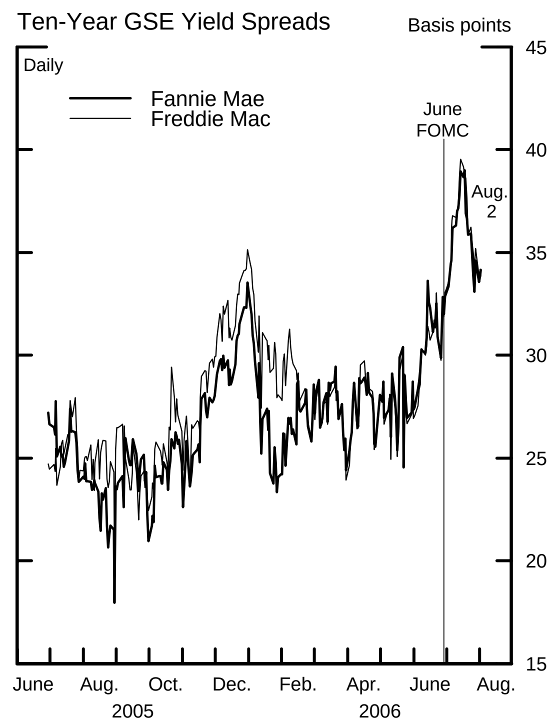
(Billions of dollars)

Item	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Apr.	2006 May	2006 June
Total surplus, deficit (–)	**45.2**	**-69.0**	**-119.3**	**-183.7**	**118.9**	**-42.8**	**20.5**
Means of financing deficit							
Net borrowing	-42.8	72.8	112.2	156.1	-52.7	-11.5	-10.7
Nonmarketable	35.9	20.6	21.2	-2.3	5.3	4.6	7.7
Marketable	-78.7	52.1	91.0	158.5	-58.0	-16.0	-18.4
Bills	-135.8	-9.3	48.8	78.1	-77.0	-10.7	-37.8
Coupons	57.1	61.4	42.3	80.4	19.0	-5.3	-19.4
Decrease in cash balance	-10.7	-2.5	-0.9	28.4	-70.8	50.9	-17.7
Other[1]	8.3	-1.2	8.0	-0.9	4.6	3.4	7.9
Memo:							
Cash balance, end of period	33.2	35.7	36.6	8.2	79.0	28.1	45.8

Note. Components may not sum to totals because of rounding.
1. Direct loan financing, accrued items, checks issued less checks paid, and other transactions.

GSE Market Developments





Note. GSE yields based on on-the-run securities. Spreads measured relative to the 10-year Treasury yield.

State and Local Government Finance

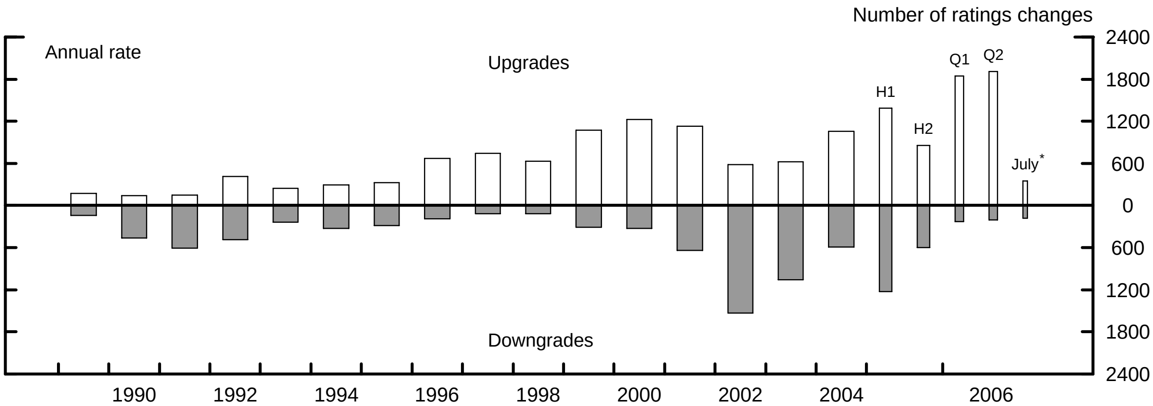
Gross Offerings of Municipal Securities

(Billions of dollars; monthly rate, not seasonally adjusted)

Type of security	2002	2003	2004	2005 H1	2005 H2	2006 Q1	2006 Q2	2006 July[e]
Total	36.3	37.9	34.7	38.1	38.6	26.1	40.0	32.2
Long-term [1]	30.3	32.0	29.8	35.0	33.3	24.1	36.3	28.3
Refundings [2]	10.1	10.0	10.8	17.1	13.8	9.0	10.1	3.7
New capital	20.2	22.1	19.0	17.9	19.4	15.2	26.2	24.6
Short-term	6.0	5.8	4.9	3.1	5.3	1.9	3.7	3.9
Memo: Long-term taxable	1.7	3.5	2.0	2.0	2.2	1.2	4.3	4.3

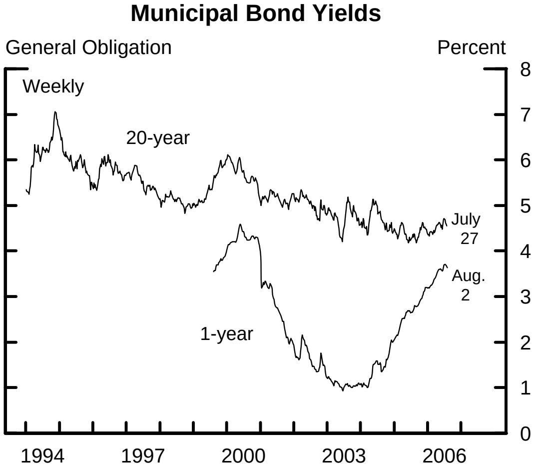
1. Includes issues for public and private purposes.
2. All issues that include any refunding bonds.
e Staff estimate based on preliminary data through July 27, 2006.

Ratings Changes



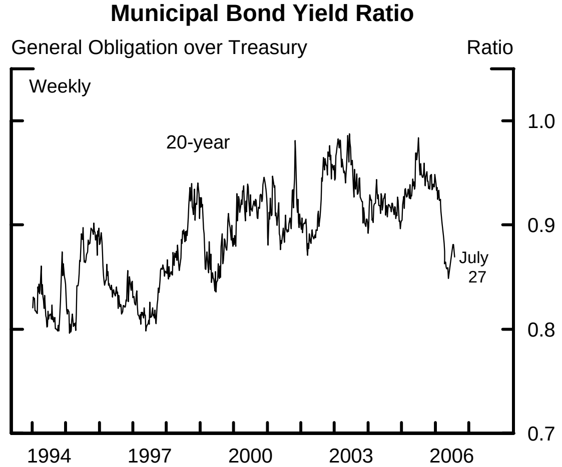
Source. S&P's Credit Week Municipal and Ratings Direct.
* Staff estimate based on data through July 26, 2006.

Municipal Bond Yields



Source. Municipal Market Advisors and Bond Buyer.

Municipal Bond Yield Ratio



Source. Bond Buyer.

Treasury and Agency Finance

Over the intermeeting period, the Treasury Department auctioned two- and five-year nominal securities and ten- and twenty-year TIPS. Demand at the auctions was fairly strong, although the proportions of securities awarded to indirect bidders—a category that includes foreign central banks—were generally lower than the historical average. In addition, Treasury securities held in custody at the Federal Reserve Bank of New York on behalf of foreign accounts fell modestly over the intermeeting period. These indicators are consistent with a continuing downward trend in foreign participation since 2004. Indeed, Treasury data released this month confirmed declining foreign-investor participation rates in auctions during May and June.

In its quarterly refunding statement, the Treasury Department announced that it will offer $44 billion in new securities between August and October, an amount unchanged from the same period last year. The Treasury also announced that it will begin auctioning thirty-year bonds—sold semiannually now—at a quarterly frequency starting in February 2007. Yields on thirty-year bonds rose a few basis points following the announcement.

On July 20, the Federal Reserve implemented revisions to its Payments System Risk policy. Under the new rules, government-sponsored enterprises (GSEs) and certain other institutions may no longer fund principal and interest payments with daylight overdrafts in their Fed accounts—overdrafts that had previously reached as much as $110 billion. To date, the new policy has not caused any discernible disruptions in funding markets, nor has it had a measurable effect on the market's willingness to hold GSE debt.

Even amid comments from officials at the Treasury Department and the Office of Federal Housing Enterprise Oversight that criticized the size of the GSEs' portfolios and Chairman Bernanke's remarks in congressional testimony regarding regulatory reform, GSE stock prices generally tracked the favorable performance of financial-sector stocks. Meanwhile, spreads between rates on long-term agency debt and those on Treasury securities were roughly unchanged, on net, despite a temporary jump perhaps related to a large issue of new on-the-run Freddie Mac benchmark bonds.

State and Local Government Finance

Gross issuance of long-term municipal bonds rose sharply in the second quarter, as advance-refunding issues held near the first-quarter pace, and new capital issuance—led by the education and housing sectors—surged. Issues for advance refunding and new capital projects fell back from the second-quarter pace in July but remained robust.

M2 Monetary Aggregate

(Based on seasonally adjusted data)

Aggregate and components	Percent change (annual rate)[1]						Level (billions of dollars), July (e)
	2004	2005	2006 Q1	2006 Q2	2006 June	2006 July (e)	
M2	5.3	4.0	6.3	3.2	5.9	4.7	6,857
Components[2]							
Currency	5.5	3.5	7.2	4.1	-2.9	-.6	741
Liquid deposits[3]	10.0	2.0	3.7	-1.8	-1.2	-2.1	4,252
Small time deposits	-.3	18.9	15.7	17.0	20.1	24.3	1,084
Retail money market funds	-11.4	-.3	8.1	13.5	35.3	21.2	773
Memo:							
Institutional money market funds	-5.6	5.1	9.1	11.5	15.6	11.0	1,213
Monetary base	5.6	3.5	6.0	4.4	-1.4	8.7	811

Note. M2 is the sum of currency, liquid deposits, small time deposits, retail money market funds, and nonbank traveler’s checks. Acting on its announcement of November 10, 2005, the Board of Governors ceased publishing the M3 monetary aggregate on March 23, 2006.

1. For years, Q4 to Q4; for quarters and months, calculated from corresponding averages.
2. Nonbank traveler’s checks are not listed.
3. Sum of demand deposits, other checkable deposits, and savings deposits.

e Estimated.

The credit quality of municipal bonds has remained strong. The number of bonds with rating upgrades far outpaced the number with rating downgrades in the second quarter, and rating changes were more balanced in July. In addition, the ratio of yields on municipal bonds to those on Treasuries, an alternative credit quality measure, increased slightly over the intermeeting period, but the level remained low.

Money and Bank Credit

M2 expanded at an annual rate of about 5 percent in June and July, a pace similar to the average during the first five months of the year. The growth of M2 was held down in July by the runoff of funds that had temporarily come into M2 to facilitate the payment of corporate taxes in June. In addition, the opportunity cost of holding M2 has inched up further in recent months, thereby adding to the restraint on the growth of the aggregate.

Although commercial bank credit slowed from its rapid advance earlier in the year, loans continued to exhibit robust growth in June and July. Loans to businesses increased at a particularly rapid clip. Respondents to the July Senior Loan Officer Opinion Survey on Bank Lending Practices reported that they had eased standards and terms on C&I loans somewhat further over the past three months. Residential real estate loans on banks' books increased at a very strong pace over the past two months. Nonetheless, a significant net fraction of survey respondents noted weaker demand for mortgages to purchase homes.

Commercial Bank Credit

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

Type of credit	2004	2005	Q1 2006	Q2 2006	June 2006	July 2006[e]	Level,[1] July 2006[e]
Total[2]	8.9	10.5	10.8	12.9	7.7	10.2	7,738
Loans[3]							
Total	9.8	11.6	11.2	11.8	8.1	9.8	5,726
To businesses							
Commercial and industrial	1.3	13.2	14.9	16.9	14.7	14.7	1,115
Commercial real estate	13.8	17.1	15.9	13.9	13.7	12.3	1,371
To households							
Residential real estate	14.0	12.0	6.4	9.4	17.1	11.4	1,735
Revolving home equity	43.7	11.3	-2.2	-4.6	1.1	5.9	431
Consumer	8.8	3.1	3.2	10.2	8.4	3.0	723
Originated[4]	5.9	.7	8.3	5.7	8.4	4.5	1,096
Other[5]	7.7	8.4	16.2	8.3	-29.4	.8	781
Securities							
Adjusted[2]	6.6	7.7	9.6	15.9	6.6	11.6	2,012
Reported	5.2	5.3	7.4	18.2	-6.4	5.8	2,146
Treasury and agency	4.9	.0	8.3	8.3	6.4	10.0	1,209
Other[6]	5.7	13.3	6.3	31.5	-22.5	.5	936

Note. Yearly annual rates are Q4 to Q4; quarterly and monthly annual rates use corresponding averages. Data are adjusted to remove estimated effects of consolidation related to FIN 46 and for breaks caused by reclassifications.

1. Billions of dollars. Pro rata averages of weekly (Wednesday) levels.
2. Adjusted to remove effects of mark-to-market accounting rules (FIN 39 and FAS 115).
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.
6. 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.

e Estimated.

Appendix

Senior Loan Officer Opinion Survey on Bank Lending Practices

The July 2006 Senior Loan Officer Opinion Survey on Bank Lending Practices addressed changes in the supply of, and demand for, bank loans to businesses and households over the past three months. Special questions in the survey addressed domestic banks' holdings of subprime residential mortgages and nontraditional residential mortgage products. In addition, the survey queried domestic banks about the change in the demand for residential real estate loans to finance homes for investment purposes. This appendix is based on responses from fifty-six domestic banks and seventeen foreign banking institutions.

In the July survey, domestic and foreign institutions indicated that they had eased lending standards and terms on commercial and industrial (C&I) loans somewhat further. Domestic banks, however, reported that they had tightened lending standards on commercial real estate loans over the previous three months, while foreign banks noted that standards on such loans were unchanged. Demand for both C&I and commercial real estate loans was reportedly about unchanged in the July survey. In the household sector, a small net fraction of domestic respondents indicated that they had eased credit standards on residential mortgages over the previous three months, while standards and terms on consumer loans were reportedly little changed. Significant net fractions of domestic institutions noted that demand for both mortgages to purchase homes and consumer loans had weakened further.

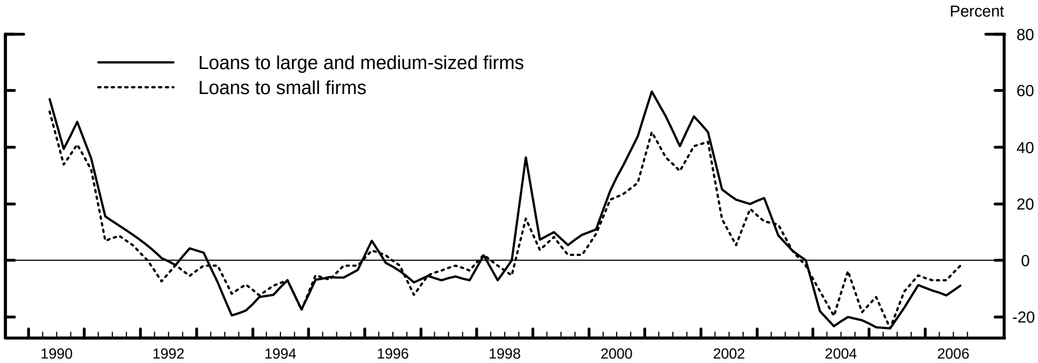
Business Lending

In the July survey, domestic institutions reported a further easing of standards and terms on C&I loans. On net, about 10 percent of domestic respondents indicated that they had eased credit standards on such loans to large and middle-market firms over the previous three months, roughly the same percentage as in the April survey. About 40 percent of domestic institutions—a significantly smaller net fraction than in April—noted that they had trimmed spreads of loan rates over their cost of funds for such firms. About one-fifth of domestic banks—a notably smaller net percentage than in the previous survey—reported that they had reduced the costs of credit lines, and smaller net fractions of domestic respondents indicated that they had eased loan covenants and increased the maximum size of credit lines that they are willing to extend to their business borrowers.

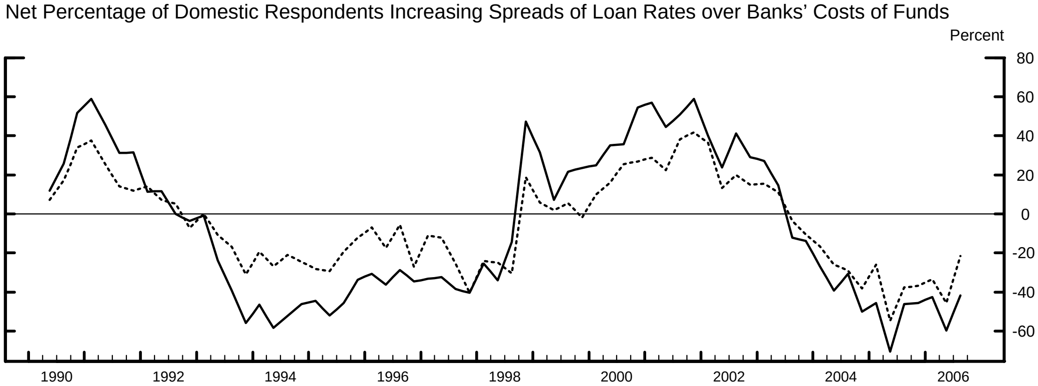
Credit standards on C&I loans to small firms were reportedly little changed, on balance, in the July survey. However, about one-fifth of domestic institutions, on net, indicated that they had trimmed spreads of loan rates over their cost of funds for such firms over the same period. Other loan terms were generally little changed.

Measures of Supply and Demand for C&I Loans, by Size of Firm Seeking Loan

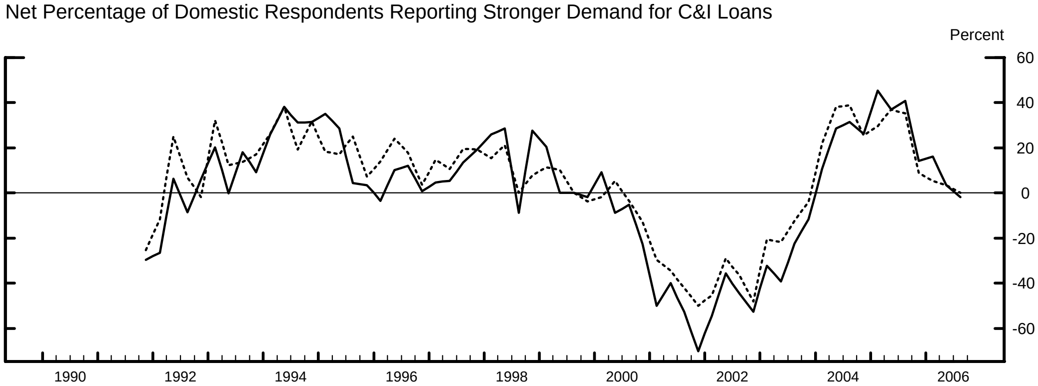
Net Percentage of Domestic Respondents Tightening Standards for C&I Loans



Net Percentage of Domestic Respondents Increasing Spreads of Loan Rates over Banks' Costs of Funds

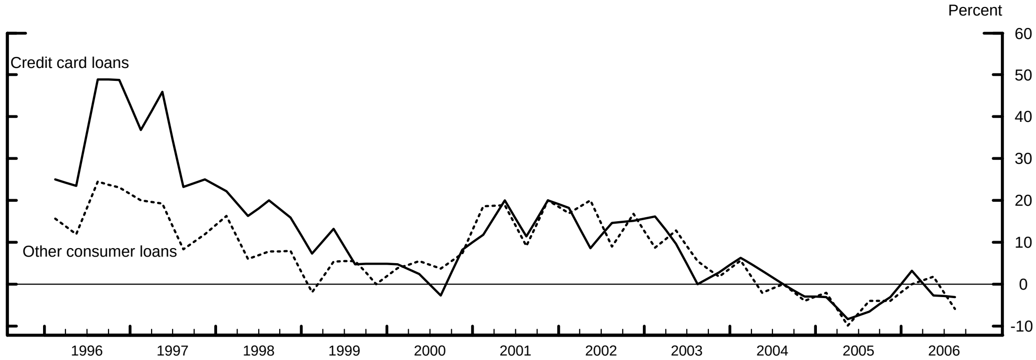


Net Percentage of Domestic Respondents Reporting Stronger Demand for C&I Loans

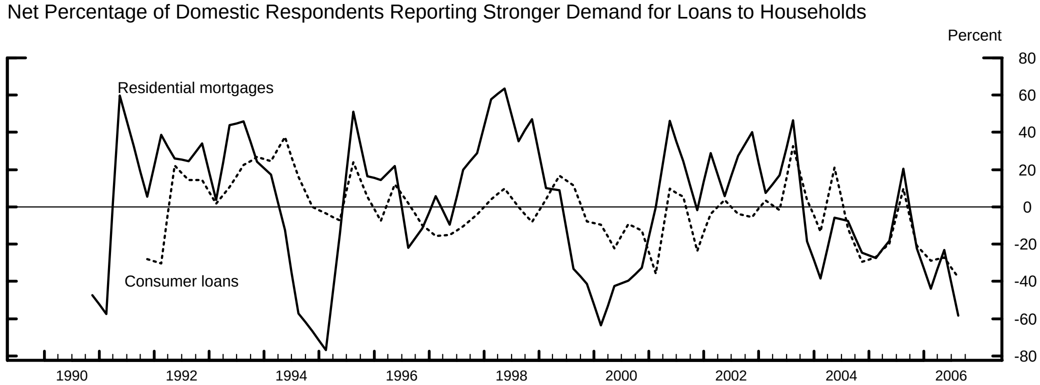


Measures of Supply and Demand for Loans to Households

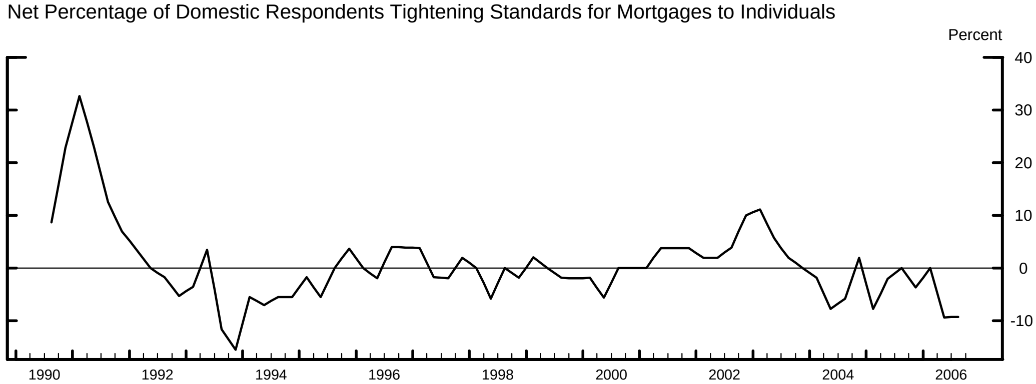
Net Percentage of Domestic Respondents Tightening Standards for Consumer Loans



Net Percentage of Domestic Respondents Reporting Stronger Demand for Loans to Households



Net Percentage of Domestic Respondents Tightening Standards for Mortgages to Individuals



Almost one-fifth of U.S. branches and agencies of foreign banks, on net, reported that they had eased their standards on C&I loans during the survey period. Considerable net fractions of these institutions also indicated that they had eased loan covenants, trimmed spreads of loan rates over their cost of funds, and reduced the cost of credit lines.

Nearly all domestic and all foreign institutions that reported having eased their lending standards and terms in the July survey pointed to more-aggressive competition from other banks or nonbank lenders as the most important reason for having done so. Notable net percentages of domestic respondents also cited increased liquidity in the secondary market for these loans, a more favorable or less uncertain economic outlook, and increased tolerance for risk as reasons for having eased credit standards or terms on C&I loans.

Demand for C&I loans was reportedly unchanged, on net, in the July survey at both domestic and foreign institutions. Among domestic banks that saw stronger demand for C&I loans, almost 90 percent explained the strengthening by pointing to increased needs to finance mergers and acquisitions, while 80 percent cited borrowers' increased needs to finance investment in plant or equipment. Among domestic institutions that experienced weaker demand for C&I loans, about 85 percent attributed the softening to borrowers' decreased needs to finance investment in plant or equipment, while significant net fractions pointed to increases in customers' internally generated funds, decreased need for inventory financing, and a shift in customer borrowing to another bank or to nonbank sources of credit. Regarding future business, both domestic and foreign institutions reported that the number of inquiries from potential business borrowers was little changed over the previous three months.

On balance, 10 percent of domestic banks indicated that they had tightened lending standards on commercial real estate loans over the previous three months. By contrast, foreign respondents noted that they had not changed standards on such loans over the same period. Both domestic and foreign institutions reported that demand for commercial real estate loans was little changed in the July survey.

Household Lending

On net, about 10 percent of domestic institutions indicated that they had eased credit standards on residential mortgage loans over the past three months, the same fraction as in the April survey. In line with other evidence of a slowdown in housing activity this year, domestic institutions reported that demand for mortgages to purchase homes had continued to weaken over the previous three months. About 60 percent of respondents saw weaker demand for such loans, a significantly larger net fraction than in the April survey.

Only a few domestic respondents indicated that their willingness to make consumer installment loans had increased over the past three months. Standards and most terms on credit card and non-credit-card consumer loans were reportedly little changed in the July survey, on balance. Demand for consumer loans weakened further over the past three months: About 40 percent of domestic banks saw weaker demand for such loans, a somewhat larger net fraction than in the April survey.

The July survey included a set of special questions on domestic banks´ holdings of *subprime* residential mortgages and *nontraditional* residential mortgage products, as well as on changes in the credit quality of such loans.[1] The subprime category of residential mortgages includes loans made to borrowers that displayed one or more of the following characteristics at the time of loan origination: weakened credit histories stemming from payment delinquencies, charge-offs, judgments, or bankruptcies; reduced repayment capacity as measured by credit scores or debt-to-income ratios; and incomplete credit histories.[2] Nontraditional residential mortgage products include—but are not limited to—adjustable-rate mortgages with multiple payment options, interest-only mortgages, and "Alt-A" products such as mortgages with limited income verification and mortgages secured by non-owner-occupied properties.

Holdings of subprime residential mortgages were generally small for the respondent banks. Of the thirty domestic banks with subprime residential mortgages on their books, nearly three-fourths indicated that such mortgages accounted for less than 5 percent of their residential mortgages, and one-fifth of institutions noted that the share of such products was between 5 percent and 15 percent. The remainder of banks reported a share that was more than 20 percent. When the responses were weighted by dollar volume, banks that reported a share of less than 5 percent accounted for nearly 60 percent of all residential mortgages on the books of those banks that responded to this special question on subprime residential mortgages at the end of the first quarter. Those institutions that reported a share between 5 percent and 15 percent accounted for 22 percent of all such mortgages.

[1] The number of banks that responded to the set of special questions varied from twenty-nine to forty-eight depending on the question. According to first-quarter Call Reports, the respondent banks accounted for between 53 percent and 63 percent of all residential real estate loans on the books of domestic commercial banks as of March 31, 2006.

[2] In considering subprime residential mortgages, banks were instructed to include first-lien loans only.

A modest net fraction of respondents indicated that the quality of their subprime residential real estate portfolios—as measured by delinquencies and charge-offs—had deteriorated somewhat over the past twelve months, a response consistent with aggregate measures suggesting some deterioration in subprime loan performance in recent quarters. Nonetheless, three institutions reported that the quality of their portfolios of such products had performed somewhat better than they had expected over that period, while only one bank noted that the quality of its portfolio had performed somewhat worse than anticipated. A few institutions indicated that they had tightened price-related terms and credit standards on such mortgages over the same period. Looking forward, about one-third of respondents reported that they anticipate that the quality of the subprime residential mortgages currently on their books will deteriorate somewhat over the next twelve months, and the rest expect loan quality to likely stabilize around current levels.

The panel banks had more-substantial holdings of residential mortgages that could be categorized as nontraditional. Among the forty-eight domestic banks that responded to this special question, about 45 percent reported that the share of such mortgages currently on their books was less than 5 percent, and about 20 percent of respondents noted that the share of such products was between 5 percent and 15 percent. Seven institutions, however, indicated that nontraditional mortgage products accounted for more than 30 percent of the residential mortgages currently on their books. When the responses were weighted by dollar volume, banks that reported a share of less than 5 percent accounted for 10 percent of all residential mortgages on the books of those banks that responded to this special question on nontraditional residential mortgage products at the end of the first quarter. Those institutions that reported a share between 5 percent and 15 percent accounted for more than 50 percent of all such mortgages. The seven institutions that indicated a share greater than 30 percent accounted for less than 10 percent of all residential mortgages on the books of the respondents.[3]

A modest net percentage of respondents indicated that the quality of their portfolio of nontraditional residential mortgage products—as measured by delinquencies and charge-offs—had improved over the past twelve months. Eight banks reported that the quality of their portfolios of such products had performed better than had been expected, and only one institution indicated that the quality of its portfolio had

[3] A similar question was included in the July 2005 Senior Loan Officer Opinion Survey. In that survey, about one-third of domestic respondents indicated that the share of nontraditional mortgage products on their books was less than 5 percent, and another one-third reported that the share of such products was between 5 percent and 15 percent. These shares were roughly similar if the responses are weighted by the respondent banks' dollar volume of residential mortgages outstanding in the first quarter of 2005.

performed somewhat worse than had been anticipated. Nonetheless, about 10 percent of institutions, on balance, noted that they had tightened price-related terms on such mortgage products. Looking forward, nearly 30 percent of banks, on net, indicated that they expect the quality of the nontraditional residential mortgage products currently on their books will deteriorate somewhat over the next twelve months. These banks accounted for more than 50 percent of all residential mortgages on the books of respondents at the end of the first quarter.

The July survey also included a special question on changes in demand for residential real estate loans used to finance homes for investment purposes.[4] Almost 20 percent of domestic institutions reported stronger demand for such loans over the past twelve months, while 30 percent noted that demand had weakened over the same period.

Last Page of Financial Developments

[4] The forty-four banks that responded to this special question accounted for 63 percent of all residential real estate loans on the books of domestic commercial banks as of March 31, 2006.

International Developments

International Developments

U.S. International Transactions

Trade in Goods and Services

The U.S. international trade deficit widened to $63.8 billion in May from $63.3 billion in April (revised). The widening of the deficit reflected a sharp increase in imports, which more than offset a sizable gain in exports.

Trade in Goods and Services

	2005	Annual rate			Monthly rate		
		2005	2006		2006		
		Q4	Q1	Q2e	Mar.	Apr.	May
	Percent change						
Nominal BOP							
Exports	11.1	13.5	17.3	8.7	1.8	-.0	2.4
Imports	12.0	19.9	7.4	5.5	.7	.8	1.8
Real NIPA							
Exports	7.2	9.6	14.0	3.3	...	...	...
Imports	5.4	13.2	9.1	.2	...	...	...
	Billions of dollars						
Nominal BOP							
Net exports	-716.7	-779.1	-763.0	-763.1	-61.9	-63.3	-63.8
Goods, net	-782.7	-850.0	-831.9	-837.9	-67.7	-69.6	-70.1
Services, net	66.0	70.9	68.9	74.9	5.9	6.2	6.2

e. BOP data are two months at an annual rate; NIPA data are BEA's advance estimate.
Source. U.S. Department of Commerce, Bureaus of Economic Analysis and Census.
n.a. Not available. ... Not applicable.

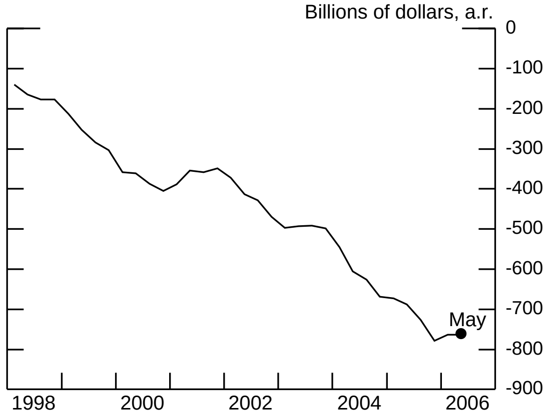
In May, the value of exports of goods and services rose 2.4 percent after a flat April. Exports rose across almost all major product categories, with exports of capital goods and consumer goods showing the largest gains. Within capital goods, there was a large increase in exports of aircraft. Exports of automotive products moved down slightly, and services exports increased somewhat.

The average value of exports in April and May increased 8.7 percent (a.r.) from the first quarter. Exports of fuels, chemicals, semiconductors, and telecommunications equipment were particularly strong. In real terms, according to the advance NIPA release, which includes the BEA's estimate of nominal trade in June, exports of goods and services increased 3.3 percent (a.r.) in the second quarter, following a rise of 14 percent in the first quarter.

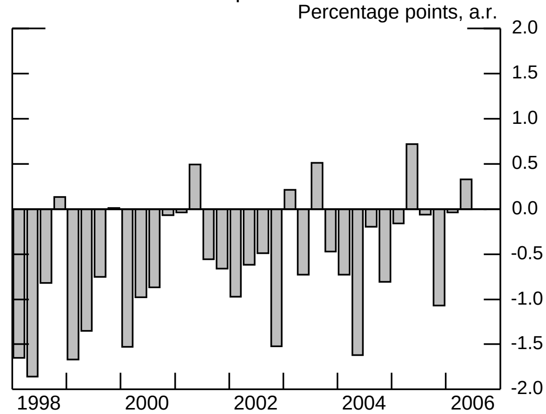
The value of imported goods and services rose 1.8 percent in May from a high April level. The increase in imports was heavily concentrated in oil, reflecting both higher

U.S. International Trade in Goods and Services
(Quarterly)

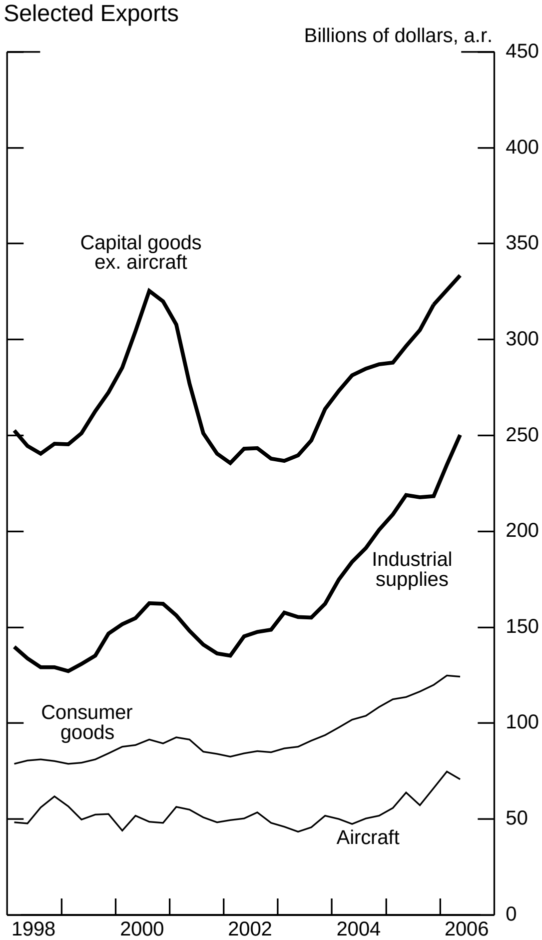
Trade Balance



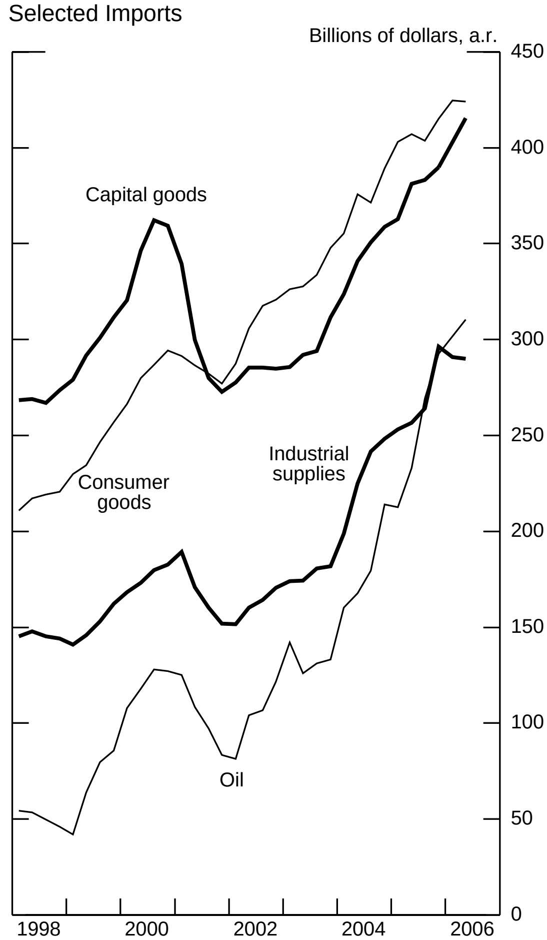
Contribution of Net Exports to Real GDP Growth



Selected Exports



Selected Imports



U.S. Exports and Imports of Goods and Services

(Billions of dollars, a.r., BOP basis)

	Levels				Change[1]			
	2006		2006		2006		2006	
	Q1	Q2[e]	Apr.	May	Q1	Q2[e]	Apr.	May
Exports of G&S	**1378.6**	**1407.5**	**1391.1**	**1423.9**	**53.9**	**28.9**	**-.2**	**32.8**
Goods exports	978.0	996.3	982.0	1010.5	46.4	18.2	-6.3	28.6
Gold	7.6	8.1	6.9	9.3	1.8	.5	-1.5	2.4
Other goods	970.5	988.1	975.1	1001.2	44.6	17.7	-4.8	26.1
Capital goods	400.6	404.2	399.4	409.1	16.3	-196.6	-1.9	9.6
Aircraft & parts	74.9	70.8	67.4	74.2	8.8	-4.1	-3.1	6.8
Computers & accessories	47.0	46.1	45.6	46.6	1.2	-.9	-1.8	1.0
Semiconductors	50.9	55.2	55.2	55.2	.4	4.3	4.3	.1
Other capital goods	227.8	232.2	231.3	233.1	5.9	4.4	-1.4	1.8
Automotive	105.5	103.2	103.9	102.5	1.0	-2.3	1.0	-1.4
Ind supplies (ex. ag, gold)	234.8	250.1	247.1	253.2	16.5	15.4	3.9	6.1
Consumer goods	124.9	124.3	121.2	127.5	4.8	-.5	-5.0	6.3
Agricultural	69.5	71.5	68.6	74.4	3.7	1.9	-2.1	5.8
All other goods	35.2	34.8	34.9	34.6	2.3	-.4	1.6	-.3
Services exports	400.5	411.3	409.1	413.4	7.5	10.7	6.1	4.2
Imports of G&S	**2141.5**	**2170.6**	**2151.2**	**2189.9**	**37.8**	**29.0**	**17.6**	**38.7**
Goods imports	1809.9	1834.2	1816.8	1851.5	28.3	24.2	16.0	34.7
Oil	288.5	310.4	286.2	334.7	-4.1	21.9	17.3	48.5
Gold	5.7	6.2	5.4	7.0	.3	.5	-.5	1.6
Other goods	1515.7	1517.6	1525.2	1509.9	32.1	1.9	-.9	-15.3
Capital goods	404.4	415.3	414.2	416.3	14.5	-191.4	1.2	2.1
Aircraft & parts	28.4	26.2	26.5	26.0	3.1	-2.2	-3.4	-.5
Computers & accessories	99.5	102.8	104.4	101.2	5.4	3.3	-1.3	-3.3
Semiconductors	27.1	27.6	28.3	27.0	.4	.6	1.3	-1.4
Other capital goods	249.4	258.6	255.0	262.2	5.7	9.2	4.6	7.2
Automotive	258.3	254.0	257.1	250.9	7.9	-4.3	5.0	-6.3
Ind supplies (ex. oil, gold)	290.7	290.1	294.7	285.5	-5.7	-.6	12.3	-9.3
Consumer goods	424.5	424.1	424.4	423.9	9.4	-.3	-14.3	-.5
Foods, feeds, bev.	74.1	73.7	74.6	72.8	3.5	-.4	-1.8	-1.8
All other goods	63.6	60.4	60.2	60.6	2.5	-3.3	-3.3	.4
Services imports	331.6	336.4	334.4	338.4	9.5	4.8	1.6	4.0
Memo:								
Oil quantity (mb/d)	14.32	13.49	12.97	14.00	-.12	-.84	-.46	1.04
Oil import price ($/bbl)	55.10	62.92	60.42	65.42	-.51	7.81	5.61	5.00

1. Change from previous quarter or month. e. Average of two months.
Source. U.S. Department of Commerce, Bureaus of Economic Analysis and Census.

prices and quantities, with other categories of imports falling on balance. Imports of non-oil industrial supplies declined, led by a sharp decline in the value of imported natural gas. Imports of automotive products also fell sharply in May. Imports of capital goods were basically flat, with increases in several categories of machinery offsetting declines in computers and semiconductors. Imports of consumer goods were also flat. Imports of services rose moderately.

The average value of imports in April and May increased 5.5 percent (a.r.) from the first quarter. Imports of oil were particularly strong, primarily reflecting higher prices. In contrast, imports of automotive products declined, and imports of consumer goods and industrial supplies were little changed. In the advance NIPA release, real imports of good and services rose only 0.2 percent (a.r.) in the second quarter, following a rise of 9.1 percent in the first quarter.

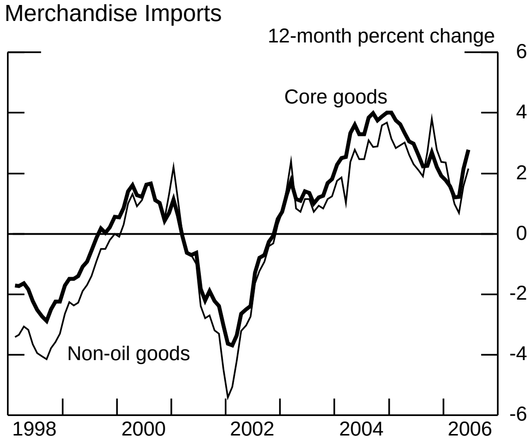
Prices of Internationally Traded Goods

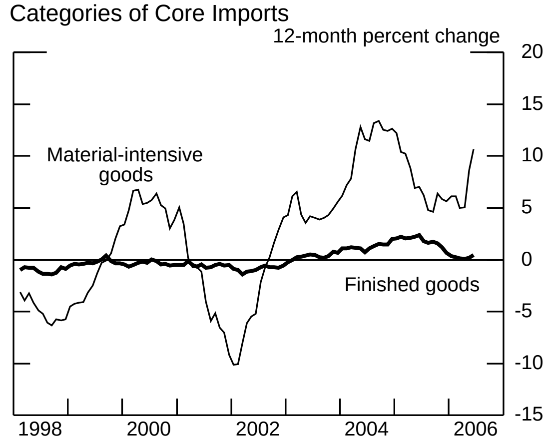
Non-oil imports. In June, import prices of non-oil goods and core goods rose 0.4 and 0.6 percent, respectively. After increasing 3 percent in May, prices for non-fuel industrial supplies rose another 2.4 percent in June, primarily reflecting a 7.3 percent increase in prices for unfinished metals. (This increase in metals prices followed a 8.5 percent increase in May.) Prices of imported finished goods also rose in June, albeit to a much smaller extent. Prices for imported capital goods (excluding computers and semiconductors) were up 0.5 percent. Prices for automotive products and consumer goods were also higher, increasing 0.2 and 0.1 percent, respectively. Prices for imported computers fell 0.3 percent, whereas prices for semiconductors rose 0.6 percent.

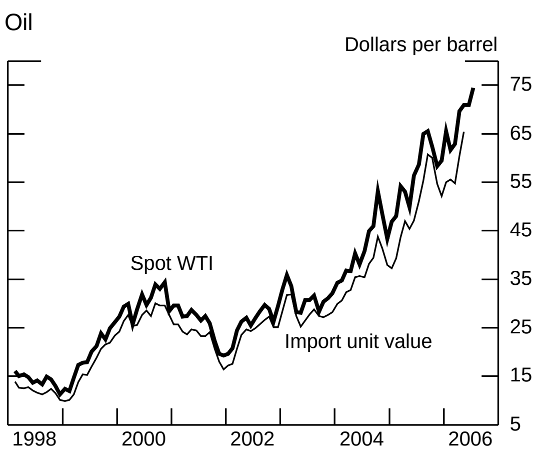
In the second quarter, according to the advance NIPA release, core import prices rose 3¾ percent at an annual rate, mostly reflecting an increase in prices for non-fuel industrial supplies. In addition, prices for capital goods (excluding computers and semiconductors) and automotive products were up slightly.

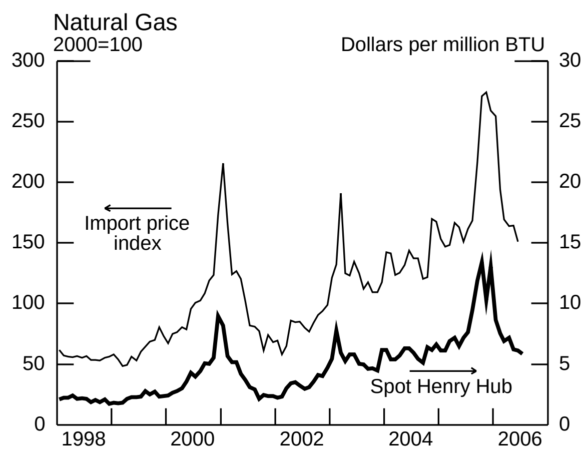
Oil. The BLS price index of imported oil fell 1.4 percent in June. In July, the spot price of West Texas Intermediate (WTI) crude oil averaged around $74.50 per barrel, up nearly 5 percent from June on increased fears of supply disruptions. The spot price closed at $75.82 per barrel on August 2, down about $1 per barrel from its peak in mid-July. Fears that the conflict between Israel and Lebanon could widen, increased tensions over Iran's nuclear program, an escalation of violence in Iraq, reduced Saudi oil production, and

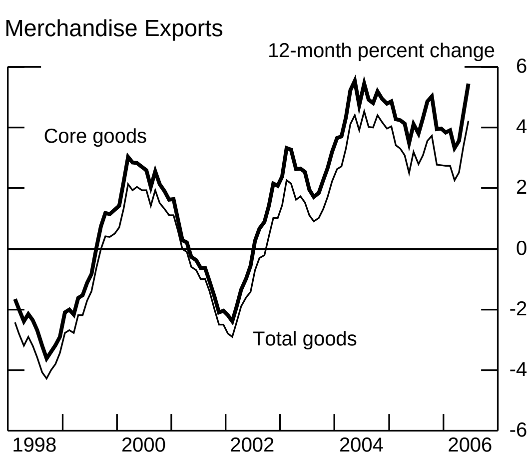
Prices of U.S. Imports and Exports

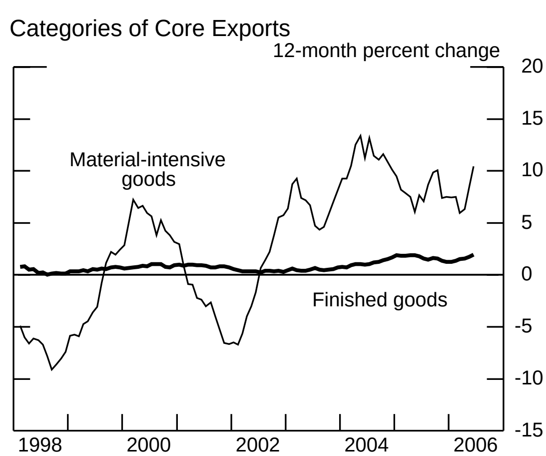












Prices of U.S. Imports and Exports
(Percentage change from previous period)

	Annual rate			Monthly rate		
	2005	2006		2006		
	Q4	Q1	Q2	Apr.	May	June
	BLS prices					
Merchandise imports	2.5	.1	12.2	2.0	1.7	.1
Oil	-11.3	6.8	74.9	11.0	6.1	-1.4
Non-oil	6.3	-1.2	1.0	.1	.7	.4
Core goods[1]	2.7	2.2	3.8	.2	.8	.6
Finished goods	.0	.6	.6	.0	.2	.3
Cap. goods ex. comp. & semi.	.0	1.7	2.0	.1	.2	.5
Automotive products	.6	-.8	1.0	.1	.1	.2
Consumer goods	-.3	.8	-.3	.0	.1	.1
Material-intensive goods	9.6	9.6	14.6	.6	2.7	1.7
Foods, feeds, beverages	7.5	5.5	-.7	-.7	1.6	-.1
Industrial supplies ex. fuels	8.0	11.8	20.6	1.0	3.0	2.4
Computers	-7.7	-6.9	-6.0	-.6	-.6	-.3
Semiconductors	-3.4	2.4	.0	-.2	-.4	.6
Natural gas	367.1	-65.2	-63.7	-3.1	.1	-8.0
Merchandise exports	3.4	2.9	6.5	.7	.6	.8
Core goods[2]	4.7	3.6	7.6	.8	.7	.9
Finished goods	1.7	2.7	2.5	.3	.2	.2
Cap. goods ex. comp. & semi.	2.6	4.0	3.0	.4	.2	.1
Automotive products	1.4	1.0	1.8	.2	.1	.1
Consumer goods	1.2	1.4	1.7	.1	.4	.3
Material-intensive goods	8.3	5.2	15.2	1.5	1.5	1.9
Agricultural products	-4.4	-1.4	1.6	-.5	.6	2.4
Industrial supples ex. ag	13.0	7.2	19.6	2.1	1.8	1.9
Computers	-8.3	1.2	-2.7	-.8	.5	-.5
Semiconductors	-6.4	-7.9	-2.6	.1	-.3	-.1
	NIPA prices					
Chain price index						
Imports of goods & services	4.3	-.7	9.3	...	...	...
Non-oil merchandise	6.3	-1.8	.7	...	...	...
Core goods[1]	2.5	1.6	3.7	...	...	...
Exports of goods & services	2.8	2.3	6.0	...	...	...
Total merchandise	2.3	2.8	5.9	...	...	...
Core goods[2]	4.0	3.7	6.6	...	...	...

1. Excludes computers, semiconductors, and natural gas.
2. Excludes computers and semiconductors.
n.a. Not available. ... Not applicable.

concerns that Tropical Storm Chris will strengthen and enter the Gulf of Mexico have all put upward pressure on oil prices. In addition, rebel attacks and a pipeline leak in Nigeria have reduced oil production.

Exports. In June, prices of U.S. exports of total goods and core goods increased 0.8 and 0.9 percent, respectively. Prices for nonagricultural industrial supplies increased 1.9 percent in June, on higher prices for metals and chemicals. Agricultural export prices rose 2.4 percent. Within finished goods, the most notable price increase was a 0.3 percent rise for consumer goods. Prices for automotive products and capital goods (excluding computers and semiconductors) increased 0.1 percent. In contrast, prices of exported computers and semiconductors fell 0.5 and 0.1 percent, respectively.

In the second quarter, according to the advance NIPA release, core export prices rose 6½ percent (a.r.), as prices increased in all sub-categories. The increase in prices for nonagricultural industrial supplies was the main contributor to the overall price increase. In addition, export prices for capital goods (excluding computers and semiconductors) continued to increase at a moderate pace.

U.S. International Financial Transactions

Foreign official flows into the United States (line 1 of the Summary of U.S. International Transactions table) moved up slightly in May and continue to run at a pace well above the average monthly pace of 2005.

Net private foreign purchases of U.S. securities surged in May (line 4) after weak net inflows in April. There were strong flows into Treasury securities (line 4a) in May, although private foreigners have still on net sold Treasury securities in 2006. Private foreign purchases of agency bonds rose to an extremely high level in May (line 4b), bringing the total for the first five months near that for all 2005. Foreign purchases of U.S. corporate bonds (line 4c) maintained the healthy average pace of recent months. The large debt inflows in May were primarily recorded against Japan, as well as the United Kingdom and Caribbean financial centers. Monthly transactions data are recorded against the country of first transactor, however, so transactions data for the two financial centers provide little information about the residence of the ultimate foreign counterparty. Flows into corporate stocks (line 4d) showed a second month of weakness, although year-to-date inflows remain sizable relative to historical levels.

U.S. acquisitions of foreign securities (line 5) picked up in May, and year-to-date purchases are slightly above last year's robust pace. Flows into foreign bonds (line 5a) neared record monthly levels, while purchases of stocks (line 5b) eased a bit. Some of this easing is due to large net sales of Japanese equities by U.S. investors, counter to the recent trend of strong U.S. demand for Asian equities.

Inflows recorded by the banking sector (line 3) were significant in May, but retreated from the unusually large level of inflows in April. This volatility is not unusual, however, as the magnitude and direction of banking flows often vary significantly from month to month.

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

	2004	2005	2005			2006		
			Q2	Q3	Q4	Q1	Apr	May
Official financial flows	**388.2**	**214.6**	**71.6**	**39.4**	**79.1**	**75.4**	**21.9**	**26.3**
1. Change in foreign official assets in the U.S. (increase, +)	385.4	200.5	72.4	34.6	74.3	74.9	21.7	25.6
a. G-10 countries + ECB	161.7	-20.7	-18.3	-4.0	-4.1	-8.9	-8.2	-3.0
b. OPEC	12.1	7.5	4.4	-3.7	10.6	12.0	4.6	4.1
c. All other countries	211.6	213.8	86.3	42.3	67.9	71.8	25.2	24.6
2. Change in U.S. official reserve assets (decrease, +)	2.8	14.1	-.8	4.8	4.8	.5	.2	.6
Private financial flows	**194.2**	**570.8**	**78.3**	**216.8**	**163.6**	**82.2**	**...**	**...**
Banks								
3. Change in net foreign positions of banking offices in the U.S. [1]	-3.8	18.3	-65.1	22.6	56.6	-2.2	90.5	21.0
Securities [2]								
4. Foreign net purchases of U.S. securities (+)	489.5	610.5	88.7	175.1	184.9	173.5	11.4	67.3
a. Treasury securities	104.2	179.1	-3.2	35.7	60.4	-2.6	-18.1	14.3
b. Agency bonds	67.9	67.5	14.4	34.6	17.0	40.4	.1	21.9
c. Corporate and municipal bonds	255.0	274.2	64.1	73.6	83.2	80.7	26.2	28.5
d. Corporate stocks [3]	62.4	89.7	13.4	31.2	24.4	55.0	3.2	2.5
5. U.S. net acquisitions (-) of foreign securities	-146.2	-197.2	-49.3	-47.5	-48.8	-53.3	-11.8	-20.9
a. Bonds	-60.9	-53.1	-24.5	-12.3	-5.5	-11.9	-2.7	-14.9
b. Stock purchases	-97.6	-140.1	-22.9	-35.1	-43.3	-37.4	-9.1	-6.0
c. Stock swaps [3]	12.2	-4.0	-1.9	.0	.0	-4.0	.0	.0
Other flows (quarterly data, s.a.)								
6. U.S. direct investment (-) abroad	-244.1	-9.1	-34.0	30.3	25.8	-61.8	...	...
7. Foreign direct investment in the U.S.	133.2	109.8	8.2	44.5	26.5	33.3	...	...
8. Foreign acquisitions of U.S. currency	14.8	19.4	4.5	4.7	9.2	1.9	...	...
9. Other (inflow, +) [4]	-49.1	19.1	125.1	-12.9	-90.6	-9.1	...	...
U.S. current account balance (s.a.)	**-665.3**	**-791.5**	**-193.3**	**-183.4**	**-223.1**	**-208.7**	**...**	**...**
Capital account balance (s.a.) [5]	**-2.3**	**-4.4**	**-.6**	**-.6**	**-.5**	**-1.8**	**...**	**...**
Statistical discrepancy (s.a.)	**85.1**	**10.4**	**44.0**	**-72.2**	**-19.1**	**52.8**	**...**	**...**

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

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

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

3. Includes (4d) or represents (5c) stocks acquired through non-market means such as mergers and reincorporations.

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

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

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

Foreign Financial Markets

Over the intermeeting period, the major currencies index of the dollar's value declined 1¼ percent on balance. The dollar depreciated following the June FOMC announcement and on the release of the U.S. June employment report, but appreciated as market participants revised down their expectations for the pace of monetary policy tightening in Canada and Japan and on higher-than-expected data on U.S. core consumer prices. The dollar subsequently depreciated following the release of the Beige Book and U.S. Q2 GDP data. On a bilateral basis, the dollar appreciated 1 percent against the Canadian dollar, but depreciated 4 percent against sterling, 2 percent against the euro, and 1 percent against the yen. The dollar's appreciation against the Canadian dollar occurred after the Bank of Canada signaled in early July that it would not resume its monetary tightening in coming months and after the release of weaker-than-expected Canadian GDP for May. The dollar's depreciation against sterling was attributed to the release of higher-than-expected U.K. consumer prices for June and a 25-basis-point surprise increase in the Bank of England's policy rate on August 3. The volatility of the dollar-euro and yen-dollar exchange rates implied by option prices remained close to historically low levels.

Equity indexes in major industrial countries were quite volatile over the intermeeting period, edging up slightly on balance in Europe and Japan. Global equity indexes rose following the June FOMC announcement, declined in mid-July on the worsening conflict in the Middle East and higher oil prices, and rose again following Chairman Bernanke's delivery of the Monetary Policy Report and on growing beliefs that the conflict in Lebanon and Israel would not spread to other parts of the Middle East. Share prices in the technology sector underperformed broad market indexes, as there were disappointing earnings reports and warnings by several leading global technology companies.

The yield on the ten-year government bond in Canada declined 30 basis points, comparable to that in the United States, but yields moved down only about 10 basis points in the euro area and 3 basis point in Japan. Realized volatility of ten-year government bonds was little changed in most industrial economies over the intermeeting period. Inflation compensation implied by the difference between long-term nominal yields and yields on inflation-indexed notes was little changed on net in the euro area and Japan, but increased slightly in the United Kingdom, consistent with the higher-than-expected U.K. consumer prices in June.

The dollar depreciated against several emerging market currencies over the intermeeting period. The dollar depreciated 3½ percent against the Mexican peso on net, and Mexican financial indicators surged in early July after Felipe Calderon appeared to win the presidential election. Subsequently, the outcome of the election was challenged by runner-up Andres Manuel Lopez Obrador, but there was only a muted reaction in Mexican financial markets. The Mexican stock market index rose 11 percent over the intermeeting period, and Mexico’s EMBI+ spreads declined 24 basis points. Other Latin American and emerging Asian equity prices took their cue from the fluctuations in industrial country equity prices; on net, they rose 2 to 7½ percent. EMBI+ spreads for most emerging market economies declined; Brazil’s and Argentina’s spreads declined 30 basis points and 46 basis points, respectively.

Since the June FOMC meeting, the spot price of gold has increased about 11 percent. The spot price of gold peaked above $660 per ounce on July 14, as market participants were concerned that the conflict in Lebanon and Israel might spread to other countries in the region (the spot price of WTI crude oil also reached a new all-time high on that day), but fell back late in the intermeeting period. Other precious and industrial metals prices also gained over the intermeeting period, and their daily fluctuations largely mirrored those of the price of gold.

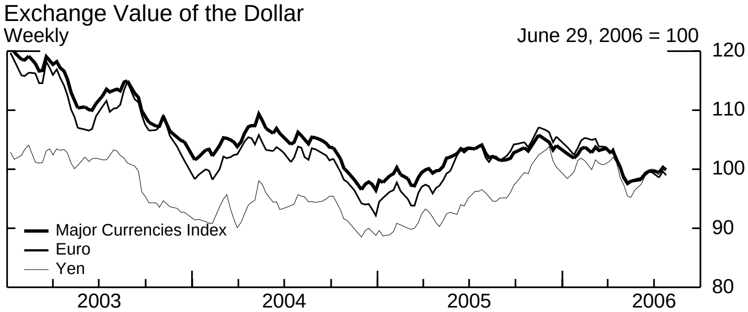
. The Desk did not intervene during the period for the accounts of the System or the Treasury.

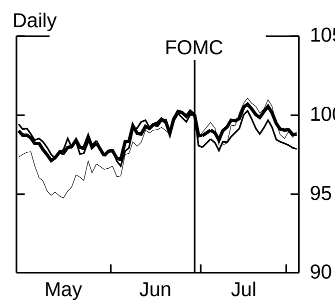
Exchange Value of the Dollar and Stock Market Indexes

	Latest	Percent change since June FOMC
*Exchange rates**		
Euro ($/euro)	1.2809	-2.1
Yen (¥/$)	114.9	-1.1
Sterling ($/£)	1.8886	-4.1
Canadian dollar (C$/$)	1.1275	1.1
*Nominal dollar indexes**		
Broad index	108.1	-1.1
Major currencies index	81.4	-1.2
OITP index	136.0	-1.1
Stock market indexes		
DJ Euro Stoxx	343.4	2.0
TOPIX	1569.5	1.4
FTSE 100	5840.8	0.9
S&P 500	1276.5	0.3

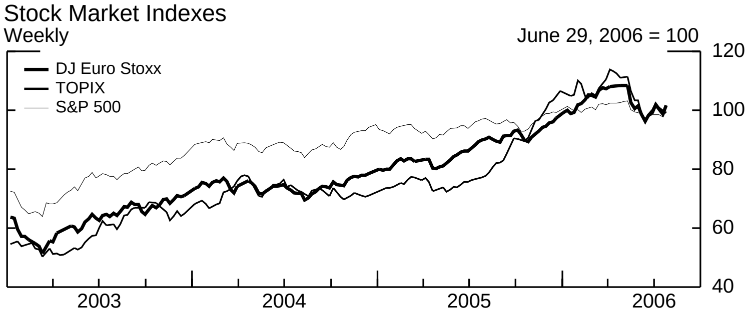
* Positive percent change denotes appreciation of U.S. dollar.

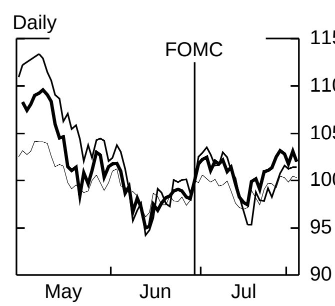
Exchange Value of the Dollar





Stock Market Indexes





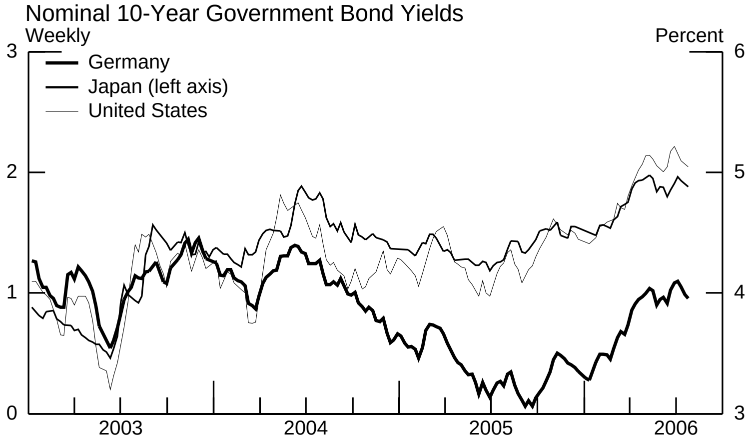
Industrial Countries: Nominal and Real Interest Rates

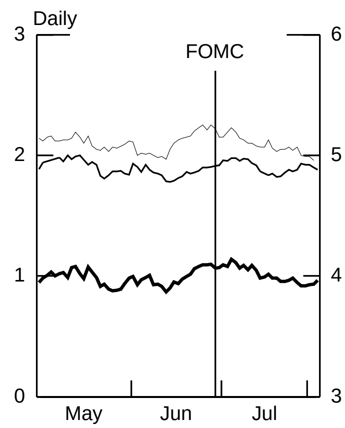
Percent

	3-month LIBOR Latest	3-month LIBOR Change since June FOMC	10-year nominal Latest	10-year nominal Change since June FOMC	10-year indexed Latest	10-year indexed Change since June FOMC
Germany	3.19	0.12	3.97	-0.10	1.83	-0.09
Japan	0.41	0.06	1.88	-0.03	1.05	-0.05
United Kingdom *	4.79	0.04	4.72	0.01	1.72	-0.06
Canada	4.30	-0.11	4.34	-0.30	...	...
United States	5.48	-0.03	4.96	-0.29	2.39	-0.22

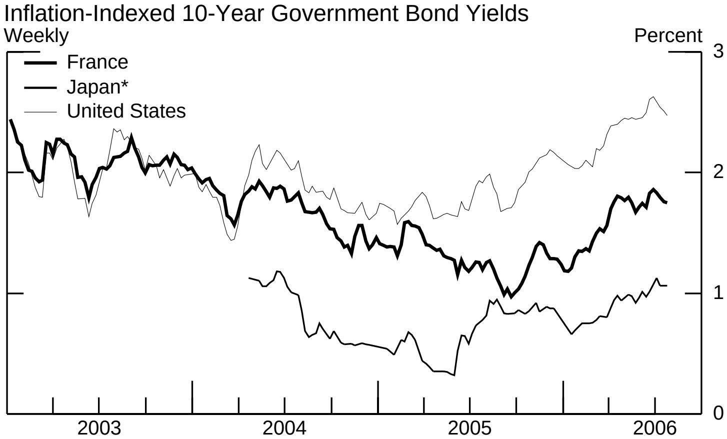
* 3-month LIBOR reported prior to Bank of England policy announcement.

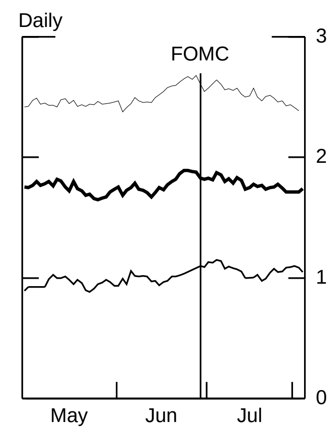
Nominal 10-Year Government Bond Yields





Inflation-Indexed 10-Year Government Bond Yields

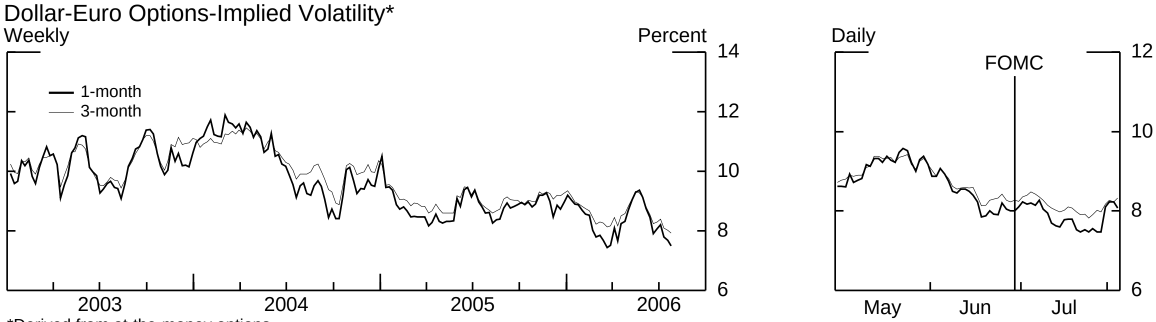




*Japan first issued inflation-indexed debt in March 2004.

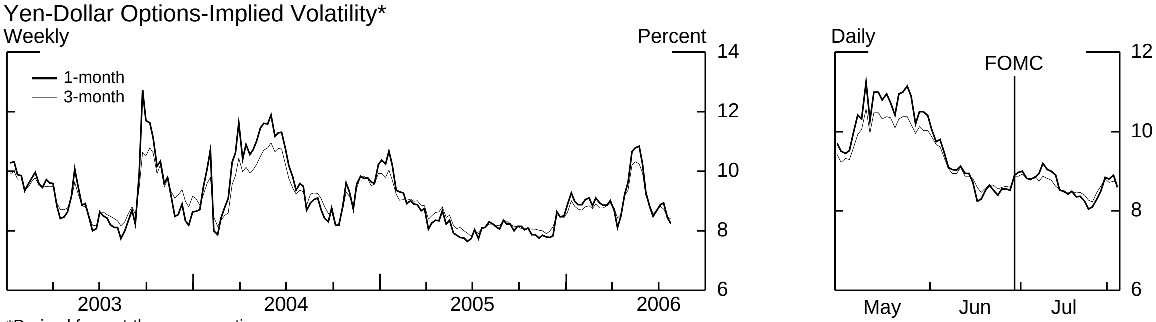
Measures of Market Volatility

Dollar-Euro Options-Implied Volatility*



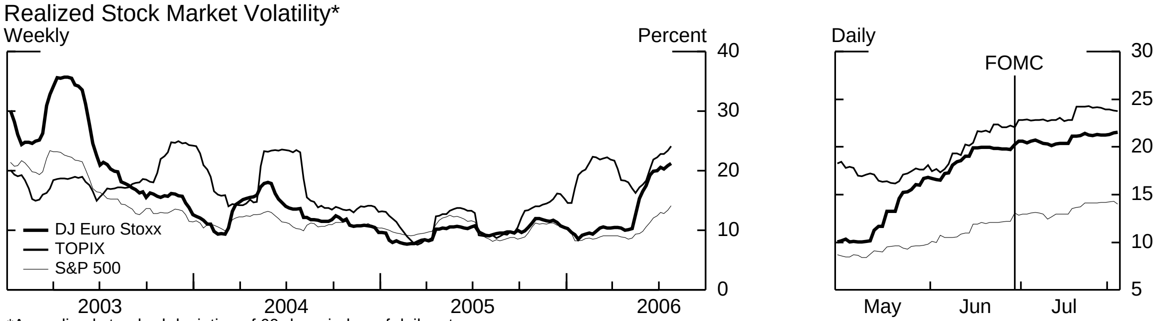
*Derived from at-the-money options.

Yen-Dollar Options-Implied Volatility*



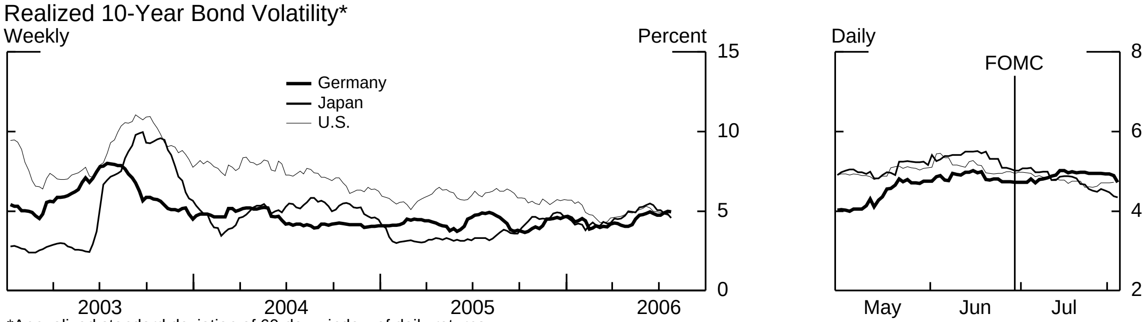
*Derived from at-the-money options.

Realized Stock Market Volatility*



*Annualized standard deviation of 60-day window of daily returns.

Realized 10-Year Bond Volatility*



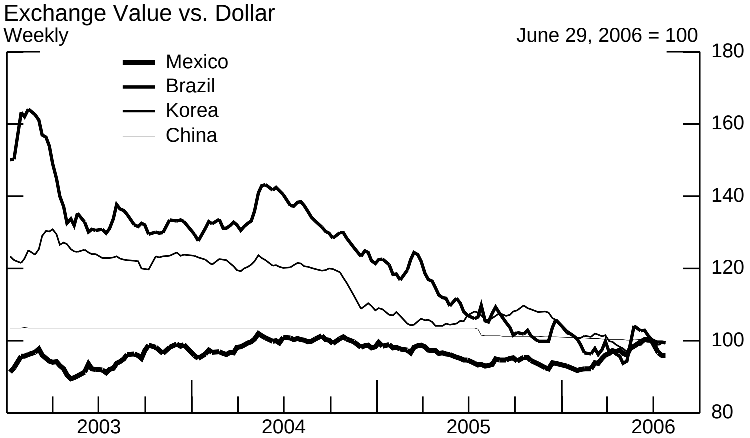
*Annualized standard deviation of 60-day window of daily returns.

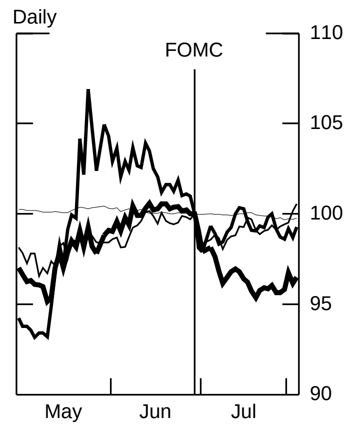
Emerging Markets: Exchange Rates and Stock Market Indexes

	Exchange value vs. dollar		Stock market index	
	Latest	Percent change since June FOMC*	Latest	Percent change since June FOMC
Mexico	10.9920	-3.5	20133	11.2
Brazil	2.1895	-0.7	36957	6.1
China	7.9768	-0.2	1601	-4.2
Hong Kong	7.7729	0.1	17048	7.5
Korea	965.6	0.5	1292	2.3
Taiwan	32.86	0.9	6462	-2.2
Singapore	1.5790	-1.0	633	2.8
Thailand	37.85	-1.5	703	4.8
India	46.56	0.9	10923	7.5

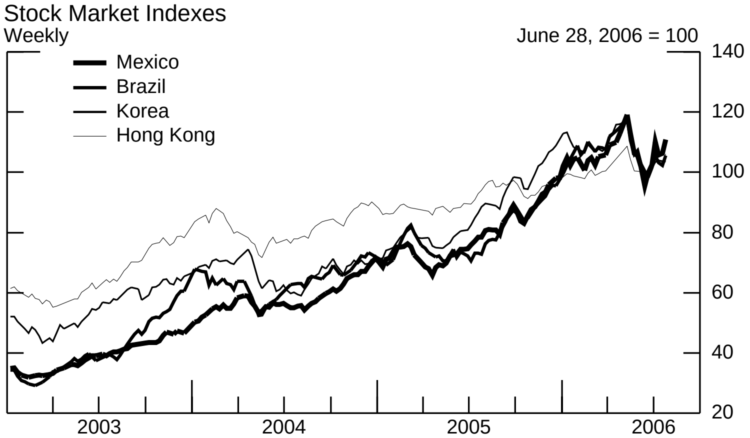
* Positive percent change denotes appreciation of U.S. dollar.

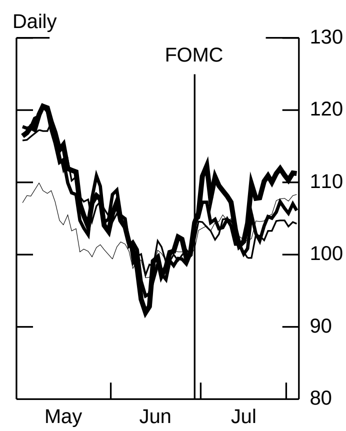
Exchange Value vs. Dollar





Stock Market Indexes





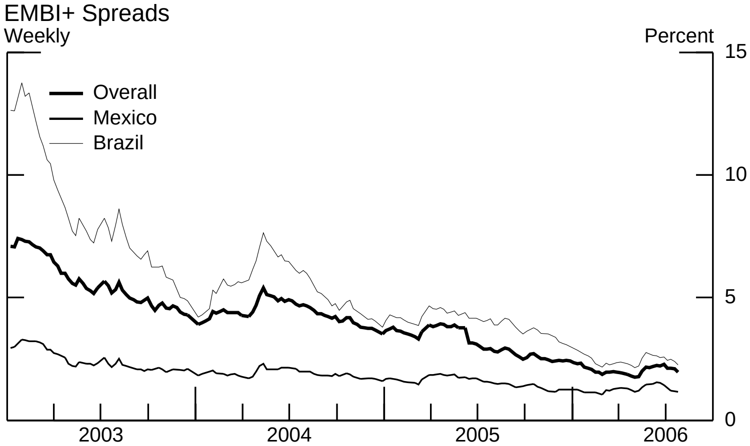
Emerging Markets: Short-Term Interest Rates and Dollar-Denominated Bond Spreads

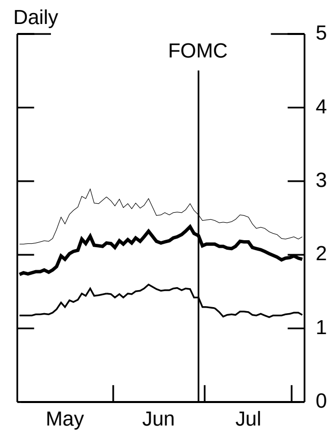
Percent

	Short-term interest rates*		Dollar-denominated bond spreads**	
	Latest	Change Since June FOMC	Latest	Change Since June FOMC
Mexico	6.95	-0.14	1.18	-0.24
Brazil	14.61	-0.43	2.24	-0.30
Argentina	10.25	0.25	3.44	-0.46
China	...	...	0.65	-0.02
Korea	4.28	0.00	...	...
Taiwan	1.76	0.01	...	...
Singapore	3.50	0.00	...	...
Hong Kong	3.88	-0.37	...	...

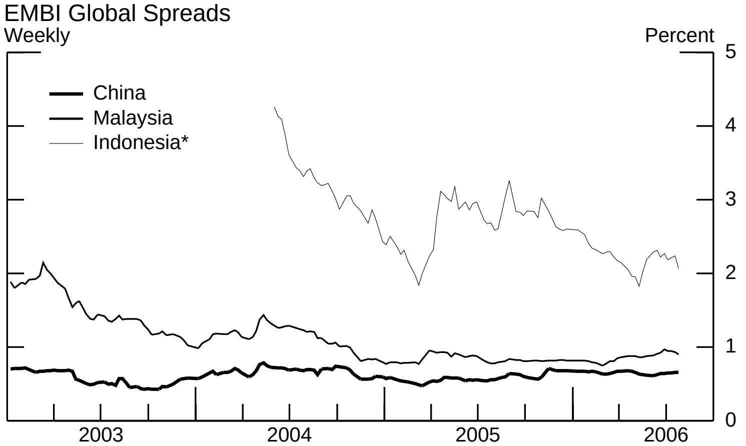
*One month interest rate except 1-week rate for Korea. No reliable short-term interest rate exists for China.
**EMBI+ or EMBI Global Spreads over similar-maturity U.S. Treasuries. Korea, Taiwan, Singapore, and Hong Kong have no outstanding dollar-denominated sovereign bonds.

EMBI+ Spreads

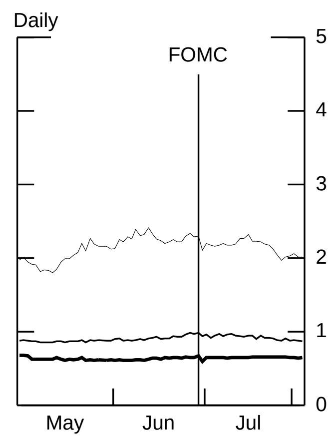




EMBI Global Spreads



*Begins May 2004.



Developments in Advanced Foreign Economies

Recent data point to a pick-up in economic growth in Europe and Japan in the second quarter but show that growth slowed somewhat in Canada from its rapid first-quarter pace. Business sentiment remains at high levels in the major economies, and labor-market conditions have continued to improve, suggesting that there is considerable economic momentum abroad despite higher energy prices and tightening financial conditions.

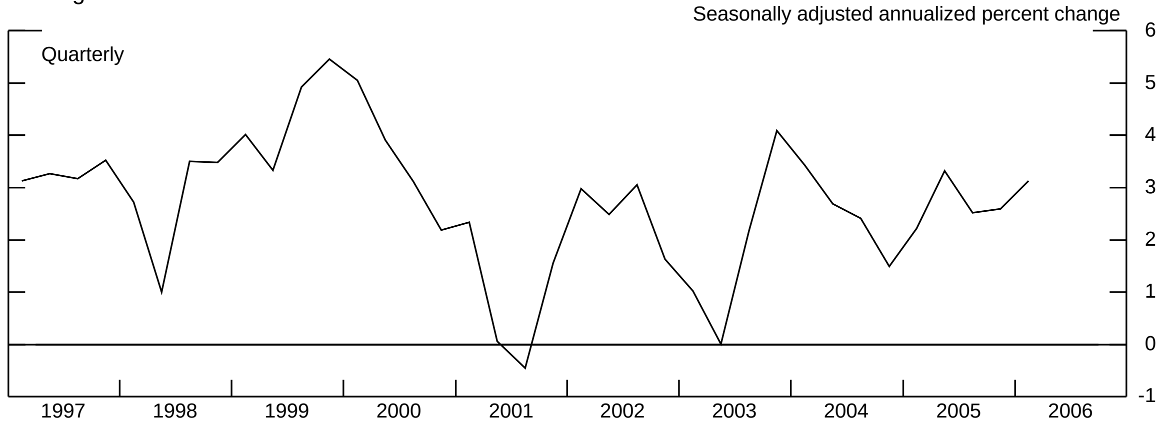
Inflation in the advanced foreign economies has been boosted by higher oil prices. Twelve-month inflation was 2½ percent in June in the euro area, the United Kingdom and Canada, above their targets of 2 percent. However, core inflation in those economies was well below 2 percent. Responding to inflation concerns, the ECB and the Bank of England raised policy interest rates ¼ percentage point on August 3. In Japan, positive inflation and further indications of economic strength led the Bank of Japan in July to end its five-year-old zero interest rate policy with a ¼ point hike in the overnight rate.

Monthly indicators for **Japan** suggest a pick-up in economic growth in the second quarter driven by investment spending. Production of capital goods rose 7.4 percent in the second quarter, while core machinery orders in April and May rose 6.3 percent from their first-quarter level. The Bank of Japan's June Tankan survey also pointed to healthy investment demand; the diffusion index of business conditions for firms of all sizes and industries rose to 6, and large firms reported that they planned to increase capital spending 11.6 percent in the current fiscal year. Indicators of demand in other sectors appeared less strong. Although average real spending by households rose 0.6 percent in the second quarter, new car registrations fell 3.6 percent and average retail sales were slightly below their first-quarter level. The real merchandise trade balance rebounded after a sharp dip in April, but the external sector seemed set to make only a weak contribution to growth as average exports rose only 1.4 percent over the second quarter.

Core consumer prices (which exclude fresh food but include energy) in the Tokyo area were flat in July but were 0.4 percent higher than a year ago. Core consumer prices for the country as a whole were 0.6 percent higher in June than a year earlier, while core consumer prices excluding both fresh food and energy were only 0.2 percent higher. Nominal wages rose 0.1 percent in June compared with a year earlier, as the labor market

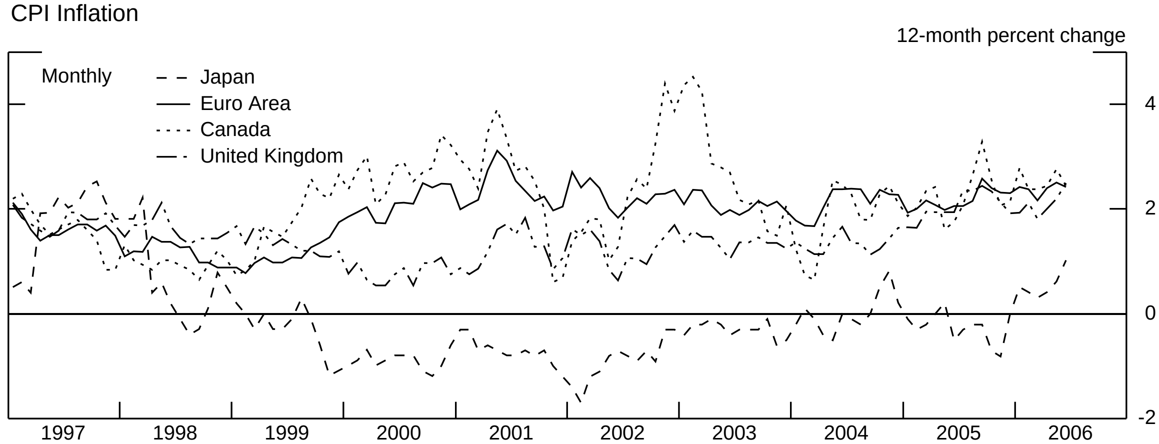
Advanced Foreign Economies

Average Real GDP*

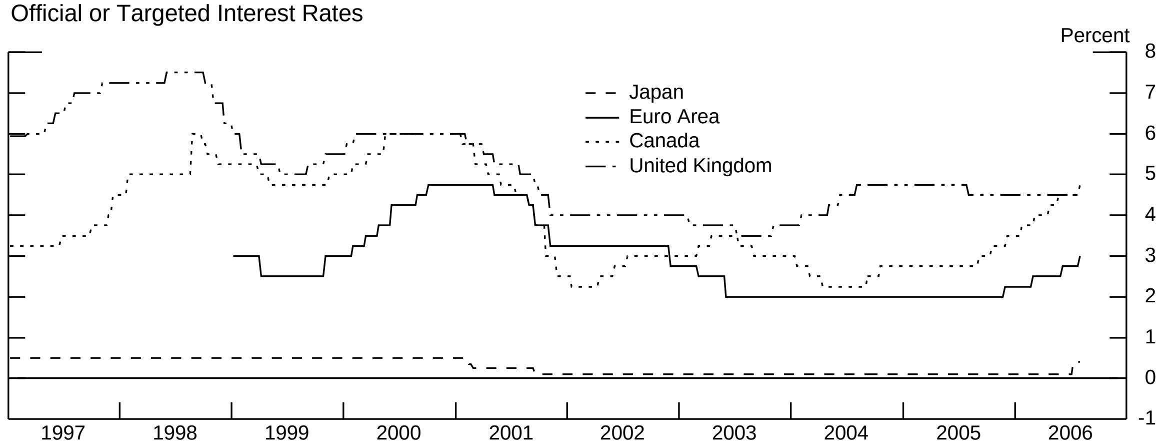


*Chain weighted by moving bilateral shares in U.S. merchandise exports.

CPI Inflation

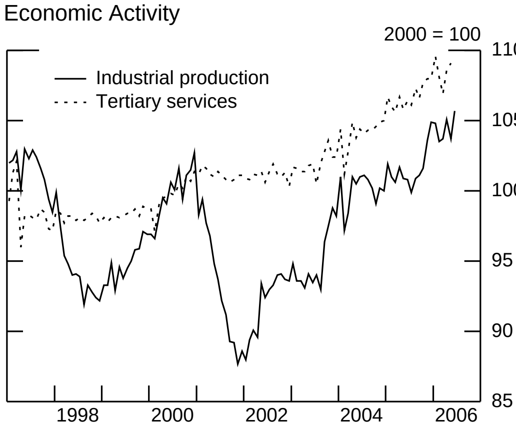


Official or Targeted Interest Rates

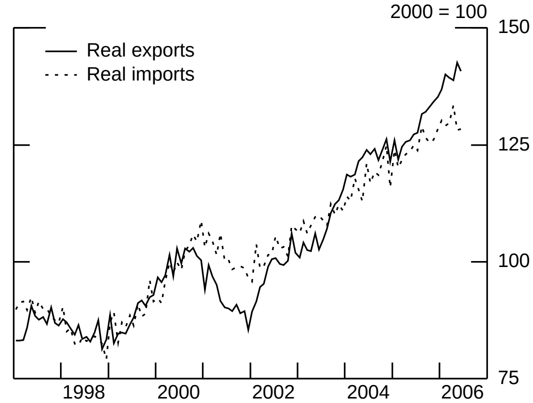


Japan

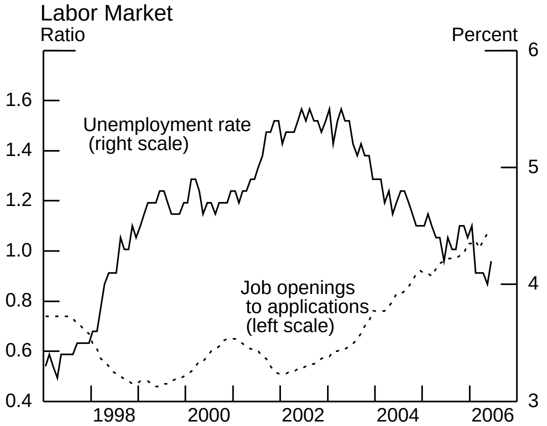
Economic Activity



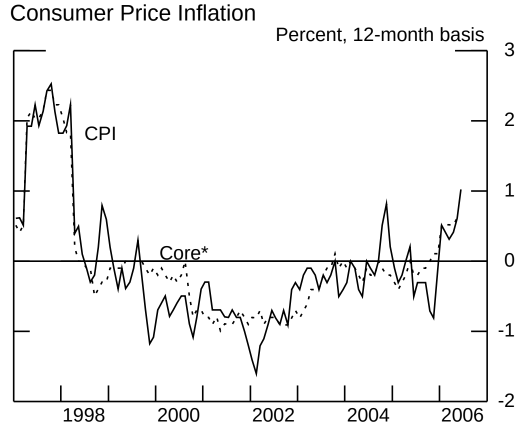
Real Trade



Labor Market



Consumer Price Inflation



*Excludes fresh food.

Economic Indicators
(Percent change from previous period except as noted, s.a.)

Indicator	2005 Q4	2006 Q1	2006 Q2	2006 Apr.	May	June	July
Housing starts	-2.0	1.7	2.5	9.1	-3.1	-0.9	n.a.
Machinery orders[1]	2.8	-0.4	n.a.	10.8	-2.1	n.a.	n.a.
Machinery shipments[2]	4.0	-0.2	3.5	5.0	-1.9	0.9	n.a.
New car registrations	-4.7	2.8	-3.9	-2.6	-2.7	1.9	-6.9
Business sentiment[3]	5.0	5.0	6.0	...	...	...	...
Wholesale prices[4]	2.1	2.8	3.0	2.5	3.3	3.3	n.a.

1. Private sector, excluding ships and electric power.
2. Excluding orders for ships and from electric power companies.
3. Tankan survey, diffusion index. Level.
4. Percent change from year earlier, n.s.a.

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

continued to improve. Although the unemployment rate rose two-tenths to 4.2 percent in June, the rise seemed primarily due to workers quitting to seek better jobs. The offers-to-applicants ratio (the number of officially posted job openings relative to the number of officially registered job seekers) reached a 14-year high.

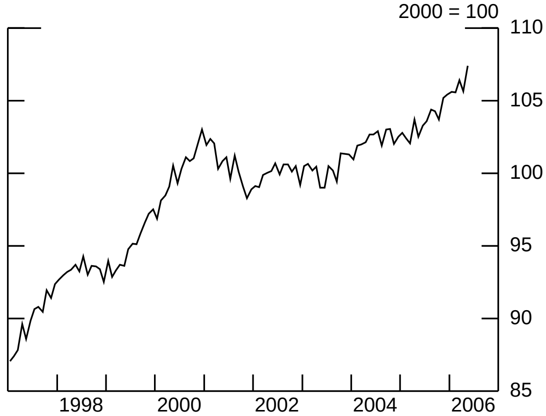
The Bank of Japan ended its zero interest rate policy in July, raising the target rate for overnight call loans to 0.25 percent. The Bank also lifted the official discount rate from 0.1 percent to 0.4 percent. The moves were widely expected following the upbeat results of the Tankan business survey released one week earlier; however, interest rates fell about 7 basis points across maturities as the Bank signaled its intent to proceed cautiously. The Bank had some difficulties keeping overnight rates near its target over the first week of the new policy, but the market has settled down and rates have since been close to the target level.

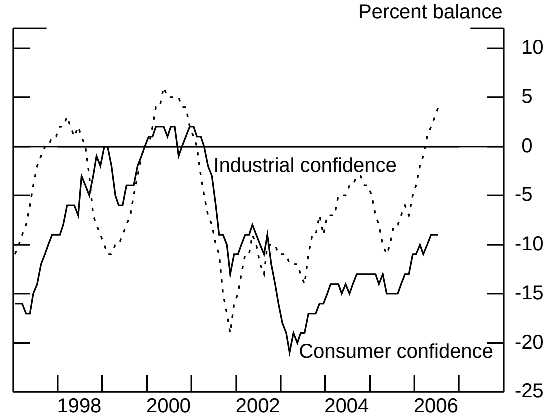
Data for the **euro area** suggest that economic growth was strong in the second quarter. Euro-area industrial production rose 1.6 percent in May, led by a 2½ percent increase in the production of capital goods. Industrial production for April and May on average was 0.6 percent higher than the first-quarter average. Belgium, the first euro-area country to release second-quarter GDP data, showed economic growth at a 3.2 percent pace, a stronger-than-expected performance that could bode well for the euro area as a whole.

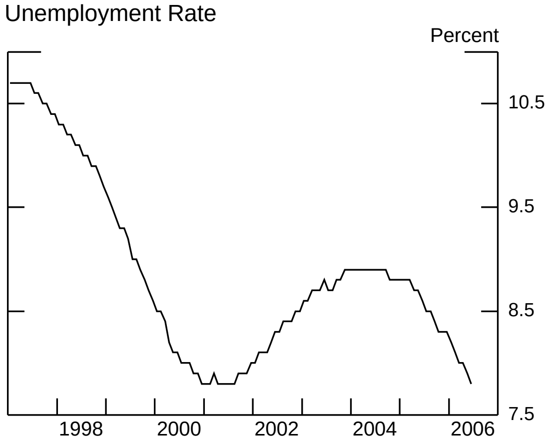
Data on consumer spending generally are consistent with continued growth. The average volume of euro-area retail sales rose 0.5 percent in June from the previous month and 0.4 percent for the second quarter as a whole. French consumption of manufactured products capped a strong second quarter by advancing 1.7 percent in June; purchases of consumer electronics made particularly large gains, which some analysts attributed to television purchases ahead of the World Cup. Euro-area consumer confidence held in June and July at the 3½-year high reached in May.

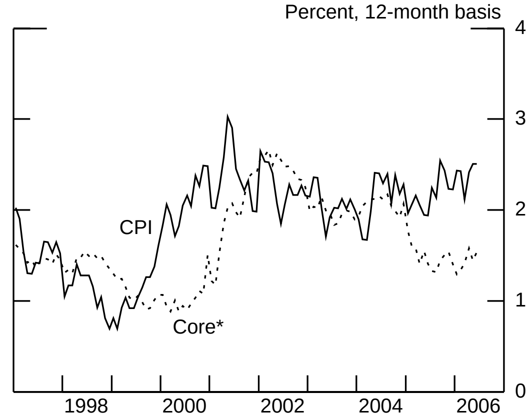
Survey data show business sentiment still at high levels in July but also show some signs of concern about future prospects. The European Commission's survey showed a further increase in industrial confidence in July and a sharp rise in construction sector confidence. In contrast, the euro-area purchasing managers' index for manufacturing gave back some of recent gains in July, declining to 57.4 from 57.7 in June, where 50 is the threshold for positive growth. The PMI for the service sector took a more substantial step back from 60.7 in June to 57.9 in July, the lowest level since January. Data from the German IFO survey suggest that German firms see current strength but are somewhat less

Euro Area









*Excludes energy and unprocessed food.

Economic Indicators
(Percent change from previous period except as noted, s.a.)

Indicator	2005 Q4	2006 Q1	2006 Q2	2006 Mar.	2006 Apr.	2006 May	2006 June
Industrial production[1]	0.6	1.1	n.a.	0.8	-0.7	1.6	n.a.
Retail Sales Volume[2]	0.4	0.2	0.4	-0.6	0.9	-0.3	0.5
Unemployment rate[3]	8.3	8.1	7.9	8.0	8.0	7.9	7.8
CPI[4]	2.3	2.3	2.5	2.2	2.4	2.5	2.5
Producer prices[4]	4.4	5.2	5.8	5.1	5.5	6.1	5.8
M3[4]	7.4	8.5	8.5	8.5	8.7	8.8	8.5

1. Excludes construction.
2. Excludes motor vehicles.
3. Percent. Euro-area standardized to ILO definition. Includes Eurostat estimates in some cases.
4. Eurostat harmonized definition. Percent change from year earlier, s.a.
n.a. Not available. ... Not applicable.

optimistic about the future than they were a few months ago. The IFO business climate index soared in June to a 15-year high, but retraced that gain in July. The current conditions component of the IFO edged just a bit lower in July, but IFO business expectations dropped to their lowest level since last December.

Euro-area consumer prices rose 0.3 percent in July from the previous month; the 12-month rate of inflation remained at 2.5 percent. Core inflation, excluding energy and unprocessed food, remained at 1.5 percent in June. The European Central Bank (ECB) raised its policy interest rate ¼ percentage point to 3 percent at its August 3 meeting. That move had been widely expected after the ECB had pledged "strong vigilance" against inflation in its statement following the July policy meeting.

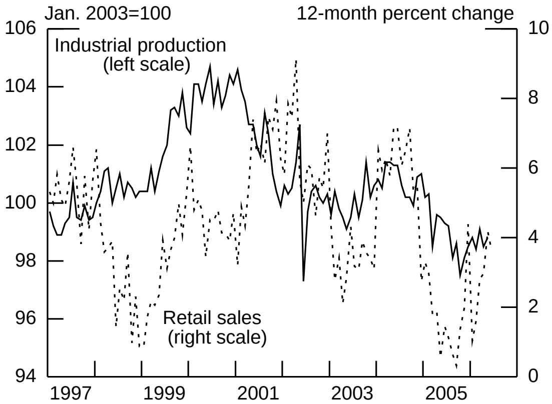
Real GDP in the **United Kingdom** rose 3.4 percent (a.r.) in the second quarter, according to the preliminary estimate. The business services and finance sector increased 5.1 percent (a.r.) and retail sales rose 2.1 percent after declining 0.5 percent in the first quarter. In contrast, industrial production declined 0.4 percent. The trade deficit narrowed, on average, in April and May relative to the first-quarter average.

Early indications suggest that on balance activity in the third quarter will continue to be relatively strong. Business confidence held steady at a high level in July. The manufacturing PMI in July indicates expansion in that sector, though it fell to 53.8 from a downwardly revised 55 in June. The PMI for the service sector and consumer confidence both moved down in July, although they both remain at a reasonably robust levels, and one of the leading surveys of retail sales suggests that the rise in July's sales will be around the average pace seen in the second quarter. House prices, as collected by Nationwide, a leading British lender, rose almost 6 percent in the twelve months ending in July, up from around 5 percent last month. While the unemployment rate has drifted upwards slightly since mid-2005, the participant rate has also risen about ½ percentage point and the growth rate of employment has been relatively strong.

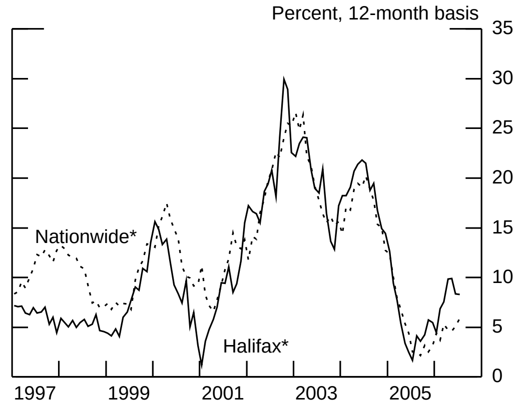
On August 3, the Bank of England raised its official rate paid on commercial bank reserves by 25 basis points to 4.75 percent. The twelve-month change in U.K. consumer prices rose to 2.5 percent in June, above the Bank of England's target of 2 percent, though consumer prices excluding energy prices rose 1.3 percent over the same period. The Bank expects the headline inflation rate "to remain above [its] 2 percent target for some while", as some recovery in pay growth and profit margins offset a moderation in energy price inflation.

United Kingdom

Retail Sales and Industrial Production

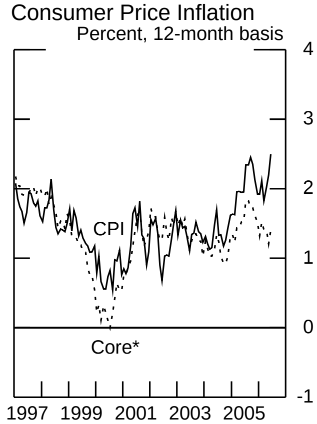


House Price Inflation



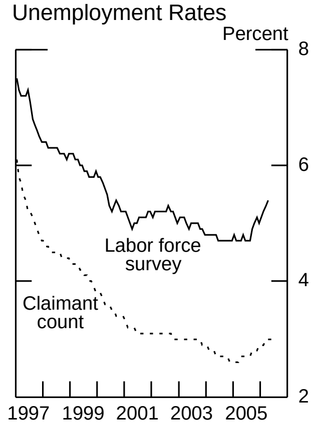
*Nationwide and Halifax are two of Britain's largest mortgage lenders.

Consumer Price Inflation

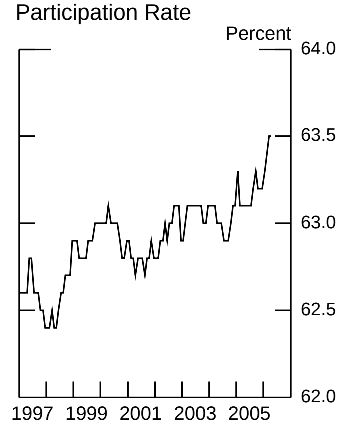


*Excludes energy and unprocessed food.

Unemployment Rates



Participation Rate



Economic Indicators
(Percent change from previous period except as noted, s.a.)

Indicator	2005 Q4	2006 Q1	2006 Q2	2006 Apr.	2006 May	2006 June	2006 July
Real GDP[1]	2.7	3.0	3.4	...	...	...	...
Producer Prices[2]	13.5	14.5	13.3	15.2	13.7	10.9	n.a.
Average Earnings[2]	3.6	4.2	n.a.	3.6	4.3	n.a.	n.a.
Business Confidence[3]	-2.0	8.0	12.0	12.0	10.0	14.0	14.0
Consumer Confidence[4]	-4.0	-4.0	-4.7	-3.0	-6.0	-5.0	-6.0
Trade Balance[5]	-31.3	-34.4	n.a.	-9.8	-12.6	n.a.	n.a.

1. Preliminary estimate (s.a.a.r.). 2. Percent change from year earlier.
3. Percentage of firms expecting output to increase in the next four months less percentage expecting output to decrease.
4. Average of the percentage balance from consumers' expetations of their financial situation, general economic situation, unemployment, and savings over the next 12 months. 5. Level in billions of US Dollars.
n.a. Not available. ... Not applicable.

Indicators of second-quarter economic activity in **Canada** suggest a sharp slowdown from the 3.8 percent rate of growth in the first quarter. In May, real GDP by industry fell 0.5 percent (a.r.), after only a modest 1.3 percent advance in April. Declines in goods production outweighed gains in services output. Except for a slight advance in the manufacturing sector, output of the major goods-producing sectors declined in May. In the service sectors, wholesale trade continued to expand, but retail sales fell for the first time since last September.

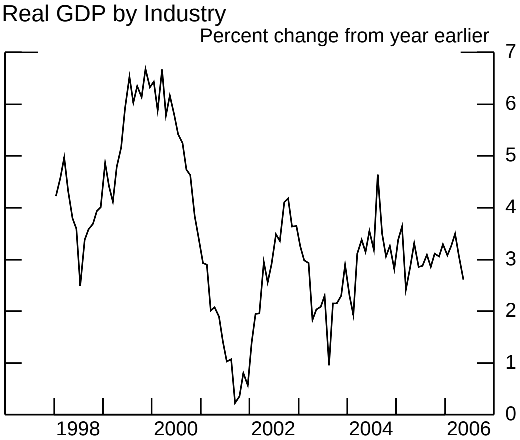
Other indicators for the second quarter also show a deceleration of GDP compared to the first quarter. Housing starts in the second quarter were below their lofty first-quarter level but were near their average over the past few years. The merchandise trade balance improved in May after declining in each of the previous four months. However, exports continued to fall. The average volume of manufacturing new orders and manufacturing shipments in April and May was each lower than their respective second-quarter averages.

Consistent with the retail sales data in the monthly GDP release, the survey of retailers also showed a decline in May led by a drop in sales in the automotive sector. The decline in retail sales was only the second in the last eight months. In contrast, the Canadian labor market has remained strong. While employment was virtually unchanged in June, second-quarter job growth was the largest in nearly four years, and the gains continued to be concentrated in full-time employment. The unemployment rate held steady at 6.1 percent, a 32-year-low.

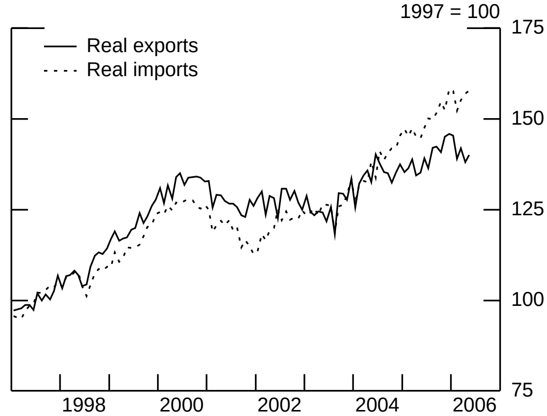
After spiking in May to 2.8 percent due to higher gasoline prices at the pump, the twelve-month rate of consumer price inflation pulled back to 2.5 percent in June as gasoline prices receded a bit. The twelve-month rate of core inflation, which excludes the eight most volatile components, fell to 1.7 percent in June after touching 2 percent in May.

Canada

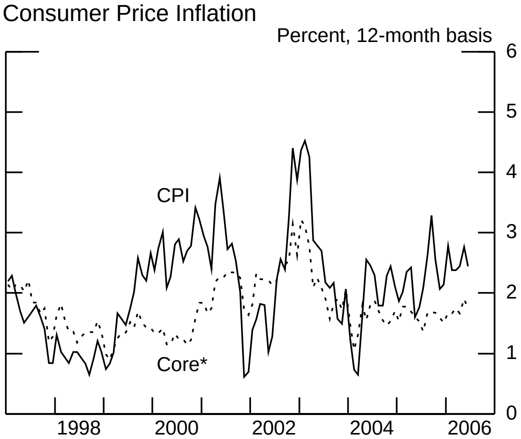
Real GDP by Industry



Real Trade



Consumer Price Inflation



*Excludes 8 most volatile components

Unemployment Rate

Economic Indicators
(Percent change from previous period except as noted, s.a.)

Indicator	2005	2006		2006			
	Q4	Q1	Q2	Mar.	Apr.	May	June
Industrial Production	0.6	-0.6	n.a.	-0.3	-0.3	-0.5	n.a.
New Manufacturing Orders	0.7	-1.3	n.a.	1.0	-1.9	0.7	n.a.
Retail Sales	0.6	3.0	n.a.	1.3	1.4	-0.6	n.a.
Employment	0.6	0.4	0.8	0.3	0.1	0.6	-0.0
Consumer Attitudes[1]	118.4	121.2	122.7	...	...	...	...
Business Confidence[1]	147.2	146.0	142.9	...	...	...	...

1. 1991=100.
n.a. Not available. ... Not applicable.

Economic Situation in Other Countries

Recent economic indicators from the developing economies have been mixed but generally suggest some moderation in growth from its rapid first-quarter pace. While the Chinese economy continued to expand strongly in the second quarter, activity elsewhere in developing Asia showed some deceleration. In Latin America, second-quarter growth appears to have moderated somewhat in Mexico and Brazil but picked up a bit in Argentina and Venezuela. Inflation in the developing world has edged up of late, but it has generally remained contained. Emerging financial markets appear to have calmed recently, most notably in Turkey.

The **Chinese** economy continued to expand at a blistering pace in the second quarter, posting growth of nearly 12 percent at an annual rate. Despite official efforts to slow investment spending, investment in fixed assets accelerated in the second quarter, with four-quarter growth rising to 30 percent from 26½ percent in the first quarter. Lending also accelerated in the second quarter. The strong second-quarter GDP growth reflected another hefty rise in the trade surplus as well, as exports continued to expand at a rapid pace while imports rose only modestly.

In June, industrial production showed a further strong gain, while twelve-month growth in retail sales remained near 14 percent. The central bank responded to the recent strength of investment by raising reserve requirements for commercial banks ½ percentage point, the second such increase in the past two months. The government also issued a new set of measures restricting foreign investments in mainland properties and announced it would more stringently enforce collection of capital gains taxes on real estate held for less than five years, thus attempting to cool the overheated real estate market. Consumer price inflation is still low but has continued to edge up, reaching 1½ percent over the twelve months ending in June.

Chinese Economic Indicators
(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006 Q1	2006 Q2	2006 Apr.	2006 May	2006 June
Real GDP[1]	10.1	9.9	13.3	11.7	…	…	…
Industrial production	14.4	17.1	5.3	4.2	-.1	3.1	2.6
Consumer prices[2]	2.5	1.6	1.2	1.4	1.2	1.4	1.5
Merch. trade balance[3]	32.1	102.0	132.8	160.8	169.9	145.6	166.8

1. Annual rate. Quarterly data estimated by staff from reported four-quarter growth rates. Annual data are Q4/Q4.
2. Percent change from year-earlier period, except annual data, which are Dec./Dec.
3. Billions of U.S. dollars, annual rate. Imports are c.i.f.
. . . Not applicable.

In **Hong Kong**, incoming indicators suggest GDP growth slowed slightly from the heady pace of the first quarter. In May, a contraction in exports and a small expansion in the value of imports generated a record monthly trade deficit. Although the trade deficit narrowed in June, it widened for the second quarter. The most recent data on indexes of the quantity of exports and imports (not shown) suggest that both fell in May, a potential indication of slowing growth in this entrepot economy. In June, twelve-month inflation was 2.7 percent, largely reflecting rising housing rents.

Hong Kong Economic Indicators
(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006 Q1	2006 Q2	2006 Apr.	2006 May	2006 June
Real GDP[1]	7.3	7.4	10.0	n.a.	…	…	…
Unemployment rate[2]	6.9	5.7	5.2	5.0	5.1	4.9	5.0
Consumer prices[3]	.2	1.8	2.0	2.6	2.3	2.8	2.7
Merch. trade balance[4]	-12.0	-10.5	-14.2	-21.7	-16.6	-33.8	-14.6

1. Annual rate. Annual data are Q4/Q4.
2. Percent. Monthly data are averages of the current and previous two months.
3. Percent change from year-earlier period, except annual data, which are Dec./Dec.
4. Billions of U.S. dollars, annual rate. Imports are c.i.f.
n.a. Not available. . . . Not applicable.

In **Taiwan**, incoming data suggest that growth picked up a bit in the second quarter after contracting slightly in the first. A surge in exports contributed to a sizeable trade surplus in the second quarter. Although industrial production fell in June, export orders for electronics increased considerably. Twelve-month inflation edged up to 1.7 percent in June, as food and energy prices increased.

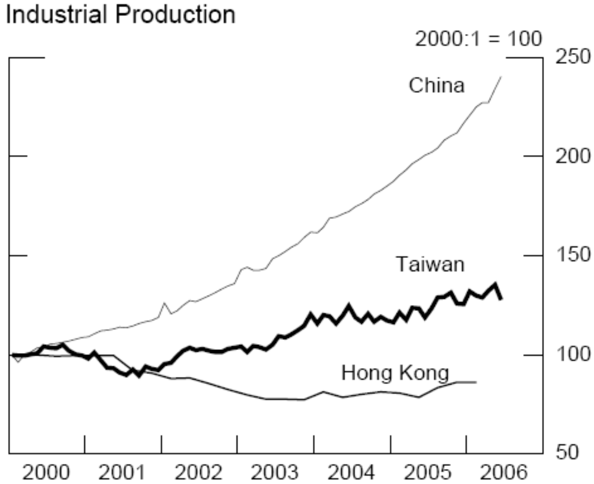
Taiwan Economic Indicators
(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q1	Q2	Apr.	May.	June
Real GDP[1]	2.6	6.4	-.7	n.a.	…	…	…
Unemployment rate[2]	4.4	4.1	4.0	3.9	3.9	3.9	3.9
Industrial production	9.8	4.1	2.1	1.1	2.6	2.2	-5.5
Consumer prices[3]	1.6	2.2	1.3	1.5	1.2	1.6	1.7
Merch. trade balance[4]	6.1	7.8	1.0	12.7	19.2	9.7	9.2
Current account[5]	18.5	16.1	25.5	n.a.	…	…	…

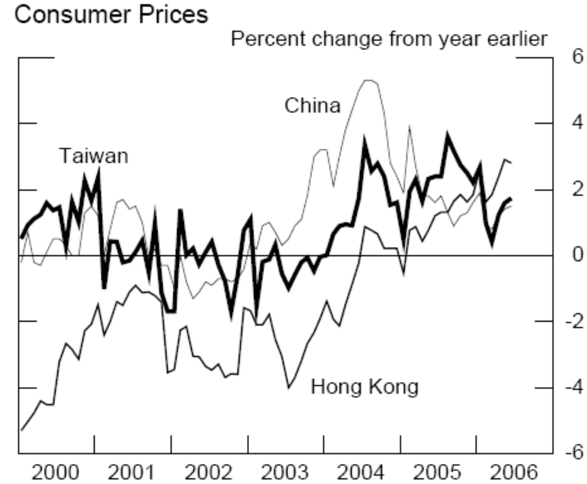
1. Annual rate. Annual data are Q4/Q4.
2. Percent.
3. Percent change from year-earlier period, except annual data, which are Dec./Dec.
4. Billions of U.S. dollars, annual rate. Imports are c.i.f.
5. Billions of U.S. dollars, n.s.a., annual rate.
n.a. Not available. . . . Not applicable.

Greater China

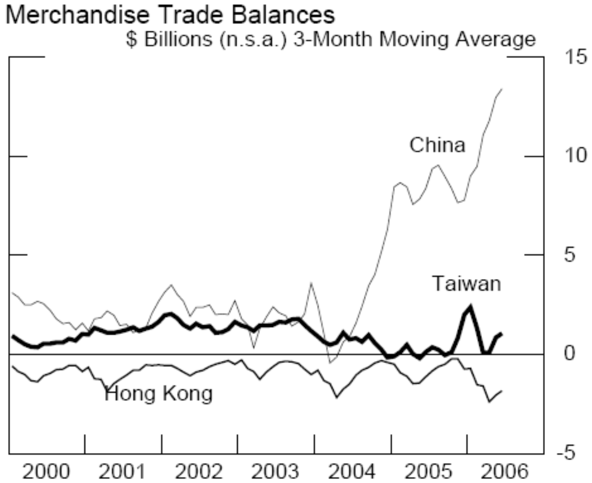
Industrial Production



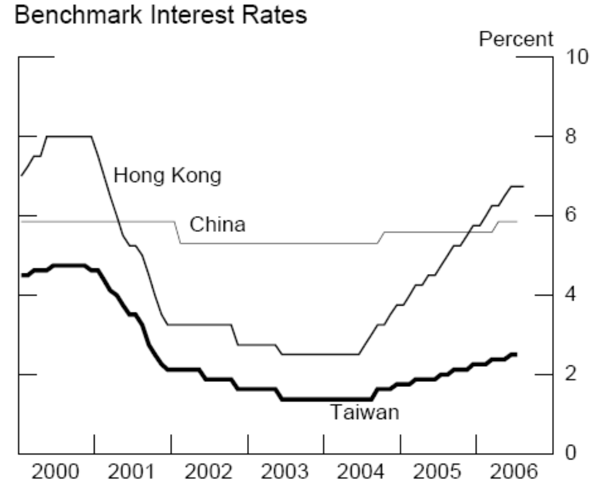
Consumer Prices



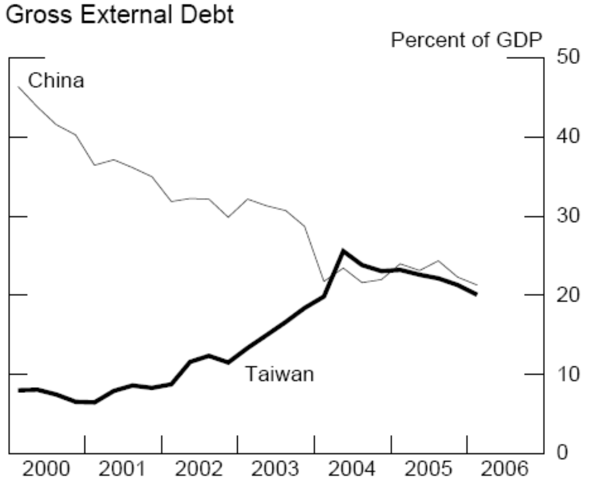
Merchandise Trade Balances



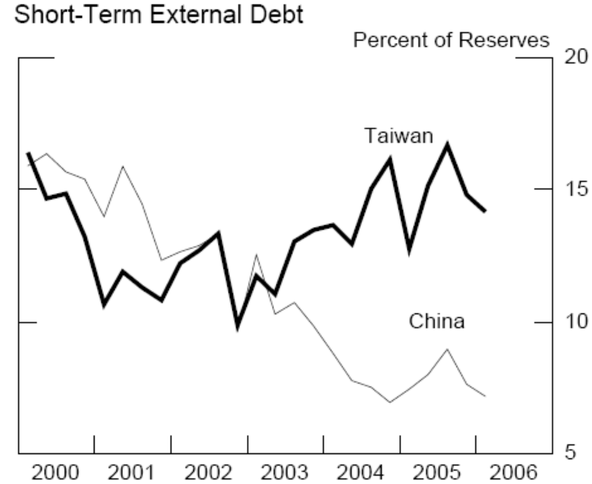
Benchmark Interest Rates



Gross External Debt



Short-Term External Debt



In **Korea**, economic conditions have moderated since the last Greenbook. Second-quarter GDP growth slowed to 3.3 percent from almost 5 percent in the first quarter. Contributing to the second-quarter weakening were a moderation in consumption, a surge in import growth, and a drop in investment in structures. Korea posted a slight current account surplus (n.s.a.) in the second quarter as export growth picked up after a first-quarter dip and the service deficit narrowed. Consumer prices rose 2.3 percent over the 12 months ending in July. The Bank of Korea left interest rates unchanged in July, citing weakness in construction and a moderation in real estate price inflation.

Korean Economic Indicators
(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q1	Q2	May	June	July
Real GDP[1]	2.9	5.3	4.9	3.3	…	…	…
Industrial production	10.0	5.9	3.1	-.4	1.8	1.2	n.a.
Unemployment rate[2]	3.5	3.7	3.5	3.5	3.4	3.5	n.a.
Consumer prices[3]	3.0	2.6	2.4	2.3	2.4	2.6	2.3
Merch. trade balance[4]	37.6	33.5	25.8	25.6	28.4	23.4	n.a.
Current account[5]	28.2	16.6	-4.5	3.4	16.3	13.2	n.a.

1. Annual rate. Annual data are Q4/Q4.
2. Percent.
3. Percent change from year-earlier period, except annual data, which are Dec./Dec.
4. Billions of U.S. dollars, annual rate. Imports are c.i.f.
5. Billions of U.S. dollars, n.s.a., annual rate.
n.a. Not available. . . . Not applicable.

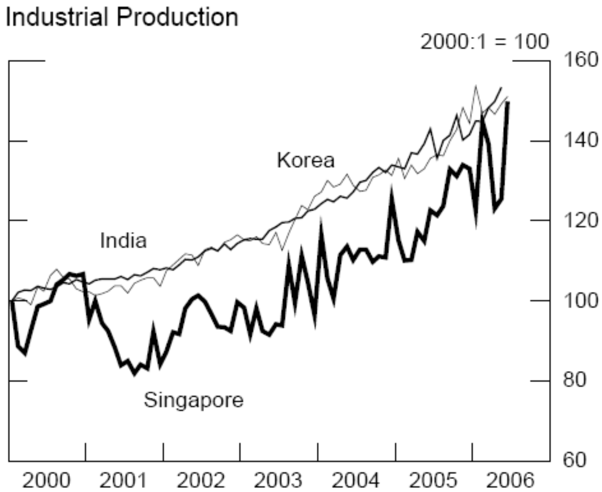
Performance of the **Indian** economy remains robust. On average, industrial production in April and May was up over 3¾ percent from the first-quarter level. Twelve-month consumer and wholesale price inflation continued to increase in June, although there are signs of moderation in the wholesale price index in July. The trade deficit remained at nearly $44 billion in the second quarter. After surprising markets with a rate hike in June, the Reserve Bank of India increased its key rate another 25 basis points at its meeting in July, partly in response to higher oil prices. Also to control inflation, the government has stopped the export of certain food products such as lentils.

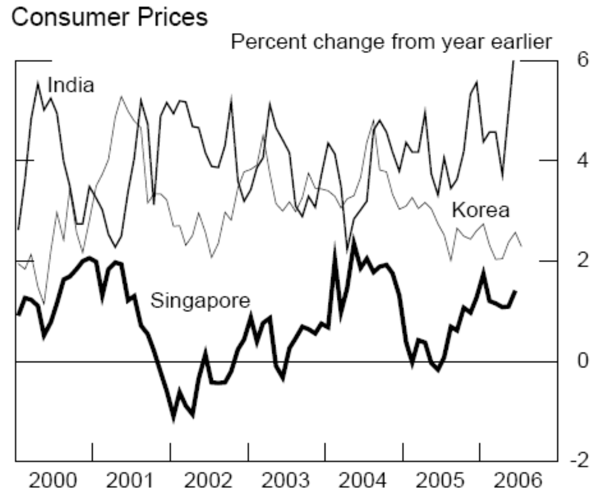
Indian Economic Indicators
(Percent change from previous period, s.a., except as noted)

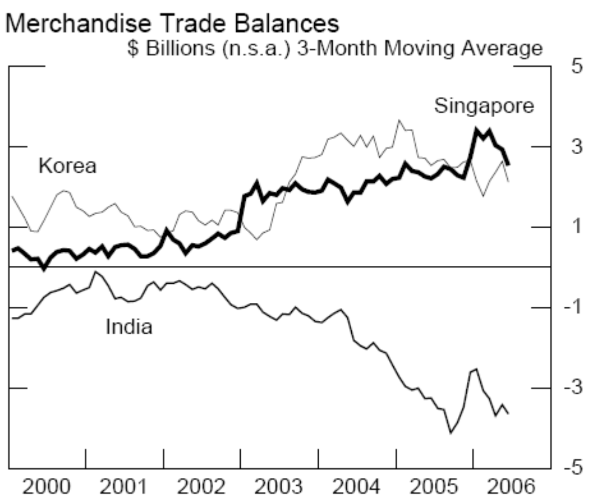
Indicator	2004	2005	2006				
			Q1	Q2	Apr.	May	June
Real GDP[1]	7.0	7.5	15.6	n.a.	…	…	…
Industrial production	8.5	7.9	2.3	n.a.	1.1	2.3	n.a.
Consumer prices[2]	3.8	5.6	4.5	5.0	3.7	5.0	6.3
Wholesale prices[2]	6.7	4.4	4.0	4.5	3.9	4.7	5.1
Merch. trade balance[3]	-21.7	-39.4	-39.1	-43.7	-48.2	-39.2	-43.6
Current account[4]	1.4	-11.9	7.3	n.a.	…	…	…

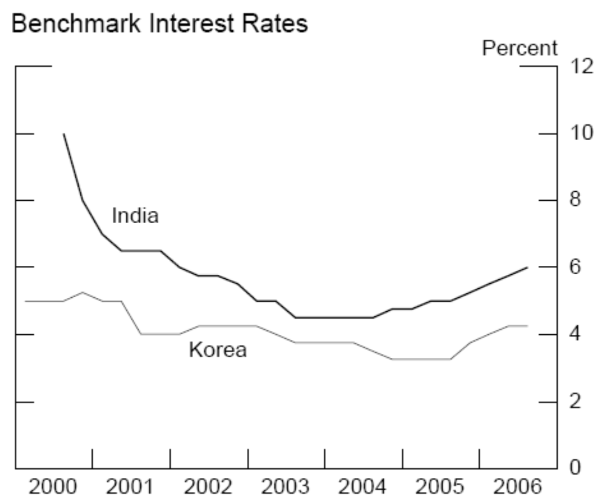
1. Annual rate. Annual data are Q4/Q4.
2. Percent change from year-earlier period, except annual data, which are Dec./Dec.
3. Billions of U.S. dollars, annual rate.
4. Billions of U.S. dollars, n.s.a., annual rate.
n.a. Not available. . . . Not applicable.

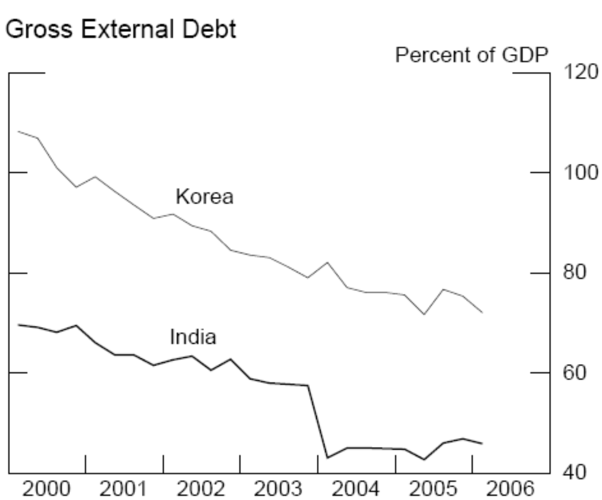
India, Korea, and Singapore

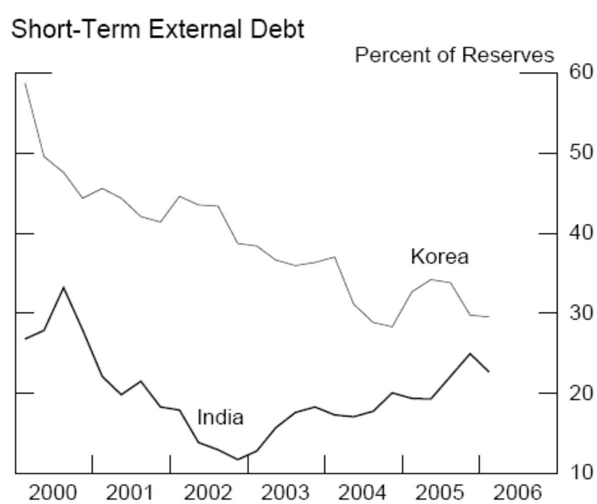












Incoming data for the **ASEAN** economies suggest that economic activity moderated in the second quarter. In Singapore, the advance unofficial estimate of second-quarter real GDP growth (not shown) suggests that growth dropped to just over 1 percent following a strong first-quarter performance, due mostly to a contraction in the volatile biomedical sector. Industrial production in Singapore appears to be rebounding, however. Elsewhere in the region, industrial production has weakened in Indonesia and Malaysia in recent months. Trade balances are down relative to the first quarter.

Twelve-month consumer price inflation in the region has moderated a bit of late, but remains elevated due to higher food prices in some countries as well as higher energy prices. Citing the moderation in inflation and the need to stimulate the domestic economy, Bank Indonesia lowered interest rates 25 basis points in early July for the second time in two months. In Thailand, the central bank left its benchmark rate unchanged at its recent meeting in mid-July after raising it thirteen times in fifteen consecutive meetings.

ASEAN Economic Indicators: Growth
(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q1	Q2	Apr.	May	June
Real GDP[1]							
Indonesia	7.0	5.0	3.0	n.a.	…	…	
Malaysia	5.9	5.2	9.4	n.a.	…	…	
Philippines	5.5	5.5	3.8	n.a.	…	…	
Singapore	6.6	8.5	6.8	n.a.	…	…	
Thailand	5.4	4.7	3.0	n.a.	…	…	
Industrial production[2]							
Indonesia[3]	3.3	1.3	.5	n.a.	7.5	-8.6	n.a.
Malaysia	11.7	4.1	3.9	n.a.	-7.1	-.6	n.a.
Philippines	1.0	2.2	-16.3	n.a.	-2.8	7.5	n.a.
Singapore	13.9	9.5	2.1	-2.0	-11.5	2.1	19.3
Thailand	11.8	9.1	2.6	1.8	-4.3	5.9	.4

1. Annual rate. Annual data are Q4/Q4.
2. Annual data are annual averages.
3. Staff estimate.
n.a. Not available. . . . Not applicable.

ASEAN Economic Indicators: Merchandise Trade Balance

(Billions of U.S. dollars, s.a.a.r.)

Indicator	2004	2005	2006				
			Q1	Q2	Apr.	May	June
Indonesia	25.1	28.0	40.0	34.3	36.2	38.5	28.2
Malaysia	21.2	26.4	29.4	n.a.	23.9	29.4	n.a.
Philippines	-4.4	-6.2	-.4	n.a.	.1	-5.4	n.a.
Singapore	25.1	29.6	40.7	30.4	35.2	21.6	34.3
Thailand	1.5	-8.6	1.4	-3.0	2.5	-7.1	-4.4

n.a. Not available.

ASEAN Economic Indicators: CPI Inflation

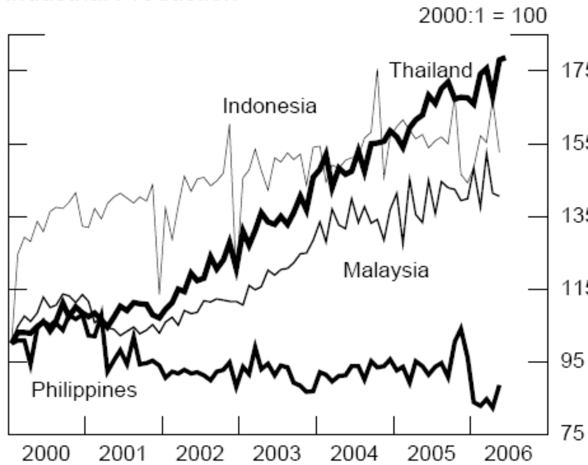
(Percent change from year earlier, except as noted)

Indicator	2004[1]	2005[1]	2006				
			Q1	Q2	May	June	July
Indonesia	6.6	17.0	17.0	15.5	15.6	15.5	14.9
Malaysia	2.2	3.3	3.8	4.1	3.9	3.9	n.a.
Philippines	8.6	6.7	7.3	6.9	6.9	6.7	n.a.
Singapore	1.3	1.3	1.4	1.2	1.1	1.4	n.a.
Thailand	2.9	5.8	5.7	6.0	6.2	5.9	4.4

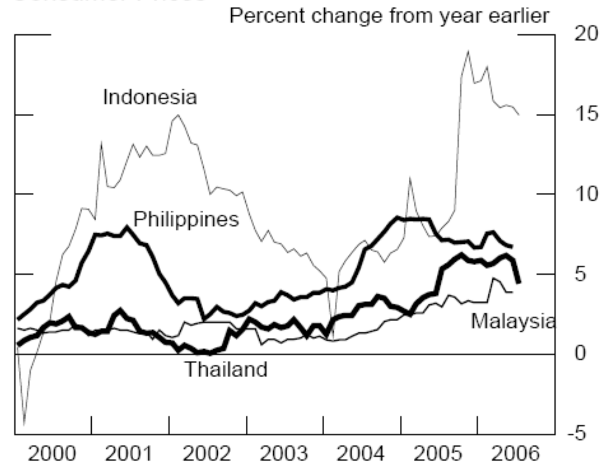
1. Dec./Dec.
n.a. Not available

ASEAN-4

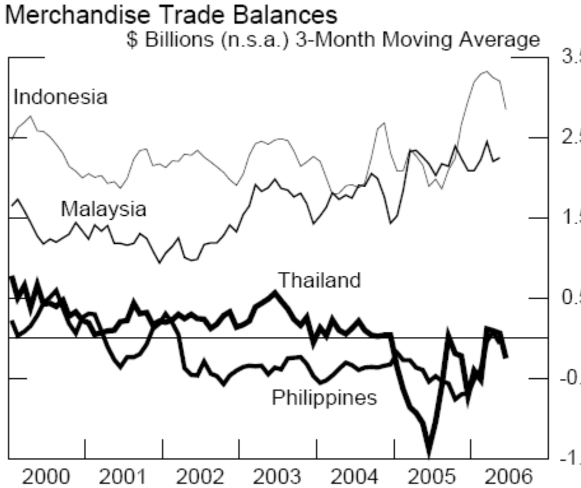
Industrial Production



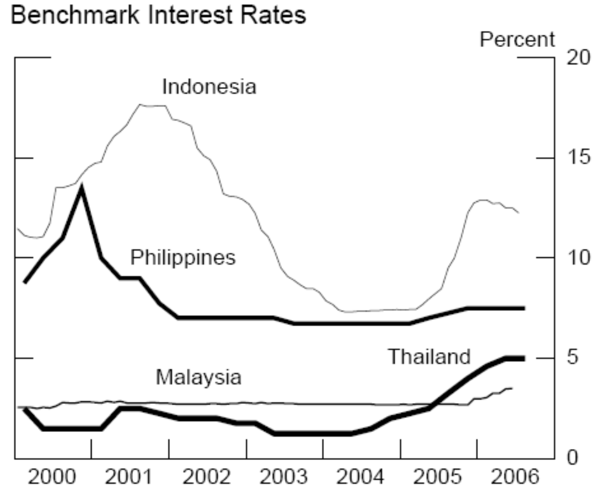
Consumer Prices



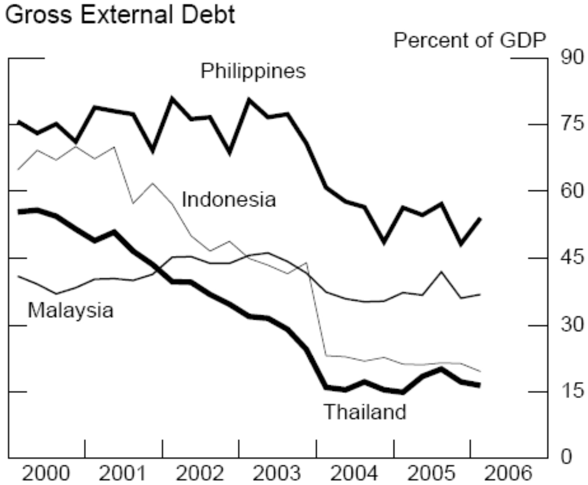
Merchandise Trade Balances



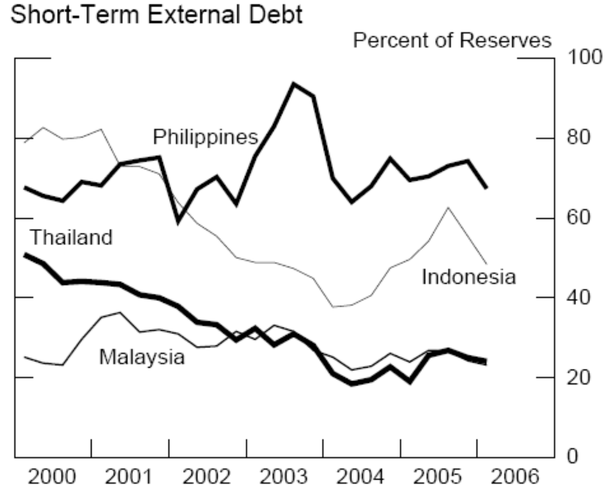
Benchmark Interest Rates



Gross External Debt



Short-Term External Debt



In **Mexico**, recent indicators suggest that economic growth remains healthy but has moderated from the strong first-quarter performance. The index of overall economic activity (a monthly proxy for real GDP) rose 0.4 percent in May from the previous month and was up 5.3 percent from its year-earlier level, mainly due to strong performance in the construction and services sectors. Industrial production edged down in May from April, but was up 5.8 percent from a year earlier mainly on the back of solid performance in manufacturing; average industrial production for April and May was up 0.7 percent from the first quarter.

Twelve-month headline inflation was 3.2 percent in June, within the target range of 2 to 4 percent. On the political front, the July 2 presidential elections have so far been inconclusive. Conservative Felipe Calderón obtained a narrow margin over leftist Andrés Manuel López Obrador. However, López Obrador has legally challenged the results before Mexico's Electoral Tribunal, which in turn has until late August to rule on these challenges and until September 6 to formally declare a president-elect. Despite this uncertainty, the peso has strengthened in recent weeks, after months of weakness.

Mexican Economic Indicators
(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q1	Q2	Apr.	May	June
Real GDP[1]	4.8	2.7	6.3	n.a.	…	…	…
Overall economic activity	3.8	3.3	2.0	n.a.	.8	.4	n.a.
Industrial production	3.9	1.9	1.7	n.a.	1.7	-.1	n.a.
Unemployment rate[2]	3.9	3.6	3.4	3.4	3.4	3.3	3.4
Consumer prices[3]	5.2	3.3	3.7	3.1	3.2	3.0	3.2
Merch. trade balance[4]	-8.8	-7.6	.9	-5.0	-1.9	-6.5	-6.6
Merchandise imports[4]	196.8	221.8	244.1	256.3	253.5	258.2	257.0
Merchandise exports[4]	188.0	214.2	245.0	251.3	251.6	251.8	250.5
Current account[5]	-6.5	-4.7	3.5	n.a.	…	…	…

1. Annual rate. Annual data are Q4/Q4.
2. Percent; counts as unemployed those working one hour a week or less.
3. Percent change from year-earlier period, except annual data, which are Dec./Dec.
4. Billions of U.S. dollars, annual rate.
5. Billions of U.S. dollars, n.s.a., annual rate.
n.a. Not available. . . . Not applicable.

In **Brazil**, incoming data have provided some evidence of solid growth in the second quarter. Industrial output jumped 1½ percent in May following a small increase in April, and May retail sales surprised on the upside. However, June indicators on automobile and retail sales suggest some slowdown in activity. The headline CPI declined 0.2 percent in June, bringing twelve-month inflation to 4 percent. June's deflation owed in part to a sharp drop in the price of sugarcane, which is used to make fuel ethanol, a required gasoline supplement in Brazil. Even excluding that and other special influences, inflation has declined to its lowest level since the late 1990s.

In mid-July, the central bank lowered its target for the policy rate 50 basis points to 14.75 percent, as was widely expected, bringing the cumulative decline to 500 basis points since the current easing phase began last September. Ahead of the October presidential election, Lula's lead over his main rival, conservative Geraldo Alckmin, has narrowed, making a runoff vote increasingly likely.

Brazilian Economic Indicators
(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q1	Q2	May	June	July
Real GDP[1]	4.7	1.5	5.7	n.a.	…	…	…
Industrial production	8.3	3.1	1.2	n.a.	1.6	n.a.	n.a.
Unemployment rate[2]	11.5	9.8	9.8	10.0	9.9	10.4	n.a.
Consumer prices[3]	7.6	5.7	5.5	4.3	4.2	4.0	n.a.
Merch. trade balance[4]	33.6	44.8	45.3	38.8	33.6	43.0	59.6
Current account[5]	11.7	14.2	7.1	5.2	5.6	7.4	n.a.

1. Annual rate. Annual data are Q4/Q4.
2. Percent.
3. Percent change from year-earlier period, except annual data, which are Dec./Dec. Price index is IPCA.
4. Billions of U.S. dollars, annual rate.
5. Billions of U.S. dollars, n.s.a., annual rate.
n.a. Not available. . . . Not applicable.

In **Argentina**, after moderate growth in the first quarter, incoming indicators point to faster growth in the second quarter. The April-May average of the index of economic activity (a monthly proxy for GDP) is almost 8 percent (a.r.) above its first-quarter level. In the second quarter, industrial production accelerated after a weak first quarter, owing largely to increased production of automobiles, cement and other construction materials. In June, twelve-month inflation edged down to 11.1 percent, in part due to the voluntary price agreements the government has secured in several sectors.

Argentine Economic Indicators
(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q1	Q2	Apr.	May.	June
Real GDP[1]	9.0	8.9	4.7	n.a.	…	…	…
Industrial production	10.7	7.7	.6	2.7	.3	.9	.9
Unemployment rate[2]	13.6	11.6	11.4	n.a.	…	…	…
Consumer prices[3]	5.9	12.2	11.5	11.4	11.7	11.5	11.1
Merch. trade balance[4]	12.1	11.4	9.5	14.2	10.5	9.4	12.0
Current account[5]	3.4	5.7	4.7	n.a.	…	…	…

1. Annual rate. Annual data are Q4/Q4.
2. Percent; n.s.a.
3. Percent change from year-earlier period, except annual data, which are Dec./Dec.
4. Billions of U.S. dollars, annual rate.
5. Billions of U.S. dollars, n.s.a., annual rate.
n.a. Not available. . . . Not applicable.

In **Venezuela**, recent indicators suggest that activity has continued to be strong, fueled by excessively expansionary monetary and fiscal policies. The high price of petroleum has resulted in large current account surpluses, and these inflows have put upward pressure on monetary growth and inflation. Monthly inflation jumped to 1.8 percent in June, bringing the twelve-month increase to nearly 12 percent. In response, some steps have been taken to restrict liquidity but at the same time avoid raising short-term interest rates. In the latest of these measures, in late July, the central bank's reserve requirement on new deposits was raised from 15 to 30 percent.

On the political front, nine opposition candidates have shown interest in competing in primary election in mid-August to determine a single candidate who would run against President Chavez when he comes up for re-election in December. However, Chavez is heavily favored to win the election.

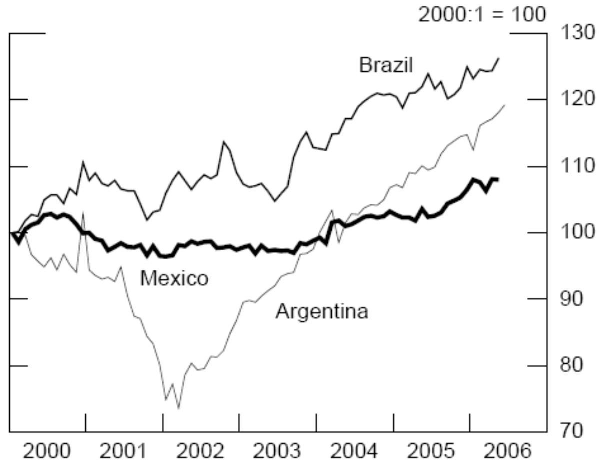
Venezuelan Economic Indicators
(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q1	Q2	Apr.	May	June
Real GDP[1]	12.1	10.2	8.6	n.a.	…	…	…
Unemployment rate[2]	15.1	12.2	n.a.	n.a.	n.a.	n.a.	n.a.
Consumer prices[3]	19.2	14.4	12.5	11.2	11.3	10.4	11.8
Non-oil trade balance[4]	-10.5	-16.5	-26.1	n.a.	n.a.	n.a.	n.a.
Merch. trade balance[4]	21.4	31.5	41.8	n.a.	n.a.	n.a.	n.a.
Current account[5]	13.8	25.4	29.9	…	…	…	…

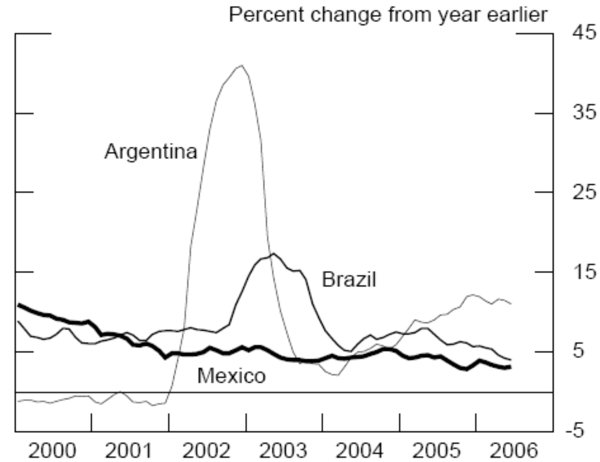
1. Annual rate. Annual data are Q4/Q4.
2. Percent.
3. Percent change from year-earlier period, except annual data, which are Dec./Dec.
4. Billions of U.S. dollars, annual rate.
5. Billions of U.S. dollars, n.s.a., annual rate.
n.a. Not available. . . . Not applicable.

Latin America

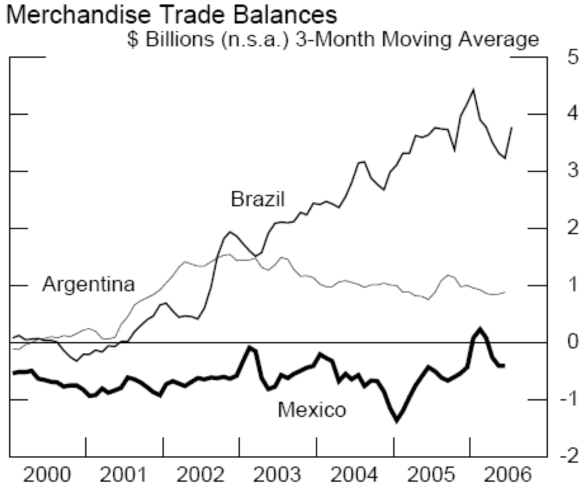
Industrial Production



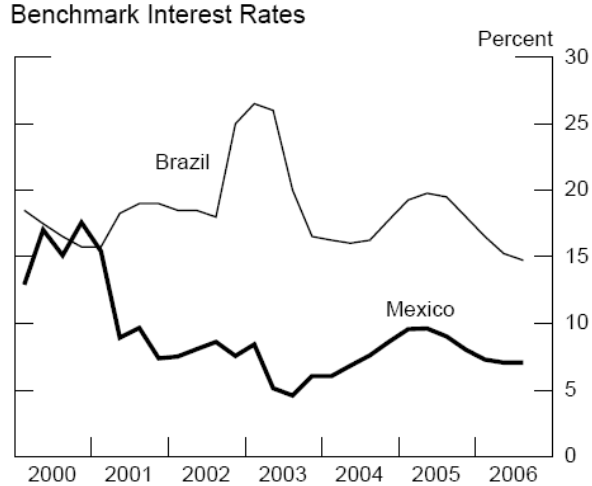
Consumer Prices



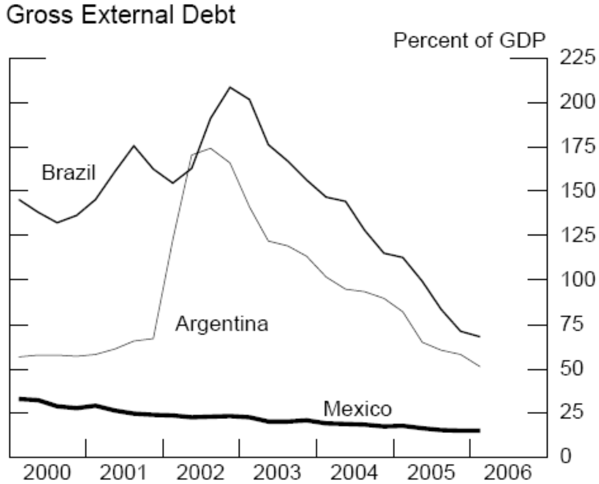
Merchandise Trade Balances



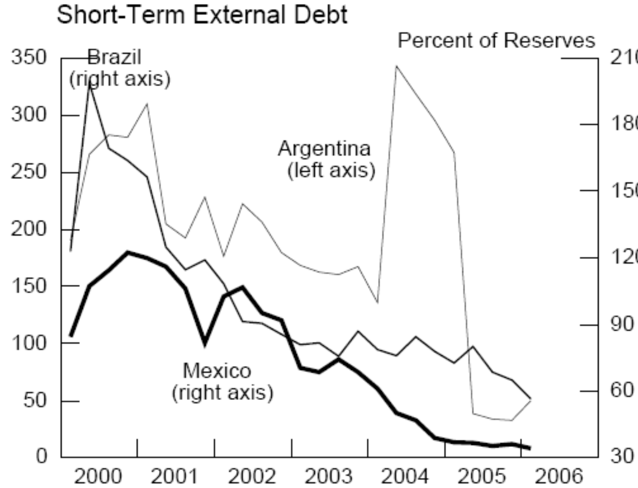
Benchmark Interest Rates



Gross External Debt



Short-Term External Debt



In **Turkey**, real GDP rose 6.4 percent in the first quarter, driven by sharp increases in investment and private consumption. More recently, industrial production edged up in May. Twelve-month consumer price inflation was 10 percent in June, making the 2006 annual target of 7 percent nearly unobtainable. June producer prices increased by almost 5 percent over May's number, driven by increased fuel and metal costs. The current account deficit continued to grow in May, reaching about 8 percent of GDP.

In response to ongoing inflationary pressure and concerns about downward pressure on the foreign exchange value of the Turkish lira, the Central Bank of Turkey has increased policy rates 4.25 percentage points since early June. The official borrowing and lending rates are now 17½ percent and 22½ percent, respectively. Financial markets have partly recovered from their weakness in June, and Turkey remains on-track with its IMF program and EU accession negotiations.

Turkey Economic Indicators
(Percent change from previous period, s.a., except as noted)

Indicator	2004	2005	2006				
			Q1	Q2	Apr.	May	June
Real GDP[1]	9.0	7.4	6.4	n.a.	…	…	…
Industrial production	9.8	5.4	-.6	n.a.	.0	.9	n.a.
Consumer prices[2]	9.4	7.7	8.1	9.6	8.8	9.9	10.1
Merch. trade balance[3]	-34.4	-43.3	-50.2	-59.2	-63.4	-64.7	-49.6
Current account[4]	-15.6	-23.2	-32.2	n.a.	-39.7	-43.8	n.a.
Unemployment rate	10.3	10.3	10.2	n.a.	…	…	…

1. Percent change from year-earlier period. Annual data are annual averages.
2. Percent change from year-earlier period, except annual data, which are Dec./Dec.
3. Billions of U.S. dollars, annual rate. Imports are c.i.f.
5. Billions of U.S. dollars, n.s.a., annual rate.
n.a. Not available. . . . Not applicable.