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March 26, 1986

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 rates)						
Civilian labor force	Feb.	03-07-86	117.1	3.1	3.3	1.8
Unemployment rate (%) ¹	Feb.	03-07-86	7.3	6.7	7.0	7.3
Insured unemployment rate (%) ¹	Dec.	03-13-86	3.0	2.8	2.8	2.8
Nonfarm employment, payroll (mil.)	Feb.	03-07-86	99.7	2.7	3.8	3.3
Manufacturing	Feb.	03-07-86	19.4	-1.8	1.0	-.7
Nonmanufacturing	Feb.	03-07-86	80.3	3.8	4.4	4.2
Private nonfarm:						
Average weekly hours (hr.) ¹	Feb.	03-07-86	35.0	35.2	35.0	35.1
Hourly earnings (\$) ¹	Feb.	03-07-86	8.72	8.68	8.67	8.49
Manufacturing:						
Average weekly hours (hr.) ¹	Feb.	03-07-86	40.6	40.9	40.7	40.1
Unit labor cost (1967=100)	Jan.	03-04-86	82.6	-12.9	-10.4	-5.6
Industrial production (1977=100)	Feb.	03-14-86	125.7	-7.6	1.0	1.6
Consumer goods	Feb.	03-14-86	124.4	1.0	5.5	4.5
Business equipment	Feb.	03-14-86	141.3	-9.3	-1.1	.9
Defense & space equipment	Feb.	03-14-86	177.6	-12.7	-6.9	6.2
Materials	Feb.	03-14-86	114.5	-9.4	.7	-8
Consumer prices all items (1967=100)	Feb.	03-25-86	327.7	-4.7	1.2	3.1
All items, excluding food & energy	Feb.	03-25-86	322.6	2.6	3.8	4.1
Food	Feb.	03-25-86	313.8	-8.0	.8	1.8
Producer prices: (1967=100)						
Finished goods	Feb.	03-14-86	291.7	-18.6	-6.7	-.1
Intermediate materials, nonfood	Feb.	03-14-86	320.0	-17.0	-6.2	-1.5
Crude foodstuffs & feedstuffs	Feb.	03-14-86	225.1	-43.2	-26.2	-9.2
Personal income (\$ bil.) ²	Feb.	03-20-86	3,406.3	6.8	7.0	4.9
(Not at annual rates)						
Mfgs. new orders dur. goods (\$ bil.)	Feb.	03-25-86	107.9	-.5	3.9	5.3
Capital goods industries	Feb.	03-25-86	36.2	3.6	10.9	5.7
Nondefense	Feb.	03-25-86	28.9	17.5	11.9	-2.2
Defense	Feb.	03-25-86	7.3	-29.5	7.2	55.1
Inventories to sales ratio: ¹						
Manufacturing and trade, total	Jan.	03-25-86	1.36	1.34	1.37	1.38
Manufacturing	Jan.	03-25-86	1.41	1.42	1.43	1.49
Trade	Jan.	03-14-86	1.31	1.28	1.31	1.29
Ratio: Mfgs.' durable goods inventories to unfilled orders ¹	Jan.	03-25-86	.530	.536	.537	.551
Retail sales, total (\$ bil.)	Feb.	03-13-86	116.8	-.1	1.2	4.3
GAF ³	Feb.	03-13-86	25.5	1.4	.6	4.7
Auto sales, total (mil. units.) ²	Feb.	03-04-86	10.8	-5.5	11.1	-2.0
Domestic models	Feb.	03-04-86	8.0	-7.5	25.1	-7.3
Foreign models	Feb.	03-04-86	2.8	.9	-15.6	16.9
Capital appropriation, Mfg.	1985-Q4	03-11-86	27,499	13.8	-8.1	-5.5
Housing starts, private (thous.) ²	Feb.	03-18-86	1,985	-3.5	20.0	21.6
Leading indicators (1967=100)	Jan.	03-04-86	173.0	-.6	1.1	4.0

1. Actual data used in lieu of percent changes for earlier periods.

2. At annual rates.

3. Excludes mail order houses.

DOMESTIC NONFINANCIAL DEVELOPMENTS

Incoming data suggest that the economy has expanded at a moderate pace in early 1986. However, the performance of different sectors has varied substantially, ranging from robust gains in housing to marked weakness in some areas of business fixed investment. Price indexes have been pushed down by the recent plunge in energy prices.

Industrial Production and Capacity Utilization

After rising sharply late last year, industrial production levelled off in January and declined an estimated 0.6 percent in February. Although output was higher in February for automotive goods and business supplies, production cutbacks were widespread for other items. In particular, petroleum drilling activity was curtailed sharply in reaction to the collapse of oil prices. In addition, production of business equipment and materials remained sluggish. In sectors linked to housing activity--construction supplies and household goods--the declines are likely to prove temporary, as increased housing construction should boost demand in these categories. The few available indicators of output in March are negative, with cutbacks reported in motor vehicle assemblies, oil and gas well drilling, and steel production.

The capacity utilization rate for total industry declined 0.6 percentage point in February to 80 percent. Apart from the automobile industry, utilization rates in most major manufacturing industries were down in February. Over the past year, the overall utilization rate has generally fluctuated between 80 and 81 percent.

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

	1985	1985		1985	1986	
	Annual ¹	Q3	Q4	Dec.	Jan.	Feb.
		--Annual rate--		--Monthly rate--		
Total Index	1.8	2.0	1.9	.8	.1	-.6
Products	2.8	4.0	1.8	.5	.3	-.5
Final products	2.2	4.0	1.5	.4	.2	-.7
Consumer goods	2.7	3.9	4.9	1.1	.2	.0
Durable	1.8	3.6	6.7	1.2	-.1	.7
Automotive products	6.2	15.7	-7.1	-.2	1.3	2.1
Home goods	-1.5	-5.1	19.1	2.2	-1.2	-.4
Nondurable	3.2	4.0	4.3	1.1	.3	-.2
Equipment	1.7	4.0	-2.1	-.4	.2	-1.4
Business	1.2	1.8	-3.7	-.4	.9	-.8
Defense and space	9.7	9.8	10.3	.0	-.7	-1.1
Oil and gas drilling	-21.2	11.0	-30.2	-.8	-4.6	-15.1
Intermediate products	4.5	4.2	3.0	.8	.8	.0
Construction supplies	4.8	8.7	-.6	-.2	2.2	-.6
Materials	.3	-1.1	2.0	1.2	-.3	-.8
Durable goods	-1.9	-2.2	1.9	.1	.4	-1.2
Nondurable goods	2.5	9.4	.2	1.5	-.3	-.5
Energy materials	2.9	-7.7	3.9	3.2	-1.7	.1

1. Annual changes are from the fourth quarter of 1984 to the fourth quarter of 1985.

CAPACITY UTILIZATION IN INDUSTRY
(Percent of capacity, seasonally adjusted)

	1978-80	1982	1967-85	1984	1985	1986	
	High	Low	Avg.	High	Dec.	Jan.	Feb.
Total industry	86.9	69.5	81.7	82.0	80.7	80.6	80.0
Manufacturing	86.5	68.0	80.6	81.8	80.4	80.5	79.9
Durable	86.3	63.7	78.8	80.4	78.0	77.9	77.1
Nondurable	87.0	74.4	83.5	84.4	84.1	84.6	84.1
Mining	95.2	76.9	87.7	86.4	80.1	80.1	77.7
Utilities	88.5	78.0	87.9	85.6	83.9	82.4	83.5
Industrial materials	89.1	68.4	82.5	83.1	80.0	79.6	79.0
Metal materials	93.6	45.7	78.4	70.6	70.4	70.1	68.6
Paper materials	97.3	79.9	91.3	97.2	94.4	94.2	n.a.
Chemical materials	87.9	63.3	80.8	79.1	79.9	79.6	n.a.

Employment and Unemployment

Aggregate labor demand has continued to expand in recent months, despite some specific areas of weakness. Nonfarm payroll employment rose 225,000 in February, after a substantial increase during the preceding month. Once again, hiring at retail trade and service establishments accounted for the bulk of the increase. In manufacturing, however, employment fell 30,000 after four months of growth, and the factory workweek dropped 0.3 of an hour from the very high levels posted at the turn of the year. Employment in mining also declined, owing to depressed conditions in the oil and gas industry. The number of construction jobs edged down in February after an unusually strong increase associated with favorable weather in January; however, the average increase in construction employment over this two-month period remains robust.

In contrast to the employment gains reported in the payroll survey, household employment fell almost 400,000 in February, and the civilian unemployment rate rate jumped 0.6 percentage point to 7.3 percent after having edged down since mid-1985. About half of the job decline in the household survey reflects a sharp drop in agricultural employment, which is not measured by the establishment data. The flooding in California apparently was partly responsible for this decline. Unusually large increases in unemployment also were evident in Texas and Illinois, which the Bureau of Labor Statistics traced to weakness in oil and gas extraction and in some areas of manufacturing.

Autos

Sales of domestic autos averaged 8.3 million units (annual rate) during January and February, spurred by cut-rate financing programs.

CHANGES IN EMPLOYMENT¹

(Thousands of employees; based on seasonally adjusted data)

	1984	1985	1985				1985	1986	
			Q1	Q2	Q3	Q4	Dec.	Jan.	Feb.
-Average monthly changes-									
Nonfarm payroll employment ²	327	250	273	188	248	290	285	421	226
Strike adjusted	329	248	267	182	254	289	286	388	226
Manufacturing	52	-14	-26	-43	-40	51	52	27	-29
Durable	45	-14	-17	-30	-37	28	22	12	-25
Nondurable	7	0	-9	-12	-3	23	30	15	-4
Construction	29	25	28	28	28	16	16	139	-25
Trade	106	72	91	77	50	69	77	164	143
Finance and services	106	124	150	94	127	125	105	117	147
Private nonfarm production workers	253	173	182	130	148	231	204	367	191
Manufacturing production workers	33	-16	-33	-47	-27	44	50	12	-21
Total employment ³	269	163	234	-117	306	229	237	404 ^e	-394
Nonagricultural	265	183	259	-59	347	184	156	324 ^e	-190

1. Average change from final month of preceding period to final month of period indicated.

2. Survey of establishments. Strike-adjusted data noted.

3. Survey of households.

e = estimated; adjusted for introduction of revised population estimates.

SELECTED UNEMPLOYMENT RATES

(Percent; based on seasonally adjusted data)

	1984	1985	1985				1985	1986	
			Q1	Q2	Q3	Q4	Dec.	Jan.	Feb.
Civilian, 16 years and older	7.5	7.2	7.3	7.3	7.2	7.0	6.9	6.7	7.3
Teenagers	18.9	18.6	18.5	18.4	18.3	19.0	18.8	18.4	19.0
20-24 years old	11.5	11.1	11.1	11.3	11.0	10.8	10.6	10.4	10.8
Men, 25 years and older	5.7	5.3	5.4	5.4	5.3	5.2	5.1	5.0	5.5
Women, 25 years and older	6.0	5.9	6.0	6.0	5.9	5.5	5.4	5.3	5.9
White	6.5	6.2	6.3	6.3	6.2	6.0	5.9	5.7	6.4
Black	15.9	15.1	15.4	15.0	14.8	15.1	14.9	14.4	14.8
Fulltime workers	7.2	6.9	7.0	6.9	6.8	6.7	6.6	6.4	6.9
Memo:									
Total national ¹	7.4	7.1	7.2	7.2	7.1	6.9	6.8	6.6	7.2

1. Includes resident Armed Forces as employed.

Although sales in the first two months of the year were up sharply from the fourth-quarter pace, they fell somewhat short of the robust rate of production, further increasing the already high level of auto inventories. Additional incentive programs were announced in late February. The new incentives cover a wider range of models than the programs available earlier this year, but, on balance, provide less generous financing terms. Although these incentives are still in effect, sales declined to an average 7.1 million unit annual rate during the first twenty days of March. Assemblies also appear to have declined some in March, but at an annual rate of about 8 million units, the reduced production level will not put a dent in dealer inventories.

Sales of foreign cars remained at a 2.8 million unit annual rate in February. During the first two months of the year, sales of Japanese cars dropped below their strong fourth-quarter pace and are likely to remain low in March owing mainly to the usual end-of-quota-year stock shortages.

Personal Income and Consumption

Gains in real disposable personal income appear to have strengthened in recent months. Data on nominal income, which are available through February, point to a small improvement in income growth, mainly because of cost-of-living adjustments for transfer payments and the indexing of personal tax brackets. The growth in nominal private wages and salaries was about in line with the 1985 average pace. In real terms, however, disposable income in January was 1/2 percent above the fourth-quarter average and, in light of the decline in consumer prices in February, apparently rose sharply further last month.

AUTO SALES, PRODUCTION, AND INVENTORIES
(millions of units at an annual rate, FRB seasonals)

	1985					1986		
	Q1	Q2	Q3	Q4	Dec.	Jan.	Feb.	Mar.
Total auto sales ¹	10.9	10.9	12.3	10.2	11.4	11.4	10.8	
Domestic	8.5	8.3	9.4	6.8	7.9	8.6	8.0	7.1 <u>2/</u>
Imported	2.4	2.7	2.9	3.4	3.5	2.8	2.8	
Domestic production	8.4	8.0	8.2	7.8	8.1	8.4	8.7	7.9 ^e
Dealers' stocks	1.49	1.51	1.31	1.67	1.67	1.66	1.74	
Days' supply ³	54	56	43	75	65	59	67	

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

2. Average sales during first twenty days.

3. Days' supply for quarter are based on end of quarter stocks and average sales for the quarter.

e--estimate

Apart from auto sales, consumer spending has been relatively sluggish since the start of the year. Expenditures on goods other than motor vehicles and gasoline and fuel oil have shown little net change in nominal terms after rising appreciably at the end of 1985. Expenditures for gasoline and oil, although off sharply in nominal terms, probably have been relatively flat in real terms. Outlays for services, by contrast, have risen briskly in recent months. Consumption growth overall has not kept pace with income gains and the personal saving rate has risen a bit from the unusually low levels of last fall.

The latest consumer surveys conducted by the Michigan Survey Research Center and the Conference Board continue to show an optimistic household sector. An exceptionally large proportion of consumers viewed this as a good time to buy autos and homes, and they expressed relatively little concern about current debt burdens. Inflation expectations also have declined, as the average rate of price increase expected over the next year by respondents to the Michigan survey fell 1/2 percentage point in February to 3.7 percent.

Business Fixed Investment

Spending for business equipment weakened in early 1986 after having surged at the end of last year. Shipments of nondefense capital goods from domestic producers, although up 5 percent in February, remained well below the fourth-quarter average. Sales of heavy trucks also have dropped markedly from their December peak. Part of the decline in

PERSONAL INCOME AND EXPENDITURES
(Based on seasonally adjusted data)

	1984	1985	1985		1986	
			Q3	Q4	Jan.	Feb.
--- Percentage changes at annual rates ¹ ---						
Total Personal Income						
Nominal	8.6	5.3	2.3	7.0	1.0	6.8
Real ²	4.3	2.1	.1	2.6	-2.2	--
Disposable Personal Income						
Nominal	8.1	4.5	-2.5	6.7	4.6	7.8
Real	3.9	1.3	-4.5	2.2	1.4	--
Expenditures						
Nominal	7.5	6.2	6.9	4.5	-4.9	3.8
Real	3.4	3.0	4.6	.1	-8.1	--
--- Changes in billions of dollars ³ ---						
Total personal income	20.5	14.7	9.8	24.8	2.8	19.2
Wages and salaries	12.7	10.1	7.6	13.7	6.4	10.3
Private	10.7	7.8	5.8	10.8	6.2	8.7
Other income	8.8	6.1	2.7	12.0	.5	9.5
Disposable personal income	16.2	11.2	6.8	21.5	11.0	18.7
Expenditures	14.7	13.9	22.1	11.1	-10.9	8.4
Durables	2.8	1.7	13.7	-7.1	-4.2	-.9
Motor vehicles and parts	1.1	.6	11.8	-9.0	-1.6	-5.0
Nondurables	4.6	3.8	4.4	4.0	-2.1	-7.0
Gasoline and oil	-.3	.5	-.2	.9	-1.9	-5.5
Services	7.3	8.3	4.0	14.2	-4.6	16.3
Personal saving rate (percent)	6.5	4.6	3.7	4.1	4.4	4.7

1. Annual changes 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. Total personal income is deflated by the personal consumption expenditure deflator.

3. 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.

RETAIL SALES
(Seasonally adjusted percentage change)

	1985			Feb./ Q4	1985 Dec.	1986	
	Q2	Q3	Q4			Jan.	Feb.
Total sales	2.4	2.2	-.8	1.0	1.2	.1	-.1
Previous estimate ¹			-.9	--	1.7	.1	--
(REAL) ²	2.2	2.0	-1.7	--	1.4	-.4	--
Previous estimate ¹			-1.8	--	1.3	-.2	--
Total less automotive group, nonconsumer stores, and gasoline stations	1.3	1.2	1.4	.6	.4	-.4	.6
Previous estimate ¹			1.5	--	.7	-.2	--
GAF ³	1.4	1.5	1.6	.8	.2	-1.0	1.4
Durable	4.0	4.3	-3.6	3.0	2.9	.9	.0
Automotive group	5.0	6.1	-8.1	2.3	3.5	.8	-1.1
Furniture and appliances	2.5	2.1	4.3	4.8	1.7	.1	3.3
Other durable goods	.9	.9	1.5	1.0	1.8	-2.2	2.1
Nondurable	1.4	.9	1.0	-.3	.2	-.4	-.2
Apparel	2.1	1.9	1.6	-1.9	-.2	-1.4	-.7
Food	1.0	1.0	1.7	.5	.9	-.3	-.2
General merchandise ⁴	.7	1.0	.4	.3	-.3	-1.3	1.5
Gasoline stations	3.5	-.7	.2	-3.6	.9	-.8	-3.4

1. Based on incomplete sample counts approximately one month ago.

2. BCD series 59. Data are available approximately 3 weeks following the retail sales release.

3. General merchandise, apparel, furniture and appliance stores.

4. General merchandise excludes mail order nonstores; mail order sales are also excluded in the GAF grouping.

Data are unavailable because of a future release date.

outlays for equipment stems from the acceleration of planned spending into 1985 to lock in tax benefits that would be eliminated if the House tax reform bill were enacted.

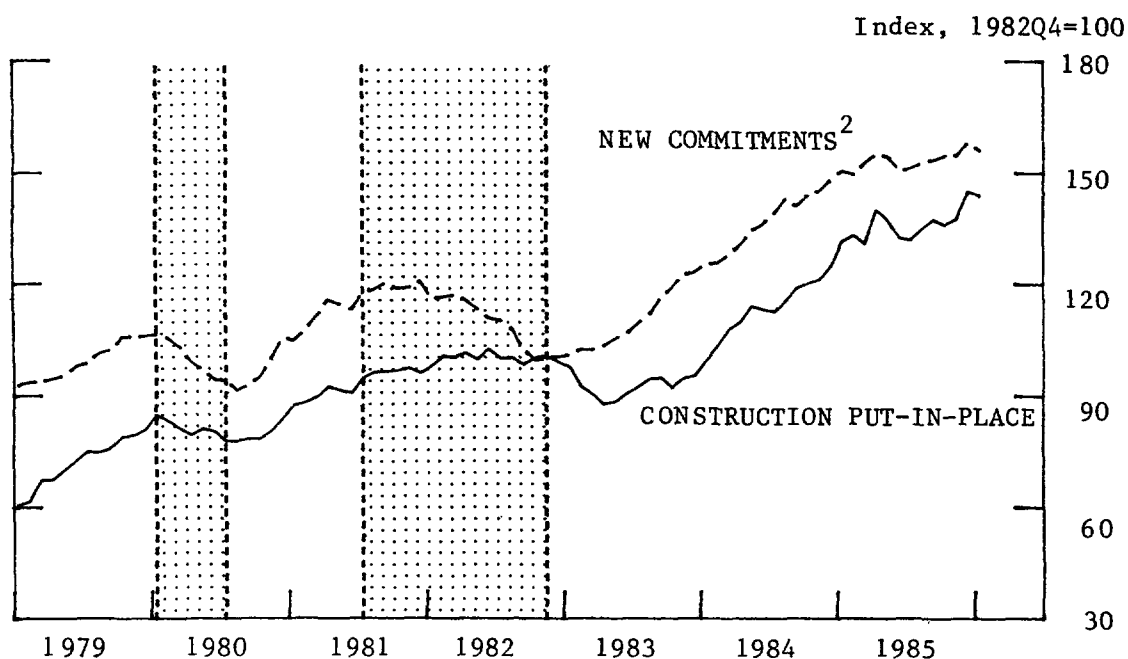
The value of nonresidential construction (which excludes petroleum drilling structures) fell 0.8 percent in January, but remained 2-1/2 percent above the fourth-quarter average--buoyed mainly by robust activity in the commercial sector. In contrast, petroleum drilling activity--which accounts for one-quarter of total spending for nonresidential structures in real terms--apparently plummeted this quarter. Although no first-quarter data are yet available for drilling footage (the primary series on which BEA bases its estimate of spending for petroleum drilling structures), the number of drilling rigs in use has dropped precipitously since December.

With regard to indicators of future investment spending, new orders for nondefense capital goods rebounded substantially in February, to a level moderately above the fourth-quarter average. In contrast, growth in new commitments for nonresidential construction has slowed in the past year, suggesting a limited scope for near-term spending gains in this area. Looking at spending plans for 1986 as a whole, the McGraw-Hill survey--conducted in January and February--indicated that businesses expect to increase nominal outlays 3.4 percent over the 1985 level, an upward revision of 4-1/2 percentage points from the previous McGraw-Hill survey. Since the most recent McGraw-Hill survey was taken, a number of oil companies have announced substantial cuts in their 1986 capital spending budgets; it is not yet clear what offsets may be in train among industries benefiting from lower energy costs.

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

	1985			1985	1986	
	Q2	Q3	Q4	Dec.	Jan.	Feb.
<u>Producers' durable equipment</u>						
Nondefense capital goods						
Shipments	2.6	.2	3.2	3.1	-10.6	4.9
Excluding aircraft and parts	3.2	-1.4	3.5	-1.9	-8.6	5.7
Office and store machinery	7.0	-7.4	.5	-2.1	-21.8	4.1
Orders	-1.6	5.6	.0	18.5	-19.7	17.5
Excluding aircraft and parts	-4.1	2.3	-1.9	-7.3	-4.8	15.8
Office and store machinery	-20.3	5.3	-16.8	-28.1	-23.0	113.2
Imports of capital goods excluding autos	-2.9	6.4	12.1	24.5	--	--
Exports of capital goods excluding autos	-2.2	-1.6	.3	5.1	--	--
Sales of heavy-weight trucks (thousands of units, A.R.)	276	264	303	342	275	253
<u>Nonresidential structures</u>						
Nonresidential construction	3.7	-1.1	1.8	4.6	-.8	--
Commercial building	1.6	-.3	4.3	6.4	1.1	--
Office	1.9	-1.7	1.0	7.7	.5	--
Other commercial	1.1	1.4	7.8	5.1	1.7	--
Rotary drilling rigs in use	-7.2	.7	-10.2	-1.4	-4.6	-15.1

NONRESIDENTIAL CONSTRUCTION AND NEW COMMITMENTS¹



1. Source F. W. Dodge and Census.

2. Six-month moving average (sum of contracts and permits).

Housing

Spurred by a rising trend of home sales and the recent decline in interest rates, housing construction quickened in early 1986. Total private starts in January and February averaged just over 2 million units at an annual rate--well above the strong pace of late 1985. The increase was concentrated in the single-family sector, while construction of multifamily units remained at a relatively high level. The jump in starts in January may have reflected, in part, unseasonably good weather, but February's 1.99 million unit annual rate provided evidence that construction has in fact picked up considerably. Building permit issuance--a more stable indicator of construction activity--also has been strong, with the average level in January and February 6 percent above the fourth-quarter level.

Although the upturn in the single-family market was widely expected, the continued strength in multifamily housing construction has been somewhat surprising. Starts in this sector rose 11 percent in February, equalling their highest level in two years. Market fundamentals do not appear to warrant this high rate of apartment and condominium building; vacancy rates for multifamily rental housing, for example, remained high in the fourth quarter. However, activity in this sector probably is being supported by the flood of tax-exempt housing bonds issued late last year in anticipation of adverse changes in the tax laws.

Sales of new single-family homes have been quite robust in recent months, confirming the favorable attitudes toward homebuying expressed in recent survey data. As demand has strengthened, price increases for both new and existing homes have picked up a bit, although the recent monthly estimates do not control for changing house quality and location. In the

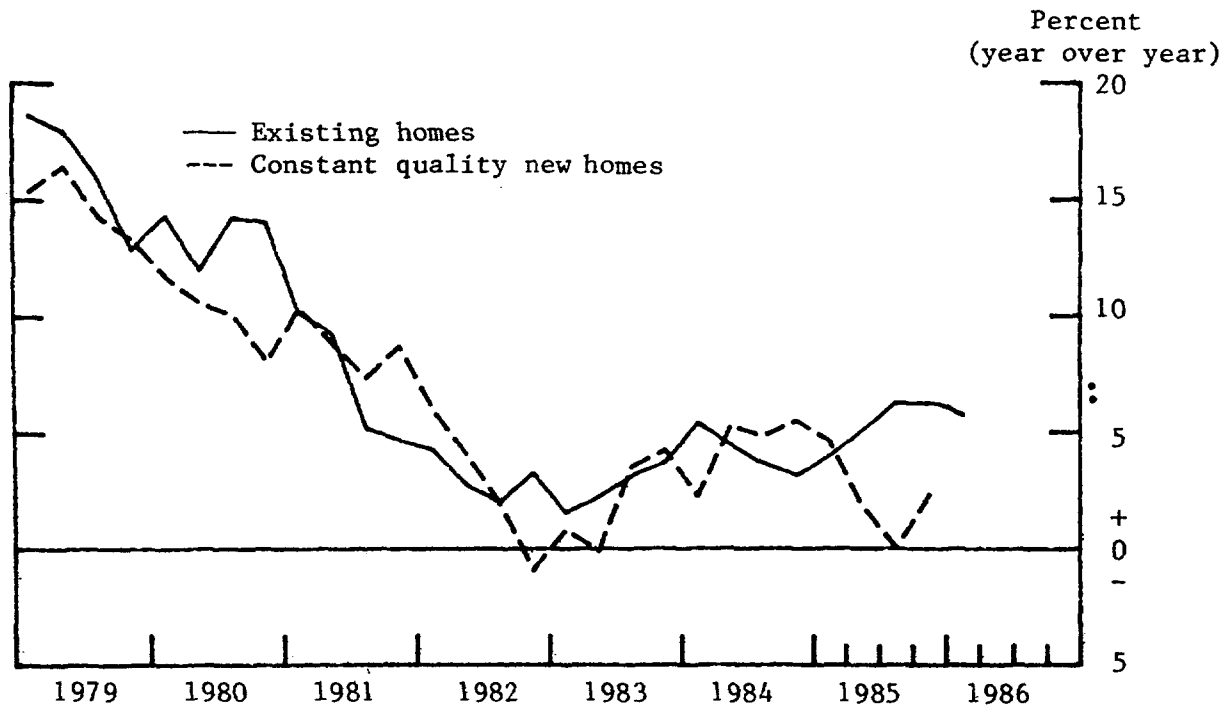
PRIVATE HOUSING ACTIVITY
(Seasonally adjusted annual rates, millions of units)

	1985	1985		1985	1986	
	Annual	Q3	Q4	Dec.	Jan.	Feb. ¹
All units						
Permits	1.73	1.76	1.74	1.87	1.91	1.78
Starts	1.74	1.69	1.77	1.88	2.06	1.99
Single-family units						
Permits	.95	.97	.95	.98	1.09	1.01
Starts	1.07	1.05	1.07	1.10	1.36	1.21
Sales						
New homes	.69	.71	.69	.72	.75	n.a.
Existing homes	3.22	3.36	3.50	3.52	3.30	3.27
Multifamily units						
Permits	.77	.79	.79	.90	.81	.77
Starts	.66	.64	.70	.78	.70	.78
Mobile home shipments	.28	.29	.29	.29	.28	n.a.

1. Preliminary estimates.

n.a.--Not available.

HOUSE PRICE INCREASES



new home market, an adjusted index—available only through the end of 1985—showed no surge in prices late last year (chart).

Business Inventories

Manufacturing and trade inventories moved in opposite directions in the most recent months for which data are available. In January, factory stocks continued the decline that began last spring while retail and wholesale inventories surged at a \$52 billion annual rate after a sizable runup in the fourth quarter.

Manufacturers' stocks are currently quite lean by historical standards. At the end of January, factory stocks in book value terms were almost 2 percent below their most recent peak in March 1985, and the inventory-shipments ratio was among the lowest observed over the current expansion. Although the sector, on balance, appears to be positioned for some restocking, efforts to build inventories appreciably probably will depend on sustained improvement in new orders.

About one-third of the January accumulation in trade inventories was in auto dealers' stocks, but there also were widespread increases in nonauto inventories. For the past year, nonauto retailers have operated with inventory-sales ratios that are relatively high by historical standards. The recent accumulation in this sector keeps these ratios on the high side, and near-term building of nonauto retail stocks is likely to be restrained.

Federal Government

Growth in total federal spending (unified budget) has abated in recent months, but outlays over the first five months of the fiscal year were up 5-3/4 percent from a year earlier, owing to large increases in defense and agriculture spending during the latter part of 1985. Revenues

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

	1985			1985		1986
	Q2	Q3	Q4	Nov.	Dec. ^r	Jan. ^p
Book Value Basis:¹						
Total	3.9	-5.5	17.3	5.1	11.4	33.7
Manufacturing	-2.0	-6.6	-8.6	-5.4	-1.3	-18.3
Wholesale	6.5	-2.0	5.8	-5.0	15.5	22.1
Retail	-6	3.1	20.1	15.5	-2.8	29.9
Automotive	.5	-6.8	19.9	19.9	8.8	15.1
Ex. auto	-1.2	9.9	.2	-4.4	-11.6	14.8
Constant Dollar Basis:						
Total	7.0	1.5	14.6	5.3	11.1	39.4
Manufacturing	-.2	-4.0	-10.5	-3.1	-6.5	-19.0
Wholesale	8.0	3.3	4.5	-7.8	20.3	17.8
Retail	-.8	2.2	20.5	16.2	-2.6	40.5
Automotive	-1.1	-5.7	19.9	22.3	8.8	18.9
Ex. auto	.3	7.9	.7	-6.2	-11.5	21.6

INVENTORIES RELATIVE TO SALES²

	1985			1985		1986		
	Q2	Q3	Q4	Nov.	Dec. ^r	Jan. ^p		
Cyclical Reference Points³								
Book Value Basis:	81 low	82 high						
Total	1.39	1.53	1.37	1.36	1.35	1.35	1.34	1.36
Manufacturing	1.60	1.77	1.47	1.46	1.42	1.41	1.42	1.41
Wholesale	1.06	1.28	1.17	1.17	1.17	1.16	1.15	1.18
Retail	1.37	1.46	1.40	1.37	1.43	1.43	1.41	1.43
Automotive	1.57	1.90	1.49	1.34	1.65	1.64	1.61	1.65
Ex. Auto	1.31	1.37	1.37	1.39	1.37	1.38	1.36	1.37
Constant Dollar Basis:								
Total	1.58	1.72	1.55	1.53	1.54	1.53	1.53	1.54
Manufacturing	1.88	2.04	1.78	1.76	1.73	1.72	1.73	1.71
Wholesale	1.26	1.45	1.30	1.31	1.31	1.30	1.30	1.32
Retail	1.38	1.49	1.40	1.37	1.45	1.46	1.43	1.47
Automotive	1.54	1.90	1.30	1.15	1.51	1.50	1.44	1.53
Ex. auto	1.31	1.41	1.43	1.44	1.43	1.45	1.43	1.45

1. Retail book-value data have been revised through January 1986; constant-dollar data for January are preliminary.
 2. Ratio of end-of-period inventories to average monthly sales for the period.
 3. Highs and lows are specific to each series and are not necessarily coincidental.
- r--Revised estimates.
p--Preliminary estimates.

through February of this fiscal year have grown at about the same rate as expenditures (table 1), even though receipts in February were depressed by faster refund payments. The deficit was about 5-1/2 percent higher than during the comparable period of FY1985.

The Gramm-Rudman-Hollings Act began to restrain spending growth in January (by rescinding the COLA for civilian and military retirement programs), and its effect became more pronounced on March 1 when a sequester order, designed to cut \$10.6 billion from federal spending during the rest of this fiscal year, went into effect. Although a federal District Court ruled in early February that the procedure used to order a sequester is unconstitutional, the ruling was stayed pending an appeal to the Supreme Court. A final ruling is expected later this spring. The Gramm-Rudman-Hollings Act includes a fall-back procedure to order a sequester, which can be implemented with legislative approval if the District court ruling is upheld.

A small downpayment on the deficit cuts required to attain the Gramm-Rudman goals was made in the fiscal year 1986 Reconciliation Bill, which Congress recently passed and sent to the President. The bill includes tax increases and spending cuts that will reduce deficits relative to the current services baseline figures by about \$6 billion in each of the next three years.¹

The Congressional Budget Office (CBO) recently released downward-revised estimates of the baseline federal deficit through 1991 (table 2).

1. The baseline deficit is computed under the assumption that taxes and mandatory spending are continued at the rates specified in current laws, and that discretionary programs are continued at levels that maintain real program services.

Table 1

FEDERAL UNIFIED RECEIPTS AND EXPENDITURES
(Not seasonally adjusted, billions of dollars)

	Total outlays ¹			Receipts			Total deficit ¹		
	FY1985	FY1986	Percent change	FY1985	FY1986	Percent change	FY1985	FY1986	Percent change
Q4 (Monthly average)	79.2	84.1	6.2	55.4	59.1	6.7	23.8	25.1	5.3
January	78.5	83.2	6.0	70.5	76.7	8.9	8.0	6.5	-18.8
February	75.1	78.0	3.9	54.0	53.4	-1.1	21.1	24.6	16.6
Total, October through February	391.2	413.5	5.7	290.6	307.3	5.7	100.6	106.2	5.6
<u>Memo:</u>									
FY1985 total	945.9			734.0			211.9		

Source: Monthly Treasury Statement.

Note: Detail may not add to totals because of rounding.

1. Includes outlays of entities classified as being off-budget by law.

Table 2

CBO REESTIMATE OF THE ADMINISTRATION BUDGET REQUEST
(fiscal years, billions of dollars)

	1987	1988	1989	1990	1991
CBO baseline deficit ¹	181.3	164.9	143.6	120.1	104.3
Effect of administration budget proposals on baseline deficit:					
Revenue	-5.9	-7.1	-8.6	-7.2	-6.5
Defense outlays	12.7	20.2	25.1	29.6	32.9
Nondefense outlays	<u>-28.3</u>	<u>-45.8</u>	<u>-68.6</u>	<u>-75.9</u>	<u>-90.6</u>
Subtotal, policy changes	-21.5	-32.7	-52.1	-53.5	-64.2
Deficit in President's budget as reestimated by CBO ²	<u>159.7</u>	<u>132.3</u>	<u>91.4</u>	<u>66.6</u>	<u>40.4</u>
Memo: Deficit in President's Budget ³	143.7	93.5	67.6	35.8	-1.3

Note: Detail may not add to totals because of rounding.

1. Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1987-1991 (February 1986).

2. Congressional Budget Office, An Analysis of the President's Budgetary Proposals for Fiscal Year 1987 (February 1986).

3. The Budget of the United States Government: Fiscal Year 1987 (February 1986).

The current projection of the baseline deficit is down sharply from estimates produced as recently as last August for several reasons: the assumption of lower interest rates has cut debt service costs, real defense spending is now assumed to remain flat rather than to grow at a 3 percent annual rate, and the Gramm-Rudman sequester and 1986 appropriations actions have cut the base from which future spending increases are computed. The CBO also has projected the size of the deficit under the President's budget proposals. It projects substantially larger deficits than the Administration--\$40 billion higher in 1991--primarily because the Administration assumes somewhat lower interest rates in future years and expects smaller outlays to result from current and proposed defense spending authority.

State and Local Sector

Spending prospects for state and local governments are being constrained by a number of factors. Budget surpluses narrowed during 1985, and the fiscal position of state and local governments in 1986 is further threatened by expected cuts in federal grants. Moreover, states whose economies depend on agriculture or oil and gas production face reduced revenues because of depressed activity. As a result, many states anticipate revenue shortfalls, and a good number already have taken steps to reduce significantly future spending. Budget cuts made so far this year range up to 13 percent of planned expenditures, with large reductions in Texas, Oklahoma, Idaho, and Mississippi. Nonetheless, the financial picture is not uniformly bleak; a number of states--especially those in New England and the mid-Atlantic region--remain in good financial condition.

Prices

Declines in energy prices have dominated the latest price reports. Led by a drop in gasoline and fuel oil prices, the consumer price index for all urban consumers was down 0.4 percent in February--the first decline in more than three years. Apart from energy, prices so far this year at the consumer level have fallen a bit for food and have risen moderately for other goods and services. Prices at the producer level also reflect tumbling energy prices, with the PPI for finished goods falling a record 1.6 percent in February.

Crude oil prices, which plunged 20 percent in the February PPI, have come down substantially more since then. Refinery prices of petroleum products also fell sharply in February, and retail prices of gasoline and fuel oil were down about 6 percent and 11 percent, respectively, in the February CPI. Further large declines in the CPI's components for gasoline and fuel oil can be expected in coming months as the declines in crude oil costs continue to be passed on to consumers.

Consumer food prices also have turned down after their brief pickup late last year. Also, prices of crude foods--notably for livestock--declined by substantial amounts during these two months, indicating little likelihood of upward pressures in the near term.

Excluding food and energy items, the CPI rose 0.2 percent in February, a bit slower than the average pace during the past year. The PPI has been little changed so far this year for both capital equipment and consumer goods (excluding food and energy items). At earlier stages of processing, prices of intermediate materials have continued to be essentially flat, while prices for crude materials have declined.

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

	Relative Importance Dec. 1985	1984	1985	1985		1986	
				Q3	Q4	Jan.	Feb.
				-Annual rate-		-Monthly rate-	
All items ²	100.0	4.0	3.8	2.4	5.3	.3	-.4
Food	18.5	3.8	2.7	2.1	5.9	.2	-.7
Energy	11.3	.2	1.8	-3.2	3.3	.1	-3.8
All items less food and energy ³	70.2	4.7	4.4	3.4	5.4	.4	.2
Commodities ³	25.9	3.1	2.1	1.1	3.6	.3	-.1
Services ³	44.4	5.6	5.7	4.8	6.5	.5	.4
Memorandum:							
CPI-W ⁴	100.0	3.5	3.6	2.0	5.2	.3	-.5

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

2. Official index for all urban consumers, based on a rental equivalence measure for owner-occupied housing after December 1982.

3. Data not strictly comparable. Before 1983, they are based on unofficial series that exclude the major components of homeownership; beginning in 1983, data include a rental equivalence measure of homeowners costs.

4. Index for urban wage earners and clerical workers, based on a rental equivalence measure for owner-occupied housing after December 1984.

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

	Relative Importance Dec. 1985	1984	1985	1985		1986	
				Q3	Q4	Jan.	Feb.
				-Annual rate-		-Monthly rate-	
Finished Goods	100.0	1.7	1.8	-2.4	9.2	-.7	-1.6
Consumer foods	24.5	3.5	.3	-2.9	15.0	-.4	-1.6
Consumer energy	12.5	-4.1	.0	-11.3	22.2	-4.2	-9.4
Other consumer goods	40.3	2.2	2.7	.0	4.5	.0	-.1
Capital equipment	22.7	1.8	2.7	-.9	5.3	-.1	.1
Intermediate materials ²	95.3	1.7	.0	-1.3	2.7	-.5	-1.4
Exc. energy	79.6	2.1	-.2	-.7	-.3	.0	-.2
Crude food materials	52.5	-1.2	-6.4	-20.6	47.0	-2.6	-3.6
Crude energy	31.6	-1.3	-4.3	-5.9	-2.0	.1	-8.2
Other crude materials	15.9	-3.4	-4.5	-4.4	1.0	-.3	-3.0

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

2. Excludes materials for food manufacturing and animal feeds.

Wage and Labor Costs

Wage inflation in the private economy has shown little change over the past year. The hourly earnings index for production and nonsupervisory workers rose 0.6 percent in February after a decline the month before. Although volatile on a monthly basis, the 12-month change in this measure has fluctuated around the 3 percent mark for well over a year.

Revised figures indicate that productivity in the nonfarm business sector fell more than 3 percent at an annual rate during the fourth quarter of 1985 as the sizable increase in employment and hours was not matched by large production gains. In general, productivity performance was poor in 1985; over the four quarters of last year, output per hour fell about 1/2 percent. As a result, unit labor costs increased more than 4 percent last year--up from the 3 percent rise in 1984--despite continued moderate increases in hourly compensation.

HOURLY EARNINGS INDEX¹
 (Percentage change; based on seasonally adjusted data)²

	1984	1985	1985				1985	1986	
			Q1-	Q2	Q3	Q4	Dec.	Jan.	Feb.
			--Annual rate--				--Monthly rate--		
Total private nonfarm	3.1	3.0	3.5	3.2	2.0	3.3	.7	-.5	.6
Manufacturing	3.3	3.3	5.2	3.5	2.0	2.3	.4	.0	.4
Durable	3.1	3.4	5.9	3.4	2.3	2.0	.4	.0	.5
Nondurable	3.7	3.1	4.0	3.8	1.5	2.9	.4	-.1	.2
Contract construction	1.3	1.0	5.2	-.1	-1.2	.3	1.1	-.9	.7
Transportation and public utilities	2.9	3.0	2.7	2.9	2.3	4.0	.6	-.1	.9
Finance, Insurance, and Real Estate	3.6	4.2	5.4	2.5	2.8	6.2	1.1	-.1	1.3
Total trade	2.6	2.0	1.8	2.1	1.2	3.1	1.0	-.9	.2
Services	4.0	4.2	2.1	5.7	3.8	5.2	.8	-.9	.9

1. Excludes the effect of interindustry shifts in employment and fluctuations in overtime hours 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 compounded annual rates.

DOMESTIC FINANCIAL DEVELOPMENTS

III-T-1
SELECTED FINANCIAL MARKET QUOTATIONS¹
(Percent)

	1982/1983	1984	1985	1986		Change from:	
	Cyclical lows	Highs	March highs	FOMC Feb.	Mar. 25	1984 highs	FOMC Feb.
Short-term rates							
Federal funds ²	8.46	11.63	8.58	7.91	7.35	-4.28	-0.56
Treasury bills ³							
3-month	7.08	10.67	8.80	7.11	6.38	-4.29	-0.73
6-month	7.62	10.77	9.13	7.19	6.45	-4.32	-0.74
1-year	7.73	11.13	9.25	7.19	6.50	-4.63	-0.69
Commercial paper							
1-month	8.00	11.42	8.94	7.75	7.25	-4.17	-0.50
3-month	7.97	11.35	9.12	7.68	7.14	-4.21	-0.54
Large negotiable CDs ³							
1-month	8.08	11.52	8.89	7.76	7.30	-4.22	-0.46
3-month	8.12	11.79	9.29	7.76	7.17	-4.62	-0.59
6-month	8.20	12.30	9.92	7.80	7.16	-5.14	-0.64
Eurodollar deposits ⁴							
1-month	8.68	11.89	8.89	7.91	7.48	-4.41	-0.43
3-month	8.71	12.20	9.58	7.95	7.39	-4.81	-0.56
Bank prime rate	10.50	13.00	10.50	9.50	9.00	-4.00	-0.50
Treasury bill futures							
June 1986 contract			10.58	6.91	6.11		-0.80
Sept. 1986 contract			10.74	7.02	6.08		-0.94
Intermediate- and long-term rates							
U.S. Treasury (constant maturity)							
3-year	9.33	13.49	11.22	8.19	7.23	-6.26	-0.96
10-year	10.12	13.99	12.02	8.91	7.70	-6.29	-1.21
30-year	10.27	13.94	11.97	9.13	7.90	-6.04	-1.23
Municipal revenue (Bond Buyer index)	9.21	11.44	10.25	8.24 ⁵	8.13 ⁵	-3.31	-0.11
Corporate--A utility Recently offered	11.64	15.30	13.23	10.45	9.36 ^e	-5.94	-1.09
Home mortgage rates							
S&L fixed-rate	12.55	14.68	13.29	10.85 ⁶	10.01 ⁶	-4.67	-0.84
S&L ARM, 1-yr.	n.a.	12.31	11.14	8.98 ⁶	8.67 ⁶	-3.64	-0.31
	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>		<u>Percent change from:</u>	
	Highs	Lows	Highs	FOMC Feb.	Mar. 25	1984 lows	FOMC Feb.
Stock prices							
Dow-Jones Industrial	1287.20	1086.57	1553.10	1629.93	1778.50	63.7	9.1
NYSE Composite	99.63	85.13	121.90	124.67	135.22	58.9	8.5
AMEX Composite	249.03	187.16	246.13	244.12	266.52	42.4	9.2
NASDAQ (OTC)	328.91	225.30	325.16	346.27	369.28	64.0	6.6

1. One-day quotes except as noted.

2. Averages for two-week reserve maintenance period closest to date shown. Last observation is average to date for the maintenance period ending March 26, 1986.

3. Secondary market.

4. Averages for statement week closest to date shown.

5. One-day quotes for preceding Thursday.

6. One-day quotes for preceding Friday.

e--estimate

DOMESTIC FINANCIAL DEVELOPMENTS

Financial markets rallied over the intermeeting period, with most interest rates falling to levels last seen in 1977 or 1978 and share prices soaring to new highs. The declines of one-half to three-fourths percentage point in short-term interest rates clearly owed much to anticipation and enactment of the March 7 cut in the discount rate from 7-1/2 to 7 percent, but less readily explained was the continued spectacular surge in long-term securities prices, which pushed yields on Treasury bonds down more than a percentage point and lifted broad stock averages as much as 10 percent. Investors apparently were viewing the further drop in oil prices as improving the chances of longer-range restraint on inflation; however, the evident rise in stock price-earnings multiples and the depreciation of the dollar suggest that the decline in bond yields reflected a shrinkage in real rates as well as in inflation premiums. Projections of favorable budgetary trends, less robust domestic economic indicators, and increased optimism about the potential for easing steps by monetary authorities here and abroad all contributed to the bullish sentiment in the fixed-income markets.

M1 growth picked up in February and appears to have strengthened appreciably further in March, evidently lifting the aggregate above the top of its 1986 target range. For M2, expansion remained anemic in February, and although somewhat faster growth likely occurred in March, this aggregate remains low relative to its 1986 range. M3, in contrast, has remained well within its longer-run target range.

The overall rate of debt expansion by domestic nonfinancial sectors has moderated substantially from the record fourth-quarter pace. Much of the slowing stems from the reduced volume of tax-exempt bond issuance;

MONETARY AGGREGATES

(Based on seasonally adjusted data unless otherwise noted)¹

	1984:Q4 to 1985:Q4		1985			1986		Growth from Q4 1985 to Feb 1986P
		Q3	Q4	Dec.	Jan.	Feb. ^P		
----- Percentage change at annual rates -----								
1. M1	11.9	14.5	10.6	12.6	1.1	7.3	6.9	
2. M2	8.6	9.5	6.0	7.0	1.4	3.6	3.9	
3. M3	7.7	7.7	6.4	7.0	8.2	6.1	7.0	
								Levels in billions of dollars Feb. 1986P
Selected components								
4. Currency	7.5	8.3	7.4	5.7	9.1	7.0	172.9	
5. Demand deposits	8.6	12.4	7.7	16.6	-11.5	1.3	269.2	
6. Other checkable deposits	22.2	23.9	18.5	12.9	12.8	17.3	183.0	
7. M2 minus M1 ²	7.6	8.0	4.6	5.2	1.4	2.4	1945.2	
8. Overnight RPs and Eurodollars, NSA	18.5	18.7	23.6	65.9	-34.7	-3.6	57.0	
9. General purpose and broker/dealer money market mutual fund shares, NSA	9.3	4.1	0.9	-2.0	8.8	21.6	180.9	
10. Commercial banks	9.1	7.9	5.3	6.9	9.8	2.8	850.0	
11. Savings deposits, SA, plus MMDAs, NSA ³	19.0	18.2	11.2	7.7	11.8	1.3	462.0	
12. Small time deposits	-0.6	-3.3	-1.6	6.0	7.5	4.7	388.0	
13. Thrift institutions	5.1	4.8	1.4	2.7	4.2	6.4	862.5	
14. Savings deposits, SA, plus MMDAs, NSA ³	13.7	16.2	7.4	-2.0	-1.3	3.7	359.4	
15. Small time deposits	-0.4	-2.8	-2.9	6.1	8.2	8.4	503.1	
16. M3 minus M2 ⁴	3.9	0.2	8.2	7.0	35.7	16.2	662.4	
17. Large time deposits	5.7	-2.7	10.8	9.7	31.3	8.3	450.9	
18. At commercial banks, net ⁵	5.1	-3.6	14.1	10.4	45.6	6.2	291.2	
19. At thrift institutions	6.8	-1.0	5.2	8.5	6.9	11.4	159.7	
20. Institution-only money market mutual fund shares, NSA	11.1	1.3	3.1	1.9	40.9	7.2	67.2	
21. Term RPs, NSA	-4.4	-7.6	39.2	51.4	51.1	33.3	70.4	
22. Term Eurodollars, NSA	-3.7	-4.0	-4.5	-39.1	-20.2	44.3	78.7	

-- Average monthly change in billions of dollars --

MEMORANDA:

23. Managed liabilities at commercial banks (24+25)	2.3	1.0	6.2	6.9	14.5	3.0	477.7
24. Large time deposits, gross	1.0	0.6	2.3	1.7	11.8	2.3	351.7
25. Nondeposit funds	1.3	0.4	3.9	5.2	2.8	0.7	126.0
26. Net due to related foreign institutions, NSA	0.4	1.4	0.8	0.9	6.0	-0.5	-22.2
27. Other ⁶	1.0	-1.0	3.1	4.3	-3.2	1.3	148.3
28. U.S. government deposits at commercial banks ⁷	0.2	-0.7	0.9	4.0	1.5	2.1	21.1

1. Quarterly growth rates are computed on a quarterly average basis. Dollar amounts shown under memoranda for quarterly changes are calculated on an end-month-of-quarter basis.

2. Nontransactions M2 is seasonally adjusted as a whole.

3. Growth rates are for savings deposits, seasonally adjusted, plus money market deposit accounts (MMDAs), not seasonally adjusted. Commercial bank savings deposits excluding MMDAs increased during January and February 1986 at rates of 2.9 percent. At thrift institutions, savings deposits excluding MMDAs increased during January and February 1986 at rates of 1.3 percent and 4.0 percent, respectively.

4. The non-M2 component of M3 is seasonally adjusted as a whole.

5. Net of large-denomination time deposits held by money market mutual funds and thrift institutions.

6. 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, loan RPs and other minor items). Data are partially estimated.

7. Consists of Treasury demand deposits and note balances at commercial banks.

p--preliminary

although there has been some rise in municipal offerings since January, uncertainties about tax reform have continued to weigh on the market. Along with reduced state and local borrowing, the federal government has been able to cut back its offerings this quarter, in part by running down its cash balance, which was swollen late last year by sales of special securities to state and local units that had undertaken advance refundings.

Borrowing by nonfinancial businesses has diminished, too; external financing needs remain light, and the volume of share retirements has fallen off. Gross corporate bond issuance has skyrocketed, as many firms have seen in this market rally a long-awaited opportunity to lengthen debt maturities at acceptable rates. Business loans and nonfinancial commercial paper have been about flat since December.

Households also have been taking advantage of lower interest rates. Fragmentary information suggests that net residential mortgage borrowing has picked up further; refinancing activity has been heavy and should permit many households to reduce their monthly payment burdens. Consumer installment credit strengthened in January, boosted by reduced-rate lending by the auto finance companies, although the underlying trend for consumer debt seems to be one of gradual deceleration.

Monetary Aggregates and Bank Credit

M1 growth rebounded to a 7-1/4 percent annual rate in February, and weekly data through mid-March point to a further step-up in the rate of expansion. The acceleration since January has largely reflected a renewed rise in demand deposits after the January runoff. Growth in other checkable deposits also picked up in February and appears to have expanded nearly as fast in March; so far this year, though, expansion in OCDs has been below

last year's brisk pace. The January deregulation of NOW accounts seems to have had little effect, with depository institutions generally not liberalizing the terms of their NOWs.

Owing primarily to the acceleration in M1, M2 growth edged up in February, but only to a 3-1/2 percent annual rate. Growth of retail deposits again was rather weak, even though sluggish downward adjustment of offering rates on such accounts resulted in more favorable yields on small time deposits relative to market instruments. In contrast, assets of broker/dealer and general-purpose money market mutual funds recorded faster growth in February and swelled further in the first half of March, as their yields, too, lagged the decline in short-term market rates.

Although M2 likely has posted a somewhat larger increase in March, its growth in recent months has been on a generally weak trajectory. Meanwhile, inflows to stock and, especially, bond mutual funds have been very sizable indeed, as savers have been attracted by the relatively high total returns recorded--and aggressively advertised--by the funds.

M3 growth fell to a 6 percent annual rate in February, when bank credit decelerated. Term RPs, along with overnight RPs, increased in association with banks' acquisitions of Treasury securities, but net issuance of other managed liabilities was off considerably. Bank CDs, which had increased \$12 billion in January, rose only about \$2 billion last month, and the sizable \$6 billion inflow of funds from foreign offices in January was partially reversed in February. Growth in M3 in early March seems to be in line with the reduced February pace.

Bank credit growth slowed sharply in February, owing importantly to the unwinding of heavy purchases of tax-exempt securities late last year.

While some of the investment in such securities had been motivated by the desire to beat the year-end deadline for qualifying for carrying-cost deductibility, a good part clearly was associated with an expectation of capital gains when tax-exempt issuance abated--a strategy that proved highly rewarding. From early January through mid-March, commercial banks ran off an estimated \$12 billion, net, of tax-exempts, more than offsetting large acquisitions of U.S. government and agency securities.

Loan growth at commercial banks in February slowed markedly to a 4 percent annual rate. The slowing resulted from substantial reductions in security loans and in loans to nonbank financial institutions, which have been financing in long-term markets along with nonfinancial firms. Real estate loans bounced back from relatively slow growth in January to a 14 percent increase in February; growth over the two months averaged about 11 percent, a shade below the average pace in recent quarters. Consumer loans at banks continued to expand at a 12 percent pace in February.

Business loan demand remained weak at banks last month, reflecting the limited credit requirements of firms and their preference for long-term borrowing. The prime rate was cut one-half percentage point, but remains well above other short-term rates. Outstanding commercial paper of nonfinancial firms continued to run off, owing partly to refinancing of earlier merger transactions.

Business Finance

While growth of short-term business debt has been very slow thus far in 1986, nonfinancial businesses have increased sharply their gross issuance of taxable bonds and stocks, taking advantage of rising securities prices. An increased portion of new offerings has been used to refinance existing

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

	1985				1986		Levels in bil. of dollars February ^P
	02	03	04	Dec.	Jan.	Feb. ^P	
----- Commercial Bank Credit -----							
1. Total loans and securities at banks	9.3	8.6	11.8	16.6	15.3	4.1	1926.1
2. Securities	5.5	12.4	19.6	26.2	24.3	3.7	455.6
3. U.S. government securities	0.0	9.0	-3.5	-18.8	-27.0	28.1	270.8
4. Other securities	16.1	18.8	61.3	103.0	103.8	-30.4	184.8
5. Total loans	10.4	7.4	9.4	13.7	12.5	4.1	1470.4
6. Business loans	2.6	2.4	5.5	8.1	0.7	2.7	495.3
7. Security loans	87.8	-18.0	4.2	28.6	139.9	-36.2	41.8
8. Real estate loans	12.4	11.2	13.0	11.5	8.2	14.1	431.1
9. Consumer loans	14.9	11.1	8.8	11.4	12.1	12.0	292.3
10. Other loans	7.1	12.3	13.5	32.6	25.9	-15.2	209.9
----- Short- and Intermediate-Term Business Credit -----							
11. Business loans net of bankers acceptances	3.6	2.2	5.0	7.1	0.7	3.4	491.5
12. Loans at foreign branches ²	17.0	-4.1	-2.1	6.2	-6.2	-68.8	18.1
13. Sum of lines 11 & 12	4.0	2.0	4.7	7.1	0.5	0.9	509.7
14. Commercial paper issued by nonfinancial firms ³	33.8	-1.5	55.5	36.2	-13.5	-2.7	87.5
15. Sums of lines 13 & 14	7.9	1.5	11.5	11.3	-1.6	0.4	597.2
16. Bankers acceptances: U.S. trade related ^{4,5}	-10.8	-6.7	-13.6	25.1	-7.0	n.a.	33.7 (Jan)
17. Line 15 plus bankers acceptances: U.S. trade related	6.7	1.0	10.1	12.1	-1.9	n.a.	630.7 (Jan)
18. Finance company loans to business ⁴	8.0	3.1	19.2	19.4	18.3	n.a.	153.1 (Jan)
19. Total short- and intermediate- term business credit (sum of lines 17 & 18)	6.9	1.4	11.8	13.5	2.0	n.a.	783.8 (Jan)

n.a.--not available.

p--preliminary

1. Average of Wednesdays for domestically chartered banks and average of current and preceding ends of months for foreign-related institutions.

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

3. Average of Wednesdays.

4. Based on average of current and preceding ends of month.

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

long-term debt issued at higher yields; however, firms also have been turning to the bond market when financing new capital needs.

Record volumes of new bonds have been issued in the domestic market, with the first-quarter total expected to be roughly two-thirds higher than the previous record set just last quarter. About half of the issuance carried maturities of 20 years or longer--a considerably greater proportion than in recent times, but not especially impressive by the standards of earlier years. Offerings of lower-quality debt have been well maintained, but the increase in volume has been primarily among investment-grade issues.

Issuance by nonfinancial corporations in the Euromarket has been robust throughout the quarter. Though rates in domestic markets declined more rapidly than those in the Euromarkets, some firms without existing shelf-registered securities have taken advantage of easier issuing procedures abroad. The dollar's depreciation and concerns among foreign investors about the possible reinstatement of the withholding tax on foreign interest earnings on new issues, as proposed in the Packwood tax plan, reportedly have tempered the willingness of investors to acquire Eurobonds.

Prices in the stock market climbed to record highs in February and again in March, prompting a pickup in new stock offerings. The rise in equity issuance has been more noticeable among financial institutions, some of which have benefited considerably from the decline in interest rates: prices of New York City bank stocks moved up more than 20 percent over the intermeeting period. Equity prices for some energy companies have declined in the midst of the general market rally as a result of lower oil prices. Prices of shares of real estate-related companies located in certain areas of the country have also fallen as a result of excessive construction in those areas.

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

	1984	1985	1985		1986		
	Year	Year	Q3	Q4	Q1 ^e	Feb. ^p	Mar. ^e
Corporate securities - total ¹	9.90	16.12	15.64	19.29	27.76	28.10	33.80
Public offerings in U.S.	8.02	12.97	12.73	14.86	23.54	23.80	29.80
Stocks--total ²	1.89	2.96	3.02	3.32	4.17	4.60	4.80
Nonfinancial	1.08	1.61	1.53	1.81	2.14	2.50	1.90
Utility	.22	.37	.19	.38	.45	.50	.30
Industrial	.86	1.24	1.34	1.43	1.69	2.00	1.60
Financial	.81	1.35	1.49	1.51	2.03	2.10	2.90
Bonds--total ¹	6.13	10.01	9.71	11.54	19.37	19.20	25.00
By industry							
Nonfinancial	2.80	5.21	4.86	6.04	10.02	9.25	14.00
Utility	.87	1.51	1.60	2.28	3.35	4.10	4.50
Industrial	1.93	3.70	3.26	3.76	6.67	5.15	9.50
Financial	3.33	4.80	4.85	5.50	9.35	9.95	11.00
By quality ³							
Aaa and Aa	1.87	2.37	2.67	2.67	5.39	6.95	6.00
A and Baa	2.11	4.58	3.81	5.20	7.75	7.90	10.60
Less than Baa	1.09	1.42	1.35	1.72	2.65	1.05	3.00
No rating (or unknown)	.25	.34	.23	.39	.35	.37	.40
Memo items:							
Equity based bonds ⁴	.63	.70	.84	.38	1.00	.90	.90
Mortgage-backed bonds	.81	1.30	1.65	1.56	3.23	2.93	5.00
Variable-rate notes	.72	.87	.41	.56	.27	.10	.17
Bonds sold abroad - total	1.88	3.15	2.91	4.43	4.22	4.30	4.00
Nonfinancial	.84	1.26	1.23	1.73	2.09	2.56	2.30
Financial	1.06	1.89	1.68	2.70	2.13	1.74	1.70

p--preliminary. e--staff estimate.

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

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

3. Bonds categorized according to Moody's bond ratings. Excludes mortgage-backed bonds.

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

As stock prices generally have continued their sharp rise, announcements of new merger proposals have dropped off noticeably. The rise in stock prices also may be slowing company repurchases of their own stock, further contributing to a smaller net retirement of stock than the extraordinary amounts of last year.

Treasury and Federally Sponsored Agency Finance

The combined deficit of the federal government for the current quarter is expected to be \$63 billion. This will be financed in part by borrowing roughly \$36 billion, net, in the market and by drawing down the cash balance by almost \$19 billion. The cash balance had risen to an unusually high level because of heavy sales of nonmarketable issues to state and local governments in December.

For the quarter, the Treasury will have raised all of its new cash in auctions of marketable coupon issues; there will have been a \$7 billion net payoff of bills. In the next three months the deficit is likely to decline seasonally, and net borrowing is expected to be about \$30 billion.¹

Federally sponsored credit agencies, as a group, are paying down an estimated \$1-1/2 billion of debt in the first quarter. The largest decline in net borrowings has been that of the Farm Credit Banks which continued the paydowns that had been evident most of last year. This decline is largely the result of weak demand for farm loans, because of overall weakness in the farm sector and a tendency for the more able borrowers to obtain funds from other sources that may have had lower rates.

¹ The ceiling for bond issues with coupons in excess of 4-1/4 percent was increased from \$200 billion to \$250 billion by congressional action on March 20. This action was too late to permit the Treasury to include a 20-year bond in its end-of-quarter financing, as it normally would have done, but it will permit normal financing patterns to resume thereafter.

TREASURY AND AGENCY FINANCING¹
(Total for period; billions of dollars)

	1985		1986			
	Q4	Dec.	Q1 ^e	Jan.	Feb.	Mar. ^e
<u>Treasury financing</u>						
Combined surplus/deficit(-)	-75.2	-14.7	-63.1	-6.5	-24.6	-32.0
Means of financing deficit:						
Net cash borrowing from the public	90.6	33.4	36.3	12.7	16.0	7.6
Marketable borrowings/ repayments(-)	63.3	17.2	35.0	12.2	14.2	8.6
Bills	15.7	2.3	-7.0	-.3	-2.1	-4.6
Coupons	47.6	14.9	42.0	12.5	16.3	13.2
Nonmarketable	27.3	16.2	1.3	.5	1.8	-1.0
Decrease in the cash balance	-13.8	-20.8	18.7	-9.3	13.9	14.1
Memo: Cash balance at end of period	30.9	30.9	12.2	40.2	26.3	12.2
Other ²	-1.6	2.1	8.1	3.1	-5.3	10.3
<u>Federally sponsored credit agencies, net cash borrowing³</u>						
FHLBs	2.1	0.6	0.3	-1.2	-0.6	2.1
FNMA	2.2	-0.7	-0.8	-1.2	0.5	-0.1
Farm Credit Banks	0.6	-1.6	-3.6	-1.8	-1.0	-0.8
FHLMC	-0.8	0.9	1.4	1.2	0.1	0.1
SLMA	0.7	.0	1.4	.0	0.8	0.4

^e--staff estimate.

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

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

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

Fannie Mae reduced its debt as its net purchases of mortgages slowed sharply; the agency evidently has not offset fully the effect of increased loan prepayments on the net growth of its asset portfolio. While outstanding debt at Fannie Mae declined in the first quarter, its pass-through security issuance was reported to be very heavy. In contrast to the situation at Fannie Mae, mortgage refinancing has been boosting the borrowing of the Federal Home Loan Mortgage Corporation, which has risen to about \$1-1/2 billion in the first quarter. As homeowners refinance, the gross issuance of pass-through securities increases, and Freddie Mac must finance a portion of these loans until a pool is formed that can be sold into the market as a participation certificate. The Federal Home Loan Banks paid down debt in the first two months of the year, owing to the seasonally weak demand for advances to savings and loans; however, borrowing rebounded in March when the demand for advances increased, apparently in connection with the higher level of mortgage activity.

Tax-Exempt Market

Gross offerings of tax-exempt bonds rose somewhat in March from depressed levels earlier this year, despite continued uncertainties about tax reform. The gross volume of long-term securities totaled \$3.1 billion in February, and may more than double that rate in March. The recent increases have been facilitated by pledges by the issuers of compliance with tax-reform legislation passed late in 1985 by the House. However, issuance could rise somewhat further, as the result of an agreement reached in mid-March by key members of the Congress and Treasury Secretary Baker to postpone several restrictions on public-purpose bonds

contained in the same bill.¹ A proposal put forth by Senator Packwood on March 19, to subject the interest earnings on all outstanding tax-exempt debt to the alternative minimum personal income tax, brought the municipal market to a temporary halt, but the proposal was unanimously defeated in the Senate Finance Committee on March 24.

GROSS OFFERINGS OF TAX-EXEMPT SECURITIES
(Monthly rates, not seasonally adjusted, billions of dollars)

	1984	1985	1985			1986		
	Year	Year	Q3	Q4	Dec	Jan	Feb ^p	Mar ^e
Total	10.60	19.82	16.29	37.70	58.19	2.50	3.43	7.50
Short-term ¹	1.71	1.97	2.67	.91	.76	.74	.33	.50
Long-term	8.89	17.85	13.62	36.79	57.43	1.76	3.10	7.00
Refundings ²	1.05	4.85	4.20	9.40	10.64	.22	1.32	3.70
New capital	7.84	13.00	9.42	27.39	46.79	1.54	1.78	3.30
Total housing ³	1.69	2.46	2.44	3.86	5.60	.00	---	---
Single-family	1.12	1.08	1.17	1.35	1.35	.00	---	---

p--preliminary.

e--staff estimate

1. Does not include tax-exempt commercial paper.
2. Includes all refunding bonds, not just advance refundings.
3. Data from the Department of Housing and Urban Development.

Virtually all of the municipal bonds sold thus far in 1986 have been for public purposes. Refunding bonds have accounted for a large share of the sales, owing primarily to the continued low level of rates. More than half of the recent refundings have been sold by municipal utilities.

1. Certain restrictions on public-purpose bonds contained in H.R. 3838 were postponed until September 1 or until a tax reform package is passed, whichever comes first. In particular, restrictions on early issuance, including the requirement that at least 5 percent of bond proceeds be spent within 30 days, have been relaxed. In addition, \$25 million, or 25 percent, whichever is less, of public-purpose bond proceeds can be used to benefit a private concern under existing law, instead of the \$10 million, or 10 percent, proposed under the House bill.

The ratio of tax-exempt to taxable yields has moved up substantially in recent weeks. The relatively sluggish decline in municipal yields likely reflects expectations of continued weak institutional demand, with only spotty demand from casualty insurance companies and with commercial banks out of the market entirely.

Strong demand for tax-exempt investments with relatively short maturities is evident from the fact that tax-exempt money market mutual fund assets have increased \$10 billion, to \$51 billion, since the beginning of January and now make up 20 percent of all money fund assets. Purchases apparently have comprised earlier issues for the most part, given the low volume of short-term offerings so far this year.

Mortgage Markets

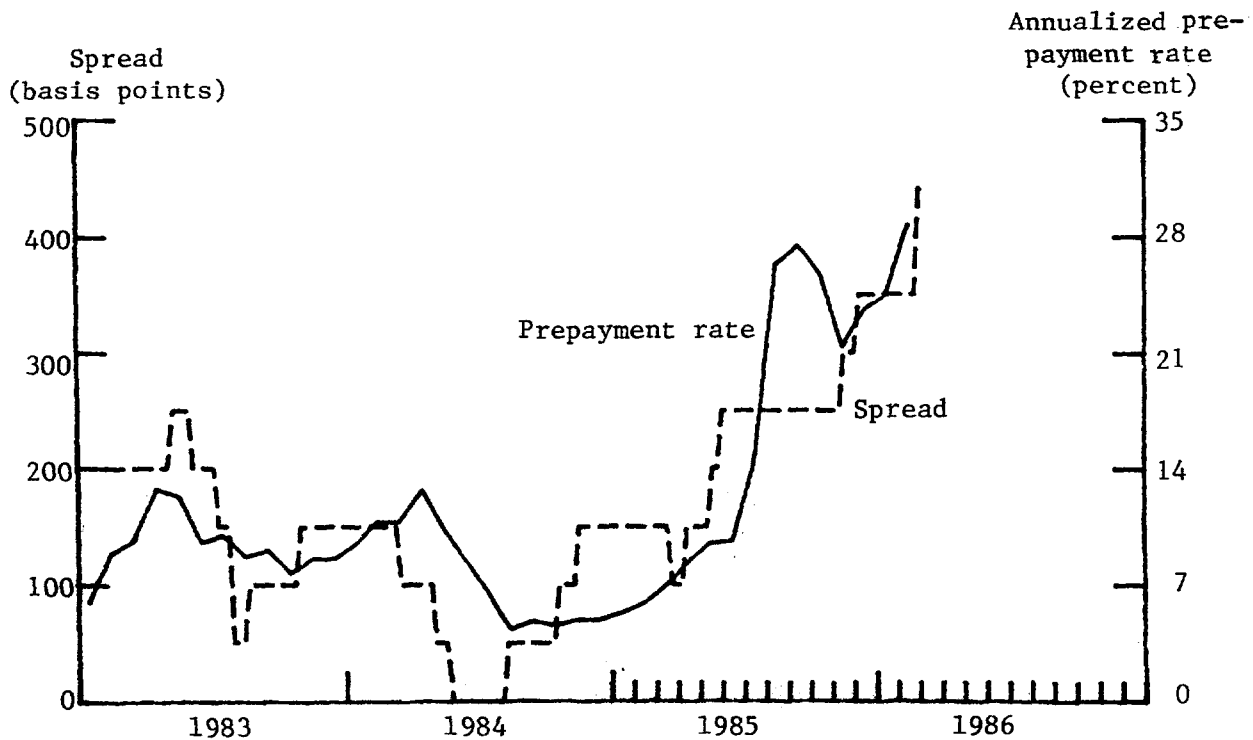
Interest rates have continued to drop in the primary mortgage market since the February FOMC meeting, reaching the lowest levels since 1978. Commitment rates at savings and loan associations for conventional fixed-rate loans on single-family homes have fallen nearly one percentage point, to 10.01 percent. The VA cut by one percentage point the ceiling rate on mortgages that it guarantees, lowering the contract rate on level-payment loans to 9-1/2 percent.

The proportion of fixed-rate financing has increased in the primary market. At major lenders, the share of conventional home loans closed with fixed rates rose to 62 percent in early February, the largest share in 2-1/2 years. By mid-March, the difference between commitment rates on fixed-rate loans and on one-year adjustable-rate loans at S&Ls had dipped below 1-1/2 percentage points, about 40 basis points narrower than a month

REFINANCING OF HOME MORTGAGE LOANS

	Refinancing as a share of the number of	
	FHA-insured loan applications processed (percent)	VA-guaranteed loans closed (percent)
1984-Q1	13.6	11.0
Q2	9.0	9.0
Q3	9.3	5.2
Q4	11.9	5.8
1985-Q1	15.4	8.1
Q2	13.0	9.1
Q3	13.2	10.4
Q4	13.6	14.1
1986-Jan.	21.3	15.7
Feb.	24.9	18.2

PREPAYMENT RATE ON GNMA 13.5s AND SPREAD BETWEEN 13.5 COUPON AND CURRENT-COUPON GNMA's



earlier and a full percentage point less than the spread last November, reducing the attractiveness of ARMs to borrowers.

The drop in interest rates has precipitated a surge of mortgage refinancings; they accounted for 18 percent of all VA-guaranteed home loans closed in February, 3-1/3 times their frequency a year and a half earlier. Refinancing activity also was up on FHA-insured loans; 25 percent of the insurance applications processed in February involved refinancing of existing mortgages, compared with an average of less than 14 percent in the fourth quarter of 1985.¹

Reflecting the increased refinancing activity, the pace at which FHA/VA mortgages prepay in high-coupon GNMA pools has accelerated. For example, during February, GNMA's with a coupon of 13-1/2 percent--issued against pools of FHA and VA mortgages with contract rates of 14 percent--attained a record rate of prepayment.²

The fall in interest rates since last autumn has spurred mortgage acquisition activity at thrift institutions. The net change in mortgage assets at FSLIC-insured entities rose to a seasonally adjusted \$6.3 billion in January, the strongest pace since September. The increase was concentrated in mortgage-backed securities, as many thrifts swapped seasoned mortgages for pass-through securities. Swap issues by FHLMC and FNMA

1. Authority for FHA to issue mortgage commitments expired on March 17, but a bill is expected to be signed shortly that would extend FHA authority through April 30.

2. Some commercial mortgages and construction loans contain prepayment penalties, which are prohibited on VA-guaranteed and FHA-insured residential mortgages and on all conventional home mortgages in some states. There are reports that even with these penalties some commercial borrowers have been able to refinance their loans on favorable terms, indicating that refinancing activity may be increasing for commercial as well as for home mortgages.

NEW ISSUES OF MORTGAGE-BACKED PASS-THROUGH SECURITIES
BY FEDERALLY SPONSORED AGENCIES
(Monthly averages, billions of dollars, not seasonally adjusted)

Period	Total	GNMAs	FHLMCs	FNMA's	Memo:
					FNMA and FHLMC swap issues
1985-Q1	6.4	2.7	2.4	1.3	3.0
Q2	7.5	3.3	2.8	1.5	3.3
Q3	10.4	4.1	3.8	2.5	4.7
Q4	11.5	5.2	3.6	2.7	4.6
1985-Oct.	11.1	5.8	3.1	2.2	3.8
Nov.	11.2	5.3	3.4	2.5	4.3
Dec.	12.1	4.5	4.3	3.4	5.8
1986-Jan.	13.1	5.3	3.8	4.0	6.1
Feb. p	12.4	5.0	4.4	3.0	6.0

p--preliminary.

MORTGAGE ACTIVITY AT FSLIC-INSURED INSTITUTIONS
(Billions of dollars, seasonally adjusted)

	Mortgage transactions		Net change in mortgage assets ¹		
	Originations	Sales	Total	Mortgage loans	Mortgage-backed securities
	(1)	(2)	(3)	(4)	(5)
1985-Jan.	15.0	6.3	4.1	4.5	-.4
Feb.	15.0	6.4	3.1	2.9	.2
Mar.	14.7	6.2	4.2	4.8	-.6
Apr.	15.9	6.4	4.1	4.5	-.4
May	16.1	7.6	2.3	3.2	-.9
June	14.3	7.8	-2.2	2.8	-5.0
July	14.9	9.6	2.4	4.7	-2.3
Aug.	16.0	8.2	6.6	4.9	1.7
Sept.	17.0	9.6	9.3	4.4	4.9
Oct.	19.3	11.3	4.7	6.5	-1.8
Nov.	18.5	12.5	4.1	2.8	1.3
Dec.	19.8	10.8	5.3	7.0	-1.7
1986-Jan. p	18.7	9.3	6.3	2.4	3.9

1. Data are adjusted to account for structural changes through mergers, acquisitions, liquidations, terminations, or de novo institutions.

p--preliminary.

averaged \$6.1 billion in January and February (NSA), up \$1.5 billion from the monthly average for the final quarter of last year.

GNMA gross security issuance also remained robust, stimulated in part by the rush of refinancings of seasoned FHA/VA mortgages as well as by the tighter underwriting standards currently employed on conventional mortgage loans.

Consumer Installment Credit

Growth in consumer installment credit outstanding rebounded in January to a 15-1/4 percent annual rate, boosted mainly by a resurgence in auto credit that was sparked by another round of reduced-rate financing from the automobile finance companies. Auto credit advanced at nearly an 18 percent rate after gains averaging 7 percent in the prior two months. Revolving credit growth also was strong in January. In total, however, credit growth remained well below the peak rates of the current cycle.

Consumer installment credit expansion likely continued fairly strong in February, as auto financing incentives remained in force through most of the month, and retail sales of non-auto durable goods were relatively strong. Available data suggest that consumer credit growth at banks in February stayed at about the January pace, while data for large banks in early March suggest a modest slowing.

A broad decline in interest rates on consumer loans appears to be in process. At commercial banks, a gradual downtrend has been evident since the fall of 1984. Between that time and February of this year, new-car loan rates dropped 1-3/4 percentage points to 12-1/4 percent. In recent days, a number of banks have announced cuts of 1/2 percentage point or more on auto loans, home improvement loans, and most other types of consumer credit.

CONSUMER INSTALLMENT CREDIT

	1984	1985	1985		1985		1986
			Q3	Q4	Nov.	Dec.	Jan.p
----- Percent rate of growth, SAAR -----							
Change in outstandings--total	20.0	19.5	18.8	14.4	10.8	12.6	15.2
By type:							
Automobile credit	20.6	21.9	24.5	12.2	6.5	7.5	17.7
Revolving credit	23.9	21.5	14.1	22.9	27.9	17.4	18.2
All other ¹	17.5	16.2	15.8	12.1	6.0	15.0	11.3
----- Billions of dollars, SAAR -----							
Change in outstandings--total	76.8	89.9	94.0	75.3	57.5	67.4	82.5
By type:							
Automobile credit	29.5	37.8	47.1	24.8	13.4	15.5	37.1
Revolving credit	19.6	21.9	15.1	25.3	31.4	20.0	21.2
All other ¹	27.8	30.2	31.9	25.2	12.7	31.9	24.2
By major holder:							
Commercial banks	40.4	39.6	29.3	33.0	37.7	26.9	37.7
Finance companies	9.3	24.1	41.6	18.4	6.6	10.8	27.9
All other	27.1	26.2	23.0	24.0	13.2	29.7	16.9
----- Annual percentage rate -----							
Interest rates							
At commercial banks ²							
New cars, 48 mos.	13.71	12.91	12.72	12.39	12.39	n.a.	12.29 ⁴
Personal, 24 mos.	16.47	15.94	15.84	15.61	15.61	n.a.	15.52 ⁴
Credit cards	18.77	18.70	18.62	18.57	18.57	n.a.	18.48 ⁴
At auto finance companies ³							
New cars	14.62	11.98	10.72	11.40	11.71	12.52	9.99
Used cars	17.85	17.59	17.46	17.24	17.28	17.22	16.60

1. Includes primarily personal cash loans, home improvement loans, mobile home loans, and sales finance contracts for non-automotive consumer durable goods.

2. Average of "most common" rates charged, on loans of specified type and maturity, during the first week in the middle month of each quarter.

3. Average rate for all loans of each type made during the period, regardless of maturity.

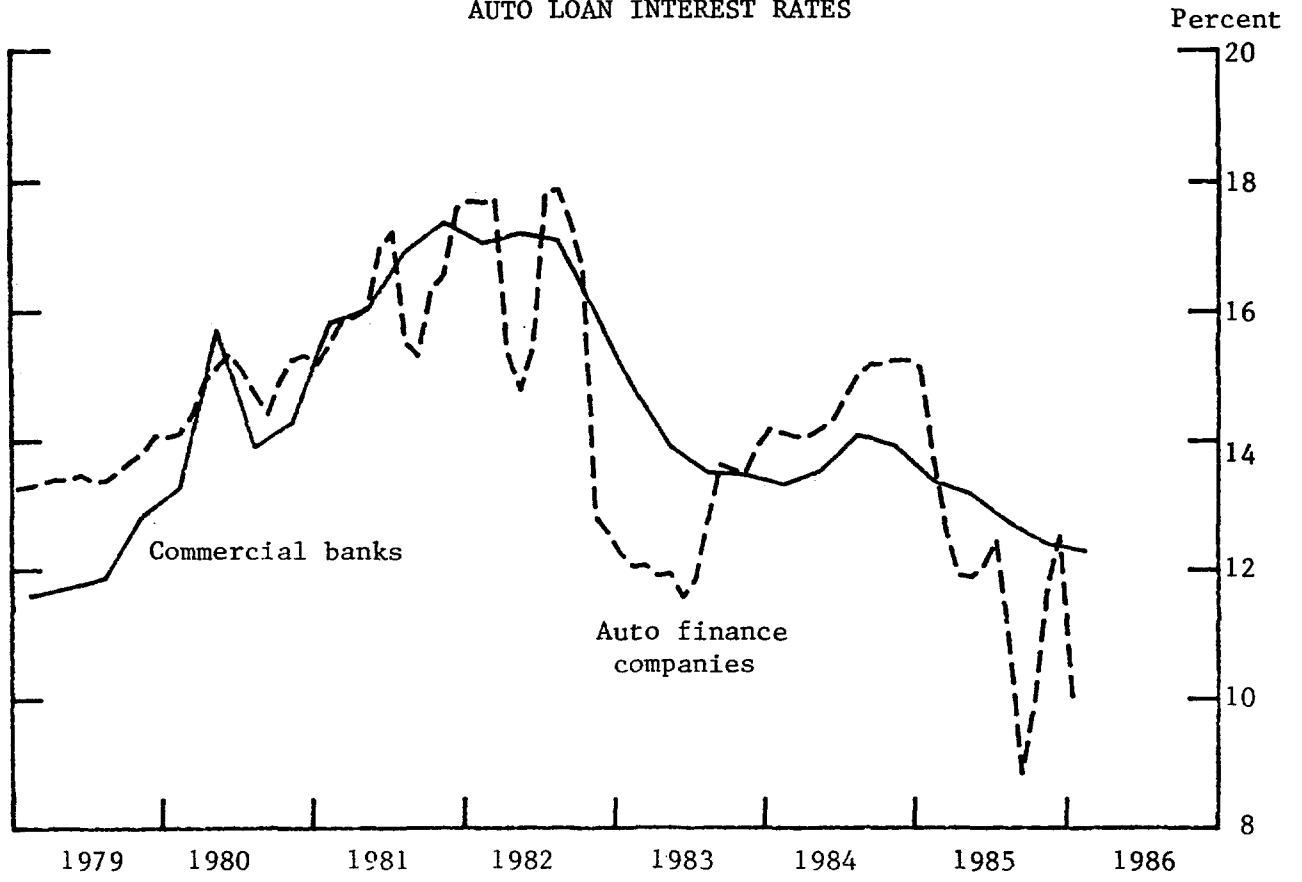
4. February data.

n.a.--not available.

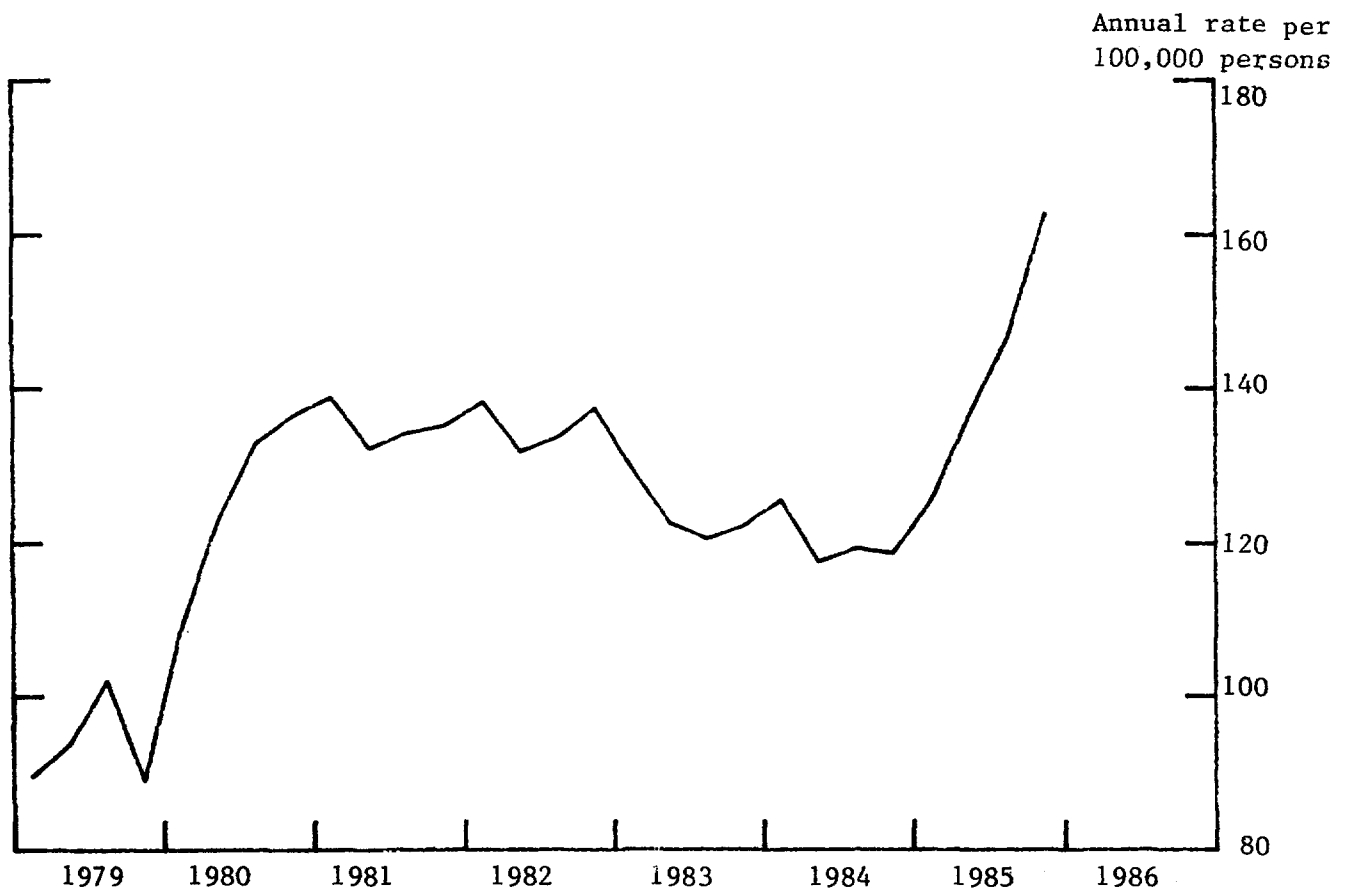
p--preliminary.

Various measures of debt payment problems have been suggesting increased strains on households in the past several months. Delinquency rates on closed-end loans at banks, though leveling off since about last spring, have retraced half the decline from their previous cyclical peak, and credit card delinquencies rose steadily throughout 1985. At the auto finance companies, delinquencies also trended upward all year, and in the home mortgage market major delinquency rate series were at or near historical highs. Moreover, debt-troubled households resorted to personal bankruptcy last year at an accelerating pace (see chart on page III-20).

AUTO LOAN INTEREST RATES



PERSONAL BANKRUPTCIES



INTERNATIONAL DEVELOPMENTS

Foreign Exchange Markets

In the period since the last FOMC meeting, the trade-weighted average foreign exchange value of the dollar initially registered further sharp declines, but later rebounded, for a net decline of 2 percent. The dollar's weighted-average value now stands 15 percent below its level preceding the G-5 announcement of last September and about 28 percent below its peak in February 1985.

The dollar declined sharply in the first half of the intermeeting period, as data on U.S. economic activity disappointed market expectations and as the continued steep decline in crude oil prices raised concern about the viability of U.S. banks with large exposures to the energy sector and to oil-producing developing countries. Meanwhile, statements by some G-5 officials gave market participants the impression that policy would not be adjusted to lend support to the dollar.

The dollar steadied in early March when the central banks of Germany, Japan, and the United States made coordinated cuts of 1/2 percentage point in their discount rates. The move perhaps alleviated market concern that the Federal Reserve might act unilaterally.

Around mid-March, however, the dollar again weakened, especially against the Japanese yen, which registered a new postwar high vis-a-vis the dollar.

. In addition, the Japanese Ministry of Finance announced some easing of restrictions on holdings of foreign securities at life

Chart 1 Strictly Confidential (FR)

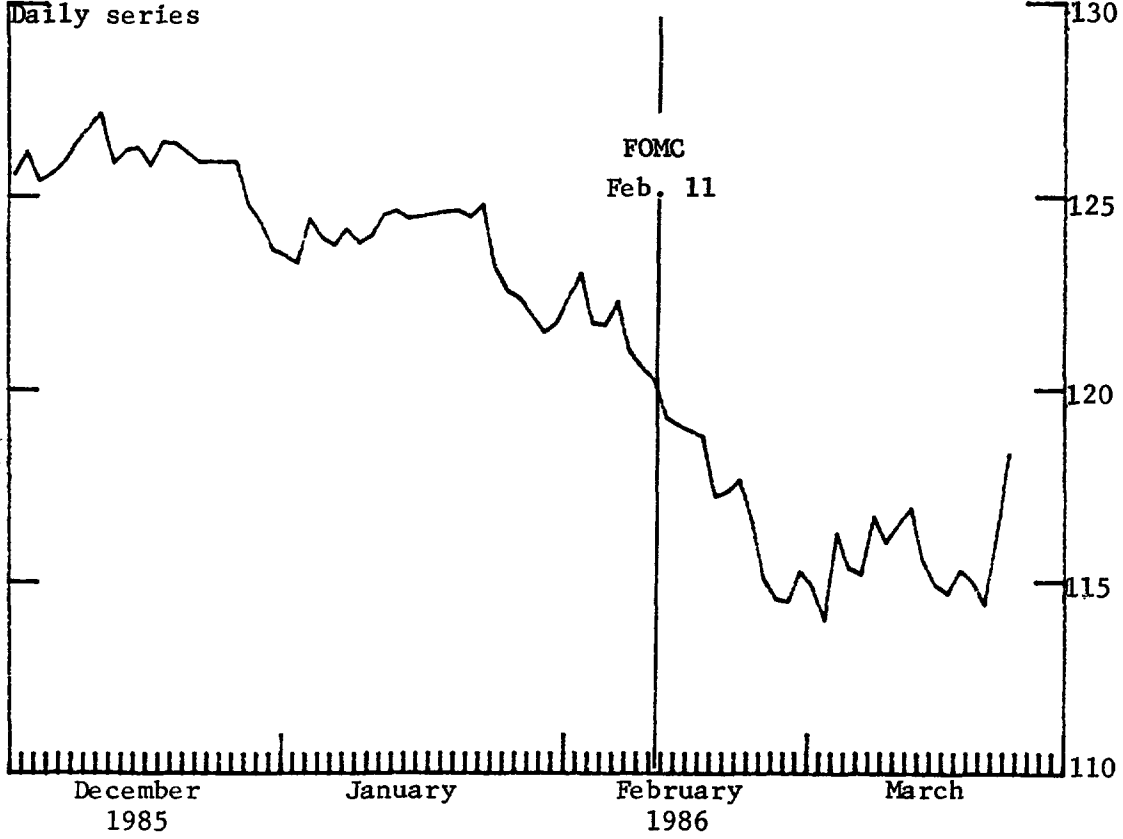
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March 1973=100

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR

Daily series



insurance companies. The dollar subsequently recovered a bit from its lows.

Late in the intermeeting period, the dollar rose sharply when Japanese officials said that they would take further action to stem additional appreciation of the yen. They also alleged that the Federal Reserve agreed the dollar's drop is complete. In this context, the dollar appeared to derive some support from U.S. economic data presenting a stronger picture than many market participants reportedly expected.

The discount-rate cuts in Germany, Japan, and the United States encouraged official rate reductions elsewhere. The central banks of the Netherlands and France responded immediately to the Bundesbank's action by reducing their official rates 1/2- and 1/4-percentage point, respectively. Over the next two weeks, the central banks of Sweden and Italy lowered their discount rates by 1 percentage point, and the Bank of England reduced its money market dealing rates by that amount. As pressures on the Canadian dollar diminished, the Bank of Canada let short-term interest rates in Canadian markets back down as much as 2 percentage points. Market interest rates on both short- and long-term instruments denominated in foreign currencies generally have declined significantly since the last FOMC meeting. However, in most instances the declines have been smaller than those on comparable dollar-denominated assets.

. The
pound derived strength from a favorable market assessment of the U.K.
government's budget for the coming fiscal year.

U.S. bank lending to foreigners in the fourth quarter. In nominal terms, U.S.-chartered banks' claims on foreigners were virtually unchanged in the fourth quarter. After adjustment for the effect of a 7 percent decline in the value of the dollar on the value of nondollar claims, it appears that claims fell about \$8 billion. For the year 1985 as a whole, adjusted claims declined about \$27 billion, or 6 1/2 percent, of which about \$21 billion represented the change in dollar value resulting from the dollar's decline. The effect of the exchange rate adjustment was greatest on claims with the largest nondollar component, i.e., claims on the G-10, smaller developed, and East European countries.

In the fourth quarter, a drop of \$4-1/2 billion in claims on the non-OPEC developing countries (unadjusted for exchange rate changes) accounted for almost three-fourths of the entire 1985 decline in claims on that group of borrowers. There were declines in the fourth quarter of \$0.2 to \$1 billion in claims on each of the principal Far Eastern and Southeast Asia borrowers, as well as Argentina and Brazil. A partial explanation is that reported claims were reduced by a sizeable sale of loans by a U.S. bank to its foreign parent bank. The fourth-quarter declines in claims on the non-OPEC developing countries and several other groups were approximately offset by increases in claims on the G-10 countries and offshore banking centers.

For 1985 as a whole, the unadjusted changes in claims on every group were small. For the non-OPEC developing countries, on which claims fell \$6 billion as a group, the principal changes were decreases

CLAIMS ON FOREIGNERS OF U.S.-CHARTERED BANKS
(Billions of dollars)

	Changes (no sign = increase)					Outstanding 12/31/85
	1984	1985				
	Year	Year	1st H	Q-3	Q-4	
<u>Total, all countries</u>	<u>-28.1</u>	<u>-5.7</u>	<u>-6.7</u>	<u>1.4</u>	<u>-0.4</u>	<u>403.5</u>
Non-OPEC developing countries	1.3	-6.1	-1.9	0.2	-4.4	106.8
of which:						
(Latin America)	2.1	-2.4	-0.9	-0.5	-1.0	74.6
(Asia and Africa)	-0.8	-3.7	-1.0	0.7	-3.4	32.2
OPEC countries	-3.1	-4.0	-2.0	0.3	-2.3	21.8
Eastern Europe	-0.9	-0.3	-0.1	0.3	-0.5	4.1
Smaller developed countries	-2.2	-3.4	-1.4	-0.2	-1.8	30.5
G-10 countries	-20.0	7.7	-1.1	6.2	2.6	155.7
Offshore banking centers	-3.5	0.4	-0.2	-5.4	6.0	67.4
Miscellaneous	0.3	-0.2	-	0.3	-0.5	17.1

of \$0.7 billion each on Brazil and Mexico, \$0.4 billion on Peru, \$1.2 billion on Korea, \$0.8 billion on Taiwan, \$0.5 billion on Malaysia and \$0.4 billion on Thailand.

U.S. International Financial Transactions

Substantial net capital inflows, both official and private, were recorded in January. (See the Summary Table of U.S. International Transactions.) Foreign purchases of U.S. corporate stocks (line 2B) were strong in January, continuing the trend observed during the booming stock markets of November and December. Foreign net purchases of U.S. corporate bonds (line 2A) declined somewhat in January from the record rate in the fourth quarter of 1985, reflecting a decline in new Eurobonds issued by U.S. corporations at the end of the year (but with payments dates in January).

Newly announced Eurobond issues by U.S. corporations were more than \$4 billion dollars a month in both January and February, still relatively strong compared with the average monthly rate of \$3 billion in 1985, although down somewhat in February as a percentage of total new issues by U.S. corporations (18 percent compared to 24 percent in January and 1985 as a whole). In February, Amoco, following the precedent set by the World Bank several months earlier, became the first corporate borrower to issue a 30-year bond in the Euromarket. The Amoco issue was linked to a domestic issue and offers investors the option to resell the bonds in the United States in registered form. Both the growing number of long-term issues in the Euromarket and the linking of a domestic and Eurodollar issue indicate a blurring of the lines between the U.S. and Eurodollar bond markets.

Private foreigners, particularly Japanese residents, sold U.S. Treasury securities net in January, probably in response to the narrowing of dollar-yen interest rate spreads since late October. On

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

	1984	1985	1985				1985		1986
	Year	Year	Q1	Q2	Q3	Q4	Nov.	Dec.	Jan.
Private Capital									
Banks									
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	21.3	31.0	15.2	-0.5	8.5	7.7	-3.9	1.5	12.1
Securities									
2. Private securities transactions, net	7.6	42.7	7.0	4.9	10.0	20.9	9.7	6.9	4.9
a) foreign net purchases (+) of U.S. corporate bonds	13.8	45.9	10.7	6.7	10.3	18.3	8.4	5.5	3.3
b) foreign net purchases (+) of U.S. corporate stocks	-0.8	4.8	-1.1	0.5	1.4	4.0	1.4	2.0	1.6
c) U.S. net purchases (-) of foreign securities	-5.4	-8.0	-2.6	-2.4	-1.7	-1.4	-0.1	-0.5	*
3. Foreign net purchases (+) of U.S. Treasury obligations ^{1/}	23.0	20.5	2.2	5.1	7.5	5.7	3.9	0.4	-0.7
Official Capital									
4. Changes in foreign official reserve assets in U.S. (+ = increase)	2.6	-1.9	-10.6	7.9	2.5	-1.7	1.6	-1.3	2.0
a) By area									
C-10 countries (incl. Switz.)	3.1	-0.4	-5.5	6.1	2.4	-3.3	1.6	-3.4	2.3
OPEC	-5.4	-6.7	-1.6	-2.0	-2.0	-1.0	-1.0	0.4	1.1
All other countries	4.9	5.2	-3.5	3.9	2.1	2.7	0.9	1.7	-1.3
b) By type									
U.S. Treasury securities	4.7	-0.6	-7.2	8.7	-0.1	-2.0	-0.3	1.6	0.4
Other ^{2/}	-2.1	-1.4	-3.5	-0.8	2.6	0.3	1.9	-3.0	1.7
5. Changes in U.S. official reserve assets (+ = decrease)	-3.1	-3.9	-0.2	-0.4	-0.1	-3.1	-0.3	*	0.1
Other transactions (Quarterly data)									
6. U.S. direct investment (-) abroad	-4.5	-19.1	0.7	-5.3	-6.9	-7.6	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S.	22.5	16.3	2.1	6.7	6.0	1.5	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) ^{3/ 4/}	7.1	-0.6	-4.4	5.1	-5.6	3.9	n.a.	n.a.	n.a.
9. U.S. current account balance ^{4/}	-107.4	-117.7	-23.4	-28.0	-33.1	-33.1	n.a.	n.a.	n.a.
10. Statistical discrepancy ^{4/}	30.5	32.7	11.4	4.5	11.2	5.8	n.a.	n.a.	n.a.
MEMO:									
U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)	-114.1	-124.3	-23.4	-28.5	-33.0	-39.5	n.a.	n.a.	n.a.

1. Includes U.S. Treasury notes publicly issued to private foreign residents.

2. Includes deposits in banks, commercial paper, acceptances, & borrowing under repurchase agreements.

3. Includes U.S. government assets other than official reserves, transactions by nonbanking concerns, and other banking and official transactions not shown elsewhere.

4. Includes seasonal adjustment for quarterly data.

* Less than \$50 million.

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

March 18 Japan announced an easing of its regulations on the foreign investments of life insurance companies, permitting some increase in their holdings of U.S. securities. Life insurance companies may now invest up to 25 percent of their assets in non-yen securities and deposits, issued by either Japanese residents or foreigners. (There may be additional informal constraints on the division between securities and deposits and on the division between obligations of Japanese and foreign issuers.) Previously life insurance companies were limited to investing 10 percent in securities issued by foreigners, whatever the currency denomination. Because the old regulations focused on the residence of the issuer and not currency denomination, Japanese firms at times could issue dollar bonds (so called Sushi bonds) at lower cost than non-Japanese borrowers and benefit by engaging in yen-dollar swaps with foreign residents.

Another change that might affect foreign demand for Eurobonds issued by U.S. corporations is the possible reimposition of the withholding tax on interest payments to foreigners, proposed in Senator Packwood's tax-overhaul plan. Although the 5 percent tax, as currently proposed, would apply only to securities issued after the tax package is passed, the proposal has increased market uncertainty about the tax status of outstanding bonds and might dampen current sales of Eurobonds by U.S. corporations.

Bank-reported inflows were also large in January. Banks reported about \$12 billion in net inflows, about \$10 billion of which consisted of inflows from their own offices in foreign countries. More than \$3 billion of this inflow reflected a decline in Eurodollar deposits of bank holding companies. As shown on the International Banking Data

table (line 3), these inflows were not reversed in February, and were concentrated at U.S.-chartered banks. The net inflows were the product of a decline in claims held by banks other than the 25 largest, and probably reflect a further pullback by regional banks from the Euro-interbank markets in response to slow growth of domestic core deposits relative to loan demand.

Official reserve assets held in the United States increased by more than \$2 billion in January. The increase in OPEC assets in the United States probably reflects higher Saudi Arabian export revenues due to expanded oil production. The increase in G-10 assets in part reflects a swap between the Bundesbank and German commercial banks, designed to increase liquidity in DM-based money markets.

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1981	1982	1983	1984	1985				1986	
	Dec.	Dec.	Dec.	Dec.	Mar.	June	Sept.	Dec.	Jan.	Feb.
1. Net Claims of U.S. Banking Offices (excluding IBFs) on Own Foreign Offices	7.8	32.9	39.3	25.4	26.0	27.6	22.4	18.9	15.3	18.1
2. Net Claims of U.S. Banking Offices on Own IBFs <u>1/</u>	11.8	16.2	5.2	7.8	6.1	8.1	9.1	10.1	7.8	5.4
3. Sum of lines 1 and 2 of which:	19.6	49.1	44.5	33.2	32.1	35.7	31.5	29.0	23.1	23.5
(a) U.S.-chartered banks	22.3	40.0	40.5	32.1	30.6	33.4	31.5	32.4	28.7	26.4
(b) Foreign-chartered banks	-2.6	9.1	4.0	1.1	1.6	2.2	*	-3.4	-5.6	-2.8
4. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	13.2	15.8	18.6	20.7	19.2	20.2	19.5	18.7	18.2	18.1
5. Eurodollar Holdings of U.S. Nonbank Residents <u>2/</u>	95.5	112.6	124.3	117.5	118.9	109.5	114.6	112.5	114.2	114.0

1. Corresponds to net claims of international banking facilities (IBFs) on all foreign residents, including all banks whether related or not, and all nonbanks.

2. Include terms and overnight Eurodollars held by money market mutual funds.

* / Less than 50 million (+).

Note: These data differ in coverage and timing from the overall banking data incorporated in the international transactions accounts. Line 1 is an estimate constructed as the residual of line 3 minus line 2. Line 2 is data for the last Wednesday of the month for the sample of monthly IBF reporters. Line 3 is an average of daily data reported to the Federal Reserve by U.S. banking offices. Line 4 is an average of daily data. Line 5 is the month-end value for data through September 1983. For dates after September 1983, the overnight portion is an average of daily data and the term portion is an average of Wednesday data.

U.S. Merchandise Trade

Merchandise trade data are available on a preliminary, unrevised and not seasonally adjusted basis for the month of January. These data, which are subject to substantial revision, showed a trade deficit in January of \$197 billion at an annual rate (CIF value) that was somewhat larger than in December and the fourth quarter (see the table below). Exports in January were little changed from low December levels and imports rose. Preliminary data for February will be available on Thursday, March 27. Revised January data, on a seasonally adjusted basis, will not be available until the middle of next week.

At the end of 1985, the merchandise trade deficit was at a record level -- \$158 billion at an annual rate in the fourth quarter (balance-of-payments basis). Exports were little changed from rates recorded in the previous two quarters. A small upturn in agricultural

U.S. MERCHANDISE TRADE^{*/}

	Year 1985	1985					1986
		Q4	Q1	Q2	Q3	Q4	Jan.
<u>Value (Bil. \$, SAAR)</u>							
Exports	214.0	225.0	220.8	214.2	209.2	212.0	n.a.
Agricultural	29.2	38.9	32.8	28.6	26.1	29.3	n.a.
Nonagricultural	184.8	186.1	187.9	185.5	183.0	182.6	n.a.
Imports	338.3	348.5	314.3	328.1	340.9	369.9	n.a.
Oil	50.4	57.8	41.8	52.2	50.1	57.4	n.a.
Nonoil	287.9	290.7	272.4	275.9	290.8	312.5	n.a.
Trade Balance (CIF value, NSA unrevised)	-124.3 (-148.5)	-123.5 (-108.1)	-93.5 (-125.5)	-113.9 (-151.6)	-131.8 (-153.4)	-157.9 (-163.5)	n.a. (-197.5)
<u>Volume (Bil. 82\$, SAAR)</u>							
Exports							
Agricultural	30.1	38.0	32.6	28.6	27.2	31.8	n.a.
Nonagricultural	179.3	182.8	181.8	179.4	178.5	177.6	n.a.
Imports							
Oil	59.8	65.9	48.8	60.9	60.9	68.5	n.a.
Nonoil	292.4	288.5	277.0	282.3	296.1	314.3	n.a.

^{*/} Revised seasonally adjusted basis as reported in the balance-of-payments accounts.

exports in the fourth quarter (renewed shipments to the Soviet Union) was offset by declines in other items. The lagged effect of the strong dollar on the price of U.S. goods in foreign markets continued to offset the effect of a moderate rate of expansion abroad.

The increase of imports in the fourth quarter was particularly large. While the rise in volume was widespread among the different trade categories, the largest increases were in oil, consumer goods, automotive products from Japan and Europe, and in capital goods. By area (measured in value terms), nearly half of the rise in nonoil imports in the fourth quarter was from Western Europe, with the rest of the increase about evenly split between Canada and Japan. While nonoil imports from Mexico increased slightly, imports from other developing countries, particularly in Asia, declined a bit.

After recording declines or being unchanged for more than a year, import prices of various manufactured goods turned up toward the end of 1985, at least partly in a lagged response to the depreciation of the dollar that began earlier in the year. However, prices of industrial supplies and foods (except coffee) declined steadily through the fourth quarter. Notwithstanding recent price rises, nonoil import prices, on average, were no higher at the end of 1985 than at the end of 1984.

Oil imports continued to be affected by uncertainties in world oil markets. The level of oil inventories was held relatively low during much of 1985. In the fourth quarter, stocks of fuel oil were replenished in anticipation of the winter heating season raising the volume of oil imports. The price of imported oil was about 50 cents per barrel higher in the fourth quarter than in the third quarter reflecting

steadily rising world spot oil prices from June through November. Since December, spot prices for crude oil and petroleum products dropped sharply, by more than 50 percent, primarily as a result of an increase in Saudi Arabian production and a run-down in Saudi Arabian stocks. Iraq also increased its sales. OPEC members meeting from March 16-24 could not agree on how to allocate a reduced rate of production among member countries.

OIL IMPORTS^{*/}

	Year 1985	1984	1985			
		Q4	Q1	Q2	Q3	Q4
Volume (mbd, SA)	5.24	5.62	4.34	5.30	5.34	5.99
Price (\$/BBL)	26.37	27.59	26.43	27.01	25.77	26.29
Value (Bil. \$, SAAR)	50.40	57.81	41.84	52.19	50.14	57.41

^{*/} Revised seasonally adjusted basis as reported in the balance-of-payments accounts.

U.S. Current Account in 1985-Q4

The U.S. current account was in deficit by \$146 billion at an annual rate in the fourth quarter of 1985. This was a larger deficit (by \$29 billion at an annual rate) than in the third quarter. See the table below.

Most of the increase in the deficit in the fourth quarter was in merchandise trade (exports were little changed from third quarter levels and imports rose). Net receipts from service transactions, particularly portfolio income, also declined. Portfolio income payments, net, were larger than in the third quarter (primarily because the stock of U.S. liabilities to foreigners grew faster than the stock of U.S. assets abroad). Changes in net income from direct investments and from other services were relatively small.

U.S. CURRENT ACCOUNT
(Billions of dollars, SAAR)

	Year	1985				\$ Change Q4-Q3
		Q1	Q2	Q3	Q4	
1. Trade Balance	-124.3	-93.5	-113.9	-131.8	-157.9	-26.1
2. Exports	214.0	220.8	214.1	209.1	211.9	2.8
3. Imports	338.3	314.3	328.1	340.9	369.9	29.0
4. Investment income, net	24.7	10.1	21.5	34.6	32.5	-2.1
5. Direct investment, net	26.3	9.5	23.3	35.6	36.7	1.1
6. Capital gains or losses ^{1/}	4.9	-11.5	2.3	16.1	12.8	-3.3
7. Other D.I. income	21.4	21.0	21.0	19.5	23.9	4.4
8. Portfolio income, net	-1.6	0.6	-1.8	-1.0	-4.2	-3.2
9. Military, net	-2.0	-0.8	-2.3	-1.7	-3.3	-1.6
10. Other services, net	-1.2	0.1	-2.0	-2.3	-0.8	1.5
11. Unilateral transfers	-14.8	-12.7	-13.7	-16.0	-16.8	-0.8
12. <u>Current Account Balance</u>	<u>-117.7</u>	<u>-96.7</u>	<u>-110.5</u>	<u>-117.2</u>	<u>-146.2</u>	<u>-29.0</u>
13. Excluding capital gains or losses	-122.6	-85.2	-112.8	-133.3	-159.0	-25.7
Memo:						
Statistical discrepancy, not AR	32.7	10.9	3.9	7.5	10.4	2.9

^{1/} Gains or losses on foreign-currency denominated assets owing to their revaluation at current exchange rates, and other valuation adjustments. Plus = gains; minus = losses.

Economic Developments in Foreign Industrial Countries

Economic growth continues at a moderate pace in the major industrial economies. Economic activity appears to be slowing in Japan but to remain relatively strong in Germany, despite contradictory indications in fourth-quarter GNP data for both countries. In Canada, the economic expansion continues at a brisk pace. Industrial production increased recently in Germany, Canada and the United Kingdom, but declined in Japan, France and Italy. Recent evidence on the prospects for faster growth in France and Italy are mixed. Inflation abroad remains quite low, with declines in oil prices and the dollar reinforcing an underlying trend toward price stability. Consumer price inflation over the most recent 12-month period is less than 1 percent in Germany and about 2 percent in Japan, and has declined recently in France and Italy.

Official lending rates were lowered in several foreign economies, including Germany, Japan, France, the United Kingdom and Italy. The 1986/87 budget recently announced in the United Kingdom is broadly neutral while the new Canadian budget is somewhat restrictive.

Most recent trade and current account data indicate continuing record surpluses in Germany and Japan, while the United Kingdom and France registered smaller external surpluses. In contrast, Canada and Italy report trade and current account deficits, although the Canadian external position has improved recently while the Italian position has deteriorated.

Individual Country Notes. In Japan, preliminary data indicate that GNP grew 7.2 percent (s.a.a.r.) in the fourth quarter after increasing

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

	Q4/Q4 1984	Q4/Q4 1985	1985				1985					Latest 3 months from year ago 2/
			Q1	Q2	Q3	Q4	Oct.	Nov.	Dec.	Jan.	Feb.	
<u>Canada</u>												
GNP	4.3	4.9	1.0	.8	1.7	1.3	*	*	*	*	*	4.9
IP	4.4	5.0	.2	.9	2.7	1.1	.8	.4	.7	n.a.	n.a.	5.0
<u>France</u>												
GNP	1.7	2.0	-.2	1.0	.6	.6	*	*	*	*	*	2.0
IP	1.3	2.0	-.5	.5	2.0	.0	.8	2.2	-3.6	-.8	n.a.	3.1
<u>Germany</u>												
GNP	2.7	2.8	-1.2	1.4	2.2	.4	*	*	*	*	*	2.8
IP	3.5	3.4	-1.0	1.6	1.8	.9	3.1	-.5	-3.4	2.4	n.a.	3.1
<u>Italy</u>												
GNP	1.7	n.a.	.9	.8	-.2	n.a.	*	*	*	*	*	1.3
IP	2.1	.6	1.7	.1	-.5	-.6	-3.3	3.7	-4.1	n.a.	n.a.	.6
<u>Japan</u>												
GNP	5.7	4.4	.4	1.4	.7	1.7	*	*	*	*	*	4.4
IP	10.6	1.2	-.7	2.7	-.1	-.7	1.0	-1.1	.7	-.7	n.a.	.9
<u>United Kingdom</u>												
GNP	2.6	2.8	1.0	1.4	-.2	.5	*	*	*	*	*	2.8
IP	-.5	5.4	2.8	1.8	.2	.4	-.4	1.1	-2.4	1.6	n.a.	4.5
<u>United States</u>												
GNP	4.7	2.1	.9	.3	.8	.2	*	*	*	*	*	2.1
IP	7.2	1.8	.5	.3	.5	.5	-.6	.8	.7	.2	-.6	2.1

1. Asterisks indicate that data are not available on a monthly basis.

2. For quarterly data, latest quarter from year ago.

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

	Q4/Q4 1984	Q4/Q4 1985	1984		1985				1985				Latest 3 months from year ago
			Q3	Q4	Q1	Q2	Q3	Q4	Nov.	Dec.	Jan.	Feb.	
Canada													
CPI	3.7	4.2	.9	.7	1.2	1.1	.9	.9	.4	.5	.5	.4	4.3
WPI	3.6	2.8	.5	.3	1.0	.7	.2	.8	.4	.4	.6	n.a.	2.9
France													
CPI	6.8	4.8	1.7	1.4	1.4	1.8	.9	.6	.2	.1	.1	-.2	4.1
WPI	10.5	-1.2	2.2	1.6	1.6	.9	-1.4	-2.2	-1.2	-.2	n.a.	n.a.	-1.2
Germany													
CPI	2.1	1.8	.0	.7	1.1	.6	-.2	-.3	.2	.1	-.2	-.2	1.3
WPI	1.3	-1.1	-1.0	.3	1.7	.3	-2.1	-.9	.2	-.5	-.1	-2.2	-2.8
Italy													
CPI	8.8	8.5	1.4	2.2	2.6	2.2	1.1	2.3	.7	.7	.5	.7	8.1
WPI	8.9	5.9	1.2	1.9	2.7	2.2	-.1	.9	.1	.4	.3	n.a.	5.5
Japan													
CPI	2.4	2.3	-.2	1.2	.6	.5	-.1	1.0	-.9	-.1	.5	-.3	1.9
WPI	.5	-3.7	.8	-.3	.4	.7	-1.0	-2.4	-.8	-.3	-.2	-1.5	-5.0
United Kingdom													
CPI	4.8	5.5	.9	1.2	1.3	3.4	.3	.5	.3	.1	.2	.4	5.4
WPI	6.1	5.2	.6	1.3	1.6	2.0	.5	.9	.4	.4	.6	.4	5.1
United States													
CPI (SA)	3.9	3.6	.9	.8	.9	1.0	.6	1.1	.6	.4	-.3	-.4	3.6
WPI (SA)	1.7	1.6	.0	.1	.1	.6	-.2	1.1	.8	.5	-.7	-1.6	1.2

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

	1984	1985	1984		1985				1985			
			Q3	Q4	Q1	Q2	Q3	Q4	Nov.	Dec.	Jan.	Feb.
<u>Canada</u>												
Trade	15.7	12.2	4.0	4.2	4.0	3.4	2.3	2.5	.4	.9	.8	n.a.
Current account	1.9	-1.4	.7	.9	.5	.2	-1.1	-0.9	*	*	*	*
<u>France</u>												
Trade	-2.4	-2.6	.1	-.5	-1.1	-.4	-.7	-.4	-.1	-.4	.5	n.a.
Current account	-.8	.5	.4	-.2	-.6	.5	.0	.6	*	*	*	*
<u>Germany</u>												
Trade (NSA)	18.7	25.4	4.1	7.2	4.2	6.0	6.1	9.1	2.7	3.1	2.9	n.a.
Current account (NSA)	5.9	13.9	-.9	6.0	1.7	3.1	2.1	7.0	1.9	2.7	1.4	n.a.
<u>Italy</u>												
Trade	-10.9	-11.4	-1.3	-4.2	-3.5	-4.3	-.3	-3.2	-1.7	-1.1	-1.5	n.a.
Current account (NSA)	-2.9	n.a.	.7	-2.2	-2.9	-2.4	n.a.	n.a.	*	*	*	*
<u>Japan</u>												
Trade	44.1	56.1	9.9	13.7	11.5	13.1	13.7	17.8	6.4	6.2	6.0	n.a.
Current account 2/	35.0	49.3	7.2	11.7	9.4	12.1	11.7	16.1	5.6	5.9	5.5	n.a.
<u>United Kingdom</u>												
Trade	-5.3	-2.5	-2.1	-1.6	-1.4	-.3	-.5	-.3	-.3	-.0	.2	-.5
Current account	.9	4.8	-.6	.5	-.6	1.8	1.9	1.6	.3	.8	1.6	.5
<u>United States</u>												
Trade	-114.1	-124.3	-29.0	-30.9	-23.3	-28.4	-33.0	-39.5	*	*	*	*
Current account	-107.4	-117.7	-29.0	-31.8	-24.2	-27.6	-29.3	-36.6	*	*	*	*

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1. The current account includes goods, services, and private and official transfers.
 2. Annual data are subject to revisions and therefore may not be consistent with quarterly and monthly data.
 * -- monthly data are not published.

at an upward-revised 3 percent rate in the third quarter. For 1985 as a whole, real GNP grew 4.6 percent, down from the 5.1 percent increase in 1984. Domestic demand accounted for 3.6 of the 4.6 percentage point increase in real GNP in 1985. Recent data on industrial production suggest a continuation of the substantial slowing of the pace of output growth which emerged in 1985. Industrial production fell by 0.7 percent (s.a.) in January after rising by that amount in December, so that the average level of the index for the three months ending in January is just 0.9 percent above its year-earlier level. New machinery orders slipped slightly in the fourth quarter of 1985, reflecting a substantial decrease in orders placed by overseas buyers. Retail sales increased 5 percent (s.a.) in January after declining slightly in the two preceding months, and new housing starts rose for the fifth consecutive month in January. For 1985 as a whole, new housing starts were 4.1 percent above their level for the preceding year, reflecting a strong recovery in the fourth quarter due to lower mortgage lending rates and larger government housing subsidies.

The Tokyo consumer price index rose 2.1 percent during the 12 months ending in February, up 0.5 percentage point from the equivalent rate recorded in January. Japan's external surpluses continued at record rates. In January, the current account surplus was \$66 billion (s.a.a.r.), little changed from its average level in the fourth quarter of 1985.

As part of its ongoing efforts to stimulate domestic demand, and in light of the continued strengthening of the yen, the Bank of Japan lowered its discount rate from 4.5 percent to 4 percent, effective March

10. This is the second discount rate reduction in two months and is the lowest rate since March 1978.

Real GNP in Germany grew only 1.4 percent (s.a.a.r.) in the fourth quarter due to extra holidays and days off provided under reduced work time agreements for metal and automobile workers. Industrial production rose sharply in January to 4-1/4 percent above its year-earlier level. Reflecting the general shift in demand last year, new foreign manufacturing orders in January were below last year's level, while domestic manufacturing orders rose by 3 percent. Growth in employment continued to rise throughout last year, but offsetting increases in the labor force have so far kept the rate of unemployment near last year's average rate of slightly more than 9 percent.

Consumer prices have barely risen in the ten months through February, when they were 0.7 percent above the February 1985 level. Wholesale and import prices are now substantially below their year-earlier levels.

The trade and current account surpluses for January, totaling \$34.8 billion and \$16.8 billion (n.s.a., annual rates), respectively, were by far the largest January figures ever, reflecting mainly the fall in import prices in general and in the oil price in particular.

The growth of Central Bank Money (CBM) slowed in February, but the average growth rate for January and February of over 7 percent was still above the 5.5 percent upper limit of the Bundesbank's target range for the current year. Nevertheless, the Bundesbank lowered its discount rate from 4 to 3.5 percent effective March 7.

In France, recent evidence on the strength of real economic growth has been mixed. Industrial production fell by 3.6 percent (s.a.) in December and declined a further 0.8 percent in January, more than reversing the 3 percent increase recorded over October and November. On a year-over-year basis, however, industrial production in January was still up 3.1 percent. Real GDP grew by 2.4 percent (s.a.a.r.) in the fourth quarter, and was 2 percent above its year-earlier level. The sectors showing the greatest strength in the fourth quarter were household consumption and exports. The unemployment rate remained unchanged at 10.5 percent (s.a.) in February, increasing from 10.3 percent in January.

The inflation rate has continued to drop sharply under the influence of falling oil prices and a lower franc/dollar exchange rate. The consumer price index declined by 0.2 percent (n.s.a.) in February, the first monthly decline in two decades. The year-over-year inflation rate fell to 3.4 percent. The government is now forecasting an inflation rate of under 2 percent by year-end.

The trade balance moved into surplus by \$5.4 billion (s.a.a.r.) in January. The current account was in surplus by \$7.8 billion (s.a.a.r.) in the fourth quarter. For 1985 as a whole, the current account surplus totaled \$500 million, the first yearly current account surplus since 1979.

As a result of the legislative elections held on March 16, President Mitterrand's Socialist party lost its majority in the National Assembly. Jacques Chirac, leader of the conservative coalition which won a narrow majority of Assembly seats, has been appointed Prime

Minister by President Mitterrand and has formed a new government. Chirac has indicated that he will move quickly to implement the conservative's economic program, which includes removal of price and exchange controls and denationalization. Macroeconomic policies are likely to remain mildly contractionary.

In the United Kingdom, real GDP (average measure) grew 2.2 percent (s.a.a.r.) in the fourth quarter of 1985 to a level 2.8 percent above the year-earlier level. Industrial production, after declining sharply in December, rose by 1.6 percent (s.a.) in January to about its average level during the fourth quarter. Inflation continues to be moderate. Retail prices rose only 0.4 percent (n.s.a.) in February, lowering the 12-month inflation rate to 5.1 percent.

The February trade balance moved back into deficit following a slight surplus in January. The current account surplus in February fell to \$0.5 billion (s.a.) from \$1.6 billion in January.

On March 18, Chancellor Lawson presented the government's budget for fiscal year 1986/87 (beginning April 1) to Parliament. The budget calls for only small changes in tax measures and virtually no adjustment to the already-announced plans to hold expenditures essentially unchanged from the current fiscal year's levels. The basic rate in the income tax code is to be lowered one percentage point to 29 percent. Personal exemption figures are to be increased so as to remain unchanged in real terms. Similarly, excise duties on tobacco, road fuels, and some other goods will be raised slightly so that, on balance, excise tax revenue will be constant in real terms. The system of gift and death taxes will be radically changed, with gift taxes largely abolished but a

revised system of inheritance taxes left in place. There are to be no changes in corporate tax rates or depreciation allowances other than those announced in previous budgets.

The tax changes and the previously-announced expenditure plans imply a public sector borrowing requirement (PSBR) of £7 billion (1-3/4 percent of GDP) for 1986/87. The PSBR outcome for the current fiscal year is now estimated at about £7 billion (2 percent of a lower level of GDP).

The budget contained new target ranges for money growth. The range for growth in sterling M3, which refers to 12-month percentage changes, has been raised to 11 to 15 percent from this year's range of 5 to 9 percent. The M0 target range, similarly defined, will become 2 to 6 percent, slightly below this year's target of 3 to 7 percent. Through February, growth was about 14 percent for sterling M3 and 3-1/2 percent for M0. Following the budget announcement, the Bank of England lowered its money market dealing rates by 1 percentage point. Major U.K. clearing banks announced similar reductions in their base lending rates to 11.5 percent.

Economic expansion in Canada continued at a brisk pace for 1985 as a whole. Real GNP increased 5.3 percent (s.a.a.r.) in the fourth quarter, bringing the total rise to 4.9 percent in 1985. Despite relatively strong growth in investment outlays by businesses in 1985, investment expenditures for the year as a whole were still 10.5 percent below the peak rate reached in 1981. Industrial production increased 0.7 percent (s.a.) in December, following similar increases over the previous three months. Meanwhile, the unemployment rate remained at 9.8 percent in February.

Inflation has continued to be moderate in 1986. Consumer prices rose 4.1 percent in the 12 months ending in February, about the same percentage change as during 1985. In addition, Canada's industrial product price index in January was only 2.9 percent above its year-earlier level. Meanwhile, Canada's trade surplus in 1985 fell to \$12.2 billion after a record \$15.7 billion in 1984. In January, the trade surplus fell further to \$9.9 billion (s.a.a.r.). The current account deficit was about \$1 billion (s.a.) in each of the third and fourth quarters of 1985, bringing the current account deficit to \$1.4 billion for the year as a whole.

The federal budget for FY 1986/87 was issued in late February against a background of severe selling pressure on the Canadian dollar and rising interest rates. The Mulroney government has been persistently criticized for its inertia in dealing with the federal deficit. The new budget will bring the federal deficit to C\$29.5 billion in 1986/87 or 6 percent of GNP, down from 7.5 percent estimated for FY 1985/86. Initiatives in the new budget are projected to reduce the deficit about C\$2.3 billion, mostly through tax increases, while policies announced earlier will reduce the deficit an additional C\$2.5 billion. New spending reductions result from a selective freeze on government salaries, lower total subsidies paid owing to sales of government corporations, management initiatives, and restraint in foreign aid and defense spending. The major revenue-raising initiatives are a 3 percent surtax on personal federal tax liabilities, an increase of 1 percent in the federal sales tax, and increases in alcohol and

tobacco taxes of 4 and 6 percentage points, respectively. Bond and exchange market reactions to the budget have been negative.

Industrial production in Italy declined 4.1 percent (s.a.) in December 1985. For 1985 as a whole, industrial production was 1.3 percent higher than in 1984. Nevertheless, the official government surveys conducted in December, January and February show a general increase in consumers' confidence to historically high levels.

The consumer price index (n.s.a.) rose 0.5 percent in January and 0.7 percent in February, bringing the 12-month inflation rate in February to 7.6 percent. This rate of inflation in February was the lowest in more than 13 years, as the energy price component of the index dropped sharply. The trade deficit in January 1986 was a surprisingly large \$18 billion (s.a.a.r.), a sizable increase in the deficit relative to the fourth quarter of 1985.

The 1986 budget was passed by Parliament on February 26. It will result in an estimated Treasury borrowing requirement of 115 trillion lire, equal to 15.8 percent of GDP, a decrease from this year's estimated outcome of 16.3 percent. In a related action in late February, Prime Minister Craxi approved higher taxes on gasoline and diesel products. Instead of reducing administered oil price ceilings, the Italian cabinet decided to increase taxes by the equivalent amount of the oil price drop. The Italian authorities lowered the discount rate from 14 to 15 percent on March 21.

Economic Situation in Major Developing Countries. Since the last Greenbook, the most important developments for developing countries have been the further slide in oil prices and interest rates. The other significant event has been the announcement of a major anti-inflation program in Brazil on February 28. The package includes:

1. A wage and price freeze after an initial adjustment of wages. Wages will increase by an unspecified amount if the price level rises by 20 percent relative to its level at the time of the freeze.

2. Pegging the cruzado (a new currency--one cruzado equals 1,000 cruzeiros) at 13.8 cruzados to the U.S dollar. (Immediately before the program, the official exchange rate of the cruzeiro was about 13,800 to the U.S. dollar with a daily crawling devaluation linked to Brazilian inflation.)

3. Abolition of indexed treasury securities and creation of non-indexed securities.

4. Conversion of cruzeiro denominated debts to cruzados in a way that the real value of debt is reduced.

No explicit announcement was made regarding monetary and fiscal policies, although the government claims that its fiscal position in January and February had become substantially stronger. The fiscal deficit was about 3 percent of GDP in 1985. The new program declaration is also vague about whether the new fixed exchange rate would continue to be periodically adjusted to offset the effects of inflation.

It is difficult to assess the likely effects of the new program without knowing what the government plans to do with regard to underlying monetary and fiscal policies. Expansionary fiscal policy and an

accommodating monetary policy have been problems for Brazil in the past. However, the government claims to have the fiscal deficit under control, and, if the initial wage and price freeze and deindexation are supported by restrained monetary and fiscal policy, the program does provide Brazil an opportunity to reduce inflation dramatically. Inflation averaged about 15 percent per month for the three months preceding the new package. It remains to be seen how Brazil plans to deal with the relative price distortions that existed at the time of the freeze and the distortions that will develop over the next few months.

Brazil and its creditor banks agreed on March 1 to reschedule about \$6 billion of debt that fell due in 1985. The debt is to be rescheduled over seven years with five years grace. The rescheduling fee has been waived, there is no prime rate option for the banks, and the spread over LIBOR is 1-1/8 percent compared with 2 percent in the rescheduling arranged in September 1983. Brazil and the banks also agreed that \$9.5 billion of 1986 maturities would be rolled over into 1987, likewise at a spread over LIBOR of 1-1/8 percent, and that about \$15.5 billion of trade credit and interbank placement lines would be extended.

Brazil and its Paris Club creditors are still at odds on what to do about mounting arrears of principal and interest on official credits. Brazil's arrears to official creditors are now close to \$2 billion. Brazil wants a rescheduling, but official creditors have been insisting that Brazil must first negotiate an IMF program, which is a step Brazil is unlikely to take.

Mexico's export earnings and public sector revenues are being sharply lowered by the decline in oil prices and a reduction in the

volume of oil exported. At current prices and a likely export volume of 1.3 million barrels per day, oil export earnings would be about \$6.7 billion less than in 1985 and public sector revenues would fall short of the amount assumed in the budget by at least 3 percent of GDP.

Prior to the recent decline in oil prices, Mexico had been seeking net new external public sector financing of about \$4 billion (of which \$2.5 billion was to have been provided by commercial banks). On March 3, the Finance Ministry revised import projections downward by \$1.5 billion, projections of non-oil exports upward by \$500 million (partly because of higher coffee prices), estimates of external interest payments downward by \$800 million (to reflect declining world interest rates and the delayed effect of the reduced spread under the multi-year debt restructuring agreement), and the provision for an increase in net foreign exchange reserves downward by about \$1.2 billion. Finance Secretary Silva-Herzog subsequently said that only about \$4 billion would be borrowed, as originally planned (\$2.5 billion from commercial banks), and that stepped up non-oil exports and a Paris Club rescheduling would close the remaining \$2 billion gap.

In February, the CPI rose by 4.4 percent and was about 66 percent higher than a year earlier. Real GDP growth has been slowing and is likely to be negative in 1986. Since early February, the free market exchange rate has remained relatively stable, while the rate of crawl of the controlled exchange rate has continued to accelerate. On March 26, the spread between the two rates was about 3.0 percent, down from more than 50 percent in mid-November 1985. Negotiations with the IMF on a program are continuing. To reduce the public sector deficit, the sale

of state enterprises is being stepped up. The two publicly owned Mexican airlines are among 200 state enterprises to be sold in coming weeks. The list includes twelve of the 500 largest enterprises in Mexico.

New understandings between Argentina and the IMF regarding quantitative performance tests for the end of March and an extension of the IMF program through May were approved by the IMF Executive Board on March 10. This triggered the release of a drawing on the Fund that was postponed in November 1985 when deviations from the program occurred beginning in September. Reinstatement of the IMF agreement is expected to pave the way for the resumption of disbursements under the commercial bank loan, which were held up by the delays in obtaining the IMF drawings. Arrears on current transactions were still \$1.6 billion at the end of 1985, and are to be fully eliminated by the end of June 1986. Negotiations for new financing and a rescheduling of debts to foreign banks are expected to begin soon. The public sector cash deficit (plus central bank losses) amounted to 4.7 percent of GDP in 1985-Q4, but is expected to be about 3 percent in 1986, if present budgetary plans are fulfilled. The CPI rose by only 1.7 percent in February, the lowest monthly increase since 1974. Since last June, the CPI has increased at an annual rate of about 41 percent. The authorities are under strong pressure from organized labor to relax the wage freeze. A survey by a private research group shows that, while real wages fell sharply in the first half of 1985, they have remained fairly constant since the austral stabilization plan was launched last June. The spread between the official and free market exchange rates, which held steady at around 9

percent throughout February and early March, widened to nearly 15 percent on March 25, in the light of partial reports that March inflation is likely to be in the 3-1/2 - 4 percent range and on speculation that the official exchange rate will soon have to be devalued.

Venezuela signed its \$21.2 billion rescheduling agreement with commercial banks on February 26. Venezuela will make a \$750 million downpayment in July, but will receive additional time to repay \$0.9 billion of principal due in 1985 and 1986. In an annual State of the Nation address on February 27, President Lusinchi confirmed that Venezuela will try to invoke the contingency clause in the rescheduling agreement under which the terms can be renegotiated if economic conditions (in this case, the drop in oil prices) change sharply; a reduction in interest rate spreads is expected to be sought. The contingency clause does not oblige banks to change the terms, but merely to consider changes. Despite the sharp drop in export and tax revenues because of falling oil prices, the Venezuelan government intends to go ahead with its planned three-year investment program to spur growth. The plan calls for Bs. 12 billion (about \$0.6 billion at the free market rate) to be spent in 1986. On February 26 the government approved the issuance of a first tranche of Bs. 7.5 billion of bonds to finance its investment program.

Peru continues to send mixed signals regarding its intentions for servicing its external debt. On February 10, the IMF Executive Board gave Peru until April 16 to eliminate its arrears to the Fund, and if it fails to do so, the Board may declare Peru ineligible to use IMF resources. (Peru's arrears to the IMF now exceed SDR 100 million.)

Peruvian officials initially responded angrily to this prospect. More recently there have been some indications that Peru may try to reach some accommodation with the IMF. Late in February, Peru canceled the visit of a routine IMF consultation team that had been scheduled for early March. More recently Peru has indicated that it may be willing to have the consultation in Washington instead of in Peru. A Peruvian delegation recently met with Peru's commercial bank advisory committee. The Peruvians agreed to make an interest payment on Peru's medium and long-term debt, of unspecified amount, sometime in April. Peru's interest arrears to banks currently exceed \$450 million, and no interest or principal payments have been made on Peru's medium and long-term public sector debt since July 1985. The Peruvians also said that they would present a rescheduling proposal to the committee by early June.

Due to sharp increases in coffee prices, Colombia may draw only half of its 1985-86 \$1 billion commercial bank credit package and may be able to amortize some of its outstanding debt ahead of schedule. The government has reached agreement with the National Coffee Federation on the distribution of income from the coffee bonanza.

In the Philippines, President Marcos left office on February 25 and the administration of Corazon Aquino assumed power, with Jaime Ongpin (former president of a large mining company) being appointed Finance Minister. Governor Fernandez was reappointed as head of the central bank. Minister Ongpin has indicated that the new administration will give top priority to increasing food output rather than export promotion. Various state corporations will be returned to the private sector and the new administration hopes to attract equity investment. An IMF team

visited Manila the week of March 10 to assess the economic situation under the current stabilization program which runs to June 30, 1986. It seems likely that the present IMF program will be canceled and a new program will be negotiated over the next few months. Under this scenario, there would likely be delays in the disbursement of \$350 million from commercial banks, since bank disbursements are tied to performance under the IMF stand-by.