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Confidential (FR) Class II FOMC

January 27, 1982

RECENT DEVELOPMENTS

Prepared for the Federal Open Market Committee
By the staff of the Board of Governors of the Federal Reserve System

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SELECTED DOMESTIC NONFINANCIAL DATA
(Seasonally adjusted)

	Latest data			Percent change from		
	Period	Release date	Data	Preceding period	Three periods earlier	Year earlier
					(At annual rate)	
Civilian labor force	Dec.	1-8-82	106.7	-4.2	1.6	1.5
Unemployment rate (%) 1/	Dec.	1-8-82	8.9	8.4	7.5	7.4
Insured unemployment rate (%) 1/	Dec.	1-8-82	4.1	4.0	3.4	3.7
Nonfarm employment, payroll (mil.)	Dec.	1-8-82	91.2	-3.8	-3.6	.3
Manufacturing	Dec.	1-8-82	19.8	-13.4	-13.9	-1.9
Nonmanufacturing	Dec.	1-8-82	71.4	-1.2	-.6	.9
Private nonfarm:						
Average weekly hours (hr.) 1/	Dec.	1-8-82	34.9	35.0	34.9	35.3
Hourly earnings ($) 1/	Dec.	1-8-82	7.45	7.44	7.37	6.94
Manufacturing:						
Average weekly hours (hr.) 1/	Dec.	1-8-82	39.1	39.3	39.3	39.9
Unit labor cost (1967=100)	Nov.	12-29-81	220.5	24.4	18.4	10.3
Industrial production (1967=100)	Dec.	1-15-82	143.3	-25.4	-21.9	-4.7
Consumer goods	Dec.	1-15-82	142.3	-22.3	-14.9	-3.3
Business equipment	Dec.	1-15-82	176.3	-14.1	-14.0	-.5
Defense & space equipment	Dec.	1-15-82	105.4	5.7	9.3	4.4
Materials	Dec.	1-15-82	139.5	-38.3	-34.1	-8.3
Consumer prices all items (1967=100)	Dec.	1-22-82	282.6	5.1	5.2	8.9
All items, excluding food & energy	Dec.	1-22-82	268.2	5.8	5.6	9.6
Food	Dec.	1-22-82	281.2	5.1	3.7	4.1
Producer prices: (1967=100)						
Finished goods	Dec.	1-13-82	275.9	3.1	5.3	7.0
Intermediate materials, nonfood	Dec.	1-13-82	316.9	4.6	3.4	7.4
Crude foodstuffs & feedstuffs	Dec.	1-13-82	237.5	-30.0	-28.0	-13.9
Personal income ($ bil.) 2/	Dec.	1-19-82	2,492.1	2.2	4.8	9.5
					(Not at annual rates)	
Mfrs. new orders dur. goods ($ bil.)	Dec.	1-25-82	80.5	1.6	-6.7	-7.0
Capital goods industries	Dec.	1-25-82	28.1	.0	-4.9	-5.2
Nondefense	Dec.	1-25-82	22.8	-2.1	-1.1	-7.7
Defense	Dec.	1-25-82	5.4	10.5	-18.2	7.4
Inventories to sales ratio: 1/						
Manufacturing and trade, total	Nov.	1-14-82	1.50	1.48	1.42	1.40
Manufacturing	Nov.	12-31-81	1.73	1.70	1.61	1.58
Trade	Nov.	1-14-82	1.29	1.29	1.25	1.23
Ratio: Mfrs.' durable goods inventories to unfilled orders 1/	Nov.	12-31-81	.603	.597	.574	.557
Retail sales, total ($ bil.)	Dec.	1-13-82	87.5	.4	-1.3	4.9
GAF 3/	Dec.	1-13-82	18.6	1.1	.6	5.0
Auto sales, total (mil. units.) 2/	Dec.	1-5-82	7.3	-4.9	-17.6	-19.1
Domestic models	Dec.	1-5-82	4.9	-9.3	-28.8	-24.1
Foreign models	Dec.	1-5-82	2.4	5.7	21.1	-6.4
Plant & Equipment expen. ($ bil.)4/						
Total nonfarm business	1982	1-13-82	346.42	—	—	7.4
Manufacturing	1982	1-13-82	139.34	—	—	8.6
Nonmanufacturing	1982	1-13-82	207.08	—	—	6.6
Housing starts, private (thous.) 2/	Dec.	1-19-82	.98	13.3	6.8	-36.3
Leading indicators (1967=100)	Nov.	12-29-81	127.8	-.3	-4.0	-6.4

1/ Actual data used in lieu of percent changes for earlier periods.
2/ At annual rate.
3/ Excludes mail order houses.
4/ Planned-Commerce December 1981 Survey.

Economic activity contracted sharply in the fourth quarter, although the momentum of decline in some sectors appears to have moderated toward the end of the year. Consumer spending leveled off in real terms in November and December, and auto sales have edged up in recent weeks. Moreover, housing starts rose slightly in December. However, inventories apparently remained high relative to the depressed level of sales, and declines in industrial output and employment probably continued into January. The inflation rate slowed noticeably in the final months of 1981, and by year-end rates of increase in all broad price measures were well below the double-digit rates of 1979 and 1980.

Industrial Production

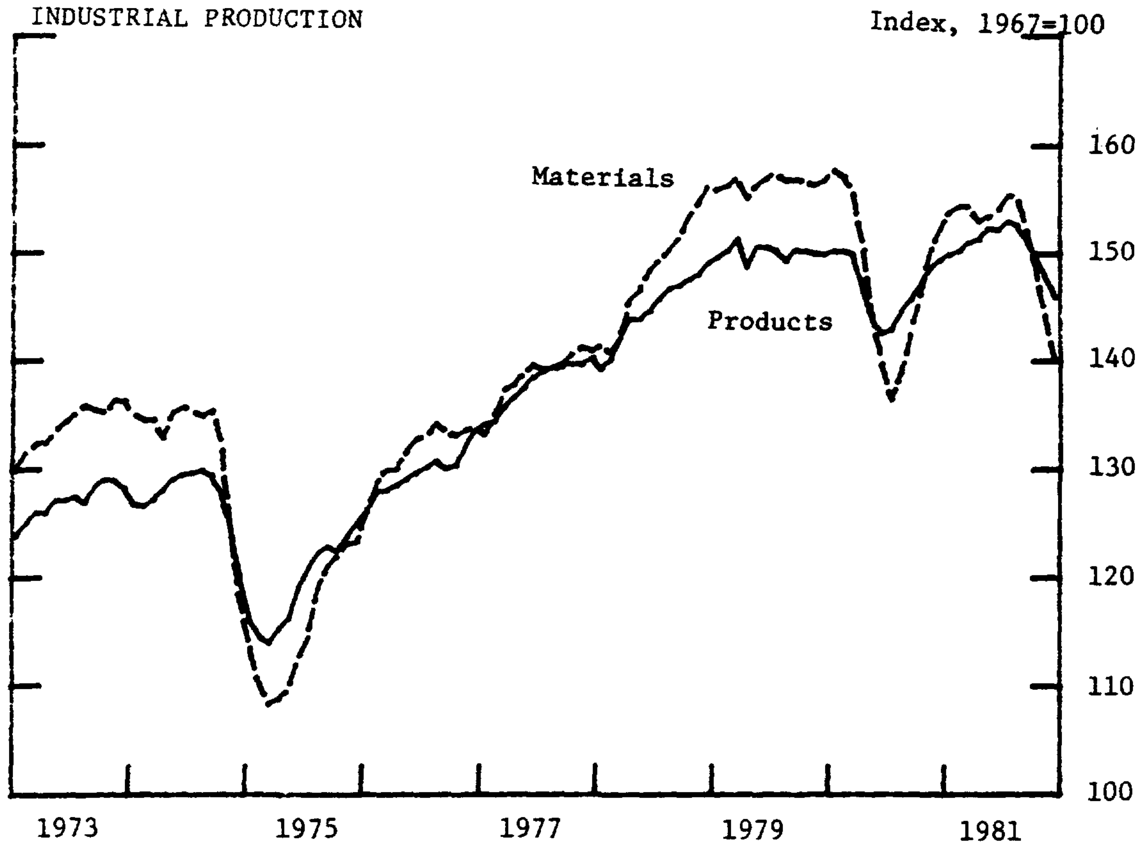
The index of industrial production fell 2.1 percent in December, slightly more than in November. The cumulative decline in industrial output since its peak in July totals nearly 7 percent, a contraction that almost equals the sharp drop in the first half of 1980. Production cutbacks at year's end again were widespread; output of defense and space equipment was the exception. Reductions were especially large for durable home goods, construction supplies, durable materials (mainly metals and parts for consumer durable goods), and nondurable materials. As is typical in cyclical downturns, the production of materials has dropped more precipitously than output of final products; from July through December, materials production fell more than 10 percent, while output of products declined about 4-3/4 percent.

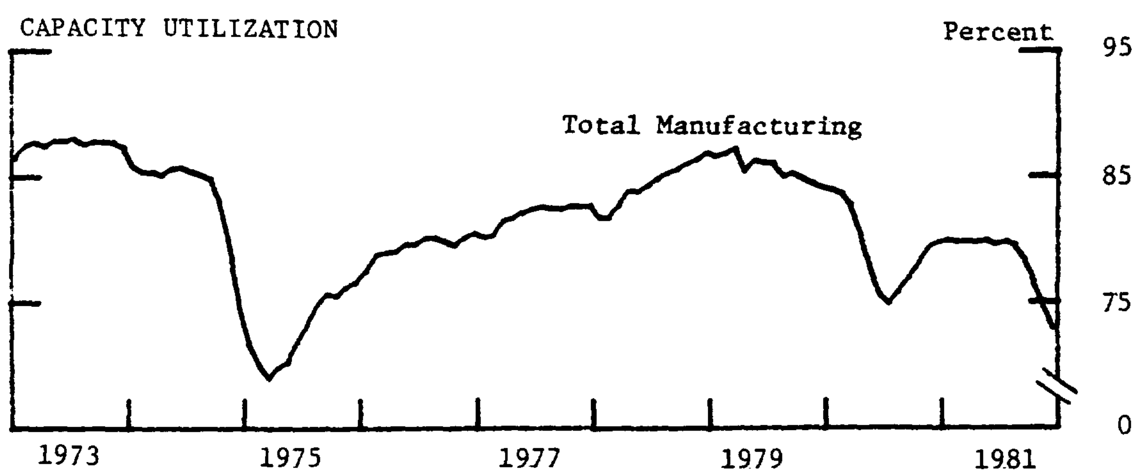
INDUSTRIAL PRODUCTION
(Percentage change from preceding period;
based on seasonally adjusted data)

	1981			1981		
	Q2	Q3	Q4	Oct.	Nov.	Dec.
	---annual rate---			---monthly rate---		
Total	1.9	1.4	-16.5	-1.6	-1.9	-2.1
Final products	7.1	.8	-9.7	-.6	-1.1	-1.4
Consumer goods	6.3	-1.5	-11.9	-.6	-1.3	-1.9
Durable	14.5	-8.9	-31.6	-2.9	-4.8	-4.2
Nondurable	3.4	1.4	-3.5	.3	-.1	-1.1
Business equipment	9.4	3.9	-11.5	-1.2	-1.2	-1.2
Defense and space eq.	4.1	4.3	8.6	1.5	.4	.5
Construction supplies	-7.4	-8.6	-26.3	-3.2	-2.4	-2.2
Materials	-1.9	2.5	-24.2	-2.6	-3.0	-3.2
Durable goods	3.7	1.2	-28.8	-3.2	-3.6	-3.9
Nondurable goods	-1.7	-5.7	-23.4	-2.8	-3.6	-3.6
Energy materials	-16.6	22.4	-11.3	-.5	-.4	-.5

CAPACITY UTILIZATION RATES: MANUFACTURING AND MATERIALS
(Percent, seasonally adjusted)

	1978-80	1980	1981		1981	
	High	Low	Q3	Q4	Nov.	Dec.
Manufacturing industries	87.2	74.9	79.3	74.8	74.8	72.9
Primary processing	90.1	71.0	79.4	72.8	72.9	69.9
Advanced processing	86.2	77.2	79.2	75.8	75.8	74.5
Motor vehicles & pts.	94.5	51.0	60.4	51.4	50.4	48.7
Materials producers	88.8	73.8	81.2	75.3	75.3	72.7
Durable goods mats.	88.4	68.2	78.7	71.9	72.0	69.0
Raw steel	100.7	55.3	81.4	70.3	70.0	67.6
Nondurable goods mats.	91.6	77.5	83.3	77.2	77.1	74.2
Energy materials	88.8	82.7	84.9	82.1	82.1	81.5


INDUSTRIAL PRODUCTION
Index, 1967=100
Materials
Products
160
150
140
130
120
110
100
1973
1975
1977
1979
1981


CAPACITY UTILIZATION
Percent
Total Manufacturing
95
85
75
0
1973
1975
1977
1979
1981

CHANGES IN EMPLOYMENT[1]
(Thousands of employees; based on seasonally adjusted data)

	1979	1980	1981 H1	Q3	Q4	1981 Oct.	Nov.	Dec.
	- - Average monthly changes - -							
Nonfarm payroll employment[2]	170	34	111	139	-276	-201	-333	-293
Strike adjusted	176	28	124	122	-287	-216	-354	-292
Manufacturing	-5	-58	42	24	-237	-255	-233	-223
Durable	1	-47	34	11	-186	-196	-187	-174
Nondurable	-6	-12	8	13	-51	-59	-46	-49
Construction	15	-12	-17	-4	-26	-13	-31	-34
Trade	30	12	41	52	-49	44	-95	-95
Finance and services	84	79	66	83	29	8	40	38
Government	27	13	-33	-45	21	33	-5	34
Private nonfarm production workers	103	-9	104	159	-321	-243	-351	-370
Manufacturing production workers	-16	-67	31	12	-230	-251	-242	-196
Total employment[3]	172	-42	185	-41	-361	-53	-192	-837
Nonagricultural	174	-48	207	-56	-296	-79	-218	-590

1. Average change from final month of preceding period to final month of period indicated. These figures are revised to reflect new seasonal factors and the 1980 benchmark to the establishment survey data.
2. Survey of establishments. Strike-adjusted data noted.
3. Survey of households.

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

	1979	1980	1981 H1	Q3	Q4	1981 Oct.	Nov.	Dec.
Total, 16 years and older	5.8	7.1	7.4	7.2	8.4	8.0	8.4	8.9
Teenagers	16.1	17.7	19.2	18.7	21.3	30.6	21.8	21.7
20-24 years old	9.0	11.5	12.1	11.7	13.2	12.8	13.0	13.7
Men, 25 years and older	3.3	4.7	4.8	4.8	5.9	5.5	5.8	6.5
Women, 25 years and older	4.8	5.5	5.8	5.7	6.3	6.1	6.4	6.5
White	5.1	6.3	6.6	6.2	7.4	6.9	7.4	7.8
Black and other	11.3	13.2	13.5	14.6	15.7	15.5	15.5	16.1
Fulltime workers	5.3	6.8	7.1	6.9	8.2	7.7	8.1	8.7
White collar	3.3	3.7	4.0	4.0	4.3	4.1	4.2	4.6
Blue collar	6.9	10.0	9.9	9.6	11.9	11.1	11.8	12.9

Further cutbacks in production appear to be occurring in January. Poor auto sales in December frustrated dealers' efforts to trim inventories significantly, and auto assemblies scheduled for January were scaled back even further to a 3.6 million unit annual rate--down from a 4.6 million unit rate in December. In addition, weekly data on steel production suggest that more reductions likely occurred in January.

Employment and Unemployment

Labor market conditions continued to deteriorate in December: manufacturing layoffs again were widespread, construction employment declined further, and hiring at retail establishments was unseasonably weak. As a result, the unemployment rate jumped another 1/2 percentage point to 8.9 percent. Moreover, in the period since the mid-December labor market surveys were taken, labor demand appears to have remained weak; initial claims for unemployment insurance have remained very high. There have been reports of additional plant closings, although some of those shutdown earlier have reopened.

The establishment survey reported that nonfarm employment fell 300,000 in December. With this third consecutive large monthly drop, employment in both manufacturing and construction fell to a level below their 1980 troughs. As in recent months, the December decline was concentrated in the cyclically sensitive durable goods industries in which sales have been especially weak; the factory workweek also was shortened again. At retail stores, pre-Christmas hiring fell short of the normal December increase, and seasonally adjusted employment dropped 80,000 for the second consecutive month.

RETAIL SALES
(Percent change from preceding period;
based on seasonally adjusted data)

	1981							
	Q1	Q2	Q3	Q4	Sept.	Oct.	Nov.	Dec.
	- - quarterly rate - -				- - monthly rate - -			
Total sales	4.9	-.4	2.3	-1.2	.1	-2.3	.7	.4
(Real)[1]	2.9	-1.7	.5	n.a.	-.8	-2.7	.4	n.a.
Total, less autos and nonconsumption items	3.5	1.0	1.1	.8	.3	-.2	.4	.6
Total, exc. auto group, gasoline, and nonconsumption items	3.3	1.1	1.3	.8	.0	.0	.3	.7
GAF[2]	3.1	1.1	.6	.1	-.9	-.5	.0	1.1
Durable goods	8.5	-4.1	5.2	-6.1	-.2	-7.3	.7	.4
Automotive	10.0	-5.6	9.8	-8.7	-.6	-10.2	1.2	-.6
Furniture & appliances	4.4	-2.6	.2	-.2	.6	-2.6	-.3	2.3
Nondurable goods	3.3	1.3	1.0	1.1	.3	.0	.6	.3
Apparel	5.1	-.5	2.3	-1.9	.2	-1.7	-1.3	.6
Food	2.1	2.2	2.1	1.8	-1.1	.8	1.8	-.4
General merchandise	1.8	3.2	.1	1.1	-1.9	.7	.6	.9
Gasoline	4.9	.1	-.1	.6	2.4	-1.5	1.3	-.4

1. BCD series 59. Data are available approximately 3 weeks following the retail sales release.
2. General merchandise (excludes mail-order nonstores), apparel, and furniture and appliance stores.

AUTO SALES
(Millions of units; seasonally adjusted annual rates)

	1981							
	Q1	Q2	Q3	Q4	Sept.	Oct.	Nov.	Dec.
Total	10.0	7.9	9.0	7.4	8.8	7.2	7.7	7.3
Foreign-made	2.7	2.3	2.1	2.2	2.0	2.0	2.3	2.4
U.S.-made	7.3	5.6	6.9	5.1	6.9	5.1	5.4	4.9
Small	3.9	2.9	3.5	2.6	3.5	2.6	2.8	2.3
Intermediate & standard	3.4	2.8	3.4	2.5	3.5	2.5	2.6	2.6

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

Virtually all of the increase in unemployment last month resulted from layoffs. Since last summer, when unemployment averaged about 7-1/4 percent, the rate has jumped 1-3/4 percentage points. Much of the increase has been among adult men, reflecting the widespread layoffs in manufacturing. In addition to the rise in measured unemployment in recent months, the number of workers on involuntary part-time schedules and the number of discouraged workers--those who have left the labor force because they think no work is available--has increased substantially.

Consumer Spending and Personal Income

Consumer demand fell sharply early in the fourth quarter, but appears to have leveled off toward year-end. Sales of new domestic model autos have averaged 5-1/4 million units (annual rate) since early December, about the same pace as for the fourth quarter as a whole. In the first three weeks of January, sales of these models were reported to have picked up to a 6 million unit annual rate. Demand for imported automobiles has remained firm in recent months, averaging 2-1/4 million units in the fourth quarter.

Outside the automotive area, retail sales for consumer items increased 0.7 percent in December, following practically no change in the three preceding months; after adjusting for price increases, sales probably were about unchanged. Sales of furniture and appliances rose substantially, partially reversing a large decline over the preceding two months, and spending for general merchandise rose almost 1 percent. The gains were partially offset by declines in expenditures for food.

PERSONAL INCOME
(Based on seasonally adjusted data)

	1979	1980	1981	1981				
				Q3	Q4	Oct.	Nov.	Dec.
	- - - - Percentage changes at annual rates[1] - - - -							
Total personal income	12.3	11.0	10.1	13.0	7.2	5.3	6.8	2.2
Wage and salary disbursements	10.8	9.0	9.0	8.9	6.7	5.7	6.7	-0.6
Private	11.6	9.2	9.3	9.5	5.2	2.4	6.7	-1.9
Disposable personal income								
Nominal	11.7	10.9	10.3	11.8	9.0	12.5	5.8	1.7
Real	2.0	.8	2.1	2.6	-1.3	4.7	.5	-3.3
	- - - - - Changes in billions of dollars[2] - - - - -							
Total personal income	18.3	18.7	18.0	26.1	9.8	10.9	14.2	4.4
Wage and salary disbursements	10.3	9.8	9.5	12.1	5.0	7.1	8.6	-0.7
Private	8.9	8.1	7.8	10.3	2.5	2.5	6.9	-2.0
Manufacturing	2.0	2.3	1.6	2.2	-2.2	-1.5	-2.3	-2.9
er income	8.9	9.6	9.7	14.7	5.2	4.5	6.0	5.0
Transfer payments	2.8	4.1	2.8	5.5	1.6	0.3	2.7	1.9
Less: Personal contributions for social insurance	.9	.8	1.2	.7	.3	.8	.4	-.2
Memorandum:								
Personal saving rate[3]	5.2	5.6	5.3	5.2	6.0	6.0	6.0	n.a.

1. Changes over periods longer than one quarter are measured from final quarter of preceding period to final quarter of period indicated. Changes for quarterly periods are compounded rates of change; monthly changes are not compounded.
2. Average monthly changes are from the final month of the preceding period to the final month of period indicated; monthly figures are changes from the preceding month.
3. Monthly saving rate equals the centered three-month moving average of personal saving as a percentage of the centered three-month moving average of disposable personal income.

As employment weakened, nominal personal income growth slowed further in December, rising just 2.2 percent at an annual rate. Cutbacks in employee hours more than offset wage gains, and wage and salary disbursements fell in December for the first time since the spring of 1980. Both farm and nonfarm proprietors' income also declined in December and are now lower than a year earlier. In addition, the growth of personal interest income slowed in the final months of the year as interest rates declined. Real disposable income was unchanged in November and posted a small decline in December, leaving real income only about 2 percent higher than a year ago. The saving rate had been boosted appreciably in October by the tax cut and by a sizable drop in spending for durable goods; but by December it fell back to 5-1/2 percent.

Housing

Housing starts remained under a 1 million unit annual rate in December, despite a 13 percent rise from November. Almost all of the December increase was for multifamily units, as starts of single-family units were little changed from their unusually depressed November level. At the same time, the number of permits issued for both single-family and multifamily construction increased somewhat; like the boost in starts, the rise in permits appeared to be widespread geographically. However, these data reflect economic conditions prior to the reversal of mortgage rates, which moved them back up to about 17-1/2 percent in recent weeks.

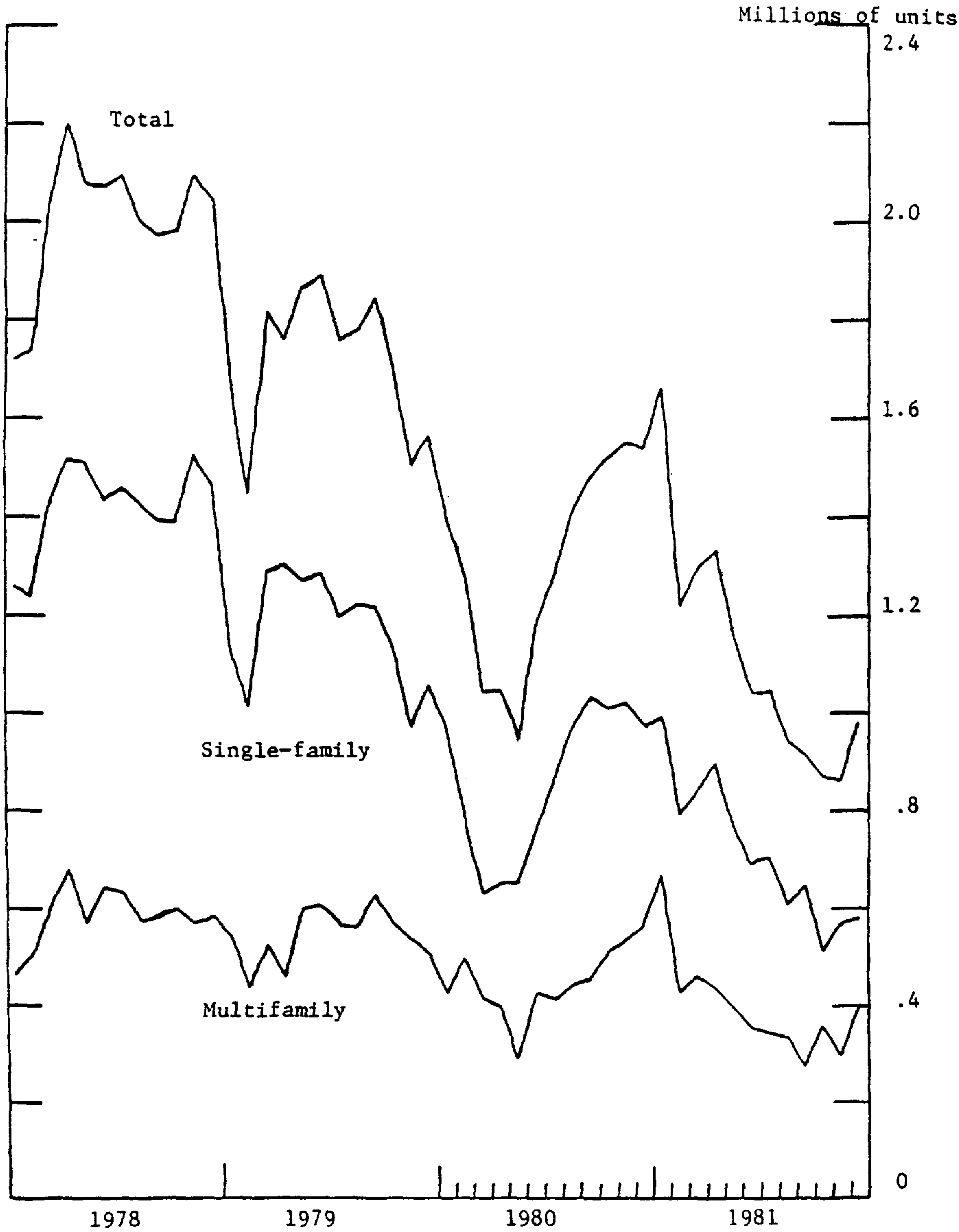
Housing sales also increased a bit at the end of the year, but they remained well below last year's depressed pace. New house sales rose more than 10 percent in November, helping to reduce inventories of unsold

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

Type of unit	1981 Annual	1981 Q2	Q3	Q4	Oct.	Nov.	Dec.[1]
Total							
Permits	.97	1.11	.88	.75	.72	.72	.81
Starts	1.09	1.18	.97	.90	.87	.86	.98
Single-family							
Permits	.56	.64	.49	.42	.40	.40	.46
Starts	.71	.78	.65	.55	.51	.57	.58
Sales							
New homes	n.a.	.44	.36	n.a.	.36	.40	n.a.
Existing homes	2.35	2.59	2.28	1.95	1.97	1.92	1.95
Multifamily							
Permits	.41	.47	.38	.33	.32	.32	.35
Starts	.38	.39	.32	.35	.36	.29	.40
Mobile home shipments	n.a.	.26	.24	n.a.	.21	.21	n.a.

1. Preliminary estimates.

PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



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

	1981					
	Q2	Q3	Q4	Oct.	Nov.	Dec.
Nondefense capital goods shipments						
Current dollars	3.2	.9	-1.3	-4.4	3.8	-1.0
Constant dollars[1]	-.6	-.1	-.3	-3.3	3.7	.1
Addendum: Sales of heavy-weight trucks (thousands)	226	232	201	196	190	216
Nonresidential construction						
Current dollars	1.7	5.1	--	-.1	-.5	--
Constant dollars	1.4	4.0	--	-.5	-.8	--
Addendum: Oil and gas well drilling (millions of feet)	30.1	26.7	36.3	36.6	33.9	38.5

1. FRB staff estimate.

BUSINESS CAPITAL SPENDING COMMITMENTS
(Percentage change from preceding comparable period;
based on seasonally adjusted data)

	1981					
	Q2	Q3	Q4	Oct.	Nov.	Dec.
Nondefense capital goods orders						
Current dollars	1.9	.2	-6.9	-8.8	10.8	-2.1
Constant dollars	.8	1.3	-5.7	-12.9	14.4	1.9
Machinery						
Current dollars	3.1	.4	-2.1	-9.9	9.4	3.4
Constant dollars[1]	.6	-1.3	-3.7	-11.0	9.7	3.1
Addenda: Ratio of current dollar unfilled orders to shipments						
Total	6.10	6.00	5.86	6.10	5.83	5.83
Machinery	4.62	4.50	4.44	4.53	4.34	4.41
Nonresidential building permits						
Current dollars	.5	14.5	--	-24.4	-11.0	--
Constant dollars[1]	.5	12.9	--	-24.8	-11.2	--

1. FRB staff estimate.

new units further, and sales of existing homes increased in December, benefiting from the brief decline in mortgage rates.

Record high mortgage rates during most of last year, coupled with reduced inflation expectations, restrained increases in house prices during 1981. The average price of existing homes sold rose 6 percent in the 12 months ending in December of 1981, in contrast with an average increase of more than 15 percent in the three preceding years. Price increases for new houses have also slowed noticeably, rising 5 percent from November 1980 to November 1981. Moreover, seller financing has become more widespread in the past year, and many sellers probably are offering concessions, that are not reflected in the price data.

Business Fixed Investment

Business fixed investment declined sharply, at an 11 percent annual rate in real terms, in the fourth quarter of 1981; this left it only slightly above a year earlier. The decline was concentrated in equipment, particularly machinery and transportation equipment. In structures, a decline in nonresidential construction was partially offset by an increase in spending for oil- and gas-well drilling rigs.

Data on near-term spending commitments have continued to be weak, and several basic determinants of capital spending remain adverse. The outlook for business sales currently is unfavorable, and capacity utilization in manufacturing, at 72.9 percent in December, has been at depressed levels for nearly two years. In addition, real interest rates remain quite high.

Bookings of orders for nondefense capital goods--an indicator of near-term demand for about 80 percent of producers' durable equipment--

SURVEY OF PLANT AND EQUIPMENT EXPENDITURES
(Percent change from prior year)

	1981 Survey (Actual)[1]	Planned for 1982		
		Commerce Department Jan. 1982	McGraw-Hill[2] Fall 1981	Merrill Lynch[2] Fall 1981
All Business	9.1	7.4	9.6	7.5
Manufacturing	10.7	8.6	11.5	8.8
Durables	6.8	7.7	10.1	3.9
Nondurables	14.8	9.5	12.9	13.6
Nonmanufacturing	8.1	6.6	8.3	6.6
Mining	24.4	11.8	24.8	19.9
Transportation	-.2	10.9	18.6	-6.3
Utilities	7.0	5.1	5.2	3.6
Trade and Services	5.5	5.7	4.7[3]	n.a.
Communications and other	11.6	6.3	12.2	7.4[4]

1. Growth in actual expenditures reported in the January Commerce Survey.
2. Not strictly comparable to Commerce Survey.
3. Includes only commercial category.
4. Includes commercial category.

ERROR[1] HISTORY OF ANNUAL SURVEYS

Year	Commerce Department	McGraw-Hill[2] Fall	Merrill Lynch[2] Fall
1970	3.8	2.8	1.5
1971	-.5	.5	1.1
1972	.2	2.6	.1
1973	.1	-2.2	-2.8
1974	-.7	.9	-1.0
1975	4.3	11.5	9.7
1976	-1.3	2.0	-3.9
1977	-1.4	.3	.8
1978	-3.2	-2.2	-3.1
1979	-3.9	-5.2	-6.1
1980	1.3	.2	-2.2
1981	1.7	3.1	-1.8
Mean Absolute Error	1.9	3.1	3.1

1. Anticipated minus actual percent change.
2. Fall Survey taken in October and November of 1981.

rose in November and fell in December. But these orders were extremely weak throughout 1981 and in real terms have remained well below their previous peak attained in early 1979. In addition, permits for nonresidential construction fell sharply in October and November.

The Commerce Department's annual survey of plant and equipment spending for 1982 confirmed the pessimistic outlook for the year as a whole. According to the survey, as of November business firms planned to increase 1982 nominal expenditures for plant and equipment 7-1/2 percent from those in 1981; given their price expectations, they anticipate no change in real expenditures. This Commerce Department survey has a history of overestimating capital expenditures during cyclical downturns--by 4-1/4 percentage points for 1975.

Inventory Investment

Production cutbacks slowed the rate of inventory accumulation in the manufacturing and trade sectors to approximately a $42 billion annual rate in book value terms in October and in November, compared with the $56 billion pace in the third quarter. In real terms, manufacturing and retail trade inventories were liquidated. However, total sales continued to slip and nudged the constant dollar inventory-sales ratio to 1.77 for November, about equal to previous cyclical peaks.

In the manufacturing sector, production cutbacks in the fourth quarter of 1981 progressively reduced accumulation of stocks of durable goods from September through November. After months of sizable increases, the book value of stocks of nondefense capital goods actually declined in November, reversing the pattern of large accumulations of these goods in the preceding months.

CHANGES IN MANUFACTURING AND TRADE INVENTORIES
(Billions of dollars at annual rates)

	1979	1980	1981 Q1	Q2	Q3(r)	Sept.	Oct.(r)	Nov.(p)
Book Value Basis								
Total	49.0	31.0	41.1	35.0	55.6	68.1	42.6	41.8
Manufacturing	31.5	16.4	34.2	12.7	27.6	39.1	21.9	13.6
Durable	23.7	10.2	18.5	9.8	25.9	35.0	18.9	5.3
Nondurable	7.8	6.2	15.7	3.0	1.8	4.0	3.0	8.2
Wholesale Trade	10.3	11.7	.0	6.7	8.3	17.7	5.5	23.3
Retail Trade	7.2	2.9	6.8	15.6	19.6	11.3	15.2	4.9
Automotive	1.4	-2.3	-3.5	12.2	7.3	-.2	.6	-2.1
Gen. Merchandise	1.1	1.4	3.1	2.6	5.5	8.1	8.4	-2.0
Constant Dollar Basis								
Total	7.2	-2.5	-1.3	11.0	12.5	17.8	13.4	6.9
Manufacturing	6.8	-1.0	4.6	.9	5.4	9.6	4.8	-.4
Wholesale Trade	.4	.6	-1.6	3.2	2.7	7.4	2.4	9.0
Retail Trade	-.1	-2.2	-4.3	6.9	4.5	.8	6.2	-1.6
Automotive	-.3	-1.2	-5.9	5.7	.0	-3.6	-1.3	-2.9

INVENTORIES RELATIVE TO SALES[1]

	1974 Cyclical Peak[2]	1980 Cyclical Peak[2]	1981 Q1	Q2	Q3(r)	Sept.	Oct.(r)	Nov.(p)
Book Value Basis								
Total	1.64	1.53	1.39	1.41	1.44	1.44	1.48	1.50
Manufacturing	1.95	1.76	1.61	1.60	1.63	1.64	1.70	1.73
Durable	2.51	2.36	2.09	2.05	2.13	2.15	2.26	2.30
Nondurable	1.39	1.18	1.11	1.12	1.11	1.11	1.13	1.15
Wholesale Trade	1.24	1.21	1.08	1.11	1.14	1.13	1.16	1.17
Retail Trade	1.57	1.44	1.31	1.36	1.39	1.38	1.43	1.42
Automotive	2.17	2.01	1.47	1.77	1.72	1.70	1.90	1.86
Gen. Merchandise	2.41	2.28	2.22	2.21	2.34	2.35	2.40	2.37
Constant Dollar Basis								
Total	1.76	1.76	1.63	1.66	1.69	1.70	1.76	1.77
Manufacturing	2.18	2.11	1.97	1.95	2.00	2.01	2.09	2.13
Wholesale Trade	1.40	1.45	1.33	1.40	1.43	1.42	1.45	1.45
Retail Trade	1.52	1.48	1.36	1.42	1.43	1.42	1.49	1.48
Automotive	2.05	2.05	1.51	1.84	1.72	1.67	1.92	1.88

1. Ratio of end-of-period inventories to average monthly sales for the period.
2. Highs are specific to each series and are not necessarily coincident.
(r) Revised estimates.
(p) Preliminary estimates.

Accumulation of retail trade inventories slowed considerably in November. The book value of retailers' stocks rose at a moderate $5 billion annual rate. General merchandise stocks, which had been accumulating rapidly since April, were reduced. Stocks held by auto dealers also declined in November, but dismal sales in December caused these stocks to climb again, prompting further production cutbacks and a new round of purchase incentive programs in January. Even if domestic auto sales were to continue at about recent relatively poor rates, the drastic production cutback in January would work off about 10 days' supply of dealer inventories.

In the wholesale trade sector, where inventory changes have been quite volatile, a substantial inventory buildup occurred during November. The book value of merchant wholesalers' stocks rose at a $23.3 billion pace, with significant runups in automotive products, machinery, and metals.

Federal Government

Total federal expenditures on national income and product account basis increased at a 15 percent annual rate during the fourth quarter, reflecting a very large increase in purchases of goods and services. Outlays for compensation were boosted by the October pay increases for civilian and military personnel. Defense operations and procurement proceeded in step with the Administration's plans, and Commodity Credit Corporation loans increased substantially. Other nondefense purchases continued the decline that began in the second quarter.

Transfer payments increased at a surprisingly moderate rate in the fourth quarter, considering the rapid deterioration in employment. Medicare payments accounted for most of the increase, as the more cyclically sensitive unemployment compensation rose only $0.8 billion at an annual rate. However, monthly and daily Treasury statement data indicate that unemployment outlays began to rise sharply in December and January.

On the receipts side of the budget, personal taxes declined $4.6 billion in annual rate terms in the fourth quarter, reflecting the first phase of the personal income tax cut and reduced employment. This revenue loss was partially offset by higher payments for Social Security taxes. Windfall profits tax receipts also declined because the rise in crude oil prices has not kept pace with the inflation rate; the windfall profits tax is based on the difference between current oil prices and a base price that is indexed to the GNP deflator.

State and Local Government

Real purchases of goods and services by state and local governments were unchanged in the final months of 1981, following sizable declines in the spring and summer. As a result, these outlays were below 1980 average levels. State and local governments hired 25,000 workers in December, offsetting only a fraction of the 260,000 jobs--mostly CETA slots--that had been eliminated in the first 11 months of the year. Jobs in local education, general administration, and the judiciary system have been reduced substantially, so that year end employment was at its lowest level in 2-1/2 years.

With $9 billion slashed from federal grants last year, the Administration's budget policy significantly alters the relationship between the federal sector and states and localities. The lack of support from the federal sector, coupled with the sluggishness and decline in growth of state and local government tax revenues, has severely limited the possibilities for spending increases. Thus, the state and local sector can be expected to lend little support to the recovery of economic activity at the aggregate level.

Wages

Wage rate increases for production workers moderated further toward the end of 1981. Preliminary data indicate that straight-time wage rates of nonfarm production workers increased at a 7.1 percent annual rate in the fourth quarter. This rise brought the increase over the four quarters of 1981 to 8.3 percent--considerably below the 9.6 percent rise in 1980. Increases in wage rates in the manufacturing and trade sectors during 1981 were about 2 percentage points less, on average, than during 1980. In contrast, there has not been a significant moderation in wage gains by service workers; wages in service industries, which so far have been relatively less affected by the recession, continued to increase more than 9 percent last year.

During 1981 a number of workers renegotiated labor contracts in industries in which heightened competition and slack demand imposed severe financial difficulties on firms. Recently, several major unions have agreed to early negotiations of contracts that were due to expire in 1982 and to significant concessions relative to their traditional contracts. In December, new labor contracts were reached with major

HOURLY EARNINGS INDEX[1]
(Percentage change at annual rates;
based on seasonally adjusted data)[2]

	1980	1981	1981 Q1	Q2	Q3	Q4	Nov.	Dec.
Total private nonfarm	9.6	8.3	9.6	8.3	8.3	7.1	11.1	1.4
Manufacturing	10.9	8.8	9.3	9.7	8.5	7.5	7.3	4.3
Durable	11.6	8.9	9.4	9.6	8.5	7.9	8.7	3.9
Nondurable	9.8	8.6	9.1	10.0	8.4	6.9	4.9	5.2
Contract construction	7.6	7.8	9.2	4.9	8.9	8.5	8.3	4.4
Transportation and public utilities	9.4	8.5	9.4	11.0	6.8	7.0	15.7	2.7
Total trade	8.8	7.1	9.6	7.1	8.0	3.7	8.0	-0.3
Services	9.5	9.1	9.8	8.5	8.8	9.5	15.5	-0.2

1. Excludes the effect of interindustry shifts in employment and fluctuations in overtime pay in manufacturing.
2. Changes over periods longer than one quarter are measured from final quarter of preceding period to final quarter of period indicated. Quarterly changes are at compound rates; monthly changes are at simple annual rates.

meatpacking firms that call for a freeze on wage rates for 44 months, and a tentative Master Freight Agreement covering 300,000 truckdrivers and warehouse workers would eliminate scheduled wage increases (leaving only annual cost-of-living adjustments) and alter work rules. At Ford and General Motors, fringe benefits for nonunion workers were cut effective January 1, and agreements are being sought with the UAW for a reduction in benefit costs along with some sort of freeze on wage rates. Furthermore, depressed conditions and high union wages in the rubber and farm machinery industries also may lead to more moderate settlements in these industries later this year.

Some spillover to other industries is likely. In the past, Master Freight Agreements often were imitated in other union contracts within the trucking and warehousing industries. Likewise, the auto settlement generally has set the tone for new agreements in supplier industries. The influence of recent union concessions on negotiations in other industries is uncertain. For example, workers at oil refineries, which are not suffering any financial strain, recently reached a new contract that raises wages nearly 17 percent over the next two years.

Prices

The rate of inflation continued to decline during the closing months of 1981. Consumer prices rose 0.5 percent in November and 0.4 percent in December, while producer prices of finished goods advanced only 0.3 percent in December. Over the year, both indexes rose considerably less than in 1980: the increase in the CPI slowed from nearly 12-1/2 percent to about 9 percent and the PPI for finished goods decelerated from 11-3/4 to 7 percent.

RECENT CHANGES IN CONSUMER PRICES[1]
(Percentage change at seasonally adjusted annual rates)[2]

	Relative importance Dec. 1980	1980	1981	1981 H1	1981 H2	1981 Nov.	1981 Dec.
All items	100.0	12.4	8.9	8.5	9.3	6.0	5.1
Food	17.3	10.2	4.3	1.0	7.3	2.6	5.1
Energy	10.8	18.1	11.9	24.9	.3	-2.3	1.4
Homeownership	25.8	16.5	10.1	9.8	10.4	2.3	2.6
All items less food, energy, and homeownership[3]	49.6	9.9	9.4	8.4	10.3	6.5	8.5
Used cars	3.0	18.3	20.3	5.7	37.0	30.7	12.2
Other commodities[3]	20.5	8.1	6.1	7.2	5.3	4.1	4.7
Other services[3]	26.1	10.3	10.6	10.0	11.3	8.9	8.4
Memorandum:							
Experimental CPI[4]	100.0	10.8	8.5	8.5	8.6	5.7	6.6

1. Based on index for all urban consumers (CPI-U).
2. Changes are from final month of preceding period to final month of period indicated; monthly changes at simple annual rates.
3. Includes the home maintenance and repair items of homeownership costs.
4. BLS experimental index for "All items"--CPI-U-X1--which uses a rent substitution measure for homeownership costs.

RECENT CHANGES IN PRODUCER PRICES
(Percentage change at annual rates; based on seasonally adjusted data)[1]

	Relative importance Dec. 1980	1980	1981	1981 H1	1981 H2	1981 Nov.	1981 Dec.
Finished goods	100.0	11.8	7.0	10.0	4.1	6.1	3.1
Consumer food	23.1	7.5	1.5	1.7	1.5	-6.1	1.4
Consumer energy	12.0	27.8	14.3	32.0	-1.1	10.9	8.8
Other consumer goods	44.6	10.4	6.9	8.3	5.4	9.6	0.5
Capital equipment	20.3	11.4	9.2	10.9	7.6	9.8	6.6
Intermediate materials[2]	93.6	12.4	7.4	10.9	3.9	5.3	4.6
Exc. energy	77.3	10.1	6.7	8.4	4.9	3.7	4.6
Crude Materials							
Food	57.7	8.6	-14.0	-8.6	-18.9	-25.6	-30.0
Energy	26.8	26.9	22.9	48.0	2.0	6.3	15.3
Other	15.5	7.5	-11.3	-12.2	-9.1	-38.5	-29.7

1. Changes are from final month of preceding period to final month of period indicated; monthly changes at simple annual rates.
2. Excludes materials for food manufacturing and animal feeds.

As during most of 1981, food prices rose relatively little at retail in November and December, and farm prices fell substantially in December for the fifth consecutive month. However, more recent developments in agricultural markets have caused spot prices of farm products to turn up sharply since early January. Cold weather damaged fruit and vegetable crops in Florida in mid-January, and while the full extent of the damage to crops is not yet clear, the experience of 1977 and 1981 suggests that consumer prices for fruits and vegetables are likely to rise steeply in the coming months. However, in these earlier years much of the weather-induced price increases dissipated fairly quickly as new crop supplies became available in the spring. Livestock prices also turned up sharply in mid-January; this upturn may reflect disruptions in marketings owing to the recent spell of bad weather, but in addition there are indications that producers are trimming output in response to low prices.

In the energy grouping, slack in the petroleum markets also contributed to a lower rate of inflation during most of 1981. Over the year, energy prices rose about 12 percent, more than the overall CPI increase but 6 percentage points less than in 1980. After jumping sharply following decontrol in January and February, gasoline prices actually fell. Natural gas rates continued to reflect the deregulation of wellhead prices, rising about 15 percent for the second year.

Homeownership costs increased sharply through much of 1981, but eased towards year-end. A decline in house prices was the major factor. Although the CPI measure of mortgage rates rose rapidly throughout most of the year, a decline in FHA/VA ceiling rates contributed to a slowing of mortgage interest costs in the December index. However, conventional settlement rates continued to climb in the December index and FHA/VA ceiling rates were increased again in mid-January.

While moderate increases for food and energy prices contributed to the drop in the inflation rate during 1981, there also was a significant downturn in the pace of price increases for many other consumer goods, and to a lesser extent for capital equipment. In the second half of the year, prices for these other consumer commodities--excluding the wide swings in used car prices--moderated to about a 5-1/4 percent annual rate. Producer prices of capital equipment rose rapidly early in 1981, but by the second half of the year they had slowed markedly to a 7-1/2 percent annual rate. In contrast, price increases for most services, notably medical and public transportation, persisted at rapid rates. However, at year's end even inflation in the service sector began to ease a bit.

Prices for intermediate materials, which represent inputs for the manufacturing and other sectors, also slowed considerably over the course of 1981. Excluding food and energy, these prices rose at about a 5 percent annual rate in the second half of 1981, down from 8-1/2 percent in the first half of the year.

SELECTED FINANCIAL MARKET QUOTATIONS[1]
(Percent)

	1981			1982	Change from:	
	Highs	Nov.-Dec. Lows	FOMC Dec. 22	Jan. 26	Nov.-Dec. Lows	FOMC Dec. 22
Short-term rates						
Federal funds[2]	20.06	12.04	12.43	13.97p	1.93	1.54
Treasury bills						
3-month	17.01	9.94	11.03	13.02	3.08	1.99
6-month	15.93	10.34	11.93	13.11	2.77	1.18
1-year	15.21	10.42	12.06	12.91	2.49	.85
Commercial paper						
1-month	18.63	11.17	12.65	13.88	2.71	1.23
3-month	18.29	11.04	12.65	14.09	3.05	1.44
Large negotiable CDs[3]						
1-month	18.90	11.16	12.73	14.02	2.86	1.29
3-month	19.01	11.23	13.11	14.58	3.35	1.47
6-month	18.50	11.64	13.76	14.91	3.27	1.15
Eurodollar deposits[2]						
1-month	19.80	11.86	13.23	14.23	2.37	1.00
3-month	19.56	12.16	13.65	15.05	2.89	1.40
Bank prime rate	21.50	15.75	15.75	15.75	0	0
Treasury bill futures						
June 1982 contract	14.46	10.58	12.70	13.58	3.00	.88
Dec. 1982 contract	14.20	11.07	13.01	13.66	2.59	.65
Intermediate- and long-term rates						
U.S. Treasury (constant maturity)						
3-year	16.59	12.54	14.11	14.71	2.17	.60
10-year	15.84	12.92	14.02	14.54	1.62	.52
30-year	15.20	12.76	13.65	14.19	1.43	.54
Municipal (Bond Buyer)	13.44	11.43	13.00[4]	13.16[4]	1.73	.16
Corporate--Aaa utility						
Recently offered	17.72	14.52	15.40	15.85	1.33	.45
S&L fixed-rate mortgage commitment	18.63	16.90	16.90[5]	17.61[5]	.71	.71

	1981		1982	Percent change from:	
	Highs	FOMC Dec. 22	Jan. 26	1981 Highs	FOMC Dec. 22
Stock Prices					
Dow-Jones Industrial	1,024.05	871.96	841.51	-17.8	-3.5
NYSE Composite	79.14	71.27	66.49	-16.0	-6.7
AMEX Composite	380.36	318.49	279.04	-26.6	-12.4
NASDAQ (OTC)	223.47	195.64	183.41	-17.9	-6.3

1. One-day quotes except as noted.
2. Averages for statement week closest to date shown.
3. Secondary market.
4. One-day quotes for preceding Thursday.
5. One-day quotes for preceding Friday.
p--Preliminary.

In the face of a considerable drop in economic activity, the monetary aggregates have climbed steeply over the past few months. The brisk uptrend in M1 that began in November extended into December and was augmented by a burst in early January. M2 also has expanded rapidly, despite some moderation in the growth of its nontransaction component following a big November increase. As a result of the strength in deposits, the gap between required and nonborrowed reserves has widened substantially, placing upward pressure on money market interest rates.

Federal funds most recently have traded in the neighborhood of 14 percent, as compared with the 12 to 12-1/2 percent range prevailing when the FOMC met in December. Other private short-term market rates are up 1-1/4 to 1-1/2 percentage points, and Treasury bill yields have risen as much or more, apparently in reflection of heavier supplies as the Treasury has tapped that sector in size to meet both seasonal and longer-range cash needs.

Yields on long-term taxable bonds are up about 1/2 percentage point since the last FOMC meeting; municipal yields have posted a smaller net increase, but, unlike other bond rates, they touched new highs during the intermeeting period. The higher levels of long-term rates appear to be due in part to a deepening pessimism about the potential conflict between fiscal and monetary policy as the money stock has soared and plans for paring prospective federal deficits have failed to materialize; in addition, however, the weakness of the bond markets seems to be symptomatic of a growing discouragement among investors who, already having suffered

MONETARY AGGREGATES
(Based on seasonally adjusted data unless otherwise noted)[1]

	1981 Q2	1981 Q3	1981 Q4	1981 Oct.	1981 Nov.	1981 Dec.	QIV '80 to QIV. '81
	---- Percentage change at annual rates ----						
Money stock measures							
1. M1	8.6	0.5	5.6	3.3	13.6	11.0	4.9
2. (Adjusted)[2]	(5.2)	(-0.4)	(4.6)	(3.1)	(11.4)	(9.3)	(2.1)
3. M2	10.6	7.2	10.6	8.1	17.3	11.3	9.5
4. M3	10.6	10.3	9.8	5.9	13.9	10.2	11.2
Selected components							
5. Currency	7.9	5.0	4.0	3.0	6.9	9.8	5.7
6. Demand deposits	-11.8	-8.0	0.0	1.5	6.1	4.1	-12.7
7. Other checkable deposits	107.4	21.5	26.6	10.0	46.2	36.5	175.2
8. M2 minus M1 (9+10+11+14)	11.3	9.4	12.3	9.7	18.4	11.4	11.0
9. Overnight RPs and Eurodollars, NSA[3]	58.9	13.9	-52.7	-124.3	25.5	21.4	3.1
10. Money market mutual fund shares, NSA	113.7	88.2	83.0	71.8	73.6	53.7	129.2
11. Commercial banks	4.2	6.7	10.6	10.9	16.5	5.2	7.1
12. savings deposits	-11.9	-19.6	-10.4	-19.0	13.9	9.2	-17.0
13. small time deposits	13.4	21.0	20.6	24.7	17.3	4.1	23.0
14. Thrift institutions	-0.3	-2.9	1.7	1.8	5.4	3.9	0.5
15. savings deposits	-12.6	-23.0	-11.8	-16.3	-1.4	16.5	-17.9
16. small time deposits	4.7	5.1	6.8	8.3	8.0	-0.7	9.1
17. Large time deposits	10.3	25.3	3.0	-4.0	-9.6	5.7	20.8
18. at commercial banks, net[4]	10.1	27.3	-1.0	-10.1	-16.0	4.4	20.3
19. at thrift institutions	11.2	15.1	23.5	26.2	21.0	13.7	22.8
. Term RPs, NSA	12.2	43.6	21.4	-17.8	36.2	-10.0	25.9
	--Average monthly change in billions of dollars--						
MEMORANDA:							
21. Managed liabilities at commercial banks (22+23)	9.0	6.6	-7.2	-4.7	-2.8	-14.0	3.2
(Adjusted for shifts to IBFs)[5]			(0.8)			(9.9)	(5.1)
22. Large time deposits, gross	7.5	7.0	-0.9	-1.2	-3.1	1.6	4.7
(Adjusted for shifts to IBFs)[5]			(-0.7)			(2.3)	(4.7)
23. Nondeposit funds	1.5	-0.4	-6.3	-3.5	0.3	-15.6	-1.5
(Adjusted for shifts to IBFs)[5]			(1.5)			(7.6)	(0.4)
24. Net due to related foreign institutions, NSA	0.7	1.1	-8.6	-4.5	-1.4	-19.8	-2.1
(Adjusted for shifts to IBFs)[5]			(-1.5)			(1.4)	(-0.3)
25. Other[6]	0.9	-1.6	2.3	1.1	1.6	4.2	0.6
(Adjusted for shifts to IBFs)[5]			(3.0)			(6.2)	(0.8)
26. U.S. government deposits at commercial banks[7]	-0.3	-0.7	0.5	3.4	-0.4	-1.5	0.2

1. Quarterly growth rates are computed on a quarterly average basis. Dollar amounts shown under memoranda for quarterly and year over year changes are calculated on an end-month-of-quarter basis.
2. Figures in parentheses have been adjusted to remove the distorting effects during 1981 of shifts of funds out of demand deposits and other accounts into NOW accounts. Based on a variety of evidence, it is estimated that 77-1/2 percent of inflows into other checkable deposits--in excess of "trend"--was from demand deposits in January, and 72-1/2 percent in other months.
3. Overnight and continuing contract RPs issued to the nonbank public by commercial banks, net of amounts held by money market mutual funds, plus overnight Eurodollar deposits issued by Caribbean branches of U.S. member banks to U.S. nonbank customers. Excludes retail RPs.
4. Net of large-denomination time deposits held by money market mutual funds and thrift institutions.
5. Numbers in parentheses have been adjusted to remove the effects of shifts of assets and liabilities from domestic banking offices to International Banking Facilities (IBFs).
6. Consists of borrowings 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 borrowings from the Federal Reserve and unaffiliated foreign banks), loans sold to affiliates, loan RPs, and other minor items. Changes since October 1980 are partially estimated.
7. Consists of Treasury demand deposits at commercial banks and Treasury note balance.

large losses over the past two years, were surprised by the sudden upturn in short rates in the midst of a cyclical decline in the economy.

While the federal government has continued to borrow at an unprecedented pace, the total volume of funds raised by other sectors appears to have fallen considerably in the past two months. Public bond issuance by nonfinancial corporations declined precipitously from a record high in November, prompting a step-up in short-term financing. Following a year-end surge swollen by housing issues, borrowing by state and local governments has abated somewhat in January. Borrowing by households in the consumer installment and mortgage credit markets evidently has remained weak.

Monetary Aggregates and Bank Credit

M1 grew at an 11 percent annual rate in December, and appears to have accelerated in January. Part of the spurt in narrow money growth in the past few months may represent a lagged response to the sizable drop in money market rates last summer and early fall. That decline in rates reduced the the opportunity cost of holding transactions balances and evidently interrupted the extraordinary effort by the public to pare transactions balances that had characterized most of 1981. Some of the recent behavior of narrow money also may derive from the use of its other checkable deposit (OCD) component as a temporary repository for savings as well as transactions balances. A good part of the increase in M1 since October has reflected a rapid expansion in OCDs that was part of a broader buildup in liquid short-term assets; this pattern of growth is consistent with the notion that investors are unwilling to take on the interest-rate risk and illiquidity associated with holding longer-term instruments, given prevailing economic uncertainties.

Related evidence of a heightened preference for liquidity also can be found in the behavior of the other components of M2. The growth rate of M2 moderated in December, but at 11-1/4 percent was still relatively strong. Within the non-transaction component of this aggregate, the more liquid short-term assets exhibited the stronger rates of growth. In particular, savings deposits surged in December, posting their largest gain since the summer of 1980, and the growth of overnight RPs and Eurodollars remained relatively strong for the second consecutive month.

Growth of shares in money market mutual funds (MMMFs) has zig-zagged over the past couple of months. Flows into these funds slowed abruptly during December, with some run-off late in the month. At first glance, this deceleration would seem to be at odds with the presumption that investors were placing funds in liquid assets; however, yields switched in mid-December to favor money market certificates and open market alternatives to MMMFs, prompting some individuals to scale back their acquisition of MMMF shares and institutions to withdraw funds.[1] To the extent such funds were shifted into short-term open market paper, the slower December growth of MMMFs would not contradict the notion of a general shift toward liquidity. In early January, MMMFs have grown more rapidly despite continuing disadvantageous rate spreads, suggesting that the portfolio adjustments to changing rate relationships were completed rather quickly.

With M2 moderating, M3 growth also slowed in December, despite a resumption in large time deposit growth. The December increase in gross

1. It should be noted that the data on money market mutual funds are not seasonally adjusted. Some of the variability in growth during December and January may thus reflect large swings associated with spending and investment patterns around the holiday season and the year-end.

issuance of large time deposits by commercial banks was probably in response to an imbalance between a strengthening demand for bank credit and a slower growth of savings and small time deposits. In January, net issuance of large time deposits appears to have accelerated, leading to some pickup in M3 growth.

Analysis of bank credit numbers for December and January is complicated by the introduction of International Banking Facilities (IBFs) beginning December 3, 1981.[1] The assets of IBFs have grown rapidly, largely because of asset transfers from domestic and offshore offices of the parent banks. By January 6, IBF assets had grown to $68.7 billion, of which approximately $38 billion is estimated to have been transferred from U.S. offices.[2]

When adjusted by adding back the domestic assets estimated to have been transferred to IBFs, bank credit accelerated to an 11 percent annual rate in December. Business loans were particularly strong (20-3/4 percent expansion), but real estate, consumer, and security loans also registered significant gains. Data through mid-January for large domestically chartered banks suggest further loan expansion, especially in the business loan category, although the pace of business lending appears to have slowed from that of December. Securities holdings turned up in December.

1. See Appendix IV-A for a discussion of the nature of International Banking Facilities and their effect on bank asset and liability growth.
2. While the bank credit measure has been affected significantly by shifts of assets from domestic offices to IBFs, the impact on the monetary aggregates has been slight. Based on reports of liabilities shifted from domestic offices to IBFs, virtually no demand deposit balances were shifted in December, and only about $750 million of large time deposits were transferred on a monthly average basis. Consequently, M3 growth was reduced by less than 1/2 percentage point in that month.

COMMERCIAL BANK CREDIT AND SHORT- AND INTERMEDIATE-TERM BUSINESS CREDIT
(Percentage changes at annual rates, based on seasonally adjusted data)[1]

	1981 Q2	Q3	Q4	Oct.	Nov.	Dec.	QIV 80 to QIV 81
	------ Commercial Bank Credit ------						
1. Total loans and investments at banks[2] [3]	10.9	6.8	- .1	5.7	3.5	-9.3	8.2
(Adjusted for shifts to IBFs)			(6.8)			(11.1)	(8.8)
2. Investments	7.2	.5	4.6	8.9	1.1	3.9	6.5
3. Treasury securities	13.5	-12.0	-8.1	- 7.4	-23.5	6.5	2.6
4. Other securities	4.0	7.2	10.8	16.5	13.1	2.6	8.5
5. Total loans[2] [3]	12.2	9.0	-1.7	4.6	4.3	-13.9	8.8
(Adjusted for shifts to IBFs)			(7.5)			(13.6)	(9.6)
6. Business loans[2] [3]	16.6	17.7	-2.7	10.6	- .3	-18.4	12.6
(Adjusted for shifts to IBFs)			(10.4)			(20.7)	(13.8)
7. Security loans	28.6	-36.2	58.6	31.4	85.7	51.4	20.9
8. Real estate loans	10.8	8.0	6.8	5.1	5.5	9.7	9.7
9. Consumer loans	1.3	4.4	4.1	1.3	2.0	9.1	3.0
	— Short- and Intermediate-Term Business Credit —						
10. Total short- and intermediate-term business credit (sum of lines 14, 15 and 16)	19.9	23.4	n.a.	10.3	14.9	n.a.	n.a.
11. Business loans net of bankers acceptances [3]	16.2	19.6	-3.0	9.2	1.3	-19.2	12.8
(Adjusted for shifts to IBFs)			(10.5)			(20.9)	(14.0)
12. Commercial paper issued by nonfinancial firms[4]	43.5	61.2	32.5	7.1	54.3	33.9	44.7
13. Sum of lines 11 & 12 [3]	19.1	24.4	1.5	8.9	8.0	-12.3	16.1
(Adjusted for shifts to IBFs)			(13.3)			(22.5)	(17.2)
14. Line 13 plus loans at foreign branches[5] [3]	19.0	26.2	4.9	12.8	11.8	-9.7	18.0
(Adjusted for shifts to IBFs)			(16.4)			(24.2)	(19.1)
15. Finance company loans to business[6]	19.3	14.7	n.a.	3.0	12.2	n.a.	n.a.
16. Total bankers acceptances outstanding[6]	26.6	16.6	n.a.	3.7	38.6	n.a.	n.a.

1. Average of Wednesdays for domestic-chartered banks and average of current and preceding ends of months for foreign-related institutions.
2. Loans include outstanding amounts of loans reported as sold outright to a bank's own foreign branches, unconsolidated nonbank affiliates of the bank, the bank's holding company (if not a bank), and unconsolidated nonbank subsidiaries of the holding company.
3. Numbers in parentheses have been adjusted to remove the effects of shifts of assets from domestic banking offices to International Banking Facilities (IBFs).
4. Average of Wednesdays.
5. Loans at foreign branches are loans made to U.S. firms by foreign branches of domestic-chartered banks.
6. Based on average of current and preceding ends of month.
n.a.--not available.

Business Finance

With the further backup in rates since the December FOMC meeting, corporate bond yields now have retraced about half of their fall rally. The Board's index of recently offered Aaa-rated utility bonds once again has edged above 16 percent. Yield spreads between lower- and higher-rated corporate bonds and between corporate and Treasury bonds have changed little on balance, which is somewhat surprising in view of the overall rise in yields and the weakening economic conditions. With the full impact of the recession on cash flows yet to be felt, there already have been extraordinary numbers of downgradings, dividend reductions, and bankruptcy filings over the past year.

Potential bond issuers backed away quickly from the weakening market.[1] A large volume of previously registered domestic offerings thus remains on the shelf, awaiting more favorable conditions for long-term financing. In the meantime, nonfinancial firms have concentrated their short-term borrowing at commercial banks, where business lending adjusted for IBFs picked up considerably in December following two months of reduced growth. Some of this strength may reflect the fall-off in lending by foreign branches of U.S. banks to U.S. residents as a decrease in the spread between the domestic prime rate and Eurodollar rates reduced the incentive of companies to use LIBOR pricing options. Commercial paper issuance by nonfinancial corporations was fairly strong in December, but appears to have dried up in early January; moreover, paper issuance by financial subsidiaries of

1. Several corporations have sold original issue discount bonds abroad in recent weeks. These Eurobond issues appear to have received relatively favorable rates; demand by Japanese investors in particular was reported to be heavy.

GROSS OFFERINGS OF CORPORATE SECURITIES
(Monthly totals or monthly averages, millions of dollars)

	1981					1982
	H1	Q3	Q4^p	Nov.	Dec.^p	Jan.^f
	------------- Seasonally adjusted ------------					
Corporate securities--total	6,105	4,047	7,360	10,557	7,317	1,865
Publicly offered bonds[1]	3,093	1,603	5,461	8,410	5,405	615
Privately placed bonds	645	587	380	176	700	400
Stocks	2,367	1,857	1,519	1,971	1,212	850
	---------- Not seasonally adjusted ----------					
Publicly offered bonds--total[1]	3,318	1,676	4,114	6,560	3,200	500
By industry						
Utility	1,200	960	1,067	1,188	1,065	--
Industrial	1,336	345	1,566	2,932	1,180	--
Financial	782	371	1,481	2,440	955	--
By quality[2]						
Aaa and Aa	1,080	685	1,881	3,668	1,265	--
A and Baa	1,696	627	1,706	2,050	1,490	--
Less than Baa[3]	542	364	527	842	445	--
Memo items:						
Convertible bonds	465	150	274	235	565	--
Original discount bonds						
Par value	671	530	1,478	3,500	800	--
Gross proceeds	283	191	676	1,601	322	--
Stocks--total	2,369	1,701	1,564	1,794	1,400	800
By industry						
Utility	756	577	455	505	400	--
Industrial	1,305	721	799	971	800	--
Financial	308	403	310	318	200	--

p--preliminary. f--forecast.
1. Total reflects gross proceeds rather than par value of original discount bonds.
2. Bonds categorized according to Moody's bond ratings.
3. Includes issues not rated by Moody's.

domestic auto manufacturers declined sharply as cutbacks in dealer inventories pared their financing needs.

Share prices have fallen substantially since early December. Most major composite indexes have declined from 6 to 12 percent since the December FOMC meeting and are currently close to their near-term lows of late September. Reflecting the drop in prices, the pace of gross stock offerings in December and January was sluggish by recent standards, running at about one-third the record rate observed for the first half of 1981. The retirement of shares through mergers--the U.S. Steel acquisition of Marathon Oil being the most important recent example--has continued to push net equity issuance into negative territory, despite the current popularity of stock-for-debt exchanges. Such exchanges, when conducted in accordance with IRS guidelines, permit firms to achieve, in effect, tax-free capital gains by purchasing outstanding debt at well below par; they have totaled at least $1 billion since September.

Government Finance

Federal Sector. The U.S. Treasury continued to place heavy demands on credit markets as the year drew to a close. It raised $15.5 billion through marketable borrowing in December--$6.1 billion in regular weekly and monthly bill auctions, $5.0 billion through cash management bills maturing in both January and April, and the remaining $4.4 billion in auctions of 2-, 4-, and 5-year notes. For the fourth quarter as a whole, the Treasury raised $37-1/2 billion in new money through the issuance of marketable securities to finance a record quarterly deficit of $50 billion.

FEDERAL GOVERNMENT AND SPONSORED AGENCY FINANCING[1]
(Total for period; billions of dollars)

	FY81	1981 Dec.[e]	1981 Q4[e]	1982 Jan.[f]	1982 Q1[f]
Treasury financing					
Combined surplus/deficit(-)	-78.9	-19.2	-50.5	8.7	-28.0
Means of financing deficit:					
(1) Net cash borrowing from the public	79.4	14.3	35.7	10.1	33.8
Marketable borrowings/ repayments(-)	88.9	15.5	37.5	10.8	36.1
Bills	23.0	11.1	21.6	5.7	17.9
Coupons	65.9	4.4	15.9	5.1	18.2
Nonmarketable	-9.5	-1.2	-1.8	-.7	-2.3
(2) Decrease in the cash balance	2.3	-4.2	6.7	-11.1	1.2
(3) Other means of finance[2]	-2.7	-9.1	8.2	-7.7	-7.0
Federally sponsored credit agencies net cash borrowing[3]	37.5	.3	2.9	--	3.1

e--estimated. f--forecast.
1. Numbers reported on a not seasonally adjusted, payment basis.
2. Includes checks issued less checks paid, accrued items and other transactions.
3. Includes debt of Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, and the Federal Farm Credit Bank System.

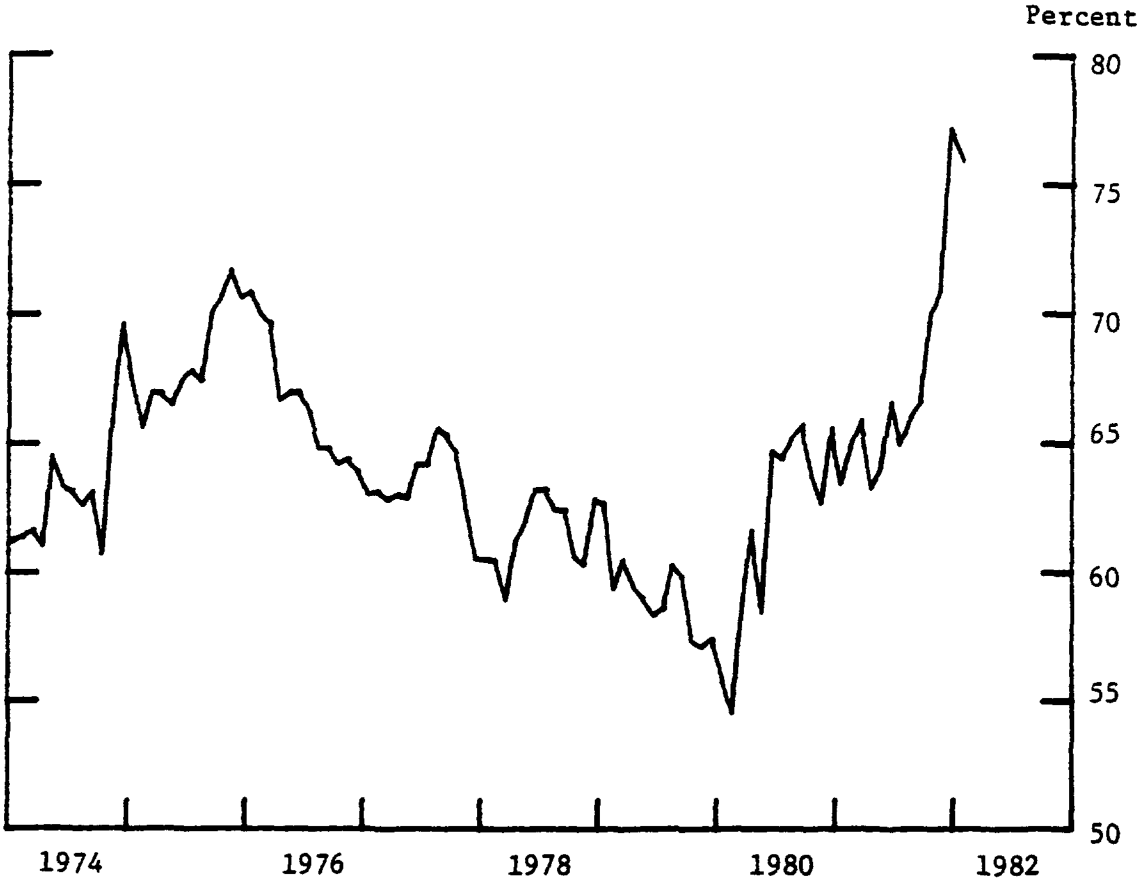
Its cash balance was depleted by $6-3/4 billion, and other means of finance provided another $8 billion or so.[1]

The Treasury is likely to raise nearly as much new money in the market during the first quarter as it did in the fourth, even though it faces a smaller combined deficit, estimated at about $28 billion. The staff expects marketable borrowing to outstrip the deficit as other means of finance drain $7 billion and nonmarketable securities decline about $2-1/2 billion. During January, the Treasury raised $5.1 billion through the sale of 7-year notes and 20-year bonds, and it raised another $1.3 billion in an auction of 2-year notes that will be issued at the beginning of February. Moreover, the weekly and monthly bill auctions were enlarged recently, and are expected to raise $5.7 billion in January. The Treasury also will be conducting its mid-quarter refunding in early February.

Net borrowing by federally sponsored agencies remained weak in December, amounting to only $300 million (NSA). Most of this borrowing was done by FNMA, which used the proceeds to buy mortgages. FHLBs raised very little money in December as their lending to thrift institutions continued to be small. A sharp drop in borrowing by the Federal Farm Credit Banks over the past few months appears to reflect a substitution by farmers of cheaper sources of finance and, possibly, some further curtailment of agricultural investment expenditures due to the adverse economic conditions in this sec-

1. The social security payment for January was pushed forward to December, increasing the deficit, but also raising the amount of uncashed Treasury checks outstanding at the end of the fourth quarter. As a result, "other means of finance" was large and positive in the fourth quarter but accordingly will be large and negative in the first quarter.

RATIO OF TAX-EXEMPT TO TAXABLE YIELDS[1/]
(Monthly)



1/ Moody's Aaa-rated municipal yield as a percent of the FRB recently offered Aaa corporate yield.

Note: The figure for January 1982 is based upon data for three weeks.

STATE & LOCAL GOVERNMENT SECURITY OFFERINGS
(Monthly averages, billions of dollars)

	1981					1982
	H1	Q3	Q4[e]	Nov.[e]	Dec.[e]	Jan.[f]
	------------- Seasonally adjusted -------------					
Total	6.61	6.46	8.60	7.80	9.00	7.50
Long-term	3.79	3.79	4.30	4.80	4.70	3.80
Short-term	2.82	2.77	4.30	3.00	4.30	3.70
	----------- Not seasonally adjusted ----------					
Total	6.50	6.11	7.50	7.80	7.20	6.30
Long-term	3.87	3.34	4.30	5.00	4.30	3.50
Hsg. rev. bonds	.38	.24	.60	.90	.95	.05
Short-term	2.63	2.77	3.20	2.80	2.90	2.80

e--estimate. f--forecast.

tor.[1] All three agencies engaged in a considerable amount of debt restructuring, however, replacing $3 billion in short-term bonds and discount notes notes with longer-term debt. Available data for January indicate that net agency borrowing has continued at about the pace set in December.

State and Local Sector. Gross issuance of long-term municipal securities maintained considerable strength through the end of the year, in spite of escalating rates, but partial data indicate a decline for January. The recent pattern in municipal offerings has been strongly influenced by the behavior of mortgage bond issuance. Under the provisions of the 1980 Mortgage Subsidy Bond Act, issuers are subject to yearly limits on the quantity of such bonds that can be sold. Consequently, issuers who had waited vainly for rates to fall earlier in 1981 found themselves having to "use it or lose it" in December, and many appear to have chosen to use it. The recent rise in interest rates, however, taken together with the greater flexibility with regard to timing that the new year permits for housing issues, has led to a reduction in the volume of long-term municipal offerings.

Although municipal bond rates are now only slightly above their mid-December levels, they reached new highs during the intermeeting period. Over the past year, ratios of tax-exempt to taxable bond yields have risen to historically high levels (see chart). Much of this movement in relative returns can be attributed to the virtual exodus of traditional institutional investors from the long-term tax-exempt market, which has left individuals swamped by the persistent flood of paper. Underwriting losses of property

1. The runoff in debt by the Farm Credit Banks in December was confined to shorter-term obligations as mortgage lending by Federal Land Banks continued to be large. Over the fourth quarter, short-term inventory loans extended to farmers by the Commodity Credit Corporation showed a sharp increase of $3.7 billion according to staff estimates.

and liability insurance companies have greatly diminished the demand for tax-exempt securities by firms in this industry. In addition, various changes in the personal income tax code--notably the reduction in marginal tax rates and possibly the liberalization of eligibility and other provisions governing IRA and Keogh accounts--have reduced the relative attractiveness of municipal obligations for many individuals.[1]

Insurance Companies

While property and liability (P/L) investment income rose to a record $13.4 billion in 1981, underwriting losses reached a record $6 billion. Underwriting losses have been growing since 1979, reflecting the impact of inflation on claims, widespread rate-cutting to attract customers, and acceptance of relatively risky policies in order to enhance the cash flow available for investment. As a consequence, P/L companies--typically large purchasers of tax-exempts--found little need to shield taxable interest income and reduced their acquisitions of such securities in 1981 to only $3 billion--less than one-third of the annual average increase over the 1977-1980 period. In contrast, their purchases of taxable debt securities surged to a record $11-1/2 billion in 1981.

Life insurance companies (LICOs) continued to experience cash flow pressures in 1981, as persistently high rates of interest stimulated large policy loan extensions and voluntary policy terminations. Preliminary data for November 1981 show that net policy loan extensions through the first 11

1. Available data do not permit any assessment of the quantitative importance of the change in retirement account rules; it seems likely that actual flows of funds to date have been small, although public interest obviously has been considerable. Investors face a confusing array of alternatives, and many firms are still exploring payroll deduction schemes. Moreover, individuals have until April 1983 to make their contributions for the current tax year.

months of that year amounted to $7.1 billion, already $500 million more than the previous annual record set in 1980. Furthermore, industry sources indicate that cash surrender values on policies terminated during 1981 may have surpassed the record $6.7 billion figure of 1980.

Accordingly, LICOs adjusted their portfolio management strategies in an effort to limit their vulnerability to changes in market conditions. One such adjustment was to increase holdings of short-term assets, primarily commercial paper. In managing their long-term portfolios, LICOs increased the liquidity of their holdings by purchasing more government securities and publicly offered corporate bonds, as well as by shortening the average maturity of their acquisitions from 15 years to about 10 years. At the same time, they substantially reduced their commitments to purchase corporate bonds and mortgages. Partly as a result of these developments, the gross volume of privately placed corporate bonds--for which LICOs are the primary customers--shrank to an estimated $7-1/2 billion in 1981, the lowest in seven years. Net acquisitions of mortgages by LICOs have dropped to the lowest level in three years. In contrast, their net direct investment in real estate rose significantly in 1981, as equity in office buildings became more attractive.

Mortgage Markets

Mortgage lending activity appears to have shown only a small response to the moderate easing in mortgage rates that occurred last fall. S&Ls issued $4.7 billion (seasonally adjusted) in new mortgage commitments in December, up slightly further from the extremely low levels of September and October. New commitments at federal and related agencies were stronger during November, although much of the activity may reflect the FHLMC program

SECONDARY MARKET FOR HOME MORTGAGES

	FNMA auctions of forward purchase commitments[1]						Yield on GNMA securities for immediate delivery[2]
	Conventional			FHA/VA			
	Amount ($ millions)		Yield to FNMA	Amount ($ millions)		Yield to FNMA	
	Offered	Accepted	(percent)	Offered	Accepted	(percent)	(percent)
1980--High	426	133	17.51	644	324	15.93	14.41
Low	29	20	12.76	97	52	12.28	10.79
1981--High	316	168	19.22	257	182	19.23	17.46
Low	12	11	14.83	26	11	14.84	13.18
Nov. 2	--	--	--	--	--	--	16.08
9	70	37	17.51	32	13	16.82	15.15
16	--	--	--	--	--	--	14.62
23	79	26	16.89	47	21	16.49	14.68
30	--	--	--	--	--	--	14.96
Dec. 7	51	26	16.82	32	16	16.76	15.36
14	--	--	--	--	--	--	15.45
21	33	22	17.07	27	11	17.08	15.45
28	--	--	--	--	--	--	15.75
1982--Jan. 4	16	12	17.33	14	10	17.56	15.98
11	--	--	--	--	--	--	16.29
18	16	0	--	27	21	18.05	16.20
25	--	--	--	--	--	--	16.30

Auction yields on fixed-rate level-payment loans are gross, before deduction of basis points for mortgage servicing.

Average net yields to investors assuming prepayment in 12 years on pools of 30-year A/VA level-payment mortgages typically carrying the prevailing ceiling rate on such ›ans.

introduced in October to buy outstanding mortgages that bear below-market rates. The volume of commitments for new loans accepted in secondary market auctions during recent weeks has been close to--or below--the extremely low levels experienced when interest rates were at their peaks.

The volume of mortgage takedowns around year-end remained quite depressed, according to the data that are currently available. In December, loan repayments to S&Ls exceeded new loans made by these institutions for the third month in a row. This three-month decline was only the second shrinkage in S&L mortgage portfolios to occur in several decades; the first occurred in the spring of 1980. Commercial bank real estate lending, which in October and November also had fallen to the lowest level since the spring of 1980, rebounded noticeably in December. During November, the volume of net mortgage lending at federal agencies increased somewhat, as commitments made earlier were taken down.

The most serious constraint on mortgage lending clearly has been the high cost of such credit. Moreover, rates on new commitments and in the secondary market have turned up in recent weeks; the average quotation on S&L commitments for conventional fixed-rate home mortgages has climbed 70 basis points since the last FOMC meeting--to 17.6 percent in late January--while yields in FNMA auctions for FHA/VA loans have risen about 150 basis points since late November, and yields for GNMA-guaranteed, mortgage-backed securities also have posted considerable increases. With discounts on FHA/VA loans rising sharply, the ceiling rate on these home mortgages was raised to 16-1/2 from 15-1/2 percent, effective January 25, 1982.

CONSUMER INSTALLMENT CREDIT
(seasonally adjusted annual rates)

	1979	1980	1981 Q2	1981 Q3	1981 Oct.	1981 Nov.
	Percent rate of growth					
Change in outstandings -- total	14.0	0.5	7.1	9.6	3.7	1.3
By type:						
Automobile credit	14.5	0.0	1.0	18.8	9.3	2.6
Revolving credit	19.9	5.5	15.3	8.5	7.7	1.0
All other	12.1	-2.9	13.8	2.2	-2.9	0.1
	Billions of dollars					
Change in outstandings -- total	38.4	1.4	22.4	30.5	12.2	4.1
By type:						
Automobile credit	14.7	0.0	1.2	22.4	11.5	3.3
Revolving credit	8.6	2.9	8.8	5.0	4.7	0.6
All other	15.1	-1.5	12.4	3.1	4.1	0.2
By major holder:						
Commercial banks	18.2	-8.4	1.0	3.0	-2.1	1.5
Finance companies	14.0	8.4	8.9	24.1	14.4	5.5
All other	6.2	1.4	12.5	4.1	-0.2	-2.9
Extensions -- total	324.8	305.9	344.1	348.3	323.4	330.0
By type:						
Automobile credit	93.9	83.0	87.9	103.7	85.7	93.0
Revolving credit	120.2	129.6	147.7	146.0	146.5	142.3
All other	110.7	93.3	108.5	98.6	91.3	94.7
Liquidations -- total	286.4	304.5	321.7	317.8	311.3	325.9
Memo: Ratio of liquidations to disposable income (percent)	17.5	16.7	16.2	15.6	15.0	15.6

Consumer Credit

Growth in consumer installment credit slowed to a 1 percent annual rate during November--the lowest rate since the end of the consumer credit restraint program in July 1980. The weakness in consumer credit was pervasive. Although gross extensions of auto credit did increase--reflecting some improvement in unit auto sales from October--this boost was more than offset by a large rise in auto credit liquidations. Revolving credit and "other" credit were virtually unchanged, mirroring the continued stagnation in non-automotive, non-food retail expenditures. As noted above, however, consumer lending at banks picked up in December.

Average rates on new-auto loans at finance companies were a full percentage point higher in November than in August, about double the increase in the average "most common" rate charged on commercial bank auto credit. The large increase in the finance company auto loan rate was due in part to the termination of a program through which the General Motors Acceptance Corporation was extending credit to customers at below-market rates.

Delinquencies on commercial bank installment credit and on auto loans at finance companies continued to decline through the third quarter, but delinquencies on mortgages have risen further through November. Third-quarter data on home mortgage delinquencies reveal that much of the increase has occurred, not surprisingly, in the North Central states, where the effects of unemployment have been the strongest and most protracted. Much of the rise in mortgage delinquency rates during 1981 has involved conventional home mortgages, suggesting that the effects of economic weakness now are being felt by those borrowers who had been able to post the higher downpayments ordinarily needed to obtain conventional mortgage financing.

Foreign Exchange Markets

Since the last FOMC the dollar's value in foreign exchange markets has remained firm, and in the past ten days it has generally risen. Overall, the dollar's weighted-average value climbed by 1-1/2 percent. These movements are indicated in the chart on the next page. Changes against individual foreign currencies have been rather diverse. Against the yen the dollar appreciated by 3-1/2 percent, whereas against the German mark and Canadian dollar the rise was a little less than 1 percent, and against the pound sterling a small net depreciation was registered.

The major factor dominating exchange-market attention during the past six weeks appears to have been current and prospective interest-rate developments in the major industrial countries. Short-term U.S. rates and Eurodollar rates have remained firm, and even climbed further until early this week, whereas foreign short-term interest rates have dropped noticeably in the past three weeks. As a result, the differential between returns on dollar assets and a weighted-average of foreign rates rose from about 0.5 percentage points in late December to around 2.0 percentage points at the end of last week. Money-market rates have declined in several foreign countries, notably Germany, France, and the United Kingdom. Last week the Bundesbank cut its special Lombard rate and the Netherlands Bank reduced its official lending rates by 0.5 percentage points each, and the Bank of England lowered some repurchase rates in several stages by about the same amount.

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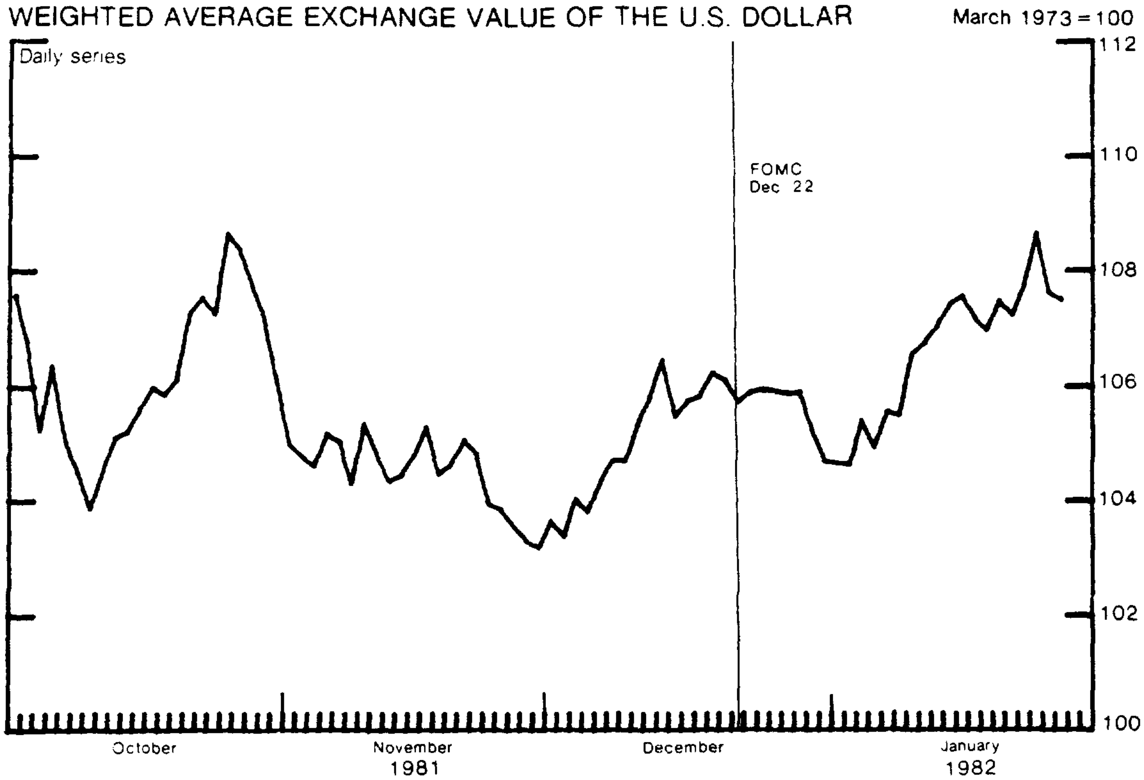
1/27/82

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR



Exchange-market participants now reportedly expect U.S. interest rates to remain high, or perhaps even rise, for the foreseeable future. During the past few weeks considerable attention has been given to the weekly money supply figures and to the outlook for substantial government budget deficits for 1982 and 1983. Following the early-January money-supply figures, Eurodollar rates jumped by around 1 percentage point, and the dollar surged still higher in the exchange markets, reaching about the DM 2.35 and ¥230 levels on Monday before dropping back at mid-week.

The Belgian franc has remained at the bottom of the EMS currency spread, and at various times the Dutch guilder, French franc, and

Italian lira have been at or near the top. For the most part, however, the currency band has not been fully extended, and EMS currencies have traded comfortably within their agreed margins from central rates.

<u>Borrowing in international capital markets</u>. The gross amount of funds raised in the markets for medium-term Eurocurrency bank credits, Eurobonds, and foreign bonds increased in 1981 to about $185 billion, a rise of $66 billion from the previous year. (See table on next page.) Two-thirds of the increase reflected arrangements by U.S. companies of credits for possible takeovers. U.S. companies also raised an increased amount through Eurocredits for purposes other than takeovers, credits to non-OPEC developing countries rebounded following their decline in 1980, and international bond issues increased considerably.

The volume of new medium-term Eurocurrency credits announced in 1981, amounting to $132 billion, was $55 billion more than in the preceding year. An estimated $42 billion was arranged by U.S. companies in connection with possible takeover efforts involving the U.S. oil industry. Almost all of these were in July; a high percentage of them have not been drawn and may never be. U.S. companies also arranged a further $12 billion of Eurocredits for other purposes, an amount almost twice as large as the total volume of such credits raised by U.S. companies in 1980.

Eurocredits to non-OPEC developing countries recovered in 1981 from the depressed levels of the year before, reaching $33 billion compared with $24 billion in 1980. However, the 1981 volume was actually less than the $35 billion raised by the non-OPEC developing countries in 1979; all of the seven largest borrowers in this group, except Chile, arranged less credit in 1981 than in 1979. Among other country groups, foreign industrial countries and OPEC countries each arranged about the same volume of credits as in 1980. Borrowings arranged by Communist countries, already reduced in 1980, declined sharply after mid-1981.

GROSS BORROWING IN INTERNATIONAL CAPITAL MARKETS
(Billions of dollars)

	1979	1980	1981			
	year	year	year	1st H	Q-3	Q-4
I. Total	123.8	119.3	185.8	60.8	77.3	47.7
II. Medium-Term Eurocredits	82.8	77.4	132.3	38.9	65.3	28.1
Industrial countries	27.2	39.1	86.0	16.0	54.7	15.3
of which: U.S.	(2.3)	(6.7)	(54.2)	(1.3)	(46.5)	(6.4)
others	(24.9)	(32.4)	(32.0)	(14.7)	(8.4)	(8.9)
Non-OPEC developing countries	35.2	24.0	33.1	17.6	7.3	8.2
of which: Brazil	(6.3)	(4.2)	(5.7)	(2.6)	(1.4)	(1.7)
Mexico	(8.2)	(6.0)	(7.5)	(5.0)	(1.3)	(1.2)
Others	(20.7)	(13.8)	(19.9)	(10.0)	(4.6)	(5.3)
OPEC countries	12.7	11.0	11.7	4.1	3.2	4.4
Communist countries	7.3	2.8	1.5	1.1	.2	.2
International org.'s	.3	.4	.1	.1	0	0
III. Bonds (Euro- and Foreign)	41.0	41.9	53.5	21.9	12.0	19.6
Industrial countries	31.9	32.7	41.7	17.1	9.7	14.9
of which: U.S.	(6.8)	(5.6)	(6.8)	(3.2)	(1.2)	(2.4)
Non-OPEC developing countries	2.7	1.9	4.1	1.6	1.1	1.4
of which: Mexico	(.4)	(.5)	(2.9)	(1.2)	(.8)	(.9)
others	(2.3)	(1.4)	(1.2)	(.4)	(.3)	(.5)
OPEC countries	.4	.5	.4	.3	*/	.1
Communist countries	.1	.1	.1	.1	0	*/
International org.'s	5.9	6.6	7.2	2.8	1.2	3.2
Eurobonds, by currency:						
U.S. dollar	12.6	16.4	26.7	10.5	6.3	9.9
German mark	3.6	3.6	1.3	.2	.3	.8
other	2.5	4.0	3.5	1.9	.6	1.0
Total, Eurobonds	18.7	24.0	31.5	12.6	7.2	11.7
Foreign bonds, by market:						
United States	4.5	3.4	8.4	3.3	1.5	3.6
Switzerland	9.8	7.6	8.3	3.7	2.1	2.5
Japan	1.8	1.1	2.4	1.2	.5	.7
Germany	5.4	4.8	1.3	.4	.2	.7
other	.8	1.1	1.6	.7	.5	.4
Total, foreign bonds	22.3	18.0	22.0	9.3	4.8	7.9

*/ Less than $0.1 billion.

Source: Morgan Guaranty Trust Co.

New Eurobond and foreign bond issues rose from $42 billion in 1980 to $53-1/2 billion in 1981, principally reflecting larger Eurobond offerings. Borrowers in industrial countries, together with international institutions, continued to account for a very high percentage of total international bond issues, but there was a surge in issues by Mexico, which raised almost $3 billion in the bond markets last year. Borrowings by U.S. companies were not greatly different from the previous two years. The proportion of Eurobonds denominated in dollars, which had been two-thirds in 1979 and 1980, rose to 85 percent last year, while the share (and absolute amount) denominated in German marks fell sharply. These changes resulted from the strength of the dollar on the exchange markets and from Germany's prohibition of DM-denominated bond issues by non-German borrowers in the first quarter of 1981 in an effort to reduce capital outflows and strengthen the mark. That prohibition also contributed to a sharp reduction in the volume of foreign issues in the German capital market, but this was more than offset by increased foreign issues in the U.S., Swiss, and Japanese markets. In the U.S. market there were large increases by Canadian issuers, international institutions, and other foreigners, especially in the closing months of the year.

U.S. International Transactions

The U.S. merchandise trade deficit was only marginally smaller in November than in the month before. For the two months combined the deficit was $49 billion at an annual rate, substantially larger than the deficits recorded during the previous six quarters. A rise in imports accounted for much of the increased deficit.

Despite a slowing of U.S. economic activity since the spring of 1981, the volume of imports has continued to grow, particularly in October-November. The October-November rise over the third-quarter level was spread among commodity categories -- with notable increases in capital goods, consumer goods, and oil imports, and lesser growth in imports of industrial supplies and automotive products.

U.S. Merchandise Trade*

	Years		1 9 8 1				
	1980	1981 1/	Q1	Q2	Q3	Oct./Nov	Nov.
Value (Bil. $, SAAR)							
Exports	224.0	237.7	244.4	241.9	232.1	229.9	230.6
Agricultural	42.2	44.6	50.9	44.3	40.2	42.4	41.2
Nonagricultural	181.7	193.1	193.5	197.6	192.0	187.5	189.4
Imports	249.3	267.0	263.1	269.5	260.3	279.2	276.8
Petroleum	78.9	79.4	83.3	84.8	71.8	76.6	78.8
Nonpetroleum	170.4	187.6	179.8	184.7	188.5	202.6	197.9
Trade Balance	-25.3	-29.3	-18.7	-27.6	-28.2	-49.2	-46.1
Volume (Bil. 72$, SAAR)							
Exports - Agricultural	18.1	18.1	19.5	17.5	16.9	18.5	18.0
- Nonagric.	73.4	71.0	73.2	73.3	69.6	66.4	67.1
Imports - Petroleum	6.8	6.0	6.3	6.2	5.6	6.1	6.3
- Nonpetrol.	67.6	72.3	67.8	70.7	73.5	79.6	78.0

*/ International Transactions and GNP basis. Monthly data are estimated.
1/ 11 months at an annual rate.

The volume of oil imports rose slightly in October-November from a low third-quarter rate, partly as a result of increased arrivals for the Strategic Petroleum Reserve, but oil imports in the second half of 1981 remained below the average rate in the first half.

1981 U.S. Oil Imports

	1Q	2Q	3Q	Oct./Nov.
Volume (mbd, SA)	6.59	6.52	5.91	6.47
Price ($/BBL)	34.63	35.62	33.27	32.43
Value (Bil. $, SAAR)	83.3	84.8	71.8	76.6

Agricultural exports increased in value in October-November from the low third-quarter rate despite continued declines in prices. Of the major export commodities, wheat export prices declined 11 percent, corn prices dropped 24 percent, and soybean prices fell by 18 percent from January to November. The volume exported in October-November was almost as large as in the strong first quarter, with stepped-up shipments to Western Europe, Eastern Europe, and the developing countries.

Nonagricultural exports have declined since the second quarter, with most of the decreases in civilian aircraft exports, in automotive exports to Canada, and in gold exports. Other industrial supplies and machinery exports (which together account for two thirds of nonagricultural exports) have been essentially unchanged since spring.

Turning to U.S. international financial transactions, the opening of International Banking Facilities (IBFs) in early December produced substantial gross shifts of eligible claims and liabilities from banks' own foreign offices to IBFs but no net effect on U.S. international capital flows.[1/] Shifts to IBFs from related foreign offices -- from early December through mid-January--have consisted primarily of IBF-eligible-foreign loans which were accompanied by an estimated $13 billion in net borrowing by IBFs from related foreign offices. Overall, U.S. banking offices (including IBFs) increased their net borrowings from own foreign offices by $7.6 billion in the December-January period (line 1(a) in the table below) as U.S. offices -- other than IBFs -- reduced their net borrowings from own foreign offices.

Loans to U.S. nonbank residents from foreign branches of U.S. banks reached $13.2 billion, on a daily average basis, in December, $4 billion greater than in September. However, the volume of these loans fell somewhat in January as the differential between prime and LIBOR, which had reached 400 basis points in November, narrowed to less than 200 basis points. Total Eurodollar holdings of U.S. nonbanks rose $4.5 billion in November, bringing the cumulative increase for the year to $29 billion.

U.S. net purchases of foreign securities reached $2 billion in November as foreign borrowers responded to the U.S. bond market rally. Subsequently, the volume of new foreign bond issues in the U.S. market tapered off as bond market conditions deteriorated.

Foreign official holdings of assets in the United States increased by $5 billion in November. Partial data, based on holdings at the FRBNY, indicated little further net change in December in either G-10 or OPEC countries' accounts.

1/ A detailed discussion of IBFs appears as Appendix IV-A.

International Banking Data
(billions of dollars)

	1980 Dec.	1981 Mar.	1981 June	1981 Sept.	1981 Nov.	1981 Dec.	1981 Jan.*
1. U.S. Banking Offices' (including IBFs) Positions Vis-a-vis Own Foreign Offices 1/							
(a) Total	6.5	3.0	3.0	7.3	2.4	8.9	10.0
(b) U.S.-Chartered Banks	-15.2	-17.2	-14.9	-12.5	-14.8	-10.2	-7.1
(c) Foreign-Chartered Banks	21.7	20.2	17.9	19.8	17.2	19.0	17.1
2. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. banks 2/	4.2	7.0	7.1	9.2	12.0	13.2	12.7
3. Eurodollar Holdings of U.S. Nonbank Residents 3/	60.8	66.3	76.8	86.8	91.2p	n.a.	n.a.

1/ Averages of Wednesday, net due to own foreign office = (+).
2/ Daily Averages.
3/ End of month
*/ Average of Wednesdays through January 13.

Summary of U.S. International Transactions
(in billions of dollars)

	1980 Year	1981 Q-1	Q-2	Q-3	Aug.	Sept.	Oct.	Nov.
Banks								
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow) 1/	-29.8	-11.8	-6.4	4.3	-1.9	-.6	-1.5	-5.5
Securities								
2. Private securities transactions, net	2.5	1.9	1.7	.4	.2	-.1	-.2	-2.0
a) Foreign net purchases (+) of U.S. corp. bonds	1.2	.7	.6	.6	.2	.1	.1	*
b) Foreign net purchases (+) of U.S. corp. stocks	4.3	1.7	2.6	.1	*	*	-.1	.1
c) U.S. net purchases (-) of foreign securities	-3.0	-.5	-1.4	-.4	*	-.2	-.2	-2.1
3. Foreign net purchases (+) of U.S. Treasury obligations 2/	2.7	1.4	.7	-.8	.3	-.5	.1	-.2
Official								
4. Changes in foreign official reserves assets in U.S. (+ = increase)	14.9	5.5	-3.0	-5.5	-4.6	-.8	-1.8	4.6
a) By area								
G-10 countries and Switzerland	-2.5	1.9	-7.9	-5.6	-2.8	-1.4	-3.0	2.2
OPEC	12.1	5.7	2.5	2.5	-1.6	1.7	1.6	1.2
All other countries	5.3	-2.1	2.4	-2.4	-.2	-1.1	-.4	1.3
b) By type								
U.S. Treasury securities	9.7	7.2	-2.1	-4.6	-1.7	-1.4	.1	2.9
Other 3/	5.2	-1.6	-.9	-.9	-3.0	.6	-2.0	1.7
5. Changes in U.S. official reserve assets (+ = decrease) 4/	-7.8	-3.7	.8	-.1	-.4	-.5	-.5	-.8
Other transactions (Quarterly data)								
6. U.S. direct investment (-) abroad	-18.5	-1.6	-4.9	-1.4				
7. Foreign direct investment (+) in U.S.	10.9	2.5	3.8	3.9				
8. Other capital flows (+ = inflow) 5/ 6/	-8.2	-8.4	-1.7	-3.7				
9. U.S. current account balance 6/	3.7	3.3	1.1	2.1				
10. Statistical Discrepancy 6/	29.6	10.9	7.9	.8				
MEMO: U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)	-25.3	-4.7	-6.9	-7.0	-4.5	-1.6	-4.4	-3.8

1/ Excludes liabilities to foreign official institutions.
2/ Includes U.S. Treasury notes publicly issued to private foreign residents.
3/ Includes deposits in banks, commercial paper, acceptances, & borrowing under repurchase agreements.
4/ Includes newly allocated SDR's of $1.1 billion in January 1979; $1.2 billion in January 1980,; and $1.1 billion in January 1981.
5/ Includes U.S. government assets other than official reserves, transactions by nonbanking concerns, and allocations of SDRs, and other banking and official transactions not shown elsewhere.
6/ Includes seasonal adjustment for quarterly data.
*/ Less than $50 million.

NOTE: Details may not add to total because of rounding.

Foreign Economic Developments. Evidence concerning the rate of economic activity abroad is currently mixed. Annual data for the growth of real GNP in Germany implies fourth-quarter growth only slightly below the 3.8 (s.a.a.r.) percent rate experienced in the third quarter. This strength is not confirmed, however, by the data for industrial production; and unemployment was still rising in December. In the United Kingdom, even though industrial production fell 1-1/2 percent (s.a.) in November, it was still above its third-quarter level, while in France real GDP grew at an annual rate of almost 4 percent during the middle quarters of 1981. In contrast, Japanese real growth in the third quarter of 1981 slowed to 2.4 percent (s.a.a.r.); and industrial production in Canada fell again in the latest observation (November).

Some improvement in the rate of inflation is evident abroad. In both Germany and the United Kingdom the December increase in the consumer price index was below that for November. In Japan wholesale prices decreased in December for the third consecutive month, while consumer prices were unchanged. Inflation rates remain high in France, Canada and Italy.

Weakness in domestic demand continued to contribute to improvement in the external sector for Germany, Japan, France, and Italy. The trade balance has improved in all these countries in 1981 relative to comparable periods in 1980. In October through December the German current account was in surplus for the first time in more than two years. Although the data are not complete, the trade balance appears to have worsened recently in the United Kingdom.

New targets for the growth of monetary aggregates in 1982 have been announced by the central banks of Germany, France, and Switzerland. As of January 22, the Bundesbank lowered its Special Lombard rate by one-half percentage point to 10 percent, and the Netherlands Bank lowered all its official rates by one-half percentage point. In addition, the Bank of England at about the same time lowered the rate at which it buys short-term bills from the market by one-half percentage point to 13-7/8 percent.

Individual Country Notes. According to provisional data, German real GNP declined by 0.3 percent in 1981. This decline was smaller than expected, owing to a relatively strong third quarter in which GNP grew at almost four percent (s.a.a.r.). The fourth-quarter growth rate, implied by the published annual rate, was almost three percent. These relatively strong results do not appear to be supported by other data on economic activity. Industrial production remained essentially flat last year through November, as did the volume of new orders. The rate of unemployment, which rose steadily throughout the year, reached 6.7 percent (s.a.) in December.

Consumer price inflation averaged six percent in 1981. The rate appears to be slowing, however, with December recording a monthly increase of only 0.3 percent. Recent declines in import prices have contributed to the slowing of consumer price inflation. Wholesale and producers prices as of December confirm the trend toward easing.

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

					1980				1981			1981			
	1978	1979	1980	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Aug.	Sept.	Oct.	Nov.
Canada: GNP	3.7	3.0	0.0	-0.9	-1.0	0.2	2.3	0.9	1.4	-1.0	*	*	*	*
IP	3.5	5.3	-2.0	-0.9	-2.5	0.0	2.2	1.0	2.6	-3.0	-1.6	-1.5	-1.3	-0.5
France: GDP	4.0	3.7	1.5	0.4	-0.5	0.0	0.0	-0.9	1.3	0.6	*	*	*	*
IP	1.9	4.7	-1.2	0.5	-2.2	0.0	-2.0	-4.4	-0.5	3.0	1.6	0.8	0.8	n.a.
Germany: GNP	3.6	4.5	1.7	1.9	-2.0	0.0	-0.4	0.4	-0.7	0.9	*	*	*	*
IP	2.0	5.3	-0.1	0.9	-2.4	-1.5	-1.8	1.6	-0.3	0.0	-0.9	0.9	0.0	-0.9
Italy: GDP	2.6	5.0	4.0	2.1	-0.9	-2.7	2.0	0.6	-1.2	-1.6	*	*	*	*
IP	1.9	6.6	5.6	4.4	-2.7	-7.6	5.3	0.7	-2.5	-4.3	-15.7	18.2	-2.5	6.8
Japan: GNP	5.2	5.2	4.2	1.6	0.2	1.2	0.7	0.7	1.2	0.6	*	*	*	*
IP	6.2	8.3	7.1	4.1	0.2	-2.3	1.6	1.7	-0.3	1.6	-2.6	3.8	1.5	-0.3
United Kingdom: GDP	3.6	1.6	-2.3	-1.0	-1.4	-1.5	-0.4	-0.8	-0.4	0.7	*	*	*	*
IP	3.6	2.7	-6.6	-2.3	-3.0	-3.0	-2.4	-1.2	-0.6	0.9	0.1	0.4	2.0	-1.5
United States: GNP	4.8	3.2	-0.2	0.8	-2.6	0.6	0.9	2.1	-0.4	0.4	*	*	*	*
IP	5.8	4.4	-3.6	0.1	-5.4	-1.5	4.5	2.0	0.5	0.3	-0.2	-1.3	-1.6	-1.9

* GNP data are not published on monthly basis.

TRADE AND CURRENT-ACCOUNT BALANCES OF MAJOR INDUSTRIAL COUNTRIES[a]
(Billions of U.S. dollars; seasonally adjusted)

			1980		1981						
	1980	1981	Q3	Q4	Q1	Q2	Q3	Q4	Oct.	Nov.	Dec.
Canada: Trade	6.7	n.a.	2.0	2.4	1.4	0.8	0.6	n.a.	0.6	0.9	n.a.
Current Account	-1.6	n.a.	-0.2	0.3	-1.2	-1.8	-2.2	n.a.	*	*	*
France: Trade[b]	-14.2	n.a.	-4.0	-3.2	-2.7	-2.1	-2.4	n.a.	-1.1	-1.2	n.a.
Current Account[b]	-7.9	n.a.	-2.1	-2.0	-2.4	-0.4	-1.9	n.a.	*	*	*
Germany: Trade	4.9	n.a.	1.1	0.9	0.2	3.1	3.1	n.a.	1.8.	1.8	n.a.
Current Account (NSA)	-17.4	-7.6	-7.1	-3.3	-4.4	-2.3	-4.9	4.0	1.3	0.5	2.2
Italy: Trade	-22.6	n.a.	-8.6	-5.5	-4.5	-4.8	-4.4	n.a.	-0.6	-0.9	n.a.
Current Account (NSA)	-9.8	n.a.	-1.0	-2.9	-5.8	-2.3	n.a.	n.a	*	*	*
Japan: Trade[b]	2.1	n.a.	1.4	2.9	3.3	5.5	6.3	n.a.	2.6	1.3	n.a.
Current Account[b]	-10.7	n.a.	-1.8	-0.2	-1.0	2.0	2.5	n.a.	1.5	-0.2	n.a.
United Kingdom: Trade	2.9	n.a.	1.5	3.0	n.a.	n.a.	n.a.	1.4	0.7	0.1	0.6
Current Account[b]	6.6	n.a.	2.1	4.5	n.a.	n.a.	n.a.	2.3	1.0	0.4	0.9
United States: Trade	-25.3	n.a.	-2.9	-5.6	-4.7	-6.9	-7.0	n.a.	-4.4	-3.8	n.a.
Current Account	3.7	n.a.	5.0	1.4	3.3	1.1	2.1.	n.a.	*	*	*

a The current account includes goods, services, and private and official transfers.
b Quarterly data are subject to revision and are not consistent with annual data.
* Comparable monthly current account data are not published.

CONSUMER AND WHOLESALE PRICES IN MAJOR INDUSTRIAL COUNTRIES
(Percentage change from preceding period)

		1980		1981				1981				MEMO: Latest 3 Months from Year Ago
		Q3	Q4	Q1	Q2	Q3	Q4	Sept.	Oct.	Nov.	Dec.	
Canada:	CPI	2.8	2.8	3.2	3.1	3.0	2.5	0.7	1.0	0.9	0.4	12.3
	WPI	2.8	3.2	2.5	2.1	1.3	n.a.	3.1	0.6	-0.1	n.a.	8.9
France:	CPI	3.2	2.8	3.0	3.3	3.9	3.2	1.1	1.2	0.9	0.6	14.1
	WPI	0.6	3.4	1.5	4.5	4.3	n.a.	0.9	0.8	-0.7	n.a.	12.9
Germany:	CPI	0.7	0.8	2.2	1.8	1.2	1.2	0.5	0.3	0.5	0.3	6.5
	WPI	-0.2	0.7	3.9	2.3	2.1	1.8	0.9	0.3	0.5	0.0	10.4
Italy:	CPI	4.2	5.3	5.2	4.4	2.9	4.6	1.2	2.0	1.7	1.0	18.3
	WPI	2.2	3.8	5.0	5.1	3.5	n.a.	1.3	1.2	1.7	n.a.	18.9
Japan:	CPI	1.1	1.2	1.3	1.3	-0.1	1.5	2.0	0.4	0.2	0.0	4.1
	WPI	0.7	-0.7	-0.7	1.1	1.4	-0.1	0.0	-0.1	-0.1	-0.1	1.7
United Kingdom:	CPI	2.2	1.9	2.4	4.9	1.7	2.5	0.6	0.9	1.1	0.6	11.9
	WPI	2.3	1.2	3.0	3.4	2.1	2.2	0.8	0.8	0.6	0.4	11.1
United States:	CPI(SA)	1.9	3.1	2.6	1.8	2.9	1.9	1.2	0.4	0.5	0.4	9.5
	WPI(SA)	3.3	2.1	2.6	2.3	1.0	1.1	0.1	0.6	0.5	0.3	7.2

During the fourth quarter of 1981 the German current account registered its first monthly surpluses since April 1979. The cumulative deficit for 1981 was $7.6 billion compared with $17.4 billion for 1980.

Central Bank Money increased in December, after declining in the two preceding months. During the target period, the fourth quarter of 1980 to that of 1981, CBM increased by 3.5 percent, below the lower limit of the Bundesbank's target range of 4 to 7 percent. The 1982 target range is again 4 to 7 percent.

In the United Kingdom, industrial production fell 1.5 percent (s.a.) in November 1981; nevertheless, the November level of production was 5 percent (s.a.a.r.) above the level prevailing six months earlier and only slightly below that recorded in November 1980.

The December 1981 increase in consumer prices was about one half the rate of growth recorded in the two preceding months. During the last six months of 1981, consumer and wholesale prices rose 8 - 9 percent (a.r.). Wage inflation moderated considerably in 1981: in the eleven months to November, average wage earnings increased 10 percent (s.a.a.r.), down over 9 percentage points from the rate of wage growth recorded during 1980. The deceleration of wages in 1981, as well as strong increases in labor productivity, have produced a marked reduction in the rate of growth of unit labor costs in the United Kingdom. Between the third quarters of 1980 and 1981, unit labor costs rose just

4 percent, compared with a 25 percent increase between the third quarters of 1979 and 1980. The recent vote by U.K. coal miners not to strike in support of this year's wage claim seems to indicate that U.K. wage increases can be expected to continue to be moderate. (The miners have been offered a package that includes a pay increase of 9 - 10 percent.)

The U.K. current-account balance appears to have been strongly positive in 1981, but data are available for five months only (January, February, September, October, and November). The (now ended) civil service labor dispute has delayed the publication of the March-August data. The September-November data indicate that the U.K.'s trade and current accounts were still in surplus in late 1981 -- averaging $1/4 billion and $1/2 billion, respectively -- but that there has been a sharp reduction from the extraordinarily high surpluses recorded in January and February. Sterling M3 increased only 2 percent (a.r.) in December. Annualized growth since February 1981 was 15.5 percent, however, well above the 6 - 10 percent target range.

In Japan the continued sluggishness of domestic demand led authorities to take steps in December to stimulate the domestic economy by easing monetary policy and thereby help reduce Japan's sizeable current-account surplus as well. Third-quarter GNP statistics, released last month, showed a disappointing real growth rate of only 2.4 percent (s.a.a.r.), well below the almost 5 percent rate of the previous quarter. Private consumption, which had been making slow progress in recent quarters, was nearly flat, while private plant and equipment investment fell slightly for the second quarter in a row. Housing, which has been on an extended decline, fell by almost 15 percent (s.a.a.r.) in the quarter. Whatever strength there was in GNP was found in external demand, but even there the previous intensity of export growth appears to have moderated. Industrial production figures have moved somewhat erratically in recent months, but the November IP index was down slightly, suggesting that weak activity continued in the fourth quarter. The labor market also appears to have been soft in recent months; the unemployment rate was 2.2 percent in November, a relatively high figure for Japan. In the face of these developments, the authorities have lowered the official forecast for real growth in FY 1981, ending in March, by more than half a percentage point to 4.1 percent.

The inflation situation continues to be a bright spot in Japan. Wholesale prices either fell or were flat in the four months ending in December, and the WPI at the end of 1981 was less than one percent above its year-ago level. Soft domestic demand and a strengthening yen in recent months have contributed to this easing. Consumer prices have continued to move ahead at about a 5.5 percent annual rate.

Although the November current account, aided by a sharp drop in export volume and surge in import volume, registered a small deficit ($210 million, s.a.), the cumulative current account for 1981 remained in strong surplus. When December's figures are included, it is estimated to have been as much as $6 billion for the year as a whole. Bilateral trade surpluses with the United States ($13.5 billion for 1981) and the

EC ($10 billion) have become particular problems. Accordingly, monetary policy has been eased in an attempt to stimulate domestic demand although some depreciation of the yen has also resulted in the short run. In addition to the reduction of the discount rate in December, restraints on lending by banks were completely eliminated for the current quarter. The authorities also initiated last month a program of other measures designed specifically to reduce the external surplus, including accelerated reductions in tariffs, $500 million in subsidized loans for import financing, and stockpiling of imported oil and metals.

The government's proposed FY 1982 budget, approved by the Cabinet in mid-December, is one of the least expansionary in the post-World War II era, as expenditure is planned to increase by only slightly more than 6 percent over that of the previous year.

In the middle quarters of 1981 French GDP grew by nearly 4 percent (s.a.a.r.), sustained by growing consumer expenditure and exports but restrained by sluggish investment expenditure. Inventories are now in the normal range, and order books and general demand perceptions continue to improve.

Consumer price inflation accelerated in each of the first three quarters of 1981 and was over 16.5 percent (a.r.) in the third quarter. Under limited price controls, inflation was under 13.75 percent in the fourth quarter. Hourly wages increased in France by about 15.5 percent over the past year; in the most recent two quarters the increase was 18 percent.

The French trade deficit through November was nearly $10 billion at an annual rate, over $4 billion less than the 1980 deficit. The French current account was in deficit at an annual rate of more than $6 billion (s.a.) for the first three quarters compared with a deficit of $8 billion for the year 1980.

After a reported disagreement between the Bank of France and the government, an M2 growth target of 12.5 - 13.5 percent was announced for this year, up from the 10 percent target originally set for 1981. In the past the French have not had a range but a single number representing an acceptable upper bound. The new practice appears to reflect disagreement to be solved later, rather than an effective range within which M2 growth is hoped to be constrained. Credit controls will be somewhat looser in 1982 than in 1981, reflecting the higher acceptable monetary growth. In the first ten months of 1981 actual M2 growth was 14 percent (s.a.a.r.).

In Canada, industrial production fell by .5 percent in November of last year -- representing the fifth consecutive monthly decline in this index. The unemployment rate rose in December to 8.6 percent after having remained virtually unchanged for the previous three months.

Consumer price inflation, which has been in double digits since June of 1980, still remains high. CPI inflation was about 12.5 percent in 1981 as compared with 10.2 percent the previous year.

The trade surplus rose about $300 million to almost $500 million in November. The surplus for the first eleven months of 1981 was about $4.5 billion, as compared with $6.3 billion for the same period in 1980.

Canadian M1 rose over 7 percent (s.a.) in December. Nevertheless, it was below its year-earlier level, was less than 1 percent above the current target base, and was therefore well below the target range of 4 - 8 percent growth.

Economic activity remains weak in Italy. Industrial production in the third quarter was about 1 percent below its year-earlier level, while the unemployment rate in October rose to 9.1 percent, compared with 8.8 percent in July. In view of planned layoffs in the automobile industry in the first quarter of this year, the unemployment rate is likely to rise further.

Inflation remained high during the fourth quarter, as the CPI rose at an annual rate of just under 20 percent. During 1981 inflation decreased, however, from approximately 21.5 percent in 1980 to just over 18 percent (fourth quarter to fourth quarter rate). The rising unemployment rate seems to have had little impact on the rate of increase in wages, which in October were 24 percent above their year-earlier level.

The effects of the current weakness of the Italian economy and the devaluation of the lira early last year have begun to appear in the trade account. During the three-month period ending in November, the trade deficit was $3.2 billion, compared with a $7.8 billion deficit in the corresponding period of 1980.

In Switzerland officials announced a target of 3 percent growth during 1982 for the Swiss measure of central bank money. This year's target was for 4 percent growth; however, data through October show an increase of less than 1 percent at an annual rate.

Appendix IV-A*

INTERNATIONAL BANKING FACILITIES

International Banking Facilities (IBFs) began operations on December 3. The authorizing amendments to Regulations D and Q were designed to reduce the costs of providing international banking services at U.S. offices. In general, they permit an IBF to accept deposits of foreign residents, other IBFs, and U.S. offices of its establishing institution, free from reserve requirements or interest rate limitations. Funds raised may support extensions of credit to the same set of entities, provided the proceeds are used to finance operations outside the United States. However, any net advances to U.S. offices of the establishing institution are subject to the same reserve requirements on Eurocurrency liabilities as are net advances from foreign offices. IBF loans and deposits may be denominated in either U.S. dollars or foreign currencies.

As of January 6, IBFs had been established by 216 institutions--76 commercial banks, 131 branches and agencies of foreign banks, and 9 Edge and Agreement Corporations. They were concentrated largely in three states--New York, California, and Florida. Those three states, along with Connecticut, Georgia, Illinois, Maryland, and North Carolina, have passed legislation providing favorable state tax environments for IBFs.

Growth and Funding of IBF Assets

On January 6 total IBF assets were $68.7 billion, of which $60.9 billion were claims on unaffiliated entities. As shown in appendix table 1, these assets were funded largely by advances from affiliated foreign offices and the U.S. offices of the establishing institutions; IBFs reported only $19.7 billion in liabilities to unaffiliated entities. As discussed below, U.S. banking offices reported shifts of claims on unaffiliated entities totaling $35.2 billion and shifts of liabilities to unaffiliated entities totaling $7.0 billion. From a flow-of-funds perspective, the $28.2 billion excess of assets over liabilities shifted from domestic offices to IBFs implies that domestic offices funded their IBFs by that amount. This funding took two forms. First, IBFs acquired direct net liabilities to their establishing U.S. offices of $13.7 billion. Second, U.S. offices transferred to IBFs from their own books $14.5 billion of net liabilities to own foreign offices. The reduction of net liabilities of U.S. offices to own foreign offices constitutes an advance of funds to the foreign offices. Thus, in effect, U.S. offices channeled $14.5 billion to their IBFs through their foreign offices.

Impact of IBFs on Bank Credit and the Monetary Aggregates

As shown in appendix table 2, about 80 percent of IBF claims on unaffiliated entities are loans and investments, with commercial and industrial loans the largest component. Since loans to foreigners on the books of

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U.S. offices of establishing institutions are included in measures of domestic bank credit but loans on the books of IBFs are excluded, shifts of loans and investments from U.S. offices of the establishing institutions to their IBFs would have a distorting effect on these measures. Bank credit measures can be adjusted for this effect by adding back the estimated amounts shifted to IBFs from U.S. offices during December. It is estimated that U.S. offices shifted a cumulative total of loans and investments to their IBFs of about $31.6 billion through January 6, and an estimated $23.8 billion on a month average basis during December. The resulting adjustment increased bank credit growth during December from -9.3 to 11.1 percent.

The monetary aggregates also exclude liabilities of IBFs. As indicated in appendix table 2, only about $1 billion of IBF liabilities due to foreign money stock holders (foreign residents other than foreign banks and foreign government and official institutions) were shifted from U.S. offices of the establishing institutions to their IBFs through January 6. Since negligible amounts were reported to have been transferred from demand deposits there was no effect on M1. In addition, IBF depositors are limited to transactions of at least $100,000; thus, it is likely that the bulk of these liabilities were transferred from large time deposits or term RPs,[1] leaving M2 unaffected. Even for M3 the effect is small. Adjusting for this shift would have added less than 1/2 percent to M3 growth on an annual basis during December.

Impact of IBFs on Eurocurrency Transactions

As discussed above, U.S. offices of establishing entities transferred to IBFs an excess of assets over liabilities of $28.2 billion by January 6. Since IBFs are included with foreign offices for reserve requirement purposes, this transfer lowered the U.S. offices' net liabilities to their foreign offices and IBFs by the same amount. Reservable Eurodollar liabilities were lowered further by shifts from U.S. offices to IBFs of borrowings from foreign banks and foreign governments and official institutions. Shifts of such borrowings are estimated to have totaled about $2-1/4 billion by the end of December. Through January 6, the reduction in required reserves against Eurocurrency liabilities resulting from these shifts is estimated to have totalled between $140 and $160 million.

It should be noted that IBFs are regarded as domestic offices for balance-of-payments purposes. Thus, transfers to IBFs from U.S. offices of the establishing institutions would have no effect on either capital inflows or outflows. In addition, transfers of assets and liabilities to IBFs from offshore have no effect on net capital inflows to the United States. Such transfers merely have the effect of increasing both sides of the aggregate U.S. resident balance sheet by, for example, increasing loans to non-U.S. residents and IBF liabilities to affiliated foreign offices by equal amounts.

1. Because IBF deposits of money stock holders are required to have a minimum maturity of two days, they are unlikely to have been substituted for overnight RPs.

Outlook

IBFs are likely to continue to grow in the months ahead, although not at the December pace. The rapid growth in December was due largely to shifts of existing assets from other offices of the establishing institutions. A large portion of the December shifts from U.S. offices was accounted for by agencies and branches of Japanese banks, which, because they have no shell branches, had large amounts of eligible assets on their U.S. books. However, many banks, particularly New York member banks, have sizable amounts of IBF-eligible assets on their U.S. books, but have not yet shifted those assets to their IBFs. Some New York member banks apparently have been cautious about transferring eligible assets to their IBFs because they fear a restrictive enforcement of IBF tax regulations by New York tax authorities. The portion of an IBF's net income to be exempt from New York state taxation is inversely related to the proportion of its funding that is provided by U.S. residents. Some banks apparently fear that in this context "U.S. funding" will not be narrowly defined as net liabilities to U.S. offices of the establishing institution, but instead will be defined to include a portion of funding obtained from offshore shell branches on the grounds that shell branches implicitly channel some deposits from U.S. residents to IBFs. If the New York tax authorities should adopt the broader definition, the growth of IBFs in New York will be deposit-driven in the sense that transfers of assets to IBFs will be delayed until IBFs obtain additional liabilities to unaffiliated entities.

Although a sizable amount of foreign resident deposits remain on the books of domestic banking offices, some of these deposits may not be eligible for transfer to IBFs.[1] For example, IBFs are prohibited from offering negotiable instruments or demand balances. Funds held in negotiable instruments could be transferred to IBFs, but only after those instruments mature. IBFs are allowed to offer very short-dated time deposits (a minimum of 2 days for foreign money stock holders, overnight for others), which may be attractive to certain depositors as cash management devices and induce some shifting from foreign-held demand deposits. However, similar short-term bank liabilities already are available offshore as well as domestically in such instruments as RPs. Hence, while the introduction of IBF liabilities may intensify the use of cash management, it is unlikely to result in large shifts of demand balances from U.S. offices to IBFs in the near future.

The ability of IBFs to obtain new deposits will depend in part on the relative attractiveness for foreign depositors of U.S. country exposure and in part on rates offered. The scope for IBFs to offer attractive

1. Deposits at U.S. banking offices of foreign money stock holders are estimated at about $18 billion ($5 billion in demand deposits, $13 billion in time deposits). Deposits of foreign banks and foreign governments and official institutions are estimated at about $25 billion ($15 billion in demand deposits, $10 billion in time deposits).

deposit rates was broadened with the passage of legislation exempting IBF deposits from FDIC insurance assessments. Nonetheless, to date IBFs have not captured a significant share of deposits in the Euromarket. In particular, one might expect that until their nonbank deposit base is developed IBFs would rely heavily on borrowings from foreign banks. But as of January 6, IBF liabilities to unaffiliated foreign banks, which totalled $130 billion at foreign branches of U.S. banks in November, accounted for only $12.2 billion of IBF liabilities. Moreover, there has not been any significant amount of inter-IBF activity.

Appendix Table 1

TOTAL IBF ASSETS AND LIABILITIES 1/
($ billions, as of January 6, 1982)

Assets	
Gross claims on non-U.S. offices of the establishing institution	7.8
Total claims on entities other than U.S. and non-U.S. offices of the establishing institution	60.9
Total Assets	68.7
Liabilities	
Gross liabilities due to non-U.S. offices of the establishing institution	35.3
Total liabilities due to entities other than U.S. and non-U.S. offices of the establishing institution	19.6
Total Liabilities	54.9
Residual: Net liabilities due to U.S. offices of the establishing institution (Total Assets minus Total Liabilities)	13.7
Memo: Net liabilities due to non-U.S. offices of the establishing institution	27.6

1/ Total assets and liabilities of all IBFs with at least $50 million in assets or liabilities as of January 6.