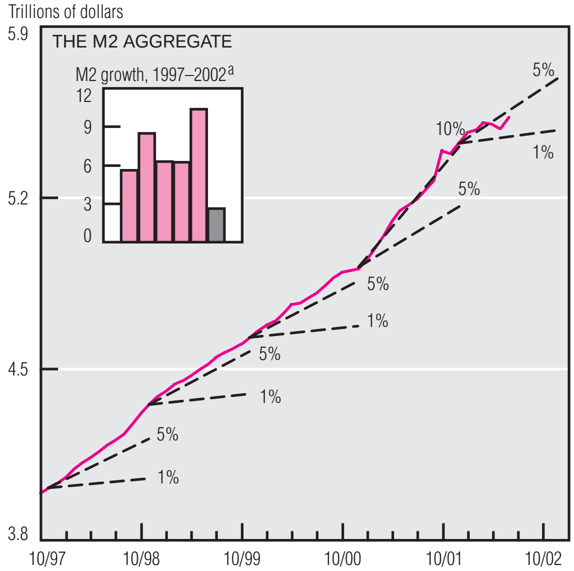
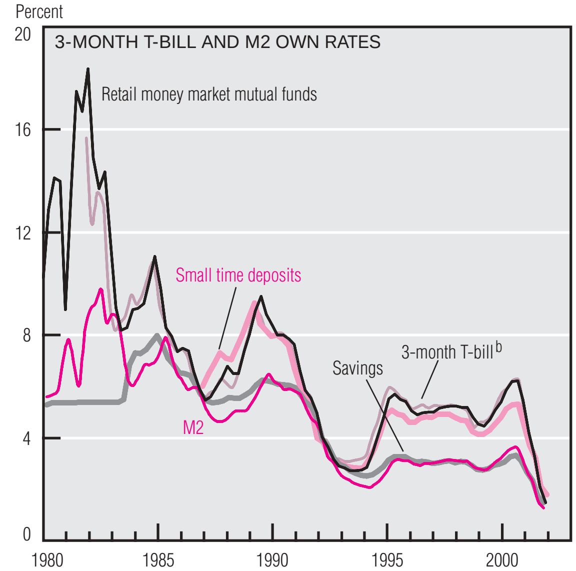
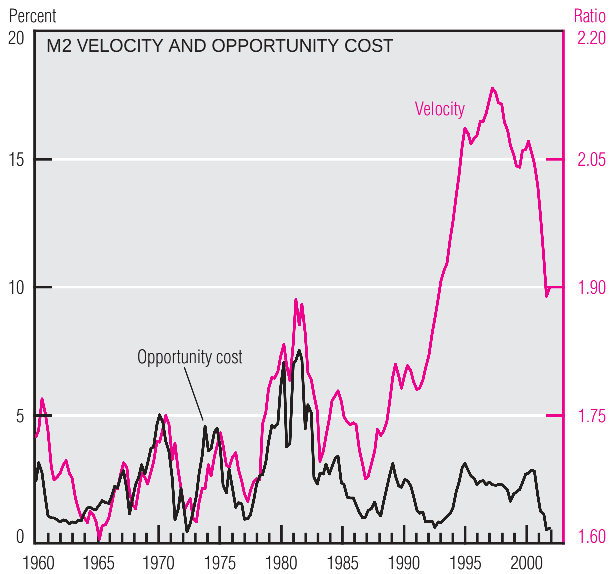
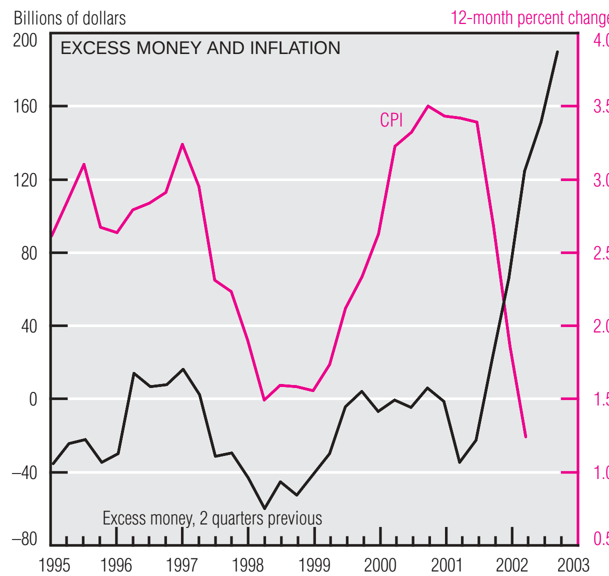
Money and Financial Markets









a. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Data are seasonally adjusted.
b. Constant maturity.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Board of Governors of the Federal Reserve System.

Growth rates for broad money measures, such as M2 and M3, slowed markedly in the early months of 2002. For example, M2 growth fell to an annual rate of 0.4% from January to April 2002, in marked contrast with 2001 growth rates that were in excess of 10%. Much of this year's M2 growth is attributable to moderate increases in holdings of savings deposits. Most other M2 components have declined since the year began, the most significant shift being away from retail money funds. The slower growth of broad monetary aggregates may reflect consumers' switch from low-risk, low-return assets to those with higher returns and greater risk.

The opportunity cost of holding M2 balances, measured as the difference between the effective rate on the 3-month T-bill and a share-weighted average of the yields on M2 components, fell dramatically in 2001. Although rates paid on M2 components declined sharply (which alone would raise the opportunity cost of holding M2 balances), this drop has been more than offset by the strong decline in 3-month T-bill rates. The drop in M2's opportunity cost was matched by the drop in its velocity. A recent uptick in its opportunity cost may partly explain this year's slower M2 growth.

Despite this slowdown, the difference between actual M2 and an econometric estimate of M2 demand (termed "excess money") suggests M2 is still growing faster than the economy's ability to absorb it. In the past, such a situation preceded a rise in inflationary pressures. Since early 2001, however, excess money and inflation have moved in opposite directions.

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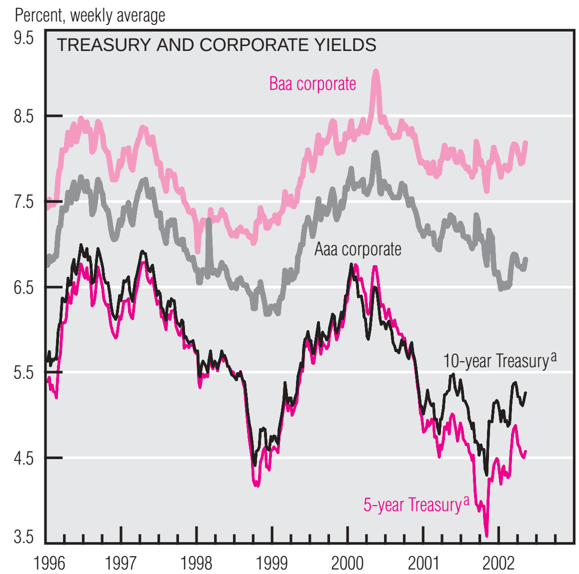
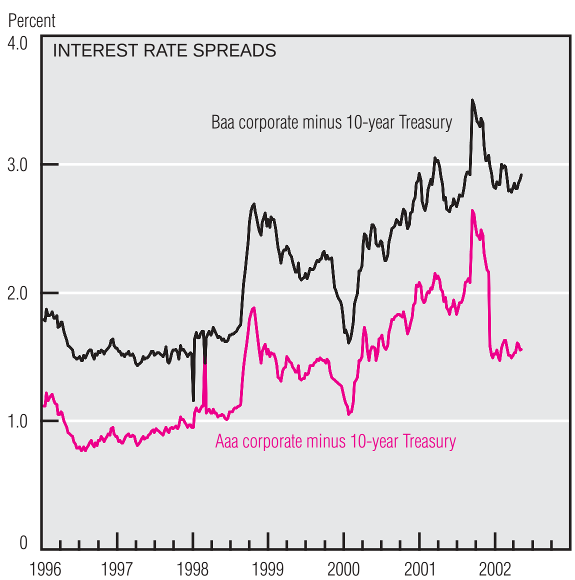
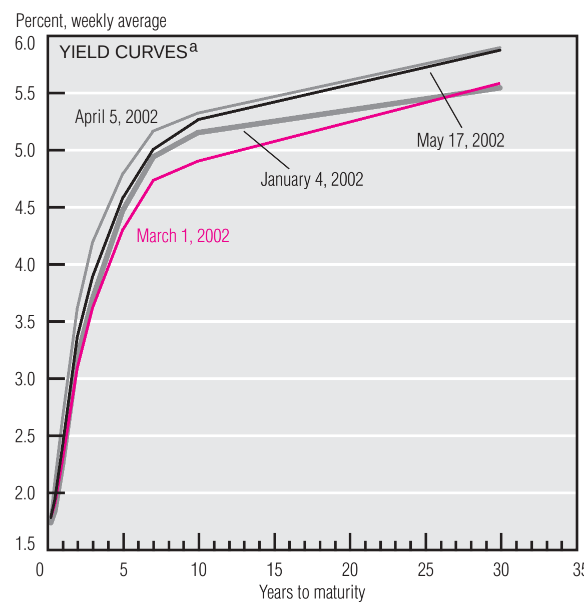
Money and Financial Markets (cont.)







a. Constant maturity
SOURCE: Board of Governors of the Federal Reserve System.

Since their peak in late 2000, 3-month Treasury bill rates have fallen an amount nearly equal to the 475 basis point (bp) decline in the federal funds rate. Yields on short-term Treasury securities rose significantly in March and early April 2002, then retrenched in late April and early May. Short-term rates have shown no general trend since late 2001.

Recessions often are associated with an increase in the spread between private borrowing costs and those of the Treasury. In 2001:IVQ, however, the spread between corporate and longer-term Treasury securities plummeted. This year, yields on Treasury and corporate securities have trended upward by similar magnitudes, keeping the spread nearly constant. The spread between Aaa-rated corporate securities and Treasuries has returned to mid-2000 levels, but the spread between riskier Baa corporate securities and Treasuries has declined less sharply.

Although the yield curve has steepened since the beginning of March, it did not change appreciably in May. The spread between 10-year and 3-month Treasury securities remains very high at nearly 350 bp, considerably more than its average of 167 bp in the 1990s. The yield curve's persistent steepness probably signals strong economic growth in the rest of 2002. The nearly 60 bp spread between the 1-year and the 3-month T-bill rates corroborates the view that the market expects interest rates to rise in coming months.

The stock market remains anemic, reflecting uncertainty about the economic outlook and concern over

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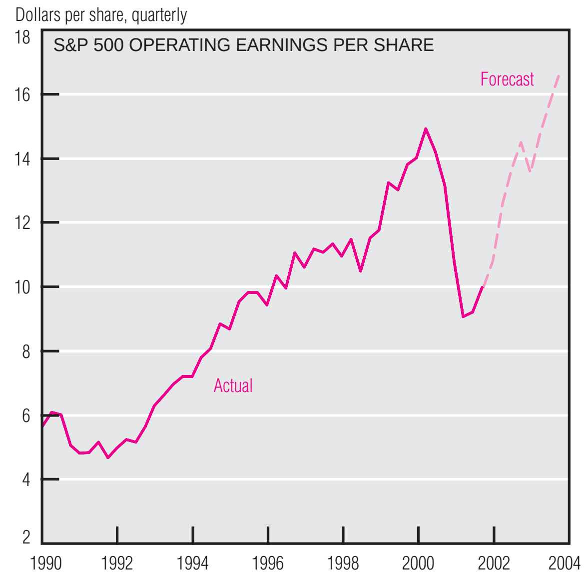

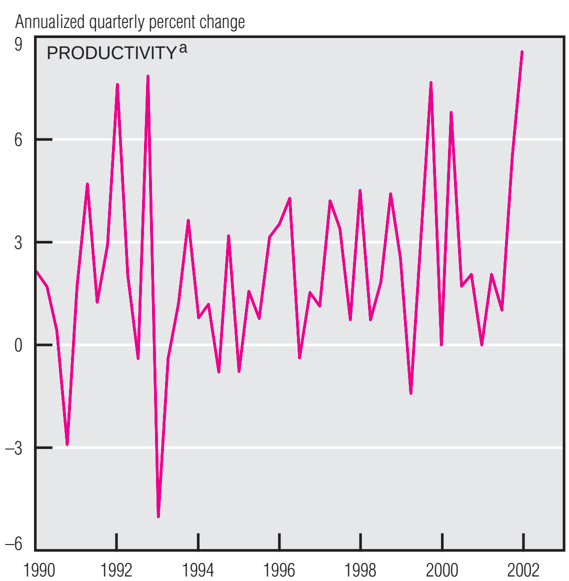

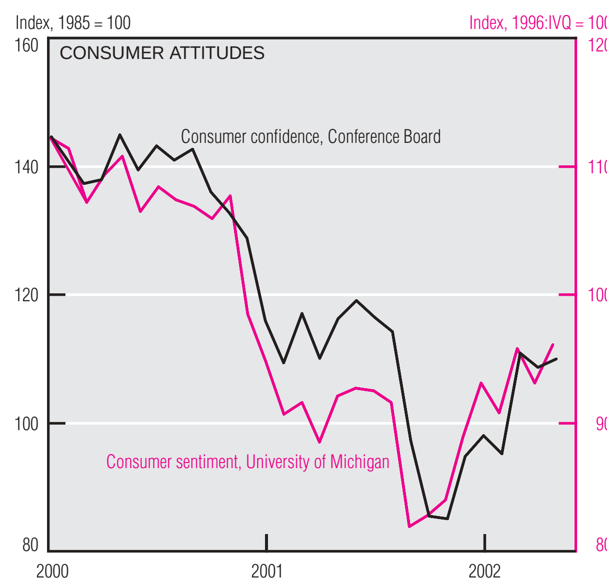

a. Output per hour, nonfarm business sector.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Standard and Poors; Bloomberg Financial Information Systems; the Conference Board; and the University of Michigan.

corporate accounting practices. However, there may be room for optimism. S&P 500 operating earnings per share rebounded at the end of 2001. Analysts expect this trend to continue, with operating earnings per share accelerating strongly for the rest of this year and into 2003.

Estimates of nonfarm business sector productivity growth surged to 8.4% in 2002:IQ, because of the sector's 2.1% decline in hours worked and its 6.1% increase in output (seasonally adjusted annual rate). Productivity gains in the early stages of an economic recovery are typical, but such vigorous growth points to a continuation of the technology-led productivity boost of the late 1990s. In fact, productivity remained unusually strong during the recent recession. Contained unit labor costs should help buoy firms' profitability.

Indexes of consumer attitudes, as measured by both the Conference Board and the University of Michigan, improved markedly in early 2002. These two indexes differ in focus: The Conference Board survey emphasizes households' perceptions of current business and labor market conditions as well as their outlook over a six-month horizon. The Michigan survey, which takes a longer-term outlook and focuses on household finances and the buying climate, hit its highest level since December 2000. This resurgence may result from higher earnings and from the prospect of rising income based on higher labor productivity. The uplift in consumer confidence is encouraging because personal consumption expenditures and housing demand have been instrumental in the early stages of the current recovery.