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CONFIDENTIAL (FR)
CLASS III FOMC

December 16, 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

Housing Starts

Total housing starts increased 6.9 percent in November to 1.54 million units at an annual rate. The starts estimate for October was revised up slightly to 1.44 million units.

The regional pattern of changes in total starts suggests that construction in November might have been boosted in part by favorable weather Temperatures in both the Northeast and the Midwest were unseasonably warm, on average, and starts in those regions rose by 25 percent or more. However, temperatures also were unusually warm in the South, where starts edged up only 2 percent In the West, where average temperatures were unusually cold. starts fell only 6 percent, well within the normal range of variation. Typically, greater severity of cold weather in the Northeast and the Midwest causes construction in these areas to be more responsive to deviations from normal weather patterns, as compared with the more temperate South and West. Despite some extreme conditions in particular areas and periods, average precipitation for the major Census regions was fairly close to seasonal norms.

Single-family starts rose to 1.20 million units in November, reversing more than half of the October decline. In contrast, single-family permits edged down in both October and November Analysis of the relationship of starts to permits (which are measured with considerably less statistical error than are starts) suggests that single-family construction in November may have been lower than was indicated by the starts estimate.

Single-family starts have been surprisingly resilient in recent months. Averaging through the monthly variations, starts have remained essentially unchanged since about midyear. This pattern is broadly consistent with the behavior of permit issuance for single-family homes, which has varied within a narrow range since June.

Another sign of continued strength in the single-family sector is that a pickup in new home sales in recent months has brought sales in line with starts. However, other indicators of housing demand, including consumer attitudes toward homebuying and builders' assessments of new home sales, continued to decline in December and applications for mortgage financing to purchase new and existing homes edged down again in early December after rising a bit in November.

Multifamily housing starts rose from 287,000 units at an annual rate in October to 344,000 in November, the highest level in four years. In 1994:Q3, the multifamily rental vacancy rate declined relative to its year-earlier level for the fifth consecutive quarter.

Retail Inventories

Retail inventories rose at a $12 billion annual rate in October, substantially below the pace observed in August and September. The October slowing was largely attributable to a sharp downswing in auto dealers' stocks, which declined at an $8.3 billion annual rate in October following increases of $44 billion and $20.5 billion in the two preceding months. Excluding auto dealers, inventories in retail trade expanded at a $20.3 billion annual rate in October, similar to the September pace and faster than the pace over the third quarter. With a 1.3 percent increase in sales, the retailers' inventory-sales ratio fell from 1.54 to 1.52 months; excluding auto dealers, the ratio was unchanged at 1.49 months.

The bulk of the non-auto inventory accumulation in October was in stocks held at stores in the GAF grouping (general merchandise, apparel, and furniture and appliance); these stocks have expanded at a rate of nearly $20 billion in each of the past three months. However GAF sales have been quite robust since June, and the inventory-sales ratio for stores in this broad category, at 2.36 months in October remained within the range observed over the past year Among the GAF stores, furniture and appliance outlets reported another sizable inventory accumulation in October, but sales of these items also have been strong in recent months. (The advance retail sales report for November showed a 2.3 percent rise in furniture and appliance sales last month, after increases of 1 1 percent in October and 2.1 percent in September) On balance, the accumulation of nondurable retail inventories in October was fairly widespread; of the major categories, only food stores reported any notable inventory declines.

For all manufacturing and trade excluding retail auto dealers, inventories rose at a $54 billion annual rate in October about the same pace as the third-quarter average.[1] With a 0.3 percent increase in non-auto shipments and sales in October the inventory-sales ratio for manufacturing and trade, excluding auto dealers, edged up to 1.38 months, only a little above the low end of the range of the past year

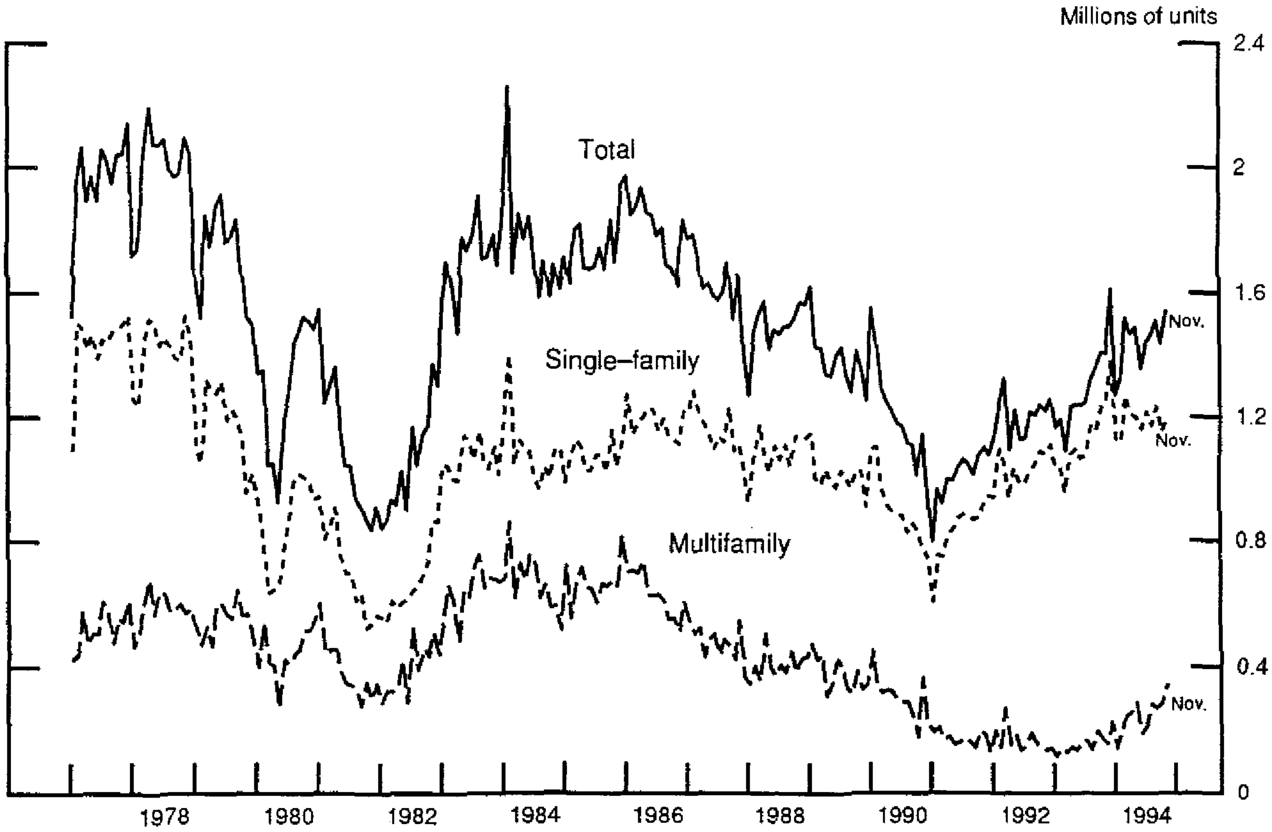
1 For all manufacturing and trade excluding auto dealers, inventory investment in September was revised up only slightly, as upward revisions to manufacturing and wholesale stock buildups were nearly offset by downward revisions to the accumulation of retail inventories. The net revision to the September inventory change is not expected to have much effect on BEA's estimate of third-quarter GDP growth.

PRIVATE HOUSING ACTIVITY
(Millions of units; seasonally adjusted annual rates)

	1993		1994					
	Annual	Q4	Q1	Q2	Q3[r]	Sept.[r]	Oct.[r]	Nov.[p]
All units								
Starts	1.29	1.48	1.37	1.44	1.47	1.51	1.44	1.54
Permits	1.20	1.38	1.29	1.35	1.37	1.43	1.40	1.38
Single-family units								
Starts	1.13	1.29	1.17	1.19	1.21	1.23	1.15	1.20
Permits	.99	1.13	1.06	1.07	1.04	1.05	1.05	1.04
New-home sales	.67	.77	.69	.66	.68	.72	.73	n.a.
Existing-home sales	3.80	4.17	4.05	4.06	3.93	3.89	3.91	n.a.
Multifamily units								
Starts	.16	.19	.20	.25	.26	.28	.29	.34
Permits	.21	.25	.23	.29	.33	.37	.35	.35

Note. p Preliminary. r Revised. n.a. Not available.

Private Housing Starts
(Seasonally adjusted annual rate)



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

	1994			1994		
	Q1	Q2	Q3	Aug.	Sept.	Oct.
Total	18.4	75.6	70.6	93.9	50.8	45.6
Excluding wholesale and retail motor vehicles	21.1	58.9	53.4	57.0	27.9	49.6
Manufacturing	9.4	13.3	13.7	4.4	-5.8	17.5
Defense aircraft	-4.4	-4.7	-2.3	-4.9	-2.9	.2
Nondefense aircraft	-1.4	3.7	-.8	2.0	-4.7	-2.5
Excluding aircraft	15.2	14.4	16.8	7.3	1.8	19.7
Wholesale	3.1	23.0	22.7	11.5	14.1	16.2
Excluding motor vehicles	8.3	16.6	23.0	18.7	11.7	11.9
Retail	5.9	39.4	34.2	78.0	42.5	12.0
Automotive	2.6	10.4	17.5	44.0	20.5	-8.3
Excluding auto dealers	3.4	29.0	16.7	34.0	22.0	20.3
Constant-dollar basis						
Total	9.9	39.0	38.4	34.5	8.2	n.a.
Excluding motor vehicles	11.8	35.6	31.2	36.2	7.2	n.a.
Manufacturing	9.9	.7	3.6	-1.6	-16.4	n.a.
Wholesale	-2.0	16.0	14.0	5.8	4.2	n.a.
Excluding motor vehicles	3.0	10.8	14.5	12.5	2.0	n.a.
Retail	2.0	22.3	20.7	30.2	20.4	n.a.
Automotive	2.5	-1.9	6.9	4.3	-2.3	n.a.
Excluding auto dealers	-.5	24.2	13.8	25.9	22.7	n.a.

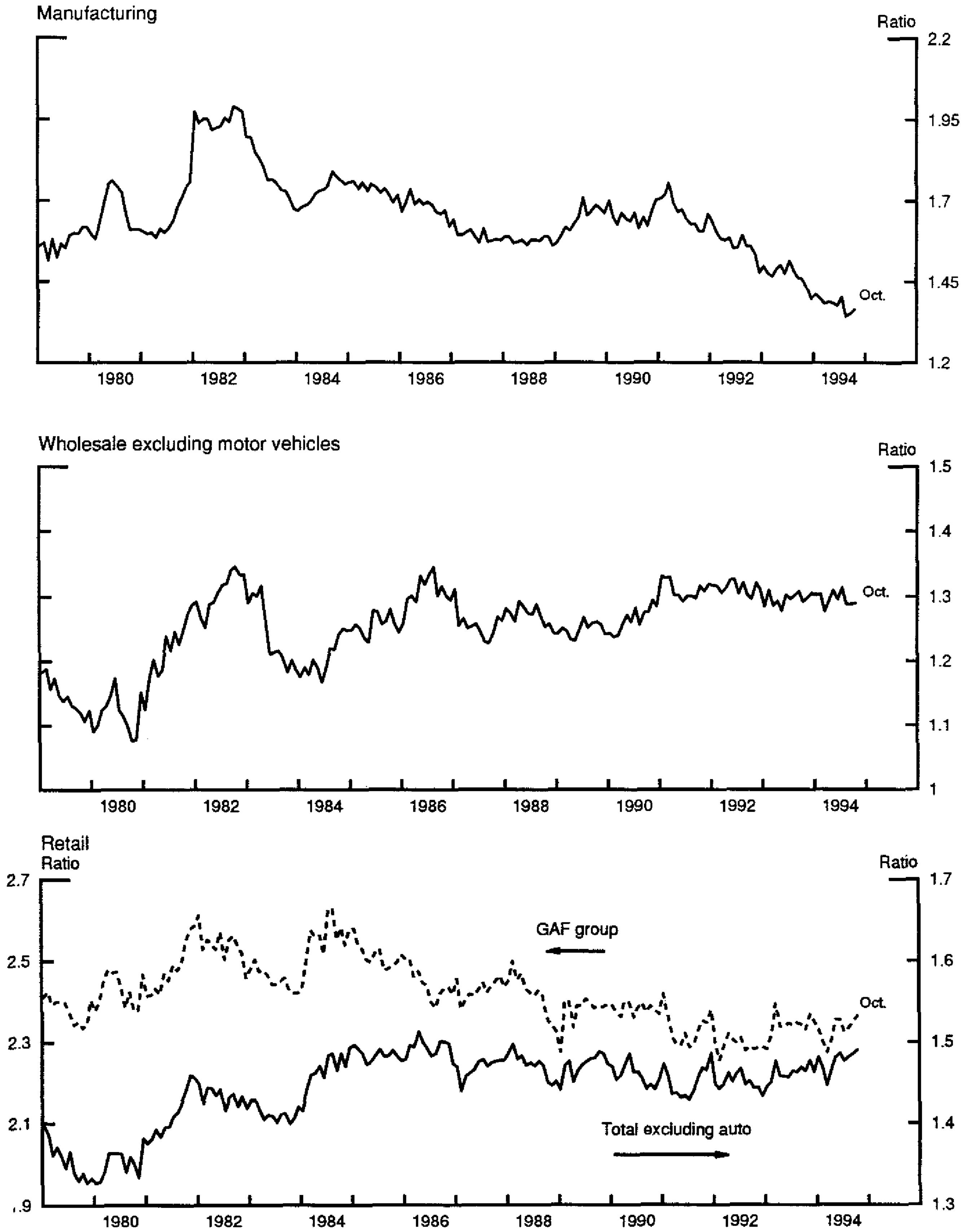
INVENTORIES RELATIVE TO SALES[1]
(Months supply; based on seasonally adjusted data at book value)

	1994			1994		
	Q1	Q2	Q3	Aug.	Sept.	Oct.
Total	1.41	1.41	1.41	1.39	1.40	1.40
Excluding wholesale and retail motor vehicles	1.39	1.39	1.38	1.36	1.37	1.38
Manufacturing	1.40	1.39	1.36	1.34	1.35	1.37
Defense aircraft	4.80	4.85	4.69	4.49	4.95	4.79
Nondefense aircraft	5.00	5.84	5.54	5.62	5.38	5.76
Excluding aircraft	1.28	1.26	1.25	1.23	1.23	1.25
Wholesale	1.31	1.33	1.32	1.30	1.31	1.32
Excluding motor vehicles	1.30	1.30	1.30	1.29	1.29	1.29
Retail	1.50	1.54	1.55	1.53	1.54	1.52
Automotive	1.61	1.67	1.75	1.70	1.71	1.63
Excluding auto dealers	1.47	1.50	1.50	1.48	1.49	1.49
Constant-dollar basis						
Total	1.46	1.46	1.46	1.44	1.44	n.a.
Excluding motor vehicles	1.52	1.51	1.51	1.49	1.50	n.a.
Manufacturing	1.44	1.43	1.41	1.40	1.40	n.a.
Wholesale	1.39	1.41	1.40	1.39	1.39	n.a.
Excluding motor vehicles	1.39	1.39	1.39	1.38	1.38	n.a.
Retail	1.53	1.56	1.57	1.56	1.56	n.a.
Automotive	1.56	1.57	1.62	1.62	1.61	n.a.
Excluding auto dealers	1.52	1.55	1.56	1.54	1.55	n.a.

1. Ratio of end-of-period inventories to average monthly sales for the period.

Ratio of Inventories to Sales

(Book value)



THE FINANCIAL ECONOMY

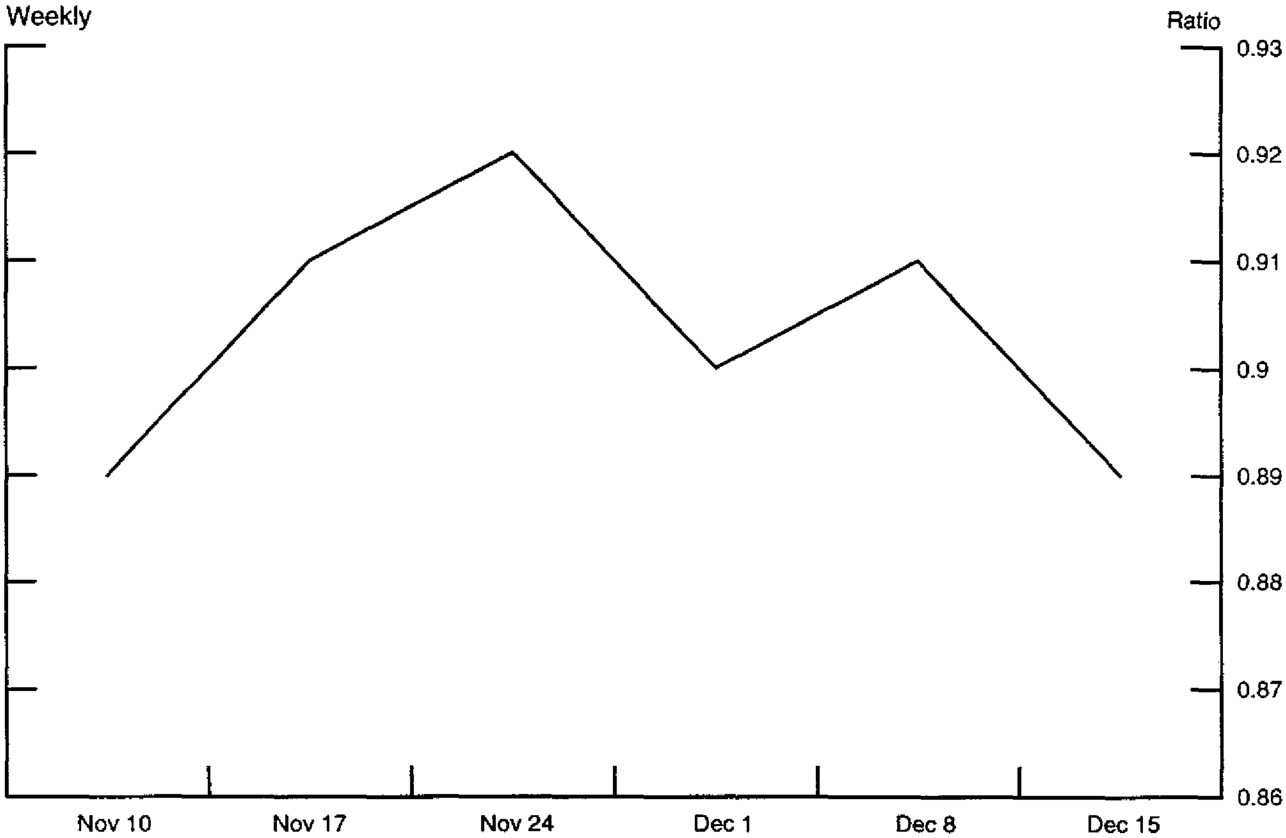
Municipal Markets

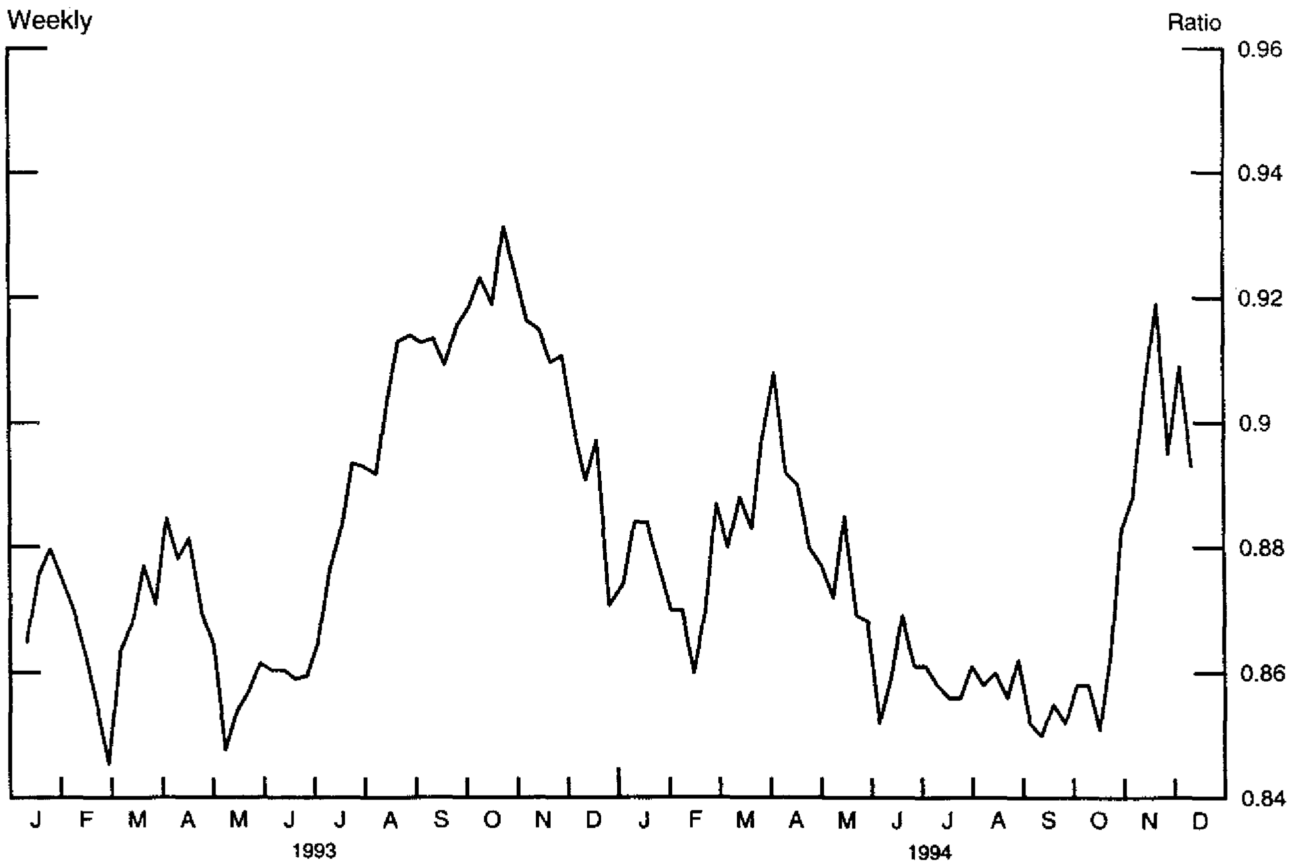
The municipal market continued to rally for a time after the close of the Greenbook on Wednesday, as concern about the Orange County developments receded further. The ratio of municipal bond yields to Treasuries dropped from 0.91 last week to 0.89, measured about Thursday noon, its lowest level since early November. Issuance of tax-exempt debt increased to almost $3 billion over the week, the highest weekly volume in about a month.

However, the rally stalled on Thursday, and the municipal market again showed signs of stress, especially in short-term maturities. Tax-exempt bond and money funds circulated large bid lists indicating sizable net redemptions over the week. The yields on Orange County notes backed by letters of credit are about 225 basis points above comparable paper issued elsewhere in California. Dealers also report being unable to place the tax-exempt paper of Riverside County, California, and Texas municipalities, even though these entities have no exposure to the loss-plagued investment pools in Orange County and Texas.

Orange County's estimate of the losses on its investment pool remains at about $2 billion. The county's new financial advisor, Robert Hayes, has vowed to completely restructure the fund's portfolio within ninety days. At that time, the average maturity of securities in the fund should resemble that of a typical money market fund. The restructuring has already begun, as the fund sold almost $500 million in medium-term fixed-income agency issues on Thursday; the remaining $1 billion in the fund's most liquid securities are slated to be sold today. The fund will sell its more unusual structured notes at later dates. In a related development, an Orange County official announced that it would file a lawsuit as early as next week, alleging that Merrill Lynch failed to disclose the risks associated with the securities it sold to the county.

Ratio of Tax-Exempt Yield to Treasury Yield





Ratio of the Bond Buyer 30-year revenue bond index to yield on 30-year Treasury bond.

SELECTED FINANCIAL MARKET QUOTATIONS
(Percent except as noted)

Instrument	1993 Oct lows	1994 Feb 3	1994 FOMC,* Nov 15	1994 Dec 15	Change to Dec 15, 1994: From Oct 93 lows	From Feb 3	From FOMC,* Nov 15
SHORT-TERM RATES							
Federal funds[2]	3.07	3.07	4.75	5.50	2.43	2.43	0.75
Treasury bills[3]							
3-month	3.01	3.13	5.28	5.54	2.53	2.41	0.26
6-month	3.09	3.27	5.69	6.19	3.10	2.92	0.50
1-year	3.23	3.52	6.11	6.64	3.41	3.12	0.53
Commercial paper							
1-month	3.13	3.16	5.32	6.13	3.00	2.97	0.81
3-month	3.23	3.25	5.76	6.30	3.07	3.05	0.54
Large negotiable CDs[3]							
1-month	3.08	3.11	5.27	6.08	3.00	2.97	0.81
3-month	3.22	3.25	5.71	6.31	3.09	3.06	0.60
6-month	3.23	3.41	6.01	6.82	3.59	3.41	0.81
Eurodollar deposits[4]							
1-month	3.06	3.06	5.25	6.06	3.00	3.00	0.81
3-month	3.25	3.25	5.75	6.25	3.00	3.00	0.50
Bank prime rate	6.00	6.00	7.75	8.50	2.50	2.50	0.75
INTERMEDIATE- AND LONG-TERM RATES							
U.S. Treasury (constant maturity)							
3-year	4.06	4.60	7.37	7.66	3.60	3.06	0.29
10-year	5.19	5.81	7.94	7.79	2.60	1.98	-0.15
30-year	5.78	6.31	8.09	7.86	2.08	1.55	-0.23
Municipal revenue[5] (Bond Buyer)	5.41	5.49	7.23	7.02	1.61	1.53	-0.21
Corporate--A utility, recently offered	6.79	7.35	8.89	8.78	1.99	1.43	-0.11
Home mortgages[6]							
FHLMC 30-yr. fixed rate	6.74	6.97	9.19	9.15	2.41	2.18	-0.04
FHLMC 1-yr. adjustable rate	4.14	4.12	6.01	6.56	2.42	2.44	0.55

Stock exchange index	Record high: Level	Record high: Date	1989 Low, Jan. 3	1994 FOMC,* Nov 15	1994 Dec 15	Percentage change to Dec 15: From record high	From 1989 low	From FOMC,* Nov 15
Dow-Jones Industrial	3978.36	1/31/94	2144.64	3829.73	3765.47	-5.35	75.58	-1.68
NYSE Composite	267.71	2/2/94	154.00	254.84	248.96	-7.00	61.66	-2.31
NASDAQ (OTC)	803.93	3/18/94	378.56	768.14	730.68	-9.11	93.02	-4.88
Wilshire	4804.31	2/2/94	2718.59	4611.07	4480.90	-6.73	64.82	-2.82

1. One-day quotes except as noted.
2. Average for two-week reserve maintenance period closest to date shown. Last observation is average to date for maintenance period ending Dec 21, 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.

* Figures are as of the close on Nov. 14, 1994.

THE INTERNATIONAL ECONOMY

U.S. International Transactions in 1994-Q3

The U.S. current account deficit was $167 billion SAAR in the third quarter, $15 billion larger than in the second quarter. Most of the change was in net trade in goods and services (imports rose more than exports grew). A 4.5 percent increase in the value of imports was spread among all major trade categories and reflected the strength of consumption and investment spending in the United States. The 3.5 percent increase in exports was largely in machinery, industrial supplies and consumer goods.

Both income payments and receipts rose sharply in the third quarter, with income payments on foreign assets in the United States increasing more than income receipts from U.S. assets abroad. The jump in income payments primarily reflected higher earnings on foreign direct investment in the United States; payments to foreign residents on their portfolio investments in the United States also rose, reflecting both higher interest rates and greater liabilities.

U.S. CURRENT ACCOUNT
(Billions of dollars, seasonally adjusted annual rates)

	Goods & services balance	Investment income, net	Transfers net	Current acct. balance
Years				
1992	-40.4	4.5	-32.0	-67.9
1993	-75.7	3.9	-32.1	-103.9
Quarters				
1993-1	-57.7	7.4	-29.1	-79.4
2	-76.3	2.7	-28.8	-102.4
3	-89.0	8.1	-30.5	-111.4
4	-79.9	-2.4	-40.1	-122.3
1994-1	-97.3	-3.2	-28.7	-129.3
2-r	-106.6	-11.2	-33.8	-151.6
3	-118.0	-15.8	-33.1	-166.9
Memo:				
$ Change				
Q2-Q1	-9.3	-8.0	-5.1	-22.4
Q3-Q2	-11.5	-4.6	.8	-15.3

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

Most of the increase in income receipts on U.S. assets abroad reflected a sharp rise in earnings on direct investments; income on portfolio investments abroad also rose largely reflecting higher interest rates.

Capital flows. Foreign direct investment in the United States rose to more than $13 billion in the third quarter, up from $5 billion in the second quarter (See line 7 of the Summary of U.S. International Transactions table.) One of the factors swelling inflows was the takeover of Gerber by Sandoz. A revival of takeover activity by foreign firms in the United States has been an important factor in swelling inflows during much of 1994. Another factor has been the revival of affiliates' profits and reinvested earnings.

U.S. direct investment abroad also has been affected by continued takeover activity abroad by U.S. firms. However, direct investment capital outflows in the third quarter ($9.5 billion) remained about level with the second quarter far below the fourth quarter of 1993 and the first quarter of 1994 (line 6) These wide swings largely reflected short-term intercompany debt transactions between finance affiliates in the United Kingdom and their U.S. parents.

SUMMARY OF U.S. INTERNATIONAL TRANSACTIONS[1]
(Billions of dollars, not seasonally adjusted except as noted)

	Year		Quarter				Month		
			1993	1994			1994		
	1992	1993	Q4	Q1	Q2	Q3	Aug.	Sept.	Oct.
Official capital									
1. Changes in foreign official reserve assets in U.S. (+ = increase)	**38.3**	**70.2**	**23.3**	**10.3**	**8.7**	**18.4**	**2.3**	**1.5**	**10.4**
a. G-10 countries	4.8	29.9	4.8	10.8	15.7	9.0	3.3	-.5	1.0
b. OPEC countries	4.9	-5.1	-.9	-2.3	-4.7	3.3	1.1	.7	.5
c. All other countries	28.6	45.4	19.4	1.9	-2.4	6.0	-2.2	1.3	8.9
2. Changes in U.S. official reserve assets (+ = decrease)	**3.9**	**-.7**	**-.7**	**-.1**	**3.5**	**-.2**	**-.1**	**-.1**	**-.2**
Private capital									
Banks									
3. Change in net foreign positions of banking offices in the U.S.[2]	**35.6**	**8.5**	**4.7**	**38.0**	**38.1**	**10.0**	**-8.1**	**7.7**	**1.3**
Securities[3]									
4. Foreign net purchases of U.S. securities (+)	**68.1**	**105.5**	**45.8**	**31.1**	**6.3**	**19.7**	**18.5**	**5.9**	**8.9**
a. Treasury securities[4]	37.4	24.7	8.1	9.5	-7.3	5.2	9.3	5.3	8.0
b. Corporate and other bonds[5]	34.3	61.2	25.5	13.7	14.8	13.3	6.2	1.7	2.7
c. Corporate stocks	-3.7	19.6	12.2	8.0	-1.3	1.1	3.0	-1.2	-1.9
5. U.S. net purchases (-) of foreign securities	**-47.9**	**-132.8**	**-34.6**	**-25.1**	**-18.0**	**-9.2**	**-3.7**	**-.2**	**-7.9**
a. Bonds	-15.6	-69.5	-13.9	-6.6	-5.3	-2.3	-.9	-.9	-3.9
b. Stocks	-32.3	-63.3	-20.7	-18.5	-12.7	-7.0	-4.6	.7	-4.0
Other flows (quarterly data, s.a.)									
6. U.S. direct investment (-) abroad	-41.0	-57.9	-22.7	-24.8	-8.0	-9.5	n.a.	n.a.	n.a.
7. Foreign direct investment in U.S.	9.9	21.4	8.1	12.0	5.4	13.3	n.a.	n.a.	n.a.
8. Other (+ = inflow)[6]	18.1	68.6	2.7	5.4	6.2	-6.1	n.a.	n.a.	n.a.
U.S. current account balance (s.a.)	-67.9	-103.9	-30.6	-32.3	-37.9	-41.7	n.a.	n.a.	n.a.
Statistical discrepancy (s.a.)	-17.1	21.1	4.0	-14.5	-4.3	5.3	n.a.	n.a.	n.a.

1. The sum of official capital, private capital, the current account balance, and the statistical discrepancy is zero. Details may not sum to totals becuse of rounding.
2. Changes in dollar-denominated positions of all depository institutions and bank holding companies plus certain transactions between broker-dealers and unaffiliated foreigners (particularly borrowing and lending under repurchase agreements). Includes changes in custody liabilities other than U.S. Treasury bills.
3. Includes commissions on securities transactions and therefore does not match exactly the data on U.S. international transactions published by the Department of Commerce.
4. Includes Treasury bills.
5. Includes U.S. government agency bonds.
6. Transactions by nonbanking concerns and other banking and official transactions not shown elsewhere plus amounts resulting from adjustments made by the Department of Commerce and revisions in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business.

n.a. Not available. * Less than $50 million.