

## **Prefatory Note**

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November 5, 2004

# CURRENT ECONOMIC AND FINANCIAL CONDITIONS

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## **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

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### The Domestic Nonfinancial Economy

#### Labor Market Developments

Unemployment was little changed in October, but, hiring picked up again. Private payroll employment increased almost 300,000 from a September level that is 81,000 higher than previously estimated.

According to the payroll survey, large increases in jobs in the professional and business services industries and in non-business services—such as health, education, and social assistance—contributed importantly to the step-up in private sector hiring. Those industries accounted for 173,000 of the overall private payroll gain of 296,000. But employment in retail trade, which has remained weak for some time, also turned up last month. In addition, construction employment was sharply higher, boosted by a surge in jobs in specialty trades that was associated with hurricane repair work. In contrast, manufacturing employment edged down for a second month in October, and the factory workweek slipped further. However, the related industries of wholesale trade (6,000) and temporary help services (48,000) experienced noticeable increases, and our contacts in the temporary help industry continue to report strong demand from manufacturing clients. On balance, with the strong gain in private employment overall and the average workweek unchanged, aggregate hours of production or nonsupervisory workers rose 0.3 percent in October to a level  $\frac{1}{2}$  percent above the third-quarter average.

In the public sector, employment at state and local governments surged 47,000 in October after large increases in the preceding three months. The strength in hiring has been in education—both at the state level and at the local level. However, states also have been adding non-education jobs for most of this year following a long streak of reductions beginning around mid-2002 and ending early in 2004. These recent trends seem consistent with the fiscal strengthening of the sector.

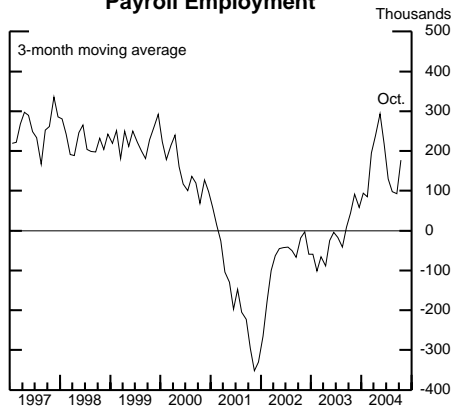
The household survey also reported a relatively strong monthly increase in employment and only a small rise in unemployment in October, but jobless rates and labor force participation rates for most demographic groups were little different than a month earlier. However, the number of individuals not in the labor force reporting that they want jobs jumped almost  $\frac{1}{2}$  million. Other indicators of the strength of the labor market were mixed. The number of job losers on temporary layoff remained below the levels of last

**Changes in Employment**  
(Thousands of employees; seasonally adjusted)

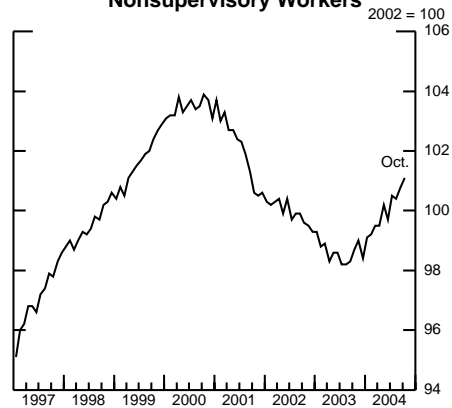
Measure and sector	2003	2004					
		Q1	Q2	Q3	Aug.	Sept.	Oct.
		Average monthly change			Monthly change		
Nonfarm payroll employment (establishment survey)	-5	198	209	141	198	139	337
Private	-1	195	218	92	141	95	296
Previous	-1	195	218	65	96	59	...
Manufacturing	-48	7	16	2	14	-14	-5
Construction	7	26	19	11	20	9	71
Wholesale trade	-3	8	5	8	3	10	6
Retail trade	-5	46	14	-4	11	-6	21
Transportation and utilities	-5	14	8	7	4	9	10
Information	-10	-2	4	-8	-7	-8	5
Financial activities	6	7	15	9	9	24	17
Professional and business services	23	26	73	35	28	44	97
Temporary help services	15	8	23	20	15	34	48
Nonbusiness services <sup>1</sup>	34	59	60	30	61	25	76
Total government	-4	3	-8	48	57	44	41
Total employment (household survey)	168	-60	244	150	21	-201	298
Memo:							
Aggregate hours of private production workers (percent change) <sup>2</sup>	-0.8	2.3	2.2	3.1	-0.1	.4	.3
Average workweek (hours) <sup>3</sup>	33.7	33.8	33.7	33.8	33.7	33.8	33.8
Manufacturing (hours)	40.4	41.0	40.9	40.8	40.9	40.8	40.7

1. Nonbusiness services comprises education and health, leisure and hospitality, and "other."
  2. Establishment survey. Annual data are percent changes from Q4 to Q4. Quarterly data are percent changes from preceding quarter at an annual rate. Monthly data are percent changes from preceding month.
  3. Establishment survey.
- ... Not applicable.

**Changes in Private Payroll Employment**



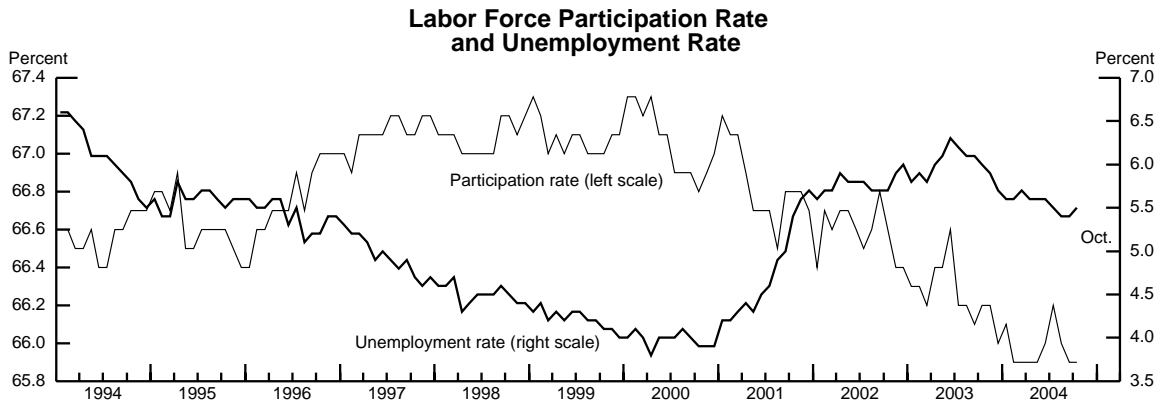
**Aggregate Hours of Production or Nonsupervisory Workers**



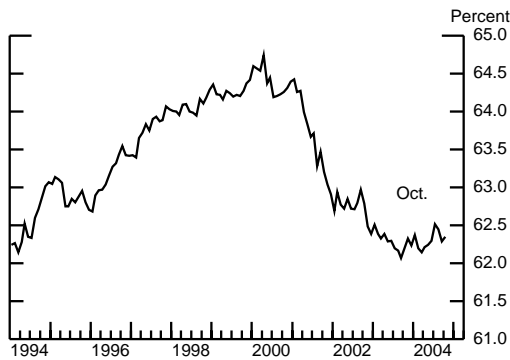
### Selected Unemployment and Labor Force Participation Rates

(Percent; seasonally adjusted)

Rate and group	2003	2004				
		H1	Q3	Aug.	Sept.	Oct.
<i>Civilian unemployment rate</i>						
16 years and older	6.0	5.6	5.5	5.4	5.4	5.5
Teenagers	17.4	16.8	17.1	17.0	16.6	17.2
20-24 years old	10.0	9.6	9.3	9.0	9.5	9.8
Men, 25 years and older	5.1	4.5	4.4	4.4	4.3	4.3
Women, 25 years and older	4.6	4.5	4.3	4.3	4.3	4.2
<i>Labor force participation rate</i>						
Total	66.2	65.9	66.0	66.0	65.9	65.9
Teenagers	44.5	43.6	43.9	44.1	43.4	43.8
20-24 years old	75.4	74.9	74.9	74.9	74.5	75.8
Men, 25 years and older	75.5	75.3	75.4	75.4	75.2	75.2
Women, 25 years and older	59.6	59.2	59.3	59.2	59.3	59.1



#### Employment-Population Ratio



#### Persons Working Part-Time for Economic Reasons

(Percent of household employment)



summer, but the number of workers on part-time schedules for economic reasons increased in November.

### Labor Output per Hour

(Percent change from preceding period at compound annual rate;  
based on seasonally adjusted data)

Sector	2001	2002	2003	2003	2004		
				Q4	Q1	Q2	Q3
Total business							
All persons	3.3	3.5	5.6	3.1	3.7	3.9	1.9
All employees <sup>1</sup>	3.4	3.7	6.1	3.3	2.9	3.3	2.9
Nonfinancial corporations <sup>2</sup>	2.0	5.1	6.6	5.0	0.1	2.7	...

Note. Annual changes are from fourth quarter of preceding year to fourth quarter of year shown.

1. Assumes that the growth rate of hours of non-employees equals the growth rate of hours of all employees.

2. All corporations doing business in the United States except banks, stock and commodity brokers, and finance and insurance companies. The sector accounts for about two-thirds of business employment

### Labor Productivity

Output per hour of all persons in the nonfarm business sector is now reported to have increased at an annual rate of 1.9 percent in the third quarter, a marked deceleration from the upward-revised second-quarter rate of 3.9 percent. The BLS reported that output increased at a 4.1 percent rate in the third quarter and that hours worked increased at a 2.1 percent rate. In the next release, the hours figure may be revised to incorporate information from today's labor market report. More important, the BLS figure for output comes from the BEA's advance estimate of third-quarter GDP; our current estimate of output is a bit lower, mainly because of this week's data on construction put-in-place. We now estimate that productivity posted a gain at a rate of 1.5 percent last quarter. Over the four quarters ending in the third quarter, the BLS reported that productivity rose 3.1 percent, well below the increase of 5.2 percent over the preceding four quarters.

### Labor Costs

Average hourly earnings of production or nonsupervisory workers rose 0.3 percent in November to a level 2.6 percent higher than a year earlier. The twelve-month change in this measure of wages is now up 1 percentage point from the low reached in February; it stood at 2.2 percent in October 2003.

Hourly compensation of all persons in the nonfarm business sector is estimated to have risen at an annual rate of 3.6 percent in the third quarter, keeping the year-over-year

### Hourly Compensation and Unit Labor Costs

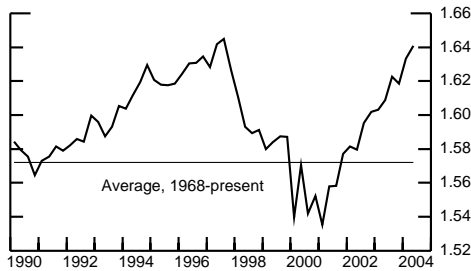
(Percent change from preceding period at compound annual rate; based on seasonally adjusted data)

Category	2002	2003	2003	2004			2003:Q3 to 2004:Q3
			Q4	Q1	Q2	Q3	
<i>Compensation per hour</i>							
Nonfarm business	2.9	5.4	4.4	2.0	4.9	3.6	3.7
Nonfinancial corporations <sup>1</sup>	2.5	5.0	4.2	2.3	4.7	n.a.	n.a.
<i>Unit labor costs</i>							
Nonfarm business	-6	-2	1.2	-1.6	1.0	1.6	.6
Nonfinancial corporations <sup>1</sup>	-2.4	-1.5	-8	2.1	1.9	n.a.	n.a.

Note. Annual changes are from fourth quarter of preceding year to fourth quarter of year shown.

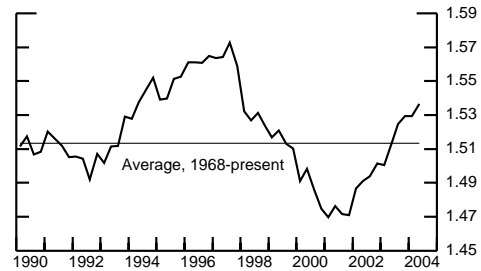
1. All corporations doing business in the United States except banks, stock and commodity brokers, and finance and insurance companies. The sector accounts for about two-thirds of business employment.

**Markup, Nonfarm Businesses**



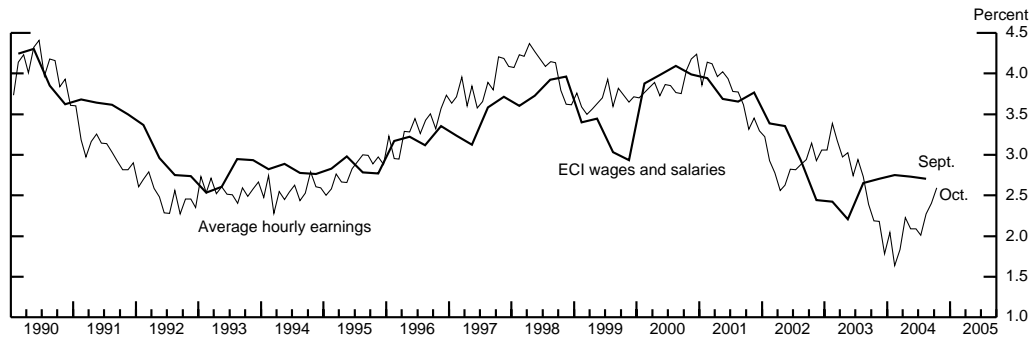
Note. Markup defined as ratio of output price to unit labor costs.

**Markup, Nonfinancial Corporations**



Note. Markup defined as ratio of output price to unit labor costs.

### Labor Costs for Production or Nonsupervisory Workers (12-month change)





change in compensation per hour at 3.7 percent.<sup>1</sup> Over the four quarters ending in 2003:Q3, the rise in hourly compensation was 4.6 percent. Unit labor costs rose at an annual rate of 1.6 percent in the third quarter but were up only 0.6 percent from a year earlier.

### **Motor Vehicles**

Sales of light motor vehicle dropped back ½ million units in October to an annual rate of 16.9 million units. Sales of light trucks slipped ¾ million units, while sales of cars moved up. The slowdown in light truck sales last month brought sales back to the average pace prevailing in the second and third quarters.

Among the Big Three automakers, Chrysler was the only firm to see an increase in sales in October. Sales at GM tumbled 1 million units, while sales at Ford edged down. The sharp decline at GM follows a steep run-up in the preceding month when special promotions boosted sales of GM light trucks.

Foreign manufacturers significantly outperformed the overall market in October. Sales of foreign nameplates built in North America as well as those built elsewhere posted strong gains. The increases were widespread and boosted the market share of Asian automakers to almost 36 percent.

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<sup>1</sup> The new estimates of hours worked released today suggest only a small change to the preliminary estimate.

**Sales of Automobiles and Light Trucks**  
(Millions of units at an annual rate, FRB seasonals)

	2002	2003	2004		2004		
			Q2	Q3	Aug.	Sept.	Oct.
Total	16.82	16.64	16.54	17.07	16.56	17.46	16.91
Autos	8.10	7.61	7.47	7.33	7.15	7.33	7.54
Light trucks	8.72	9.03	9.07	9.74	9.40	10.13	9.38
North American <sup>1</sup>	13.52	13.33	13.15	13.81	13.37	14.17	13.14
Autos	5.88	5.53	5.29	5.30	5.15	5.26	5.07
Big Three	3.74	3.39	3.09	3.05	2.93	3.10	2.87
Transplants	2.14	2.14	2.20	2.25	2.23	2.16	2.20
Light trucks	7.65	7.80	7.85	8.51	8.21	8.91	8.07
Big Three	6.61	6.60	6.50	7.06	6.75	7.53	6.53
Transplants	1.04	1.20	1.35	1.46	1.47	1.39	1.54
Foreign produced	3.29	3.31	3.39	3.27	3.19	3.29	3.78
Autos	2.23	2.08	2.18	2.03	2.00	2.07	2.47
Light trucks	1.07	1.23	1.21	1.23	1.19	1.22	1.31

Note. Components may not sum to totals because of rounding. Data on sales of trucks and imported autos for the most recent month are preliminary and subject to revision.

1. Excludes some vehicles produced in Canada that are classified as imports by the industry.

### Commercial Bank Credit

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

Type of credit	2003	Q1 2004	Q2 2004	Q3 2004	Sept. 2004	Oct. <sup>e</sup> 2004	Level, Oct. 2004 <sup>e</sup> (\$ billions)
<b>Total</b>							
<b>1. Adjusted<sup>1</sup></b>	<b>5.9</b>	<b>11.3</b>	<b>11.8</b>	<b>4.8</b>	<b>12.4</b>	<b>2.0</b>	<b>6,442</b>
2. Reported	5.6	11.9	8.7	5.4	12.4	2.3	6,616
<i>Securities</i>							
3. Adjusted <sup>1</sup>	8.7	17.9	14.4	-7.8	6.8	-5.8	1,719
4. Reported	7.3	19.5	3.7	-4.9	7.1	-4.2	1,893
5. Treasury and agency	8.8	24.2	11.1	-4.1	-4.8	-30.6	1,148
6. Other <sup>2</sup>	5.0	12.2	-8.1	-6.3	26.9	39.0	744
<i>Loans<sup>3</sup></i>							
7. Total	4.9	8.8	10.8	9.7	14.5	4.9	4,724
8. Business	-9.4	-5.1	-2.5	6.1	3.8	4.7	880
9. Real estate	11.1	10.1	21.1	7.9	11.7	14.6	2,487
10. Home equity	30.8	37.8	38.5	37.2	37.8	44.8	383
11. Other	8.8	6.2	18.4	3.2	7.2	9.3	2,103
12. Consumer	5.4	11.4	4.2	19.6	2.9	-6.6	670
13. Adjusted <sup>4</sup>	5.8	10.4	-2.2	12.3	1.6	3.5	1,040
14. Other <sup>5</sup>	6.7	20.5	-5	11.4	50.5	-17.5	688

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	2003	2004			Change to Nov. 4 from selected dates (percentage points)		
	Dec. 31	June 28	Sept. 20	Nov. 4	2003 Dec. 31	2004 June 28	2004 Sept. 20
<i>Short-term</i>							
FOMC intended federal funds rate	1.00	1.00	1.50	1.75	.75	.75	.25
Treasury bills <sup>1</sup>							
3-month	0.93	1.36	1.70	1.94	1.01	.58	.24
6-month	1.00	1.74	1.88	2.14	1.14	.40	.26
Commercial paper (A1/P1 rates) <sup>2</sup>							
1-month	1.00	1.28	1.74	1.96	.96	.68	.22
3-month	1.05	1.45	1.83	2.08	1.03	.63	.25
Large negotiable CDs <sup>1</sup>							
1-month	1.06	1.30	1.78	2.04	.98	.74	.26
3-month	1.09	1.53	1.86	2.17	1.08	.64	.31
6-month	1.16	1.82	2.02	2.31	1.15	.49	.29
Eurodollar deposits <sup>3</sup>							
1-month	1.04	1.29	1.77	1.99	.95	.70	.22
3-month	1.07	1.51	1.87	2.14	1.07	.63	.27
Bank prime rate	4.00	4.00	4.50	4.75	.75	.75	.25
<i>Intermediate- and long-term</i>							
U.S. Treasury <sup>4</sup>							
2-year	1.83	2.88	2.43	2.63	.80	-.25	.20
10-year	4.40	4.90	4.21	4.22	-.18	-.68	.01
30-year	5.22	5.55	4.96	4.91	-.31	-.64	-.05
U.S. Treasury 10-year indexed note	2.00	2.23	1.80	1.66	-.34	-.57	-.14
Municipal revenue (Bond Buyer) <sup>5</sup>	5.04	5.37	5.03	4.99	-.05	-.38	-.04
Private instruments							
10-year swap	4.66	5.21	4.51	4.48	-.18	-.73	-.03
10-year FNMA <sup>6</sup>	4.72	5.30	4.55	-	-	-	-
10-year AA <sup>7</sup>	5.05	5.59	4.86	4.84	-.21	-.75	-.02
10-year BBB <sup>7</sup>	5.74	6.18	5.44	5.38	-.36	-.80	-.06
5-year high yield <sup>7</sup>	7.94	8.30	7.66	7.30	-.64	-1.00	-.36
Home mortgages (FHLMC survey rate)							
30-year fixed	5.85	6.21	5.70	5.70	-.15	-.51	.00
1-year adjustable	3.72	4.19	4.00	4.00	.28	-.19	.00

Stock exchange index	Record high		2004			Change to Nov. 4 from selected dates (percent)		
	Level	Date	June 28	Sept. 20	Nov. 4	Record high	2004 June 28	2004 Sept. 20
Dow-Jones Industrial	11,723	1-14-00	10,357	10,205	10,315	-12.01	-.41	1.08
S&P 500 Composite	1,527	3-24-00	1,133	1,122	1,162	-23.95	2.50	3.52
Nasdaq	5,049	3-10-00	2,020	1,908	2,024	-59.92	.19	6.06
Russell 2000	606	4-5-04	584	571	602	-.70	3.09	5.50
Wilshire 5000	14,752	3-24-00	11,056	10,937	11,371	-22.92	2.85	3.97

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 beginning of the current tightening period.  
September 20, 2004, is the day before the most recent FOMC meeting.

## **The International Economy**

### **U.S. International Financial Transactions**

Private foreign purchases of U.S. securities (line 4 of the Summary of U.S. International Transactions table) recovered somewhat to \$32 billion in September after recording a relatively subdued \$26 billion inflow in August. For the third quarter, private inflows were \$117 billion, similar to the inflows recorded in each of the first two quarters of the year. For the first nine months of the year, private inflows into U.S. securities amounted to \$366 billion, close to the \$372 inflows recorded for all of 2003.

Private foreign investors sold \$8 billion in agency bonds (line 4b) in September but made record monthly purchases of \$39 billion in corporate debt (line 4c). These movements may reflect portfolio reshuffling following the news of investigations of accounting irregularities at Fannie Mae in September. For the third quarter, net purchases of agency and corporate debt combined amounted to \$99 billion, a record quarterly inflow. Private foreign investors purchased \$4 billion in Treasury securities in September (line 4a), about offsetting net sales recorded in August, and bringing quarterly inflows to a modest \$14 billion. Foreigners were net sellers of U.S. equities in September for the second consecutive month (line 4d); for the quarter they acquired only \$4 billion in U.S. equities.

Following a strong \$29 billion inflow in August, net foreign official inflows (line 1) moderated only slightly to \$20 billion in September, reflecting sizable inflows from Norway, Russia, and China. For the third quarter, foreign official inflows were \$60 billion, about half of the blistering pace recorded in the first quarter of the year. For the first nine months of the year, foreign official inflows were \$262 billion, exceeding the \$245 billion recorded for the year 2003.

U.S. investors made small net sales of foreign securities (line 5) in September, following small net purchases in August. For the third quarter, U.S. investors acquired \$19 billion in foreign securities, reflecting moderate purchases of foreign bonds (line 5a) and stocks (line 5b), as well as an acquisition of stocks through a merger-related stock-swap (line 5c). A series break in reported net purchases of foreign bonds makes it difficult to compare current transactions in foreign bonds with the reported sales recorded in previous quarters.

The volatile banking sector (line 3) recorded an outflow of \$25 billion in September and \$22 billion for the third quarter, reversing much of the inflow recorded in the second quarter.

**Summary of U.S. International Transactions**  
(Billions of dollars, not seasonally adjusted except as noted)

	2002	2003	2003	2004				
			Q4	Q1	Q2	Q3	Aug.	Sept.
<b>Official financial flows</b>	<b>113.0</b>	<b>246.5</b>	<b>85.1</b>	<b>129.4</b>	<b>74.6</b>	<b>59.6</b>	<b>27.2</b>	<b>20.1</b>
1. Change in foreign official assets in the U.S. (increase, +)	116.7	245.0	82.9	128.8	73.4	59.6	27.7	20.1
a. G-10 countries	30.7	114.7	46.6	96.5	45.6	20.3	19.1	-2.3
b. OPEC countries	-7.5	6.1	10.5	3.7	-2.6	.1	-1.3	.8
c. All other countries	93.5	124.2	25.8	28.6	30.4	39.3	9.9	21.6
2. Change in U.S. official reserve assets (decrease, +)	-3.7	1.5	2.2	.6	1.1	.0	-5	.0
<b>Private financial flows</b>	<b>457.2</b>	<b>299.3</b>	<b>83.5</b>	<b>9.3</b>	<b>72.2</b>	<b>n.a.</b>	<b>...</b>	<b>...</b>
<b>Banks</b>								
3. Change in net foreign positions of banking offices in the U.S. <sup>1</sup>	116.8	64.3	100.7	-42.2	38.5	-22.2	13.9	-24.5
<b>Securities<sup>2</sup></b>								
4. Foreign net purchases of U.S. securities (+)	390.1	372.8	92.3	128.9	119.9	117.0	25.9	31.6
a. Treasury securities	101.5	121.2	8.8	65.8	30.1	14.4	-5.3	4.1
b. Agency bonds	84.2	-14.8	2.2	6.7	36.0	14.2	11.6	-8.1
c. Corporate and municipal bonds	145.7	226.1	57.6	51.4	51.2	84.7	21.8	39.4
d. Corporate stocks <sup>3</sup>	58.8	40.3	23.6	5.1	2.7	3.7	-2.1	-3.9
5. U.S. net acquisitions (-) of foreign securities	15.5	-76.9	-26.3	-18.3	-27.1	-18.8	-2.9	1.4
a. Bonds	33.5	24.2	-7.0	3.1	13.5	-8.7	-1.7	.3
b. Stock purchases	-14.8	-83.6	-16.5	-21.4	-27.9	-8.6	.2	1.0
c. Stock swaps <sup>3</sup>	-3.2	-17.4	-2.8	.0	-12.7	.0	-1.5	.0
<b>Other flows (quarterly data, s.a.)</b>								
6. U.S. direct investment (-) abroad	-134.8	-173.8	-53.7	-47.6	-60.7	n.a.	...	...
7. Foreign direct investment in U.S.	72.4	39.9	10.7	10.2	32.7	n.a.	...	...
8. Foreign holdings of U.S. currency	21.5	16.6	7.5	-1.8	8.8	n.a.	...	...
9. Other (inflow, +) <sup>4</sup>	-24.4	56.3	-47.6	-20.0	-39.8	n.a.	...	...
<b>U.S. current account balance (s.a.)</b>	<b>-473.9</b>	<b>-530.7</b>	<b>-127.0</b>	<b>-147.2</b>	<b>-166.2</b>	<b>n.a.</b>	<b>...</b>	<b>...</b>
<b>Capital account balance (s.a.)<sup>5</sup></b>	<b>-1.3</b>	<b>-3.1</b>	<b>-.3</b>	<b>-.4</b>	<b>-.3</b>	<b>n.a.</b>	<b>...</b>	<b>...</b>
<b>Statistical discrepancy (s.a.)</b>	<b>-95.0</b>	<b>-12.0</b>	<b>-41.4</b>	<b>8.9</b>	<b>19.7</b>	<b>n.a.</b>	<b>...</b>	<b>...</b>

NOTE: Data in lines 1 through 5 differ in timing and coverage from the balance of payments data published by the Department of Commerce. Details may not sum to totals because of rounding.

1. Changes in dollar-denominated positions of all depository institutions and bank holding companies plus certain transactions between broker-dealers and unaffiliated foreigners (particularly borrowing and lending under repurchase agreements). Includes changes in custody liabilities other than U.S. Treasury bills.

2. Includes commissions on securities transactions and therefore does not match exactly the data on U.S. international transactions published by the Department of Commerce.

3. Includes (4d) or represents (5c) stocks acquired through mergers.

4. Transactions by nonbanking concerns and other banking and official transactions not shown elsewhere plus amounts resulting from adjustments made by the Department of Commerce and revisions in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business

5. Consists of transactions in nonproduced nonfinancial assets and capital transfers.

n.a. Not available. ... Not applicable.