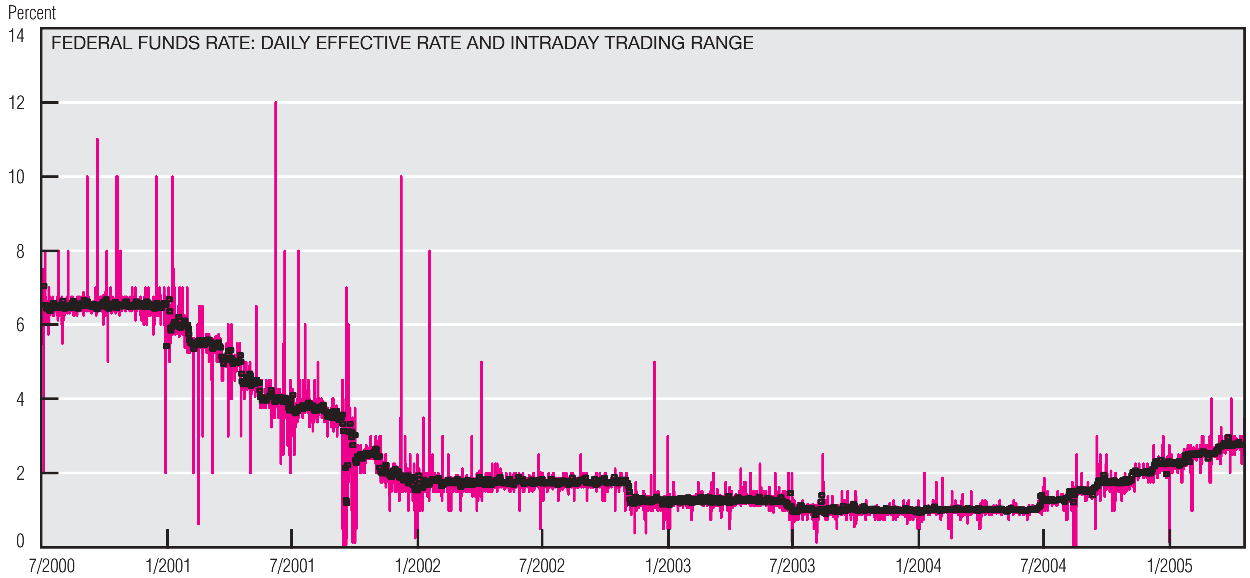
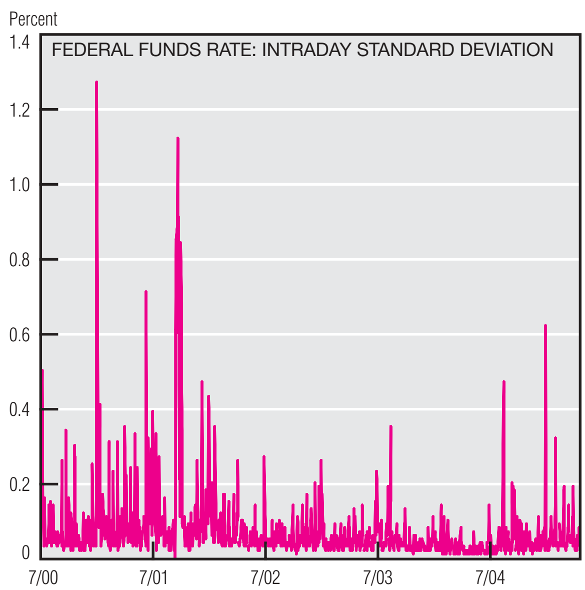
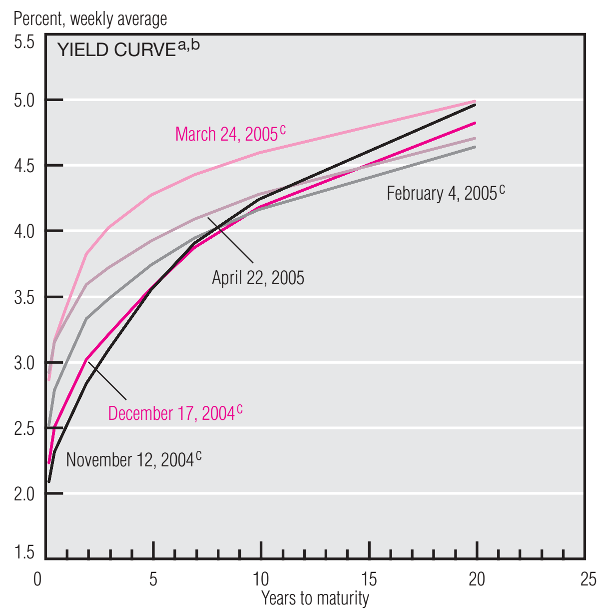
Money and Financial Markets







a. All yields are from constant-maturity series.
b. Average for the week ending on the date shown.
c. First weekly average available after the FOMC meeting.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; Federal Reserve Bank of New York; and Bloomberg Financial Information Services.

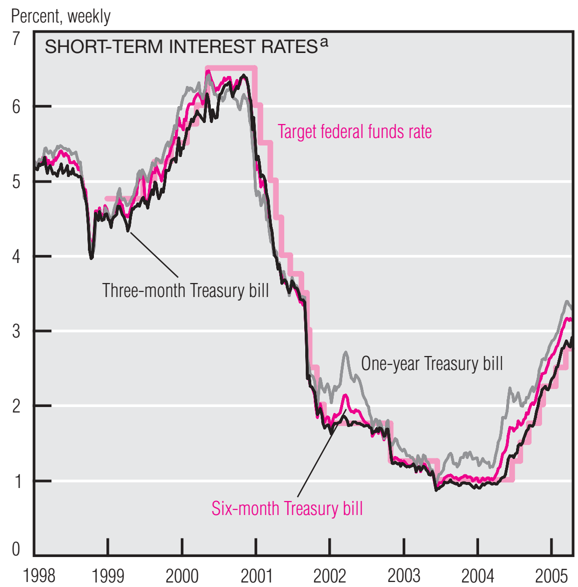
Before January 9, 2003, the Federal Reserve discount rate was set lower than the FOMC's federal funds rate target for open market operations. The Reserve Banks had to use administrative means to discourage borrowing at this attractive rate. Since that date, the discount rate has been set 100 basis points (bp) above the targeted funds rate and the Reserve Banks no longer have to discourage borrowing administratively. One expected result was reduced variability of the funds rate, which would be capped by the discount rate. If potential lenders were to ask more than that, qualified institutions would turn to the discount window to borrow at the more attractive primary credit rate.

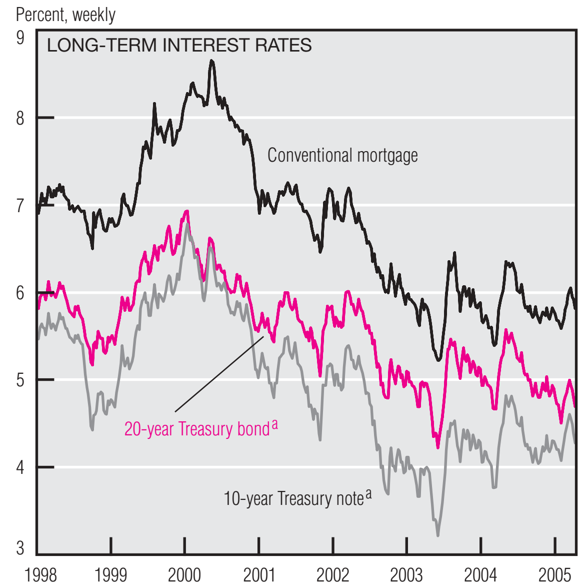
Since this policy change was implemented, the intraday federal funds rate has exceeded the primary credit rate on only four days, most recently on March 31, 2005 when it reached 4%, 25 bp above the primary credit rate. Before the policy change, the intraday range in the federal funds rate averaged 68 bp; since the change, it has averaged only 33 bp. The standard deviation of the intraday federal funds rate, which measures volatility weighted by the volume traded, also declined from an average of 9 bp to 5 bp.

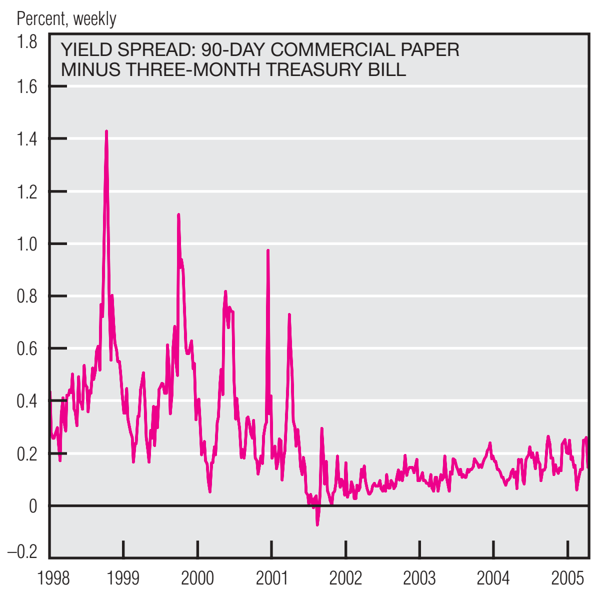
The yield curve has flattened significantly since the March FOMC meeting, with the most pronounced decline in the intermediate range. The yield on five-year Treasury securities has fallen more than 35 bp since the March meeting and more than 28 bp at the long end of the curve.

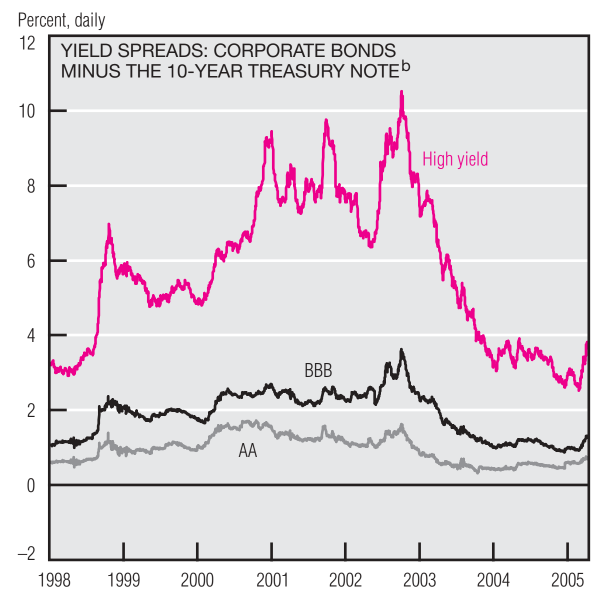
(continued on next page)

Money and Financial Markets *(cont.)*









a. Yields from constant-maturity series
b. Merrill Lynch AA, BBB, and High Yield Master II indexes, each minus the yield on the 10-year Treasury note.
SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15, *Federal Reserve Statistical Releases*; and Bloomberg Financial Information Services.

Since monetary policy tightening began in June 2004, short-term interest rates have tracked the federal funds rate fairly closely. After rising markedly in February and March, long-term Treasury security yields fell in April, possibly because of weak economic data releases during the month. The yield decline could also indicate downward revisions in investors' long-term inflation expectations or possibly their "flight to quality." Some of the major slips in Treasury yields have occurred on days of major declines in equity markets. The pattern in conventional mortgage rates has mimicked long-term Treasury yields.

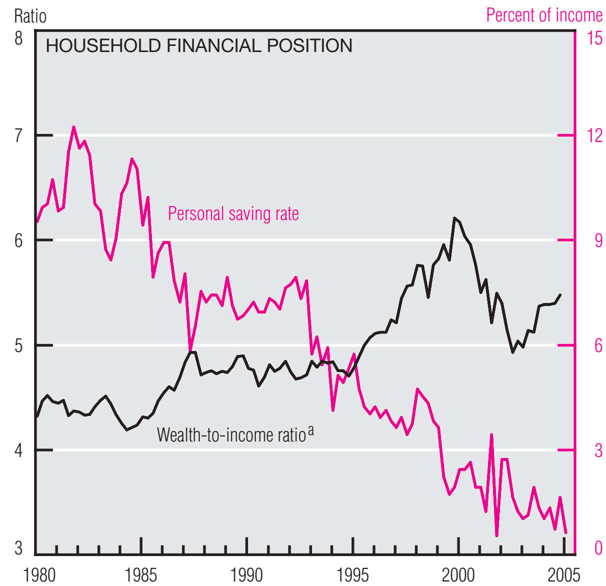
The risk spread on short-term commercial paper has varied between zero and 25 bp for three years. Although the spread increased in March and the first half of April, it has since retrenched to near its three-year average.

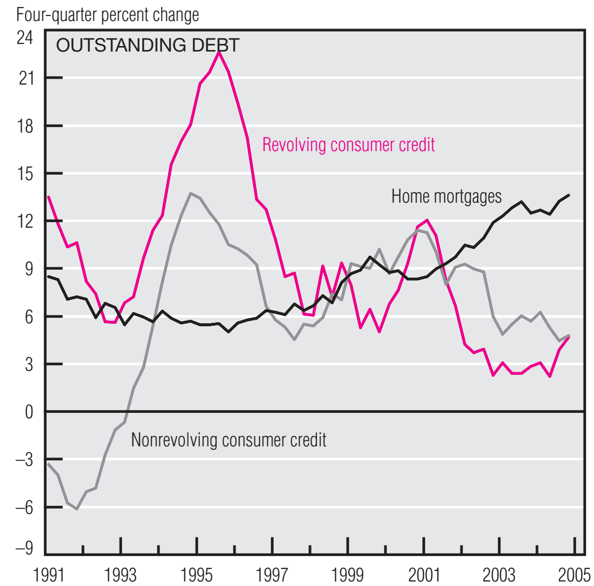
Corporate bond yields remain near historic lows, suggesting investors' willingness to take on risk as well as their confidence in the overall economic outlook. However, risk spreads on corporate bonds have increased since the beginning of March, with the spread on high-yield corporate bonds increasing more than a percentage point. Increases in spreads on less risky corporate bonds have been more moderate. The risk spread on AA- and BBB-rated corporate bonds have risen 12 bp and 31 bp, respectively, which may indicate that investors have become more cautious.

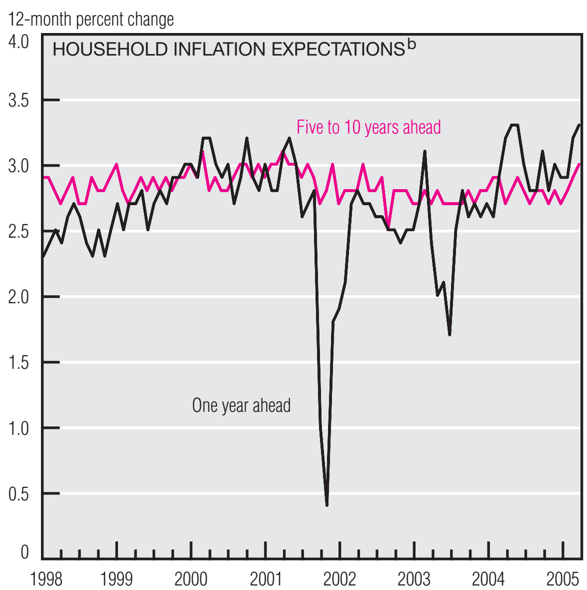
Low home mortgage rates over the last few years have contributed to a run-up in residential real estate

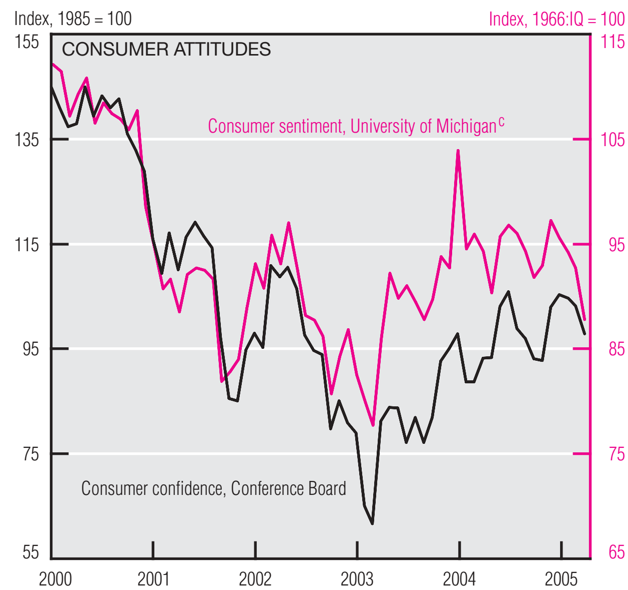
(continued on next page)

Money and Financial Markets (cont.)









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, "Flow of Funds Accounts of the United States," Z.1, *Federal Reserve Statistical Releases*; University of Michigan; and the Conference Board.

prices. Higher home prices, in turn, have contributed to a higher wealth-to-income ratio. In contrast, the personal saving rate has been falling since the mid-1980s; in the first quarter of 2005, it stood at only 0.6%. The saving rate is near its historic low, in marked contrast to its average of 7.3% from the late 1940s to the present. Increased wealth relative to income has undoubtedly contributed to households' comfort with a lower saving rate.

Historically low mortgages rates encouraged households to expand their mortgage debt at a robust pace throughout 2004; however, revolving and nonrevolving household credit increased at much more moderate rates.

Survey data show that households' longer-term inflation expectations have risen modestly since the beginning of 2005. Year-ahead inflation expectations have risen 0.5% since November 2004, undoubtedly because of higher energy prices.

In April, the University of Michigan's Consumer Sentiment Index fell for the fourth consecutive month. Respondents' views regarding their current economic situation deteriorated, as did their views about their future personal finances. The Index's expectations component has taken a particularly large hit in recent months, falling to its two-year low in April; soaring energy prices are cited as the primary factor behind the loss of confidence. The Conference Board's Index of Consumer Confidence also fell in April, with a broad-based decline in most of its components.