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December 7, 1988

## **RECENT DEVELOPMENTS**

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**This edition is dedicated to Eleanor Stockwell,  
who presently will retire from the Board after 52 years of distinguished service  
that has included many hours writing and editing portions of the Greenbook.**

Prepared for the Federal Open Market Committee

By the staff of the Board of Governors of the Federal Reserve System

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# **DOMESTIC NONFINANCIAL DEVELOPMENTS**

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## DOMESTIC NONFINANCIAL DEVELOPMENTS

The labor market surveys for October and November suggest that nonfarm output has continued to expand at a fairly strong pace. Employment growth in manufacturing was sizable in both months, and hiring in the services sector surged in November. Indications of spending are available mainly through October; at this point, it appears that consumption is growing less rapidly than in the third quarter and that capital spending has softened. Inflation for final goods and services appears to be running in the 4 to 5 percent range.

### Labor Market Developments

The labor market surveys for October and November indicate that labor demand remains strong. The number of employees on nonfarm payrolls rose more than 460,000 in November, after a gain of about 240,000 in October. Although the average workweek dropped in November, this decline merely reversed an unusually sharp increase in the workweek in October. On net, the payroll surveys for October and November left the index of aggregate hours for production and nonsupervisory workers about 0.8 percentage point above the third-quarter average. Employment also was up sharply in the household survey in November.

The job gains in the payroll survey were widespread by industry. Manufacturing employment rose sharply for the second consecutive month, with particularly large increases in machinery, electrical equipment, and lumber. Employment in service industries was up nearly 200,000 in November; the growth in these industries had been less in previous months. Hiring at construction sites apparently was sustained by

CHANGES IN EMPLOYMENT<sup>1</sup>  
(Thousands of employees; based on seasonally adjusted data)

	1987	1988			1988		
		Q1	Q2	Q3	Sept.	Oct.	Nov.
-----Average Monthly Changes-----							
Nonfarm payroll employment <sup>2</sup>	286	340	346	227	312	238	463
Strike-adjusted	283	343	345	229	305	232	452
Manufacturing	38	19	46	2	-11	99	71
Durable	21	7	35	7	-10	58	47
Nondurable	16	12	12	-6	-1	41	24
Construction	21	25	39	19	25	-1	55
Trade	68	114	81	52	39	61	47
Finance	16	11	9	4	3	18	19
Services	99	118	131	88	75	77	194
Total government	28	38	20	51	173	-16	45
Private nonfarm production workers	208	242	258	124	46	193	316
Manufacturing production workers	30	12	30	-3	-20	80	66
Total employment <sup>3</sup>	257	120	305	103	148	193	455
Nonagricultural	252	123	345	75	129	97	445

Memo:

Aggregate hours of production workers (percent change)	.3	.3	.5	.2	.4	.9	-.1
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1. Average change from final month of preceding period to final month of period indicated.

2. Survey of establishments. Strike adjusted data noted.

3. Survey of households.

SELECTED UNEMPLOYMENT RATES  
(Percent; based on seasonally adjusted data)

	1987	1988			1988		
		Q1	Q2	Q3	Sept.	Oct.	Nov.
Civilian, 16 years and older	6.2	5.7	5.5	5.5	5.4	5.3	5.4
Teenagers	16.9	16.0	15.0	15.6	15.7	14.9	13.9
20-24 years old	9.7	9.0	8.7	8.4	8.2	8.7	8.9
Men, 25 years and older	4.8	4.4	4.1	4.1	4.1	4.0	4.3
Women, 25 years and older	4.8	4.4	4.3	4.4	4.4	4.2	4.2
White	5.3	4.8	4.6	4.8	4.8	4.6	4.6
Black	13.0	12.5	12.0	11.2	10.8	11.0	11.2
Fulltime workers	5.8	5.3	5.1	5.1	5.1	4.9	5.1
Memo:							
Total National <sup>1</sup>	6.1	5.6	5.4	5.4	5.3	5.2	5.3

1. Includes resident armed forces as employed.

unusually good weather during the November survey week, while employment continued to trend up in other industries.

The data on wages in the fourth quarter, although limited, suggest that wage inflation remains on an upward course. The hourly earnings index for production and nonsupervisory workers jumped 0.7 percent in October and was unchanged in November, leaving it 1.0 percent above the third-quarter average. Moreover, revised data on labor costs show that hourly compensation picked up sharply in the third quarter to a level nearly 5 percent above a year earlier. With the growth of productivity averaging less than 1 percent over the four-quarter period ended in 1988-Q3, unit labor costs rose about 4 percent, well above the pace seen in recent years.

The acceleration in wages and compensation from a year ago likely has reflected this year's tightening of labor markets and an apparent step-up in inflation expectations. Indeed, the overall civilian unemployment rate remained below 5-1/2 percent in October and November; both this overall rate and the jobless rates for many demographic, industrial, and occupational subgroups are at levels that coincided with accelerating wages in the late 1970s.

Other indicators also hint at a tightening of labor markets. According to the Conference Board's survey of consumer confidence (chart), more than 30 percent of households continue to believe that jobs are quite plentiful; this indicator has strengthened markedly in the past two years and is above its level of 1979. In addition, the index of help-wanted advertising--a measure of job vacancies--is, on



SELECTED MEASURES OF LABOR COSTS IN THE NONFARM BUSINESS SECTOR  
(Percentage change at annual rates)

	1987	1988				
		Q1	Q2	Q3	Oct.	Nov.
<u>Hourly earnings index, wages of production workers<sup>1</sup></u>						
Total private nonfarm	2.6	3.1	3.8	2.9	.7	.0
Manufacturing	1.9	1.6	2.9	2.3	.3	.2
Contract construction	.7	4.1	1.1	3.1	-.1	.9
Transportation and public utilities	2.9	2.7	4.8	1.7	.5	-.2
Trade	2.3	2.8	4.2	3.3	.9	-.1
Services	4.6	4.2	5.7	4.4	1.1	-.5
<u>Employment cost index<sup>2</sup></u>						
Compensation, all persons	3.3	3.9	4.5	4.5	--	--
By occupation:						
White collar	3.7	3.7	4.4	4.4	--	--
Blue collar	3.1	4.4	4.7	4.5	--	--
Service workers	2.4	2.9	3.6	4.6	--	--
By sector:						
Goods-producing	3.1	4.4	4.8	4.5	--	--
Service-producing	3.7	3.6	4.3	4.4	--	--
By bargaining status:						
Union	2.8	3.9	4.3	4.5	--	--
Nonunion	3.6	4.0	4.5	4.5	--	--
Manufacturing	3.1	4.7	5.0	4.7	--	--
Wages and salaries, all persons	3.3	3.3	3.7	3.7	--	--
Benefits, all persons	3.5	5.8	6.4	6.7	--	--
<u>Major collective bargaining agreements<sup>3</sup></u>						
First-year wage adjustments	2.2	--	--	2.5	--	--
Total effective wage change	3.1	--	--	2.8	--	--
<u>Labor costs and productivity, all persons<sup>1</sup></u>						
Compensation per hour	4.1	3.5	4.2	5.6	--	--
Output per hour	1.9	3.4	-2.4	1.9	--	--
Unit labor costs	2.1	0.1	6.8	3.7	--	--
<u>Manufacturing</u>						
Compensation per hour	1.6	5.4	3.0	4.7	--	--
Output per hour	3.4	3.2	3.7	5.2	--	--
Unit labor costs	-1.8	2.2	-.7	-.5	--	--

1. Changes are from final quarter of preceding period to final quarter of period indicated at a compound annual rate. Seasonally adjusted data.

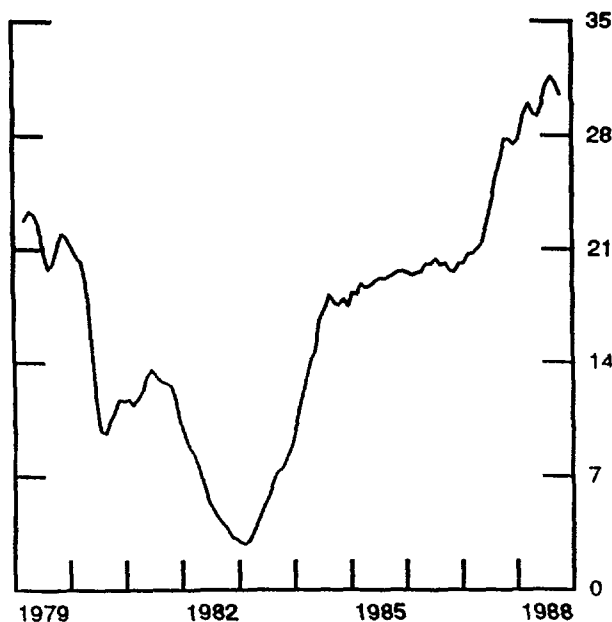
2. Four-quarter changes.

3. Averages for year to date of agreements covering 1,000 or more workers; not seasonally adjusted.

Selected Unemployment Rates  
(Percent)

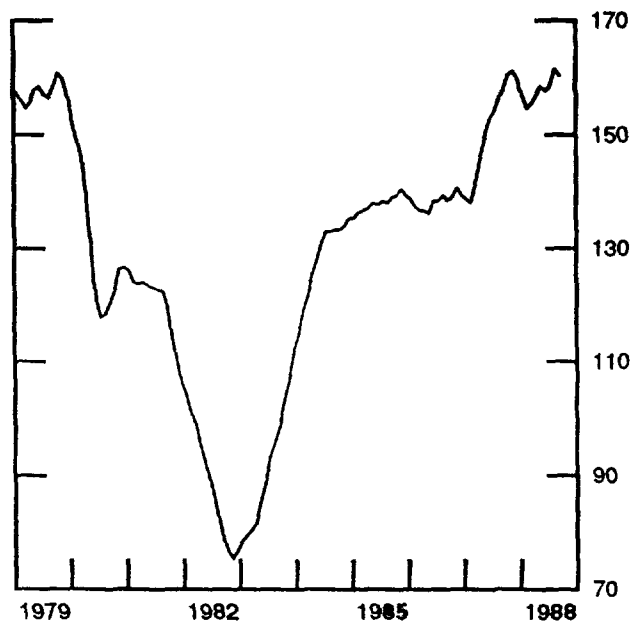
	1979	1986	1987	1988		
	Q3	Q3	Q3	Q3	Oct.	Nov.
Civilian, 16 years and older	5.9	7.0	6.0	5.5	5.3	5.4
<u>Demographic</u>						
16-24	12.1	13.3	11.8	11.0	10.9	10.6
Men 25+	3.3	5.4	4.6	4.1	4.0	4.3
Women 25+	4.8	5.4	4.7	4.4	4.2	4.2
<u>Industries</u>						
Construction	9.2	12.7	11.3	10.1	9.9	10.9
Manufacturing	6.0	7.0	5.7	5.5	5.3	5.0
Trade	6.4	7.6	6.8	6.3	5.9	6.1
Finance and service	5.0	5.6	4.9	4.4	4.6	4.6
<u>Occupations</u>						
Managerial and professional	--	2.7	2.4	2.3	1.9	1.6
Technical, sales, and administrative support	--	4.9	4.4	4.1	3.9	3.8
Service occupations	--	8.4	7.5	6.7	6.8	6.8
Precision, production, craft, and repair	--	6.2	5.2	4.4	5.0	5.2
Operators, fabricators, and laborers	--	9.8	8.3	7.5	7.0	7.8

CONFERENCE BOARD SURV., JOBS ARE PLENTIFUL \*



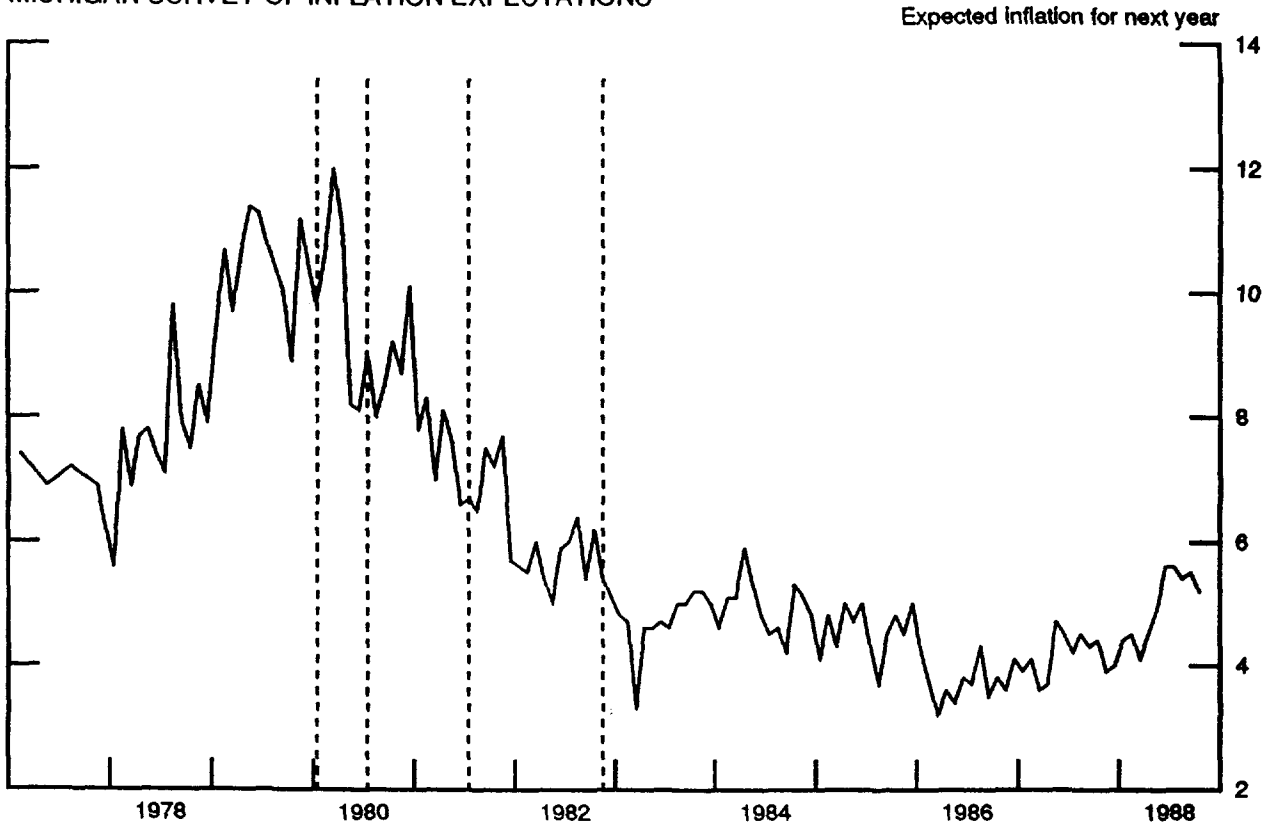
\* Three-month mov. avg., percent of respondents

HELP-WANTED INDEX \*

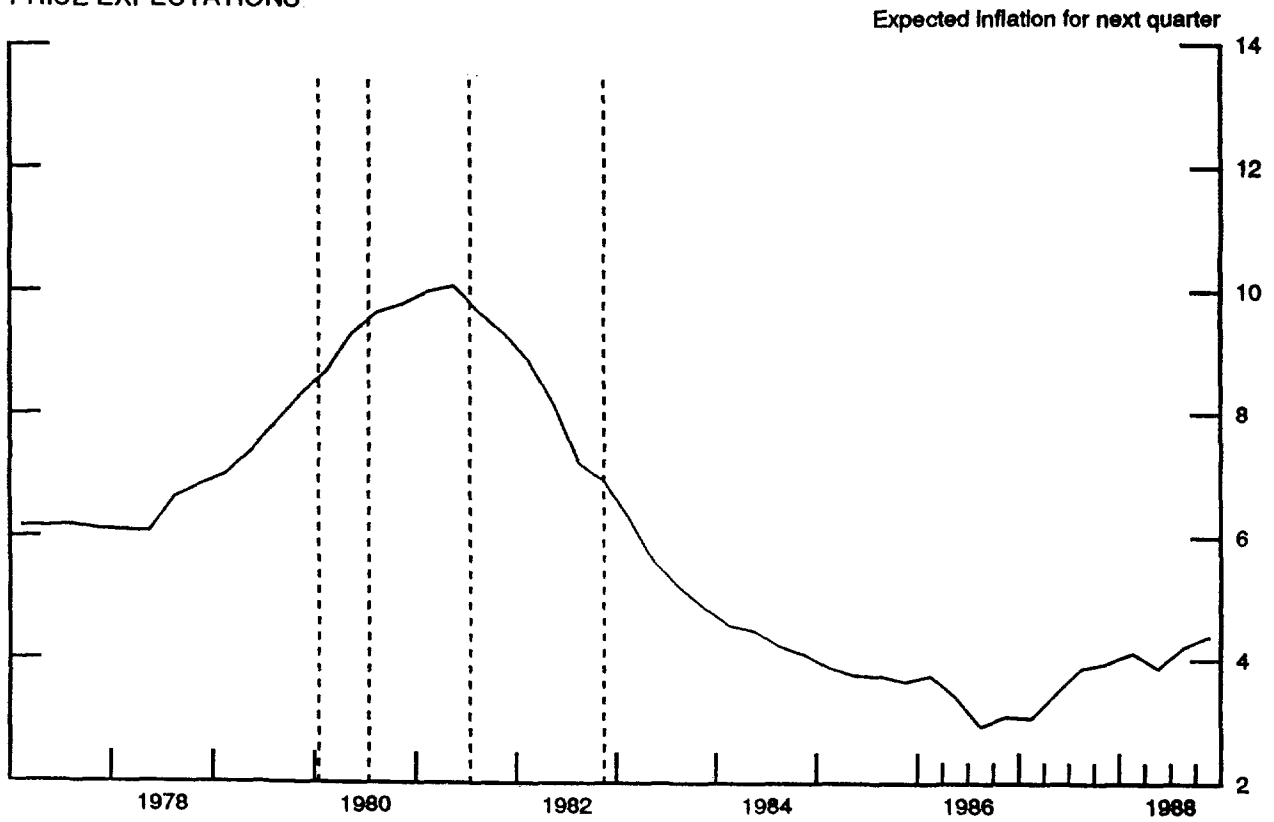


\* Three-month moving average, 1967=100

MICHIGAN SURVEY OF INFLATION EXPECTATIONS



PRICE EXPECTATIONS \*



\* Based on a distributed lag of increases in the fixed-weight price index for personal consumption expenditures over the preceding 3 years.

average, close to its 1979 high. Moreover, anecdotes of hiring difficulties are common, with reports of labor shortages evident in some areas of the U.S.

Inflation expectations, which play a critical role in wage determination, have moved up over the past year and are unlikely to provide any offset to the upward pressures on wages associated with hiring bottlenecks. As shown in the top panel of the chart, consumer expectations of price inflation, as measured in the Michigan survey, rose from about 4-1/4 percent in late 1987 to about 5-1/2 percent in the spring and have remained high in recent months. Econometric results based on the assumption that employers and workers are backward-looking in formulating their expectations--so that expectations are based solely upon past price changes--suggest that inflation expectations would have risen roughly 1/2 percentage point this year.<sup>1</sup>

#### Industrial Production and Capacity Utilization

Total industrial production is estimated to have risen 0.4 percent in October and apparently posted a sizable gain in November. Production worker hours in manufacturing rose considerably, partly because of continued advances in the machinery and fabricated metals industries. The available data on physical product (which constitute about 15 percent of the first estimate of industrial production) are mixed. Motor vehicle assemblies were about unchanged in November. In the

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1. In particular, the formulation shown in the accompanying chart assumes that inflation expectations are based on a geometrically-declining distributed lag of increases in the fixed weight price index for personal consumption expenditures over the preceding three years.

INDUSTRIAL PRODUCTION  
(Percent change from preceding period;  
based on seasonally adjusted data)

	1	1988			1988		
	1987	Q1	Q2	Q3	Aug.	Sept.	Oct.
		---Annual rate---			---Monthly rate---		
Total Index	5.8	3.9	4.6	7.2	.3	.2	.4
Products	4.9	6.3	4.4	6.3	.4	.2	.6
Final products	4.6	6.0	5.1	6.4	.4	.2	.6
Consumer goods	3.2	5.8	4.0	6.3	.5	-.2	.6
Durable goods	4.2	-6.1	13.2	2.3	.1	.1	1.2
Automotive products	4.4	-4.5	23.2	-1.8	-.5	1.8	1.7
Home goods	4.0	-7.3	6.2	5.6	.6	-1.2	.8
Nondurable goods	2.8	10.1	1.1	7.6	.7	-.3	.4
Clothing	4.0	2.7	.0	2.5	-.5	.3	-.5
Paper products	1.7	10.9	11.3	5.9	.2	.6	.4
Chemical prod.	2.7	20.9	14.6	14.4	1.2	.8	.4
Consumer energy	.8	15.5	-9.6	7.5	3.4	-4.3	1.2
Equipment	6.3	6.4	6.3	6.6	.3	.6	.5
Business equipment	7.0	9.3	11.6	9.9	.5	.8	.8
Computers	9.4	20.7	15.5	1.2	.5	.6	n.a.
Ex. computers	6.2	5.7	10.3	13.1	.4	.9	.7
Defense & space equip.	1.9	2.6	-9.2	-2.6	-.1	.0	.0
Intermediate products	5.9	7.1	2.2	5.7	.4	.2	.9
Construction supplies	4.7	10.9	2.1	1.1	-.2	.4	1.3
Materials	7.2	.3	4.8	8.8	.1	.2	.0
Durable goods	8.0	3.8	8.2	9.1	-.2	1.1	.1
Nondurable goods	8.1	-2.1	3.3	8.0	.2	.0	.2
Energy materials	4.5	-4.7	-1.2	8.7	.8	-1.6	-.7
Manufacturing	5.9	4.7	5.6	7.2	.2	.4	.5
Mining	7.6	-6.6	3.7	2.4	-.3	-.2	-.9
Utilities	2.9	8.6	-9.2	11.9	2.9	-3.8	.4

1. Change from 1986-Q4 to 1987-Q4.

energy sector, output of refined fuels declined last month, while crude oil extraction and electricity generation were little changed, and drilling activity fell further. Output of steel rose slightly after a sharp decline in October.

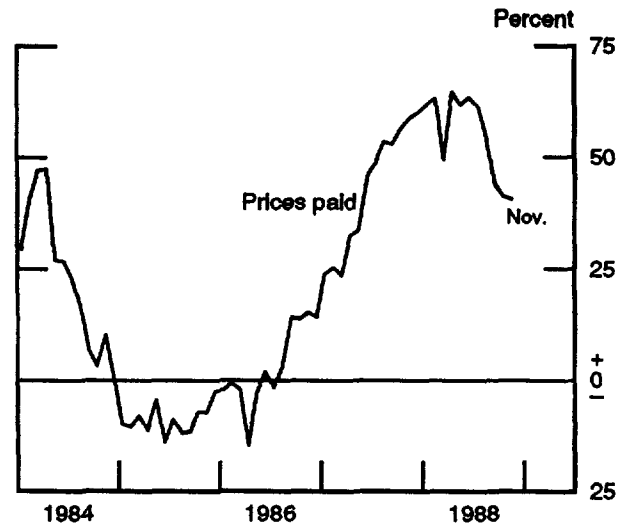
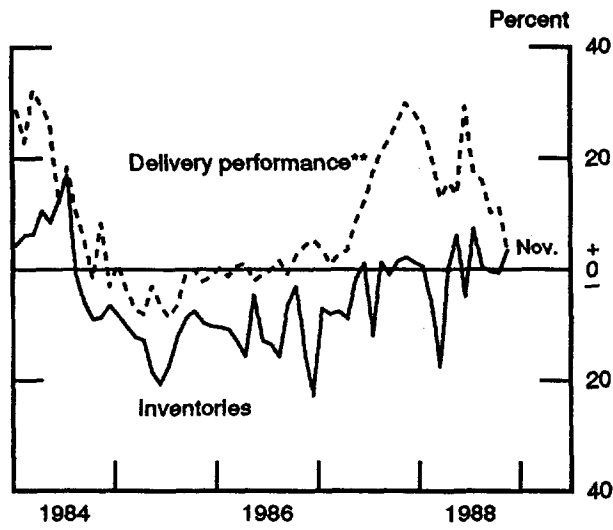
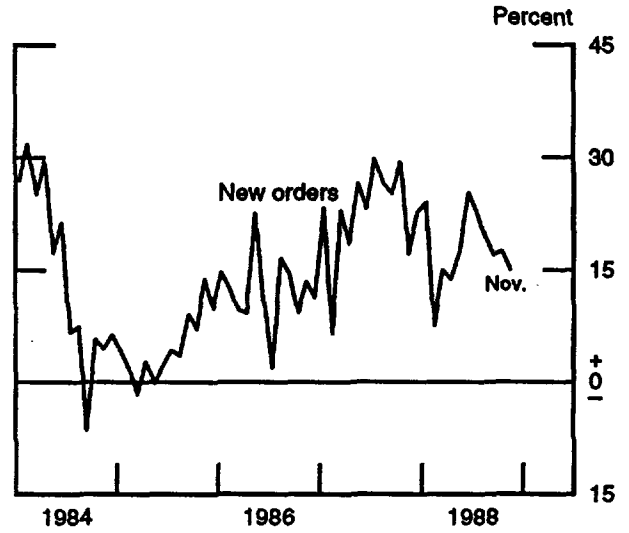
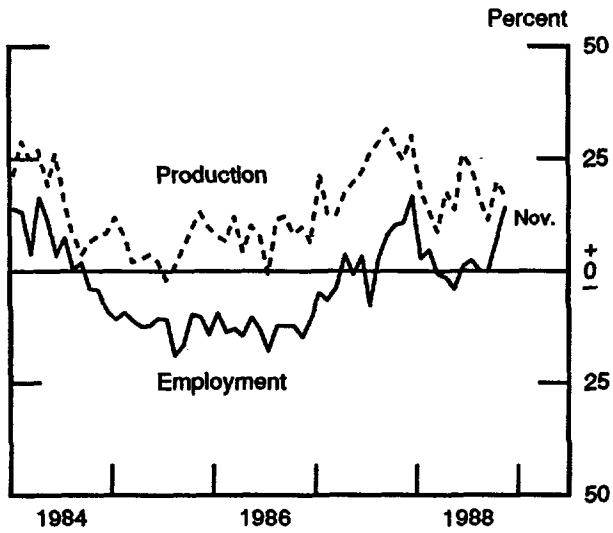
Separately, the results of the November survey of purchasing managers generally confirmed the strength in industrial activity indicated by the labor market surveys. In particular, the number of managers reporting increases in production, employment, and new orders outnumbered those reporting declines by a wide margin.

In recent months the output of capital goods has continued to post strong advances, but the composition of these gains has shifted. In particular, production of computers rose 18 percent at an annual rate during the first half of this year, accounting for nearly one-half of the growth in output of business equipment; but during the third quarter, production of computing machines was little changed.<sup>2</sup> By contrast, output of other types of business equipment--which includes machine tools, materials handling equipment, and general industrial equipment (for example, pumps, bearings, and air compressors)--accelerated during the third quarter. These gains stem from strong export growth as well as efforts by domestic manufacturers to update and expand capacity.

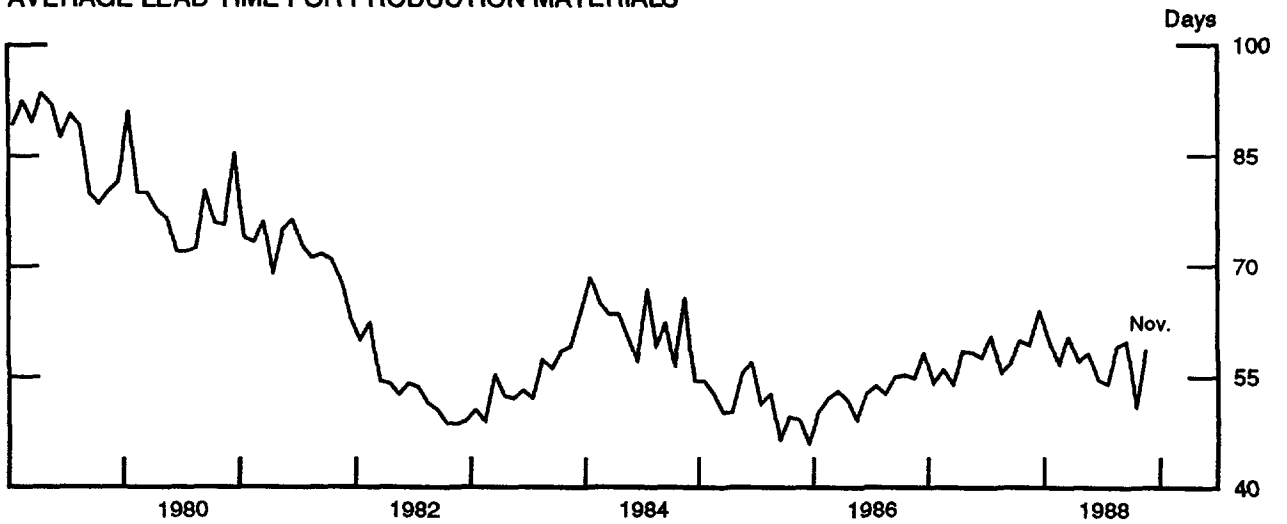
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2. The 1977 value-added weight of computers in business equipment is 8.4 percent. However, since 1977 (the current base year for the IP index) the output of computing machines has risen more than three times faster than output of other capital goods. As a result, the current proportion of computers in business equipment is about 26 percent.

Purchasing Managers\*  
(Seasonally Adjusted)



AVERAGE LEAD TIME FOR PRODUCTION MATERIALS



\* Percent reporting increases are netted with those reporting decreases.

\*\* Positive entries represent slower deliveries.

CAPACITY UTILIZATION IN INDUSTRY<sup>1</sup>  
(Percent of capacity; seasonally adjusted)

	<u>1967-87</u>	<u>1973</u>	<u>1978-80</u>	<u>1987</u>	<u>1988</u>		
	Avg.	High	High	Oct.	Aug.	Sept.	Oct.
Total industry	81.5	88.6	86.9	81.9	83.8	83.8	84.0
Manufacturing	80.6	87.7	86.5	82.0	83.9	84.1	84.3
Primary processing	81.7	91.9	89.1	86.2	87.3	87.3	87.5
Advanced processing	80.1	86.0	85.1	80.1	82.3	82.5	82.8
Durable manufacturing	78.7	87.4	86.3	80.1	82.3	82.6	83.0
Primary metals	79.6	101.9	97.1	88.8	89.1	90.9	89.4
Iron and steel	78.6	105.8	100.3	90.9	88.4	90.8	87.7
Nonferrous metals	81.2	95.6	91.1	85.9	90.0	91.0	91.6
Fabricated metal products	77.8	85.0	87.4	79.5	83.7	84.1	84.4
Nonelectrical machinery	78.1	89.0	86.0	76.6	82.7	83.4	84.0
Motor vehicles & parts	78.1	97.1	93.3	82.0	81.9	82.6	84.4
Nondurable manufacturing	83.5	88.8	87.0	84.9	86.3	86.2	86.2
Textile mill products	85.0	92.1	88.3	92.4	89.2	89.1	88.7
Paper and products	88.5	95.6	92.7	94.5	94.7	94.1	93.9
Chemicals and products	78.9	88.6	82.9	83.1	88.6	88.6	88.7
Petroleum products	86.9	99.6	91.7	85.5	85.9	85.4	86.7
Mining	86.7	92.8	95.2	80.6	82.4	82.4	81.8
Utilities	86.9	95.6	88.5	80.5	83.9	80.6	80.8
Electric utilities	88.0	98.7	87.6	82.5	88.9	84.6	84.8
Industrial materials	82.2	92.0	89.1	82.1	84.3	84.3	84.2
Raw steel	80.2	106.0	98.9	87.8	98.0	97.5	89.5
Aluminum	87.3	95.7	97.4	91.8	100.5	100.3	100.8
Paper materials	91.7	98.4	97.3	97.4	98.2	97.7	97.5
Chemical materials	81.0	92.5	87.9	88.0	89.3	88.6	88.6

1. Data for iron and steel, nonferrous metals, textile mill products, paper and products, chemicals and products, raw steel, aluminum, paper materials, and chemical materials are unpublished estimates for October.



PERSONAL INCOME  
(Average monthly change at an annual rate; billions of dollars)

	1987	1988		1988		
		Q2	Q3 <sup>r</sup>	Aug. <sup>r</sup>	Sept. <sup>r</sup>	Oct. <sup>p</sup>
Total personal income	26.3	19.7	22.7	16.8	22.4	72.1
Wages and salaries	16.8	17.6	15.3	7.2	14.2	38.1
Private	14.5	15.7	13.1	5.1	12.1	36.1
Other labor income	1.0	.7	1.0	1.0	1.0	1.0
Proprietors' income	1.4	-3.0	-2.2	-1.4	-.8	24.4
Farm	-.6	-5.5	-4.6	-3.1	-4.3	20.2
Rent, dividends and interest	6.1	4.9	8.0	8.4	8.2	7.4
Transfer payments	2.1	.5	1.6	2.0	.5	3.2
Less: Personal contributions for social insurance	1.1	1.1	.9	.3	.9	2.0
Less: Personal tax and nontax payments	4.5	.0	3.1	1.7	3.0	6.4
Equals: Disposable personal income	21.8	19.6	19.6	15.1	19.5	65.7
Memo: Real disposable income	7.5	3.1	4.6	6.2	.4	39.0

r--Revised.  
p--Preliminary.

REAL PERSONAL CONSUMPTION EXPENDITURES  
(Percent change from preceding period)

	1987	1988		1988		
		Q2	Q3 <sup>r</sup>	Aug. <sup>r</sup>	Sept. <sup>r</sup>	Oct. <sup>p</sup>
	----Annual rate----			----Monthly rate----		
Personal consumption expenditures	1.8	3.0	4.0	.8	-.4	.3
Durable goods	-2.4	9.8	-1.1	1.2	-1.1	-1.5
Excluding motor vehicles	1.0	7.2	.0	-.1	-.2	-.2
Nondurable goods	.6	.4	5.4	.9	-.4	.2
Excluding gasoline	.6	-.1	6.2	1.3	-.9	.1
Services	4.2	2.8	4.7	.6	-.3	.9
Excluding energy	4.3	3.0	3.6	.3	.3	.5
Memo:						
Personal saving rate (percent)	3.2	3.7	4.1	3.8	4.2	5.2

r--Revised.  
p--Preliminary.

Production of consumer goods has grown sharply in recent months-- at an annual rate of 6.3 percent during the third quarter and 0.6 percent in October. Output of nondurables has been bolstered by continued advances in production of consumer chemicals and paper products. Among durable consumer goods, production of appliances has rebounded from earlier declines, and auto assemblies have risen to their highest level since early 1987. However, the number of assemblies of light trucks has shown little net change during the past few months, apparently limited in part by capacity constraints.

The output of materials has changed little since its surge in July. The recent weakness is attributable, in part, to declines in crude oil extraction and the production of steel. Nevertheless, the output of parts for capital goods has continued to rise.

Total capacity utilization rose 0.2 percentage point in October to 84 percent. The increase resulted from further upward movement in utilization among manufacturing industries, principally those producing nonelectrical machinery and motor vehicles. The operating rate for manufacturing increased more than 2 percentage points during the year ended in October, to 84.3 percent, its highest level since July 1979, when it was 84.7 percent. In November the manufacturing utilization rate apparently increased further. By contrast, capacity utilization in the mining and utilities industries in October remained relatively low.

#### Personal Income and Consumption

Total personal income increased \$72 billion at an annual rate in October, owing to the temporary effects of two federal programs

providing subsidy payments to farmers.<sup>3</sup> Excluding farm subsidy payments as well as a one-time \$6-1/2 billion bonus payment to workers in the automobile industry, personal income rose \$35 billion in October, considerably above the average monthly increase for the year to date. Disposable income was correspondingly strong, and the monthly saving rate jumped to 5.2 percent.

The growth in consumer spending appears to be slowing in the current quarter. This slowdown reflects softness in spending for motor vehicles, and (on a quarterly basis) an easing of residential electricity consumption, which had climbed during the summer heat wave. However, a recent see-saw pattern in the monthly data, as well as the possibility of big revisions, is making it difficult to identify the underlying trend in consumer spending. In October, real personal consumption expenditures rose 0.3 percent, reversing most of September's 0.4 percent decline. Spending in October was boosted by a sharp bounceback in outlays for electricity and natural gas from a depressed September level; outlays for other services remained on a sharp uptrend. Spending on durables declined for the second consecutive month in real terms, mainly because of reduced purchases of new autos. Nondurable consumption was lackluster in October but was revised up to show additional strength in August and September.

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3. The October payments to farmers reflected the final installment of deficiency payments for corn harvested in 1987 and the payments for participation in this year's land conservation program. The total subsidies were \$2.5 billion, or \$30.5 billion at an annual rate.

Autos and Trucks

Sales of new motor vehicles strengthened a bit in November, to an annual rate of 14.8 million units, but thus far in the fourth quarter, the sales pace is running below the level of the first three quarters of the year. Sales of domestically produced autos posted a 7.2 million unit annual rate (BEA seasonals) last month--up from a 6.8 million unit pace in October--while sales of imported cars edged down slightly to a 2.9 million unit annual rate. Sales of light trucks declined to a 4.6 million unit annual rate.

SALES OF AUTOMOBILES AND LIGHT TRUCKS  
(Millions of units at an annual rate, BEA seasonals)

	1987	1988			1988		
		Q1	Q2	Q3	Sept.	Oct.	Nov.
Autos and light trucks <sup>1</sup>	15.0	15.5	15.4	15.8	15.2	14.6	14.8
Autos	10.3	10.8	10.6	10.7	10.6	9.8	10.2
Light trucks	4.7	4.7	4.8	5.1	4.6	4.8	4.6
Domestically produced <sup>2</sup>	11.0	11.7	11.7	12.0	11.6	11.0	11.4
Autos	7.1	7.6	7.5	7.6	7.6	6.8	7.2
Light trucks	3.9	4.1	4.2	4.4	4.0	4.3	4.1
Imports	4.0	3.8	3.7	3.8	3.7	3.5	3.4
Autos	3.2	3.2	3.1	3.1	3.1	3.0	2.9
Light trucks <sup>3</sup>	.8	.6	.6	.7	.6	.5	.5 <sup>e</sup>

1. Components may not add to totals due to rounding.

2. Includes vehicles produced in Canada and Mexico for General Motors, Ford, and Chrysler.

3. BEA seasonals for sales of domestic light trucks are applied to sales of imported light trucks.

e--estimated.

Production of domestic autos exceeded sales in November for the fourth consecutive month, and inventories have risen to the highest

**BUSINESS CAPITAL SPENDING INDICATORS**  
 (Percentage change from preceding comparable periods;  
 based on seasonally adjusted data)

	1988			1988		
	Q1	Q2	Q3	Aug.	Sept.	Oct.
<u>Producers' durable equipment</u>						
Shipments of nondefense capital goods	4.8	3.8	2.6	1.3	.3	-.1
Excluding aircraft and parts	3.9	4.3	2.4	1.9	-.3	-1.3
Office and computing equipment	5.6	6.6	.7	1.2	-1.2	-1.4
All other categories	3.4	3.7	2.8	2.0	.0	-1.3
Shipments of complete aircraft <sup>1</sup>	32.5	12.1	-8.8	-6.1	18.2	--
Sales of heavy-weight trucks	1.3	6.3	6.7	3.1	-1.3	7.7
Orders of nondefense capital goods	6.1	1.1	9.1	7.2	-10.2	-3.0
Excluding aircraft and parts	4.3	3.4	4.5	5.3	-6.2	-1.3
Office and computing equipment	5.3	8.6	-.4	6.4	-16.1	5.0
All other categories	4.1	2.1	5.8	5.1	-3.7	-2.7
<u>Nonresidential structures</u>						
Construction put-in-place	-5.5	1.4	1.0	.5	-.6	-.1
Office	-3.1	4.1	.9	1.3	-4.9	2.8
Other commercial	-8.4	6.0	-2.5	-2.3	2.6	-7.8
Public utilities	-8.8	-.2	10.6	2.8	1.4	-1.8
Industrial	-2.6	-.2	-6.3	-2.1	-1.2	7.7
All other	-2.0	-3.5	-3.4	1.0	-1.9	4.1
Rotary drilling rigs in use	-2.1	6.7	-8.0	-5.0	-4.5	-6.0

1. From the Current Industrial Report (CIR) titled "Civil Aircraft and Aircraft Engines." To estimate PDE spending for aircraft, BEA uses the aircraft shipments shown in that report, not the corresponding M-3 series. The CIR does not provide information on aircraft orders.

level since the turn of the year. Consequently, automakers have trimmed their production plans a bit. Nevertheless, production plans for December remain at a robust 8 million unit annual rate (BEA seasonals), and intentions for the first quarter of 1989 have been revised up somewhat to a 7.3 million unit annual rate. Should sales remain near current levels for long, some combination of more substantial cutbacks in scheduled assemblies and expanded incentive plans would seem likely.

#### Business Fixed Investment

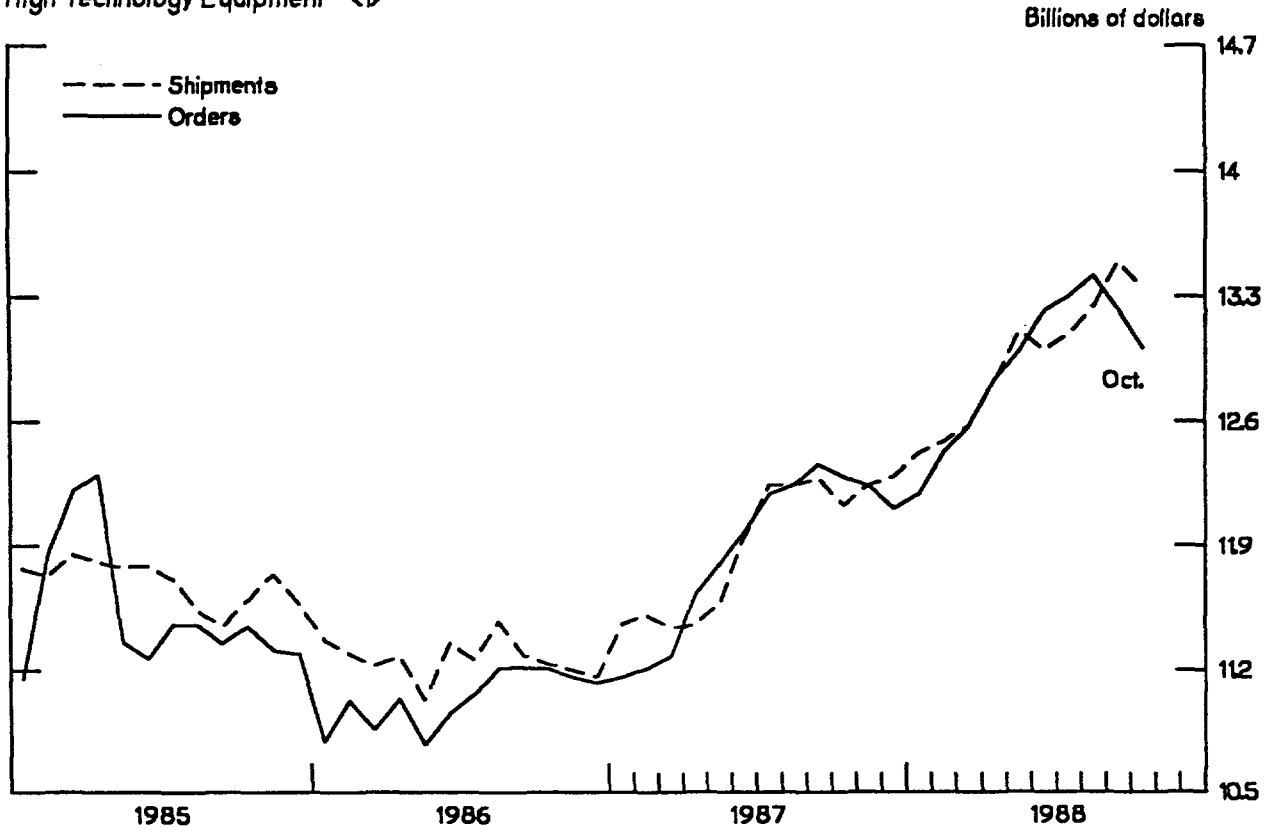
Outlays for business fixed investment were weak in early autumn. However, this weakness seems likely to be temporary. The backlog of orders is sizable in many industries, and the initial surveys of firms' capital spending plans for 1989 are pointing to a continued rise in spending on plant and equipment, albeit at a slower pace than in 1988.

In October, shipments of nondefense capital goods were little changed. However, excluding aircraft and parts, shipments fell about 1-1/4 percent, pushing the October level 1 percent below the third-quarter average. In addition to the fairly broad-based deceleration in shipments of nondefense capital goods, business purchases of new cars probably edged lower.

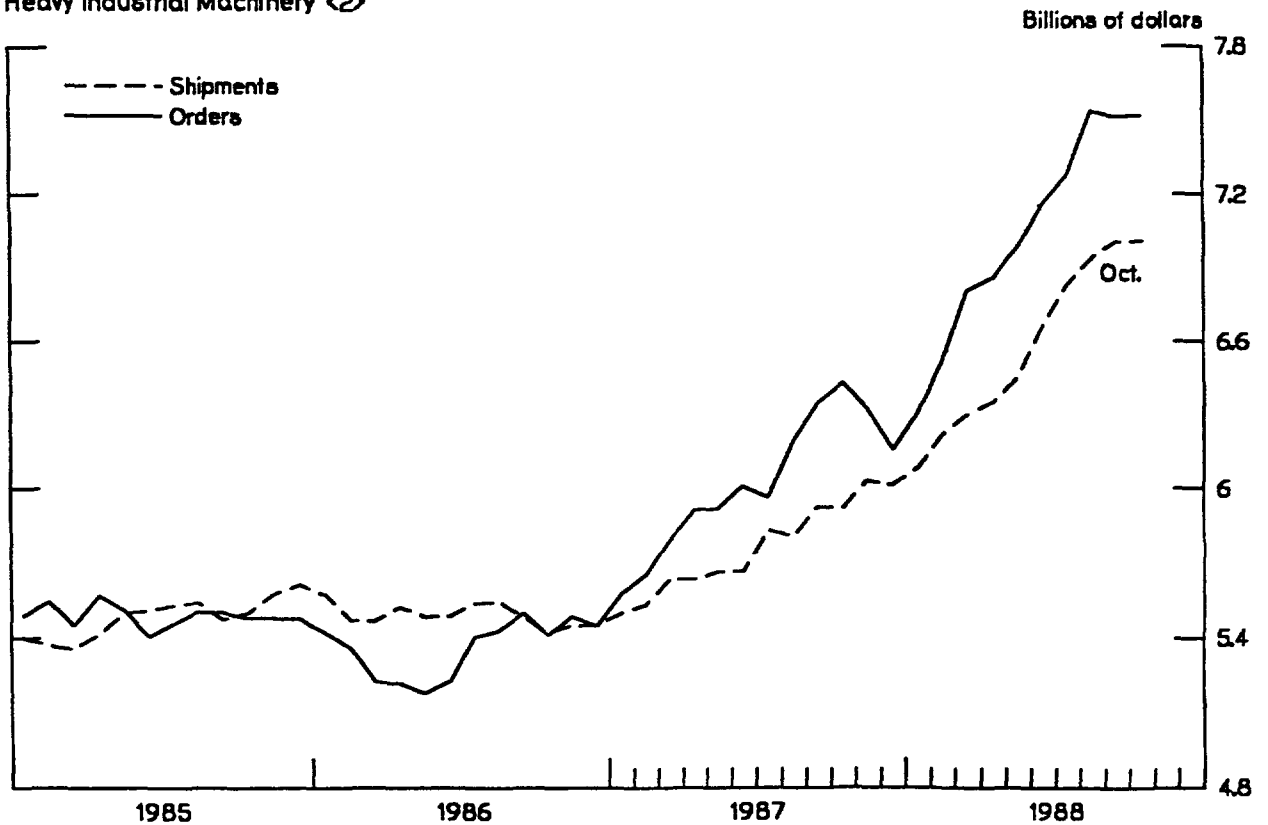
New orders for nondefense capital goods, excluding the aircraft group, declined for a second month in October to a level 3-3/4 percent below the third-quarter level. The softening in new bookings in these two months comes in the wake of very rapid gains earlier in the year. Much of the recent decline has been in the high-technology area (chart), particularly for office and computing machinery, but also for

## RECENT DATA ON ORDERS AND SHIPMENTS (three-month moving average)

### High Technology Equipment <D>

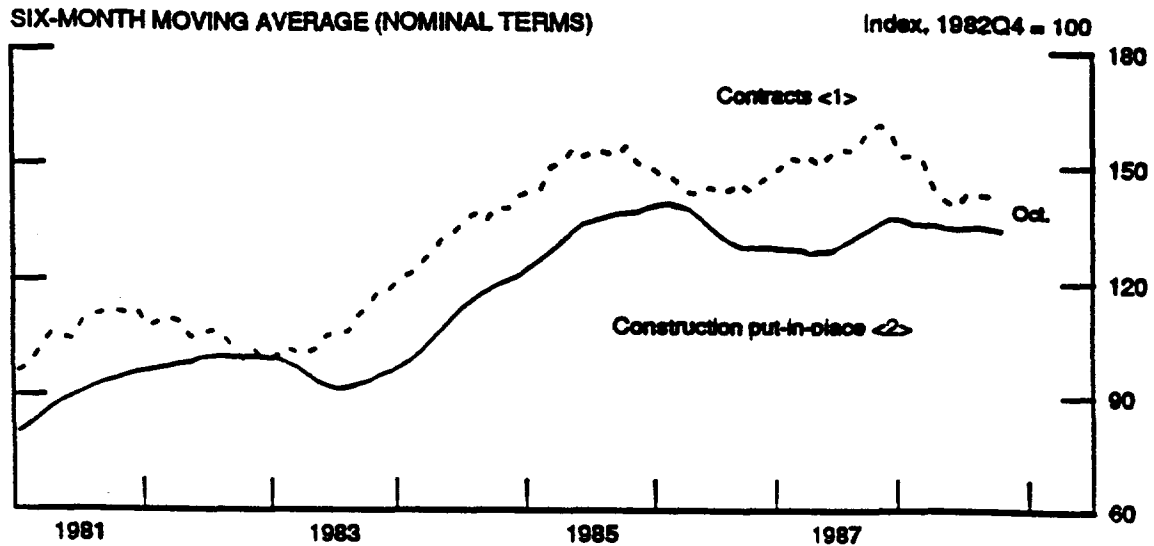


### Heavy Industrial Machinery <E>



<D> Includes communication, science and engineering, and office and computing equipment  
 <E> Includes metalworking, special industry, general industry, electrical industrial apparatus, and electrical transmission and distribution machinery

### Nonresidential Construction Put-in-Place and Construction Contracts



<1> From F.W.Dodge. Includes industrial, commercial, and institutional construction.  
 <2> Includes the building components of nonresidential construction, i.e., industrial, commercial, institutional, and hotels and motels.

#### SURVEYS OF PLANT AND EQUIPMENT EXPENDITURES (Percent change from previous year, current dollars)

	1988 <sup>1</sup>	Planned for 1989	
		McGraw-Hill (Sept.-Oct.)	ECAP <sup>2</sup> (Oct.-Nov.)
All business	10.6	5.8	5.3
Manufacturing	12.1	6.9	6.3
Durable	9.9	4.8	5.8
Nondurables	14.2	11.7	6.7
Nonmanufacturing	9.7	5.1	4.6

Memo:

Mean error <sup>3</sup>	-1.03	-1.81
Mean absolute error <sup>3</sup>	4.01	4.70

1. As estimated in the July-August Commerce Department Survey.  
 2. Economic Consulting and Planning Inc. (ECAP) is the successor firm to the Merrill Lynch Economic Consulting Group.  
 3. Estimated from 1970 to the present.



communications equipment. Orders for heavy industrial machinery--which constitute about half of total orders, excluding aircraft and parts and high-technology equipment--have softened as well in recent months, after a pronounced run-up earlier in the year. However, these orders continue to outstrip shipments by a wide margin and should support a healthy rate of spending for heavy machinery in the near term.

The value of nonresidential construction put-in-place, which includes all structures except oil and gas wells, was little changed in October and remains just below the third-quarter level. Petroleum drilling activity, as measured by the number of rigs in use, continued to fall through November. The value of new nonresidential construction contracts, a broad but volatile indicator of future building activity, fell 5-3/4 percent in October but has shown little net change over the past six months. All told, these indicators suggest that spending on nonresidential construction is likely to remain sluggish into 1989.

The McGraw-Hill survey of planned capital spending, taken in September and October, indicated that firms expect nominal outlays to increase about 5-3/4 percent in 1989. Similarly, the fall survey from Economic Consulting and Planning Inc.--the successor to the Merrill Lynch survey--reported a 5-1/4 percent expected increase.<sup>4</sup> Over the past two decades, these fall surveys have tended to underpredict spending by between 1 and 2 percentage points, and the mean error without regard to sign is roughly 5 percentage points.

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4. The Commerce Department survey of capital spending plans will not be released until December 21, 1988.

Business Inventories

Business inventories continued to rise through the third quarter at a pace roughly in line with the growth in business sales. In constant dollars, stocks at all manufacturing and trade establishments rose \$24.4 billion at an annual rate in September, bringing the rate of accumulation for the third quarter to \$22.5 billion. About one-third of last quarter's inventory buildup occurred at retail auto dealerships. Excluding auto dealers, the rate of stockbuilding remained moderate, and the inventory-sales ratio for nonauto businesses was little changed over the third quarter.

Current-cost data indicate that manufacturers' inventories continued to expand moderately in October. On the whole, factory inventory investment in recent months has been concentrated in industries that have enjoyed robust demand in both domestic and export markets--in particular, metals, aircraft, and many types of industrial and commercial machinery. In most manufacturing industries, inventory-shipments ratios at the end of October remained well within the historically low range of the past year.

In the trade sector, recent inventory accumulation, on balance, has been slow since late spring. Although the accumulation of durable goods inventories accelerated a little at the wholesale level in the third quarter--mainly in stocks of motor vehicles and machinery--the pace was still moderate compared with last winter, and does not seem to have led to serious imbalances. In the retail sector, the buildup of nonauto stocks has been broadly in line with sales; indeed, the

CHANGES IN MANUFACTURING AND TRADE INVENTORIES  
(Billions of dollars at annual rates;  
based on seasonally adjusted data)

	1988			1988		
	Q1	Q2	Q3	Aug.	Sept.	Oct.
Current cost basis:						
Total	39.7	54.7	73.5	95.5	65.1	--
Total ex. auto	61.3	41.8	52.3	67.4	31.5	--
Manufacturing	22.3	21.1	23.3	24.1	23.8	25.5
Wholesale	26.5	13.1	17.5	22.3	2.5	--
Retail	-9.1	20.5	32.7	49.1	38.8	--
Automotive	-21.6	12.8	21.2	28.1	33.7	--
Ex. auto	12.5	7.7	11.5	21.0	5.1	--
Constant dollar basis:						
Total	39.9	19.4	22.5	46.8	24.4	--
Total ex. auto	50.0	8.4	15.0	31.3	4.2	--
Manufacturing	15.8	5.8	6.5	9.5	9.0	--
Wholesale	22.7	.0	4.5	9.3	-4.0	--
Retail	1.5	13.7	11.5	28.0	19.4	--
Automotive	-10.1	11.0	7.5	15.4	20.3	--
Ex. auto	11.6	2.7	4.1	12.6	-9	--

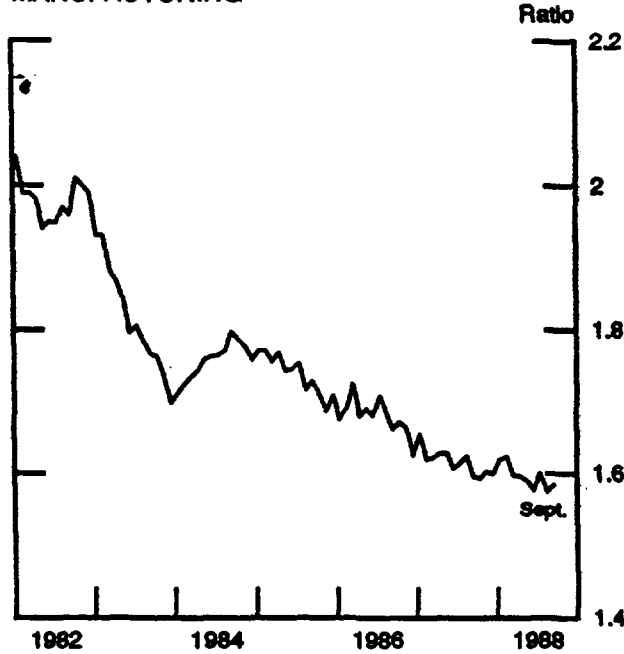
INVENTORIES RELATIVE TO SALES<sup>1</sup>  
(Months supply; based on seasonally adjusted data)

	1988			1988				
	Q1	Q2	Q3	Aug.	Sept.	Oct.		
Range in <sup>2</sup> preceding 12 months:								
	Low	High						
Current cost basis:								
Total	1.48	1.53	1.53	1.51	1.52	1.50	1.51	--
Total ex. auto	1.46	1.51	1.51	1.49	1.48	1.47	1.48	--
Manufacturing	1.56	1.62	1.62	1.58	1.58	1.56	1.57	1.57
Wholesale	1.21	1.30	1.31	1.30	1.29	1.29	1.28	--
Retail	1.56	1.64	1.60	1.61	1.65	1.62	1.65	--
Automotive	1.74	2.06	1.76	1.86	2.06	1.96	2.10	--
Ex. auto	1.50	1.55	1.55	1.54	1.54	1.53	1.53	--
Constant dollar basis:								
Total	1.48	1.52	1.52	1.52	1.52	1.51	1.52	--
Total ex. auto	1.46	1.51	1.51	1.50	1.50	1.49	1.49	--
Manufacturing	1.58	1.62	1.62	1.59	1.59	1.58	1.58	--
Wholesale	1.22	1.32	1.32	1.32	1.32	1.32	1.32	--
Retail	1.51	1.59	1.57	1.59	1.61	1.59	1.62	--
Automotive	1.65	1.93	1.73	1.83	1.92	1.86	1.96	--
Ex. auto	1.47	1.53	1.53	1.52	1.52	1.52	1.52	--

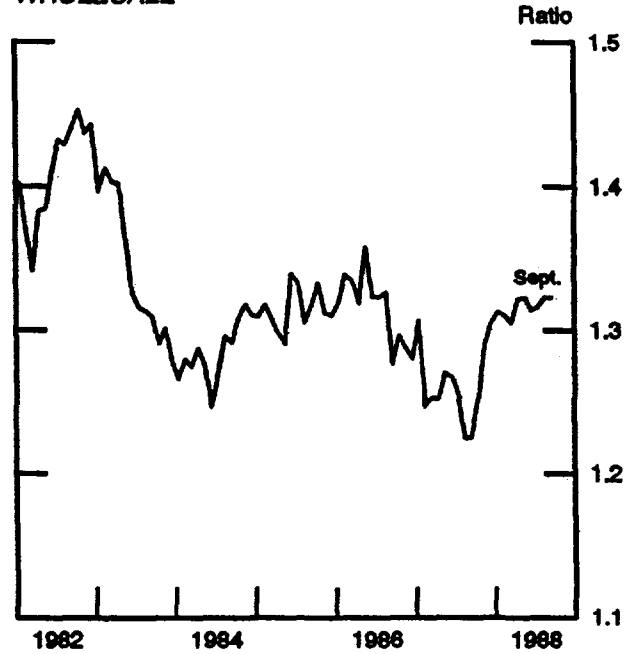
1. Ratio of end-of period inventories to average monthly sales for the period.  
2. Highs and lows are specific to each series and are not necessarily coincidental. Range is for the 12-month period preceding the latest month for which data are available.

**Ratio of Inventories to Sales**  
(Constant dollar basis)

**MANUFACTURING**



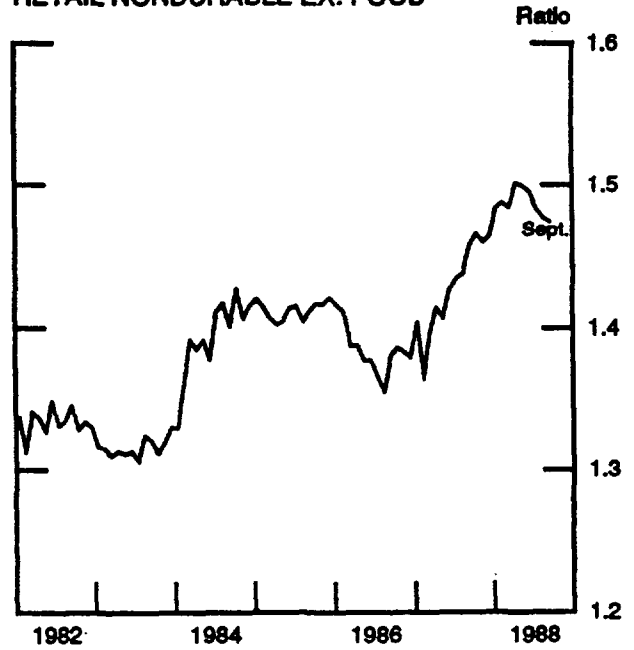
**WHOLESALE**



**RETAIL DURABLE EX. AUTO**



**RETAIL NONDURABLE EX. FOOD**

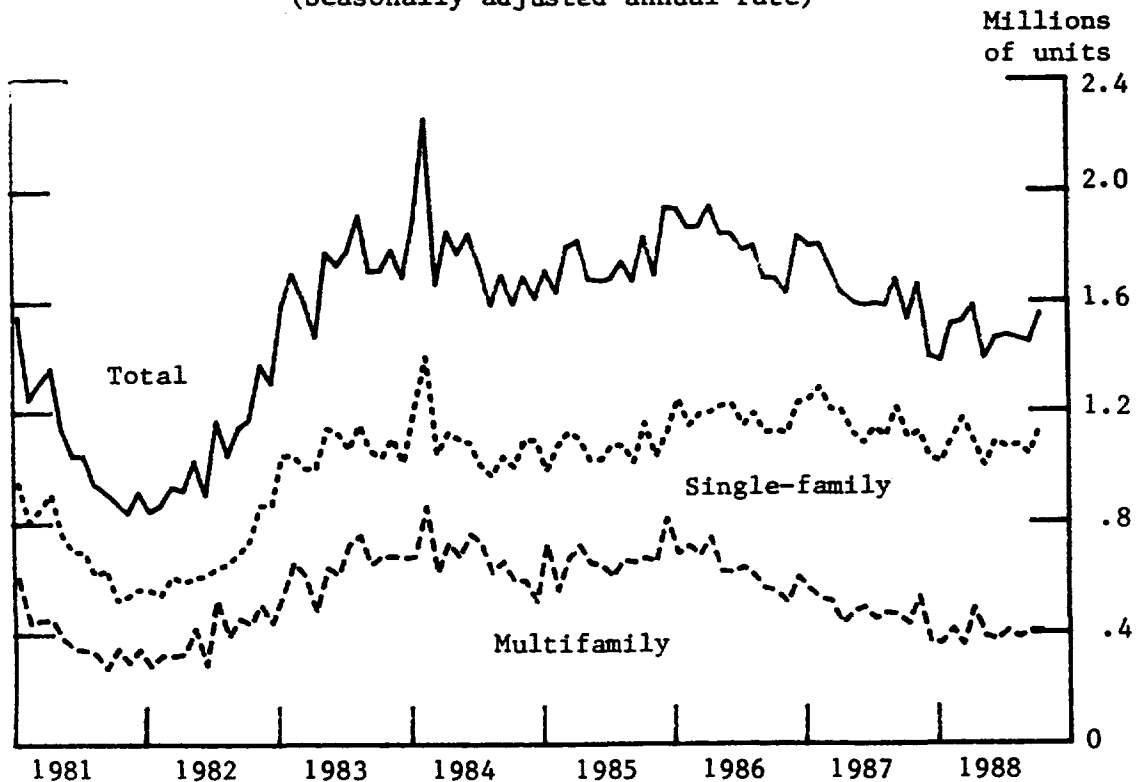


**PRIVATE HOUSING ACTIVITY**  
(Seasonally adjusted annual rates; millions of units)

	1987	1988			1988		
	Annual	Q1	Q2	Q3 <sup>r</sup>	Aug. <sup>r</sup>	Sept. <sup>r</sup>	Oct. <sup>p</sup>
<b>All units</b>							
Permits	1.54	1.38	1.46	1.43	1.46	1.39	1.50
Starts	1.62	1.48	1.48	1.46	1.46	1.45	1.55
<b>Single-family units</b>							
Permits	1.02	.98	.98	.99	1.02	.97	1.02
Starts	1.15	1.10	1.06	1.06	1.08	1.04	1.15
<b>Sales</b>							
New homes	.67	.63	.69	.71	.72	.71	.73
Existing homes	3.53	3.25	3.64	3.67	3.71	3.67	3.63
<b>Multifamily units</b>							
Permits	.51	.40	.48	.43	.44	.42	.47
Starts	.47	.38	.42	.40	.38	.41	.41

p--preliminary estimates. r--revised.

**PRIVATE HOUSING STARTS**  
(Seasonally adjusted annual rate)



inventory-sales ratio has been unchanged since April. Retail apparel inventories, which appeared burdensome earlier this year, turned down in recent months, but remain at a relatively high level. Elsewhere in the trade sector, there appears to be no significant inventory overhang at the present time.

### Housing Markets

Housing activity strengthened in October. Single-family starts spurted to 1.15 million units, likely owing in part to some downward movement in mortgage interest rates after August. New home sales rose further in October to 733,000 units at an annual rate, the strongest monthly pace since February 1987. In the existing home market, sales did drop a little in October, but were only modestly below the strong sales rate recorded for the third quarter. Multifamily housing starts remained flat in October, reflecting the continued effects of unfavorable market fundamentals.

Looking ahead, the annual increase in the number of households is projected to slow from about 1.4 million in recent years to about 1.2 million in the first half of the 1990s (table). This reduction in household formations, in turn, implies a decline in required additions to the housing stock and hence in housing expenditures. However, the changing age composition of the population should provide some offset to the expected negative effect of lower household formations on housing investment expenditures. The projected contraction in the number of households below age 35 suggests reduced demand for relatively less expensive "starter" homes (table). By contrast, the number of

households in the 35 to 54 year age bracket is projected to rise more rapidly in coming years than it did in the late eighties. More expensive "trade-up" homes typically are demanded by families in these age groups.

ESTIMATED AVERAGE ANNUAL CHANGE IN HOUSEHOLDS, BY AGE OF HEAD  
(Thousands)

Age of head (years)	Period	
	1985 to 1990	1990 to 1995
Under 25	-145	-69
25 - 34	219	-195
35 - 44	706	534
45 - 54	338	677
55 - 64	-143	-16
65 and over	420	297
All ages	1,395	1,216

Source: U.S. Bureau of the Census, "Projections of the Number of Households and Families: 1986 to 2000," Current Population Reports, Series P-25, no. 986, p. 3. Data shown correspond to Census projection Series B.

Federal Government

In October, the first month of the 1989 fiscal year, the federal government recorded a budget deficit of \$27.4 billion, compared with \$30.8 billion a year earlier. The year-earlier deficit figure, however, was inflated by special factors that changed the timing of outlays and boosted October 1987 spending by roughly \$3 billion. Moreover, in some key sectors, outlays this October were not yet

reflecting influences that will become more apparent as the fiscal year unfolds. Outlays under the special drought relief programs had not yet begun in October and now are expected to be small until next quarter. In addition, outlays by the deposit insurance agencies hit a lull at the start of the new fiscal year, perhaps owing to administrative delays; FSLIC's ongoing program of reorganizing troubled thrifts suggests a resurgence soon.

Total receipts in October were about 2 percent higher than a year earlier. As expected, personal income taxes were little changed from a year ago, as growth in nominal income has been offset by the second installment of the rate reduction legislated in the Tax Reform Act of 1986. Social insurance tax receipts were up about 7 percent from a year earlier, reflecting in part the January tax rate hike.

Reports are that the Office of Management and Budget's preliminary estimates of the current services budget for FY1990 point to a deficit of a bit less than \$135 billion. President Reagan is required by law to submit FY1990 budget proposals on January 9 (the first Monday after January 3) that meet the Gramm-Rudman-Hollings deficit target of \$100 billion for FY1990. The economic projections the Administration will use in preparing the budget were released earlier in the month and are shown in the following table. These projections show real GNP growth of 3.5 percent in 1989 and reductions in the rates of unemployment, interest, and inflation. Given these economic assumptions and no major changes in technical assumptions, it appears that the



FEDERAL GOVERNMENT RECEIPTS AND OUTLAYS<sup>1</sup>  
(Billions of dollars)

	Receipts	Outlays	Surplus (+) or deficit (-)
<b>Fiscal years:</b>			
1985	734.1	946.3	-212.3
1986	769.1	990.2	-221.1
1987	854.1	1004.6	-150.4
1988	909.0	1064.1	-155.1
-----Fiscal 1988-----			
<b>Monthly data:</b>			
1987--October	62.4	93.2	-30.8
November	57.0	84.0	-27.0
December	85.5	109.9	-24.4
1988--January	81.8	65.9	15.9
February	60.4	84.4	-24.0
March	65.7	95.0	-29.3
April	109.3	95.6	13.8
May	59.7	82.3	-22.6
June	99.2	90.1	9.1
July	60.7	83.6	-22.9
August	69.5	92.6	-23.1
September	97.8	87.6	10.2
-----Fiscal 1989-----			
1989--October	63.6	91.1	-27.4

Source: Department of the Treasury, Monthly Treasury Statement.

1. Includes all receipts and outlays of programs and entities that are classified as off-budget.

Reagan Administration's proposed budget will contain \$35 billion in deficit reductions.

ADMINISTRATION ECONOMIC PROJECTIONS

	Calendar years					
	1988	1989	1990	1991	1992	1993
	-----Percent change, Q4 to Q4-----					
Nominal GNP	6.6	7.4	7.0	6.4	5.8	5.3
Real GNP	2.6	3.5	3.4	3.3	3.2	3.2
GNP deflator	3.9	3.7	3.5	3.0	2.5	2.0
	-----Percent, annual average-----					
Civilian unemployment rate	5.5	5.3	5.2	5.0	5.0	5.0
Interest rates						
(3-month Treasury bill)	6.6	6.3	5.5	4.5	4.0	3.5
(10-year Treasury note)	8.8	8.3	7.3	6.0	5.0	4.5

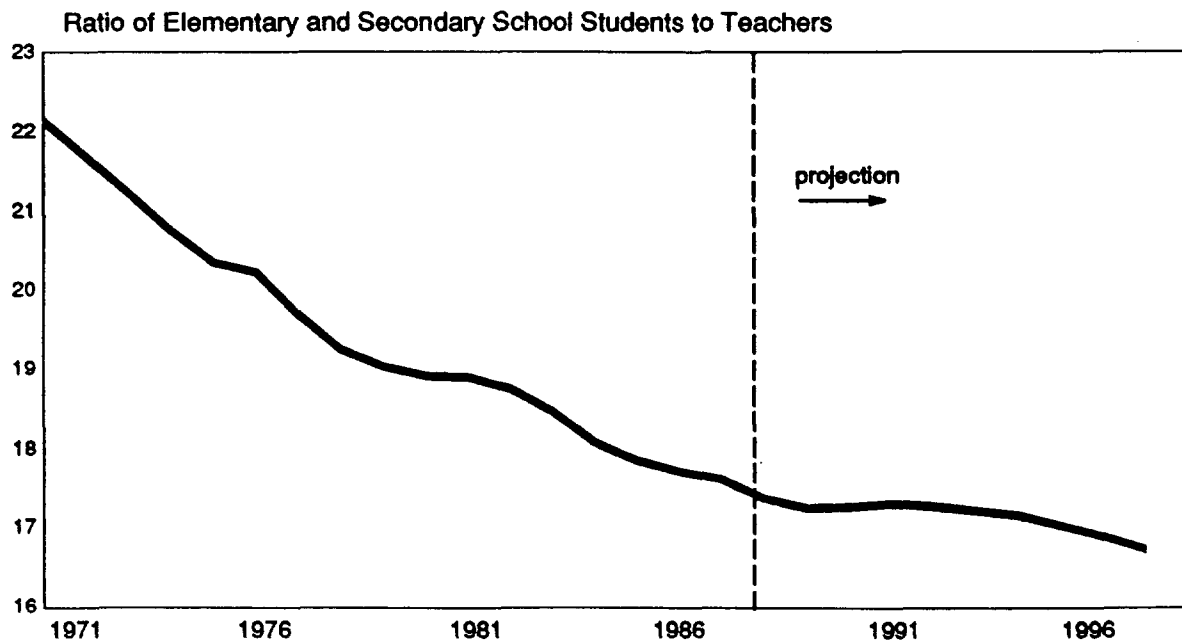
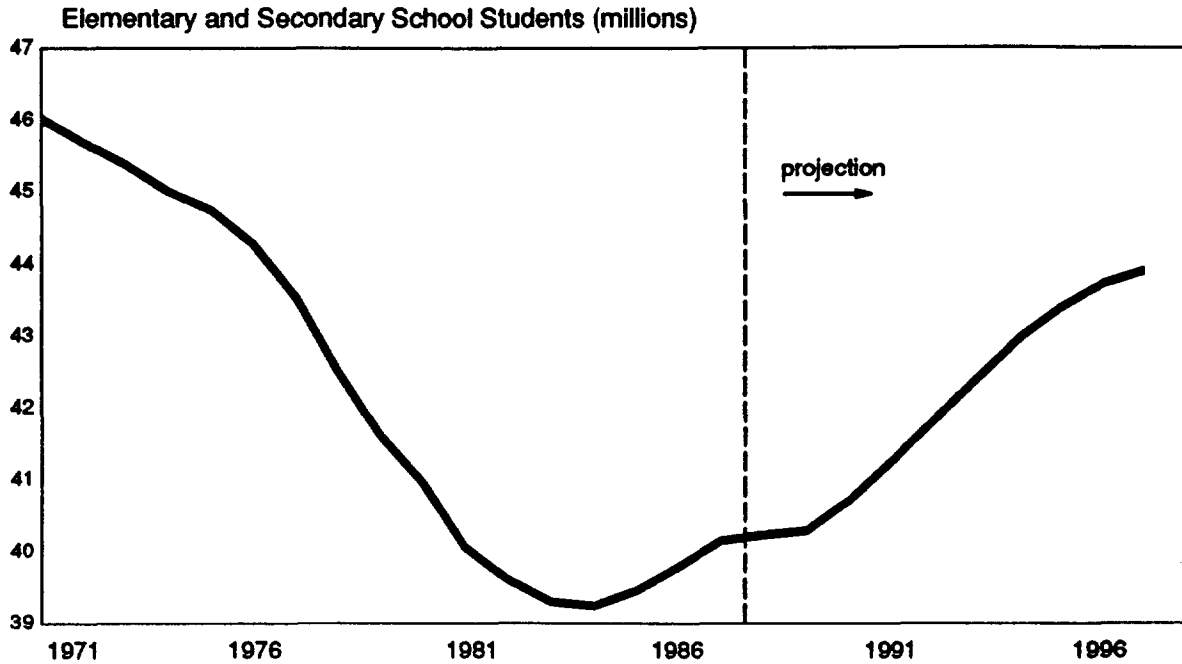
Source: CEA Chairman Beryl Sprinkel, press conference, November 22, 1988.

State and Local Government Sector

Real purchases of goods and services by state and local governments have expanded in recent months. In October, state and local government construction outlays resumed their upward course, and employment in the sector rose in November to 128,000 above its third-quarter average.

Underlying demand for infrastructure remains strong in the state and local sector. Indeed, voters approved nearly \$14 billion in general obligation issues in this year's bond referenda, nearly double the record 1986 pace. This was the fifth consecutive year that more than 80 percent of proposed bond authority was approved. Proceeds of these bonds will finance a broad range of capital projects, ranging from roads

### PUBLIC SCHOOL ENROLLMENT AND STUDENT-TEACHER RATIO



Source: Data on enrollment and teachers are from the Department of Education.

and sewers to prisons. Public education also likely requires significant expansion of infrastructure as well as staffing. Elementary and secondary school enrollments have been rising since 1985 and are expected to advance further in coming years (chart). Moreover, according to projections of the Department of Education the student-teacher ratio will likely decline a bit further.

Spending over the next year may be restrained to some extent by fiscal pressures, which have become more widespread of late. To date, 29 states anticipate low year-end balances, or deficits, in fiscal year 1989, which ends June 30 for most states; by comparison, 13 states experienced such budgetary pressures in fiscal year 1988. The problem appears to be particularly troublesome among six relatively large states, owing to lower-than-expected tax collections in four states and weak oil prices in the other two. A variety of strategies have been undertaken to ameliorate the shortfalls, including the use of "rainy-day" funds and a reduction in outlays. New York, for example, has temporarily frozen state hiring as well as its outlays for construction and equipment.

### Prices

Consumer prices for food eased in October, and energy prices were little changed, but prices of other goods and services increased, on balance, somewhat more rapidly than in preceding months. And, although there are reports of an easing of pressures on some materials prices, overall inflation for intermediate supplies continues to be rapid.

RECENT CHANGES IN CONSUMER PRICES  
(Percentage change; based on seasonally adjusted data)<sup>1</sup>

	Relative importance Dec. 1987	1987	1988			1988	
			Q1	Q2	Q3	Sept.	Oct.
			----Annual rate----			-Monthly rate-	
All items <sup>2</sup>	100.0	4.4	4.2	4.5	4.8	.3	.4
Food	16.1	3.5	1.4	7.1	9.9	.8	.2
Energy	7.6	8.2	-4.9	4.2	2.7	-.6	.1
All items less food and energy	76.3	4.2	5.4	4.3	4.0	.4	.5
Commodities	25.8	3.5	4.7	3.9	3.1	.8	.7
Services	50.6	4.5	5.9	4.5	4.1	.1	.5
Memorandum:							
CPI-W <sup>3</sup>	100.0	4.5	3.5	4.9	4.9	.3	.5

1. Changes are from final month of preceding period to final month of period indicated.

2. Official index for all urban consumers.

3. Index for urban wage earners and clerical workers.

RECENT CHANGES IN PRODUCER PRICES  
(Percentage change; based on seasonally adjusted data)<sup>1</sup>

	Relative Importance Dec. 1987	1987	1988			1988	
			Q1	Q2	Q3	Sept.	Oct.
			----Annual rate----			-Monthly rate-	
Finished goods	100.0	2.2	2.7	3.8	6.5	.4	.0
Consumer foods	25.9	-.2	6.0	8.2	10.0	1.2	-.1
Consumer energy	9.6	11.2	-18.5	.7	-.7	-3.3	.3
Other consumer goods	40.1	2.7	5.7	2.4	6.6	.4	.0
Capital equipment	24.4	1.3	3.2	2.5	6.5	.8	-.3
Intermediate materials <sup>2</sup>	95.0	5.5	4.3	7.8	4.9	.4	.1
Excluding energy	82.5	5.2	8.2	6.9	7.2	.6	.5
Crude food materials	39.5	1.8	17.7	31.0	23.0	1.6	1.4
Crude energy	41.9	10.7	-24.1	7.8	-26.1	-3.1	-2.2
Other crude materials	18.6	22.6	15.9	-6.5	8.5	-.6	.2

1. Changes are from final month of preceding period to final month of period indicated.

2. Excludes materials for food manufacturing and animal feeds.

Pressures of the drought on food prices appear to be tapering off, after the sharp runup of the summer. In October, the CPI for food rose only 0.2 percent, as further drought-related increases for foods such as cereal and bakery products, vegetable oils, and processed fruits and vegetables were largely offset by declines for fresh fruits and vegetables, meats, and poultry. More recently, livestock price changes in agricultural commodity markets have been mixed: cattle prices have been firm, but hog prices dropped in late November to the lowest level since 1980. Crop prices have retreated noticeably since mid-October, and when coupled with recent trends in livestock prices, suggest that the PPI for crude foods will turn down in November after 11 months of increase.

Retail energy prices edged up 0.1 percent in October; the prices of gasoline and fuel oil fell, but there were offsetting increases for natural gas and electricity. In late November, OPEC members agreed to cut output of crude oil well below the pace of recent months, and both spot and posted prices of crude oil have since moved up. Nevertheless, the effectiveness of this agreement clearly is in doubt; even if production limits are adhered to, the overhang of crude oil stocks accumulated during the recent period of high production will restrain prices. Moreover, because most of the price declines of this summer had not shown through at the pump, some of the firming of crude oil prices (to the extent that it persists) may be partially absorbed by refiners and marketers; by contrast, a drop in crude prices to their pre-

PRICE INDEXES FOR COMMODITIES AND MATERIALS<sup>1</sup>

	Last Observation	Percent change <sup>2</sup>			
		1988			
		1986	1987	To Oct. 25 <sup>*</sup>	Oct. 25 <sup>*</sup> to date
. PPI for crude materials <sup>3</sup>	Oct.	-8.9	8.9	1.5	n.a.
1a. Ex. energy	Oct.	-.6	7.7	12.4	n.a.
1b. Ex. food and energy	Oct.	1.8	22.6	4.7	n.a.
1c. Ex. food and energy, seas. adj.	Oct.	1.7	22.8	4.4	n.a.
. IMF commodity index <sup>3</sup>	Oct.	-7.9	30.8	6.8	n.a.
2a. Metals	Oct.	-.5	51.9	16.9	n.a.
2b. Nonfood agric.	Oct.	8.5	47.5	-11.7	n.a.
. Commodity Research Bureau					
3a. Futures prices	Dec. 5	-9.1	11.7	4.2	.6
3b. Industrial spot prices	Dec. 2	5.1	19.2	3.6	1.5
. <u>Journal of Commerce</u> industrials	Dec. 5	-1.4	10.7	.3	1.7
. <u>Economist</u> (U.S. dollar index)					
5a. Industrials	Nov. 29	-4.7	42.5	10.4	.7
	Nov. 29	5.8	62.6	11.1	.8
. Dow-Jones Spot	Dec. 5	-8.9	17.0	.3	1.1

1. Not seasonally adjusted.

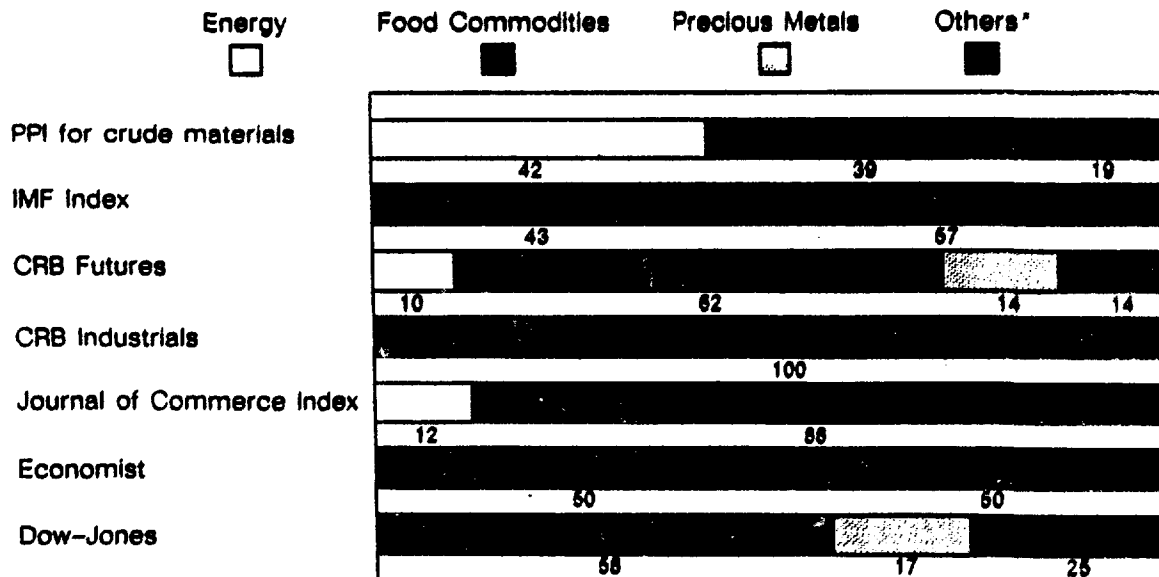
2. Change is measured to end of period, from last observation of previous period.

3. Monthly observations. IMF index includes items not shown separately.

n.a.--Not available.

\*Week of the October Greenbook.

Index Weights



\*Forest products, industrial metals, and other industrial materials.

agreement levels could result in further declines in prices of petroleum products.

Excluding food and energy items, the CPI rose 0.5 percent in October, after increasing 0.4 percent in September. The goods component, up 0.7 percent, was boosted for the second month by a hike in apparel prices. The increases for apparel--about 2 percent in both September and October--were associated with the introduction of fall and winter clothing in the CPI sample and, to some extent, with seasonal adjustment difficulties.<sup>5</sup> Price advances for other goods averaged between 0.3 and 0.4 percent in October. Nonenergy service prices rose 0.5 percent, with large increases for auto insurance and finance, as well as for some entertainment items.

In contrast to the CPI for goods, the producer price index excluding food and energy fell in October. Much of this divergence reflects different approaches to pricing new-model cars and light trucks in these indexes. In the CPI, the new models are phased into the sample as they replace vehicles from the previous model year in dealer sales; new car prices were up 0.2 percent in October, in part reflecting higher-priced 1989 models. By contrast, the PPI records manufacturers' prices only for the latest models, beginning in October and continuing through September of the following year--often leading to more volatile price changes at this time of year. This year, the PPI for cars

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5. With the 1987 CPI revision, the BLS improved markedly its pricing procedures for the months when new seasonal clothing styles are introduced. However, the seasonal adjustment factors are based mainly on prior years. This has resulted in sharp increases in the seasonally adjusted index for apparel in September, October, March, and April.



## CHANGES IN CONSUMER PRICE INDEXES, 1985 TO 1988

	Relative Importance Dec. 1987	12-Month percent changes to:			
		Oct. 1985	Oct. 1986	Oct. 1987	Oct. 1988
All items	100.0	3.2	1.5	4.5	4.2
Food	16.1	1.8	4.5	3.6	5.2
Energy	7.6	0.1	-18.4	8.1	.1
Less food and energy	76.3	4.1	4.0	4.3	4.5
Commodities	25.8	2.1	1.3	3.8	3.8
Used cars	1.3 <sup>1</sup>	-2.4	-3.9	7.6	3.2
Apparel	5.8	2.1	.5	6.2	4.6
House furnishings	4.3	-.1	.9	.9	2.2
New cars	4.4	3.2	5.0	2.9	2.2
Entertainment	2.1	3.4	1.0	2.7	4.6
Tobacco and products	1.3	6.3	6.8	7.4	9.5
Services	50.6	5.5	5.5	4.6	4.8
Owners' equivalent rent	19.3	5.5	5.4	4.9	4.6
Residential rent	6.0	6.3	5.4	3.8	3.7
Medical	4.7	6.4	8.1	6.0	6.7
Entertainment	2.3	4.8	5.6	5.0	3.9
Personal and educational	3.2	7.8	8.0	6.3	6.7

1. Before 1987, the relative importance weight for used cars was about 4 percent.

declined 1-3/4 percent in October, on a seasonally adjusted basis, reversing a September increase of about the same magnitude. Also, incentive programs changed relatively little in the September-October period, in marked contrast to the previously typical seasonal pattern of very large discounts in September that are virtually eliminated in October.

At earlier stages of processing, the PPI for intermediate materials less food and energy rose 0.5 percent in October, about the average pace in recent months. Prices of crude nonfood materials less energy edged up 0.2 percent, as increases--notably for copper ore and scrap--were largely offset by declines for steel and aluminum scrap and other materials. Since the pricing date for the October PPI, prices in spot commodity markets have reached new highs for copper but have receded for steel scrap.

A longer-term perspective on the composition of price inflation is provided by the final table, which compares twelve-month changes in selected components of the CPI over the past four years. Excluding the food and energy sectors, prices have accelerated from about 4 percent in 1985 and 1986 to 4-1/2 percent in 1988. The commodities component more than accounts for this acceleration. Some of the pickup in this category reflects a sharp turnaround in used car prices in the past two years. Among other goods, the acceleration likely reflects higher import prices and, more recently, a pickup in the prices of domestic manufactures. This has been most notable for apparel, but also is apparent for housefurnishings, entertainment goods, and tobacco

products. An important exception to this pattern of acceleration has been new car prices, which have slowed over the past two years.

In contrast to the pickup in commodity prices, the CPI for nonenergy services has decelerated over the past two years--to about 4-3/4 percent per year compared with the 5-1/2 percent pace in 1985-86. The slowing has been fairly broadly based across the items composing the services category. Nonetheless, the extent of the deceleration should be viewed with some caution. A slowing in the rent categories, which are heavily weighted in services, has coincided with a marked improvement in the CPI sample beginning with the 1987 revision. Thus, it is difficult to ascertain whether the smaller increases in the past two years reflect a slowing in underlying housing costs or the changed sample of rental units.

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# **DOMESTIC FINANCIAL DEVELOPMENTS**

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III-T-1

SELECTED FINANCIAL MARKET QUOTATIONS<sup>1</sup>  
(Percent)

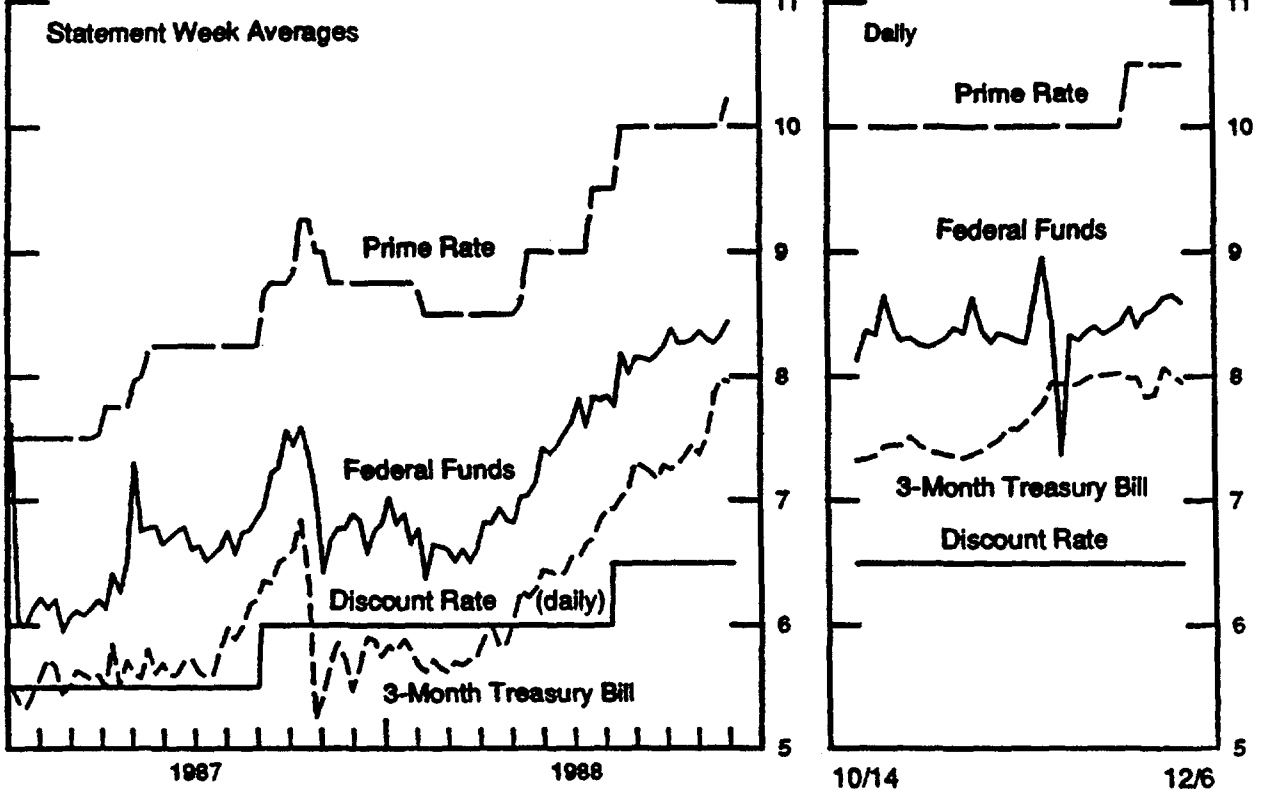
	1987		1988			Change from:
	Jan.-Feb.	Oct. 16 <sup>2</sup>	Feb	FOMC	Dec. 6	FOMC
	lows		lows	Nov. 1		Nov. 1
<b>Short-term rates</b>						
Federal funds <sup>3</sup>	5.95	7.59	6.38	8.31	8.61	.30
Treasury bills <sup>4</sup>						
3-month	5.30	6.93	5.59	7.34	7.95	.61
6-month	5.31	7.58	5.77	7.47	8.15	.68
1-year	5.35	7.74	6.10	7.49	8.15	.66
<b>Commercial paper</b>						
1-month	5.81	7.94	6.41	8.19	9.29	1.10
3-month	5.73	8.65	6.45	8.29	9.12	.83
<b>Large negotiable CDs<sup>4</sup></b>						
1-month	5.85	7.92	6.44	8.19	9.36	1.17
3-month	5.80	8.90	6.49	8.40	9.26	.86
6-month	5.78	9.12	6.55	8.41	9.27	.86
<b>Eurodollar deposits<sup>5</sup></b>						
1-month	6.00	7.79	6.60	8.25	8.58	.33
3-month	6.00	8.69	6.69	8.56	9.29	.73
Bank prime rate	7.50	9.25	8.50	10.00	10.50	.50
<b>intermediate- and long-term rates</b>						
<b>U.S. Treasury (constant maturity)</b>						
3-year	6.34	9.52	7.28	8.33	8.91	.58
10-year	7.01	10.23	8.11	8.68	8.95	.27
30-year	7.29	10.24	8.32	8.76	8.95	.19
<b>Municipal revenue<sup>6</sup></b>						
(Bond Buyer)	6.92	9.58e	7.76	7.63e	8.01e	.38
<b>Corporate A utility</b>						
(recently offered)	8.78	11.50	9.63	9.96e	10.03e	.07
<b>Home mortgage rates<sup>7</sup></b>						
S&L fixed-rate	9.10	11.58	9.84	10.22	10.44	.22
S&L ARM, 1-yr.	7.52	8.45	7.59	8.13	8.26	.13
	<u>1986</u>	<u>1987</u>		<u>1988</u>		<u>Percent change from:</u>
	<u>Year-end</u>	<u>Record</u>	<u>Lows</u>	<u>FOMC</u>	<u>Dec. 6</u>	<u>FOMC</u>
		<u>highs</u>		<u>Nov. 1</u>		<u>Nov. 1</u>
<b>Stock prices</b>						
Dow-Jones Industrial	1895.95	2722.42	1738.74	2150.96	2149.36	-.07
NYSE Composite	138.58	187.99	125.91	156.98	155.78	-.76
AMEX Composite	263.27	365.01	231.90	299.56	297.36	-.73
NASDAQ (OTC)	348.83	455.26	291.88	382.35	377.00	-1.40

1. One-day quotes except as noted.  
Last business day prior to stock market line on Monday, October 19, 1987.  
Average for two-week maintenance period closest to date shown except lows shown which are one-week average ending Feb.25 and Feb.10, respectively. Last observation is average to date for maintenance period ending 12/14/88.

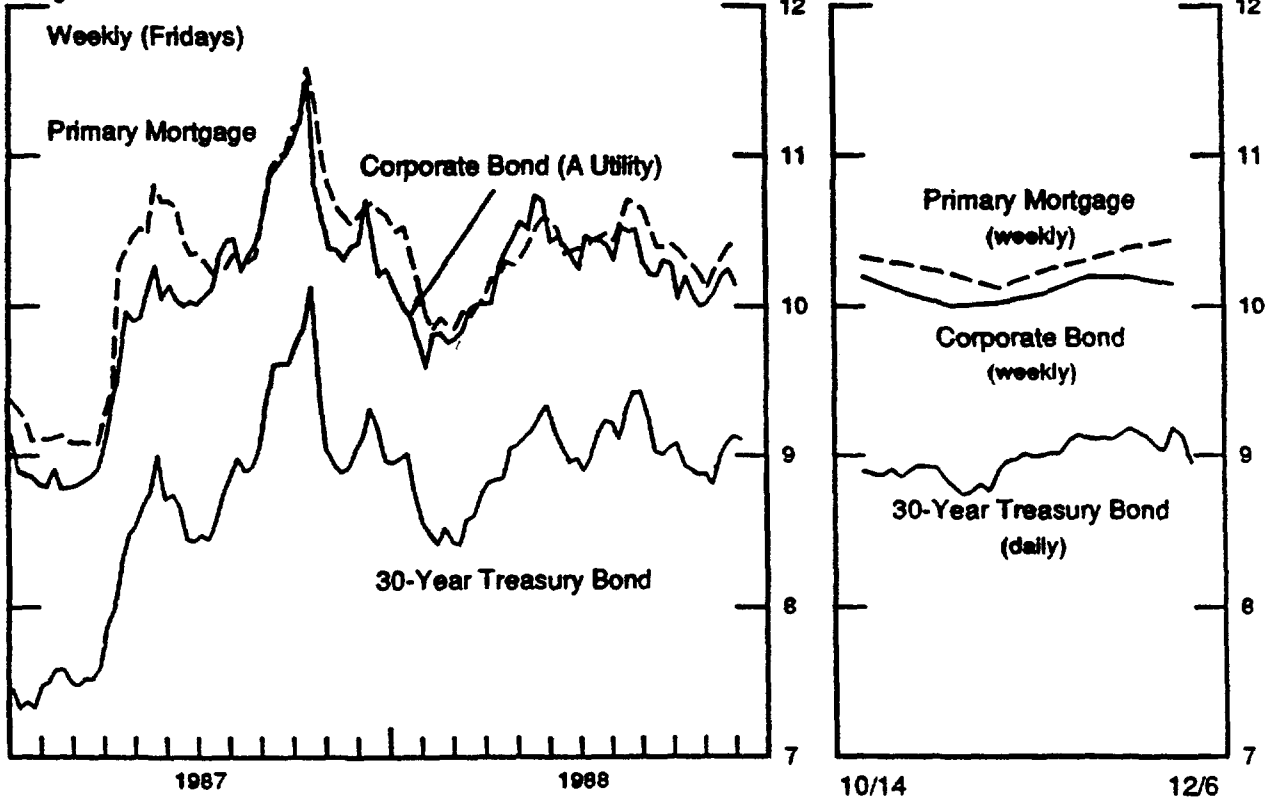
4. Secondary market.  
5. Average for statement week closest to date shown.  
6. Based on one-day Thursday quotes and futures-market index changes.  
7. Quotes for week ending Friday closest to date shown.  
e--estimate

**Selected Interest Rates\***  
(percent)

**Short-Term**



**Long-Term**



\*--Friday weeks through December 2, Wednesday weeks through November 30.

## DOMESTIC FINANCIAL DEVELOPMENTS

Short-term interest rates have moved up considerably since the last FOMC. Although the federal funds rate has edged only a little higher-- from below 8-3/8 percent in early November to above 8-1/2 percent in recent days--incoming indicators pointing to continued strong economic expansion, a rebound in oil prices, and a decline in the dollar all have led to a marked revision in market participants' expectations regarding prospective money market conditions. Consequently, key Treasury bill rates have risen about 65 basis points over the intermeeting period, while most private short-term rates are up about 85 points. (One-month rates have shown larger increases, as they began to incorporate anticipated year-end rate pressures.) The prime rate was raised 1/2 percentage point to 10-1/2 percent on November 28.

In addition to these bearish developments, the bond markets have had to deal with some special uncertainties, particularly those associated with the recent wave of corporate restructurings. A heightened sense of "event risk" has caused an aversion to investment-grade industrial bonds, prompting strong demands for mortgage- and other asset-backed instruments and for utility bonds. On net, long-term yields have risen much less than short rates over the intermeeting period, resulting in a further flattening of the term structure of interest rates.

Expansion of the broader monetary aggregates picked up in November. Demand for liquid retail-type instruments showed an especially strong increase, perhaps reflecting a preference for liquidity in light of

uncertain interest rate prospects as well as some temporary parking of funds generated by sales of equity in corporate restructurings. Barring unanticipated sharp fluctuations in December, the fourth-quarter to fourth-quarter increases in M2 and M3 will be well centered in the 1988 target ranges of 4 to 8 percent. M1 was about flat in November, as it has been for several months, but will expand around 4 percent for the year as a whole.<sup>1</sup>

Credit growth seems to have slowed a bit thus far in the fourth quarter, although private credit demands are expected to rise considerably in December to finance acquisitions and leveraged buyouts of unprecedented size. For the fourth quarter, net equity retirements are expected to approach \$200 billion at an annual rate. Through November, however, expansion of business credit is estimated to have been down, even with an increased volume of junk bond issuance and other merger-related financing. Federal borrowing will pick up only moderately in the quarter, despite a near-doubling of the quarterly budget deficit. Municipal bond issuance fell off in November, but remained a bit above the third-quarter pace. Available data suggest that mortgage demand has been well maintained thus far in the quarter and that other household borrowing is not much changed from the moderate pace of the preceding months.

#### Monetary Aggregates and Bank Credit

M2, boosted by unusual growth in savings deposits as well as by strength in money market mutual funds, is estimated to have expanded at

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1. A discussion of money and credit growth in 1988 appears in an appendix.



about a 7 percent annual rate last month, up sharply from its October pace. Still, based on October and November levels, M2 this quarter should expand at only around a 3 percent rate, broadly in line with econometric models of money demand that suggest growth should be significantly restrained by earlier increases in interest rates and opportunity costs. M3 is estimated to have picked up much less last month, to a 6 percent rate, as bank credit growth and associated funding needs remained quite moderate.

M1 was about unchanged in November. Demand deposits resumed running off as rising interest rates increased opportunity costs and likely led to reductions in compensating balances. In addition, some firms may be seeking to run down demand balances held under such arrangements in order to square accounts by year-end. With their opportunity cost relative to retail time deposits rising much more slowly, other checkable deposits expanded at a 6 percent annual rate in November after being little changed on average over the preceding two months.

The strengthening of other checkable deposits was part of a more general shift by retail depositors to more liquid assets within the nontransactions component of M2. Savings deposits, which had been running off, surged, primarily reflecting a single deposit of proceeds of a change in corporate ownership. In addition, growth of general purpose/broker-dealer money market mutual funds leapt in November to a 35 percent annual rate, even though higher market interest rates were acting to discourage inflows by late in the month.

MONETARY AGGREGATES  
(based on seasonally adjusted data unless otherwise noted)

	1987 <sup>1</sup>	1988 Q2	1988 Q3	1988 Sep	1988 Oct	1988 Nov pe	Growth Q4 87- Nov 88pe
-----Percent change at annual rates-----							
1. M1	6.2	6.3	5.2	-0.2	1.7	0	4
2. M2	4.0	7.7	3.6	1.0	1.3	7	5½
3. M3	5.4	7.7	5.7	1.7	4.8	6	6½
-----Percent change at annual rates-----							
							Levels bil. \$ Oct 88
<u>Selected components</u>							
4. M1-A	2.8	3.9	3.4	-0.7	3.1	-2	505.5
5. Currency	8.7	8.4	7.1	7.5	5.8	5	209.5
6. Demand deposits	-1.0	1.0	0.7	-7.0	0.8	-8	288.6
7. Other checkable deposits	13.6	10.6	8.8	0.9	-1.3	6	277.9
8. M2 minus M1 <sup>2</sup>	3.3	8.2	3.1	1.4	1.1	9	2253.9
9. Overnight RPs and Eurodollars, NSA	4.1	3.0	-4.0	-37.5	-29.4	-43	75.7
10. General purpose and broker/dealer money market mutual fund shares, NSA	5.8	3.3	-3.1	0.5	2.6	35	231.4
11. Commercial banks	2.5	6.8	5.1	4.0	8.1	12	971.5
12. Savings deposits, SA, plus MMDAs, NSA <sup>3</sup>	1.8	3.2	1.2	-7.9	-4.0	9	542.2
13. Small time deposits	3.5	11.8	10.2	20.0	23.4	17	429.2
14. Thrift institutions	3.5	9.1	2.7	1.6	-0.1	2	976.4
. Savings deposits, SA, plus MMDAs, NSA <sup>3</sup>	0.8	2.3	0.4	-10.7	-12.6	-6	395.8
. Small time deposits	5.6	14.0	4.5	10.1	9.0	7	580.7
. M3 minus M2 <sup>4</sup>	11.2	7.4	13.6	4.0	17.9	5	831.6
18. Large time deposits	8.5	7.6	15.8	19.8	15.1	3	530.2
19. At commercial banks, net <sup>5</sup>	11.2	6.7	21.5	17.6	15.0	3	356.7
20. At thrift institutions	3.4	9.3	4.5	24.3	15.4	3	173.5
21. Institution-only money market mutual fund shares, NSA	3.0	-30.6	-23.3	-4.3	12.9	35	84.6
22. Term RPs, NSA	32.9	28.3	12.0	-15.6	26.7	29	124.2
23. Term Eurodollars, NSA	13.8	19.8	38.1	-10.6	-24.9	28	99.3

MEMORANDA:<sup>6</sup>

	-----Average monthly change in billions of dollars-----						
24. Managed liabilities at commercial banks (25+26)	6.2	7.8	1.8	-8.3	0.8	4	601.5
25. Large time deposits, gross	3.5	1.5	6.4	6.1	4.0	0	423.7
26. Nondeposit funds	2.7	6.3	-4.6	-14.4	-3.2	4	177.8
27. Net due to related foreign institutions, NSA	2.9	3.9	0.1	-9.5	-4.3	5	4.8
28. Other <sup>7</sup>	-0.2	2.4	-4.7	-4.9	1.1	-1	173.0
29. U.S. government deposits at commercial banks <sup>8</sup>	0.3	-1.0	0.8	8.7	6.2	-9	30.7

1. Amounts shown are from fourth quarter to fourth quarter.
2. Nontransactions M2 is seasonally adjusted as a whole.
3. Commercial bank savings deposits excluding MMDAs grew during October and November at rates of -2.5 percent and 21 percent, respectively. At thrift institutions, savings deposits excluding MMDAs grew during October and November at rates of -8.9 percent and -1 percent, respectively.
4. The non-M2 component of M3 is seasonally adjusted as a whole.
5. Net of large denomination time deposits held by money market mutual funds and thrift institutions.
6. Dollar amounts shown under memoranda are calculated on an end-month-of-quarter basis.
7. Consists of borrowing from other than commercial banks in the form of federal funds purchased, securities sold under agreements to repurchase, and other liabilities for borrowed money (including borrowing from the Federal Reserve and unaffiliated foreign banks, loan RPs and other minor items). Data are partially estimated. Consists of Treasury demand deposits and note balances at commercial banks.
- preliminary estimate

Growth in small time deposits, although down a bit, remained in double digits last month. Expansion of these deposits at thrifts, however, continued to be unusually weak compared with that at banks. In addition to any investor portfolio shifts motivated by the steady stream of bad publicity about the FSLIC and the thrift industry, weaker inflows to thrifts reflect the persistence of the less aggressive deposit pricing by these institutions that emerged early in the summer. Since June, small time deposit growth at thrifts has been approximately half that at banks. This new pricing alignment may reflect the closing of thrifts that had paid unusually high rates, as well as jawboning by the FHLBB. Pressure on thrifts' net interest margins arising from the continued flattening of the market yield curve also may be prompting more conservative pricing of deposits.

THRIFT AND COMMERCIAL BANK PRICING OF RETAIL DEPOSITS  
AND SMALL TIME DEPOSIT GROWTH

	Thrift 6-mo. CD rate less bank rate <sup>1</sup>	Slope of thrift deposit yield curve <sup>1</sup>	Slope of bank deposit yield curve <sup>2</sup>	Small time deposit growth	
				Thrifts	Banks
		--basis points--		--percent, s.a.a.r.--	
1987 Q3	41	134	123	9.3	7.5
Q4	43	180	167	16.1	14.8
1988 Q1	53	186	161	21.3	13.7
Q2	35	165	160	14.0	11.8
Q3	26	181	183	4.5	10.2
October	26	233	232	9.0	23.4
November <sup>pe</sup>	28	244	240	7	17

Note: Interest rate data are for the week ending on the last Wednesday of the previous month. All deposit interest rate data reflect effective annual yields.

1. Rate paid by FSLIC-insured institutions less that paid by commercial banks.

2. Rate paid on retail 6-month CDs less rate paid on NOW accounts.

pe--preliminary estimate.

COMMERCIAL BANK CREDIT AND SHORT- AND INTERMEDIATE-TERM BUSINESS CREDIT<sup>1</sup>  
 (Percentage changes at annual rates, based on seasonally adjusted data)

	1986:Q4	1988					Levels
	to						bil.\$
	1987:Q4	Q2	Q3	Sept.	Oct.	Nov. <sup>p</sup>	Nov. <sup>p</sup>
----- Commercial Bank Credit -----							
1. Total loans and securities at banks	7.9	11.6	4.3	-.7	7.1	5.5	2397.1
2. Securities	5.0	8.3	-.2	-.4	8.3	1.1	551.0
3. U.S. government securities	9.6	12.1	2.3	6.8	8.9	4.4	356.4
4. Other securities	-1.9	1.6	-4.7	-13.4	7.4	-4.9	194.6
5. Total loans	8.9	12.6	5.6	-.8	6.8	6.9	1846.6
6. Business loans	7.0	15.2	3.2	-4.4	7.6	-1.4	599.7
7. Security loans	.8	-18.4	-30.5	-113.7	69.4	-37.5	37.2
8. Real estate loans	18.8	13.3	12.6	11.5	13.4	13.1	659.1
9. Consumer loans	5.1	9.9	5.5	7.3	2.4	6.9	350.8
10. Other loans	-3.1	13.8	-1.6	-18.4	-21.6	20.8	199.4
----- Short- and Intermediate-Term Business Credit -----							
11. Business loans net of bankers acceptances	7.2	15.5	3.1	-4.0	8.3	-1.4	596.4
Loans at foreign branches <sup>2</sup>	-4.1	4.1	24.1	66.0	34.1	-11.1	21.5
13. Sum of lines 11 & 12	6.8	15.1	3.8	-1.8	9.0	-1.7	617.9
14. Commercial paper issued by nonfinancial firms	-1.6	12.2	-4.8	-1.3	39.9	24.4	95.2
15. Sum of lines 13 & 14	5.7	14.7	2.6	-1.7	13.1	1.9	713.2
16. Bankers acceptances: U.S. trade related <sup>4</sup>	13.3	-9.5	-7.3	-3.7	-18.6	n.a.	31.7 <sup>5</sup>
17. Line 15 plus bankers acceptances: U.S. trade related	6.0	13.5	2.2	-1.8	11.6	n.a.	744.2 <sup>5</sup>
18. Finance company loans to business <sup>3</sup>	19.3	12.1	10.9	18.2	n.a.	n.a.	227.2 <sup>6</sup>
19. Total short- and intermediate-term business credit (sum of lines 17 & 18)	8.8	13.2	4.2	2.9	n.a.	n.a.	964.4 <sup>6</sup>

1. Average of Wednesdays.

2. Loans at foreign branches are loans made to U.S. firms by foreign branches of domestically chartered banks.

3. Based on average of data for current and preceding ends of month.

4. Consists of acceptances that finance U.S. imports, U.S. exports, and domestic shipment and storage of goods.

5. October data.

6. September data.

n.a.--not available.

p--preliminary

Within the non-M2 component of M3, institution-only MMMFs accelerated to a 35 percent annual rate last month, after an increase in their yields relative to alternative market instruments early in the month. However, issuance of large time deposits slowed substantially in November at both banks and thrifts. At thrifts, this appears to have represented greatly increased reliance on FHLB advances, which typically have longer maturities than large CDs. The shift may represent an attempt by some thrifts to lock in funding costs in anticipation of further rate increases. At banks, curtailment of large CD issuance occurred despite a substantial outflow of government balances and reflected a shifting of funding sources toward offshore branches in addition to a weakening of credit growth.

Bank credit is estimated to have expanded at a 5-1/2 percent annual rate in November, somewhat below its October pace, as net acquisitions of securities slowed. Total loan growth was essentially unchanged despite a contraction in business and security loans. C&I loan growth has been generally sluggish since July, and a survey of senior loan officers conducted in mid-November suggests that the weakness had been caused by a reduction in loan demand resulting primarily from decreased corporate funding needs and some falloff in completed mergers and buyout deals. Nevertheless, C&I loan growth in November would have weakened substantially more had it not been for merger-related demands.

Real estate lending remained robust in November, expanding at a 13 percent annual rate. Growth of consumer loans at banks picked up, although adjusted to reflect securitization activity, it moderated to

GROSS OFFERINGS OF SECURITIES BY U.S. CORPORATIONS  
(Monthly rates, not seasonally adjusted, billions of dollars)

	1987	1988			Sept. <sup>P</sup>	Oct. <sup>P</sup>	Nov. <sup>e</sup>
	Year	Q1	Q2	Q3 <sup>P</sup>			
Corporate securities - total <sup>1</sup>	24.08	23.56	25.09	20.49	23.89	21.46	22.35
Public offerings in U.S.	21.89	22.17	22.50	18.40	21.18	20.00	19.70
Stocks--total <sup>2</sup>	4.45	3.89	3.68	3.78	2.88	3.00	3.20
Nonfinancial	2.32	.76	1.65	1.47	.92	1.00	.60
Utility	.57	.32	.31	.16	.24	.20	.10
Industrial	1.75	.44	1.34	1.31	.68	.80	.50
Financial	2.12	3.13	2.03	2.31	1.96	2.00	2.60
Bonds--total <sup>1</sup>	17.44	18.28	18.82	14.62	18.30	17.00	16.50
Nonfinancial	6.61	6.59	7.93	5.17	6.15	5.80	5.60
Utility	2.02	2.25	2.55	1.17	1.95	2.10	.90
Industrial	4.59	4.34	5.38	4.00	4.20	3.70	4.70
Financial	10.83	11.69	10.88	9.45	12.15	11.20	10.90
By quality <sup>3</sup>							
Aaa and Aa	3.25	3.83	3.11	1.93	1.60	2.66	1.50
A and Baa	5.20	7.06	7.24	4.12	6.00	4.82	2.60
Less than Baa	2.77	1.33	2.85	2.69	2.30	2.95	4.80
No rating (or unknown)	.07	.05	.14	.06	.15	.15	.15
Memo items:							
Equity-based bonds <sup>4</sup>	.87	.13	.37	.32	.39	.59	.35
Mortgage-backed bonds	5.19	5.48	4.16	4.13	4.75	5.50	6.00
Other asset-backed	.96	.53	1.32	1.67	3.49	.92	1.44
Variable-rate notes	1.88	1.44	1.35	.85	.47	.72	.70
Bonds sold abroad - total	2.03	1.34	2.40	2.01	2.70	1.40	2.60
Nonfinancial	.94	.39	.87	.81	.80	.60	.80
Financial	1.09	.95	1.53	1.20	1.90	.80	1.80
Stocks sold abroad - total	.16	.05	.19	.08	.01	.06	.05
Nonfinancial	.12	.04	.14	.07	.00	.06	.05
Financial	.04	.01	.05	.01	.01	.00	.00

1. Securities issued in the private placement market are not included. Total reflects gross proceeds rather than par value of original discount bonds.

2. Includes equity issues associated with debt/equity swaps.

3. Bonds categorized according to Moody's bond ratings or Standard and Poors if unrated by Moody's. Excludes mortgage-backed and asset-backed bonds.

4. Includes bonds convertible into equity and bonds with warrants that entitle the holder to purchase equity in the future.

p--preliminary. e--staff estimate.

its slowest pace since July. The senior loan officer survey, however, suggests that bank willingness to lend to households has continued to increase, perhaps partly as a consequence of the greater ease of removing receivables from their books via securitization.

#### Business Finance

Growth of commercial paper of nonfinancial businesses is estimated to have slowed somewhat from the very rapid pace in October. Some of the continued strength may reflect shifts from long- to short-term financing that were motivated by recent increases in long-term rates and by the takeover-induced turbulence in sectors of the corporate bond market. Any such shifting, however, does not appear to be showing through to bank lending, and the sum of commercial paper and bank loans expanded at only a 2 percent rate last month.

A surge in merger-related junk bond issuance left gross public long-term offerings by nonfinancial firms unchanged in November, as investment-grade issuance by industrial firms became minuscule after the announcement on October 20 of a proposed management-led LBO of RJR Nabisco, by far the largest takeover ever attempted. Bond markets were disrupted by concern that even high quality debt of large corporations now was subject to substantial devaluation in the event of a takeover attempt.<sup>2</sup>

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2. The board of directors of RJR Nabisco announced on November 30 that it had accepted a bid for the purchase of the company from the firm of Kohlberg Kravis Roberts & Co. The purchase price was \$25.1 billion. The financing of this takeover, scheduled for early January, is expected to entail around \$13 billion of borrowing from a consortium of 65 to 80 domestic and foreign banks. Of the remainder, \$5 billion will come from a bridge loan from two investment banks that will be repaid with (Footnote continues on next page)

This so-called event risk caused the spread between A-rated industrial bonds and 30-year Treasury bonds to widen by as much as 25 basis points during the week after the announcement of the RJR Nabisco proposal. With issuance of investment-grade instruments coming to a standstill over the subsequent five weeks, the additional yield premium over Treasuries on most industrial issues was eliminated. However, trading in the secondary market has been thin, and any new issuer of debt deemed subject to event risk likely would have had to pay a significant premium. Investment-grade issuance by industrial firms revived slightly in late November, as a few firms came to market with issues embodying covenants that provide bondholders with additional protections.<sup>3</sup>

Investors have responded to the greater event risk in the industrial bond sector by redirecting demand to other quality issues, such as mortgage-backed and other asset-backed bonds, encouraging an increase in the quantity of these instruments supplied. Owing to the nearly \$5 billion issuance of junk bonds in November, and to prospects

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(Footnote continued from previous page)  
proceeds of junk bond issuance. Phillip Morris' takeover of Kraft for around \$13 billion will be financed in large part by a \$12 billion facility involving 80 foreign and domestic banks; financing is expected to take place by mid-December.

3. Starting in 1986, many corporate bond offerings included "poison puts," which allowed bondholders to sell their bonds back to the issuer at par in the event of an unfriendly takeover. However, these covenants have afforded bondholders little effective protection because most takeovers ultimately are consummated without opposition from the target firm's board of directors. The late-November issues included stronger covenants that would allow bondholders to put the bonds back to the company at par over the next ten years if the bonds fall below investment grade following a major restructuring.



for considerable additional supply, junk bond spreads over Treasuries reportedly have increased 50 to 100 basis points since the summer.

Stock prices have declined by about 2 percent from the post-crash peaks reached on October 21. Prices of takeover candidates, while still outperforming the broad market averages, have softened somewhat since the last FOMC. While equity issuance by nonfinancial firms continues to be light, initial public offerings by closed-end funds have been sizable and four bank holding companies have issued a total of \$710 million in preferred stock over the past two months as part of their efforts to meet new capital requirements.

#### Treasury and Sponsored Agency Financing

The staff expects the fourth-quarter federal budget deficit to mount to \$68 billion, almost double that posted last quarter. It is anticipated that this widening of the deficit will be financed by an unusually large, more than \$20 billion, drawdown of the Treasury's cash balance, while the further pickup in government borrowing is relatively small. Marketable borrowing is expected to rise about \$4 billion from the third-quarter level. Nonmarketable borrowing also is likely to increase somewhat, reflecting stronger issuance of SLGS associated with an earlier pickup in municipal bond offerings. "Other borrowing" is likely to be about unchanged as issuance of FSLIC notes, which slumped in October, is expected to accelerate before year-end, owing to the tax incentives to complete resolutions by that time.<sup>4</sup>

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4. The Technical and Miscellaneous Revenue Act requires that, after December 31, 1988, the amount of losses and interest expense on the books of acquired insolvent thrifts that acquiring institutions may carry over to their own books be reduced to 50 percent of the value of tax-free FSLIC assistance.

TREASURY AND AGENCY FINANCING<sup>1</sup>  
(Total for period; billions of dollars)

	1988		1988		
	Q3	Q4 <sup>e</sup>	Oct.	Nov. <sup>P</sup>	Dec. <sup>e</sup>
<u>Treasury financing</u>					
Total surplus/deficit (-)	-35.8	-68.7	-27.4	-27.1	-14.1
Means of financing deficit:					
Net cash borrowing from the public	41.7	47.7	10.7	30.4	6.6
Marketable borrowings/ repayments (-)	32.8	37.0	8.0	26.6	2.4
Bills	16.2	15.8	5.2	16.0	-5.4
Coupons	16.7	21.2	2.8	10.6	7.8
Nonmarketable <sup>2</sup>	3.8	5.8	2.2	2.8	.8
Other borrowing <sup>2</sup>	5.0	4.9	.4	1.0	3.5
Decrease in the cash balance	-4.8	22.0	13.8	9.2	-1.0
Memo: Cash balance at end of period	44.4	22.4	30.6	21.4	22.4
Other <sup>3</sup>	-1.1	-1.0	3.0	-12.5	8.5
<u>Federally sponsored credit agencies, net cash borrowing<sup>4</sup></u>					
FHLBs	8.2	--	1.1 <sup>P</sup>	--	--
FNMA	1.2	--	-.3	--	--
Farm Credit Banks	-1.7	--	.2	--	--
FAC <sup>5</sup>	.5	--	.0	.2	--
FHLMC	.7	--	.2 <sup>P</sup>	--	--
FICO	.9	--	.0	.7	--
SLMA	.7	--	.1 <sup>P</sup>	--	--

1. Data reported on a not seasonally adjusted, payment basis.

2. Securities issued by federal agencies under special financing authorities (primarily FSLIC).

3. Includes checks issued less checks paid, accrued items and other transactions.

4. Excludes mortgage pass-through securities issued by FNMA and FHLMC.

5. Financial Assistance Corporation, an institution within Farm Credit System, was created in January 1988 by Congress to provide financial assistance to Farm Credit Banks. It first issued bonds in July 1988.

e--staff estimate.

p--preliminary.

Note: Details may not add to totals due to rounding.

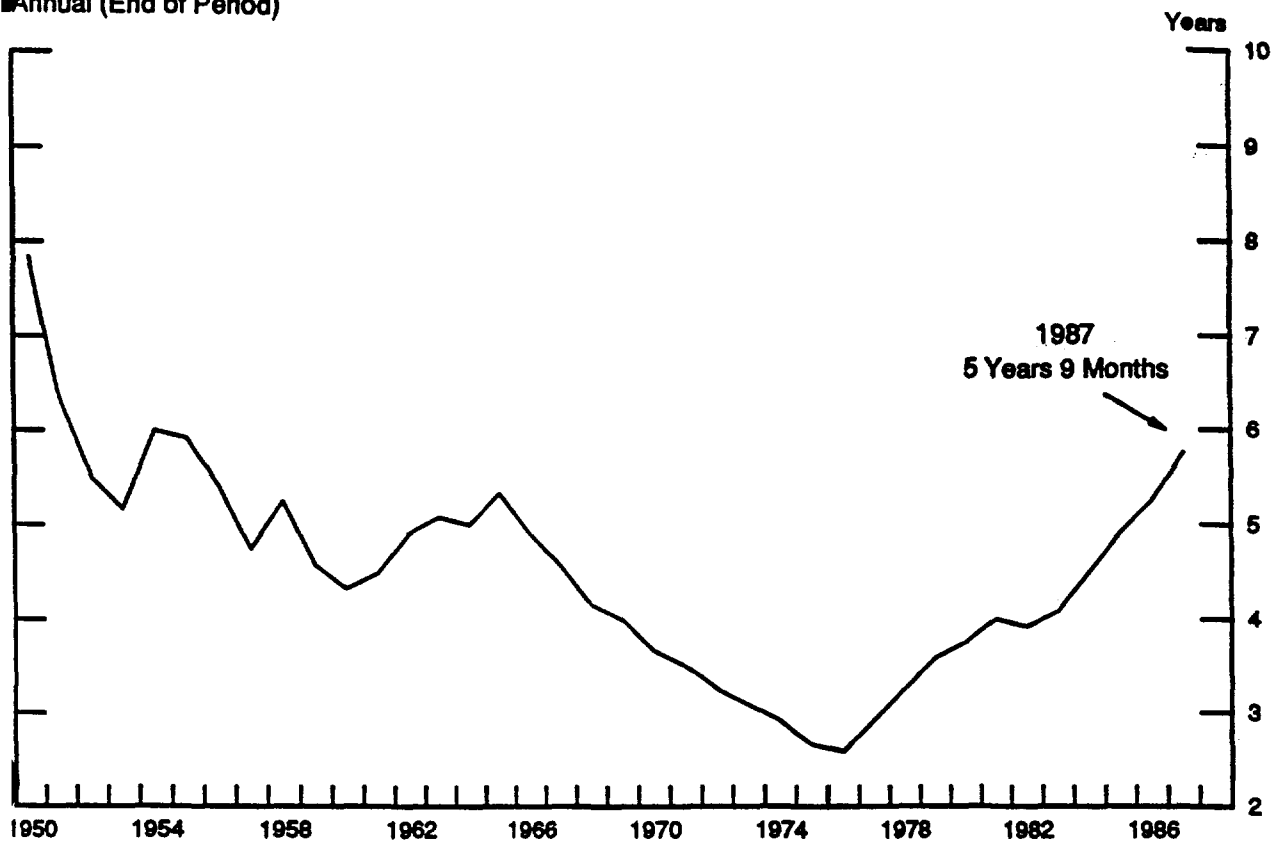
Since the end of the second quarter, the gross size of weekly bill auctions has been increased four times. The rise in bill issuance has contributed to some upward pressure on bill rates over this period and, in conjunction with the cancellation of the bond auction in August, led to a stalling out in the upward trend in the average maturity of privately held marketable Treasury debt (see chart on page III-14). However, with the signing into law in early November of the Technical and Miscellaneous Revenue Act, which rescinded the limit on the Treasury's long-bond authority, coupon auctions during the fourth quarter are expected to raise about \$5 billion more than in the third quarter.

The unusually narrow spread between rates on 30-year bonds and 10-year notes was little affected by the delayed auction of \$9 billion in 30-year bonds late in November. Possibly contributing to the narrowness of this spread has been the robust demand for stripped securities. At the end of October, roughly 42 percent of outstanding 30-year bonds was held in stripped form, compared with 27 percent a year ago, an increase of roughly \$20 billion.

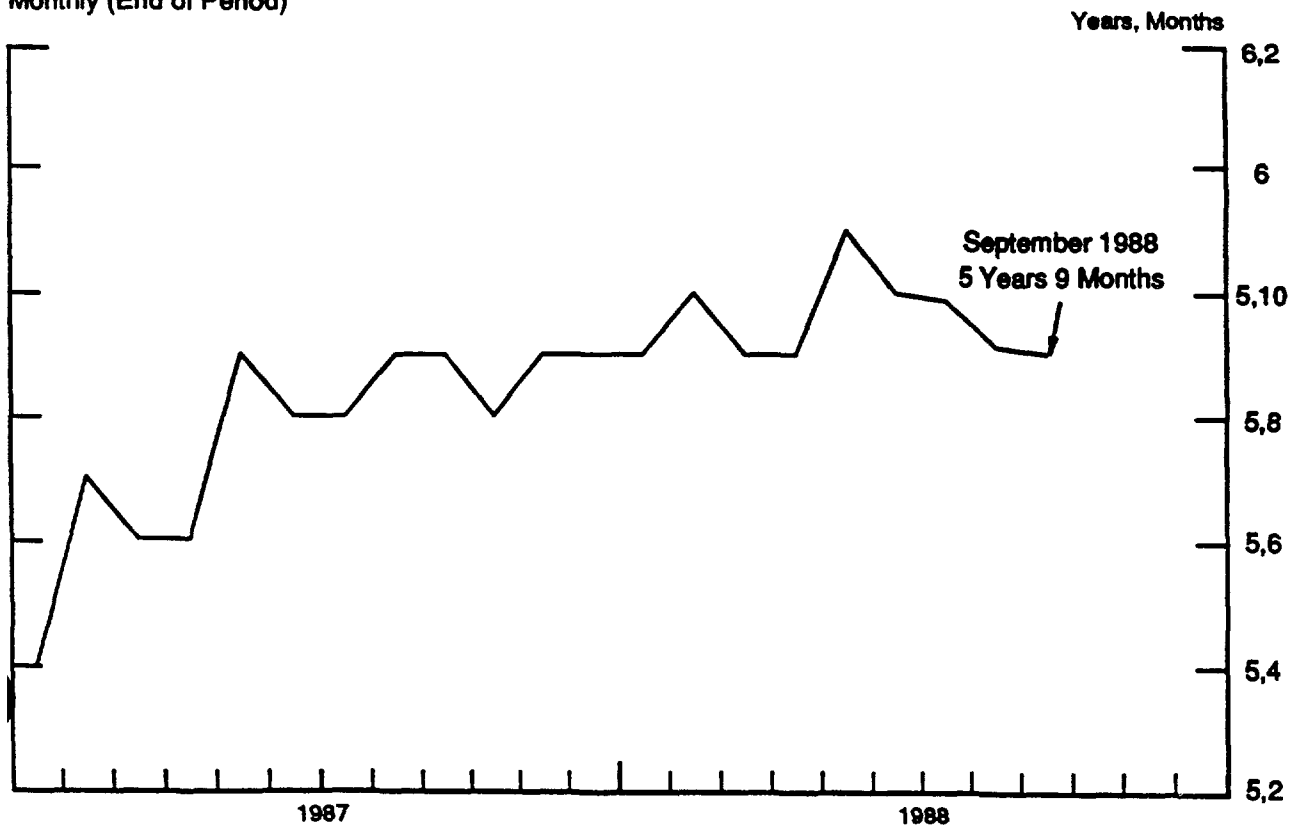
Since midyear, the Federal Home Loan Banks have raised an estimated \$9 billion of new funds, accounting for 80 percent of all borrowing by sponsored agencies, in order to meet a strong demand for advances by member institutions. Despite the heavy issuance and continued adverse publicity about the thrift industry, yields on FHLB issues relative to those on Treasury securities increased only slightly

### Average Maturity of Marketable Treasury Debt Privately Held\*

■ Annual (End of Period)



Monthly (End of Period)



\*-Excludes holdings by Federal Reserve and other U.S. agencies.

during the third quarter. In part, this may reflect an overall slowing in credit demands by other agencies over that period.

### Municipal Securities

Gross new issues of long-term tax-exempt securities totaled about \$9 billion in November, a decline from October's pace. Most of the slowdown followed a midmonth increase in interest rates that resulted in a substantial drop in issuance of refunding bonds; new capital offerings, which are less sensitive to interest rate movements, equaled October's volume.

GROSS OFFERINGS OF MUNICIPAL SECURITIES  
(Monthly rates, not seasonally adjusted, billions of dollars)

	1986	1987	1988			1988		
	Year	Year	Q1	Q2	Q3	Sept.	Oct. <sup>p</sup>	Nov. <sup>f</sup>
Total offerings <sup>1</sup>	14.39	10.44	8.68	11.73	11.52	10.21	10.96	10.30
Total tax-exempt	14.04	10.05	8.46	11.41	11.32	9.86	10.94	9.90
Long-term <sup>2</sup>	12.25	8.53	7.94	9.20	8.80	9.67	10.05	9.00
Refundings <sup>2</sup>	5.29	3.80	3.05	3.18	1.87	2.59	3.29	2.20
New capital <sup>3</sup>	6.96	4.73	4.89	6.02	6.93	7.08	6.76	6.80
Short-term <sup>3</sup>	1.79	1.52	.52	2.21	2.52	.64	.89	.90
Total taxable	.35	.39	.22	.32	.20	.36	.02	.40

p--preliminary. f--staff forecast.

1. Includes issues for public and private purposes; also includes taxable issues.

2. Includes all refunding bonds, not just advance refundings.

3. Does not include tax-exempt commercial paper.

Nearly \$210 billion of industrial development bonds backed by corporations, but issued by municipalities prior to the imposition of restrictions in the Tax Reform Act of 1986, has been adversely affected by greater corporate leveraging. Prices of other tax-exempt bonds, on the other hand, generally fared better immediately after the RJR

announcement than federal government and some corporate bonds, although this improvement subsequently disappeared.

Los Angeles County announced plans to place privately with Japanese institutional investors \$100 million in 10-year taxable bonds denominated in yen. This unusual financing should further open international markets to state and local governments. The program is aimed entirely at earning arbitrage profits, earmarked for a county employee pension fund. The proceeds will be reinvested in high-yield securities, including dollar-denominated foreign securities; a series of foreign currency swaps is being used to reduce foreign exchange risk.

#### Mortgage Markets

Despite a rise in interest rates that began in March, growth in total mortgage debt outstanding picked up in the third quarter from the comparatively moderate second-quarter pace, though it ran behind the average quarterly pace of the past few years.

Much of the growth of residential mortgage debt in the third quarter and continuing through October, was associated with larger net acquisitions of mortgage-related assets by FSLIC-insured thrifts. Virtually all of the whole mortgage loans acquired by thrifts in the third quarter featured adjustable rates, as these institutions continued to sell fixed-rate mortgages outright or to swap them for agency-backed pass-throughs, which can be funded less expensively through repurchase agreements.

The strength in mortgage growth at thrifts partly reflects borrower preference for ARMs. The ARM share of newly originated mortgage loans has edged up despite some recent narrowing of the spread between fixed-rate mortgages and ARMs. ARMs have accounted for more than 70 percent of loans originated at FSLIC-insured thrifts in recent months, while a lesser share of loans closed at commercial banks and mortgage companies have been ARMs.

The strength in home lending activity in the third quarter, and thrift activity in particular, may reflect robust sales of homes--especially in the western United States, as institutions in California, Arizona, and Nevada have accounted for more than half of all thrift mortgage originations in recent months. The monthly volume of mortgage loans closed at FSLIC-insured institutions in the third quarter was 12 percent above the average for the first half of the year. Loan originations at thrifts subsequently backed down in October.

Because of the large ARM share of conventional home loans closed, and the limited scale of ARM securitization, issuance of federally related pass-through securities continues to run well below the average monthly pace of the past two years. Issuance of these securities totaled a seasonally adjusted \$13.5 billion in September, about unchanged from the August level.

While pass-through issuance has been flat in recent months, Freddie Mac and Fannie Mae have stepped up issuance of multiclass mortgage-backed securities. The heightened demand for collateral for multiclass mortgage securities, given the limited mortgage supply, continues to be

MORTGAGE ACTIVITY AT ALL FSLIC-INSURED INSTITUTIONS  
(Monthly averages, billions of dollars, seasonally adjusted)

	Mortgage transactions			Net change in <sup>1</sup> mortgage assets		
	Origina- tions	Commit- ments	Sales	Total	Mortgage loans	Mortgage- backed securities
1985	16.4	14.9	8.2	4.1	4.2	-.2
1986	22.1	19.8	14.1	4.7	1.3	3.4
1987	21.1	20.1	10.3	6.1	2.4	3.7
1988-Q1	18.6	17.8	7.7	2.6	3.6	-.9
Q2	19.7	19.1	10.1	5.7	3.3	2.4
Q3 r	21.5	20.8	8.7	6.1	5.1	1.0
1988-Apr.	18.7	17.7	10.4	6.0	2.7	3.2
May	19.5	19.0	9.4	5.1	3.6	1.5
June r	21.0	20.5	10.4	6.2	3.7	2.4
July r	19.8	18.8	8.9	6.6	4.4	2.1
Aug. r	22.8	22.7	8.2	7.9	7.5	.4
Sept. r	21.9	20.9	9.1	3.8	3.4	.4
Oct. p	18.6	18.8	8.4	5.7	5.4	.4

1. Net changes are adjusted to account for structural changes caused by mergers, acquisitions, liquidations, terminations, or de novo institutions.

NEW ISSUES OF MORTGAGE-BACKED PASS-THROUGH SECURITIES  
BY FEDERALLY RELATED AGENCIES  
(Monthly averages, billions of dollars)

Period	Seasonally adjusted				Not seasonally adjusted	
	Total	GNMAs	FHLMCs	FNMA's	Total	ARM-backed
1985	9.0	3.8	3.2	2.0	9.0	.3
1986	21.6	8.2	8.3	5.0	21.6	.7
1987	19.6	8.1	6.3	5.3	19.6	1.2
1988-Q1	9.4	3.7	2.6	3.1	8.5	.9
Q2	13.1	4.4	3.0	5.8	12.5	3.0
Q3	13.5	5.8	3.5	4.3	14.9	3.0
1988-Apr.	12.9	3.4	3.1	6.4	11.0	3.0
May	11.9	4.2	2.4	5.2	11.1	2.3
June	14.7	5.6	3.4	5.7	15.4	3.8
July r	13.5	5.7	3.5	4.3	15.3	1.6
Aug. r	13.6	5.9	3.8	3.9	14.3	2.8
Sept. r	13.5	5.8	3.1	4.6	15.0	4.5
Oct. p	n.a.	n.a.	3.5	5.1	n.a.	n.a.

r--revised. p--preliminary. n.a.--not available.



reflected in narrow rate spreads between mortgage products and Treasury securities. This spread also has been kept down by lower interest rate volatility, which lessens the likelihood that the mortgage borrower's prepayment option will be exercised, and by the takeover-related developments in the market for corporate securities.

In the primary mortgage market, the average contract rate on new commitments for 30-year, fixed-rate conventional home loans has increased 22 basis points over the intermeeting period and the average initial rate quoted on ARMs indexed to the one-year constant maturity Treasury yield has risen only 13 basis points. Lenders tend to increase the initial discounts offered on ARMs in periods of rising rates, in some cases recouping the lost income through increased points.

#### Consumer Installment Credit

Consumer installment credit expanded at a 6-1/2 percent seasonally adjusted annual rate during October, following a flat September and a 10 percent rate of increase in August. The sharp month-to-month swings between August and October partly reflect cessation this year of large-scale automobile incentive programs of the type that had been in place in each of the previous three years and had been built into seasonal adjustment factors. As a result, seasonally adjusted auto credit contracted at a 3-1/3 percent rate in September but expanded at a 5-1/2 percent pace in October. Revolving credit--the fastest growing component this year--also strengthened substantially in October from a slow September.

CONSUMER CREDIT  
(Seasonally adjusted)

	Percent change (at annual rate)						Net change (billions of dollars)		Memo: Outstandings (billions of dollars)
	1986	1987	1988		1988		1988		1988
			Q2	Q3 <sup>r</sup>	Sept. <sup>r</sup>	Oct. <sup>p</sup>	Sept. <sup>p</sup>	Oct. <sup>p</sup>	Oct. <sup>p</sup>
Total installment <sup>1</sup>	10.4	7.2	9.5	5.6	.0	6.5	.00	3.56	656.9
Installment, excluding auto	5.7	6.2	10.7	7.1	2.5	7.3	.78	2.24	370.8
Selected types									
Auto	17.4	8.6	7.9	3.6	-3.3	5.6	-.78	1.32	286.1
Revolving	11.8	16.8	17.3	13.6	7.5	14.5	1.11	2.17	180.8
All other	1.7	-1.5	4.8	1.2	-2.1	.5	-.33	.08	189.9
Selected holders									
Commercial banks	8.5	7.4	13.0	11.6	7.2	15.2	1.84	3.91	312.9
Finance companies	20.4	4.8	1.9	-5.6	-10.3	-2.0	-1.24	-.24	142.5
Credit unions	5.9	6.4	11.2	3.0	-4.6	3.2	-.33	.23	85.8
Savings institutions <sup>2</sup>	14.5	12.4	13.5	7.1	-7.8	-10.8	-.45	-.62	67.8
Memorandum:									
Total <sup>3</sup>	9.0	6.1	7.6	4.5	-.2	4.1	-.23	2.44	723.3

1. Includes items not shown separately.

2. Savings and loans, mutual savings banks, and federal savings banks.

3. Installment plus noninstallment.

r--revised. p--preliminary.

Note: Details may not add to totals due to rounding.

CONSUMER INTEREST RATES  
(Annual percentage rate)

	1985	1986	1987	1988				
				May	Aug.	Sept.	Oct.	Nov.
At commercial banks <sup>1</sup>								
New cars (48 mo.)	12.91	11.33	10.46	10.55	10.93	...	...	11.22
Personal (24 mo.)	15.94	14.83	14.23	14.40	14.81	...	...	15.06
Credit cards	18.69	18.26	17.92	17.78	17.79	...	...	17.77
At auto finance cos. <sup>2</sup>								
New cars	11.98	9.44	10.73	12.29	12.64	12.93	13.10	...
Used cars	17.59	15.95	14.61	14.81	15.16	15.46	15.67	...

1. Average of "most common" rate charged for specified type and maturity during the first week of the mid-month of each quarter.

2. Average rate for all loans of each type made during the month regardless of maturity.

Interest rates on most types of consumer loans have risen in recent months. Rates on new-car loans at auto finance companies in October averaged above 13 percent, up nearly one percentage point from their level last spring. Finance rates at banks on both new-car and personal loans rose about 70 basis points between early May and early November. Rates on credit cards, however, which had declined much less than other consumer rates earlier in the expansion, edged down slightly over the same time span.

As it had the previous quarter, the delinquency rate on credit card accounts at commercial banks declined fairly sharply in the July to September period. Delinquencies on various types of closed-end loans were mixed, however. A decline in past due auto loans partly offset higher delinquencies on personal and mobile home loans, and the overall average for the closed-end categories was up moderately. The proportion of delinquent car loans at the auto finance companies was virtually unchanged during the third quarter. Most of these series are around the middle of their ranges of the past 15 years.

DELINQUENCY RATES ON CONSUMER INSTALLMENT LOANS AT BANKS  
(Number delinquent 30 days or more as percent of number of loans  
outstanding, seasonally adjusted)

	1986	1987	1988		1988	
			Q2	Q3	Aug.	Sept.
All closed-end loans <sup>1</sup>	2.34	2.42	2.32	2.42	2.38	2.42
Auto - direct	1.75	1.78	1.89	1.81	1.81	1.77
Auto - indirect	2.08	2.22	2.28	2.30	2.23	2.31
Personal, home goods	3.46	3.35	3.17	3.31	3.31	3.28
Mobile home	3.06	3.05	2.53	2.67	2.70	2.63
Property improvement	1.85	2.09	1.99	1.93	1.90	1.92
Credit cards <sup>2</sup>	3.13	2.36	2.39	2.21	2.22	2.14

1. Weighted average of separate categories, excluding credit cards.
2. Discontinuity exists in credit card series between 1986 and 1987.

## APPENDIX<sup>1</sup>

### GROWTH OF MONEY AND CREDIT IN 1988

Money growth has been moderate but uneven over the course of 1988, with the monetary aggregates expanding rapidly in the first part of the year and slowing thereafter. The pattern of M1 and M2 growth this year has reflected variations in interest rates and opportunity costs. Initially, the decline in market interest rates after the October 1987 stock market crash buoyed money growth; however, the demand for monetary assets has been damped since the spring by the climb in market rates that began in the first quarter of this year. On balance, M1 grew at a 4 percent rate from the fourth quarter of 1987 through November of this year, down from last year's 6-1/4 percent rate. M2 expanded at a 5-1/2 percent rate, up from 4 percent in 1987; this growth placed M2 in the lower half of its 1988 annual target range of 4 to 8 percent.

Variation in M3 growth during 1988 mirrored trends in bank and thrift credit, which posted stronger growth over the first half the year. After expanding 5-1/2 percent in 1987, M3 remained close to the top of its 4 to 8 percent target cone through July. The subsequent slowdown, however, accompanying a moderation in bank and thrift credit growth, left the aggregate only slightly above the midpoint of its range and resulted in 6-1/2 percent growth through November.

In contrast to the monetary aggregates, domestic nonfinancial sector debt grew at a fairly steady pace of 8-1/2 percent from the last quarter of 1987 through October of this year, which placed it slightly below the midpoint of its monitoring range of 7 to 11 percent. This year's rate of debt expansion was down from nearly 10 percent in 1987 and well below the pace of other recent years, as growth in both private and government credit demands receded.

#### M1

M1 growth for 1988 is likely to be the slowest in almost 20 years. Velocity, which began to increase in 1987, rose at roughly a 2 percent annual rate over the first three quarters of 1988 and is expected to rise further in the fourth quarter. M1 expanded on balance at nearly a 6 percent pace over the first seven months of the year, although month-to-month swings in its growth were quite large during this period. The lower interest rates early in the year and strong income growth boosted demands for money. Since July, however, M1 has increased very little, mostly because of the effects of higher market interest rates.

With regard to the components of M1, growth in other checkable deposits remained strong through midyear. Their opportunity costs had narrowed appreciably after the stock market crash, boosting demand for

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1. Prepared by John Rea, Economist, Banking and Money Market Section, Division of Monetary Affairs.

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MONETARY AND CREDIT AGGREGATES  
(Q4 to Q4 averages, seasonally adjusted unless noted otherwise)

Growth rates or flows	1984	1985	1986	1987	1988 <sup>1</sup>	Levels in billions of dollars <sup>1</sup>
Growth rates (percent)						
M1	5.3	12.0	15.6	6.2	4.0	783.7
M2	7.6	8.9	9.4	4.0	5.4	3053.9
M3	10.4	7.7	9.1	5.4	6.4	3888.9
Domestic nonfinancial debt	14.3	13.2	13.3	9.8	8.4	8849.5
Bank credit	11.1	10.2	9.9	7.9	7.3	2397.1
Thrift credit	16.5	9.8	9.8	8.1	7.7	1794.1
Flows (\$ billions)						
M1						
Currency	10.2	11.5	12.4	15.6	15.4	210.3
Demand deposits	3.1	21.3	31.1	-2.9	-5.0	286.7
Other checkable deposits	13.9	32.0	51.8	31.1	19.5	279.2
M2						
Nontransaction M2	137.7	141.5	143.3	67.5	126.1	2270.2
MMDAs (NSA)	28.7	105.0	59.3	-40.3	-23.1	505.8
Savings deposits	-21.3	12.9	62.3	53.2	18.8	434.2
Small time deposits	104.5	-1.3	-18.2	40.5	119.8	1019.2
General purpose and broker/dealer money market mutual fund assets (NSA)	23.5	15.1	30.8	12.1	18.5	238.2
Overnight RPs, net (NSA)	2.1	7.5	6.8	4.4	-1.8	61.5
Overnight Eurodollars, net (NSA)	0.4	3.6	4.0	-1.3	-6.3	11.5
M3						
Non-M2 component	113.5	20.9	51.6	76.6	76.1	835.0
Institution-only money market mutual fund assets (NSA)	14.5	6.4	20.6	2.5	-0.1	87.1
Large time deposits	92.1	21.0	7.6	37.7	52.2	531.4
Term RPs, net (NSA)	17.3	-2.6	19.9	27.2	17.4	127.2
Term Eurodollars, net (NSA)	-7.6	-4.1	3.4	11.2	9.4	101.6

1. Data for monetary aggregates and bank credit for 1988 are through November; those for domestic nonfinancial debt are through October; and those for thrift credit are through the third quarter.

these deposits. But the effects of the climb in market interest rates began to depress OCD growth by midsummer, especially as the higher rates were reflected fairly promptly in yields on time deposits. As a result, OCDs rose at only a 1 percent rate from July to November.

Although demand deposits in 1988 increased sharply at times because of special factors such as tax payments, on the whole, these deposits declined at a pace that exceeded last year's runoff. In fact, they were considerably weaker than would have been expected from past relationships to interest rates and income, perhaps owing to a greater business share of these deposits resulting from household shifts to NOW accounts and to an accelerated movement by corporations toward the use of fees, rather than compensating balances, to pay for bank services.

Although currency growth slowed a bit from last year's brisk pace, it nonetheless remained surprisingly rapid, outpacing the overall growth of consumption spending.

#### M2

M2 growth averaged a strong 9 percent rate over the first four months of the year before tapering off to as low as 1 percent in September and October, a pattern shaped generally by changes in the aggregate's opportunity cost. More recently, M2 growth has rebounded somewhat from its very slow pace earlier in the fall. Reflecting the increase in market interest rates, M2 velocity rose, on balance, over the first three quarters of the year and is likely to advance further in the current quarter.

Interest rates affected not only the overall movement of M2 but also its composition, especially among retail-type deposits. Early in the year, slow adjustment of deposit offering rates, especially those on more liquid accounts, contributed to the extremely rapid growth in small time deposits and enabled liquid deposits--MMDAs plus savings deposits plus OCDs--to post solid gains. As market interest rates began to rise in the spring, growth in these deposits slowed. The slowdown in the growth of small time deposits was less pronounced, however, because yields on retail CDs tend to adjust more quickly than yields on liquid deposits to changes in market rates. Small time deposits thus opened up a sizable rate advantage over liquid deposits by midsummer, encouraging households to shift funds from liquid deposits to retail CDs.

During the year, the growth of small time deposits at banks began to noticeably exceed their growth at thrift institutions. In the past, small time deposit growth at thrifts has been above that at banks, as thrifts typically offered a significant yield premium, and this relationship continued to prevail through the first half of this year. Since then, however, the relationship has reversed, partly in response to a narrowing of the spread between retail CD rates at thrifts and at banks. This new pricing development has been attributed to the closing of a number of insolvent saving and loan associations that had been very

aggressive in pricing these accounts and to pressure from the Federal Home Loan Bank Board on other thrifts to limit their offering rates.

General purpose and broker/dealer money market mutual funds also contributed to the variation in M2 growth during 1988. The growth of assets was exceptionally strong in the first quarter, as yields on money funds fell more slowly than those on Treasury bills. However, with market rates moving up over the remainder of the year, money funds experienced outflows in some months and, on balance, showed very little growth.

Overnight RPs and Eurodollars were subject to large monthly changes, but on the whole, they declined significantly during the year. The reasons for this weakness are not clear, but substantial core deposit growth allowed banks to bid less aggressively for nondeposit sources of funds, especially overnight funds. The downward movement, most of which occurred in the second half of the year,<sup>2</sup> contributed to slower M2 growth over that period.

### M3

M3 growth in 1988 has been more closely aligned with the growth of credit at banks and thrifts than it was in 1987, as these institutions have relied to a lesser extent this year on non-M3 sources of funds. During the first half of 1988, M3 grew at a rate only slightly below the 7-3/4 percent expansion in bank and thrift credit. Rapid growth in institution-only money market mutual funds during the first quarter also boosted M3. The growth of large time deposits, however, was relatively slow, as core deposits provided institutions with funds to support their lending activities.

The drop in M3 growth since midyear came in the context of a slowdown in the expansion of most major loan and investment activities at banks. M3 growth was further restrained by large increases in advances from Federal Home Loan Banks to thrift institutions and by substantial inflows to banks of U.S. government balances during September and October. Despite the slower growth in bank credit since mid year, banks stepped up their issuance of large time deposits during the third quarter to offset partially a slowdown in core deposit growth.

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2. Overnight and term RPs were reduced to some extent by several banks shifting the operations of their government securities dealers to nonbank subsidiaries of their holding companies. This action was probably taken in response to decisions made by the Federal Reserve Board permitting bank holding company subsidiaries to underwrite certain previously prohibited private and municipal securities, provided that this activity does not exceed 5 percent of the subsidiary's business. Since these subsidiaries are not depository institutions, their RPs are excluded from M2 and M3. Thus far, the impact of these shifts on the aggregates has been negligible.

Domestic Nonfinancial Sector Debt

Although the growth of domestic nonfinancial sector debt slowed in 1988, as it had in 1987, it still exceeded the growth of nominal GNP. The federal sector's demand for credit abated slightly, as the deficit narrowed on a calendar-year basis. More important to the overall slowdown in debt growth, however, was the decline in debt expansion in other sectors; the growth of credit demand outside the federal sector fell to an 8-1/2 percent annual rate from the fourth quarter of last year through October 1988, down from 10 percent in 1987. This slowdown occurred in borrowing by state and local governments and in mortgage borrowing by households, which was restrained by higher interest rates. Consumer credit rose at about the same rate as last year, which was well below the extremely rapid rates of the mid-1980s. Business credit also grew at about last year's pace; within this sector, corporate borrowing increased sharply, as the financing gap widened and as mergers, buyouts, and share repurchases led to large retirements of equity. Corporate demand for credit weakened in the third quarter, in reflection of higher interest rates and a reduced pace of equity retirements, but corporate borrowing should strengthen late in the current quarter given the sizable leveraged acquisitions and buyouts that have occurred recently or will be completed in coming weeks.



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# **INTERNATIONAL DEVELOPMENTS**

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INTERNATIONAL DEVELOPMENTS

U.S. Merchandise Trade

The merchandise trade deficit for September narrowed to a monthly rate of \$10.5 billion on a seasonally adjusted CIF basis from the August deficit of \$12.3 billion. Valued on a customs basis, which excludes insurance and freight charges from imports, the deficit was \$9.0 billion in September compared with \$10.6 billion in August. Exports continued to grow in September, with increases recorded in industrial supplies, capital goods, and consumer goods. About one-third of the decrease in September imports was due to a fall in the value of oil imports, as both the volume and the price of imported oil declined from August levels. Declines in non-oil imports were widespread across major trade categories, as only the value of automotive products increased in September.

U.S. MERCHANDISE TRADE: MONTHLY DATA  
(Billions of dollars, seasonally adjusted, Census basis)

	Exports	Imports		Balance	
		CIF	Customs	CIF	Customs
1988-Jan	24.5	35.8	34.3	-11.3	-9.8
Feb	24.5	38.9	37.7	-14.4	-13.2
Mar	26.9	38.6	36.6	-11.7	-9.8
Apr	26.0	36.3	34.8	-10.3	-8.8
May	27.5	37.2	35.7	-9.8	-8.3
Jun	26.3	39.5	37.9	-13.2	-11.7
Jul <sup>r</sup>	26.5	36.0	34.5	-9.5	-8.0
Aug <sup>r</sup>	27.5	39.8	38.1	-12.3	-10.6
Sep <sup>p</sup>	28.2	38.7	37.2	-10.5	-9.0

r -revised  
p -preliminary

On a balance-of-payments basis, the trade deficit continued to improve in the third quarter, registering a deficit of \$114 billion (at a seasonally adjusted annual rate), reflecting higher prices for agricultural exports and lower prices for oil imports. In real terms, the third-quarter deficit was little changed from the second-quarter level.

U.S. MERCHANDISE TRADE: BOP BASIS  
(Billions of dollars, seasonally adjusted annual rates)

	Exports			Imports			Balance
	Total	Ag.	Nonag.	Total	Oil	Non-oil	
1985	216	30	186	338	50	288	-122
1986	224	27	197	369	34	335	-144
1987	250	30	220	410	43	367	-160
1986-1	216	29	188	358	42	317	-142
-2	228	26	202	363	31	332	-135
-3	225	27	199	372	32	340	-147
-4	227	28	199	381	32	348	-154
1987-1	227	26	201	387	35	352	-159
-2	239	28	211	398	40	357	-158
-3	260	33	226	418	51	367	-159
-4	272	31	242	437	45	392	-165
1988-1	301	36	265	442	40	402	-141
-2	318	39	280	439	41	398	-121
-3	329	42	287	443	40	404	-114
- - - - - Constant 1982 Dollars - - - - -							
1987-1	249	31	218	417	70	347	-168
-2	263	34	230	421	72	349	-158
-3	286	40	246	446	88	358	-160
-4	299	35	264	460	81	379	-161
1988-1	328	39	289	463	82	381	-135
2	339	40	299	458	85	373	-119
3	344	38	306	466	87	379	-122

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

The value of total exports rose 3-1/2 percent in the third quarter, somewhat less than in previous quarters. Since the third quarter of last year, the value of exports has increased almost 27 percent; three-quarters of this gain has been in volume terms. The volume of nonagricultural exports increased almost 25 percent over the past year; but, volume rose only 2 percent in the third quarter, with increases in exports of capital goods and consumer goods. The value of agricultural exports increased by almost 8 percent in the third quarter, reflecting a sharp increase in the prices of agricultural commodities, which was offset somewhat by a decline in the volume. Export prices for wheat, corn, and soybeans continued to increase because of the drought in the United States.

IMPORT AND EXPORT PRICE MEASURES  
(percentage change from previous period, annual rates)

	1987		1988			1988Q3
	Q3	Q4	Q1	Q2	Q3	1987Q3
- - - - Prices in the GNP Accounts - - - -						
Fixed-Weighted						
Exports, Total	3.7	3.3	8.7	8.1	13.4	8.3
Imports, Total	7.4	4.7	3.3	6.3	-0.4	3.4
Imports, Non-oil	6.0	8.7	12.8	7.5	2.8	7.9
Deflators						
Exports, Total	-0.7	0.1	2.6	9.2	9.7	5.3
Imports, Total	-3.2	5.2	1.6	1.4	-1.7	1.6
Imports, Non-oil	-0.0	3.8	8.1	4.1	0.6	4.1

The volume of non-oil imports increased somewhat in the third quarter but has been fairly flat since the fourth quarter of last year. In the third quarter, strong increases in the quantity of imported computers, peripherals and parts, as well as consumer goods were

outweighed by declines in nonmonetary gold and aircraft. Prices of non-oil imports on a GNP fixed-weight basis increased about 3 percent at an annual rate, less than in recent quarters, reflecting the appreciation of the dollar between June and August.

The value of oil imports fell about 3-1/2 percent in the third quarter, as substantial declines in the price of imported oil outweighed a small increase in oil import volume. In September, the average price of imported oil was \$13.69 per barrel, a decline of about \$1.80 per barrel from the May peak. Prices of imported oil are estimated to have declined further in October and November, by a total of about \$1.00 per barrel, as OPEC members continued to produce well in excess of quota. The quantity of oil imported appears to have risen in both October and November, largely reflected in an increase in oil inventories.

IMPORTS OF PETROLEUM AND PRODUCTS  
(BOP basis, seasonally adjusted, value at annual rates)

	Year	1987		1988			
		Q3	Q4	Q1	Q2	Q3	Sep
Value (Bil. \$)	42.88	51.04	45.15	39.82	41.02	39.50	37.45
Price (\$/BBL)	17.33	18.26	17.46	15.23	15.16	14.22	13.69
Volume (mbd.)	6.78	7.66	7.08	7.14	7.39	7.59	7.47

U.S. International Financial Transactions

U.S. banks reported a substantial net outflow in September of \$8.4 billion, primarily through transactions with their own foreign offices. (See line 1 of the Summary of International Transactions Table.) This outflow was associated with a decline in the level of U.S. commercial bank credit in that month. According to the monthly average banking

IV-5  
SUMMARY OF U.S. INTERNATIONAL TRANSACTIONS  
(Billions of dollars)

	1986	1987	1987		1988					
	Year	Year	Q3	Q4	Q1	Q2	Q3	July	Aug.	Sept.
<b>Private Capital</b>										
<b>Banks</b>										
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	22.3	47.8	30.8	11.0	-2.6	15.5	-5.2	2.9	3.9	-8.4
<b>Securities</b>										
2. Private securities transactions, net <1>	65.9	36.6	11.5	-6.9	-2.1	11.2	8.3	3.5	1.7	1.1
a) foreign net purchases (+) of U.S. corporate bonds	53.5	26.4	7.5	2.8	2.6	9.0	7.0	3.3	1.8	2.0
b) foreign net purchases (+) of U.S. corporate stocks	18.0	16.8	5.4	-7.4	*	1.0	1.2	1.0	0.6	-0.4
c) U.S. net purchases (-) of foreign securities	-5.5	-6.7	-1.5	-2.3	-4.8	1.2	-2.0	-0.8	-0.6	-0.6
3. Foreign net purchases (+) of U.S. Treasury obligations	4.0	-7.3	-2.8	0.5	-7.0	5.6	3.4	2.9	0.6	-0.1
<b>Official Capital</b>										
4. Changes in foreign official reserves assets in U.S. (+ = increase)	33.5	47.7	0.9	19.8	24.8	6.5	-2.5	-0.1	-0.8	-1.7
a) By area										
G-10 countries (incl. Switz.)	30.8	38.8	-5.7	15.6	17.7	-0.8	-6.4	-1.8	-3.6	-1.1
OPEC	-8.3	-8.9	-1.3	-2.8	-1.6	-1.6	-0.8	-0.1	-0.4	-0.4
All other countries	10.8	17.8	7.9	7.1	8.7	8.9	4.7	1.8	3.2	-0.3
b) By type										
U.S. Treasury securities	34.4	43.2	0.8	19.1	27.7	5.9	-3.7	-1.0	-1.4	-1.3
Other <2>	-1.0	4.5	0.1	0.7	-2.9	0.7	1.2	0.1	0.6	-0.4
5. Changes in U.S. official reserve assets (+ = decrease)	0.3	9.1	*	3.7	1.5	*	-7.4	-3.4	-4.1	0.1
<b>Other transactions (Quarterly data)</b>										
6. U.S. direct investment (-) abroad <4>	-27.8	-44.5	-7.9	-19.7	-6.4	-0.1	n.a.	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S. <4>	34.1	42.0	15.0	11.7	7.3	13.4	n.a.	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) <3> <4>	-9.1	4.1	-1.1	-2.9	3.1	-3.1	n.a.	n.a.	n.a.	n.a.
9. U.S. current account balance <4>	-138.8	-154.0	-42.0	-33.5	-36.9	-33.3	n.a.	n.a.	n.a.	n.a.
10. Statistical discrepancy <4>	15.6	18.5	-4.4	16.3	4.3	-15.7	n.a.	n.a.	n.a.	n.a.
<b>MEMO:</b>										
U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)	-144.5	-160.3	-39.7	-41.2	-35.2	-29.9	n.a.	n.a.	n.a.	n.a.

<1> These data have not been adjusted to exclude commissions on securities transactions and therefore, do not match exactly the data on U.S. international transactions as published by the Department of Commerce.

<2> Includes deposits in banks, commercial paper, acceptances, borrowing under repurchase agreements, and other securities.

<3> Includes U.S. government assets other than official reserves, transactions by nonbanking concerns, and other banking and official transactions not shown elsewhere. In addition, it includes amounts resulting from adjustments to the data made by the Department of Commerce and revisions of the data in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business.

<4> Includes seasonal adjustment for quarterly data.

data reported to the Federal Reserve, the outflow slowed in October and was reversed through the first three weeks of November, showing a small net inflow on balance since September (line 1 of the International Banking Table).

Net foreign private purchases of U.S. securities were small in September (lines 2 and 3 of the Summary Table). There were net sales of both U.S. corporate equities (line 2b) and U.S. Treasury obligations (line 3).

Foreign purchases of U.S. corporate bonds remained depressed in September (see line 2a). New issues of Eurobonds by U.S. corporations were fairly small in October. Market commentary on the decline in Eurodollar bond issues has focused on investor uncertainty about the outlook for the foreign exchange value of the dollar and on concern about the potential downgrading of U.S. corporate issues because of restructurings. For October, an estimated 60 percent (approximately \$560 million) of the Eurobonds issued by U.S. corporations was denominated in foreign currencies; this can be compared with an average from June through September of 27 percent and only \$145 million.

U.S. purchases of foreign securities continued to be moderate in September (line 2c of the Summary Table). These data do not, however, reflect the value of the bonds issued in September on behalf of Israel by a U.S. trust.

Under the provisions of the Foreign Military Sales Debt Refinancing Act, passed last summer, foreign governments are allowed to repay relatively high-cost debt to the U.S. government and refinance

INTERNATIONAL BANKING DATA  
(Billions of dollars)

	1986	1987				1988					
	Dec.	Mar.	June	Sept.	Dec.	Mar.	June	Aug.	Sept.	Oct.	Nov. 2/
1. Net Claims of U.S. Banking Offices (excluding IBFS) on Own Foreign Offices and IBFS	22.3	9.1	5.0	-7.8	-10.9	8.7	-4.8	-14.5	-4.9	-.7	-5.3
(a) U.S.-chartered banks	31.7	21.5	16.3	12.6	15.2	27.8	17.0	8.2	16.6	21.7	20.6
(b) Foreign-chartered banks	-9.4	-12.4	-11.3	-20.3	-26.1	-19.0	-21.8	-22.7	-21.5	-22.4	-25.9
2. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	16.8	16.0	15.6	17.1	15.8	19.1	19.7	20.2	21.4	22.2	22.6
3. Eurodollar Holdings of U.S. Nonbank Residents <1>	124.5	34.0	135.7	141.1	132.6	128.9	138.1	143.3	141.1	137.2	138.9

<1> Includes term and overnight Eurodollars held by money market mutual funds.

Note: These data differ in coverage and timing from the overall banking data incorporated in the international transactions accounts. Line 1 is an average of daily data reported to the Federal Reserve by U.S. banking offices. Line 2 is an average of daily data. Line 3 is an average of daily data for the overnight component and an average of Wednesday data for the term component.

<2> Through November 21, 1988.



that debt by issuing bonds that carry a 90 percent guarantee by the United States. The government of Israel floated a \$2.5 billion issue in September and a further \$2.2 billion at the end of November. In both cases the Israelis put up collateral equal to 10 percent of the value of the issue. Turkey is expected to float \$1.5 billion in December. Lesser amounts have been, or are expected to be, issued by 7 to 10 other countries; by the end of 1989 a total of \$8.5 billion is expected to be refinanced. In terms of balance-of-payments accounting, the repayments will reduce the U.S. government's claims on foreigners (included in line 8). If the new bonds are sold directly in the United States by a foreign government, the balancing item would be included in line 2c (U.S. net purchases of foreign securities); if sold through a trust, as was the case for the Israeli issues, they would be included in line 8 (other capital flows).

A second development indicating the increased use of U.S. financial markets by foreign governments is a recently announced plan by the French government to market French government bonds in the United States in the form of American Depository Receipts (ADRs). The ADRs are issued on demand and, from the program's inception in September to the present, a total of \$2.9 million has been sold. Market sources indicate that other sovereign borrowers are interested in establishing similar programs, but are waiting to assess the success of the French program.

Foreign official reserve assets held in the United States fell a moderate \$1.7 billion in September (line 4). However, preliminary data on changes in holdings at FRBNY for October and November indicate that

G-10 reserves in the United States have started to increase again, possibly reflecting the shift in the direction of foreign exchange market intervention.

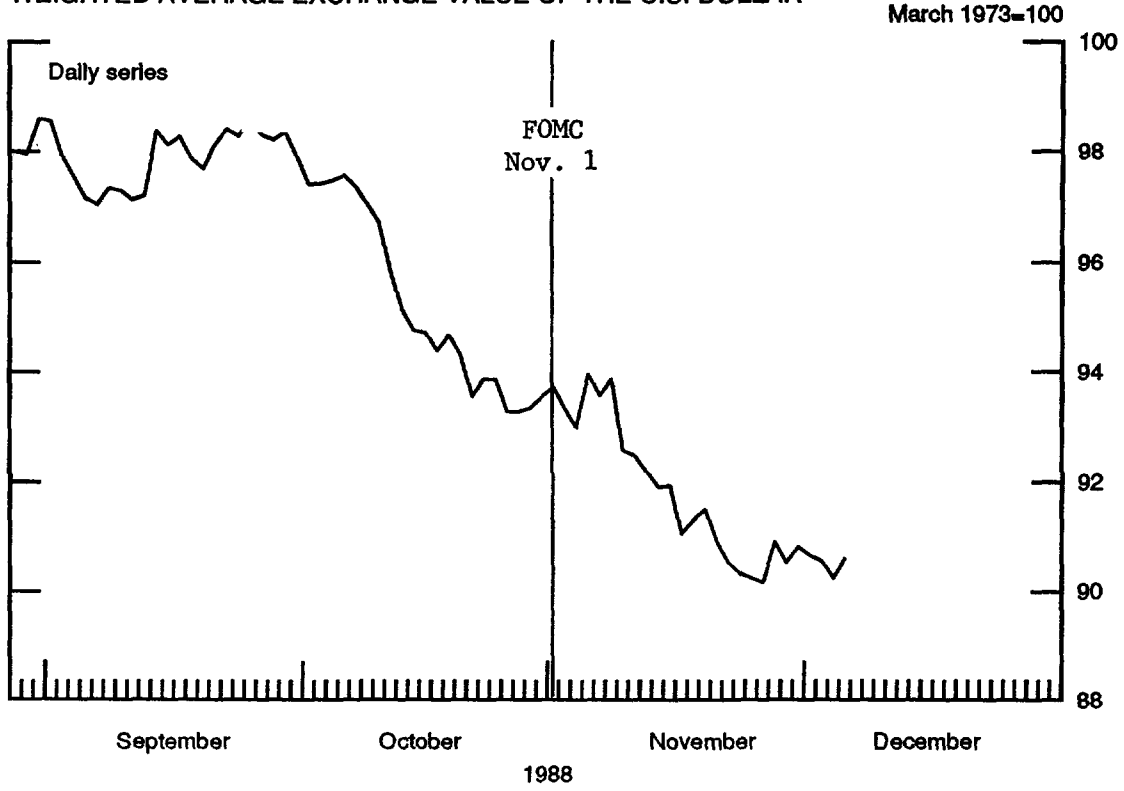
Foreign Exchange Markets

The weighted-average exchange value of the dollar in terms of the other G-10 currencies has declined about 2 percent, on balance, since the November FOMC meeting and 8 percent since its peak last August, as shown in the accompanying chart. Following a pause in late October and early November, the dollar began to decline again after the U.S. election, as comments from U.S. observers and foreign officials reinforced the market's shift in focus toward the U.S. budget and trade deficits. Market sentiment remained negative on the dollar through most of the intermeeting period,

. Very late in the period, however, the dollar appeared to be bolstered by expectations of tightening by the Federal Reserve and the market response to proposed cuts in Soviet armed forces.

. Beginning just before the last FOMC meeting, the Desk purchased a significant amount of dollars against yen for the first time since last April.

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR



against marks.

. The Desk purchased a total of about \$1.6 billion against yen and \$600 million against marks.

Interest differentials between U.S. and foreign short-term assets generally widened during the intermeeting period. German interest rates rose somewhat, with the German three-month rate and the average of long-term bond yields both increasing about 15 basis points. Interest rates fell in Japan, with the three-month rate decreasing 10 basis points and the yield of the bellwether bond falling 20 basis points. In the United Kingdom, the three-month rate rose more than 1 percentage point as the Bank of England raised its money market dealing rate 1 percentage point to just below 13 percent, and Chancellor of the Exchequer Lawson stated that a strong pound and higher U.K. interest rates are needed to combat inflation. Sterling rose more than 2 percent against the mark, to above 3.23 marks per pound.

The Canadian dollar experienced wide swings during the intermeeting period. During the early part of the period, voter opinion polls showing strong support for the Liberal party before the parliamentary elections caused the Canadian dollar to fall sharply. On November 21, the day of the election, new polls surfaced showing the Conservative party regaining the lead, and the Canadian dollar's value soared. Since the election, the positive trend for the Canadian dollar has continued, partly based on the imminent passage of the U.S.-Canada free trade pact which is expected to increase foreign investment in Canada.

Oil prices rose after Thanksgiving, when OPEC reached an agreement on production quotas. The price of a barrel of West Texas Intermediate crude oil rose, on balance, \$2 since the last FOMC meeting, to about \$15-1/2. The price of gold followed oil prices upward, increasing \$11, on balance, to about \$423 an ounce.

#### Developments in the Foreign Industrial Countries

Real economic activity accelerated or remained strong in most of the major foreign economies in the third quarter. After declining 3.3 percent in the second quarter, real GNP rose 9.3 percent (s.a.a.r.) in Japan in the third quarter, based on growth of 7.4 percent in domestic demand and a positive contribution to growth from the external sector. German real GNP rose 5.2 percent, led by both strong exports and private investment, while the output measure of real GDP in the United Kingdom rose 5.3 percent. French real marketable GDP rose 3.2 percent, about twice the second-quarter pace, based on strength in consumer spending but with a large negative contribution of net exports. In contrast, growth slowed in Canada in the third quarter, as real GDP increased 2.6 percent compared with 4 percent growth in the second quarter. Canadian consumption remained strong, but investment spending slackened. Little information is available yet for the fourth quarter, but initial indicators suggest growth has perhaps slowed somewhat in Japan, Canada, and France.

Signs of increasing price pressures have appeared in recent months in some of the major foreign economies. In Japan and Germany, inflation remains low, with consumer prices in October and November about 1-1/2

REAL GNP AND INDUSTRIAL PRODUCTION IN MAJOR INDUSTRIAL COUNTRIES  
(Percentage change from previous period, seasonally adjusted) 1/

	Q4/Q4 1986	Q4/Q4 1987	1987 Q4	1988 Q1	1988 Q2	1988 Q3	1988 June	1988 July	1988 Aug.	1988 Sept.	1988 Oct.	Latest 3 months from year ago 2/
<b>Canada</b>												
GDP	1.2	6.1	1.6	.6	1.0	.7	*	*	*	*	*	4.0
IP	-.3	8.5	2.5	1.2	1.1	.7	.0	-.6	1.4	-.1	n. a.	5.6
<b>France</b>												
GDP	2.1	2.6	.7	1.1	.4	n. a.	*	*	*	*	*	3.1
IP	-.3	3.6	.6	.6	.8	2.7	2.0	.6	.0	.6	n. a.	4.8
<b>Germany</b>												
GNP	2.3	2.4	.8	1.4	-.2	1.3	*	*	*	*	*	3.3
IP	.8	1.5	.7	1.1	.3	1.8	2.9	-3.7	6.6	-2.0	-.8	4.5
<b>Italy</b>												
GDP	3.0	2.8	.3	1.3	.6	n. a.	*	*	*	*	*	3.1
IP	2.8	5.7	3.3	2.7	-.7	-.5	1.5	2.9	-6.5	3.1	n. a.	4.9
<b>Japan</b>												
GNP	2.1	5.7	1.7	2.4	-.8	2.2	*	*	*	*	*	5.7
IP	-.6	8.1	3.4	3.2	-.2	2.5	3.3	-.9	2.7	.5	-.8	8.7
<b>United Kingdom</b>												
GDP	4.4	4.3	.7	1.1	.4	n. a.	*	*	*	*	*	4.1
IP	2.3	4.1	1.0	-.7	2.4	.4	-.9	.0	1.3	-.5	n. a.	3.1
<b>United States</b>												
GNP	2.0	5.0	1.5	.8	.7	.6	*	*	*	*	*	3.8
IP	1.0	5.8	1.7	1.0	1.1	1.7	.3	1.1	.3	.2	.4	5.5

1. Asterisk indicates that monthly data are not available.
2. For quarterly data, latest quarter from year ago.

CONSUMER AND WHOLESALE PRICES IN MAJOR INDUSTRIAL COUNTRIES  
(Percentage change from previous period) 1/

	Q4/Q4 1986	Q4/Q4 1987	1987			1988			1988				Latest 3 months from year ago
			Q2	Q3	Q4	Q1	Q2	Q3	Aug.	Sept.	Oct.	Nov.	
<b>Canada</b>													
CPI	4.3	4.2	1.4	1.2	.7	.8	1.3	1.1	.3	.1	.5	n. a.	4.1
WPI	.3	4.3	1.3	1.4	1.1	1.1	.9	.8	.1	.1	-.1	n. a.	3.5
<b>France</b>													
CPI	2.1	3.2	.9	.6	.5	.5	1.0	.9	.3	.2	.2	n. a.	2.9
WPI	-3.4	2.6	.5	.5	1.0	1.1	.8	n. a.	*	*	*	n. a.	3.5
<b>Germany</b>													
CPI	-1.0	1.0	.4	.0	.0	.5	.5	.1	.1	.0	.1	.2	1.4
WPI	-9.0	-.7	.0	-.4	-.2	.1	1.1	.4	.2	.2	.4	n. a.	1.7
<b>Italy</b>													
CPI	4.7	5.2	1.0	1.1	1.7	1.1	1.0	1.0	.4	.5	.8	.8	4.9
WPI	-2.4	4.6	1.0	.8	1.2	1.1	1.3	1.2	.7	.5	n. a.	n. a.	4.9
<b>Japan</b>													
CPI	.1	1.1	1.2	-.2	.4	-.2	.6	.0	-.1	1.1	.7	-.3	1.4
WPI	-9.1	-.6	-.7	1.3	-.4	-1.2	-.3	.9	.1	.1	-.6	n. a.	-1.1
<b>United Kingdom</b>													
CPI	3.4	4.1	1.5	.2	1.1	.5	2.4	1.4	1.1	.5	1.0	n. a.	6.0
WPI	4.2	3.9	1.1	.5	1.1	1.3	1.5	.8	.4	.3	.5	n. a.	4.8
<b>United States</b>													
CPI (SA)	1.3	4.4	1.2	.9	.9	.8	1.2	1.2	.4	.3	.4	n. a.	4.2
WPI (SA)	-1.9	2.5	1.1	.7	.0	.2	1.0	1.4	.6	.4	.0	n. a.	2.8

1. Asterisk indicates that monthly data are not available.

TRADE AND CURRENT ACCOUNT BALANCES OF MAJOR INDUSTRIAL COUNTRIES 1/  
(Billions of U. S. dollars, seasonally adjusted except where otherwise noted)

	1986	1987	1987			1988			1988			
			Q2	Q3	Q4	Q1	Q2	Q3	July	Aug.	Sept.	Oct.
<u>Canada</u>												
Trade	7.1	8.3	2.1	2.3	1.6	1.9	2.2	2.6	1.5	.6	.5	n. a.
Current account	-6.7	-8.0	-1.9	-2.1	-2.6	-1.3	-1.8	n. a.	*	*	*	*
<u>France</u>												
Trade	.1	-5.2	-2.0	-1.0	-1.0	-.9	-1.0	-2.0	-.6	-1.4	.1	-.7
Current account	3.0	-4.9	-1.2	-1.0	-2.6	1.3	-.6	n. a.	*	*	*	*
<u>Germany</u>												
Trade (NSA)	52.5	65.9	15.5	15.2	20.1	15.0	19.9	17.0	6.0	4.9	6.1	5.8
Current account (NSA)	39.7	45.4	10.9	7.8	15.3	8.6	15.0	8.7	3.0	2.6	3.2	4.4
<u>Italy</u>												
Trade	-2.0	-9.0	-2.6	-2.6	-2.8	-2.9	-1.7	-2.8	-1.0	-.7	-1.1	-.7
Current account (NSA)	2.9	-1.1	1.1	1.6	-1.6	-5.1	1.1	n. a.	*	*	*	*
<u>Japan</u>												
Trade	82.4	79.5	19.5	17.8	18.3	20.8	16.7	17.8	6.2	5.5	6.1	7.2
Current account 2/	85.8	87.0	21.3	19.9	20.5	23.1	17.6	17.8	4.9	6.2	6.6	6.8
<u>United Kingdom</u>												
Trade	-12.4	-15.9	-3.9	-5.0	-5.3	-7.1	-8.2	-9.4	-4.5	-3.1	-1.8	-5.1
Current account	.1	-3.0	-.5	-1.4	-2.3	-5.1	-5.4	-6.9	-3.7	-2.2	-1.0	-4.2
<u>United States</u>												
Trade 2/	-144.5	-160.3	-39.6	-39.7	-41.2	-35.2	-30.2	-28.5	*	*	*	*
Current account	-138.8	-154.0	-40.9	-42.0	-33.5	-36.9	-33.3	n. a.	*	*	*	*

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1. The current account includes goods, services, and private and official transfers. Asterisk indicates that monthly data are not available.  
2. Annual data are subject to revisions and therefore may not be consistent with quarterly and/or monthly data.



percent above a year ago. Consumer prices rose sharply in Italy in November to 5.2 percent above a year earlier, but inflation changed little in October in Canada and France from the moderate rates experienced in recent months. Consumer price inflation remains high in the United Kingdom at 6.4 percent in October from a year earlier, and inflation concerns there have been heightened by evidence of continued strength in domestic demand.

External adjustment has slowed in recent months and in some cases may even have reversed. Japan's trade surplus widened in September and October in both nominal and real terms. German trade and current account surpluses for the first ten months of 1988 are slightly larger than those for the comparable period in 1987. Trade deficits widened in some of the other major foreign industrial economies. In October, the U.K. trade and current account deficits reached record levels, and the French and Italian trade deficits also increased.

Individual country notes. In Japan, the pace of real economic activity was robust in the third quarter after a weak second quarter. Real GNP grew 9.3 percent (s.a.a.r.), based on growth of domestic demand of 7.4 percent, with net exports making a positive contribution. Personal consumption, private capital spending, and exports were the primary sources of strength. Real consumer spending grew 5.8 percent while plant and equipment investment rose 18.6 percent. The strength of the external sector derived from rapid growth in exports of 41.3 percent offset by a slower but still strong rise in imports of 27.7 percent. Residential investment also was strong, growing 26.5 percent. Public

investment, which fell 7 percent, and slower stock accumulation were the only sources of weakness.

Available data for the fourth quarter suggest some slowing of growth from the rapid third-quarter pace. Preliminary data indicate industrial production (s.a.) fell 0.8 percent in October, although the level of production was still 6.6 percent above a year ago.

Consumer price inflation remains low, but has increased in the fourth quarter. The Tokyo index of consumer prices in October and November averaged 1.6 percent above a year ago, twice the increase in the third quarter. Higher prices for food and clothing are cited as the primary source of the increase in consumer prices.

Data show a widening of Japan's external surplus in recent months, partly reversing previous progress on external adjustment. In the third quarter, the 5.6 percent growth of export volume (s.a.) outstripped the 2.6 percent increase in import volume, and in October the 6.5 percent decline in import volume was twice the decline in export volume. The nominal trade surplus (in dollars) increased in September and October, contributing to the cumulative surplus in the first ten months of 1988 of \$75 billion (s.a.a.r.), compared with a surplus of \$79.5 billion in 1987. The current account through October was \$79.4 billion (s.a.a.r.), compared with a surplus of \$87 billion in 1987.

The rate of growth of broad money remains rapid. In October, M2+CDs stood 11 percent higher than a year earlier, a slightly higher increase than in the third quarter. The Bank of Japan expects money growth to slow in November. In September, the Bank had projected that

growth in M2+CDs would average about 10 percent in the fourth quarter, but it now appears likely that actual growth will exceed that projection.

The Liberal Democratic Party achieved a major breakthrough in the Diet debate over tax reform, and final passage of the bill, including the controversial 3 percent VAT (to be imposed in April 1989), now appears assured. The LDP reached a compromise with two opposition parties in which the latter ended their boycott of the debate in return for the establishment of a special Diet committee to investigate the Recruit Cosmos insider trading scandal. The tax reform bill should be passed by the Upper House in December.

Economic activity accelerated in Germany in the third quarter, following a flat second quarter. Real GNP increased 5.2 percent (s.a.a.r.) in the third quarter. The gain was led by strength in net exports, but all components of demand, except construction, advanced briskly. Overall, net exports accounted for about 40 percent of GNP growth and domestic demand 60 percent. However, the 5.2 percent growth rate was boosted by weather-related factors in the first half of the year and statistical factors relating to working-days in the third quarter. Compared with its year-earlier level, real GNP was up 3.4 percent in the third quarter.

Monthly data on production and new orders were varied sharply as a result of an abnormal pattern of summer holidays, but smoothed data show a pickup in activity. For example, industrial production increased 0.7 percent (s.a.) in the September-October period from the July-August

average. Also, manufacturers' new orders rose 3.5 percent (s.a.) in real terms from the second to the third quarter, with domestic orders up 3.8 percent and foreign orders up 2.9 percent.

As a result of the expansion, the unemployment rate fell by 0.1 percentage point to 8.5 percent (s.a.) in November, the fourth consecutive monthly decline, and the number of part-time workers was down by about one-half from its year-earlier level. Capacity utilization reached its highest rate in 10 years in the third quarter.

While the high utilization rate has raised some concern in Germany about future inflation, German inflation rates remain moderate. The consumer price index rose 0.2 percent (n.s.a.) in November and stands 1.6 percent above its November 1987 level, up from 1.4 percent in September. Wholesale prices increased 0.4 percent (n.s.a.) in October and are 2 percent above their year-earlier level, the same as in September. Import prices, which had contributed to inflation earlier by rising 3.3 percent between March and August, fell 0.9 percent between August and October.

The monthly trade and current account surpluses (n.s.a.) narrowed in September but widened in October from their year-earlier levels. As a result, for the first 10 months of the year, the trade surplus was up from \$51.4 billion in 1987 to \$57.7 billion in 1988, while the current account surplus was up from \$34.1 billion to \$36.7 billion. Comparing the first eight months of 1987 and 1988, Germany's trade surplus with the U.S. was down 38 percent, from \$8.6 billion to \$5.3 billion, while

its surplus with other EC countries was up 43 percent, from \$20.9 billion to \$29.9 billion.

Growth in the average level of M3 was rapid again in September and October, putting M3 at 6.8 percent above the target base period of 1987 Q4 and outside the 3 to 6 percent target range for 1988. Thus, 1988 is likely to mark the third successive year that money growth exceeds the Bundesbank's target range. Meanwhile, the pickup in economic growth has caused the government to revise downward its projections of the total public sector budget deficit, which it now estimates at 2.8 percent of GNP in 1988 and 2 percent in 1989. In addition, the government has postponed for three years the application of tax withholding on accrued bond interest. This action does not affect the government's plan to introduce 10 percent withholding on the coupon payment of interest on domestic bonds in 1989.

In the United Kingdom, recent data have provided further evidence of overheating. The output measure of real GDP increased by 5.3 percent (s.a.a.r.) in the third quarter. The volume of retail sales increased by 1.9 percent (s.a.) in October and showed a 12-month increase of 7.1 percent. The unemployment rate declined for the 27th consecutive month in October to 7.7 percent (s.a.). The 12-month rate of consumer price inflation rose to 6.4 percent in October, the eighth consecutive monthly increase.

The trade and current account deficits were at record levels in October. For the first 10 months of the year, the current account

deficit was \$25.7 billion (s.a.a.r.), far exceeding the \$1.5 billion deficit rate in the same period last year.

On November 1, the government released its autumn statement on the economy containing revised economic forecasts and spending plans. (Changes in taxes and monetary targets are normally announced in the March budget message.) Spending plans remained virtually unchanged. Forecasts of real GDP growth, inflation, and the current account deficit for this year were revised upward substantially compared with forecasts contained in the March budget. The official outlook for next year is for somewhat lower real growth and inflation and a slightly reduced current account deficit compared with 1988.

On November 25, the government further tightened monetary conditions in response to stronger evidence of domestic overheating. The Bank of England's money market dealing rates were increased by 1 percentage point to 12-7/8 percent. Over the past six months, official rates have been raised nine times for a total of 5-1/2 percentage points.

#### Economic Situation in Major Developing Countries

In his inaugural address on December 1, Mexican President Salinas de Gortari called for new negotiations on Mexico's external debt in order to reduce both the total debt and the net transfer of financial resources abroad. Financing arrangements in Brazil proceeded on schedule with the country paying its remaining interest arrears. The mid-November municipal elections weakened Brazilian President Sarney's political position further. Late in October the World Bank approved

\$1.25 billion in loans for Argentina and in mid-November the Inter-American Development Bank approved approximately \$460 million in loans. Discussions are still continuing with the IMF on a new stand-by arrangement for Argentina. Venezuela's new president, Carlos Andres Perez, plans to move quickly to renegotiate the terms of repayment of his country's commercial bank debt. Peru, facing possible hyperinflation, implemented a new economic package on November 23, including a 50 percent devaluation of its currency and additional wage and price increases.

Individual country notes. In his inaugural address on December 1, Mexico's new president, Carlos Salinas de Gortari, called for new negotiations on the country's external debt with the aim of reducing the net transfer of financial resources abroad and the stock of external debt. He said that he wanted to continue avoiding confrontation, but that the interests of the Mexican people were more important than those of the creditors. He stressed that economic growth had to be revived and that this could not happen so long as the country continues to transfer annually 5 percent of its GDP abroad.

Since the October 17 announcement that the U.S. Treasury and the Federal Reserve were prepared to advance a bridge loan of up to \$3.5 billion to Mexico, little progress has been made by Mexico in developing the IMF and World Bank programs upon which the U.S. bridge loan is to depend. However, now that the new Mexican administration is in place, movement is expected.

In the past seven weeks, Mexican foreign exchange reserves have continued to decline. A trade deficit of about \$80 million was incurred in September, in part because Hurricane Gilbert reduced the volume of crude oil exported during the month by 25 percent. This was the first monthly trade deficit since March 1982. In October, the CPI was less than 1 percent higher than a month earlier, and 82 percent higher than a year earlier. Since the Mexican authorities announced on October 16 that they were tightening monetary policy, the 28-day Treasury bill rate has increased by nearly 900 basis points. At the November 29 auction, it was 52.2 percent at an annual rate.

In Brazil, the Democratic Movement Party registered a poor showing throughout the country in mid-November municipal elections. The political center, including President Sarney, was weakened by the elections, although the most extreme parties on the left and right did not achieve major gains. The election results may make it more difficult for President Sarney to implement his legislative agenda even though the membership of Congress was not affected by the elections.

On November 4 Brazil received \$2 billion from its 1987 Interim Financing Arrangement with commercial banks. On November 14 it received an additional \$4 billion from the \$5.2 billion new money package that was signed on November 1; part of these funds were used to pay off the Interim Arrangement. Brazil has now paid its remaining interest arrears to commercial banks and is current on its interest obligations for the first time since February 1987, when the country declared a moratorium on interest payments on medium-term debts to banks.



Consumer prices rose 27 percent in November, after rising the same amount in October and 24 percent in September. Inflation would likely have been even higher in November except for the "social pact" agreement between business, labor, and government reached on November 4 that mandated maximum price increases of 26.5 percent for November and 25 percent for December on a list of commonly used commodities. Interest rates in the overnight market have remained below 40 percent on a monthly basis in recent weeks. The spread between the official and parallel market exchange rates has fluctuated in the 55 to 65 percent range recently.

Brazil's trade surplus was \$1.6 billion in October--down from a surplus of \$1.9 billion in September--but still setting a record pace for the year as a whole. The surplus for the first ten months of 1988 was \$16.1 billion, substantially larger than any annual figure in Brazilian history.

Next month the authorities are planning to introduce a tourist exchange rate in an effort to close the gap between the official and parallel market rates. Finance Ministry officials indicated that this move marked the start of a process toward easing controls that could lead eventually to freely determined exchange rates.

On October 27, 1988, the World Bank approved \$1.25 billion in loans to Argentina, including a \$400 million banking sector loan, a \$300 million trade sector loan, a \$300 million housing project loan, and a \$250 million power sector loan. The trade sector loan became effective November 15, 1988, allowing a first disbursement of \$150 million to be

made. The Inter-American Development Bank approved \$459 million in power sector, water, and agricultural loans in mid-November. On November 22, the first disbursement of \$150 million from the U.S. Treasury and the BIS loans bridged to the World Bank loans was drawn. Because the first disbursement of the bridge loan was tied to the effectiveness of the fast-disbursing trade sector loan, \$60 million of the disbursements of the bridge loan were repaid the following day. Talks on a new IMF stand-by arrangement are continuing.

Inflation has continued to decline following implementation of the stabilization plan announced in August 1988. Consumer price inflation decelerated from 27.6 percent in August (monthly basis) to 11.7 percent in September, and to 9.1 percent in October. However, widespread strike activity on the part of public sector workers in October and November has forced the government to make wage concessions to some unions in excess of the government's 4 percent monthly guideline. At the same time, the increasing real appreciation of the exchange rate is heightening the probability of a destructive flight out of australs and into dollars. In order to forestall such an event, the central bank responded to a surge in the demand for dollars in mid-November by announcing a rise in the basic government bond rate and other measures to tighten liquidity. It also announced an increase in official dollar sales in an effort to reduce the free market premium. The trade surplus has improved substantially in 1988, registering \$1.7 billion in the first seven months of this year, 171 percent higher than in the same period last year.

Venezuela's presidential election on December 4 was won by Carlos Andres Perez, the candidate of the left-of-center Democratic Action Party. Perez served previously as president from 1974 to 1979 and at that time promoted a statist populism. More recently he has supported economic liberalization, and his advisors expect him to implement a major program of economic stabilization and structural reform soon after he is inaugurated in February. Perez has also indicated that he plans to move quickly to renegotiate the terms of repayment of Venezuela's commercial bank debt. To stabilize liquid reserves for a few months in the face of continued large balance-of-payments deficits, the current Venezuelan government has asked the Bank of America and Salomon Brothers to raise \$1 billion through the private sale of future oil export receivables.

Peru is currently in the midst of an economic crisis. Several public sector price increases and devaluations over the past year have failed to reduce the government's budget deficit and restore international competitiveness. Wage increases have also accompanied price hikes. On November 23 the government announced further price and wage increases and devalued the exchange rate by 50 percent. A few days after the package was announced, the finance minister resigned, reportedly because the package contemplates insufficient adjustment. The CPI increased by 114 percent in September over the previous month, 41 percent in October, and 24 percent in November. Prices in November were 1,300 percent higher than they were in November 1987. The recent economic package is expected to add to the social unrest that followed

September's austerity program. Aside from President Garcia, there is a general consensus that a more effective economic program is needed.

On November 30, the IMF Managing Director announced that the Fund and Nigeria had reached an agreement on Nigeria's SDR 475 million, 15-month, stand-by arrangement. The stand-by will facilitate the approval of a \$500 million World Bank Trade and Investment Policy Loan and will also pave the way for a Paris Club rescheduling early next year.