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CONFIDENTIAL (FR)
CLASS III FOMC

November 10, 1994

SUPPLEMENT
CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Prepared for the
Federal Open Market Committee

By the Staff
Board of Governors
of the Federal Reserve System

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THE DOMESTIC NONFINANCIAL ECONOMY

Producer Prices

The PPI for finished goods fell 0.5 percent in October with all three major commodity groups contributing to the decline. Food prices edged down 0.2 percent; energy prices dropped 1.2 percent; and the PPI excluding food and energy fell 0.5 percent. Lower prices for gasoline and fuel oil pulled down the energy index, while the drop in food prices reflected declines for fresh fruits, fish, and meat.

The 0.5 percent decline in the PPI excluding food and energy in October reflected a 2.9 percent plunge in the price of motor vehicles.¹ Seasonal adjustment of motor vehicle prices is especially difficult around this time of year.² It is standard practice for the BLS to switch to pricing new model year vehicles in October. That is, the September PPI is based on end-of-year prices for last year's model—which may or may not be discounted—while the October PPI is based on prices for new models typically at full price.

Excluding motor vehicles, as well as food and energy, the PPI increased 0.1 percent in October—about in line with the average monthly changes in the core PPI over the past year.

The PPI for intermediate materials other than food and energy rose 0.7 percent in October, the fifth consecutive month of increases of 0.4 percent or more.

1 On a not seasonally adjusted basis, prices of motor vehicles jumped 4.7 percent (not annual rate) last month.

2 The extent of this problem is suggested by the fact that the seasonally adjusted index for motor vehicles rose 6.2 percent (not at an annual rate) during the first ten months of the 1994 model year, but fell 3.4 percent in the past two months.

Consumer Sentiment

The Michigan index of consumer sentiment fell slightly in early November, with declines in both the index of current conditions and the index of expected conditions. Despite the deterioration, the level of the overall index remains in the high end of the range seen over the past four years.

Results for questions not included in the overall index were mixed in early November. The index of home buying conditions dropped sharply, with many more respondents saying that it is a bad time to buy a house because of high prices or high interest rates. The home buying index is currently at its lowest level in more than two years. Households' appraisals of car and appliance buying conditions also deteriorated a bit in early November. In contrast, perceptions of labor market conditions improved somewhat as more respondents reported that they expected unemployment to fall over the next 12 months.

The mean value of expected inflation over the coming year rose 0.4 percentage point to 4.3 percent and the median value increased 0.2 percentage point to 3.2 percent in early November. However, the mean and median values of expected inflation over the next five to ten years declined to their lowest values since 1990, when the survey began to include these questions on a regular basis. The mean value fell 0.5 percentage point to 4.1 percent; the median value fell 0.1 percentage point to 3.1 percent.

Claims

Initial claims for unemployment insurance rose to 335,000 during the week ended November 5. The four-week moving average was little changed at 331,000. The level of insured unemployment edged up to 2.63 million during the week ended October 29. (Table and charts)

RECENT CHANGES IN PRODUCER PRICES
(Percent change; based on seasonally adjusted data)¹

	Relative importance, Dec. 1993	1992	1993	1994			1994	
				Q1	Q2	Q3	Sept.	Oct.
				-----Annual rate-----			-Monthly rate-	
Finished goods	100.0	1.6	.2	3.6	-.3	2.6	-.5	-.5
Consumer foods	22.9	1.6	2.4	-.6	-5.5	3.9	-.2	-.2
Consumer energy	13.3	-.3	-4.1	15.4	-1.0	3.2	-2.9	-1.2
Other finished goods	63.7	2.0	.4	3.0	2.1	2.1	.1	-.5
Consumer goods	40.3	2.1	-.4	2.0	1.5	2.0	.1	-.3
Capital equipment	23.4	1.7	1.8	4.3	3.0	2.4	.1	-1.0
Intermediate materials ²	95.2	1.1	.8	2.8	3.1	5.9	.3	.4
Excluding food and energy	82.3	1.2	1.6	1.9	3.9	6.2	.6	.7
Crude food materials	44.1	3.0	7.2	-4.5	-20.6	-12.9	.2	-2.0
Crude energy	34.4	2.3	-12.3	10.1	21.0	-20.5	-5.3	.0
Other crude materials	21.5	5.7	10.7	22.7	-.8	18.8	1.3	.9

1. Changes are from final month of preceding period to final month of period indicated.
2. Excludes materials for food manufacturing and animal feeds.

RECENT CHANGES IN PRODUCER PRICES -- RELATIVE CONTRIBUTION¹
(Percent change; based on seasonally adjusted data)²

	Relative importance Dec. 1993	1992	1993	1994			1994	
				Q1	Q2	Q3	Sept.	Oct.
				-----Annual rate-----			-Monthly rate-	
Finished goods	100.0	1.6	.2	3.6	-.3	2.6	-.5	-.5
Consumer foods	22.9	.3	.5	-.1	-1.3	.9	.0	-.0
Consumer energy	13.3	.0	-.6	2.2	-.2	.5	-.4	-.2
Other finished goods	63.7	1.2	.2	1.8	1.3	1.3	.0	-.3
Consumer goods	40.3	.9	-.2	.8	.5	.8	.0	-.1
Capital equipment	23.4	.4	.4	1.0	.7	.6	.0	-.2

1. Data may not add due to rounding.
2. Changes are from final month of preceding period to final month of period indicated.

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UNIVERSITY OF MICHIGAN SURVEY RESEARCH CENTER: SURVEY OF CONSUMER ATTITUDES
(Not seasonally adjusted)

	1994 Mar	1994 Apr	1994 May	1994 Jun	1994 Jul	1994 Aug	1994 Sep	1994 Oct	1994 Nov (p)
Indexes of consumer sentiment (Feb. 1966=100)									
Composite of current and expected conditions	91.5	92.6	92.8	91.2	89.0	91.7	91.5	92.7	90.1
Current conditions	101.4	108.1	106.3	104.5	105.4	108.7	104.0	104.6	102.1
Expected conditions	85.1	82.6	84.2	82.7	78.5	80.8	83.5	85.1	82.4
Personal financial situation									
Now compared with 12 months ago*	105	116	111	111	116	117	105	108	104
Expected in 12 months*	125	124	123	127	121	126	130	131	118
Expected business conditions									
Next 12 months*	121	117	119	112	105	108	114	119	114
Next 5 years*	96	91	96	93	88	90	91	92	99
Appraisal of buying conditions									
Cars	147	150	143	144	143	143	144	138	136
Large household appliances*	158	164	165	160	158	165	164	163	160
Houses	176	170	167	161	159	160	162	163	148
Willingness to use credit	50	58	57	50	61	51	38	53	36
Willingness to use savings	69	71	75	76	81	74	71	72	57
Expected unemployment change - next 12 months	112	116	116	114	111	121	117	116	112
Expected inflation - next 12 months	4.4	4.5	3.9	4.1	4.2	4.6	4.6	3.9	4.3
Expected inflation - next 5 to 10 years	5.4	5.0	4.6	4.8	4.7	5.5	4.9	4.6	4.1

* -- Indicates the question is one of the five equally-weighted components of the index of sentiment.

(p) -- Preliminary

(f) -- Final

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

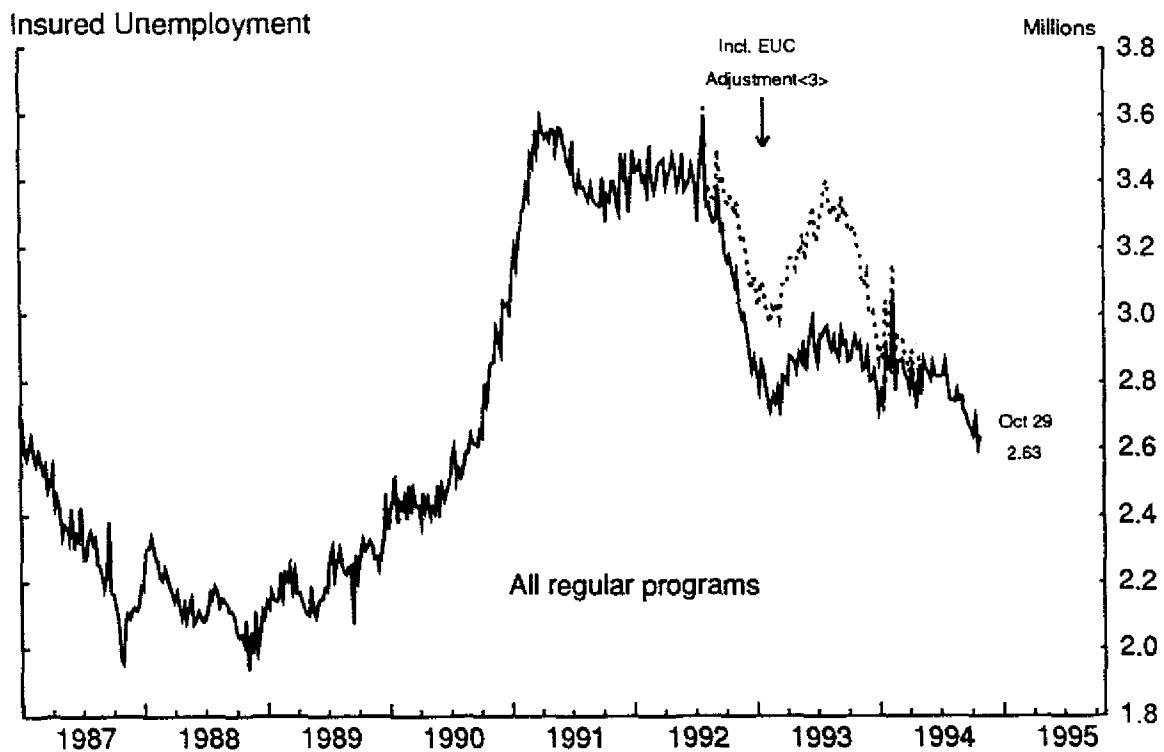
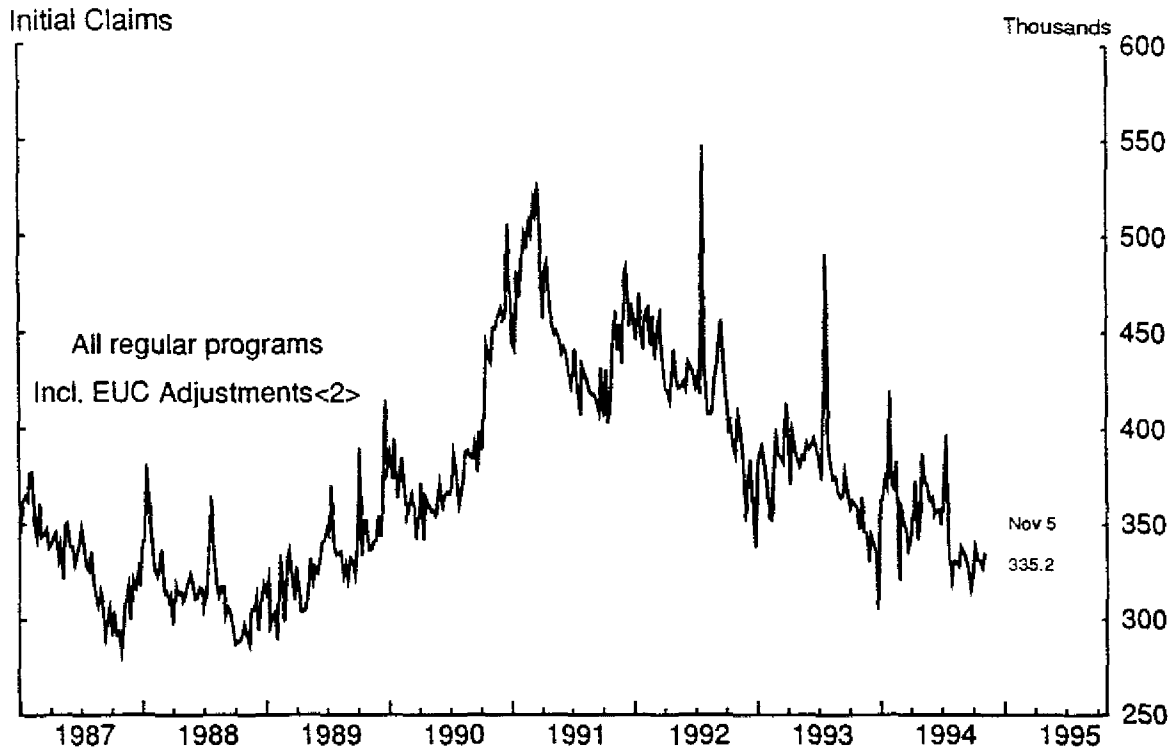
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UNEMPLOYMENT INSURANCE BENEFITS
(In thousands)

	1994						
	Sept. 24	Oct. 1	Oct. 8	Oct. 15	Oct. 22	Oct. 29	Nov. 5
	-----Seasonally adjusted; BLS basis ¹ -----						
Initial Claims							
All regular programs ²	316	325	338	331	331	327	335
State programs	310	319	329	325	324	322	330
Insured unemployment							
All regular programs ³	2672	2654	2638	2690	2607	2634	--
State programs	2604	2584	2571	2614	2537	2565	--
Extended benefits	16	16	12	17	14	14	--
State-insured Unemployment rate ⁴	2.4	2.4	2.4	2.4	2.3	2.4	--
	-----Not seasonally adjusted-----						
<u>Regular state programs</u>							
Initial claims	251	254	323	273	297	292	336
Insured unemployment	2117	2075	2006	2193	2103	2168	--

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

Unemployment Insurance (Weekly data; seasonally adjusted, BLS basis <1>)



<1> Only the state program components of these series are seasonally adjusted.
<2> Beginning July 18, 1992, includes initial claims filed under the emergency unemployment benefits program by individuals also eligible to file under regular programs. The EUC program ended on April 30, 1994.
<3> Includes staff estimate of emergency benefits recipients who are also eligible to file under regular programs.

THE FINANCIAL ECONOMY

The November 1994 Senior Loan Officer Opinion Survey on Bank Lending Practices

The November 1994 Senior Loan Officer Opinion Survey on Bank Lending Practices posed questions about changes in bank lending standards and terms, changes in loan demand by businesses and households, the loan underwriting process, and the pricing of small business loans. Fifty-seven domestic commercial banks and twenty-four U.S. branches and agencies of foreign banks participated in the survey.

The survey results show a further easing of the terms and standards on loans to businesses with roughly equal shares of respondents reporting having eased standards for borrowers of all sizes. The fraction of banks that reported easing was larger than in the August survey. Demand for business credit has continued to grow according to the November reports, with responses suggesting a more widespread pickup than in the last survey. Standards for commercial real estate loans were little changed. Respondents reported an increased willingness to make loans to individuals, and a few indicated that they had eased standards on home mortgage loans. Household demand for credit was essentially flat since August, but presumably remains at a high level.

Special questions on the survey addressed the extent to which banks evaluate the riskiness of their business borrowers and the effect of such evaluations on the setting of price and non-price terms on loans. Virtually all of the respondents indicated that they categorize borrowers of all sizes based on risk. In some cases the category is determined, in part, by a statistical credit scoring model, but more often it is based on a less formal assessment of borrower risk. Most banks reported using borrowers' risk categories in setting both price and non-price loan terms. In addition, banks

reported an improvement in the average risk rating for their borrowers compared to a year ago.

The respondents indicated that the persistence of relatively wide spreads on small business loans in recent years was the result of a number of factors. Increases in the costs and risks associated with small business lending since the late 1980s were cited most often. In addition, a number of banks noted that competition for small business borrowers is less intense than it was in the late 1980s. Finally, half of the respondents indicated that they do not expect a decline in the current wide spread of the prime rate over market rates.

Business Lending

Commercial and industrial loans other than for mergers. A significant number of domestic respondents reported having eased credit standards for business loans, with around one-fifth easing for large firms and somewhat smaller fractions easing for middle-market and small firms. These figures are higher than the 5 to 10 percent figures posted in August. There was no net change in standards reported by U.S. branches and agencies of foreign banks in November. With respect to loan terms, many domestic banks reported having cut credit line costs and spreads over base rates. Nearly half the domestic respondents reported reductions for large firms, and substantial, although smaller, fractions reported lower costs and spreads on loans to middle market firms and small businesses. These levels are similar to the ones reported in August. As in recent quarters, smaller fractions of respondents eased other terms, including loan covenants, maximum credit line sizes, and collateralization requirements. As has been the case since banks began reporting having eased terms in the second quarter of 1993, more respondents reported easing these terms for large firms than

for small firms. Similarly, many of the foreign respondents reported having eased terms, with the largest fractions cutting loan fees and spreads, and a substantial fraction easing loans covenants.

Both the domestic and the foreign respondents attributed the easing of terms and standards primarily to more aggressive competition for business customers by other banks as well as by non-bank lenders. A large share of banks also noted the improved economic outlook and a lessening of industry-specific problems in industries to which they lend. In addition, about half of the banks noted that the demand for loans at their bank was more sensitive to the terms offered by their bank relative to their competitors than had been the case six months ago.

Real estate loans. Both domestic and foreign respondents indicated that credit standards for commercial real estate loans were little changed. On net, domestic respondents reported no change in standards for construction and land development loans and a slight easing for other types of commercial real estate lending. Although scattered signs of easing have been evident in recent surveys, the substantial tightening of lending standards for commercial real estate loans reported in 1990 and 1991 has not been reversed. At U.S. branches and agencies of foreign banks standards for commercial real estate loans were little changed, with a small tightening reported for construction and land development loans and no net change for other commercial real estate loans.

Demand. Demand for business loans continued to expand over the last three months. About 40 percent of the domestic respondents reported an increase in demand for business loans by large firms. Smaller, but still substantial, fractions reported increased demand by small and medium-sized borrowers. More than 40 percent of the foreign branches and agencies, which generally have large business

customers, reported a pick-up in demand. Respondents attributed the increased demand to their customers' needs to finance inventories and purchases of plant and equipment. Somewhat surprisingly, in view of very weak bond issuance by non-financial firms, the respondents did not indicate that demand from large firms had been boosted by declines in customers financing in the capital markets. In contrast when bond issuance was heavy in late in 1993 the respondents noted that demand from large customers had weakened because of increased use of the capital markets.

Lending to Households

As in August about a fifth of the domestic banks reported that they were more willing to make consumer loans than they had been three months earlier, and a few banks indicated that standards for approving mortgage applications had been eased. Consumer loan demand has eased in the last two surveys. About as many banks reported weaker demand for installment loans in November as reported stronger demand. By contrast between 20 and 40 percent of the respondents reported stronger demand for installment loans each quarter between the third quarter of 1993 and the second quarter of this year. The respondents continue to report weaker demand for home mortgages, likely reflecting the fall off in refinancing activity. Despite this decline, and the likely resulting fall off in the refinancing of home equity loans with new mortgage loans, demand for home equity loans was reported little changed in the November survey, as it has been for the past several quarters.

Risk-Rating of Business Loans

The November survey asked a series of questions about banks' evaluation of the riskiness of their business borrowers. Most of the respondents reported that most or all business borrowers are assigned to a risk category in the course of the underwriting

process. Only 5 to 10 percent of the respondents indicated that they rarely or never graded the risk of potential borrowers. Only about a sixth of the respondents, however, reported using a statistically-based credit scoring model to help assign risk grades, and thus risk grading is presumably done on a judgmental basis in most cases. Small customers are somewhat more likely to be assessed using a statistical model than are middle-market or large customers. A large majority of the respondents indicated that price and non-price loan terms are varied based on a borrower's risk. The fraction of banks that reported that they vary price terms according to risk is higher than previous anecdotal evidence had indicated. In many cases, however, differences in price or non-price terms are based on a less formal assessment of the borrower's risk, rather than on the borrower's assigned risk grade. A large share of the respondents reported that the average risk grade of their borrowers that have been assigned a risk grade has improved over the past year, suggesting that the improved economy has had a stronger influence than the steady easing of standards reported in surveys since mid-1993.

Two final questions focused on the pricing of small business loans. According to the Federal Reserve Board's quarterly Survey of Terms of Bank Lending, spreads of rates on smaller business loans (those under \$1 million) over base rates are currently elevated relative to spreads posted in the late 1980s. By contrast, spreads on large loans are not similarly elevated, suggesting that the spreads on smaller loans do not reflect higher costs of intermediation owing to factors such as increased FDIC premia or capital requirements. The survey respondents indicated that the higher spreads on small loans were primarily the result of an increase in the costs of making small business loans as well as a

rise in the riskiness of such loans relative to the late 1980s. A number of the respondents also noted an easing of competition for small business loans from both other banks and non-bank lenders. A final question asked whether the current high level of the spread of the prime rate over market rates is likely to persist over the next year. About half of the respondents indicated that it would do so.

COMMERCIAL BANK CREDIT AND SHORT- AND INTERMEDIATE-TERM BUSINESS CREDIT¹
(Percentage change at annual rate, based on seasonally adjusted data)

Type of credit	Dec. 1992 to Dec. 1993	1994 Q2	1994 Q3	1994 Aug	1994 Sep	1994 Oct	Level, Oct 1994 (\$billions)
Commercial bank credit							
1. Total loans and securities	5.3	5.8	6.8	3.9	3.4	3.0	3,286.7
2. Securities	8.6	6.3	-3.4	-9.4	-5.2	-10.9	958.1
3. U.S. government	9.6	2.6	-6.1	-7.8	-10.0	-18.5	728.6
4. Other	4.8	19.3	5.9	-14.8	10.7	14.3	229.6
5. Loans	4.0	5.5	11.2	9.6	7.0	8.8	2,328.6
6. Business	-1.8	10.0	11.6	9.1	8.5	11.1	633.6
7. Real estate	4.5	5.4	9.5	10.8	9.3	5.8	983.5
8. Consumer	9.0	13.5	18.2	17.0	13.7	18.8	441.7
9. Security	35.8	-34.5	-36.7	-41.7	-92.8	50.3	72.1
10. Other	-.6	-7.2	21.8	8.5	15.1	-19.1	197.7
Short- and intermediate-term business credit							
11. Business loans net of bankers acceptances	-2.1	9.7	11.7	8.9	8.8	12.2	624.5
12. Loans at foreign branches ²	-12.1	18.8	17.9	15.9	21.0	-36.1	22.6
13. Sum of lines 11 and 12	-2.5	9.9	11.8	9.1	8.9	10.7	647.1
14. Commercial paper issued by nonfinancial firms	4.4	-9.2	11.0	7.2	15.8	32.8	157.7
15. Sum of lines 13 and 14	-1.1	6.1	11.7	8.7	10.4	14.8	804.8
16. Bankers acceptances, U.S. trade-related ^{3,4}	-12.2	-13.3	-3.9	11.9	-11.8	n.a.	20.1 ⁵
17. Loans at finance companies ⁴	1.3	13.5	7.2	5.8	22.0	n.a.	339.1 ⁵
18. Total (sum of lines 15, 16, and 17)	-.7	7.9	10.1	8.0	13.2	n.a.	1,154.1 ⁵

1. Except as noted, levels are averages of Wednesday data and percentage changes are based on averages of Wednesday data; data are adjusted for breaks caused by reclassification; changes are measured from preceding period to period indicated.

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

3. Acceptances that finance U.S. imports, U.S. exports, and domestic shipment and storage of goods.

4. Changes are based on averages of month-end data.

5. September 1994.

n.a. Not available.

SELECTED FINANCIAL MARKET QUOTATIONS¹
(Percent except as noted)

Instrument	1993		1994		Change to Nov 9, 1994:			
	Oct lows	Feb 3	FOMC. Sep 27	Nov 9	From Oct 93 lows	From Feb 3	From FOMC. Sep 27	
SHORT-TERM RATES								
Federal funds ²	3.07	3.07	4.70	4.75	1.68	.68	0.05	
Treasury bills ³								
3-month	3.01	3.13	4.71	5.20	2.19	2.07	0.49	
6-month	3.09	3.27	5.20	5.62	2.53	2.35	0.42	
1-year	3.23	3.52	5.56	5.97	2.74	2.45	0.41	
Commercial paper								
1-month	3.13	3.16	5.03	5.24	2.11	2.08	0.21	
3-month	3.23	3.25	5.18	5.73	2.50	2.48	0.55	
Large negotiable CDs ³								
1-month	3.08	3.11	5.00	5.21	2.13	2.10	0.21	
3-month	3.22	3.25	5.18	5.72	2.50	2.47	0.54	
6-month	3.23	3.41	5.60	6.01	2.78	2.60	0.41	
Eurodollar deposits ⁴								
1-month	3.06	3.06	5.00	5.19	2.13	2.13	0.19	
3-month	3.25	3.25	5.19	5.75	2.50	2.50	0.56	
Bank prime rate	6.00	6.00	7.75	7.75	1.75	1.75	0.00	
INTERMEDIATE AND LONG-TERM RATES								
U.S. Treasury (constant maturity)								
3-year	4.06	4.60	6.83	7.35	3.29	2.75	0.52	
10-year	5.19	5.81	7.61	7.94	2.75	2.13	0.33	
30-year	5.78	6.31	7.85	8.09	2.31	1.78	0.24	
Municipal revenue ⁵ (Bond Buyer)	5.41	5.49	6.66	7.16	1.75	1.67	0.50	
Corporate--A utility, recently offered ⁶	6.79	7.35	8.73	9.00	2.21	1.65	0.27	
Home mortgages								
FHLMC 30-yr. fixed rate	6.74	6.97	8.73	9.05	2.31	2.08	0.32	
FHLMC 1-yr. adjustable rate	4.14	4.12	5.56	5.91	1.77	1.79	0.35	
Stock exchange index								
Stock exchange index	Record high		1989	1994		Percentage change to Nov 9:		
	Level	Date	Low, Jan. 3	FOMC, Sep 27	Nov 9	From record high	From 1989 low	From FOMC, Sep 27
Dow-Jones Industrial	3978.36	1/31/94	2144.64	3863.04	3831.75	-3.69	78.67	-0.81
NYSE Composite	267.71	2/2/94	154.00	254.87	255.01	-4.74	65.59	0.05
NASDAQ (OTC)	803.93	3/18/94	378.56	755.37	767.25	-4.56	102.68	1.57
Wilshire	4804.31	2/2/94	2718.59	4582.41	4610.18	-4.04	69.58	0.61

1. One-day quotes except as noted.
2. Average for two-week reserve maintenance period closest to date shown. Last observation is average for maintenance period ending Nov 9, 1994.
3. Secondary market.

4. Bid rates for Eurodollar deposits at 11 a.m. London time.
5. Most recent observation based on one-day Thursday quote and futures market index changes.
6. Quotes for week ending Friday previous to date shown.