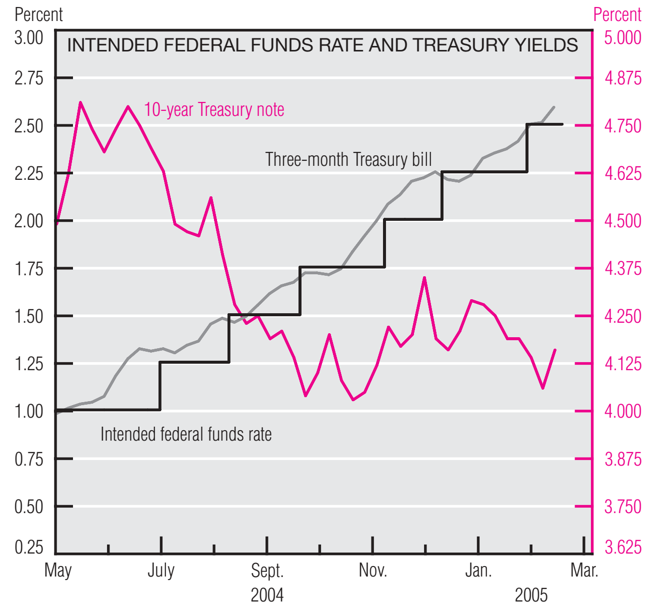
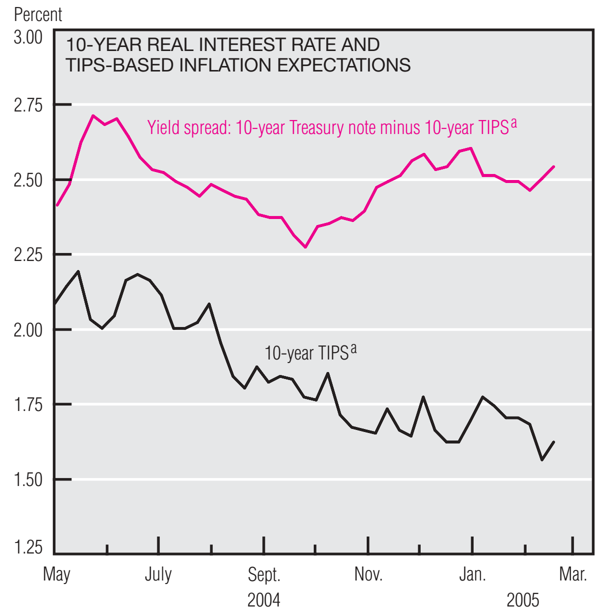
Money and Financial Markets





a. Treasury inflation-protected securities.
b. Merrill Lynch High-Yield Master II Index minus the yield on the 10-year Treasury note.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15 and Bloomberg Financial Information Services.

In his February 16 testimony before Congress, Federal Reserve Chairman Greenspan discussed these yield curve movements. Changes at the long end of the nominal yield curve can be attributed to one or both of two causes: changes in real rates and changes in inflation expectations. Treasury inflation-protected securities (TIPS), which provide one measure of a real interest rate, indicate that long-term real interest rates have fallen about 50 bp since June. Since the real rate's decline matches that of the nominal rate, TIPS imply that long-term inflation expectations are generally flat.

Some analysts argue that this decline reflects market participants' view of slower economic growth in the future, possibly a consequence of rising energy prices. But, as Chairman Greenspan observed, this "does not mesh seamlessly with the rise in stock prices and the narrowing of credit spreads observed over the same interval." Others suggest that the yield curve's flattening reflects lower long-term inflation expectations. This appears contrary to the information from TIPS yields.

Technical factors, such as heavy purchases of Treasury securities by foreign central banks, may have contributed to the puzzling drop in long-term yields. However, the Chairman remarked that accounting for the decline in long-term rates by technical factors affecting only U.S. markets may be missing the point "because yields and risk spreads have narrowed globally." Certainly, the cause of the decline in long-term rates remains unclear.

With strong consumer spending in 2004, the personal saving rate fell to 1/2% in 2004:IIIQ. More recently, the personal rate has increased and now stands at 1.3%. Strong growth in

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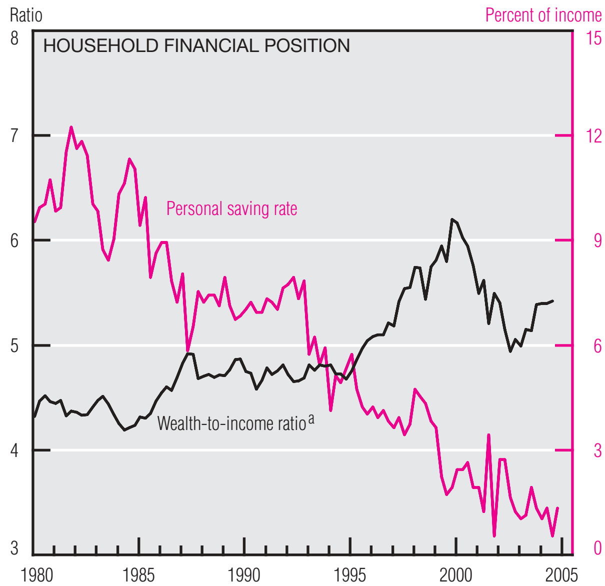

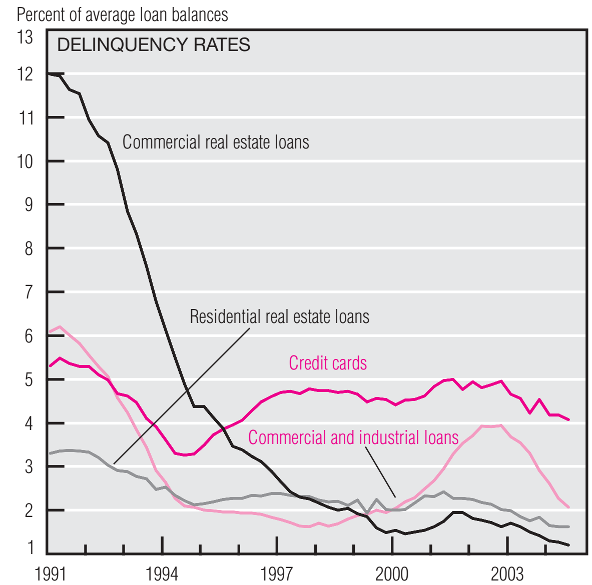

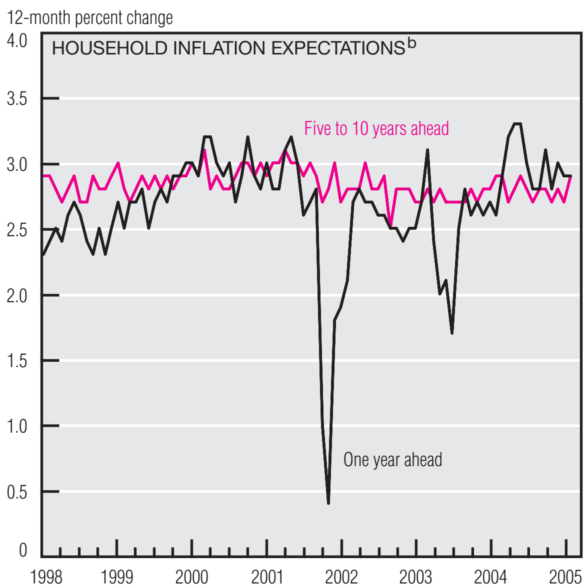

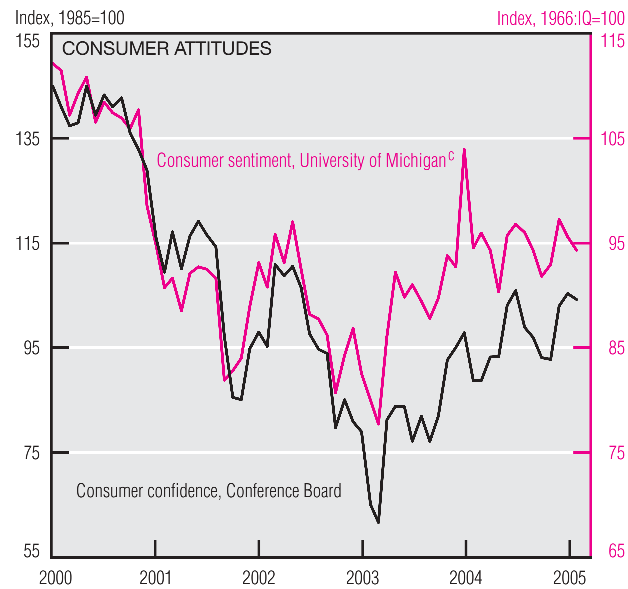

a. Wealth is defined as household net worth; income is defined as personal disposable income. Data are not seasonally adjusted.
b. Median expected inflation as measured by the University of Michigan's Survey of Consumers.
c. Data are not seasonally adjusted.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks" and "Flow of Funds Accounts of the United States," *Federal Reserve Statistical Releases*, Z.1; University of Michigan; and the Conference Board.

equity prices and home prices led to a sharp increase in the wealth-to-income ratio during 2003, which supported consumer spending. Although equity prices moderated in 2004, continued increases in home prices led to further rises in the wealth-to-income ratio last year.

Despite an estimated increase in total household debt of 9.75% in 2004, fueled mainly by increases in home mortgage debt, delinquency rates on residential real estate loans and credit cards continue to drift down. Low interest rates and gains in disposable income contributed to households' ability to repay debt. Even with rapid growth in commercial real estate loans in 2004, delinquency rates on commercial loans fell because of firms' strong earnings and strengthened cash positions.

Household survey data are consistent with the FOMC's view that longer-term inflation expectations remain well contained. Although short-term expectations varied markedly in response to headlines about energy prices in 2004, longer-term inflation expectations remained relatively steady at around 2.8%. In February the Conference Board's Index of Consumer Confidence fell slightly, erasing part of January's gain, and the University of Michigan's Consumer Sentiment Index registered a similar decline. Respondents' views of their current economic situation remained stable, but their expectations about their future personal finances deteriorated.