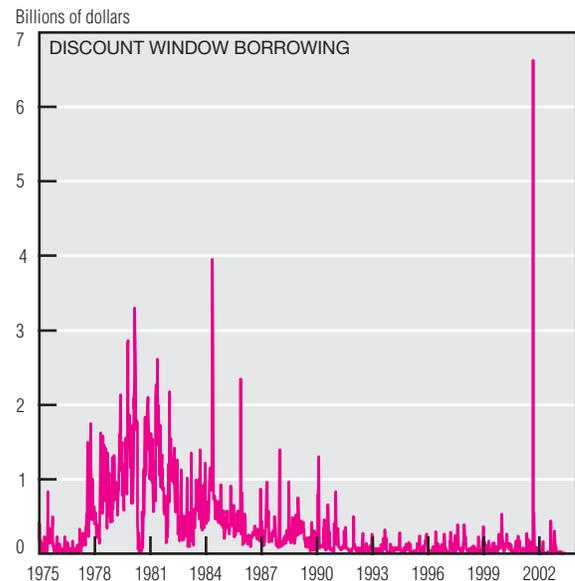
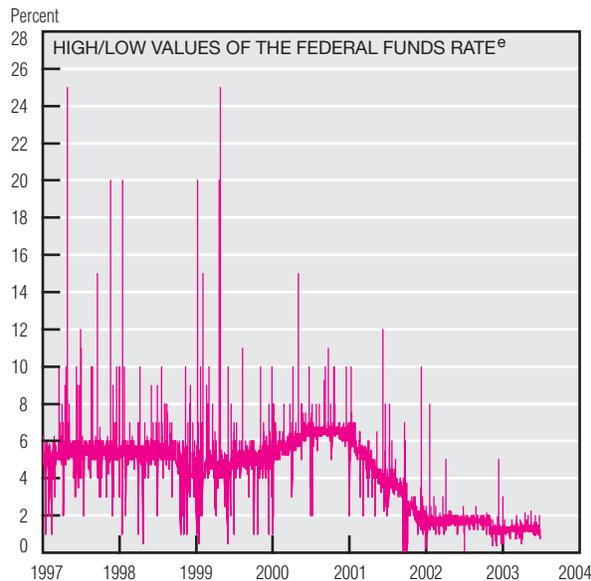
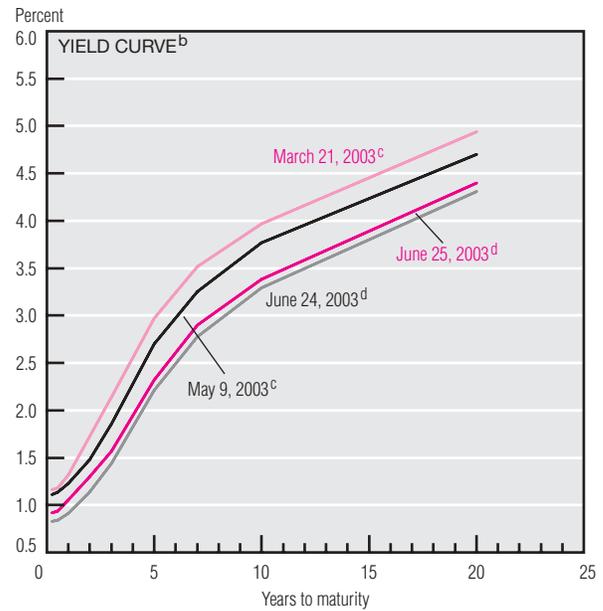
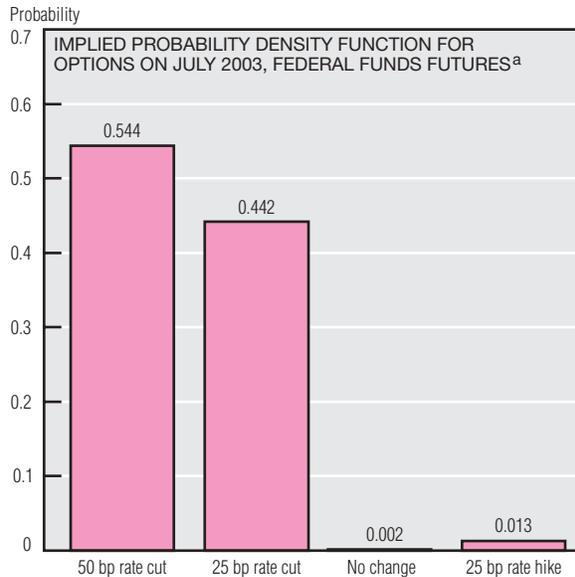


# Money and Financial Markets



- a. Probability estimates are derived from option prices as of July 24.  
 b. All yields are from constant-maturity series.  
 c. Average for the week ending on the date shown.  
 d. Daily observations.  
 e. Highs and lows are reported daily.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15 and "Aggregate Reserves of Depository Institutions and the Monetary Base," H.3, *Federal Reserve Statistical Releases*; Federal Reserve Bank of New York; Chicago Board of Trade; and Bloomberg Financial Information Services.

Options on federal funds futures have traded on the Chicago Board of Trade since March 2003. Unlike the federal funds futures market, the structure of this option market can furnish an estimate of the distribution of expected policy changes. On June 24, participants placed a high probability on a cut at the meeting on the following day, with the probability of a 50 bp cut exceeding that of a 25 bp cut.

Movements in the yield curve since May 6 also foreshadowed an easing at the June 25 meeting. Yields declined roughly 25 bp to 40 bp across the

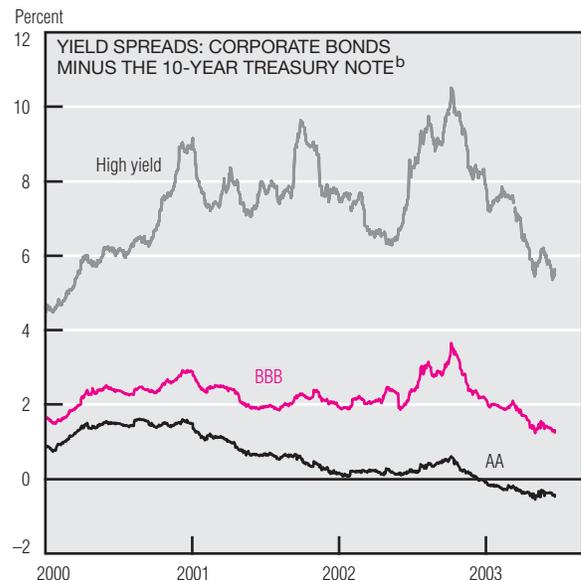
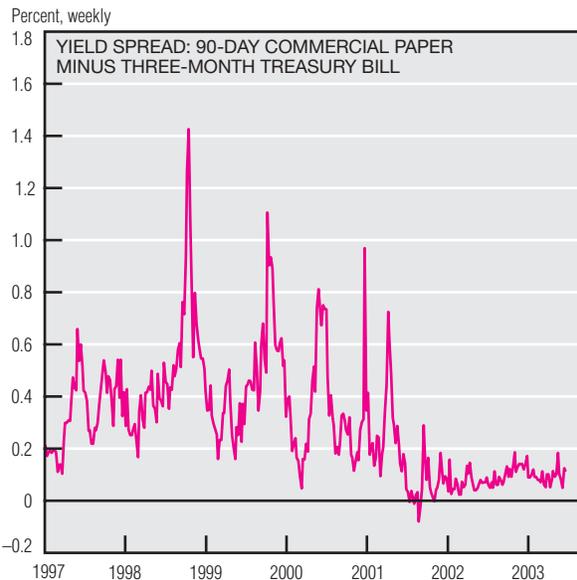
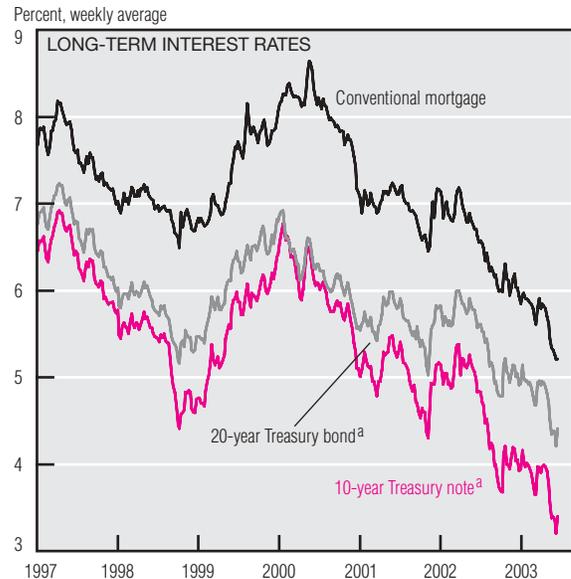
spectrum of maturities. After the rate cut of June 25, the yield curve moved upward 10 bp to 16 bp, with the two-year yield increasing the most.

Under a policy in effect since January 9, 2003, Federal Reserve Banks extend short-term credit to qualified institutions at the primary credit rate, currently 100 bp above the intended federal funds rate. This credit is extended with "no questions asked," unlike the previous regime, which rationed credit at the discount window. It was hoped that such a change would encourage use of the discount

window and contain upward movements in the federal funds rate. However, as has been true since the early 1990s, use of the discount window remains low. In fact, since the introduction of the new regime, outstanding primary credit has averaged only \$12 million. From January 1990 to the end of 2002, adjustment credit borrowing averaged \$113 million. So far, upward movements in the federal funds rate have been contained. Since the regime change, the federal funds rate reached the primary credit rate on only one day, May 14.

(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," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

Short-term interest rates continue their strong downward trend, moving together with the federal funds rate during this period of easing. The yield curve remains relatively flat at the short end, with three-month, six-month, and one-year Treasury bill rates within 10 bp of one another. Nonetheless, the spread has increased in the last few weeks, which may indicate expectations of a round of policy tightening in the coming year.

Interest rates on conventional mortgages have declined nearly 70 bp since late March. Yields on long-term government securities declined more

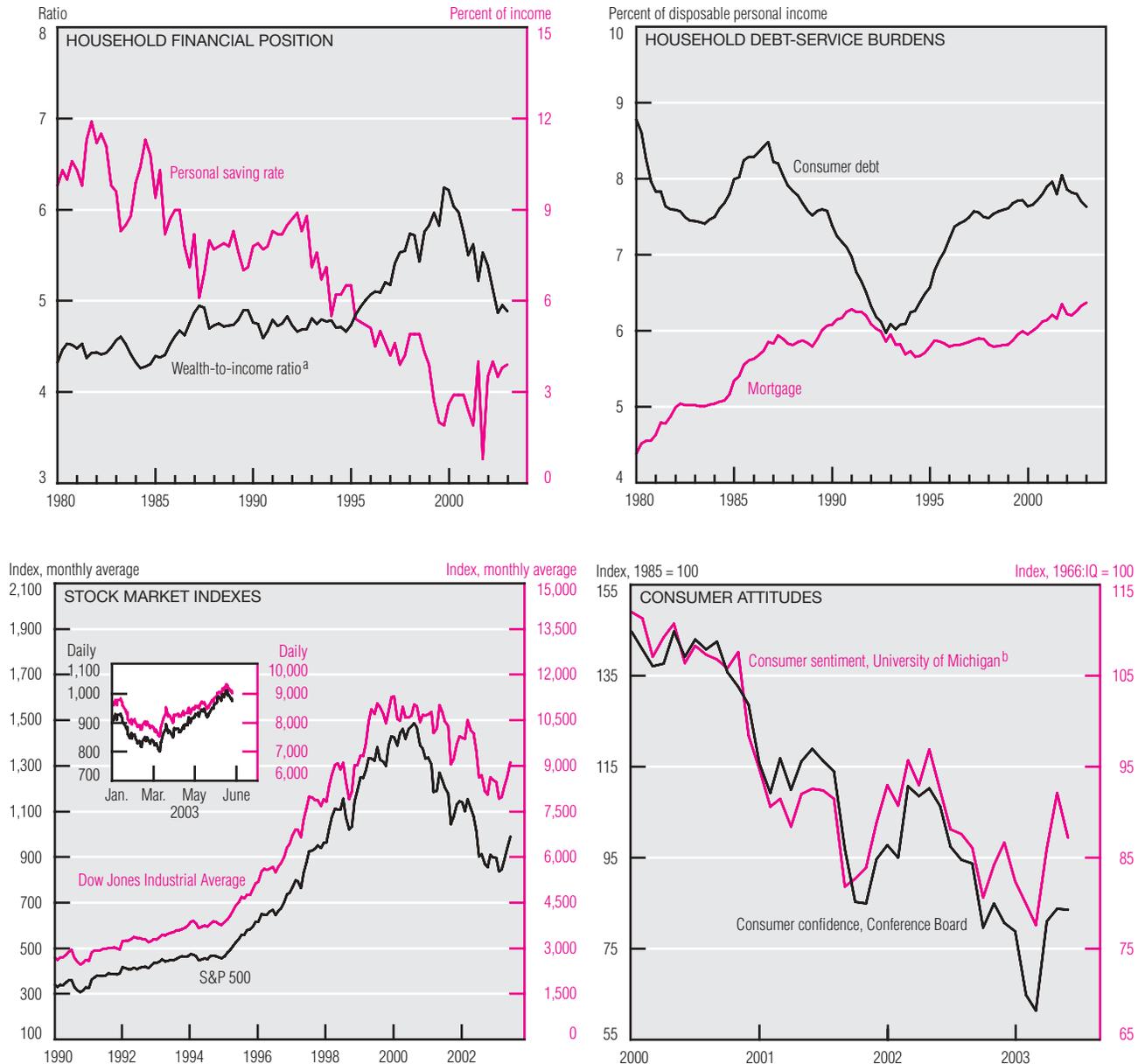
than 50 bp during the same period. Low mortgage rates contributed to a 6.1% increase in housing starts between April and May.

The spread between the 90-day commercial rate and the three-month Treasury bill rate remains low, probably because only higher-quality issuers remain in the market. Over the last two and a half years, the amount of outstanding nonfinancial commercial paper has fallen nearly 60%. Although they declined in the first part of this year, financial commercial paper issues have rebounded in the last few months.

Yield spreads between corporate bond issues and Treasury notes continue to trend downward. These spreads narrowed noticeably as the outcome of the war in Iraq became more certain. The spread between high-yield corporate bonds and Treasury notes has narrowed the most, having dropped 5 percentage points since the fall of 2002. Notably, the yields on AA-rated corporate bonds have fallen below those of 10-year Treasury notes. The decline in corporate bond rates may give firms the necessary incentive to step up investment in the coming months.

(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. Data are not seasonally adjusted.

SOURCES: Board of Governors of the Federal Reserve System, "Household Debt-Service Burden," *Federal Reserve Statistical Releases*; University of Michigan; Conference Board; and Bloomberg Financial Information Services.

The personal saving rate fluctuated markedly during 2001 as tax cuts were phased in. The rate stabilized in 2002 and has remained relatively steady, between 3.5% and 4%, over the last few months. As consumers begin receiving tax rebate checks in late July from the latest round of tax cuts, the personal saving rate may again fluctuate markedly. After falling more than 1 percentage point since late 1999, the wealth-to-income ratio has remained steady, with moderate increases in personal disposable income this year.

Consumer credit increased 7% in April owing to a marked rise in nonrevolving credit. However, consumers' debt-service burdens have declined in recent months because falling interest rates and rising income have offset overall increases in consumer debt levels. Despite declines in mortgage rates, mortgage debt burdens increased because of the strong housing market.

After reaching a six-year low in March, the S&P 500 stock price index has rebounded strongly in recent months, posting an overall increase of nearly 22%. The Dow Jones index showed similar improvements, in

which reduced uncertainty regarding geopolitical tensions doubtless played a major role.

The Conference Board's Index of Consumer Confidence was essentially unchanged in June. Consumers' deteriorating views of their current situation were offset by expectations of an improving job market. On the other hand, the University of Michigan's Index of Consumer Sentiment survey fell markedly in June. In this index, consumers' perceptions of their current situation and their outlook for the future both worsened.