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Confidential (FR) Class III FOMC

July 2, 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	May	06-06-86	117.7	4.4	2.0	2.0
Unemployment rate (%)[1]	May	06-06-86	7.3	7.1	7.3	7.3
Insured unemployment rate (%)[1]	Mar	06-13-86	2.9	2.8	3.0	2.9
Nonfarm employment, payroll (mil.)	May	06-06-86	99.9	1.8	2.1	2.7
Manufacturing	May	06-06-86	19.2	-2.4	-1.8	-.6
Nonmanufacturing	May	06-06-86	80.7	2.8	3.0	3.5
Private nonfarm:						
Average weekly hours (hr.)[1]	May	06-06-86	34.7	34.8	34.9	35.0
Hourly earnings ($)[1]	May	06-06-86	8.74	8.71	8.71	8.53
Manufacturing:						
Average weekly hours (hr.)[1]	May	06-06-86	40.6	40.7	40.7	40.4
Unit labor cost (1967=100)	May	07-01-86	82.0	1.5	-2.9	-4.3
Industrial production (1977=100)	May	06-13-86	124.2	-7.7	-4.5	.1
Consumer goods	May	06-13-86	123.0	-5.8	-.6	2.5
Business equipment	May	06-13-86	138.8	-12.8	-6.5	-2.2
Defense & space equipment	May	06-13-86	179.3	2.0	5.9	4.7
Materials	May	06-13-86	113.9	-7.3	-5.2	-.3
Consumer prices all items (1967=100)	May	06-20-86	326.0	2.2	-2.1	1.6
All items, excluding food & energy	May	06-20-86	325.3	1.1	3.3	4.0
Food	May	06-20-86	316.4	5.3	3.3	2.6
Producer prices: (1967=100)						
Finished goods	May	06-13-86	298.6	7.5	-4.3	-1.9
Intermediate materials, nonfood	May	06-13-86	312.1	-3.1	-9.9	-4.4
Crude foodstuffs & feedstuffs	May	06-13-86	224.9	48.9	-.4	-2.9
Personal income ($ bil.)[2]	May	06-19-86	3,444.8	-1.3	5.2	5.3
				(Not at annual rates)		
Mfgrs. new orders dur. goods ($ bil.)	May	07-02-86	103.6	-.1	-3.6	.6
Capital goods industries	May	07-02-86	35.2	7.6	-1.9	2.3
Nondefense	May	07-02-86	26.3	.4	-8.2	2.7
Defense	May	07-02-86	8.9	36.6	23.3	1.2
Inventories to sales ratio:[1]						
Manufacturing and trade, total	Apr.	07-02-86	1.38	1.40	1.35	1.36
Manufacturing	May	07-02-86	1.44	1.42	1.42	1.46
Trade	Apr.	06-13-86	1.34	1.35	1.31	1.27
Ratio: Mfgrs.' durable goods inventories to unfilled orders[1]	May	07-02-86	.526	.527	.525	.555
Retail sales, total ($ bil.)	May	06-12-86	117.1	-.1	-.1	2.7
GAF[3]	May	06-12-86	26.1	-.2	1.9	5.8
Auto sales, total (mil. units.)[2]	May	06-04-86	11.3	1.7	4.1	-.5
Domestic models	May	06-04-86	8.2	2.7	2.6	-3.7
Foreign models	May	06-04-86	3.1	-.8	8.2	9.1
Plant and equipment expen.[4]						
Total nonfarm business	1986	06-12-86	387.25	—	—	2.2
Manufacturing	1986	06-12-86	149.17	—	—	-2.6
Nonmanufacturing	1986	06-12-86	238.07	—	—	2.1
Capital appropriation, Mfg.	1986-Q1	06-13-86	24,504	-9.9	-11.1	-18.2
Housing starts, private (thous.)[2]	May	06-17-86	1,888	-7.4	-5.6	12.1
Leading indicators (1967=100)	May	07-01-86	178.8	.2	2.1	7.0

1. Actual data used in lieu of percent changes for earlier periods.
2. At annual rates.
3. Excludes mail order houses.
4. Planned-Commerce for April and May 1986 survey.

Economic activity apparently expanded sluggishly in the second quarter, with marked unevenness across sectors. Consumer spending has been exceptionally strong, encouraged by rapid growth in real disposable income, and housing construction has been brisk. However, business expenditures on equipment and structures have been lagging, and--production in the industrial sector has declined in recent months. At the same time, wage and price increases have been moderate.

Industrial Production

Industrial production fell 0.6 percent in May and has declined 1-3/4 percent since December, erasing the gains that occurred at the end of 1985. One-half of the drop this year has been related to the contraction in oil and gas well drilling and in production of energy materials. Reductions in output elsewhere in the economy this year have been smaller but widespread. Output of business equipment has declined almost 2 percent, since December with about a fourth of this loss attributable to motor vehicles. The remainder of the falloff was largely the result of decreases in the output of commercial equipment, especially computers. Construction and mining, and farm and power equipment also are down since the end of 1985. However, increased production of aircraft continues to provide some support in the equipment area.

Indicators of industrial activity in June are mixed. Auto assemblies are expected to have increased, and early figures on electricity generation show a gain. In addition, weekly information suggests that oil and gas well

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

	1985 Q4	1986 Q1	May 86 Dec. 85[1]	1986 Mar.	1986 Apr.	1986 May
	--Annual rate--			--Monthly rate--		
Total Index	1.9	.7	-1.7	-.9	.4	-.6
Products	1.7	-.1	-1.7	-.9	.6	-.6
Final products	1.6	-1.6	-2.4	-1.1	.7	-.7
Consumer goods	4.9	1.5	-1.0	-.8	1.2	-.5
Durable	6.5	2.8	-2.7	-2.8	2.6	-2.0
Nondurable	4.4	1.0	-.4	-.2	.7	.0
Equipment	-1.9	-4.9	-3.9	-1.5	.1	-1.0
Business	-3.5	.3	-1.8	-1.4	.9	-1.1
Defense and space	10.3	-4.0	-.8	1.0	.3	.2
Oil and gas drilling	-30.2	-59.7	-51.9	-16.9	-18.0	-12.8
Intermediate products	2.1	5.3	.6	-.3	.2	-.1
Construction supplies	-.6	10.7	2.2	-.1	.1	-.2
Materials	2.2	1.8	-1.7	-.9	.2	-.6
Durable goods	2.2	.7	-2.6	-1.3	-.1	-.8
Nondurable goods	.4	7.7	1.1	-1.0	.6	.2
Energy materials	4.0	-1.2	-2.5	-.2	.5	-.9
Memo: Total IP less oil and gas extraction and motor vehicles and parts	2.9	1.3	-1.1	-.5	.3	-.3

1. Five-month change.

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

	1978-80 High	1982 Low	1967-85 Avg.	1984 High	1986 Mar.	1986 Apr.	1986 May
Total industry	86.9	69.5	81.7	82.0	79.0	79.2	78.6
Manufacturing	86.5	68.0	80.6	81.8	78.9	79.4	78.8
Durable	86.3	63.7	78.8	80.4	76.2	76.6	75.7
Nondurable	87.0	74.4	83.5	84.4	83.3	83.6	83.5
Mining	95.2	76.9	87.7	86.4	76.5	75.8	74.2
Utilities	88.5	78.0	87.9	85.6	82.9	83.2	83.4
Industrial materials	89.1	68.4	82.5	83.1	78.8	78.9	78.3
Metal materials	93.6	45.7	78.4	70.6	66.3	66.7	66.4
Paper materials	97.3	79.9	91.3	97.2	92.3	92.2	n.a.
Chemical materials	87.9	63.3	80.8	79.1	80.5	80.4	n.a.

drilling will show a much smaller decrease for June than in earlier months. However, the output of steel declined in June, and strike activity hampered production in the lumber, aluminum, and communication equipment industries.

Capacity utilization in manufacturing was 78.6 percent in May, off 0.6 percentage point from April and more than 2 percentage points lower than January. Sharp declines occurred in durable manufacturing, where the operating rate was 2-1/2 percentage points below the beginning of the year. Capacity utilization in both the electrical and the nonelectrical machinery industries dropped below 70 percent in May--about 9 percentage points below the average level of 1967-85. In addition, cutbacks in oil and gas well drilling, together with recent production cutbacks in the coal industry, contributed to a substantial decline in the utilization rate in mining.

Employment and Unemployment

Nonfarm employment, as measured by the establishment survey, rose 150,000 in May. Service industries again accounted for the bulk of the hiring, and construction continued to expand. But cutbacks occurred again in oil and gas drilling and in manufacturing. Since the beginning of the year, service-producing industries have added more than a million jobs, with particularly strong growth in finance, insurance, and real estate as well as in business services. And, the construction industry has hired another 200,000 workers. In contrast, employment in manufacturing declined almost 40,000 in May, bringing the cumulative loss so far this year to 80,000 workers. Layoffs have been particularly large in machinery, transportation equipment, and metal industries. In addition, the plunge in oil and gas drilling has brought the number of jobs in that industry to the lowest level since 1979.

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

			1985		1986	1986		
	1984	1985	Q3	Q4	Q1	Mar.	Apr.	May
	--Average monthly changes--							
Nonfarm payroll employment[2]	332	230	229	261	191	55	313	149
Strike adjusted	334	229	235	260	184	66	310	148
Manufacturing	44	-18	-31	30	-11	-39	-8	-39
Durable	42	-16	-32	13	-14	-37	-2	-31
Nondurable	3	-2	1	17	3	-2	-6	-8
Mining	-1	-4	-6	-5	-16	-28	-31	-32
Construction	34	21	19	20	17	-26	132	21
Trade	102	65	50	55	79	31	41	55
Finance and services	114	122	131	123	98	96	194	127
Total government	24	38	59	31	23	18	21	21
Private nonfarm production workers	236	159	137	191	135	-29	246	101
Manufacturing production workers	27	-18	-25	24	-13	-36	6	-31
Total employment[3]	269	163	306	229	194	227	104	218
Nonagricultural	265	183	347	184	149	38	167	280

1. Average change from final month of preceding period to final month of period indicated.
2. Survey of establishments. Strike-adjusted data noted.
3. Survey of households.

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

			1985		1986	1986		
	1984	1985	Q3	Q4	Q1	Mar.	Apr.	May
Civilian, 16 years and older	7.5	7.2	7.2	7.0	7.1	7.2	7.1	7.3
Teenagers	18.9	18.6	18.3	19.0	18.5	18.2	19.6	19.0
20-24 years old	11.5	11.0	11.0	10.8	10.6	10.6	10.9	11.7
Men, 25 years and older	5.7	5.3	5.3	5.2	5.3	5.5	5.2	5.4
Women, 25 years and older	6.0	5.9	5.9	5.5	5.7	5.9	5.8	5.7
White	6.5	6.2	6.2	6.0	6.1	6.2	6.1	6.2
Black	15.9	15.1	14.8	15.1	14.6	14.7	14.8	14.8
Fulltime workers	7.2	6.9	6.8	6.7	6.7	6.9	6.7	7.0
Memo:								
Total national[1]	7.4	7.1	7.1	6.9	7.0	7.1	7.0	7.2

1. Includes resident Armed Forces as employed.

The unemployment rate rose 0.2 percentage point to 7.3 percent in May; the jobless rate has fluctuated between 7.1 and 7.3 percent for the past four months. Much of the increase in the unemployment rate was among adult men who worked in the goods-producing sector. In contrast, the unemployment rate for adult women declined slightly. On a geographical basis, employment losses were heaviest in states closely associated with the oil and gas industry.

Personal Income and Expenditures

Real income growth and consumer spending have strengthened noticeably this year. With falling energy prices boosting purchasing power, real disposable income has risen rapidly over the first five months of the year. The monthly pattern, however, has been erratic, owing to the lumpy nature of farm subsidies, which surged in April and then fell sharply in May. Excluding farm subsidies, nominal personal income increased 0.4 percent in May after a 0.3 percent advance in April--about equal to the moderate pace of nominal income growth that has prevailed since late 1985.

On the spending side, total car sales in April and May were at an 11-1/4 million unit annual rate, up from the 10-3/4 million unit pace reported in the first quarter. Since the incentive programs were enhanced in late April, sales of domestic models have averaged around 8-1/4 million units at an annual rate, up from the 7-3/4 million unit pace earlier in the year. Sales of imported cars in May, which had dipped in late winter, remained at a 3.1 million unit rate. Moreover, light-duty trucks and vans, many of which are used for personal transportation, sold at close

PERSONAL INCOME AND EXPENDITURES
(Based on seasonally adjusted data)

	1985	1985 Q3	1985 Q4	1986 Q1	May Q1	1986 Mar.	1986 Apr.	1986 May
	--Percentage changes not at annual rates--							
Total personal income	5.3	.6	1.7	1.3	1.4	.2	1.2	-.1
Wages and salaries	6.5	1.1	1.8	1.5	.8	.5	.1	.2
Private	6.3	1.1	1.8	1.5	.6	.5	.1	.1
Manufacturing	3.5	.5	1.6	.3	-.3	.5	-.5	.0
Other income	4.4	-.1	1.5	1.3	2.2	-.2	2.6	-.4
Disposable personal income	4.5	-.6	1.6	1.7	1.5	.3	1.4	-.2
Real	1.3	-1.1	.6	1.3	n.a.	.6	1.4	n.a.
Expenditures	6.2	1.7	1.1	1.3	1.6	.0	.5	.9
Real	3.0	1.1	.0	.9	n.a.	.4	.5	n.a.
Durables	6.0	5.5	-3.7	.3	5.3	-3.5	4.3	3.5
Motor vehicles and parts	3.0	10.6	-11.4	-.1	6.3	-9.1	11.0	2.7
Furn. and household equip.	8.6	.8	4.3	.5	5.0	1.2	-.4	4.4
Other durables	8.4	1.6	2.0	.9	3.6	1.4	-1.5	3.6
Nondurables	5.1	.5	1.5	.8	-.1	.6	-1.0	.5
Clothing and shoes	6.5	-.4	2.4	1.6	3.8	4.6	-1.1	.4
Gasoline and oil	3.6	-.7	.9	-6.0	-14.9	-7.7	-7.0	-1.8
Food	5.0	.8	1.4	1.3	.5	.9	.0	.2
Services	7.1	1.5	2.2	1.9	1.8	.6	.5	.5
Household operation	3.3	1.3	.6	-.6	1.6	-1.8	.9	1.5
Personal saving rate (percent)	4.6	3.7	4.0	4.4	n.a.	4.5	5.4	4.3

RETAIL SALES
(Seasonally adjusted percentage change)

	1985 Q3	1985 Q4	1986 Q1	May Q1	1986 Mar.	1986 Apr.	1986 May
Total sales	2.2	-.8	1.2	.0	-.4	.4	-.1
(REAL)[1]	2.3	-1.6	1.3	--	.5	1.0	.2
Total less automotive group, nonconsumer stores, and gasoline stations	1.2	1.4	1.3	.7	1.1	-.5	.3
GAF[2]	1.6	1.6	1.4	1.7	1.8	.3	-.2
Durable	4.6	-3.6	2.0	2.1	-1.5	3.1	.2
Automotive group	6.5	-8.1	1.1	1.8	-3.9	4.3	.6
Furniture and appliances	2.1	4.3	1.0	3.4	1.3	-.4	2.8
Other durable goods	.9	1.5	.1	1.6	.6	-1.1	2.0
Nondurable	.9	1.0	.7	-1.3	.2	-1.2	-.3
Apparel	2.1	1.6	1.6	1.1	3.2	.4	-1.9
Food	1.0	1.7	1.4	-.9	.8	-1.4	.1
General merchandise[3]	1.1	.4	1.4	1.3	1.3	.5	-.7
Gasoline stations	-.7	.2	-4.4	-14.4	-7.0	-7.4	-2.0
Addendum: Total sales less gasoline stati.ns	2.6	-.9	1.6	1.0	.1	.9	.1

1. BCD series 59. Data are available approximately 3 weeks following the retail sales release, and dashes indicate these data are unavailable.
2. General merchandise, apparel, furniture and appliance stores.
3. General merchandise excludes mail order nonstores; mail order sales are also excluded in the GAF grouping.

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

	1985 Q3	1985 Q4	1986 Q1	1986 Mar.	1986 Apr.	1986 May	1986 June
Total auto sales[1]	12.3	10.2	10.7	9.7	11.1	11.3	—
Domestic	9.4	6.8	7.8	6.9	8.0	8.2	8.3[3]
Imported	2.9	3.4	2.8	2.8	3.1	3.1	—
Domestic production	8.2	7.8	8.3	7.7	8.1	7.6	8.0P
Dealers' stocks	1.31	1.67	1.81	1.81	1.85	1.81	—
Days' supply[2]	43	75	71	81	71	68	—

1. Components may not add to totals due to rounding.
2. Days' supply for the quarter are based on end-of-quarter stocks and average sales for the quarter.
3. First 20-days.

to a 3.6 million unit rate in May—about the same as their elevated 1985 pace and about 250,000 units above their selling rate in the first quarter.

Other types of spending also have been strong in recent months, with sizable gains in purchases of clothing and shoes outlays, furniture and appliances, and "other" durables--which includes recreational equipment and jewelry. In addition, prices have stimulated gasoline usage, purchases in real terms in May probably were up more than 6 percent compared with the first quarter, although nominal sales were 15 percent lower. Nominal service outlays in May were 1.8 percent above the first quarter level, with higher purchases widespread by category.

Buying plans and consumer confidence as measured by both the Conference Board and Michigan Survey Research Center surveys of households remained at optimistic levels in May, although some questions were down a little from the April reports. Michigan reported that consumers were more willing to use credit than at anytime during the past 10 years; some of the Michigan questions suggest that this reflects an expectation of less favorable interest rates in the future. Respondents forecast an inflation rate of 3.4 percent for the next 12 months, and in the lower range that has been anticipated since January 1986. Last year, respondents' year-ahead inflation expectations generally were reported to be in the 4 to 5 percent range.

Business Fixed Investment

Investment outlays probably declined again in the second quarter. Activity related to petroleum has continued to plunge, and spending for other types of nonresidential construction declined sharply between February and May. Shipments of nondefense capital goods also have been sluggish in recent months, and in May were only about 1 percent above the depressed first-quarter average. In recent months, reduced shipments were reported for most categories of equipment, with the notable exception of aircraft and parts. Sales of heavy-weight trucks during April and May were little changed from the first-quarter level.

Looking ahead, new commitments for nonresidential buildings have fallen since late last year with much of the weakness traceable to the office sector, where projects are restrained by record-high vacancy rates. In addition, excess capacity in manufacturing has held down demand for new building in that sector.

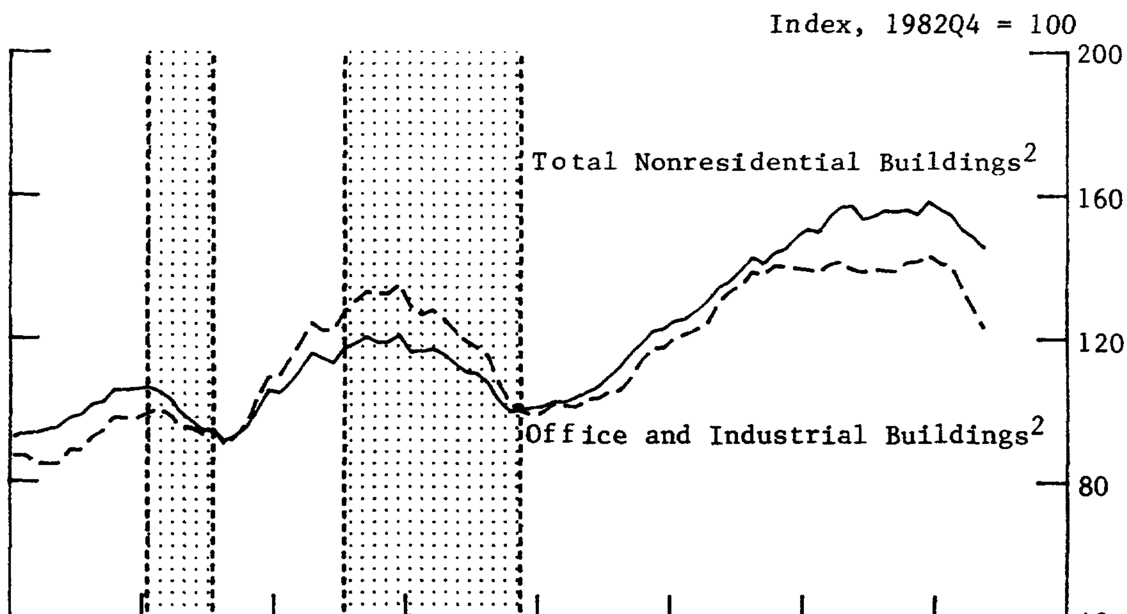
In the equipment sector, new orders for nondefense capital goods were flat in May after having fallen during the two preceding months. Substantial gains in bookings for office and computing equipment and for aircraft and parts were offset by reduced orders for most other types of equipment. In the case of office and computing, the advance was from a low level and the pace of bookings is still below the average of last year. More generally, new orders for nondefense capital goods have remained essentially unchanged since their peak in early 1984.

The most recent Commerce Department survey of capital spending plans--conducted in April and May--indicates that businesses expect to spend the same amount this year as last, as compared with the 2-1/4 percent gain expected in the January-March survey. Taken at face value, the capital spending surveys conducted this spring imply a second-half

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

	1985	1986	1986		
	Q4	Q1	Mar.	Apr.	May
Producers' durable equipment					
Nondefense capital goods					
Shipments	3.2	-5.8	2.8	.2	-2.6
Excluding office & store mach.	3.7	-3.6	1.4	.6	-3.0
Office and store machinery	.5	-17.5	11.5	-2.2	-.5
Orders	.0	-4.8	-7.3	-1.4	.4
Excluding office & store mach.	3.2	-4.8	-2.5	.1	-2.3
Office and store machinery	-16.8	-4.7	-29.9	-10.8	20.1
Sales of heavy-weight trucks (thousands of units, A.R.)	303	262	259	195	321
Nonresidential structures					
Nonresidential construction	2.2	1.0	-5.5	.1	-2.2
Commercial building	4.3	1.4	-4.3	-1.0	-2.8
Office	1.1	-.8	-2.4	-.9	-2.3
Other commercial	7.2	3.3	-5.8	-1.1	-3.2
Industrial building	3.4	-6.2	-18.5	9.8	-6.1
Rotary drilling rigs in use	-10.2	-21.0	-17.5	-18.0	-12.8

NONRESIDENTIAL NEW COMMITMENTS[1]



1. Source F.W. Dodge and Census.
2. Six-month moving average (sum of contracts and permits).

increase in outlays to fulfill investment goals on a year-over-year basis. However, there are as yet no signals of such a pickup.

Housing

Construction of housing generally has been brisk, with starts declining just a bit to a 1.9 million unit annual rate in May. Single-family starts held steady at a level that was fractionally above the high first-quarter average. Although sales of both new and existing homes dropped in May, the combined was nearly 8 percent selling pace above the average for 1985.

Multifamily starts fell sharply in May. The falloff in new multifamily construction is attributable in part to the depletion of tax-exempt funds raised by huge issues of mortgage revenue bonds in late 1985 and to overbuilding in a number of major markets. According to industry reports, the possibility that tax reform will cut the investment yield of rental apartment buildings also may have begun to restrain new activity in this area.

With home sales at a high level, average sales prices have risen at double-digit rates over the 12 months ending in May. While these price measures do not adjust for changes in the quality of homes sold or in the composition of the sample, informal reports also suggest that home prices have begun to accelerate on a quality-adjusted basis. Regionally, the largest price increases were registered in the Northeast, where sales prices have risen nearly twice as quickly as for the national average.

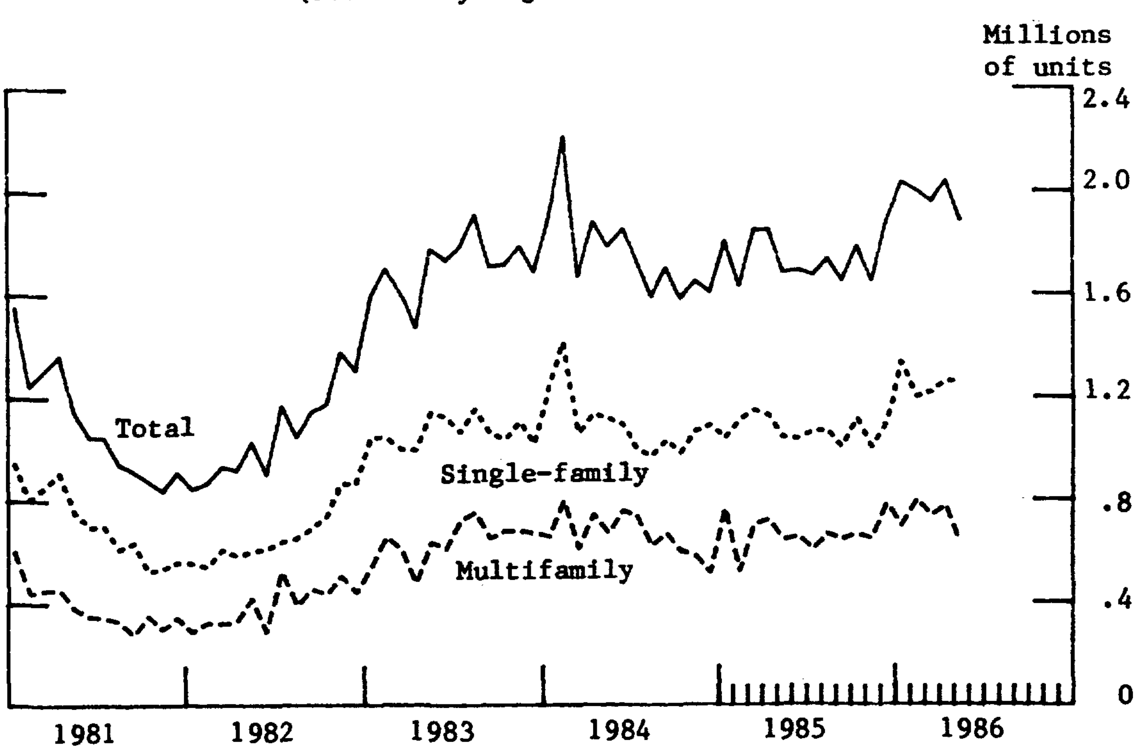
Manufacturers' shipments of mobile homes have dropped significantly below the 1985 average. The decline in shipments from last year's pace seems attributable principally to oil-related setbacks in Texas, Louisiana,

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

	1985 Annual	1985 Q4	1986 Q1	1986 Mar.	Apr.	May[1]
All units						
Permits	1.73	1.74	1.83	1.83	1.89	1.79
Starts	1.74	1.77	2.00	1.96	2.04	1.89
Single-family units						
Permits	.96	.96	1.04	1.04	1.14	1.10
Starts	1.07	1.07	1.25	1.22	1.26	1.26
Sales						
New homes	.69	.70	.80	.92	.86	.76
Existing homes	3.22	3.50	3.26	3.20	3.57	3.45
Multifamily units						
Permits	.78	.78	.79	.79	.75	.69
Starts	.67	.70	.75	.74	.78	.63
Mobile home shipments	.28	.29	.26	.24	.25	n.a.

1. Preliminary estimates.
n.a.—Not available.

PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



and Oklahoma; these states normally account for roughly a fifth of total shipments.

Business Inventories

According to the limited available information, business inventory investment appears to have continued in the second quarter at about the first quarter pace. The composition, however, has been somewhat different. During the first quarter, the bulk of the accumulation was attributable to a buildup in auto dealers' stocks while inventory investment elsewhere was relatively moderate. In the spring, however, auto stocks were pared a bit, as auto assembly rates were reduced and sales responded to interest incentives.

In contrast, April data point to somewhat larger accumulation at nonauto trade establishments. Retail outlets of general merchandise, apparel, and furniture as well as building materials and wholesale distributors of motor vehicles, machinery, and electrical goods all reported sizable buildups in April. Although the sharp accumulation of inventories in the trade sector was accompanied by rising sales, the inventory-sales ratio for retail trade establishments other than automotive remains at the high end of the range of recent years. In manufacturing, where inventories were declining through the second half of 1985 and early 1986, book value stocks dropped again in May, at an $11 billion annual rate.

The Federal Government

Federal spending rose in April and May from first-quarter levels primarily because of a sharp pickup in defense spending and large farm subsidy payments by the Commodity Credit Corporation. At the same time, revenues from excise taxes slowed significantly, owing mostly to the virtual elimination of receipts from the "windfall profits" tax on oil

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

	1985 Q3	1985 Q4	1986 Q1	1986 Mar.	1986 Apr.r	1986 Mayp
Book Value Basis:						
Total	-5.6	17.6	20.1	36.0	25.7	--
Manufacturing	-6.6	-8.6	-9.3	4.0	-2.6	-11.1
Wholesale	-2.1	6.1	4.5	5.9	11.5	--
Retail	3.1	20.1	24.9	26.1	16.7	--
Automotive	-6.8	19.9	15.1	20.5	-1.9	--
Ex. auto	9.9	.2	9.8	5.5	18.6	--
Constant Dollar Basis:						
Total	1.5	14.6	30.8	36.8	46.2	--
Manufacturing	-4.0	-10.5	-6.1	10.5	5.5	--
Wholesale	3.3	4.5	5.4	5.0	16.6	--
Retail	2.2	20.5	31.5	21.3	24.1	--
Automotive	-5.7	19.9	18.2	19.2	-2.4	--
Ex. auto	7.9	.7	13.4	2.2	26.5	--

INVENTORIES RELATIVE TO SALES[1]

	Cyclical Reference Points[2] 81 low	Cyclical Reference Points[2] 82 high	1985 Q3	1985 Q4	1986 Q1	1986 Mar.	1986 Apr.r	1986 Mayp
Book Value Basis:								
Total	1.39	1.53	1.36	1.36	1.38	1.40	1.38	--
Manufacturing	1.60	1.77	1.46	1.42	1.43	1.46	1.42	1.44
Wholesale	1.06	1.28	1.18	1.18	1.20	1.22	1.21	--
Retail	1.37	1.46	1.37	1.43	1.47	1.47	1.48	--
Automotive	1.57	1.90	1.34	1.65	1.78	1.84	1.75	--
Ex. Auto	1.31	1.37	1.39	1.37	1.38	1.37	1.40	--
Constant Dollar Basis:								
Total	1.58	1.72	1.53	1.54	1.55	1.56	1.53	--
Manufacturing	1.88	2.04	1.76	1.73	1.73	1.75	1.70	--
Wholesale	1.26	1.45	1.31	1.31	1.31	1.31	1.30	--
Retail	1.38	1.49	1.37	1.45	1.50	1.49	1.48	--
Automotive	1.54	1.90	1.15	1.51	1.68	1.76	1.63	--
Ex. auto	1.31	1.41	1.44	1.43	1.45	1.42	1.44	--

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

production. Other types of corporate taxes also were lower. Although the total federal deficit, on a unified budget basis, fell about $4 billion below year-earlier levels during April and May, a calculation that adjusts for the abnormal concentration of refunds in April and May of last year indicates a small increase in the 1986 deficit on a year-over-year basis.

The Congress completed action on the fiscal 1987 congressional budget resolution on June 27. As shown in the table, the resolution proposes a deficit path that is just below the 1987 Gramm-Rudman deficit target; it also is somewhat above target in 1988 and 1989. The resolution requires $6 billion in new revenues, a $5 billion reduction in defense spending, and a $16 billion reduction in nondefense outlays; sales of assets are scheduled to provide $5 billion in receipts. These estimates are based on the Congressional Budget Office's February economic assumptions. Because recent income growth has been slower than in these assumptions and spending for defense and farm programs has been higher than anticipated, an updated deficit estimate would be higher in the resolution.

The Senate and House proposals for tax reform are discussed in some detail in an appendix. Both bills cut marginal tax rates by broadening the tax base and shifting the distribution of tax payments somewhat from individuals to corporations. Numerous significant differences between specific provisions of the bills imply a difficult conference between the Senate and House, but ultimate enactment of a reform package now seems

FEDERAL RECEIPTS AND EXPENDITURES
(Total unified budget basis, not seasonally adjusted, billions of dollars)

	Receipts		Outlays		Deficit	
	1985	1986	1985	1986	1985	1986
October	52.3	57.9	80.3	85.0	28.0	27.1
November	51.5	51.2	80.4	84.5	28.9	33.4
December	62.4	68.2	77.0	82.8	14.6	14.7
January	70.5	76.7	78.4	83.2	8.0	6.5
February	54.0	53.4	75.1	78.0	21.1	24.6
March	49.6	49.6	79.1	79.7	29.5	30.1
April	94.6	91.4	83.2	81.5	-11.4	-9.9
May	39.8	47.9	81.8	84.1	42.0	36.2
Memo:						
April plus May	134.4	137.7	165.0	167.2	30.6	29.5
Fiscal year through May	474.7	494.6	635.3	660.4	160.6	165.8
Fiscal year total	734.0	n.a.	945.9	n.a.	211.9	n.a.

Source: Monthly Treasury Statement of Receipts and Outlays of the United States Government.

SUMMARY OF THE 1987 CONGRESSIONAL BUDGET RESOLUTION
(Total unified budget basis, fiscal years, billions of dollars)

	1987	1988	1989
Baseline revenues[1]	846.5	923.8	994.2
Tax increases	5.9	6.0	6.9
Budget resolution revenues	852.4	929.8	1001.1
Baseline outlays[1]	1021.0	1084.8	1130.7
Outlay cuts (including debt service savings)	26.0	39.4	51.7
Budget resolution outlays	995.0	1045.4	1079.0
Baseline deficit[1]	174.5	161.0	136.5
Deficit reductions	31.9	45.3	58.6
Budget resolution deficit	142.6	115.7	77.9
Memo:			
Gramm-Rudman-Hollings:			
Target deficit	144	108	72
Trigger for sequester	154	118	82

1. Baseline is based on CBO's February economic assumptions; revenue and spending estimates were updated by CBO in March to reflect more recent technical information; includes the deficit reductions specified in the Comprehensive Budget Reconciliation Act of 1985.

very likely in view of the large margin of the Senate vote and strong encouragement by the administration.

State and Local Government Sector

State and local governments appear to have increased their real outlays early in the second quarter, following a 2.8 percent annual rate rise in the first quarter. Employment continued to drift upward in April and May, and in May real spending for construction substantially exceeded the first-quarter average. Even so, these expenditures reflect cuts from previously planned levels in states that have been facing eroding budget positions because of their dependence on energy, mining, and agriculture.

Although many states have passed or are planning tax increases, others are expecting fiscal relief from the proposed tax reform legislation. About 30 states base their income taxes on either federal adjusted gross income or federal taxable income; both of these measures would rise as a result of tax reform. In contrast, tax receipts could fall in a few states that link their personal income tax collections to federal tax liability. Some states plan to adjust their tax codes to prevent windfall gains or losses.

A loss of revenue from severance taxes on oil and gas remains a problem in energy-dependent states. In recent years, some states such as Texas and Louisiana--which together collect more than 40 percent of all severance tax revenue--reduced their own collections from around 28 percent of state tax revenue to 19 percent. However, a few states have increased their reliance on severance taxes.

State and Local Government Severance
Tax Collections
(Fiscal year basis)

	Severance Tax Revenue as a Percent of Total State Tax Revenue	
State	1985	1981
Alaska	73.6	50.5
Wyoming	50.1	29.4
New Mexico	27.2	27.4
North Dakota	25.4	22.8
Oklahoma	23.8	26.9
Montana	23.5	21.3
Louisiana	19.3	29.1
Texas	18.8	26.9

Prices and Wages

The consumer and producer price indexes turned up in May, as the steep declined in energy prices ended. The CPI for energy rose 0.3 percent in May, with a 2-1/2 percent advance for gasoline more than offsetting declines in fuel oil, electricity, and natural gas. Despite the May increase, the retail price of gasoline was more than one-fifth below a year earlier; refinery prices were down more than one-third over the year. At the wellhead, the PPI for crude petroleum (a measure of the price of domestic output) fell somewhat and was about half the level of a year ago.

Retail food prices in the CPI rose 0.3 percent in April and 0.4 percent in May, but because of the first-quarter decline are little changed so far this year. The volatile fresh fruit and vegetable category largely was responsible for the advances of the last two months. At the farm level, crude food prices increased in May for the first time since

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

	Relative Importance Dec. 1985	1985	1985 Q3	1985 Q4	1986 Q1	1986 Apr.	1986 May
			—Annual rate—			—Monthly rate—	
All items[2]	100.0	3.8	2.4	5.3	-1.9	-.3	.2
Food	18.5	2.7	2.1	5.9	-1.4	.3	.4
Energy	11.3	1.8	-3.2	3.3	-34.2	-5.8	.3
All items less food and energy[3]	70.2	4.4	3.4	5.4	4.1	.4	.1
Commodities[3]	25.9	2.1	1.1	3.6	.3	-.1	-.1
Services[4]	44.4	5.7	4.8	6.5	6.5	.7	.2
Memorandum:							
CPI-W[4]	100.0	3.6	2.0	5.2	-2.7	-.4	.2

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	1985	1985 Q3	1985 Q4	1986 Q1	1986 Apr.	1986 May
			—Annual rate—			—Monthly rate—	
Finished Goods	100.0	1.8	-2.4	9.2	-12.4	-.6	.6
Consumer foods	24.5	.5	-2.9	16.0	-7.5	.1	1.1
Consumer energy	12.5	-.3	-11.3	20.7	-67.6	-8.4	2.7
Other consumer goods	40.3	2.7	.0	4.4	2.9	.2	.2
Capital equipment	22.7	2.7	-.9	5.6	.7	.3	.1
Intermediate materials[2]	95.3	-.1	-1.3	2.9	-11.9	-1.0	-.3
Exc. energy	79.6	-.1	-.7	.0	-1.2	-.3	.0
Crude food materials	52.5	-6.4	-20.6	47.0	-25.2	-3.1	4.1
Crude energy	31.6	-4.9	-5.9	-4.0	-50.1	-7.7	.2
Other crude materials	15.9	-4.3	-4.4	1.5	-3.7	1.2	.2

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

November. Since May, farm crop prices have moved lower, particularly for grain, while livestock prices have risen, primarily in response to reduced marketings of hogs.

Outside of food and energy, the CPI inflation measure rose about 3-1/2 percent at an annual rate over the first five months of 1986. The CPI for commodities less food and energy edged down 0.1 percent in May for the fourth consecutive month, in large part because of declines in prices for used cars. However, new car prices rose 0.6 percent in April and 0.8 percent in May, with increases in both domestic and foreign models. Service prices, excluding energy, accelerated in March and April but slowed in May, mainly because of the rent component; so far this year, the average monthly increase of 0.5 percent is similar to that in 1985.

At the producer level, prices of capital equipment in April and May continued to rise at an average rate of 0.2 percent per month--about the same as in recent years. Prices of intermediate materials, less food and energy, were down somewhat in these months, while prices of crude nonfood materials, less energy, turned up after their first-quarter decline.

Labor costs also have continued to rise slowly. The hourly earnings index--the only recent data on wages--rose 0.2 percent in May and is up just 1.5 percent at an annual rate since the beginning of the year. Despite rapid hiring, the hourly earnings index for the construction industry has been relatively flat so far this year while service industry wages have risen at a 2.3 percent rate. In manufacturing, the index has risen 2.1 percent at an annual rate. Overall, this measure of wage change shows a deceleration in pay increases relative to 1985 for most industries.

Recent collective bargaining agreements continue to bring small wage adjustments for unionized workers. A tentative settlement in the Communications Workers of America strike of AT&T, which involves 155,000 employees, calls for a 2 percent pay increase in the first year of the contract and a 3 percent increase in both the second and the third. There is no provision for COLAs over the three years of the tentative contract, although the language of a possible cost-of-living adjustment is retained as a starting point for negotiations in 1989.

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

	1984	1985	1985 Q3	1985 Q4	1986 Q1	1986 Year to date
Hourly earnings index, wages of production workers[1]						First five months
Total private nonfarm	2.9	3.0	2.4	3.2	2.7	1.5
Manufacturing	3.4	3.3	2.5	2.4	2.3	2.1
Nonmanufacturing	1.3	3.1	2.3	2.5	2.1	1.2
Employment cost index, wages and salaries of all persons[2]						1985 Q1 to 1986 Q1
Total	4.1	4.1	5.3	2.3	3.9	3.9
By occupation:						
White collar	4.4	4.9	5.9	3.2	4.1	4.5
Blue collar	3.6	3.4	4.7	1.0	3.7	3.4
Service workers	6.2	2.3	6.3	1.0	4.5	3.4
By bargaining status:						
Union	3.4	3.1	3.6	1.9	2.9	3.2
Nonunion	4.5	4.6	6.0	2.3	4.5	4.3
Employment cost index, compensation of all persons[2]						
Total	4.9	3.9	5.2	2.2	4.5	3.8
Major collective bargaining agreements						First three months
First-year wage adjustments	2.4	2.3	--	--	--	.8
Total effective wage change	3.7	3.3	--	--	--	2.4
Labor costs and productivity, all persons[1]						1985 Q1 to 1986 Q1
Compensation per hour	3.8	3.7	2.8	3.2	2.2	3.0
Output per hour	.8	-.6	.4	-4.1	3.6	.0
Unit labor costs	3.0	4.3	2.4	7.6	-1.4	3.0

1. Changes are from final quarter of preceding period to final quarter of period indicated. Quarterly and year-to-date changes at compound rates. Seasonally adjusted data.
2. Changes are from final month of preceding period to final month of period indicated. Quarterly changes at compound rates; not seasonally adjusted.

APPENDIX*

HOUSE AND SENATE TAX REFORM BILLS

The Senate approved a comprehensive income tax reform package on June 24 that resembles in broad outline, but not in many details, the tax reform bill that was passed by the House on December 18. Both bills would finance sizable cuts in personal and corporate tax rates by broadening the tax base. Each bill would also shift some of the income tax burden from individuals to corporations. The Senate and House do not agree, however, on which tax preferences and loopholes should be eliminated in order to broaden the tax base. Because these differences are substantial, the Senate and House conference that will reconcile differences between the bills will likely be long and difficult. The conference is expected to begin work on the bill shortly after Congress returns from its recess on July 14, with the goal of completing a tax bill by the middle of August.

The revenue impact of the Senate and House bills is summarized in table 1. It shows that both bills are revenue neutral when revenue effects are summed over their respective projection horizons. Official revenue estimates were computed for five years beyond the general effective date of each bill. Some revenues are expected from the Senate plan during FY1986, prior to its general January 1, 1987 effective date, primarily because of the proposed retroactive repeal of the investment tax credit. The bills are not, however, revenue neutral in each individual year. The Senate bill, in particular, would generate large year-to-year revenue swings--a prospect that is complicating budget planning under the Gramm-Rudman-Hollings targets. The Senate bill would also shift less of the tax burden to corporations than the House bill.

Many of the similarities and differences between the House and the Senate bills are summarized in table 2, which compares provisions of the two bills to current law. Significant similarities include a general reduction of personal and corporate income tax rates, the repeal of the investment tax credit, the retention of itemized deductions for mortgage interest on a principal and second residence and all real estate taxes, greater reliance on alternative minimum taxes, and stricter accounting rules which limit the ability of taxpayers to defer taxes on their net economic income.

Major differences between the bills reflect the emphasis that the Senate placed on reducing personal income tax preferences compared to the greater emphasis that the House placed on reducing corporate income tax preferences. For example, only the Senate bill would limit or repeal itemized deductions for state and local sales taxes and consumer interest, limit Individual Retirement Account deductions to individuals without a company pension plan, substantially increase the individual capital gains tax rate, and sharply restrict the deductibility of tax losses from

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"passive" investments. The House bill, on the other hand, would generate more revenue than the Senate bill from the introduction of less favorable depreciation schedules for investment, repeal industry specific tax breaks for financial institutions and natural resource industries, and limit private-purpose tax-exempt bond financing. There is, however, some offset to these differences in the minimum tax provisions of the two bills. The Senate bill makes up for some of its apparent ease on corporations by collecting significant revenues from an expanded corporate minimum tax, while the House plan would collect relatively more revenues through the individual minimum tax.

The Senate plan would generally be effective on January 1, 1987 while the House plan is retroactive January 1, 1986. Both bills would, in effect, delay the individual and corporate rate cuts to July by "blending" the current law tax rates with the proposed rates during the first year of the new law. The Senate bill requires that individual withholding rates be cut to reflect the blended rates on January 1, 1987. Many other provisions of both bills also are phased in with often complex transition rules. It is likely that the Senate's effective dates will prevail for many provisions because making the bulk of tax reform retroactive would be administratively difficult and would raise equity issues.

Table 1

BUDGET IMPACT OF THE HOUSE AND SENATE TAX REFORM BILLS[1]
(Fiscal years, billions of dollars)

	1986	1987	1988	1989	1990	1991	Total[2]
Individual receipts:							
Senate[3]	.8	.6	-35.6	-33.8	-17.7	-14.3	-100.0
House	-8.3	-25.4	-34.7	-35.0	-36.4	n.a.	-139.8
Corporate receipts:							
Senate[3]	6.6	23.1	15.2	12.8	17.3	25.4	100.4
House	15.6	22.9	27.1	32.0	41.2	n.a.	138.9
Total receipts[4]							
Senate[3]	7.4	22.8	-20.7	-21.1	-.4	11.0	-1.0
House	7.3	-2.4	-7.5	-2.8	5.0	n.a.	-.4

1. The estimates are not strictly comparable across tax reform bills because they were prepared at different times based on somewhat different economic assumptions.
2. Total is for 1986 through 1991 for the Senate plan, and for 1986 through 1990 for the House plan.
3. Estimates are for the Senate Finance Committee-reported bill. Revenue estimates for the Senate-passed bill will be about the same because only minor "revenue neutral" amendments were added on the Senate floor.
4. Includes minor effects on excise, employment, estate and gift, and customs taxes, which are not shown separately on this table.

Source: Joint Committee on Taxation.

Table 2

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE HOUSE AND SENATE TAX BILLS[1]

	Current law	House Bill	Senate Bill
Individual Taxes			
Individual tax rate schedule	14 rate brackets: 11% to 50%; during 1986 50% bracket applies to incomes above $175,250. Brackets indexed.	4 rate brackets: Rate — Taxable income bracket 15% — 0 - $22,500 25% — $22,500- $43,000 35% — $43,000-$100,000 38% — Over $100,000 Brackets indexed.	2 rate brackets: Rate — Taxable income bracket 15% — 0 - $29,300 27% — Over $29,300 (The phase-out of the benefit of the 15% bracket for taxpayers with an A.G.I. between $75,000 and $145,320 and the phase-out of personal exemptions between $145,320 and $185,320 would raise marginal rates above 32%.) Brackets indexed.
Personal exemption	$1,080 in 1986, indexed.	$1,500 for itemizers, $2,000 nonitemizers, indexed.	$1,900 in 1987, $2,000 in 1988, indexed; phased out at high income levels.
Income averaging	Yes	Repeal	Retained only for farmers.
Adjustments and exclusions:			
Two earner deduction	$3,000 maximum.	Repeal	Repeal
Unemployment compensation	Taxed if AGI above $18,000 ($12,000 on single return).	Included in taxable income.	Included in taxable income.

1. Unless noted, the tax rates, allowances and limits shown in this table are for taxpayers filing a joint return. Different rates and limits may apply to single taxpayers, heads of households, and married taxpayers filing separate returns.

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE HOUSE AND SENATE TAX BILLS

	Current law	House Bill	Senate Bill
Business meals and entertainment expense	Deductible	80% deductible	80% deductible
Employee business expenses	Reduce adjusted gross income.	Included in itemized deductions--limited deductibility.	Included in itemized deductions--limited deductibility.
Retirement plans:			
IRA limit	$2,000	$2,000 (would be included in limit under 401(k) plan).	$2,000-limited to employees without qualified pension plan.
Spousal IRA	$250	$250	$250-limited to spouses of employees without qualified pension plan.
Deferred compensation plans (401(k)).	$30,000 limit	$7,000 per year limit.	$7,000 per year limit.
Standard deduction	1986 zero bracket amount is $3,670 ($2,480 for singles) Indexed.	Current law in 1986, $4,800 ($2,950 for singles) in 1987. Indexed.	$3,800 in 1987, $5,000 ($3,000 for singles) in 1988. Indexed.
Itemized deductions:			
State and local income, property and sales taxes	Deductible	Deductible	Sales tax deduction limited to 60% of amount by which they exceed state income taxes. Income and property taxes remain deductible.
Charitable contributions	Deductible for itemizers and nonitemizers in 1986.	Deductible for itemizers, limited for nonitemizers	Deductible for itemizers only.
Mortgage interest	Deductible	Deductible for principal residence and second home.	Deductible for principal residence and second home.

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE HOUSE AND SENATE TAX BILLS

	Current law	House Bill	Senate Bill
Other interest	Limited to $10,000 plus amount of investment income.	Limited to $20,000 plus amount of investment income, broadens definition of interest subject to limit.	No consumer interest deduction. Investment interest deduction limited to investment income; five year phase-in.
Medical expenses	Amount above 5% of AGI deductible.	Amount above 5% of AGI deductible.	Amount above about 9% of AGI deductible.
Miscellaneous deductions	Union dues, other expenses related to earning income deductible if itemized.	Combined with employee business expenses, deduction limited to excess over 1% of adjusted gross income.	Miscellaneous deductions repealed. Employee business expense deduction limited to excess over 1% of AGI.
Tax shelters:			
Passive losses	Losses from shelters that taxpayer does not actively manage may offset portfolio and earned income.	No provision.	Passive losses deductible only against passive income, with some exceptions for oil, gas and rental housing losses: five year phase-in.
At-risk limits on deductions	Losses which can be deducted on most activities are limited to the amount a taxpayer has invested (including loans for which the taxpayer is personally liable). Holdings of real estate are excepted.	At-risk rules extended to real estate.	At-risk rules extended to real estate.
Capital gains of individuals:			
Capital gains exclusion	60% exclusion.	42% exclusion.	No exclusion.
Maximum tax rate:			
Short-term gains	50%	38%	27%
Long-term gains	20%	22%	27%

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE HOUSE AND SENATE TAX BILLS

	Current law	House Bill	Senate Bill
Individual minimum tax	Alternative minimum tax with 20% rate.	Expands list of preferences included in the minimum tax base, 25% rate.	Expands list of preferences included in tax base, 20% rate.
<u>Corporate and Business Taxes</u>			
Corporate tax rates	Graduated up to $100,000, 46% top rate.	Graduated up to $75,000, 36% top rate.	Graduated up to $75,000, 33% top rate.
Dividend relief for individuals	$200 exclusion ($100 on single returns).	Exclusion repealed; 10% deduction for payer, phased in over 10 years.	Exclusion repealed.
Corporate deduction for dividends received	85% deduction.	85% deduction phased down to 70% over 10 years.	80% deduction.
Capital gains of corporations	28% maximum rate.	Preferential rate repealed (36% maximum rate).	28% preferential rate is retained.
Investment tax credit	6% credit for equipment in 3 year ACRS class. 10% credit for other equipment.	Repealed	Repealed
Depreciation	ACRS: 3-year class: (autos, light trucks and some R.&D. equipment, for example) 150% declining balance schedule. 5-year class: (all personal property not included in other classes--majority of equipment is in this class) 150% declining balance schedule.	IDS (Incentive Depreciation System): New system with 10 asset classes ranging from 3 to 30 years; asset lives are generally longer than under ACRS (classification scheme is based on the pre-ACRS asset depreciation range system); double declining balance schedules except for real property and	Asset classifications are similar to ACRS. Major changes are: A straight line schedule would apply to most 3 year property. A 200% declining balance schedule would apply to most equipment in the 5, 10, and 15 year classes.

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE HOUSE AND SENATE TAX BILLS

	Current law	House Bill	Senate Bill
Depreciation (continued)	10-year class: (Public utility property with 18.5 to 25 year ADR life, mobile homes, for example) 150% declining balance schedule. 15-year public utility class: (utility property with ADR life above 25 years) 150% declining balance schedule. 15-year real property class: (Low income housing) 200% declining balance schedule. 19-year real property class: (Buildings and structures) 175% declining balance schedule.	equipment in the 30-year class, to which a straight line schedule applies; overall, allowances are less favorable than ACRS. There is limited indexing for inflation of depreciation allowances.	Residential real property would be depreciated over 27-1/2 years using a straight-line schedule. Other real property would be depreciated over 31-1/2 years using a straight line schedule.
Corporate minimum tax	Add-on tax. 15% tax rate on certain preferences with exemption of $10,000 or regular tax paid.	New alternative tax applies to an expanded list of preferences. Minimum tax base includes, for example, accelerated depreciation, capital gains preference, bad debt reserve deductions of financial institutions, and percentage depletion. 25% tax rate.	New alternative tax applies to more preferences than the House bill. Would include as a preference one-half of income reported to shareholders that is not otherwise included in the minimum tax base. 20% tax rate.
State and local bonds	Tax-exempt: volume limits on private purpose bonds.	Limit projects funded by private-purpose bonds, reduce volume limits, additional arbitrage restrictions.	Current law volume limits retained.

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE HOUSE AND SENATE TAX BILLS

	Current law	House Bill	Senate Bill
Accounting provisions:			
Deferral of income from installment sales	Yes	No deferral if receivables are pledged, exception for revolving credit plans.	No deferral if receivables are pledged, no revolving credit exception.
Cash method of accounting	Permitted for firms without inventories.	Disallowed for all but professional services corporations with income below $5 million.	Disallowed for financial institutions, otherwise current law.
Long-term contracts	Income can be deferred until contract is completed.	Requires percentage of completion method based on costs incurred.	Retains current law with requirement for capitalization of indirect costs on federal contracts.
Industry specific provisions:			
Oil industry:			
Percentage depletion	Available to small independent producers.	Phase out, exception for stripper wells.	Retain current law.
Intangible drilling costs	May be expensed.	Expense costs incurred prior to installation of production casing.	Retain current law.
Timber	Special capital gains treatment and other special rules.	Repeal capital gains rate for corporations, and other special rules for large producers.	Retain current law.

Table 2--continued

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE HOUSE AND SENATE TAX BILLS

	Current law	House Bill	Senate Bill
Financial institutions:			
Bad debt reserves	Special deduction	Repeal for banks with more than $500 million in assets.	Retain current law.
Deduction for interest to carry tax exempts	Yes	Repeal	Retain.
Credit union exemption	Yes	Repeal if more than $5 million in assets.	Retain.
Insurance companies:			
Special life insurance deductions	Yes	Repeal	Repeal
Tax exemption for Blue-Cross, Blue-Shield, TIAA-CREF	Yes	Repeal	Retain
Property and casualty reserve deductions	Yes	Include portions of unearned premium reserves and tax-exempt bond interest in income.	Include portion of unearned premium reserves in income.
Foreign provisions		Numerous provisions with small separate revenue impacts would increase receipts $11.5 billion over 5 years.	Numerous provisions with small separate revenue impacts would increase receipts $4.3 billion over 5 years.
Compliance Estimated tax payments (individual):	Lesser of 100% previous year's liability or 80% of current year's liability.	Lesser of 100% of previous year's liability or 90% of current year's liability.	Same as House bill.

COMPARISON OF SELECTED PROVISIONS OF CURRENT LAW AND THE HOUSE AND SENATE TAX BILLS

	Current law	House Bill	Senate Bill
IRS enforcement	n.a.	Increases many fees and penalties, requires greater information reporting.	Provides expanded manpower for IRS enforcement, increases many fees and penalties, more information reporting requirements.
Effective dates	n.a.	Generally January 1, 1986; individual and corporate rate cuts to be effective July 1, 1986; investment under construction or under contract by September 25, 1985 still receives current law (ACRS) benefits; complex transition rules for many provisions.	Generally January 1, 1987, individual and corporate rate cuts to be effective July 1, 1987 (reduced withholding under "blended" rates would begin January 1, 1987); repeal of investment tax credit retroactive to January 1, 1986; long lived investments under way or under contract by March 1, 1986 continues under ACRS; interest deduction limits and passive loss restrictions are phased in over 5 years; other complex transition rules for many provisions.

III-T-1
SELECTED FINANCIAL MARKET QUOTATIONS[1]
(Percent)

	1984 Highs	1985 March highs	1986 April Lows	1986 FOMC May 20	1986 July 1	Change from: April Lows	Change from: FOMC May 20
Short-term rates							
Federal funds[2]	11.63	8.58	6.95	6.84	6.92	-0.03	0.08
Treasury bills[3]							
3-month	10.67	8.80	5.77	6.23	5.99	0.22	-0.24
6-month	10.77	9.13	5.81	6.26	5.97	0.16	-0.29
1-year	11.13	9.25	5.79	6.33	6.01	0.22	-0.32
Commercial paper							
1-month	11.42	8.94	6.42	6.78	6.69	0.27	-0.09
3-month	11.35	9.12	6.30	6.72	6.54	0.24	-0.18
Large negotiable CDs[3]							
1-month	11.52	8.89	6.51	6.82	6.67	0.16	-0.15
3-month	11.79	9.29	6.39	6.82	6.49	0.10	-0.33
6-month	12.30	9.92	6.35	6.83	6.48	0.13	-0.35
Eurodollar deposits[4]							
1-month	11.89	8.89	6.59	6.86	6.96	0.37	0.10
3-month	12.20	9.58	6.55	6.79	6.91	0.36	0.12
Bank prime rate	13.00	10.50	8.50	8.50	8.50	--	--
Treasury bill futures							
Sept. 1986 contract		10.74	5.16	6.19	5.63	0.47	-0.56
Dec. 1986 contract			5.27	6.10	5.60	0.33	-0.50
Intermediate- and long-term rates							
U.S. Treasury (constant maturity)							
3-year	13.49	11.22	6.49	7.46	7.00	0.51	-0.46
10-year	13.99	12.02	6.98	7.88	7.37	0.39	-0.51
30-year	13.94	11.97	7.14	7.58	7.21	0.07	-0.37
Municipal revenue[5] (Bond Buyer index)	11.44	10.25	7.55	7.91	8.05	0.50	0.14
Corporate--A utility							
Recently offered	15.30	13.23	9.15	9.52[e]	9.58[e]	0.43	0.06
Home mortgage rates[6]							
S&L fixed-rate	14.68	13.29	9.60	10.08	10.62	1.02	0.54
S&L ARM, 1-yr.	12.31	11.14	8.41	8.57	8.54	0.13	-0.03

	1984 Lows	1985 March Lows	1986 April Highs	1986 FOMC May 20	1986 July 1	Percent change from: April Highs	Percent change from: FOMC May 20
Stock prices							
Dow-Jones Industrial	1086.57	1247.35	1855.90	1783.98	1903.54	2.57	6.70
NYSE Composite	85.13	102.46	141.07	136.06	144.68	2.56	6.34
AMEX Composite	187.16	222.28	274.59	274.16	284.67	3.67	3.83
NASDAQ (OTC)	225.30	276.18	392.34	385.28	407.61	3.89	5.80

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

Interest rates have registered mixed changes on balance since the last FOMC meeting. Securities markets have been volatile as traders have struggled to gauge the prospects for growth here and in other industrial countries and the likelihood of further easing steps by monetary authorities. Market sentiment also has been colored at the margin by the troubling news on the international debt front, especially that regarding Mexico.

Although the federal funds rate has remained in the 6-7/8 percent area, most other short-term rates have declined somewhat. In the bond markets, Treasury coupon yields also are down--having retraced much of their May backup--but corporate and municipal rates have risen slightly, and commitment rates on new fixed-rate home mortgages have increased appreciably. The unusual behavior of spreads appears to reflect a confluence of many disparate factors: market participants point to extraordinary demand for recent Treasury bonds by Japanese security dealers and investors; the corporate and mortgage-backed securities markets have been affected by concerns about call protection; the tax-exempt bond market has been buffeted by tax-reform discussions and mushrooming volumes; and mortgage lenders have been faced with huge volumes of loan applications, which may have contributed to the firmness of rates in that sector.

The narrower monetary aggregates continued to grow rapidly in May and June, with at least a considerable part of the growth apparently stemming from earlier declines in interest rates. M1 sailed farther above its target range for 1986. The expansion in M1, combined with strength in the more liquid retail accounts, contributed to brisk growth in M2. M3 growth remained relatively subdued as banks, experiencing continued weak credit demands, ran

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

	1984:Q4 to 1985:Q4	1986 Q1	1986 Q2pe	1986 Apr.	1986 May	1986 June pe	Growth from Q4 1985 to June 1986 pe
	------ Percentage change at annual rates ------						
1. M1	11.9	7.7	15-3/4	14.5	23.2	15	13
2. M2	8.6	4.3	10-1/4	13.8	11.9	9	7-3/4
3. M3	7.7	7.3	8-1/4	10.8	6.7	7	7-3/4
							Levels in billions of dollars May 1986
Selected components							
4. Currency	7.5	7.5	6-1/2	3.5	9.6	7	175.8
5. Demand deposits	8.6	3.0	15-1/2	11.0	25.7	15	281.6
6. Other checkable deposits	22.3	15.0	25-3/4	30.5	32.9	24	195.1
7. M2 minus M1[2]	7.6	3.2	8-1/4	13.6	8.2	7	1988.3
8. Overnight RPs and Eurodollars, NSA	18.9	3.6	-13-3/4	12.7	-9.0	-94	66.5
9. General purpose and broker/dealer money market mutual fund shares, NSA	9.3	10.9	27-3/4	33.5	12.5	27	193.4
10. Commercial banks	9.1	7.2	5-3/4	5.9	4.2	8	862.2
11. Savings deposits, SA, plus MMDAs, NSA[3]	19.0	8.7	13-1/4	13.6	15.5	22	477.4
12. Small time deposits	-0.6	5.3	-3-1/4	-3.4	-9.6	-10	384.8
13. Thrift institutions	5.1	4.3	7-1/4	8.9	6.0	7	877.9
14. Savings deposits, SA, plus MMDAs, NSA[3]	13.7	1.3	13-3/4	12.9	21.4	24	371.8
15. Small time deposits	-0.4	6.6	2-3/4	5.9	-5.0	-5	506.1
16. M3 minus M2[4]	3.8	19.5	1/2	-0.9	-13.7	-1	659.8
17. Large time deposits	5.7	15.5	-2	4.3	-15.4	-4	446.2
18. At commercial banks, net[5]	5.1	18.5	-9	0.0	-23.4	-6	281.4
19. At thrift institutions	6.8	10.0	11	11.8	-1.5	-1	164.7
20. Institution-only money market mutual fund shares, NSA	11.1	26.8	39-1/4	66.7	32.4	-17	76.1
21. Term RPs, NSA	-4.6	44.1	-8-3/4	-32.3	-5.2	-28	68.4
22. Term Eurodollars, NSA	-4.0	1.5	5	-19.1	-13.4	3	79.4
	— Average monthly change in billions of dollars —						
MEMORANDA:							
23. Managed liabilities at commercial banks (24+25)	2.3	7.7	-6	-8.7	-5.2	-5	470.5
24. Large time deposits, gross	1.0	3.4	-2-3/4	-0.8	-6.6	-1	340.3
25. Nondeposit funds	1.3	4.3	-3-1/4	-7.9	1.4	-4	130.2
26. Net due to related foreign institutions, NSA	0.3	2.4	-1-3/4	-6.9	4.2	-3	-22.2
27. Other[6]	1.0	2.0	-1-1/2	-1.0	-2.9	-1	152.4
28. U.S. government deposits at commercial banks[7]	0.2	-0.6	3/4	1.7	3.9	-4	21.3

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 May and June 1986 at rates of 21.8 percent and 21 percent, respectively. At thrift institutions, savings deposits excluding MMDAs increased during May and June 1986 at rates of 31.2 percent and 28 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.
pe--preliminary estimate

down their managed liabilities further. Both M2 and M3 remain near the midpoints of their 1986 target ranges.

The overall rate of debt expansion by domestic nonfinancial sectors picked up in the second quarter after a first-quarter deceleration. Much of the acceleration occurred in the federal government sector, as the Treasury borrowed more than needed to cover its deficit and boosted its cash balance. In the household sector, residential mortgage growth rebounded from the low first-quarter pace, even though heavy refinancing activity reportedly has continued to strain the ability of lenders to process real estate transactions; consumer installment credit expansion apparently has remained on a more moderate growth trajectory. Aggregate borrowing by nonfinancial businesses has stayed below last year's pace, with corporat. fund-raising concentrated in the bond markets. Despite a near record pace of new stock issues, net retirement of equity in the second quarter dropped only slightly, with merger and restructuring activity continuing strong. In municipal markets, state and local governments enlarged their offerings of public-purpose and refunding issues while private-purpose offerings remained weak.

Monetary Aggregates and Bank Credit

M1 accelerated sharply in May to about a 23 percent annual rate of growth, well above the brisk pace of March and April, and rose in June at about a 15 percent annual rate. The surge in May resulted from acceleration in demand deposits and continued strength in other checkable deposits (OCDs); in June, growth in both of these components moderated but remained quite robust. With nominal GNP growing slowly, the velocity of M1 likely declined at or at close to an unprecedented pace in the second quarter.

Much of the strength in M1 in recent months appears attributable to earlier declines in interest rates. In the case of OCDs, econometric work suggests that the rapid growth can be fairly well explained by the extraordinarily narrow spreads between OCD rates and those available on alternative assets. The surge in demand deposits seems less consistent with historical relationships, however. To shed more light on the growth of demand deposits, Board staff surveyed a small number of corporate cash managers and contacted officers of a number of banks that have been experiencing strong growth in these accounts over recent months.[1] A majority of the bank contacts indicated that much of the increase was in business demand deposits, and many attributed this behavior to increases in compensating balance requirements.[2] Some contacts suggested that heavy mortgage market activity also contributed to the growth.

M2 expansion in May and June also was strong, though somewhat below the advanced April pace. Paralleling the experience with OCDs, flows into money market deposit accounts and savings accounts picked up as the yield curve on retail deposits flattened. The May growth in passbook savings accounts, more than 27 percent at an annual rate, was the highest since the fall of 1982, just prior to the authorization of MMDAs; growth in June was almost as strong as in May. However, the small-time deposit component of M2, which had shown strength in the first quarter when deposit rates lagged declining long-term market rates, contracted in May and early June. Growth of money market mutual funds continued at a brisk pace, with most of the growth deriving from tax-exempt money funds.

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1. A summary of these conversations is contained in the appendix.
2. Firms often pay for the operational and credit services they receive from banks, at least in part, by holding demand deposit balances. When interest rates decline, firms must increase their balances to pay for the same level of services or they must pay more in fees.

Growth in M3 weakened in May, with appreciable declines in its non-M2 component, and remained moderate in June. After increasing rapidly earlier in the year, institution-only money fund assets slowed in May and contracted in June, and term repurchase agreements and Eurodollar deposits remained weak. Large time deposits declined at banks, apparently reflecting surges in retail and government deposits coupled with weak credit growth, while declines in large time deposits at thrifts may have reflected a shift toward other borrowings to finance asset growth.

Bank credit continued to advance slowly in May and June, owing in large measure to sluggish business loan demand and perhaps to some caution on grounds of credit quality and capital adequacy.[1] Consumer lending dropped off in June, leaving the second-quarter average well below that for the first quarter. Real estate loans picked up in May but moderated in June, and security loans continued to run off. Bank acquisitions of U.S. government securities jumped in May, evidently in association with trading activities, but these holdings contracted again in June. In contrast, holdings of other securities, particularly state and local government issues, rose in June after declining steadily since January.

Business Finance

Gross bond issuance by nonfinancial businesses, although substantially below April's hectic pace, nevertheless remained strong in May and June as companies continued to shed high-coupon debt and to lengthen the maturity of their liabilities. Shorter-term credit usage continued to languish in May and June; domestic plus foreign branch bank loans to businesses contracted

1. June estimates for bank credit are based on incomplete data, especially for small banks.

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

	1985 Q4	1986 Q1	Q2p	Apr.	May	Junep	Levels in bil. of dollars Junep
	Commercial Bank Credit						
1. Total loans and securities at banks	11.5	9.3	2.5	2.0	4.9	0.4	1956.6
2. Securities	19.9	2.0	2.8	-1.9	10.1	0.3	456.0
3. U.S. government securities	-3.5	-5.3	4.5	2.2	17.8	-6.6	272.5
4. Other securities	62.5	12.8	0.4	-7.9	-1.3	10.6	183.5
5. Total loans	8.9	11.6	2.4	3.2	3.4	0.5	1500.6
6. Business loans	5.3	4.6	1.0	4.0	-3.1	2.1	507.4
7. Security loans	4.0	101.7	-47.7	-57.3	-40.1	-51.8	44.3
8. Real estate loans	12.6	13.0	12.3	12.7	15.0	8.9	449.5
9. Consumer loans	8.5	11.0	4.9	6.4	6.4	2.0	303.2
10. Other loans	10.2	7.3	-7.2	-9.0	0.0	-12.7	196.2
	Short- and Intermediate-Term Business Credit						
11. Business loans net of bankers acceptances	6.0	5.2	-0.1	3.1	-4.3	1.0	502.2
12. Loans at foreign branches[2]	-16.5	2.2	-19.3	-12.8	-19.5	-26.4	17.8
13. Sum of lines 11 & 12	5.1	5.1	-0.7	2.5	-4.8	0.2	520.1
14. Commercial paper issued by nonfinancial firms[3]	55.5	-14.4	-7.5	-40.7	-2.9	21.8	83.9
15. Sums of lines 13 & 14	11.8	2.2	-1.6	-3.4	-4.6	3.2	604.0
16. Bankers acceptances: U.S. trade related[4,5]	-30.8	-6.2	n.a.	3.8	18.8	n.a.	32.5 (May)
17. Line 15 plus bankers acceptances: U.S. trade related	9.5	1.8	n.a.	-3.2	-3.4	n.a.	634.9 (May)
18. Finance company loans to business[4]	19.2	16.4	n.a.	11.5	n.a.	n.a.	158.5 (Apr)
19. Total short- and intermediate-term business credit (sum of lines 17 & 18)	11.3	4.6	n.a.	-0.5	n.a.	n.a.	795.2 (Apr)

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.
Note: Data in this table have been revised since the last Greenbook, reflecting benchmark and seasonal factor revisions in the bank credit series.

over the two months, and outstanding commercial paper of nonfinancial businesses was up only moderately in June after a small run-off in May.

The volume of bond offerings in the second quarter by U.S. firms--both financial and nonfinancial--slightly exceeded the high first-quarter total. Gross borrowing by nonfinancial firms was especially heavy, and almost 95 percent of their offerings carried maturities of 10 years or more. Debt offerings by financial corporations dropped in May--as captive auto finance companies cut back their issuance after borrowing heavily early in the year--but rebounded in June. Offerings by banks jumped to $2 billion in June, with half the total in the form of variable coupon renewable notes ("VCRs").[1]

A relatively high proportion of recent corporate issues have been below investment grade. Many of these bonds were merger-related, including several issues by firms intending to pay down bank loans and retire other debt incurred in connection with prior acquisitions. The volume of equity-based debt has been large, with issuers taking advantage of a strong stock market to lower the cost of financing, although such offerings appear to have edged down in June.

With broad stock price indexes setting new records in May and June, equity issuance surged. Offerings in May climbed to $6.3 billion, the largest monthly volume this year, and continued strong in June. Thus far in 1986, corporations have raised, gross, almost $30 billion in equity markets, a pace that, if continued, would exceed the previous record volume

1. Variable coupon renewable notes are floating rate instruments that can be extended by the holder for three months at a time, but the decision to extend must be made a year in advance. In return for extending the note, the holder gets a yield premium for the next quarter.

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

	1985	1985	1986				
	Year	Q4	Q1	Q2p	Apr.p	May p	June p
Corporate securities - total[1]	16.09	19.29	27.77	29.34	39.91	21.10	27.00
Public offerings in U.S.	12.94	14.86	23.75	25.15	32.56	18.90	24.00
Stocks—total[2]	2.96	3.32	4.46	5.56	5.39	6.30	5.00
Nonfinancial	1.61	1.81	2.20	3.28	2.63	3.80	3.40
Utility	.37	.38	.65	.40	.35	.65	.20
Industrial	1.24	1.43	1.55	2.88	2.28	3.15	3.20
Financial	1.35	1.51	2.26	2.28	2.76	2.50	1.60
Bonds—total[1]	9.98	11.54	19.29	19.59	27.17	12.60	19.00
Nonfinancial	5.21	6.04	10.00	11.84	17.62	8.50	9.40
Utility	1.51	2.28	3.31	4.34	7.06	2.85	3.10
Industrial	3.70	3.76	6.69	7.50	10.56	5.65	6.30
Financial	4.77	5.50	9.29	7.75	9.55	4.10	9.60
By quality[3]							
Aaa and Aa	2.35	2.67	5.35	6.00	8.85	2.45	6.70
A and Baa	4.58	5.20	7.73	5.45	9.09	3.75	3.50
Less than Baa	1.42	1.72	2.74	4.50	5.76	3.75	4.00
No rating (or unknown)	.34	.39	.31	.54	.28	.55	.80
Memo items:							
Equity-based bonds[4]	.70	.38	1.18	1.25	1.73	1.29	.72
Mortgage-backed bonds	1.30	1.56	3.16	3.10	3.19	2.10	4.00
Variable-rate notes	.87	.54	.24	.43	.15	.00	1.13
Bonds sold abroad - total	3.15	4.43	4.02	4.18	7.35	2.20	3.00
Nonfinancial	1.26	1.73	2.04	2.01	4.04	1.39	.60
Financial	1.89	2.70	1.98	2.17	3.31	.81	2.40

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.

of 1983. Among those attracted to equity markets were numerous businesses issuing public shares for the first time; approximately 120 initial public offerings (IPOs) have reached the market since April. Some of the IPOs were traditional start-ups, but others, like the $1.2 billion Henley Group deal, were part of ongoing restructurings of corporate assets.[1] The Henley offering boosted the dollar volume of IPOs to a record $2.4 billion in May, or 40 percent of total equity issuance for the month. Despite the heavy volume of new equity issues, offerings by nonfinancial firms in the second quarter still were swamped by stock retirements resulting from mergers and restructurings. And, owing in part to the completion of the big GE-RCA merger in June, net retirements of equity likely were nearly as large in the second quarter as in the first.

Corporate bond yields are about unchanged since the May FOMC and up about 40 basis points from their mid-April lows. The spread between yields on recent offerings of A-rated utilities and 30-year Treasuries widened dramatically in the early spring as the volume of new corporate issues grew. More recently this spread expanded further despite some reduction in corporate volume, and it now exceeds 200 basis points. Part of the continuing wide spread between corporate and Treasury yields may be related to changed evaluations by investors of the limited call protection in corporate debt issues; recent calls have heightened awareness of the flexibility companies have to retire even "nonrefundable" bonds. To a large extent, the explanation may lie with special factors affecting the

1. The Henley Group is a collection of companies being spun off by Allied-Signal Corporation. After its merger last year, Allied-Signal restructured operations and chose this method of divesting itself of these less profitable units.

TREASURY AND AGENCY FINANCING[1]
(Total for period; billions of dollars)

	1986				
	Q1	Q2p	Apr.	May	Junep
Treasury financing					
Combined surplus/deficit(-)	-61.2	-25.4	9.9	-39.4	4.1
Means of financing deficit:					
Net cash borrowing from the public	37.1	50.8	14.3	18.0	18.5
Marketable borrowings/ repayments(-)	35.3	39.7	9.0	14.5	16.2
Bills	-6.7	3.6	.5	1.2	1.9
Coupons	42.0	36.1	8.5	13.3	14.3
Nonmarketable	1.8	11.1	5.3	3.5	2.3
Decrease in the cash balance	18.7	-12.4	-22.2	21.6	-11.8
Memo: Cash balance at end of period	12.2	24.6	34.4	12.8	24.6
Other[2]	5.4	-13.0	-2.0	-.2	-10.8
Federally sponsored credit agencies, net cash borrowing[3,4]	-1.8	5.7	2.0	2.3	1.4
FHLBs	.3	7.1	1.8	2.3	3.0
FNMA	-1.5	-.3	.0	.2	-.5
Farm Credit Banks	-2.9	-2.4	-.7	-.6	-1.1
FHLMC	1.2	.5	.2	.2	.1
SLMA	1.1	.8	.7	.2	-.1

p--preliminary
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.
4. Second quarter numbers are based on both preliminary and forecasted data.

behavior of yields on newly issued Treasury securities, discussed below. Deteriorating debt quality does not appear to be a major factor; one indication is that spreads between corporate securities of differing credit quality have not widened appreciably.

Treasury and Sponsored Agency Financing

The combined (on- and off-budget) federal deficit for the second quarter appears to have been about $25 billion. Net Treasury borrowing totaled roughly $50 billion for the quarter, however, which produced a cash balance increase of about $12 billion. Nonmarketable borrowing amounted to $11 billion, most of it special issues for state and local governments (SLGS) purchased with proceeds from the sizable volume of municipal refunding issues sold during the quarter. In addition, the net change in savings bonds was running nearly $1 billion a month in the second quarter, up from an average of $500 million per month for 1985 and early 1986.[1] As in previous quarters, the Treasury concentrated its marketable borrowing in coupon securities, although recently the size of the regular weekly 3- and 6-month bill auctions was increased.

Over the course of the intermeeting period, large disparities have emerged among market yields on Treasury coupon issues. Long-term issues sold in the past few months are in very heavy demand, and, consequently, their yields in the secondary market are much lower than those on earlier issues of roughly comparable, or even somewhat shorter, maturities. Some yield concession is normally made by investors in current issues in periods of overall rate declines because the new securities are the most heavily

1. The Treasury has indicated that it is reviewing the floor rate (currently 7-1/2 percent) on its series EE bonds.

traded and liquid, and low-coupon issues are preferred to high-coupon issues for technical reasons.[1] However, current spreads are much wider than typical, perhaps owing to heavy foreign demand for the recent issues and a dearth of alternative low-coupon issues. In addition, special problems developed with the trading in one particular issue, the 30-year bond auctioned last February. The issue was widely sold short by dealers who anticipated, incorrectly, that the price of the bond would fall when the May bond was auctioned. Problems in finding adequate supply to cover the short positions led to a number of delivery failures and increases in prices.

Borrowing by federally sponsored credit agencies was boosted in the second quarter by the heavy bond issuance of the Federal Home Loan Banks (FHLBs). As the volume of FHLB issues increased, the spread between yields on these securities and comparable 7- to 10-year Treasury bonds widened to about 60 basis points from the typical spread of around 30 basis points. Part of this increase may reflect investor concerns about the role the FHLBs will play in meeting the funding needs of the Federal Savings and Loan Insurance Corporation if a proposed recapitalization plan is approved by the Congress.

Tax-Exempt Markets

Issuance of tax-exempt securities rebounded in the second quarter from the low first-quarter pace. Long-term offerings in June appear to have totaled about $12 billion, near the average for the quarter as a whole, and a large volume in comparison with periods prior to mid-1985.

1. Some companies may prefer not to hold securities that trade at a premium because standard accounting practices force them to show the premium as a loss on their books. These companies are concerned that some shareholders may not be able to see through this accounting illusion.

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

	1985 Year	1985 Q4	1986 Q1	1986 Q2p	1986 Apr.	1986 Mayp	1986 Junep
Total	19.82	37.69	4.79	14.51	15.74	12.00	15.80
Short-term[1]	1.97	.91	.64	2.58	3.83	.21	3.70
Long-term	17.85	36.78	4.15	11.93	11.91	11.79	12.10
Refundings[2]	4.84	9.40	2.34	4.55	5.51	4.94	3.20
New capital	13.00	27.38	1.95	7.38	6.40	6.85	8.90
Total housing	2.11	2.64	0.0	.39	.20	.09	.88
Single-family[3]	.98	.99	0.0	.38	.20	.09	.86

p--preliminary.
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.

The bulk of recent offerings in the long-term market has been for public purposes. Indeed, general obligation bonds accounted for more than half of the volume in the second quarter, compared with around 25 percent in recent years; such financings accelerated in the spring after public officials agreed to make changes in the House tax reform bill (H.R. 3838) to postpone the effective date for restrictions on public-purpose bonds to September 1 or enactment, whichever came first. Several recent general obligation offerings have been sold to raise funds for projects, such as mass transit, that could lose their tax-exempt status under tax reform. The market apparently has continued to react to the proposed constraints in H.R. 3838, which are in many respects more restrictive than those in the Senate proposal.

Recent economic problems faced by states dependent on revenues derived from energy, timber, mining, and agricultural sources were the basis for several debt downgradings during the second quarter. General obligation debt issues of Texas, Louisiana, and North Dakota were downgraded.

In contrast, New York, New Hampshire, Michigan, as well as the cities of Detroit, San Diego, and Columbus, received upgradings on their GO debt in recent months, largely reflecting improved fiscal positions.

Rates on municipal bonds advanced sharply through mid-June and then retreated a bit; at the end of June the Bond Buyer revenue bond index was 14 basis points higher than at the time of the May FOMC meeting. Investors have required historically high yields relative to yields on other long-term bonds, in part in response to the heavy supply of tax-exempt securities coupled with continued investor wariness about possible tax reform. Individuals have been concerned about the eventual tax status of some bonds issued this year and about their own future tax status. Banks and insurance companies also have been hesitant about purchasing municipals in part because of concern about the eventual form of the alternative minimum tax under tax reform.

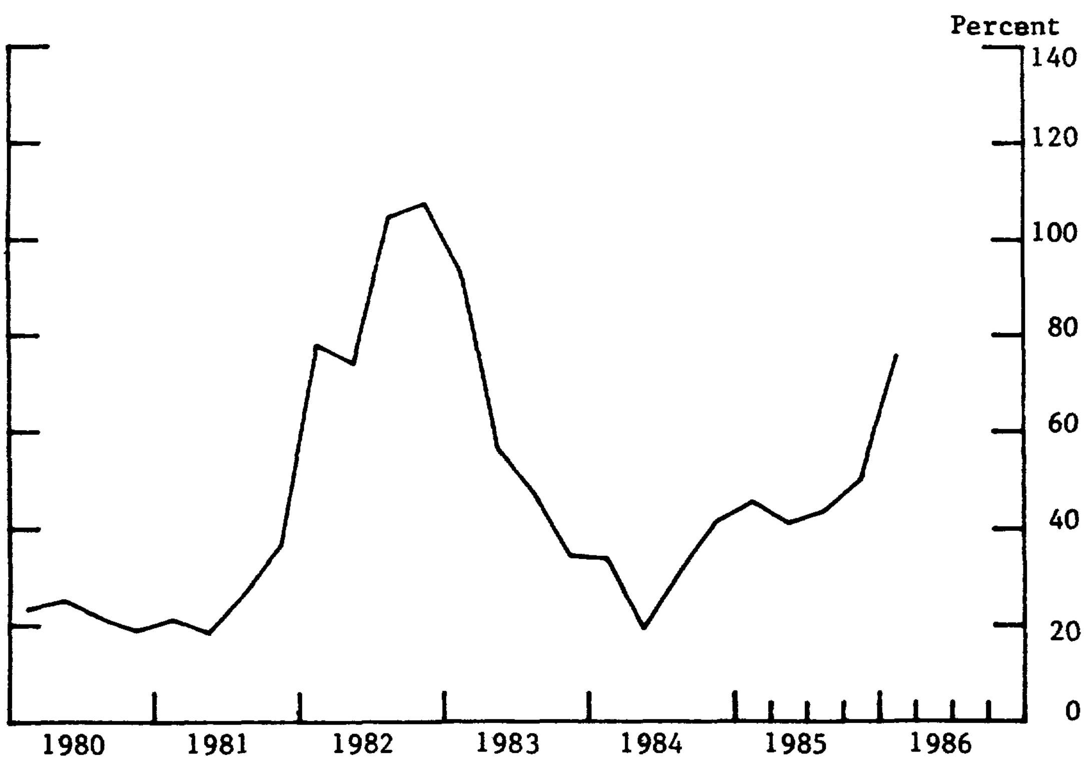
Residential Mortgage Markets

Residental mortgage lending picked up sharply in the second quarter, according to available indicators. The vigorous pace of residential construction, a large volume of home sales, and a spate of refinancings have all contributed to a boom in loan originations. Thrift institutions originated a greater volume of mortgages in April and May than in any previous two-month period.

The recent flood of new issues of mortgage pass-through securities is a further indication of the increase in gross mortgage lending. Gross issuance in May rose to a record for the third consecutive month and continued torrid through the first three weeks of June. Federally sponsored pass-throughs are accounting for a large share of total growth in mortgage debt this year, judging from first-quarter estimates and the pickup in issuance since then. In part, the increase in the pool share reflects borrowers' shift toward fixed-rate mortgage credit, which is more readily securitized.

In the primary market, originations of FHA-insured and VA-guaranteed home mortgages rose sharply in May. In early June, however, FHA's insurance authority expired, limiting FHA loan closings to applications already processed, and by mid-June the agency had reached its $74.4 billion credit ceiling. Some borrowers reportedly have been diverted to the conventional market, despite the less attractive terms on high loan-to-value mortgages. On June 25, the Congress passed legislation enabling the FHA to resume operations; the legislation extended FHA authority through September 30,

EXPANSION OF FEDERALLY SPONSORED MORTGAGE POOLS
AS SHARE OF RESIDENTIAL MORTGAGE DEBT GROWTH



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

Period	Total	GNMAs	FHLMCs	FNMAs	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	11.8	5.2	3.9	2.7	4.9
1986-Q1 r	12.6	5.1	4.4	3.1	5.3
1985-Oct.	11.1	5.8	3.1	2.2	3.8
Nov.	11.2	5.3	3.4	2.5	4.3
Dec.	13.2	4.5	5.3	3.4	6.7
1986-Jan.	12.3	5.3	3.0	4.0	5.4
Feb. r	12.3	5.0	4.3	3.0	6.0
Mar. r	13.2	5.1	5.9	2.3	4.5
Apr. r	14.9	6.9	5.1	2.8	5.7
May p	19.4	5.9	9.0	4.5	9.0

p--preliminary. r--revised.

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

	Mortgage transactions		Net change in mortgage assets[1]		
	Originations (1)	Sales (2)	Total (3)	Mortgage loans (4)	Mortgage-backed securities (5)
1985-July	14.9	10.6	2.4	4.7	-2.3
Aug.	16.0	7.9	6.6	5.1	1.5
Sept.	17.0	10.0	9.5	4.0	5.5
Oct. r	19.5	8.2	5.5	6.2	-.7
Nov.	18.6	13.1	3.4	3.1	.3
Dec. r	20.2	8.3	5.5	4.8	.7
1986-Jan. r	18.4	11.1	5.0	3.0	2.0
Feb. r	17.8	10.9	3.1	2.2	.9
Mar. r	16.4	12.4	3.4	3.1	.3
Apr. r	19.6	13.0	6.0	1.6	4.4
May p	19.9	16.5	7.9	1.3	6.7

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

although the $9.5 billion increase in lending authority is likely to be exhausted well before that date.

Refinancings continue to strain the mortgage processing pipeline in both the federally insured and conventional markets and have lengthened the time between commitment and loan closing. In May, 39 percent of all commitments made for FHA home loans on existing properties were for refinancing, compared with an average of 25 percent in the first quarter.

The cost of fixed-rate mortgage credit moved up nearly 75 basis points between the last FOMC and early June but has since backed down; as of June 27, the average contract interest rate on fixed-rate loans at savings and loans was 10.6 percent, up about one-half percentage point on balance over the intermeeting period. Spreads of mortgage rates over rates on Treasury securities of comparable maturity have remained unusually wide in recent weeks, reflecting the strong demand for mortgage credit and heightened investor concern regarding prepayment risk, as well as possible distortions in the Treasury market.

Consumer Installment Credit

Growth in consumer installment credit appears to have picked up a bit in April and May, but current growth rates remain substantially below those of last year. A stepup in new car sales apparently buoyed auto credit in May; sales continue to be supported by attractive interest rates offered through captive auto finance companies.

Interest rates on consumer loans at banks have declined considerably in recent months, with the exception of rates on credit cards, which have edged down only about 50 basis points over the last year. Although earnings on credit card portfolios have outstripped those on other banking activities

CONSUMER INSTALLMENT CREDIT

	1984	1985	1985 Q4	1986 Q1	1986 Mar.r	1986 Apr.p	1986 May e
	-------- Percent rate of growth, SAAR --------						
Change in outstandings--total	20.6	18.0	14.5	11.8	6.8	9.4	10.8
By type:							
Automobile credit	18.7	19.3	15.8	15.3	5.7	4.9	12.8
Revolving credit	25.7	20.1	15.6	13.0	14.0	12.9	9.0
All other[1]	19.7	15.6	12.6	7.9	3.7	11.8	10.0
	--------- Billions of dollars, SAAR ---------						
Change in outstandings--total	77.3	81.5	74.7	63.4	37.0	51.6	60.2
By type:							
Automobile credit	27.2	33.4	31.3	31.5	12.2	10.5	27.5
Revolving credit	20.1	19.8	17.8	15.3	16.9	15.7	11.1
All other[1]	30.0	28.4	25.6	16.5	7.9	25.3	21.6
By major holder:							
Commercial banks	39.8	31.6	29.0	17.5	4.9	27.9	8.4
Finance companies	10.0	24.0	20.7	29.3	17.1	8.8	25.5
All other	27.6	25.9	25.0	16.6	15.1	14.9	26.3
	---------- Annual percentage rate ----------						
Interest rates							
At commercial banks[2]							
New cars, 48 mos.	13.71	12.91	12.39	12.29	n.a.	n.a.	11.45
Personal, 24 mos.	16.47	15.94	15.61	15.52	n.a.	n.a.	14.89
Credit cards	18.77	18.70	18.57	18.48	n.a.	n.a.	18.32
At auto finance companies[3]							
New cars	14.62	11.98	11.40	10.07	10.51	10.55	9.49
Used cars	17.85	17.59	17.24	16.66	16.63	16.67	16.56

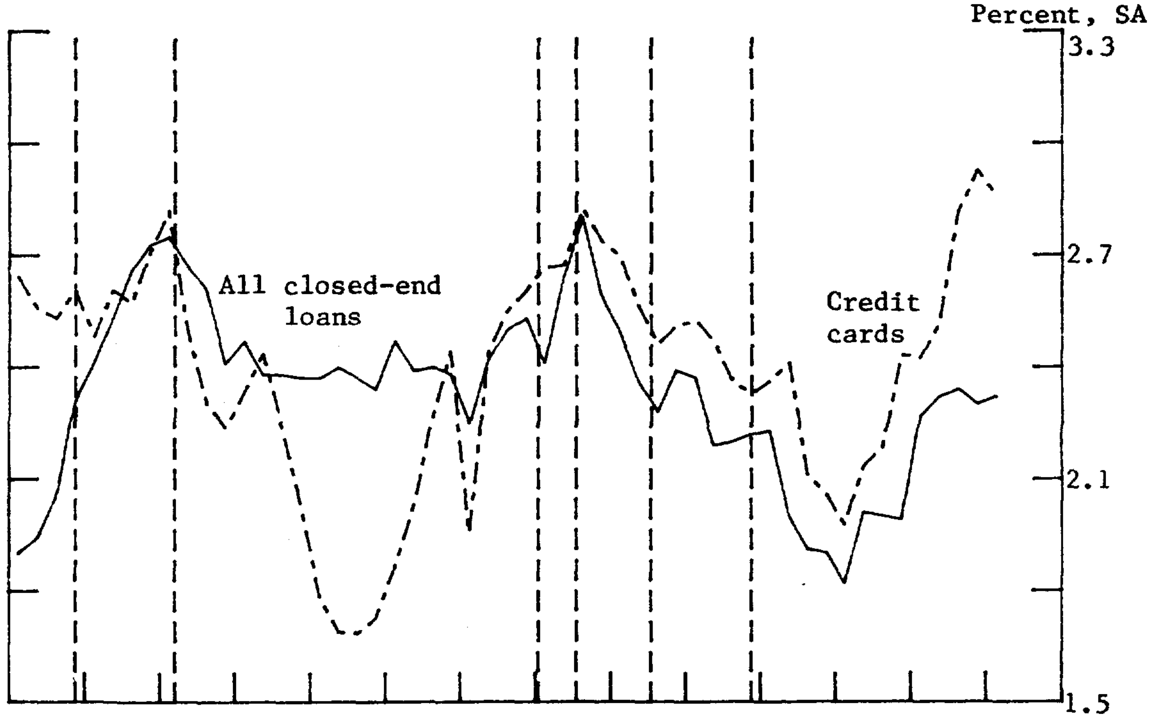
1. Includes primarily personal cash loans, home improvement loans, mobile home loans, and sales finance contracts for non-automotive consumer durable goods.
2. Average of "most common" rates charged, on loans of specified type and maturity, during the first week in the middle month of each quarter.
3. Average rate for all loans of each type made during the period, regardless of maturity.
n.a.--not available.
r--revised.
p--preliminary.
e--estimated.

in the past year and a half, card issuers generally have been reluctant to reduce rates. This reluctance is due in part to various regulatory and administrative requirements (concerning notification and phase-in of rate changes) that would hamper the implementation of possible rate increases in the future. And card receivables have been growing rapidly despite the 18 to 21 percent finance charges, providing little incentive to cut rates. For whatever reason, however, price competition seems to have heated up and rate reductions have appeared more frequently in recent weeks.

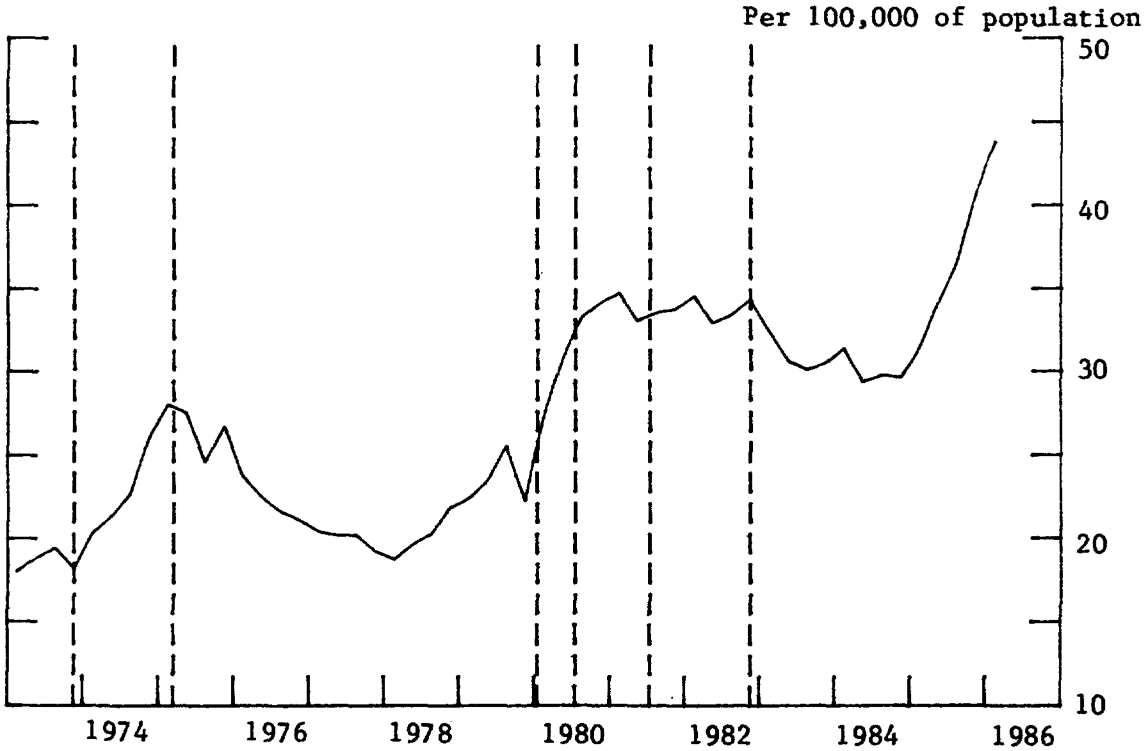
Some loan delinquency measures suggest that consumers increasingly are having difficulty making timely payments on the sizable debt load accumulated in the past few years. Mortgage delinquency rates, which have been high during much of the expansion period, are at or near their peaks; recent increases in mortgage delinquencies in the southwest offset declines in the northeast and elsewhere. Delinquencies on bank credit cards (see chart on page III-20) have surged in the past two years, partly as a consequence of very aggressive marketing policies. They soared to a new high at the end of 1985, before edging down slightly in the first quarter of 1986. Delinquency rates on other types of consumer loans at banks have risen more moderately and are currently about in the middle of their range of the past dozen years.

Perhaps the most striking indication of household financial difficulty is the very sharp uptrend in personal bankruptcy cases since early last year. The number of filings rose 20 percent in 1985 and grew more than 30 percent (annual rate) in the first quarter of this year. Only a small part of the surge in personal bankruptcies can be attributed to areas with unusually depressed economies. Personal bankruptcies in farm states have

DELINQUENCY RATES ON CONSUMER LOANS AT BANKS



NUMBER OF PERSONAL BANKRUPTCIES



risen no more than the average this year.[1] Bankruptcies in oil-dependent states have risen at a higher-than-average rate, but the impact has been to raise the overall annual rate of increase by only about 3 percentage points in 1986.

1. Bankruptcies of farmers are generally classified as business bankruptcies.

APPENDIX A*

THE RECENT SURGE IN DEMAND DEPOSITS: RESULTS OF STAFF INTERVIEWS WITH BANKERS AND CASH MANAGERS

M1 growth has been exceptionally rapid since February, reflecting a surge in its demand deposit and OCD components. The growth in OCDs may well be consistent with recent large reductions in the opportunity cost of holding these deposits. This cost, measured as the spread between rates on short-term market instruments or small time deposits and rates on NOW accounts, has dropped to a level not previously experienced. The growth in demand deposits, however, appears to exceed that which could be expected on the basis of historical relationships with output and interest rates.

In an effort to obtain additional information on the factors influencing the recent growth in demand deposits, Board staff members held telephone conversations in mid-June with officers of 49 large- and medium-sized commercial banks that, based on their weekly deposit reports, experienced large increases in demand deposits over the February to May period. Four-fifths of the banks contacted stated that growth in their demand deposits occurred mainly in business accounts and about half of these banks attributed this to higher compensating balances resulting from lower interest rates (see table). A number of bankers also thought businesses were managing transactions accounts less carefully because of the lower yield on short-term investments. An informal Board staff survey of nine cash managers generally reinforced the conclusions drawn from the conversations with bankers.

Although there has been a trend away from compensating balances in favor of explicit pricing of loans and payment for bank services with fees, compensating balances at banks other than money center banks apparently remain widespread and are a significant component of changes in demand deposits. As interest rates fall, the earnings credit rate (i.e., the remuneration per dollar of demand balances) declines, resulting in increased required balances for compensation purposes. In addition, the absolute difference between the market interest rate and the earnings credit rate--which reflects the cost of reserve requirements and determines the opportunity cost of holding these balances--has declined as interest rates have fallen.

While lower interest rates have reduced the incentive to minimize demand balances, nothing in the conversations with bankers or cash managers suggested that the decline in interest rates has induced firms to abandon cash management operations. Indeed, some smaller firms contacted happened to be upgrading their cash management techniques. A few bank officers did suspect that some firms may be managing their balances more conservatively in the wake of publicity about the E.F. Hutton incident. The implementation of daylight overdraft restrictions, however, does not appear to have affected business balances.

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* Prepared by Laurence Kantor and Patrick Mahoney, Economists, Banking Section, Division of Research and Statistics.

Increased financial transactions also appear to have boosted demand deposit balances; more than one-third of the banks contacted attributed part of their demand deposit growth to accelerated real estate and mortgage financing activity. A Board staff study of the effects of mortgage financing estimates that an increase in such activity may have contributed importantly to the pick-up in demand deposit growth over the March to June period, with the largest effects coming from idle balances held during settlement transactions and prepayments of mortgages underlying pass-through securities. In addition, a few cash managers indicated that their firms were holding higher balances because of ongoing corporate refinancing. However, only a few banks cited other primary and secondary market security transactions as a factor in the increase in demand deposits.

Growth in consumer accounts also appears to have contributed to the increase in demand deposits over the February to May period. About one-third of the banks contacted cited increases in these accounts and attributed it mainly to less careful cash management by consumers. A few institutions also indicated that funds from maturing retail CDs were being held, at least temporarily, in demand accounts in light of lower opportunity costs. Few of the banks contacted had changed their fees or minimum balance requirements on consumer demand accounts.

The responses from both bank officials and cash managers are quite similar to those obtained from conversations held last year. It should be noted, however, that in both years the sample of banks was biased toward larger institutions, which are more likely to have deposit bases dominated by business accounts. Another factor that may have contributed to the finding that business deposits were again the primary component of demand deposit strength is that business accounts tend to be larger than consumer accounts, and hence their fluctuations are more likely to be noticed. Some respondents in both this and last year's surveys did not know why their demand deposits had risen so rapidly, and in other cases the increase in deposits resulted from factors that clearly applied only to a specific institution or geographic market. Finally, the bankers who could only speculate on the cause of the rapid increase in demand deposits frequently cited lower interest rates or some associated factor when pressed for an explanation.

In sum, the results suggest strongly that lower interest rates are the dominant factor in explaining the surge in demand deposits. Bankers attributed the increases in their demand deposits primarily to business accounts, which were boosted by additions to compensating balances and by less aggressive cash management practices. In addition to the usual impact of lower interest rates on demand deposit balances, the rise in mortgage financing activity appears to have been an important factor in the increase in demand deposits over recent months.

Table 1

SUMMARY OF FACTORS CITED BY COMMERCIAL BANK OFFICERS AS CONTRIBUTING TO DEMAND DEPOSIT GROWTH FROM FEBRUARY TO MAY
(49 banks contacted)

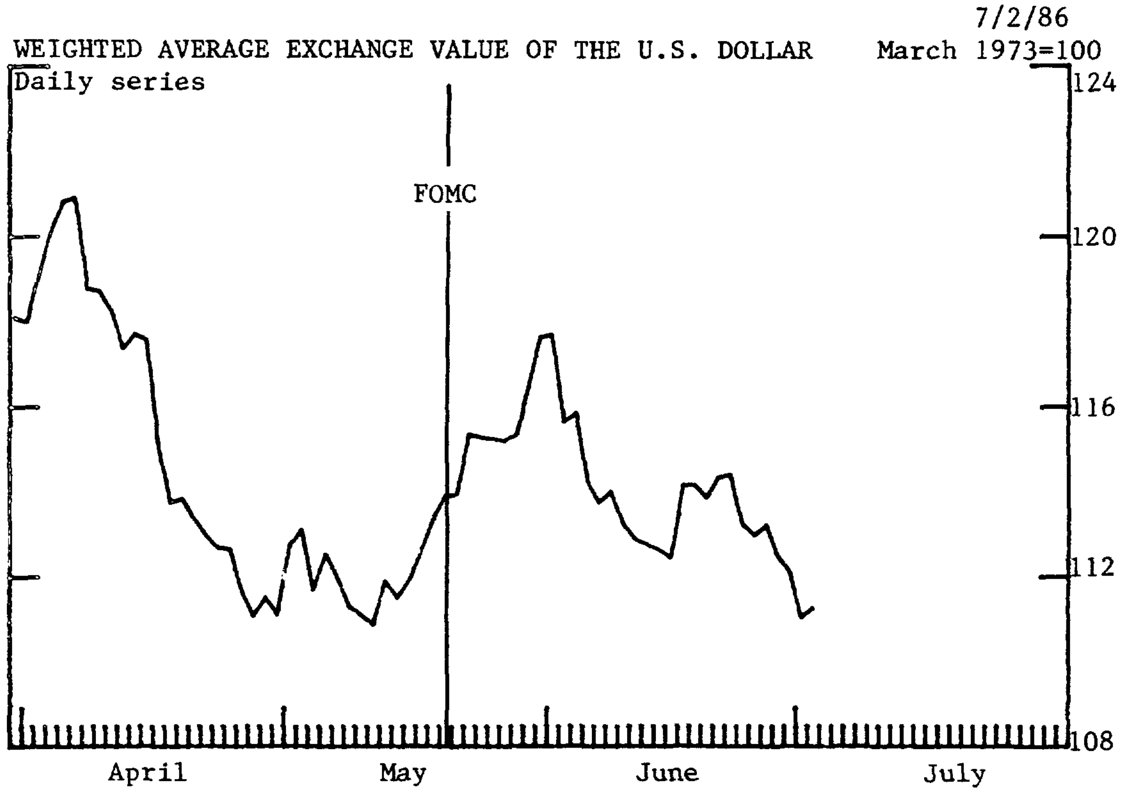
Item	Number citing
Business accounts	41
Consumer accounts	17
Municipal accounts	5
Compensating balances	19
Real estate/mortgage activity	19
Mutual fund or securities activity	6

Foreign Exchange Markets

The weighted-average foreign exchange value of the dollar has declined 2-1/4 percent on balance since the last FOMC meeting, as shown in the chart. In the first two weeks of the intermeeting period, the dollar appreciated 3-1/4 percent in continued reaction to official statements suggesting the desirability of a consolidation of exchange rates around prevailing levels, and in response to data indicating a possible pickup in U.S. economic activity. The dollar subsequently declined, however, as additional data on U.S. economic performance disappointed market expectations, and as Japanese and German authorities expressed continued reluctance to foster lower interest rates in the near term.

U.S. interest rates declined relative to comparable Japanese and German interest rates on balance over the intermeeting period. Nevertheless, the differential between U.S. and weighted-average foreign interest rates in the short end of the maturity spectrum remained little changed as official interest rates were again reduced by several countries with relatively high interest rates. The Bank of England cut its money-market dealing rates another 1/2 percentage point, and major U.K. clearing banks reduced their base lending rates by that amount to 10 percent. The bank of Italy cut its discount rate another 1 percentage point to 12 percent. Belgian authorities lowered both their discount and Lombard rates a further 1/2 percentage point to 8 and 8-1/4 percent, respectively. The Bank of France dropped its

Chart 1


7/2/86
WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR
March 1973=100
Daily series
FOMC
124
120
116
112
108
April
May
June
July

money-market intervention rate 1/4 percentage point further to 7 percent. In contrast, Swiss interest rates rose sharply as strong seasonal demands for liquidity ran up against continued monetary restraint by Swiss authorities in a context of healthy recovery and high employment.

Bilateral exchange rate movements in part reflected these differences in monetary policies; over the intermeeting period, the dollar depreciated only 1-3/4 percent in terms of sterling but registered its largest bilateral movement, a 4-3/4 percent decline, vis-a-vis the Swiss franc. The dollar depreciated somewhat more against the yen (3-1/4 percent) than against the mark (2-1/2 percent), as the persistence of large U.S. trade deficits revived market participants' expectations that a possible further official effort to lower the dollar's value would be directed particularly at the dollar/yen exchange rate. The dollar appreciated 3/4 percent in terms of its Canadian counterpart, which was depressed by data showing a deterioration in Canada's current account balance and by U.S. moves to discourage imports of Canadian wood products.

; in the April 6 EMS realignment, the krone was revalued 1 percent, and its parity level and intervention limits vis-a-vis the French franc (which was devalued 3 percent) effectively were raised 4 percent, contributing to the recent difficulties.

U.S. bank lending to foreigners in the first quarter. U.S.-chartered banks' claims on foreigners declined $1 billion, in nominal terms, in the first quarter of 1986. However, the weighted average exchange rate of the dollar declined a further 4-1/2 percent during the quarter, and after adjustment for this decline the banks' foreign claims decreased about $6 billion. From the end of 1984 to the end of March 1986, U.S. banks' claims on foreigners fell by about $33 billion, or 8 percent, on an exchange-rate adjusted basis, while in nominal terms the drop was only $12-1/2 billion.

In the first quarter, claims on non-OPEC developing countries (not adjusted for exchange rate changes) were reduced by $1.9 billion, about in line with the 1985 quarterly average. Write-offs of claims on these countries may have continued at about last year's rate, estimated at about $1 billion for the year. The only changes in the first quarter greater than $0.2 billion were declines in claims on Colombia ($0.4 billion) and Israel ($0.3 billion). Claims on Mexico fell $0.2 billion; revised data for September and December 1985 now show a drop in the second half of last year of $1.2 billion in claims on Mexico, rather than the $0.3 billion decline reported earlier for that period. Changes in claims on other country groups in the first quarter were generally small and tended to offset one another.

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

	1984	1985			1986	Outstanding
	Year	Year	Q-3	Q-4	Q-1	3/31/86
Total, all countries	-28.0	-11.5	-2.0	-0.1	-1.0	395.9
Non-OPEC developing countries of which:	0.9	-6.7	-2.2	-2.7	-1.9	103.6
(Latin America)	2.1	-3.2	-2.4	0.1	-0.5	73.0
(Asia and Africa)	-1.2	-3.5	0.2	-2.8	-1.4	30.6
OPEC countries	-3.5	-3.5	0.1	-1.3	-1.1	20.7
Eastern Europe	-0.9	-0.2	0.3	-0.4	-0.2	4.0
Smaller developed countries	-2.3	-3.3	-0.3	-1.7	1.1	31.6
G-10 countries	-19.7	2.4	4.9	-1.0	6.4	156.9
Offshore banking centers	-3.5	0.5	-4.7	6.9	-4.6	62.6
Miscellaneous	0.5	-0.3	0.3	-0.4	-0.7	16.5

U.S. International Financial Transactions

Data for April on U.S. international capital flows indicate that the current account deficit continued to be financed to a significant degree by private foreign purchases of U.S. securities. Official net capital inflows were also large in April, while banking offices in the United States recorded a net capital outflow, partially reversing the inflow recorded in the first quarter.

Net private foreign purchases of U.S. corporate securities totaled $8.6 billion in April. Net foreign purchases of U.S. corporate stocks represented $3.6 billion of this total, bringing total foreign net stock purchases for the first four months of 1986 to $9.7 billion. (Line 2b of the Summary Table.) That is nearly twice the value recorded for all of 1985.

Private foreign net purchases of U.S. corporate bonds were strong again in April totaling $5 billion (line 2a of the Summary Table). This reflects the continuing efforts of U.S. corporations to lengthen the maturity structure of their liabilities by heavy issuance of longer-term debt in both the domestic market and the Euromarkets.

Debt issues denominated in foreign currencies continued to be attractive in April. Over 28 percent of total U.S. corporate debt issuance in the Euromarket was denominated in currencies other than the dollar, primarily yen and Swiss francs. Swaps were coupled with a large portion of these issues to hedge the issuer against the risks of foreign currency exposure.

In 1986 U.S. corporations have also begun to offer bond issues denominated in foreign currencies in the U.S. market. Over $1.5 billion have been issued in the first five months of the year. Most were denominated in Australian or New Zealand dollars and issued by bank holding companies. They reportedly have been purchased by high risk bond funds and institutional investors who were attracted by the high coupon yield offered on these instruments.

Foreign net purchases of U.S. Treasury securities also increased moderately in April. (Summary Table line 3.) Japanese purchases, which accounted for 75 percent of the $2.6 billion April total, rebounded from a low first quarter value, but remained somewhat below the record levels which were reached in 1985. Almost all of the Japanese purchases in April were of long-term instruments.

Foreign official reserve assets in the United States increased by nearly $8 billion in April (Summary Table line 4.) This increase was primarily concentrated in the G-10 countries and appears to have been associated with widespread net intervention purchases of dollars. Data for May indicates that foreign official holdings at the Federal Reserve Bank of New York increased slightly.

Data on first quarter balance of payments flows that was recently released by the Commerce Department indicates that U.S. direct investment abroad increased by $10.1 billion in the first quarter. (See Summary Table line 6.) This net outflow includes $2 billion to Netherlands Antilles finance affiliates of U.S. corporations that reflected in part the calling of high-interest Eurobonds that had been issued through these affiliates before July of 1984 when the Tax Reform Act of 1984 diminished the incentives for corporations to issue Eurobonds through offshore finance subsidiaries rather than through their domestic offices.

Another factor contributing to the large recorded increase in the U.S. direct investment abroad was the inflation of reinvested earnings by unrealized currency translation capital gains as a result of the depreciation of the dollar in recent months.

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

	1984 Year	1985 Year	1985 Q2	1985 Q3	1985 Q4	1986 Q1	1986 Feb.	1986 Mar.	1986 Apr.
Private Capital									
Banks									
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	20.6	31.3	-0.2	11.5	5.2	11.2	1.6	-0.8	-6.2
Securities									
2. Private securities transactions, net	7.7	42.9	4.9	10.0	21.1	12.7	4.4	3.4	5.9
a) foreign net purchases (+) of U.S. corporate bonds	13.7	46.0	6.7	10.3	18.4	12.7	4.4	5.1	5.0
b) foreign net purchases (+) of U.S. corporate stocks	-0.9	4.9	0.5	1.4	4.1	6.1	1.8	2.8	3.6
c) U.S. net purchases (-) of foreign securities	-5.0	-8.0	-2.3	-1.6	-1.4	-6.1	-1.7	-4.4	-2.7
3. Foreign net purchases (+) of U.S. Treasury obligations 1/	23.1	20.5	5.1	7.5	5.7	8.4	1.4	7.7	2.6
Official Capital									
4. Changes in foreign official reserve assets in U.S. (+ = increase)	2.6	-1.8	7.9	2.5	-1.6	2.3	-0.4	0.7	7.9
a) By area									
G-10 countries (incl. Switz.)	3.1	-0.4	6.0	2.4	-3.3	3.9	1.0	0.8	6.8
OPEC	-5.4	-6.7	-2.1	-2.0	-1.0	1.3	0.7	-0.5	-0.2
All other countries	4.9	5.2	3.9	2.1	2.7	-2.8	-2.1	0.4	1.3
b) By type									
U.S. Treasury securities	4.7	-0.5	8.7	-0.1	-2.0	3.3	1.3	1.5	6.9
Other 2/	-2.1	-1.3	-0.8	2.6	0.4	-0.9	-1.8	-0.8	1.0
5. Changes in U.S. official reserve assets (+ = decrease)	-3.1	-3.9	-0.4	-0.1	-3.1	-0.1	-0.1	-0.1	0.1
Other transactions (Quarterly data)									
6. U.S. direct investment (-) abroad	-3.9	-18.8	-4.2	-6.2	-10.1	-10.1	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S.	25.4	17.9	5.8	6.1	2.4	1.3	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) 3/ 4/	6.8	6.6	3.6	-1.5	9.0	5.1	n.a.	n.a.	n.a.
9. U.S. current account balance 4/	-106.5	-117.7	-29.4	-28.5	-33.7	-33.7	n.a.	n.a.	n.a.
10. Statistical discrepancy 4/	27.3	23.0	6.9	-1.3	5.1	2.9	n.a.	n.a.	n.a.
MEMO:									
U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)	-112.5	-124.4	-30.4	-31.7	-37.4	-36.6	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.

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1981	1982	1983	1984	1985			1986		
	Dec.	Dec.	Dec.	Dec.	June	Sept.	Dec.	Mar.	Apr.	May
1. Net Claims of U.S. Banking Offices (excluding IBFs) on Own Foreign Offices	7.8	32.9	39.3	25.4	27.6	22.4	18.9	21.0	17.5	18.1
2. Net Claims of U.S. Banking Offices on Own IBFs 1/	11.8	16.2	5.2	7.8	8.1	9.1	10.1	1.0	11.4	6.5
3. Sum of lines 1 and 2 of which:	19.6	49.1	44.5	33.2	35.7	31.5	29.0	22.0	28.9	24.6
(a) U.S.-chartered banks	22.3	40.0	40.5	32.1	33.4	31.5	32.4	27.1	30.9	29.9
(b) Foreign-chartered banks	-2.6	9.1	4.0	1.1	2.2	*	-3.4	-5.1	-2.0	-5.3
4. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	13.2	15.8	18.6	20.7	20.2	19.5	18.7	17.6	18.1	18.1
5. Eurodollar Holdings of U.S. Nonbank Residents 2/	95.5	112.6	124.3	117.5	110.3	114.1	112.4	117.1	116.2	116.1

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

Last Friday, the Commerce Department released U.S. merchandise trade figures for the month of May showing a larger deficit in May than in April. These data are shown in columns 4-6 in the table below, and are subject to substantial revision when the effects of late documents are sorted out. As is shown in the footnote, revisions to monthly import data have been much larger than revisons to the export data.

U.S. Merchandise Trade - Monthly Estimates
Billions of dollars, annual rates

	Seasonally Adjusted Balance-of-Payments Basis			Not Seasonally Adjusted Unrevised Census Data 1/		
	Exports	Imports	Balance	Exports	Imports (cif)	Balance (cif)
	(1)	(2)	(3)	(4)	(5)	(6)
Quarters						
1985-3	210	337	-127	201	354	-153
4	211	360	-149	209	373	-164
1986-1	214	360	-146	215	389	-174
A/M	213e	n.a.	n.a.	212	370	-158
Months:						
1986-Jan.	215e	375e	-160e	204	402	-198
Feb.	220e	355e	-135e	213	363	-150
Mar.	210e	355e	-145e	227	401	-174
Apr.	215e	370e	-155e	216	361	-145
May	210e	n.a.	n.a.	209	380	-170

e/ F.R. staff estimate.
1/ Data unrevised for effects of late documents. Range of revisions for monthly data:
Exports: ± $10 billion.
Imports: ± $50 billion.
Balance: ± $60 billion.

The staff estimates that after all the revisions are made and the data are adjusted to a balance-of-payments basis, the value of the trade deficit in April (column 3) will be somewhat larger than the first quarter average. However, given the variability of even revised monthly data, it is not yet possible to get a good fix on the second quarter as a whole from published data.

Using some very preliminary estimates for May, it appears that the value of exports for April and May combined will be no higher than the first-quarter rate; small increases in some categories of trade (for example, broadcasting equipment, some categories of machinery, consumer goods, tobacco, and automotive equipment to countries other than Canada) were offset by declines in other categories. Assessment of recent developments in imports is more difficult. Preliminary estimates for April suggest that the value of imports was somewhat above the average in the first quarter. A decline in the value of oil imports was more than offset by an increase in imports of other goods. The decrease in the value of oil imports was entirely because of the fall in the price of oil (see the table on Oil Imports below); the quantity of oil imports in April increased.

In the first quarter, U.S. merchandise trade deficit was $146.3 billion, SAAR, slightly smaller than in the fourth quarter of last year. An increase in the value of nonoil imports was offset by a sharp decline in the value of imported oil and an increase in the value of exports. See the table below.

The volume of nonoil imports rose by 4½ percent in the first quarter, about the same rate of increase as in the fourth quarter. The strongest increases were in machinery with somewhat smaller increases in consumer goods and gold. The volume of automotive imports dropped in the first quarter, reflecting at least in part, reduced shipments from Japan at the end of the export-restraint agreement-year.

U.S. Merchandise Trade 1/
billions of dollars, SAAR

	Exports			Imports			
	Total	Agric.	Nonagric.	Total	Oil	Nonoil	Balance
Years:							
1983-r	201.8	37.1	164.7	268.9	55.0	213.9	-67.1
1984-r	219.9	38.4	181.5	332.4	57.0	275.1	-112.5
1985-r	214.4	29.6	184.8	338.9	50.5	288.4	-124.4
Quarters:							
1985-1-r	221.3	33.3	187.9	321.5	41.6	279.9	-100.2
2-r	215.5	29.8	185.9	337.0	54.5	282.4	-121.5
3-r	210.0	26.7	183.3	336.7	49.5	287.2	-126.7
4-r	210.9	28.5	182.4	360.3	56.5	303.8	-149.4
1986-1-r	214.2	28.4	185.8	360.5	40.0	320.5	-146.3

1/ Balance-of-payments basis; excludes military trade of U.S. defense agencies and reflects adjustments for timing, coverage and valuation to the trade data reported by the Census Bureau.

The average price of nonoil imports rose in the first quarter as it did in the fourth quarter; this follows a year of import-price declines. On a fixed-weight basis, nonoil import prices rose at a 6½ percent annual rate. There were strong increases for some categories of trade; for example the average price of passenger cars from Japan increased 7 percent (not at an annual rate) following a 5 percent increase in the fourth quarter and average coffee prices rose 26 percent. Price increases of consumer goods and capital goods in the first quarter were 6-7 percent at an annual rate on a fixed-weight basis. Price declines continued to be recorded for industrial supplies.

By area, the largest increases in the value of nonoil imports in the first quarter were from non-OPEC developing countries in Latin America and Asia, which together accounted for nearly 40 percent of the increase, from Western Europe (nearly 25 percent of the increase) and from Japan (about 20 percent of the increase).

The value of oil imports fell by 29 percent in the first quarter. More than half of the decline was in price. Prices dropped rapidly during the quarter in response to world spot market developments; prices, which averaged about $25.50 per barrel in January, dropped to about $16.50 per barrel in March and to an estimated $13.65 per barrel

Oil Imports*

	Year 1985	1985 Q1	1985 Q2	1985 Q3	1985 Q4	1986 Q1	1986 April
Value (Bil. $ SAAR)	50.53	41.61	54.53	49.49	56.48	40.06	28e
Price ($/BBL)	26.40	26.67	26.92	25.74	26.30	21.56	13.65e
Volume (MB/D)	5.24	4.27	5.55	5.27	5.88	5.09	5.5e

* Balance of payments basis, seasonally adjusted.

in April. The volume of oil imported slackened in the first quarter as inventories were drawn down; oil imports increased in April.

The value of exports rose slightly in the first quarter, virtually all in volume. There were moderate increases in machinery exports, various industrial supplies items (particularly chemicals and lumber and wood products), and in consumer goods. Offsetting these increases were declines in exports of automotive products, aircraft and petroleum products. In addition, the volume of agricultural exports fell by about 4 percent. A rise in prices of agricultural exports (particularly corn) offset the decline in volume; the value of agricultural exports was unchanged from fourth-quarter levels.

By area, the value of nonagricultural exports rose in the first quarter to Western Europe, Canada and Asia; there were declines to Latin American and Communist countries.

Foreign Economic Developments. Recently released data provide further evidence of generally weak economic activity in the foreign industrial countries early this year. In the first quarter, real GNP declined in both Japan and Germany, and the pace of real GDP growth slowed sharply in France. Only in Italy and the United Kingdom was there evidence of a strengthening of real growth in the first quarter. As yet incomplete information on activity in the second quarter provides some evidence of a rebound in growth abroad.

Inflation rates abroad have moderated further or remained at low levels in recent months. In May, the weighted-average rate of consumer price inflation in the six largest foreign industrial countries was only 2.2 percent on a year-over-year basis, down from 4 percent at the end of last year.

External surpluses in Germany and Japan have continued at record high levels. In both France and Italy, trade deficits so far this year have been reduced compared with last year. In contrast, the United Kingdom's trade deficit has increased this year, and Canada has recorded a reduced trade surplus.

Individual Country Notes. In Japan, the pace of economic activity slowed substantially in the first quarter. GNP declined 2.1 percent (s.a.a.r.), compared with (downward revised) growth of 5.8 percent in the fourth quarter. This was the first negative quarterly growth rate in 11 years. The main factor contributing to the decline in GNP was a fall in exports at an annual rate of 21 percent and a sharp drop in inventories. Private consumption expenditure provided the principal positive contribution to growth, increasing at a 2.7 percent rate

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

	Q4/Q4 1984	Q4/Q4 1985	1985 Q2	1985 Q3	1985 Q4	1986 Q1	1986 Jan.	1986 Feb.	1986 Mar.	1986 Apr.	1986 May	Latest 3 months from year ago 2/
Canada												
GNP	4.3	4.9	.8	1.7	1.3	n.a.	*	*	*	*	*	4.9
IP	4.4	5.3	1.2	2.3	1.4	-.0	.2	1.0	-3.1	2.9	n.a.	4.9
France												
GNP	1.4	2.2	.9	1.0	.6	.3	*	*	*	*	*	2.8
IP	1.8	1.5	.5	2.0	.0	-1.5	-.8	1.5	.0	3.0	n.a.	1.3
Germany												
GNP	3.0	2.4	1.7	1.7	-.1	-1.7	*	*	*	*	*	1.6
IP	3.5	3.4	1.8	2.1	.4	-1.1	2.7	-1.3	-1.0	1.3	n.a.	2.6
Italy												
GNP	2.7	2.3	1.4	.3	.6	1.5	*	*	*	*	*	3.8
IP	2.1	1.0	.4	-1.1	.2	3.0	1.6	2.8	2.9	n.a.	n.a.	2.6
Japan												
GNP	5.7	4.0	1.4	.7	1.4	-.5	*	*	*	*	*	3.0
IP	10.6	1.2	2.7	-.1	-.7	-.4	-.6	.1	.2	.0	.3	.1
United Kingdom												
GNP	2.6	2.8	1.4	-.2	.5	.7	*	*	*	*	*	2.5
IP	-.4	4.7	1.8	.0	-.0	.5	.7	1.3	-.1	1.1	n.a.	2.3
United States												
GNP	4.7	2.1	.3	.8	.2	.7	*	*	*	*	*	1.9
IP	7.2	1.8	.3	.5	.5	.1	.2	-.9	-1.0	.5	-.6	.4

1. Asterisk indicates that monthly data are not available.

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	1985 Q1	1985 Q2	1985 Q3	1985 Q4	1986 Q1	1986 Q2	1986 Mar.	1986 Apr.	1986 May	1986 June	Latest 3 months from year ago
Canada													
CPI	3.7	4.2	1.2	1.1	.9	.9	1.2	n.a.	.2	.2	.5	n.a.	4.0
WPI	4.0	2.3	1.2	.5	-.0	.6	.9	n.a.	-.4	-.2	n.a.	n.a.	1.6
France													
CPI	6.8	4.8	1.4	1.8	.9	.6	.1	n.a.	.3	.3	.2	n.a.	2.6
WPI	10.5	-1.2	1.6	.9	-1.4	-2.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-1.2
Germany													
CPI	2.1	1.8	1.1	.6	-.2	.3	.0	-.3	-.2	-.1	.0	.2	-.2
WPI	1.3	-1.1	1.7	.3	-2.1	-.9	-2.1	n.a.	-1.0	-.4	-.9	n.a.	-7.3
Italy													
CPI	8.8	8.5	2.6	2.2	1.1	2.3	1.8	1.1	.4	.3	.4	.4	6.4
WPI	8.9	5.9	2.7	2.2	-.1	.9	-.5	n.a.	-.7	-.4	n.a.	n.a.	.7
Japan													
CPI	2.4	2.3	.6	.5	.1	1.0	-.1	.0	-.5	.5	.3	-.8	1.1
WPI	.5	-3.7	.4	-.7	-1.0	-2.4	-2.4	n.a.	-2.2	-1.4	-1.0	a.	-9.0
United Kingdom													
CPI	4.8	5.5	1.3	3.4	.3	.5	.7	n.a.	.1	1.0	.2	n.a.	3.4
WPI	6.1	5.2	1.6	2.0	.5	.9	1.4	n.a.	.7	.8	.2	n.a.	4.7
United States													
CPI (SA)	4.1	3.5	.8	1.0	.6	1.1	.4	n.a.	-.4	-.3	.2	n.a.	1.8
WPI (SA)	1.7	1.6	.1	.6	-.2	1.1	-1.4	n.a.	-1.1	-.6	.6	n.a.	-1.8

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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				1986	1986			
			Q4	Q1	Q2	Q3	Q4	Q1	Feb.	Mar.	Apr.	May
Canada												
Trade	15.9	12.3	4.4	4.0	3.2	2.2	2.9	1.7	.1	.9	.8	n.a.
Current account	1.9	-.8	.9	.8	.2	-1.1	-.7	-2.1	*	*	*	*
France												
Trade	-2.4	-2.6	-.5	-1.1	-.4	-.7	-.4	.1	.0	-.4	-.7	-.3
Current account	-.8	.5	-.2	-.6	.5	.0	.6	1.0	*	*	*	*
Germany												
Trade (NSA)	18.7	25.4	7.2	4.2	6.0	6.1	9.1	9.5	2.9	3.7	4.4	3.6
Current account (NSA)	5.9	13.9	6.0	1.7	3.1	2.1	7.0	6.8	2.9	2.1	3.6	2.7
Italy												
Trade	-11.0	-11.9	-3.3	-3.7	-3.8	-1.2	-3.1	-3.0	-.7	-.7	-.2	.1
Current account (NSA)	-2.8	-6.1	-2.1	-2.9	-2.4	-.4	-.4	n.a.	*	*	*	*
Japan												
Trade	44.1	56.1	13.2	11.5	13.1	14.1	17.3	17.5	5.3	6.2	7.2	8.4
Current account 2/	35.0	49.3	11.3	9.4	12.2	12.1	15.6	15.6	4.4	5.6	7.4	7.8
United Kingdom												
Trade	-5.5	-2.5	-2.0	-1.4	-.2	-.6	-.3	-2.0	-.5	-1.8	-.4	-1.0
Current account	1.3	4.0	.2	-.4	1.7	1.5	1.3	.7	.2	-1.0	.7	.1
United States												
Trade 2/	-112.5	-124.4	-29.2	-25.0	-30.4	-31.7	-37.4	-36.6	*	*	*	*
Current account	-106.5	-117.7	-30.1	-26.1	-29.4	-28.5	-33.7	-33.7	*	*	*	*

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

compared with 2.2 percent in the fourth quarter. Growth in private sector investment in machinery and equipment slowed substantially to 1.4 percent from 10.4 percent in the fourth quarter.

Recent data on industrial production indicate that growth did not pick up substantially in the second quarter. Industrial production was unchanged (s.a.) in April and rose only 0.3 percent in May, leaving the index 2.2 percent below its year-earlier level. The Economic Planning Agency has projected a drop in new orders in the second quarter even larger than the 3.1 percent (s.a.) first quarter decline. In both April and May, the export volume index was 0.2 percent below its year-earlier level. Housing starts dropped 3.4 percent (s.a.) in April, the third consecutive monthly decline. The principal signs of strength have continued to come from the consumer sector, with retail sales rising by 0.4 percent (s.a.) in March and April. In May, the unemployment rate declined by 0.2 percentage point to 2.7 percent (s.a.), reversing the rise of the previous month.

Japanese consumer prices have been rising slowly in recent months. In June, the Tokyo consumer price index was 0.7 percent above its level of one year ago. Wholesale prices have continued to decline, reflecting the recent sharp appreciation of the yen and the drop in oil import prices, and in May were nearly 10 percent below their year-earlier level.

External surpluses have continued at record rates. In the first five months of this year, the cumulative current account surplus was $73.7 billion (s.a.a.r.) while the cumulative trade surplus was $79.3 billion (s.a.a.r.).

In late May, Japanese authorities announced a series of measures to supplement the April demand stimulus package. The May measures called for lower interest rates on public loans to small and medium-sized firms, and asked distributors of liquified petroleum gas to pass on lower prices to their customers. Any additional stimulus to growth resulting from the May measures is likely to be slight.

In mid-June, Prime Minister Nakasone announced that he was willing to consider a large supplemental budget for this fall if it became necessary to stimulate domestic demand. Nakasone stated that a record supplemental budget as large as 3 trillion yen (about $18 billion, nearly 1 percent of Japanese GNP) was under consideration. No details were given about how the supplemental expenditures would be financed, although Nakasone stated his opposition to a consumption tax. It was difficult to determine if this announcement represented a significant softening of the Prime Minister's resolve to continue his program of fiscal restraint, or whether the remarks reflected political considerations ahead of the July 6 general election.

First quarter real GNP in Germany fell by 6.5 percent (s.a.a.r.). While the size of the drop was exaggerated by calendar irregularities, it was still larger than generally expected. The weakest component was construction, which fell at an annual rate of over 40 percent, a drop at least partly explained by another unusually severe winter . Investment in equipment and exports were also weak. Private consumption, on the other hand, grew at an annual rate of more than 3-1/2 percent, consistent with a strong gain in household income.

Early indicators suggest a better performance in the second quarter In April, industrial production rose by 1.3 percent (s.a.) and the volume of new orders (particularly construction orders) increased markedly. The unemployment rate was 9 percent (s.a.) in April and May, down from 9.2 percent in the first quarter. Several surveys taken in April and subsequently have reported strong further increases in consumer confidence, and improvements in the business climate and investment intentions. Three independent surveys of the construction sector undertaken recently concluded that construction would at least not decline further this year.

Consumer prices in June were 0.2 percent below their level of a year ago. Producer prices, wholesale prices, and especially import prices have continued to decline and are substantially below year-earlier levels.

Trade and current account surpluses have continued at record levels this year. Through May, the cumulative current account surplus was $13.2 billion (n.s.a.), substantially larger than the $4.9 billion surplus in the same period last year. The trade surplus in the first five months of this year was $17.5 billion (n.s.a.), up from $8.4 billion in the corresponding period last year. The strong trade figures this year have been entirely due to price effects, especially the decline in import prices. The volume of merchandise exports has declined slightly and the volume of imports has increased so far this year.

Recent evidence suggests that real economic activity in France has been weak. Real GDP increased by only 1.2 percent (s.a.a.r.) in the first quarter, a substantial reduction from the 3.4 percent rate of growth recorded in the second half of last year. The unemployment rate increased by 0.1 percentage point (s.a.) in April and remained at a record high 10.7 percent in May. Industrial production rose by 3 percent (s.a.) in April and was 4.6 percent above its year-earlier level. However, the government statistical institute noted that a substantial part of the sharp rise in the industrial production index represented increased energy output due to unusually cold April weather. Excluding energy, industrial production in April was up by only 1.5 percent on a year-over-year basis.

The inflation rate has continued to ease. Consumer prices increased by 0.2 percent (n.s.a.) in May following a 0.3 percent rise in April. The year-over-year consumer price inflation rate declined to 2.3 percent, equal to the government's inflation target for the end of this year.

The trade deficit narrowed in May. For the first five months of this year, the trade deficit was $2.1 billion (s.a.a.r.), about half of the deficit rate during the corresponding period last year. The current account was in surplus by $3.9 billion (s.a.a.r.) in the first quarter, the largest quarterly surplus in more than six years.

At mid-May, the new conservative government of Prime Minister Chirac announced further relaxations of financial and exchange market controls. In addition, there was a confirmation of the plans of the previous government to switch by next year from quantitative controls on banks' credit growth to open market operations as the principal method of carrying out monetary policy. The Bank of France's money market intervention rate was lowered by 1/4 percentage point on May 14 and again on June 16 to a level of 7 percent.

Real GDP in the United Kingdom grew 2.8 percent (s.a.a.r.) in the first quarter and was 2.5 percent above its year-earlier level. Part of the growth of GDP in the first quarter was probably accounted for by an acceleration of investment plans in advance of an April 1 change in the tax treatment of depreciation. Industrial production grew 1.1 percent (s.a.) in April, suggesting some continued strength. This growth, however, was not sufficient to reduce unemployment, which rose slightly to 13.3 percent (s.a.) in May.

Inflation in the United Kingdom has continued to be moderate. Retail prices rose only 0.2 percent (n.s.a.) in May, lowering the 12-month inflation rate to 2.8 percent.

The trade deficit widened substantially in May while the current account was in near balance. For the first five months of 1986, the cumulative trade deficit was $8.3 billion (s.a.a.r.) and the cumulative current account surplus was $3.4 billion (s.a.a.r.). This compares with a trade deficit of $2.5 billion and a current account surplus of $4 billion for all of 1985.

The Bank of England lowered its money market dealing rates by 1/2 percentage point on May 23, supporting the 1/2 percentage point reduction in the clearing banks' base rates taken one day earlier. Clearing banks' base rates are now down to 10 percent.

Economic expansion in Canada appears to have slowed early this year. The average level of GDP in the first quarter was only 0.3 percent (s.a.) above that in the previous quarter, and the index of industrial production in the first quarter was unchanged (s.a.) from its level in the fourth quarter. In April, however, industrial production increased by 2.9 percent (s.a.), reversing almost all of the sharp decline of the previous month. The unemployment rate remained at 9.6 percent (s.a.)in May for the third consecutive month.

Inflation has continued to be moderate in 1986. Consumer prices rose 4.1 percent in the 12 months ending in May, about equal to the year-over-year inflation rate at the end of last year. The industrial product price index declined (n.s.a.) in April, lowering its 12-month increase to 1.5 percent.

The merchandise trade surplus narrowed slightly in April. For the first four months of this year, the trade surplus was $7.7 billion (s.a.a.r.), less than half of the surplus rate recorded in the comparable period last year. The current account deficit widened to $8.4 billion (s.a.a.r.) in the first quarter, the largest quarterly deficit ever recorded.

In Italy, real GDP increased by 6.1 percent (s.a.a.r.) in the first quarter. The year-over-year increase was 3.8 percent. Industrial production in March was 2.6 percent above its year-earlier level.

The consumer price index rose 0.4 percent (s.a.) in June, lowering the twelve-month inflation rate to 6.3 percent, the lowest such figure since 1973. The wholesale price index dropped 0.4 percent (s.a.) in April following a 0.7 percent decline in March, leaving the index 0.8 below its year-earlier level. The cumulative decrease in the wholesale price index in February, March, and April was the greatest such decrease in more than 25 years.

Over the first five months of this year, trade was in deficit by $7.5 billion (s.a.a.r.), substantially less than the $14.9 billion deficit rate in the same period last year.

Italian authorities lowered the discount rate from 13 to 12 percent on May 27. This is the third such cut in as many months. A bill which would be the initial step in the liberalization of foreign exchange and capital controls was approved by the Chamber of Deputies in mid-June. The law would give the government one year to rewrite foreign exchange regulations. Officials at the Bank of Italy emphasized that a gradual approach should be taken in liberalizing capital controls.

On June 27, Prime Minister Craxi submitted his resignation. Mr. Craxi's three-year-old coalition government had been the longest lasting in Italy's postwar history. The sudden governmental crisis was apparently triggered by political disputes between the Christian Democrat and Socialist coalition partners. While a reconstituted Craxi government is a possibility, the outcome remains unclear.

Economic Situation in Major Developing Countries. Mexico continues to negotiate with the IMF on an economic stabilization program after changing its finance minister in mid-June. Argentina received a waiver for the non-observance of some performance criteria and this allowed the final disbursements from both the IMF and commercial banks in June. Brazil took steps in June to clear a portion of its arrears with the official creditors that comprise the Paris Club. In light of oil market developments, Venezuela has been developing proposals to banks under the "contingency clause" in its recently concluded bank rescheduling to stretch out amortization obligations currently scheduled through 1989. Nigeria announced a new economic package on June 17 which moves it substantially closer to concluding agreements with the IMF and World Bank. Agreement with the Fund would make reschedulings with commercial banks and with official creditors possible.

Individual Country Notes. Mexico changed its finance minister on June 17. The new minister, Gustavo Petricioli, is a highly respected technocrat who has spent much of his career at the Bank of Mexico, the Ministry of Finance, and other financial institutions. It is too early to tell whether a significant change in economic policies is in prospect. There have been no changes at the Bank of Mexico. The government is continuing to work with the IMF to develop a new adjustment program.

Mexico's CPI rose by 5.6 percent in May to a level 76.5 percent higher than a year earlier. Effective June 1, the minimum wage was raised by 25 percent, 7 percentage points less than the CPI increase since the last increase in the minimum wage, five months earlier. In real terms, the Mexican minimum wage has declined in each of the past four years and, at the end of 1985, amounted to about 72 percent of its 1980 level. Also effective June 1, there were sharp increases in the controlled prices of tortillas and bread.

In early June, there was a precipitous fall of the peso in the free foreign exchange market, reflecting fears that Mexico might take unilateral steps to reduce its debt service burden. This speculation was fueled by the lack of progress in the protracted negotiations with the IMF and the continued low level of oil prices and volume of oil exported by Mexico. The peso rebounded on June 9, when cautiously optimistic statements by U.S. and Mexican officials were made about the prospect that Mexico would reach agreement with the IMF. Together with some accelerated daily depreciation of the controlled rate, this reduced the spread between exchange rates in the controlled and free markets from about 35 percent on June 9 to 12 percent on July 1. Between June 1985 and June 1986, in the controlled market, the peso has experienced approximately a 35 percent effective depreciation in real terms--putting Mexico's non-oil export industries in a very strong internationally competitive position.

Argentina has obtained a waiver for the non-observance of some of the performance criteria under its IMF program. In late June, Argentina drew the last tranche (SDR 236 million) of the IMF stand-by credit and the last tranche ($600 million) of the $4.2 billion commercial bank loan signed last summer. The IMF performance criteria that were not observed as of the end of March related to the central bank's net domestic assets, the combined deficit of the public sector and the central bank, and external payments arrears. The IMF granted a waiver in consideration of Argentine commitments to achieve in the second half of 1986 a reduction in the combined deficit to 3 percent of GDP (from 5¼ percent in the first quarter), a reduction in the monthly rate of increase in broad money to 3 percent (from 7 percent in the period August 1985-April 1986), and to eliminate in the near future the remaining payments arrears as well as most restrictions on external payments for services. Achievement of these fiscal and monetary objectives will require a major effort in holding down public enterprise expenditures, obtaining legislation for new revenues, and collecting interest on central bank rediscounts. Argentine officials said on June 18 that the country probably would delay negotiations with the IMF on a new stand-by agreement until after the outcome of Mexico's negotiations with the IMF is known.

In the three months March-May 1986, the CPI rose at an average monthly rate of 4.4 percent, compared with an annual rate of 2.3 percent in the previous six months. The Central Bank, which had tightened monetary conditions in May by raising commercial bank reserve requirements and resuming the sale of its own paper in the market, took the further step in mid-June of raising interest rates on regulated loans and deposits. The monthly rates on 30-day loans and deposits were raised to 5 and 3.5 percent, respectively, from 4.5 and 3.1 percent. The mini-devaluation policy is continuing to be carried out. Since its inception in early April, the austral price of the dollar has been increased by 11 percent. In the same period, the price of the dollar in the parallel market has declined by about 4 percent. As a result, the spread between the two rates has been eliminated as of July 1.

In Brazil, consumer and government demand continues to expand very briskly; real GDP is likely to increase about 7 percent in 1986. There have been increasing reports of shortages of a variety of products as a result of the price controls. Consumer prices rose 1.4 percent in May, bringing the cumulative change in prices since the February 28 price freeze to 2.1 percent. The operational budget deficit is rising because state enterprise revenues are constrained by the price freeze. Given present trends, the operational budget deficit is expected to be in excess of 5 percent of GDP in 1986, compared with 3.5 percent in 1985. Earlier in the year, the government was planning for rough balance in the operational deficit. Money growth slowed in May but nevertheless was very rapid. The monetary base increased 15 percent (monthly rate) in May after increasing about 35 percent in both March and April; M1 increased by 16 percent in May after increasing 75 percent in March and 20 percent in April. Given the huge increase in the demand for money after the introduction of the stabilization plan, it is difficult to judge whether the recent rates of monetary growth are excessive. On the external side, the trade surplus remained strong at $5 billion in the first five months of 1986, compared with a $4.2 billion surplus in the same period a year earlier.

In June, Brazil took some steps toward regularizing its relations with official creditors. The government announced that it would repay 15 percent of the roughly $2.4 billion in principal and interest arrears owed the official creditors that comprise the Paris Club. (This represents an amount well less than Brazil's interest arrears.) The remainder of arrears accrued between January 1, 1985 and April 30, 1986 will be repaid over 15 years including a five-year grace period. The 15 percent of arrears will be repaid in three half-year payments starting June 30. Interest on the remainder of the approximately $8 billion Brazil owes to Paris Club members falling due after May 1, 1986 will be paid immediately and kept up to date in the future, but principal repayments scheduled to be paid from May 1 will be lodged with the Brazilian central bank which will pay interest to creditors. The future of this principal will be discussed with Paris Club members early next year. Any formal rescheduling of Paris Club debt would require an IMF arrangement.

The downpayment of $750 million due on Venezuela's $21.2 billion rescheduling is still expected to be made. However, the government has recently indicated that, under the contingency clause of the rescheduling agreement, it would request from banks the deferral of principal payments due in 1987-9 (which would save $3.4 billion over those three years), new financing of $600 million to be used to replace part of the payment of the $750 million downpayment, and an extension from 5 to 12 years of the schedule for repayment of the subsidized, pre-1983 private sector debt.

Nigeria, which is attempting to reschedule its Paris and London Club (commercial bank) debt, outlined a new economic package on June 17. The major feature of this package is the introduction of a free, second-tier foreign exchange market, which would begin operation in October. All private purchases of foreign currency would go through this market. The market would be supplied in part by oil revenues, and the two foreign exchange markets would be unified within 12 months through a downward crawl of the official rate. The current extensive administrative requirements for importing and exporting would be reduced and a new duty structure would be established. The number of banned imports would increase.

Nigeria also announced that some sort of IMF arrangement will be sought, but that Nigeria will not borrow from the Fund. An IMF arrangement is a prerequisite for the rescheduling of Paris and London Club debt, as well as for increased World Bank lending, which could total as much as $1 billion per year. After a mid-June meeting with the London Club commercial banks, Nigeria secured an extension to October 1 of the recent freeze on scheduled principal payments for non-trade related government debt.

Commercial banks decided at the end of June to extend for the Philippines the termination date for the new money facility from June 30 to December 31, 1986 so that the remaining $350 could be disbursed once agreement is reached with the IMF. An IMF team is scheduled to visit the Philippines in mid-July for the completion of negotiations on a new stand-by arrangement, which will focus on tax reform, trade liberalization and restructuring of public sector financial institutions. The IMF Board is expected to consider the new program in September. At present the Philippines has a comfortable reserve position. In October the government plans to present a detailed and comprehensive medium-term program of economic recovery and reform for use at the IBRD Consultative Group meeting of donors in November or December. Inflation has been reduced sharply to 2 percent (April-to-April); economic activity remains depressed, with real GDP down 1.2 percent in the first quarter of this year from the same period a year earlier.