# **Prefatory Note**

The attached document represents the most complete and accurate version available based on original files from the FOMC Secretariat at the Board of Governors of the Federal Reserve System.

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Class III FOMC - Internal (FR)

October 28, 2005

# CURRENT ECONOMIC AND FINANCIAL CONDITIONS

## Supplemental Notes

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

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# Supplemental Notes

## The Domestic Nonfinancial Economy

**Gross Domestic Product**

According to the BEA's advance release, real GDP rose at an annual rate of 3.8 percent in the third quarter following a 3.3 percent increase in the second quarter. Real private inventories are reported to have declined $17 billion in the third quarter, subtracting 0.6 percentage point from GDP growth. In the second quarter, the change in private inventories held down GDP growth by more than 2 percentage points. Thus, this sector was an important contributor to the step-up in GDP growth from the second quarter to the third quarter.

Final sales grew at an annual rate of 4.4 percent in the third quarter after a 5.6 percent increase in the previous quarter that had been boosted by an unusually sizable contribution from net exports. In contrast, the growth rate of final sales to domestic purchasers was little changed between the second and third quarters. Within this category, real PCE increased at an annual rate of 3.9 percent following a 3.4 percent increase in the second quarter; notably, spending for durable goods posted a double-digit gain last quarter as spending on motor vehicles jumped. Business fixed investment rose 6.2 percent in the third quarter, down somewhat from the 8.8 percent increase in the second quarter; the growth in spending on both equipment and software and on nonresidential structures was weaker than in the second quarter. Residential investment growth slowed to 4.8 percent in the third quarter. Total government spending increased 3.2 percent in the third quarter; a large increase in federal government expenditures was balanced by a more modest gain in the state and local sector.

Real output in the nonfarm business sector rose 4.2 percent in the third quarter. Based on data currently available, the staff estimates that productivity in the nonfarm business sector rose at an annual rate of 4.3 percent last quarter following a 2.1 percent increase in the second quarter.

The GDP price index increased at an annual rate of 3.1 percent in the third quarter after rising 2.6 percent in the preceding quarter. PCE prices rose at an annual rate of 3.7 percent in the third quarter, and core PCE prices increased 1.3 percent. The four-quarter change in core PCE prices was 1.9 percent.

On the income side of the accounts, real disposable personal income fell 0.9 percent at an annual rate in the third quarter, primarily reflecting a large drop in rental income. Rental income, which is calculated net of costs incurred by homeowners and landlords, was hit hard by the uninsured damage to the housing stock from the hurricanes. Proprietors' income was also adversely affected by the storms. Largely as a result, the personal saving rate fell -1.1 percent from 0.1 percent in the second quarter.

**Employment Cost Index**

The employment cost index for hourly compensation of private industry workers rose at an annual rate of 3.2 percent over the three months ending in September—up somewhat

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

| Item | 2005:Q1 Final | 2005:Q2 Final | 2005:Q3 Advance |
|---|---|---|---|
| Gross Domestic Product | 3.8 | 3.3 | 3.8 |
| Final sales | 3.5 | 5.6 | 4.4 |
| Consumer spending | 3.5 | 3.4 | 3.9 |
| Durables | 2.6 | 7.9 | 10.8 |
| Nondurables | 5.3 | 3.6 | 2.6 |
| Services | 2.8 | 2.3 | 3.2 |
| Business fixed investment | 5.7 | 8.8 | 6.2 |
| Nonresidential structures | -2.0 | 2.7 | -1.4 |
| Equipment and software | 8.3 | 10.9 | 8.9 |
| Residential investment | 9.5 | 10.8 | 4.8 |
| Federal government | 2.4 | 2.4 | 7.7 |
| State and local government | 1.6 | 2.6 | .7 |
| Exports of goods and services | 7.5 | 10.7 | .8 |
| Imports of goods and services | 7.4 | -.3 | .0 |
| *ADDENDA:* | | | |
| Inventory investment[1] | 58.2 | -1.7 | -16.6 |
| Net exports of goods and services[1] | -645.4 | -614.2 | -611.8 |
| Nominal GDP | 7.0 | 6.0 | 7.0 |
| Nominal GDI | 6.7 | 6.1 | n.a. |
| Statistical discrepancy[2] | 39.4 | 37.6 | n.a. |
| Change in economic profits[2] | 68.8 | 59.3 | n.a. |
| Profit share, excluding FR banks[3] | 10.3 | 10.6 | n.a. |
| Real disposable personal income | -3.4 | 1.5 | -.9 |
| Personal saving rate (percent) | .5 | .1 | -1.1 |

1. Level, billions of chained (2000) dollars.
2. Billions of dollars.
3. Economic profits as a share of GNP.
n.a. not available.

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

| Item | 2005:Q1 Final | 2005:Q2 Final | 2005:Q3 Advance |
|---|---|---|---|
| Gross domestic product | 3.1 | 2.6 | 3.1 |
| Gross domestic purchases | 2.9 | 3.3 | 4.0 |
| Personal consumption expenditures | 2.3 | 3.3 | 3.7 |
| Food and Beverages | 1.0 | 3.5 | 1.3 |
| Energy | 3.6 | 28.6 | 49.8 |
| Excluding food and energy | 2.4 | 1.7 | 1.3 |
| Market-based components | 2.2 | 1.5 | 1.2 |
| Business fixed investment | 3.1 | 1.9 | 2.2 |
| Equipment and Software | 0.9 | -0.7 | -1.5 |
| Computers and peripheral equipment | -15.4 | -14.9 | -13.2 |
| Nonresidential structures | 10.3 | 9.9 | 14.3 |
| Residential investment | 1.6 | 4.3 | 4.2 |
| Government consumption expenditures and investment | 5.7 | 3.7 | 6.3 |
| Exports of goods and services | 4.6 | 3.7 | 3.6 |
| Imports of goods and services | 2.9 | 8.2 | 9.3 |
| Nonpetroleum goods | 3.7 | 1.6 | -0.1 |
| *ADDENDA:* | | | |
| GDP less food and energy | 2.9 | 2.4 | 2.5 |
| Gross domestic purchases less food and energy | 3.0 | 2.1 | 2.2 |

NOTE: Percent change from previous period at compound annual rates from the low rate of increase posted over the first half of this year. For the twelve months ending in September, hourly compensation in private industry rose 3 percent, ¾ percentage point less than the increase over the previous year.

The wages and salaries component of the index remained subdued last quarter, rising at the same annual rate of 2.4 percent that was seen in the first half of the year. However, benefits costs increased at a more rapid annual rate of 5.2 percent in the three months ending in September. Still, over the past twelve months, the 4.8 percent increase in benefits costs was 2 percentage points smaller than the increase over the preceding twelve-month period. Most of this deceleration in benefits costs over the past year stemmed from businesses' smaller contributions to defined-benefit pension plans, likely associated with the rebound in equity values over the past few years. In addition, costs for workers' compensation insurance decelerated notably over the past year despite the fact that health-insurance costs continued to rise rapidly.

Most major industry groups saw compensation costs decelerate over the past year; the most notable exception was the finance, insurance, and real estate industry, where faster compensation growth was driven by sales workers, whose pay tends to include an important commissions component. By occupation, increases in hourly compensation slowed substantially for blue-collar and service workers, while compensation growth slowed only modestly for white-collar workers.

Based on the data in today's GDP release and previously published data on hours, we estimate that hourly compensation in the nonfarm business sector rose at an annual rate of 3.8 percent in the third quarter. Although a little higher than the ECI reading for the third quarter, this increase nevertheless is the second consecutive quarter in which hourly compensation rose at a rate less than 4 percent. In the preceding two quarters, hourly compensation posted much larger increases that likely reflected, in part, a jump in stock-option exercises. Averaging together those two earlier large increases with the two recent more modest increases, we estimate that the four-quarter change in hourly compensation through the third quarter was 5.8 percent.

**Orders and Shipments of Durable Goods**

Shipments of nondefense capital goods excluding aircraft declined 0.1 percent in September after having risen 2.2 percent in August. Shipments of high-tech goods were mixed in September: Deliveries of computers and peripheral equipment slid 5.9 percent, but shipments of communications equipment rose 2.4 percent. In the non-high-tech category, shipments moved up 0.6 percent, led by a surge in deliveries of engines and turbines.

New orders for nondefense capital goods excluding aircraft slipped 1.2 percent in September following a 4 percent gain in August. Bookings of communications equipment tumbled 6.8 percent last month, while orders for computing equipment fell 4.4 percent. Outside of the high-tech sector, orders edged up 0.2 percent.

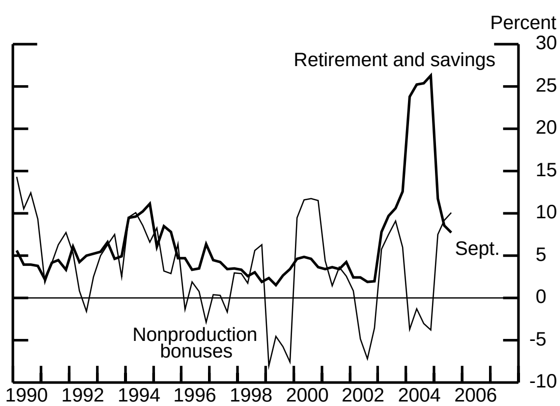
**Change in Employment Cost Index of Hourly Compensation for Private-Industry Workers**

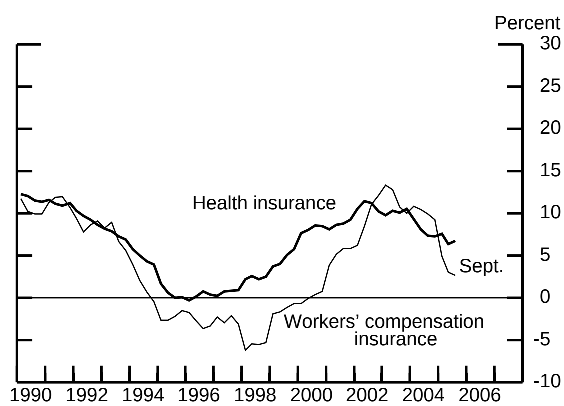
| Index | 2004 Sept. | 2004 Dec. | 2005 Mar. | 2005 June | 2005 Sept. |
|---|---|---|---|---|---|
| | Quarterly change (compound annual rate)[1] | | | | |
| **Total hourly compensation** | **4.0** | **3.2** | **2.5** | **2.5** | **3.2** |
| Wages and salaries | 3.0 | 1.7 | 2.4 | 2.4 | 2.4 |
| Benefits | 5.5 | 6.7 | 4.3 | 3.2 | 5.2 |
| | 12-month change | | | | |
| **Total hourly compensation** | **3.7** | **3.8** | **3.4** | **3.2** | **3.0** |
| Wages and salaries | 2.6 | 2.4 | 2.4 | 2.4 | 2.2 |
| Benefits | 6.8 | 6.9 | 5.8 | 4.9 | 4.8 |

1. Seasonally adjusted by the BLS except June.

**Employment Cost Index**
(Private-industry workers; 12-month change)


**ECI Benefits Costs (confidential)**
(Private-industry workers; 12-month change)



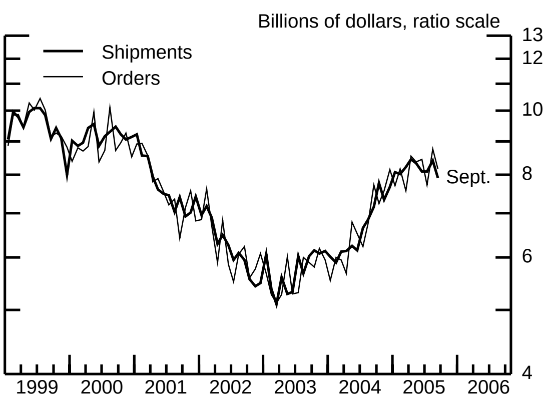
## Orders and Shipments of Nondefense Capital Goods

(Percent change; seasonally adjusted current dollars)

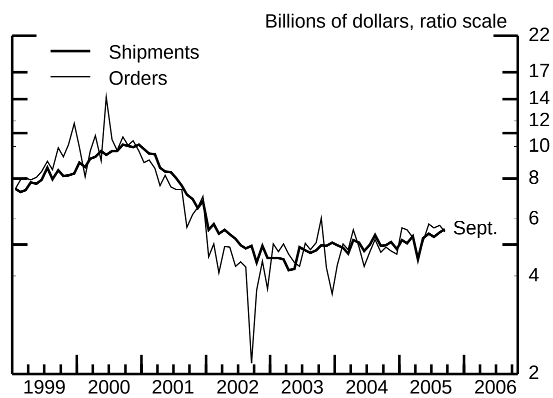
| Indicators | 2005 Q2 | 2005 Q3 | 2005 July | 2005 Aug. | 2005 Sept. |
|---|---|---|---|---|---|
| | Annual rate | | Monthly rate | | |
| Shipments | 8.2 | 2.6 | -1.2 | 3.6 | -2.2 |
| Excluding aircraft | 1.3 | 3.6 | -1.0 | 2.2 | -.1 |
| Computers and peripherals | 9.3 | -6.9 | .0 | 4.0 | -5.9 |
| Communications equipment | -8.5 | 34.2 | -2.3 | 2.9 | 2.4 |
| All other categories | 1.0 | 2.5 | -1.0 | 1.8 | .6 |
| Orders | 66.1 | -14.6 | -7.6 | 4.1 | -8.1 |
| Excluding aircraft | 2.2 | 5.3 | -3.9 | 4.0 | -1.2 |
| Computers and peripherals | 36.8 | -10.9 | -8.7 | 13.5 | -6.8 |
| Communications equipment | -20.5 | 38.2 | -2.7 | 1.7 | -4.4 |
| All other categories | .0 | 5.1 | -3.2 | 2.7 | .2 |
| Memo: | | | | | |
| Shipments of complete aircraft[1] | 30.2 | n.a. | 26.8 | 37.5 | n.a. |

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

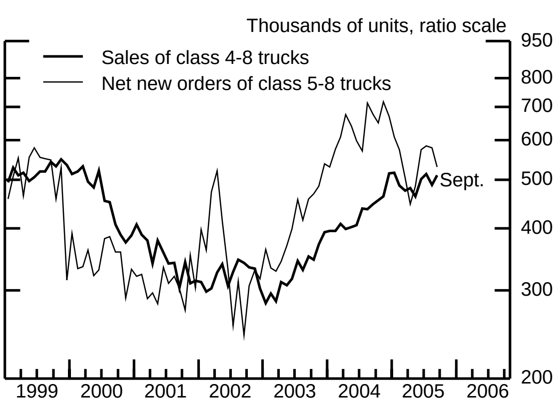
### Computers and Peripherals




### Communications Equipment

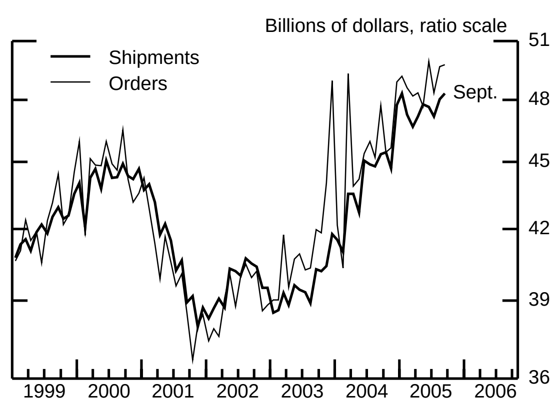



### Medium and Heavy Trucks



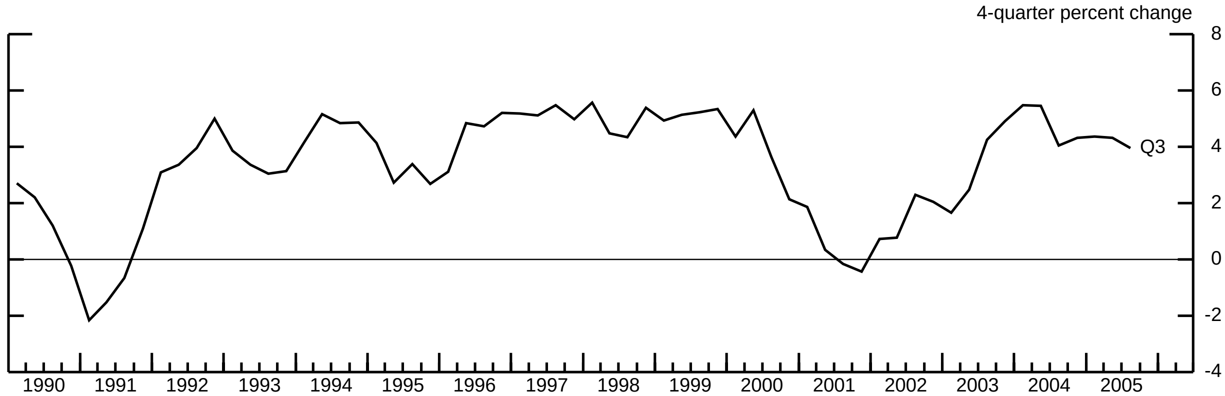

Note. Annual rate, FRB seasonals.
Source. For class 4-8 trucks, Ward's Communications; for class 5-8 trucks, ACT Research.

### Other Equipment



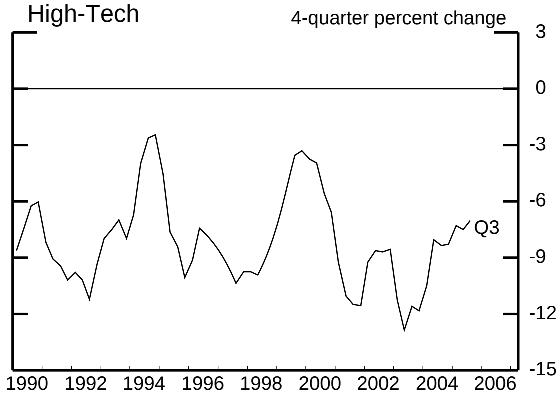
# Fundamentals of Equipment and Software Investment

Real Business Output

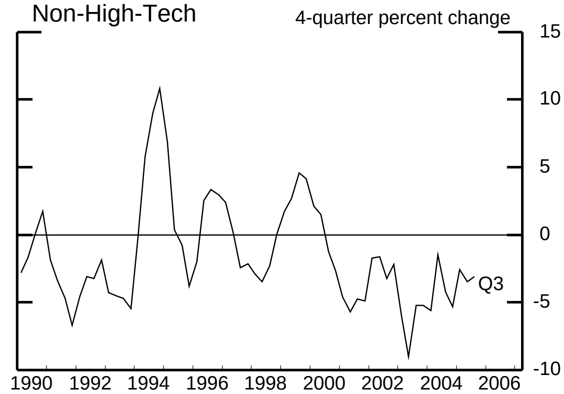



## User Cost of Capital

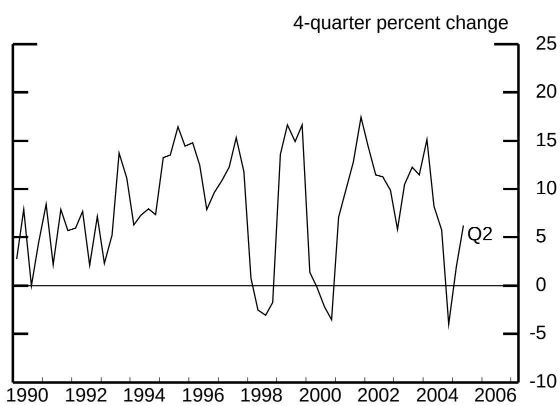
High-Tech



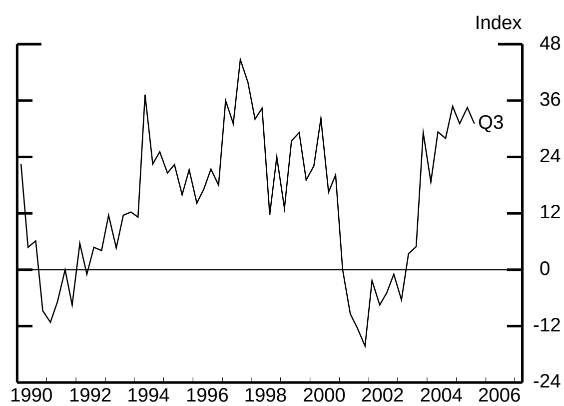

Non-High-Tech




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.

The staff's constructed series on real adjusted durable goods orders fell 1.5 percent in September after surging 6.1 percent in August. This series—which strips out nondefense aircraft, defense capital goods, and industries for which reported orders actually equal shipments—has historically had some predictive power for industrial production.

The book value of manufacturing durable goods inventories (which constitute nearly two-thirds of total manufacturing inventories) decreased at an annual rate of $3.4 billion in September, and the inventory-shipments ratio edged down to 1.34 months.

**Michigan Survey**
The Michigan Survey Research Center's index of consumer sentiment dipped 2.7 points in October after plunging more than 12 points in September. The index now stands at its lowest level in thirteen years and is likely damping gains in consumer spending.

The October decrease reflected a further weakening of the "current conditions" component as consumers reported being less sanguine about their current financial situation. The "expected conditions" component was essentially unchanged. Among the items not included in the overall index, consumers' expectations about the change in unemployment improved slightly, but remained considerably less favorable than in August. In addition, appraisals of buying conditions for cars and houses continued to slide with both well below the levels posted this past summer.

The mean of expected inflation over the next twelve months was unchanged, but the median firmed in October to 4.6 percent, the highest value since December 1990. The mean of expected inflation over the next five to ten years was also unchanged, but the median edged up to 3.2 percent.

**Sales of New Homes**
Sales of new homes rose 2.1 percent in September to an annual rate of 1.22 million units. Sales in July and August were revised down. By region, sales in September were down in the Northeast and West, and up in the Midwest and South. The stock of new homes for sale moved up in September and represented 4.9 months of sales at last month's sales pace. Months' supply is now at the upper end of the range it has occupied since 1996.

The average sales price of new homes was 6.1 percent higher in September than a year earlier, similar to the 5.8 percent increase recorded during the preceding twelve-month period. The median price of new homes in September was up 1.9 percent from a year earlier, compared with the 10.2 percent gain posted over the previous twelve-month period. On a constant-quality basis, new home prices in the third quarter were 7.4 percent higher than a year earlier, compared with a 7 percent increase during the previous four-quarter period.

**Initial Claims for Unemployment Insurance**
Initial claims for unemployment insurance under state programs declined 28,000 to 328,000 for the week ending October 22. Our contact at the Employment and Training

October 28, 2005

**University of Michigan Survey Research Center: Survey of Consumer Attitudes**

Indexes of consumer sentiment

(Not seasonally adjusted)

| Category | 2005 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Mar. | Apr. | May | June | July | Aug. | Sept. | Oct.[F] |
| Composite of current and expected conditions[1] | 92.6 | 87.7 | 86.9 | 96.0 | 96.5 | 89.1 | 76.9 | 74.2 |
| Current conditions[1] | 108.0 | 104.4 | 104.9 | 113.2 | 113.5 | 108.2 | 98.1 | 91.2 |
| Expected conditions[1] | 82.8 | 77.0 | 75.3 | 85.0 | 85.5 | 76.9 | 63.3 | 63.2 |
| Personal financial situation | | | | | | | | |
| Now compared with 12 months ago[2] | 117 | 113 | 109 | 122 | 122 | 117 | 103 | 96 |
| Expected in 12 months[2] | 130 | 121 | 121 | 129 | 133 | 121 | 115 | 112 |
| Expected business conditions | | | | | | | | |
| Next 12 months[2] | 104 | 96 | 95 | 109 | 112 | 102 | 62 | 68 |
| Next 5 years[2] | 98 | 91 | 85 | 103 | 99 | 85 | 76 | 72 |
| Appraisal of buying conditions | | | | | | | | |
| Cars | 130 | 128 | 133 | 139 | 152 | 147 | 125 | 119 |
| Large household appliances[2] | 163 | 158 | 163 | 172 | 172 | 164 | 151 | 139 |
| Houses | 150 | 149 | 156 | 146 | 145 | 140 | 130 | 125 |
| Expected unemployment change - next 12 months | 112 | 118 | 119 | 116 | 117 | 123 | 137 | 134 |
| Prob. household will lose a job - next 5 years | 23 | 27 | 24 | 23 | 22 | 23 | 23 | 22 |
| Expected inflation - next 12 months | | | | | | | | |
| Mean | 4.0 | 4.0 | 3.8 | 4.0 | 3.6 | 3.7 | 5.5 | 5.5 |
| Median | 3.2 | 3.3 | 3.2 | 3.2 | 3.0 | 3.1 | 4.3 | 4.6 |
| Expected inflation - next 5 to 10 years | | | | | | | | |
| Mean | 3.3 | 3.4 | 3.5 | 3.1 | 3.3 | 3.3 | 3.8 | 3.8 |
| Median | 2.9 | 3.0 | 2.9 | 2.8 | 2.9 | 2.8 | 3.1 | 3.2 |

Note. Figures on financial, business, and buying conditions are the percent reporting ’good times’ (or ’better’) minus the percent reporting ’bad times’ (or ’worse’), plus 100. Expected change in unemployment is the fraction expecting unemployment to rise minus the fraction expecting unemployment to fall, plus 100.

F Final.

1. Feb. 1966 = 100.
2. Indicates the question is one of the five equally-weighted components of the index of sentiment.

## The Market for New Single-Family Homes

| | 2004 | 2005 Q1 | 2005 Q2 | 2005 Q3 | 2005 July | 2005 Aug. | 2005 Sept. |
|---|---|---|---|---|---|---|---|
| *Sales*[1] | | | | | | | |
| Total | 1,203 | 1,249 | 1,287 | 1,258 | 1,354 | 1,197 | 1,222 |
| Percent Change | 10.8 | .5 | 3.0 | -2.3 | 4.3 | -11.6 | 2.1 |
| *Previously reported level* | | | *1,289* | | *1,373* | *1,237* | |
| *Regional Sales* | | | | | | | |
| Northeast | 83 | 74 | 91 | 74 | 95 | 70 | 56 |
| Midwest | 210 | 193 | 228 | 207 | 215 | 181 | 226 |
| South | 562 | 633 | 614 | 621 | 616 | 607 | 641 |
| West | 348 | 349 | 354 | 355 | 428 | 339 | 299 |
| *Inventories* | | | | | | | |
| New homes for sale[2] | 395 | 443 | 451 | 479 | 466 | 478 | 493 |
| Months' supply[3] | 4.0 | 4.3 | 4.3 | 4.7 | 4.2 | 4.9 | 4.9 |
| *Prices*[4] | | | | | | | |
| Average | 274.5 | 288.5 | 286.5 | 284.7 | 282.0 | 287.5 | 285.7 |
| Percent change | 11.4 | 9.7 | 8.0 | 3.9 | 1.0 | 5.6 | 6.1 |
| Median | 221.0 | 232.5 | 232.5 | 221.7 | 219.8 | 228.8 | 215.7 |
| Percent change | 13.3 | 5.0 | 6.8 | 3.8 | 3.5 | 4.9 | 1.9 |
| Constant-quality price index[5] | 141.9 | 148.9 | 152.6 | 153.5 | n.a. | n.a. | n.a. |
| Percent change | 7.6 | 6.7 | 7.8 | 7.4 | n.a. | n.a. | n.a. |

1. Thousands of units, seasonally adjusted annual rate, except where noted. Percent change is from previous comparable period, not at an annual rate.
2. Thousands of units, seasonally adjusted. Monthly figures are end of periodstock. Quarterly and annual figures are averages of monthly figures.
3. At current sales rate, seasonally adjusted. The ratio of NSA inventories to NSA sales is seasonally adjusted by Census; as a result, the seasonally adjusted ratio may not be the same as the ratio of SA inventories to SA sales. Quarterly and annual figures are averages of monthly figures.
4. Price levels are expressed in thousands of dollars and are not seasonallyadjusted. Quarterly and annual values of average and median prices are equal to a weighted average of monthly data;the weights are based on the response rate to the survey in each month. Percent changes are from the previous comparable period a year earlier.
5. 1996 = 100. Based on characteristics of homes sold in 1996.

n.a.--data not reported on a monthly basis.

October 27, 2005

Administration (ETA) estimates that, on a not-seasonally-adjusted basis, hurricane-related initial claims were about 24,000 for the week ending October 22 and 40,000 for the week ending October 15. The total number of hurricane-related initial claims filed since early September now stands at 502,000. Our contact at the ETA also reported that about 68,000 claims for FEMA's Disaster Unemployment Assistance (DUA) were about 68,000 in September. These DUA claims were all related to Hurricane Katrina; no DUA claims for Hurricane Rita were reported for September.

The level of insured unemployment under state programs was 2.9 million for the week ending October 15, slightly above the previous week's figure and more than 300,000 higher than in late August. The insured unemployment rate ticked up to 2.3 percent.

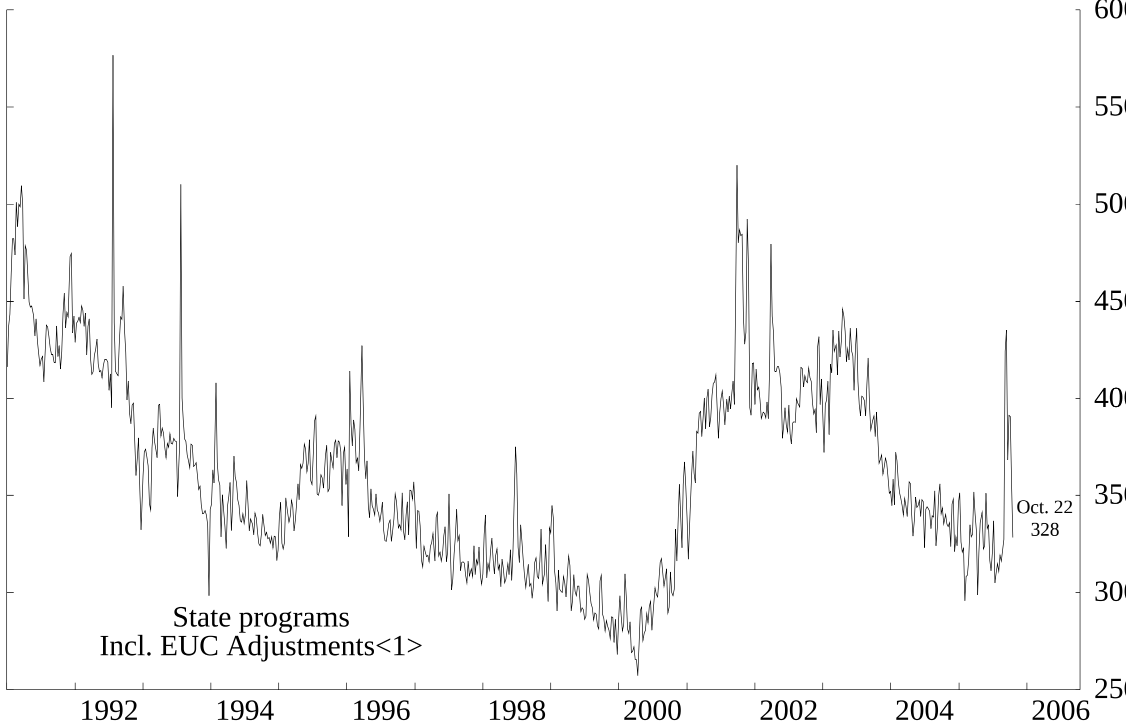
## Unemployment Insurance Programs
(In Thousands)

| Item | 2005 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Sept. 10 | Sept. 17 | Sept. 24 | Oct. 1 | Oct. 8 | Oct. 15 | Oct. 22 |
| *Seasonally adjusted*[1] | | | | | | | |
| Initial Claims | | | | | | | |
| All regular programs[2] | 428 | 439 | 371 | 394 | 396 | 360 | 332 |
| State programs | 424 | 435 | 368 | 391 | 391 | 356 | 328 |
| Insured unemployment | | | | | | | |
| All regular programs[3] | 2704 | 2833 | 2916 | 2903 | 2907 | 2949 | NA |
| State programs | 2658 | 2787 | 2870 | 2858 | 2862 | 2904 | NA |
| Extended benefits[4] | 0 | 0 | 0 | 0 | 0 | NA | NA |
| State-insured Unemployment rate[5] | 2.1 | 2.2 | 2.2 | 2.2 | 2.2 | 2.3 | NA |
| Initial Claims (Four-week moving avg.) | | | | | | | |
| All regular programs[2] | 351 | 380 | 392 | 408 | 400 | 380 | 370 |
| State programs | 347 | 377 | 389 | 405 | 396 | 377 | 367 |
| *Not seasonally adjusted* | | | | | | | |
| Regular state programs | | | | | | | |
| Initial claims | 322 | 346 | 292 | 314 | 380 | 303 | 303 |
| Insured unemployment | 2312 | 2350 | 2394 | 2372 | 2344 | 2468 | NA |

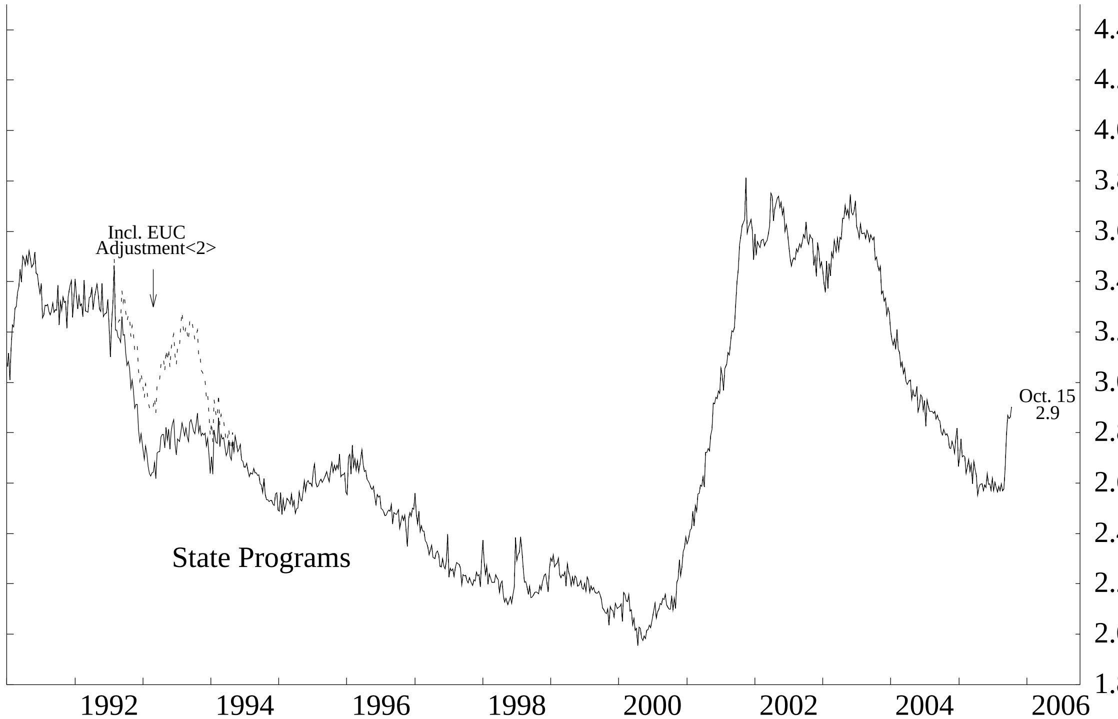
1. Only data for regular state programs are seasonally adjusted.
2. Includes federal employees and ex-servicemen.
3. Includes federal employees, railroad workers, and ex-servicemen.
4. Includes state and federal emergency extended benefits.
5. Percent of covered employees receiving regular state benefits.

# Unemployment Insurance
(Weekly data; Seasonally adjusted)

Initial Claims




Insured Unemployment




<1> Beginning July 18, 1992, includes initial claims filed under the emergency unemployment benefits program by individuals also eligible to file under regular programs. The EUC program ended on April 30, 1994.
<2> Includes staff estimate of emergency benefits recipients who are also eligible to file under regular programs.

## The Domestic Financial Economy

**Senior Loan Officer Opinion Survey on Bank Lending Practices**

The October 2005 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. The survey contained special questions on longer-term changes in terms on mortgage loans to purchase homes. The survey also asked banks about changes in lending standards and terms on home equity lines of credit in light of a supervisory letter issued by federal bank regulators in May 2005. Finally, banks were queried about anticipated changes in the supply of, and demand for, loans to businesses and households stemming from the recently enacted bankruptcy reform legislation. This appendix is based on responses from fifty-seven domestic banks and nineteen foreign banking institutions.

Domestic commercial banks reported a further net easing of lending standards and terms for commercial and industrial (C&I) loans over the past three months, while lending standards for commercial real estate loans had changed little. At U.S. branches and agencies of foreign banks, lending standards and terms for both types of loans were about unchanged over the same period. Small net fractions of domestic banks noted stronger demand for both C&I and commercial real estate loans in the October survey. At foreign institutions, a few respondents indicated that demand for C&I loans had picked up, while demand for commercial real estate loans was unchanged. Significant net fractions of domestic respondents reported weaker demand for mortgages to purchase homes as well as weaker demand for consumer loans over the past three months. On net, credit standards on residential mortgages and consumer loans were little changed in October.

In response to the special question about changes in terms on mortgage loans to purchase homes, notable net fractions of domestic institutions reported that they had eased a number of terms, including the maximum size of primary and second mortgages, spreads of mortgage rates over an appropriate market base rate, and the maximum loan-to-value ratio over the past two years. Turning to home equity lines of credit, only a few domestic banks reported having tightened their lending policies in response to concerns expressed in a supervisory letter distributed last spring. Finally, in response to special questions on changes in the supply of, and demand for, loans to businesses and households in light of the new bankruptcy law, nearly all domestic and foreign institutions noted that they had not changed their business and household lending policies. Moreover, the new bankruptcy law is generally expected to have no effect on the demand for credit from existing customers. However, a considerable number of domestic banks, on net, reported that they expect credit losses on new loans to businesses and households to be moderately lower as a result of the new bankruptcy law.

**Business Lending**

On balance, the October survey pointed to some further easing of business lending standards and terms and continued strengthening of loan demand. However, the pace of these changes generally has slowed relative to recent surveys.

In the October survey, domestic banks indicated that they had further eased standards and terms on C&I loans over the past three months. Nearly 10 percent of respondents, on net, reported having eased their credit standards on loans to large and middle-market firms, a somewhat smaller net fraction than in recent surveys. Almost one-half of domestic institutions—roughly the same net fraction as in the July survey—indicated that they had trimmed spreads of loan rates over their cost of funds for such firms. About 30 percent of domestic respondents—a smaller net percentage than in the previous survey—reported that they had reduced the costs of credit lines in October. Domestic respondents also indicated that they had eased other lending terms to large and middle-market firms, on net, over the same period: About one-fifth of banks reported that they increased the maximum size and maturity of loans or credit lines and eased covenants on such loans. For C&I loans to small firms, only a few domestic respondents indicated that they had eased lending standards, but almost 40 percent of them, on net, noted that they had trimmed spreads of loan rates over their cost of funds. U.S. branches and agencies of foreign banks said that their standards on C&I loans were essentially unchanged over the past three months. However, a moderate net fraction of these institutions reported having eased terms on C&I loans.

As in recent surveys, almost all domestic banks that reported having eased their lending standards and terms in the October survey cited more-aggressive competition from other banks or nonbank lenders as an important reason for doing so. A substantial percentage of respondents also pointed to an increased tolerance for risk as a reason for having eased standards or terms on C&I loans.

On net, 15 percent of domestic banks reported an increase in demand for C&I loans from large and middle-market firms over the past three months, a considerable reduction from the 40 percent that did so in the previous survey. Similarly, the net fraction of respondents reporting stronger demand from small firms fell back from its level in the July survey. At U.S. branches and agencies of foreign banks, only a few respondents noted that demand for C&I loans was moderately stronger over the past three months. Among the domestic respondents that experienced stronger demand for C&I loans, most cited borrowers' increased financing needs for accounts receivable and inventories. A significant proportion of these respondents also pointed to a rise in merger and acquisition activity and increased financing needs for investment in plant and equipment. Regarding future business, about 15 percent of domestic and 25 percent of foreign institutions, on net, indicated that inquiries from potential business borrowers had increased over the past three months.

Domestic and foreign institutions reported little change in lending standards on commercial real estate loans in the current survey. On net, 12 percent of domestic banks saw an increase in demand for commercial real estate loans over the past three months, down from one-fourth in the July survey. Foreign institutions indicated that demand for this type of loan was unchanged in October, down from 15 percent reporting stronger demand in the previous survey.

**Household Lending**

Credit standards on residential mortgage loans were little changed in the October survey. Demand for mortgages to purchase homes—which banks had reported as having risen in the July survey—weakened over the past three months: Almost one-fourth of domestic institutions reported a decline in demand. However, this decline may reflect, in part, lower refinancing activity in recent months, a source of demand some respondents may find difficult to separate from mortgage demand to purchase homes.

The survey contained two special questions on residential real estate loans: The first question asked domestic banks about changes over the past two years in various terms on mortgage loans to purchase homes; the second queried domestic banks about changes in lending standards and terms for home equity lines of credit in light of a May 2005 supervisory letter regarding the appropriate management of the risk posed by such loans.

Almost 40 percent of domestic banks, on net, reported that over the past two years they had increased the maximum size of primary mortgages they were willing to provide, while about 30 percent, on net, indicated that over the same period they had increased the maximum size of second mortgages. In addition, about one-fourth of respondents, on net, said that they had narrowed spreads of mortgage rates over an appropriate market base rate and had increased the maximum loan-to-value ratio on such loans. By contrast, banks noted that the maximum length of extended interest-rate locks, minimum required credit scores, and loan origination fees were little changed over the past two years.

In response to the supervisory letter, only five banks reported having tightened price-related terms and only a few banks reported tightening their non-price-related terms and credit standards on home equity lines of credit, while most domestic institutions indicated that they had not changed their lending standards or terms on such facilities.

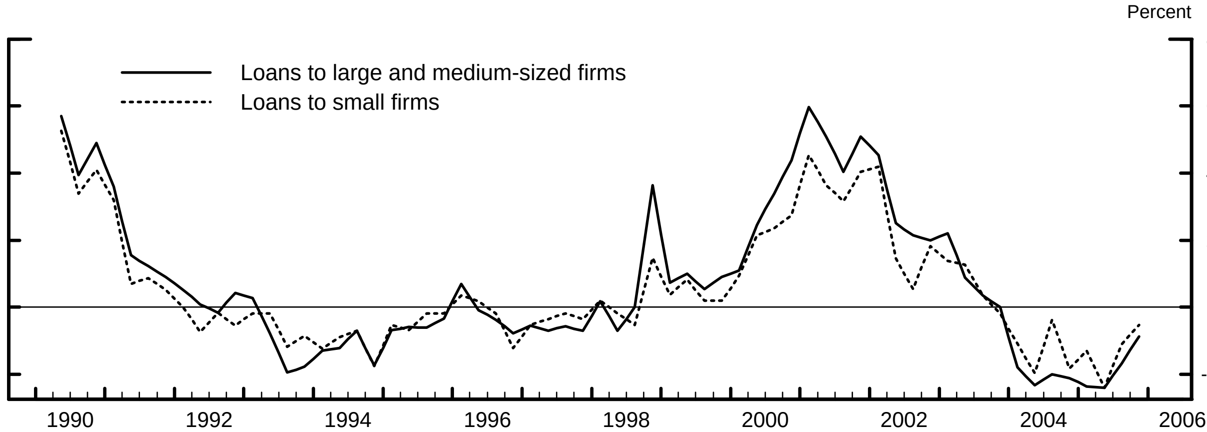
Domestic institutions indicated that their willingness to make consumer installment loans was about unchanged over the past three months. On net, standards and terms on credit card and non-credit-card consumer loans were about flat in the October survey. After strengthening in July, demand for consumer loans reportedly weakened over the past three months: About 20 percent of domestic banks, on net, saw weaker demand for such loans.

The final set of special questions addressed the expected effect of bankruptcy reform legislation (which took effect on October 17, 2005) on the supply of, and demand for, loans to businesses and households.[1] Virtually all domestic and foreign respondents noted that the new law had had no effect on their business and household lending policies. In addition, all foreign and nearly all domestic institutions reported that, after accounting for changes in standards and terms, the new bankruptcy law would likely have no effect on the demand for credit from existing customers. Finally, almost one-third of domestic institutions, on net, indicated that, after accounting for changes in standards and terms and assuming economic activity progresses in line with consensus forecasts, credit losses on new loans to households are expected to be moderately lower as a result of the changes. About 15 percent of respondents, on net, noted that credit losses on new loans to businesses are anticipated to be lower. By contrast, foreign institutions indicated that they expect the bankruptcy law changes to have no effect on credit losses on new loans to businesses.

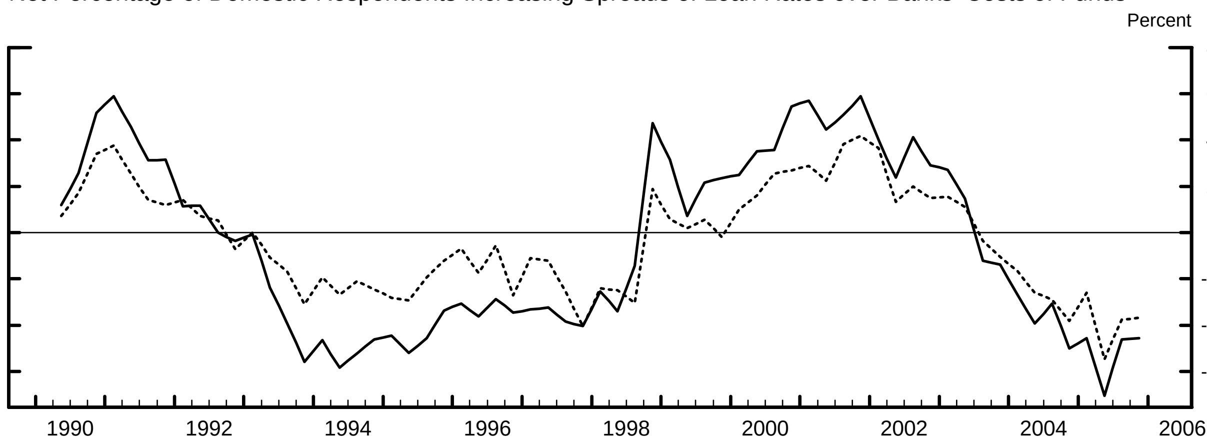
[1] This legislation, known as the Bankruptcy Abuse Prevention and Consumer Protection Act, was passed by the Congress in March and signed into law by the President on April 20, 2005. The legislation makes bankruptcy a less attractive option for some businesses and households.

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

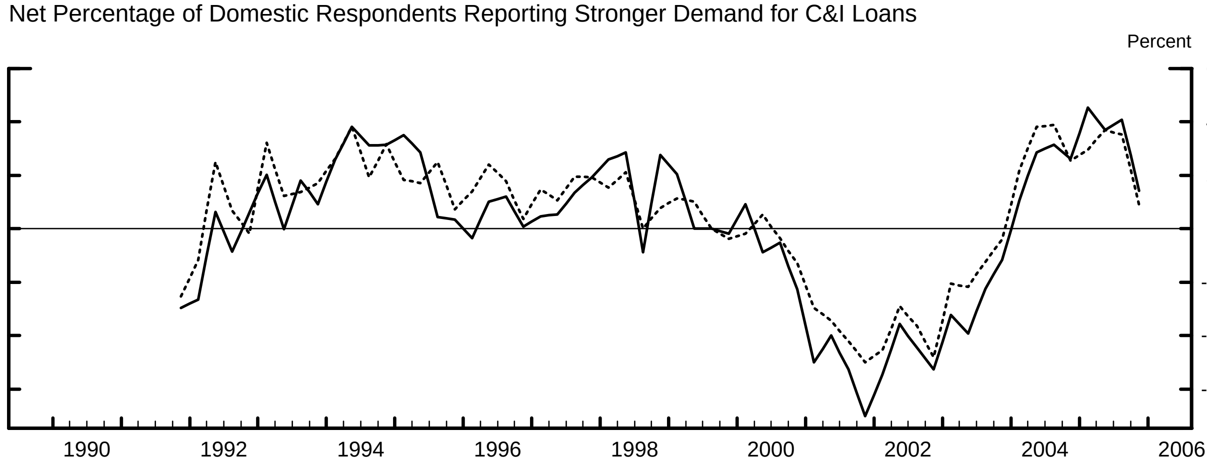
Net Percentage of Domestic Respondents Tightening Standards for C&I Loans




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

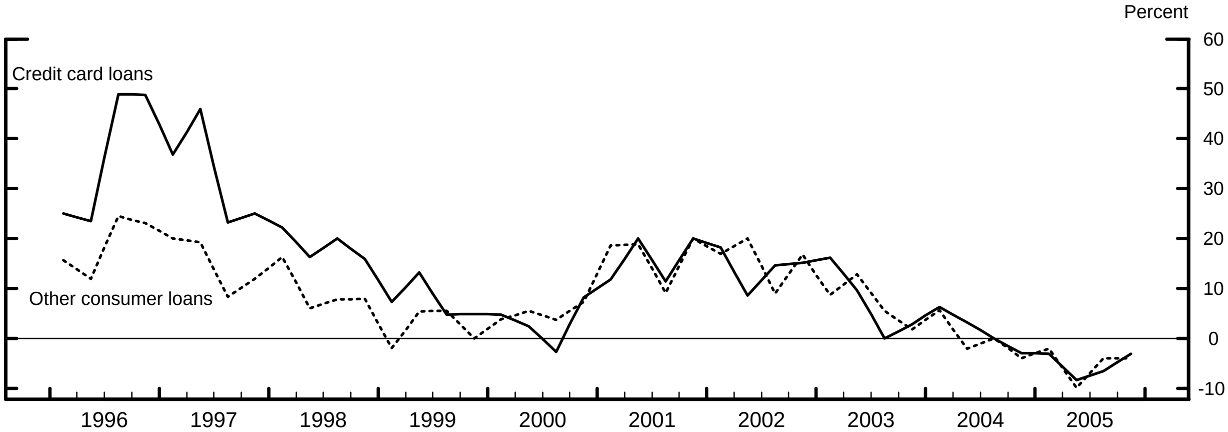



Net Percentage of Domestic Respondents Reporting Stronger Demand for C&I Loans

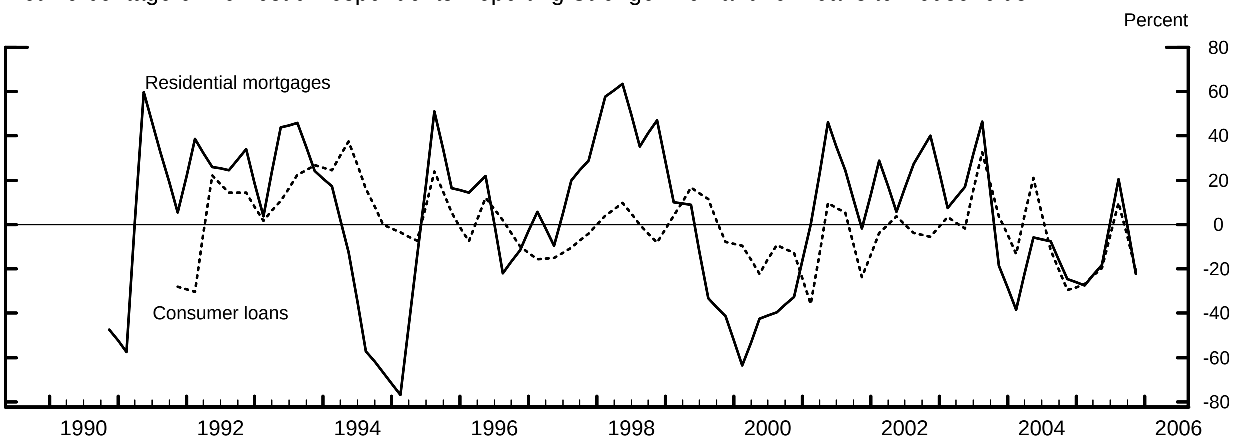


# Measures of Supply and Demand for Loans to Households

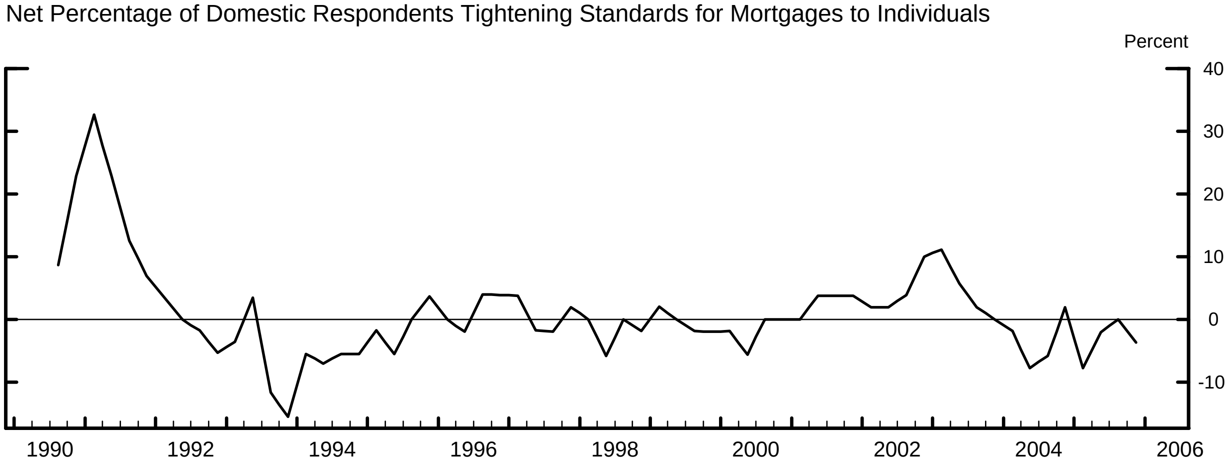
Net Percentage of Domestic Respondents Tightening Standards for Consumer Loans




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




Net Percentage of Domestic Respondents Tightening Standards for Mortgages to Individuals



## Commercial Bank Credit

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

| Type of credit | 2003 | 2004 | H1 2005 | Q3 2005 | Sept. 2005 | Oct.[e] 2005 | Level ($ billions), Oct. 2005[e] |
|---|---|---|---|---|---|---|---|
| **Total** | | | | | | | |
| **1. Adjusted[1]** | **5.9** | **8.9** | **12.5** | **9.3** | **5.0** | **4.6** | **7,125** |
| 2. Reported | 5.6 | 8.4 | 11.3 | 9.2 | 7.1 | 3.4 | 7,273 |
| *Securities* | | | | | | | |
| 3. Adjusted[1] | 8.6 | 6.6 | 14.5 | 1.5 | -1.0 | 3.8 | 1,866 |
| 4. Reported | 7.2 | 5.2 | 10.2 | 1.8 | 6.7 | -.6 | 2,015 |
| 5. Treasury and agency | 8.9 | 4.8 | 7.2 | -6.0 | -8.3 | -2.8 | 1,162 |
| 6. Other[2] | 4.8 | 5.8 | 14.8 | 13.3 | 27.9 | 2.3 | 853 |
| *Loans*[3] | | | | | | | |
| 7. Total | 5.0 | 9.8 | 11.8 | 12.1 | 7.2 | 5.0 | 5,259 |
| 8. Business | -9.3 | 1.3 | 15.5 | 12.4 | 8.9 | 16.1 | 1,006 |
| 9. Real estate | 11.1 | 14.0 | 14.1 | 15.5 | 3.5 | 6.8 | 2,837 |
| 10. Home equity | 30.8 | 43.9 | 16.7 | 11.7 | -2.7 | -4.4 | 437 |
| 11. Other | 8.8 | 9.8 | 13.6 | 16.2 | 4.6 | 8.9 | 2,401 |
| 12. Consumer | 5.4 | 8.8 | 5.7 | 4.7 | 4.3 | -21.7 | 689 |
| 13. Adjusted[4] | 5.8 | 5.9 | 1.1 | 4.4 | 3.3 | -24.9 | 1,042 |
| 14. Other[5] | 7.2 | 7.9 | 4.2 | 5.7 | 22.4 | 8.1 | 727 |

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

1. Adjusted to remove effects of mark-to-market accounting rules (FIN 39 and FAS 115).
2. Includes private mortgage-backed securities, securities of corporations, state and local governments, foreign governments, and any trading account assets that are not Treasury or agency securities, including revaluation gains on derivative contracts.
3. Excludes interbank loans.
4. Includes an estimate of outstanding loans securitized by commercial banks.
5. Includes security loans and loans to farmers, state and local governments, and all others not elsewhere classified. Also includes lease financing receivables.

e Estimated.

III-T-1

**Selected Financial Market Quotations**

(One-day quotes in percent except as noted)

| Instrument | 2004 June 28 | 2004 Dec. 31 | 2005 Sept. 19 | 2005 Oct. 27 | Change to Oct. 27 from selected dates (percentage points): 2004 June 28 | 2004 Dec. 31 | 2005 Sept. 19 |
|---|---|---|---|---|---|---|---|
| *Short-term* | | | | | | | |
| FOMC intended federal funds rate | 1.00 | 2.25 | 3.50 | 3.75 | 2.75 | 1.50 | .25 |
| Treasury bills[1] | | | | | | | |
| 3-month | 1.36 | 2.18 | 3.51 | 3.79 | 2.43 | 1.61 | .28 |
| 6-month | 1.74 | 2.52 | 3.72 | 4.06 | 2.32 | 1.54 | .34 |
| Commercial paper (A1/P1 rates)[2] | | | | | | | |
| 1-month | 1.28 | 2.29 | 3.74 | 3.96 | 2.68 | 1.67 | .22 |
| 3-month | 1.45 | 2.28 | 3.79 | 4.13 | 2.68 | 1.85 | .34 |
| Large negotiable CDs[1] | | | | | | | |
| 3-month | 1.53 | 2.50 | 3.88 | 4.20 | 2.67 | 1.70 | .32 |
| 6-month | 1.82 | 2.72 | 4.03 | 4.41 | 2.59 | 1.69 | .38 |
| Eurodollar deposits[3] | | | | | | | |
| 1-month | 1.29 | 2.32 | 3.75 | 4.03 | 2.74 | 1.71 | .28 |
| 3-month | 1.51 | 2.49 | 3.85 | 4.19 | 2.68 | 1.70 | .34 |
| Bank prime rate | 4.00 | 5.25 | 6.50 | 6.75 | 2.75 | 1.50 | .25 |
| *Intermediate- and long-term* | | | | | | | |
| U.S. Treasury[4] | | | | | | | |
| 2-year | 2.88 | 3.08 | 3.94 | 4.41 | 1.53 | 1.33 | .47 |
| 5-year | 3.97 | 3.63 | 4.03 | 4.45 | .48 | .82 | .42 |
| 10-year | 4.90 | 4.34 | 4.34 | 4.67 | -.23 | .33 | .33 |
| U.S. Treasury indexed notes | | | | | | | |
| 5-year | 1.56 | 1.03 | 1.36 | 1.80 | .24 | .77 | .44 |
| 10-year | 2.25 | 1.65 | 1.71 | 2.02 | -.23 | .37 | .31 |
| Municipal general obligations (Bond Buyer)[5] | 5.01 | 4.49 | 4.30 | 4.56 | -.45 | .07 | .26 |
| Private instruments | | | | | | | |
| 10-year swap | 5.21 | 4.65 | 4.69 | 5.05 | -.16 | .40 | .36 |
| 10-year FNMA[6] | 5.30 | 4.61 | 4.58 | 4.95 | -.35 | .34 | .37 |
| 10-year AA[7] | 5.59 | 4.98 | 5.04 | 5.37 | -.22 | .39 | .33 |
| 10-year BBB[7] | 6.18 | 5.38 | 5.59 | 5.97 | -.21 | .59 | .38 |
| 5-year high yield[7] | 8.30 | 7.34 | 7.91 | 8.30 | .00 | .96 | .39 |
| Home mortgages (FHLMC survey rate) | | | | | | | |
| 30-year fixed | 6.21 | 5.77 | 5.80 | 6.15 | -.06 | .38 | .35 |
| 1-year adjustable | 4.19 | 4.10 | 4.48 | 4.91 | .72 | .81 | .43 |

| Stock exchange index | Record high: Level | Record high: Date | 2004 Dec. 31 | 2005 Sept. 19 | 2005 Oct. 27 | Change to Oct. 27 from selected dates (percent): Record high | 2004 Dec. 31 | 2005 Sept. 19 |
|---|---|---|---|---|---|---|---|---|
| Dow Jones Industrial | 11,723 | 1-14-00 | 10,783 | 10,558 | 10,230 | -12.74 | -5.13 | -3.10 |
| S&P 500 Composite | 1,527 | 3-24-00 | 1,212 | 1,231 | 1,179 | -22.82 | -2.72 | -4.23 |
| Nasdaq | 5,049 | 3-10-00 | 2,175 | 2,145 | 2,064 | -59.12 | -5.13 | -3.80 |
| Russell 2000 | 689 | 8-2-05 | 652 | 667 | 624 | -9.37 | -4.23 | -6.45 |
| Wilshire 5000 | 14,752 | 3-24-00 | 11,971 | 12,292 | 11,760 | -2.28 | -1.76 | -4.33 |

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

NOTES:

June 28, 2004, is the day before the most recent policy tightening began.
September 19, 2005, is the day before the most recent FOMC meeting.