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October 26, 1988

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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DOMESTIC NONFINANCIAL DEVELOPMENTS

The Commerce Department estimates that growth in real GNP slowed somewhat in the third quarter, consistent with recent monthly indicators that have suggested that the expansion may be moderating. Nonetheless, the unemployment rate has continued to fluctuate around 5-1/2 percent, and factory use rates have remained high in a number of industries. Under the circumstances, wages and prices have continued to rise at the faster pace reached earlier this year, though there have been no clear signs of further acceleration in recent months.

Labor Market Developments

Growth in both employment and hours worked slowed during the third quarter from the exceptionally strong pace of the first half. Nonetheless, labor demand has been sufficiently strong to hold the unemployment rate at the relatively low level reached in the spring. From July to September, payroll employment increases averaged about 215,000 per month--well below the monthly 340,000 average in the first half, but still a substantial 2-1/2 percent annualized growth rate. With employment gains augmented by a slight rise in the average workweek, for the third quarter, on average, hours worked rose 3-1/4 percent at an annual rate.

In the past two months, there has been a broad-based slowing in the growth of private payrolls. In the private service-producing sector, employment rose just 130,000 per month in August and September, with the strongest job gains at wholesale and retail trade establishments and

CHANGES IN EMPLOYMENT¹
(Thousands of employees; based on seasonally adjusted data)

	1987	1988			1988		
		Q1	Q2	Q3	July	Aug.	Sept.
-----Average monthly changes-----							
Nonfarm payroll employment ³	286	340	346	213	214	169	255
Strike-adjusted	283	343	345	215	234	164	248
Private goods-producing	61	43	87	15	71	-17	-9
Private service-producing	197	259	239	151	192	111	151
Manufacturing	38	19	46	4	49	-19	-18
Durable	21	7	35	11	51	-12	-6
Nondurable	16	12	12	-7	-2	-7	-12
Construction	21	25	39	14	22	5	16
Trade	68	114	81	58	82	32	59
Finance and services	114	128	141	79	94	75	69
Total government	28	38	20	46	-49	75	113
Private nonfarm production workers	208	242	258	113	212	84	42
Manufacturing production workers	30	12	30	0	41	-16	-26
Total employment ³	257	120	305	103	41	121	148
Nonagricultural	252	123	345	75	81	15	129

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)

	1987	1988			1988		
		Q1	Q2	Q3	July	Aug.	Sept.
Civilian, 16 years and older	6.2	5.7	5.5	5.5	5.4	5.6	5.4
Teenagers	16.9	16.0	15.0	15.6	15.2	15.8	15.7
20-24 years old	9.7	9.0	8.7	8.4	8.5	8.4	8.2
Adults, 25 years and older	4.8	4.4	4.2	4.3	4.2	4.4	4.2
Men, 25 years and older	4.8	4.4	4.1	4.1	3.9	4.4	4.1
Women, 25 years and older	4.8	4.4	4.3	4.4	4.5	4.4	4.4
White	5.3	4.8	4.6	4.8	4.7	4.9	4.8
Black	13.0	12.5	12.0	11.2	11.4	11.3	10.8
Fulltime workers	5.8	5.3	5.1	5.1	5.0	5.3	5.1
Memo:							
Total National ¹	6.1	5.6	5.4	5.4	5.4	5.5	5.3

1. Includes resident armed forces as employed.

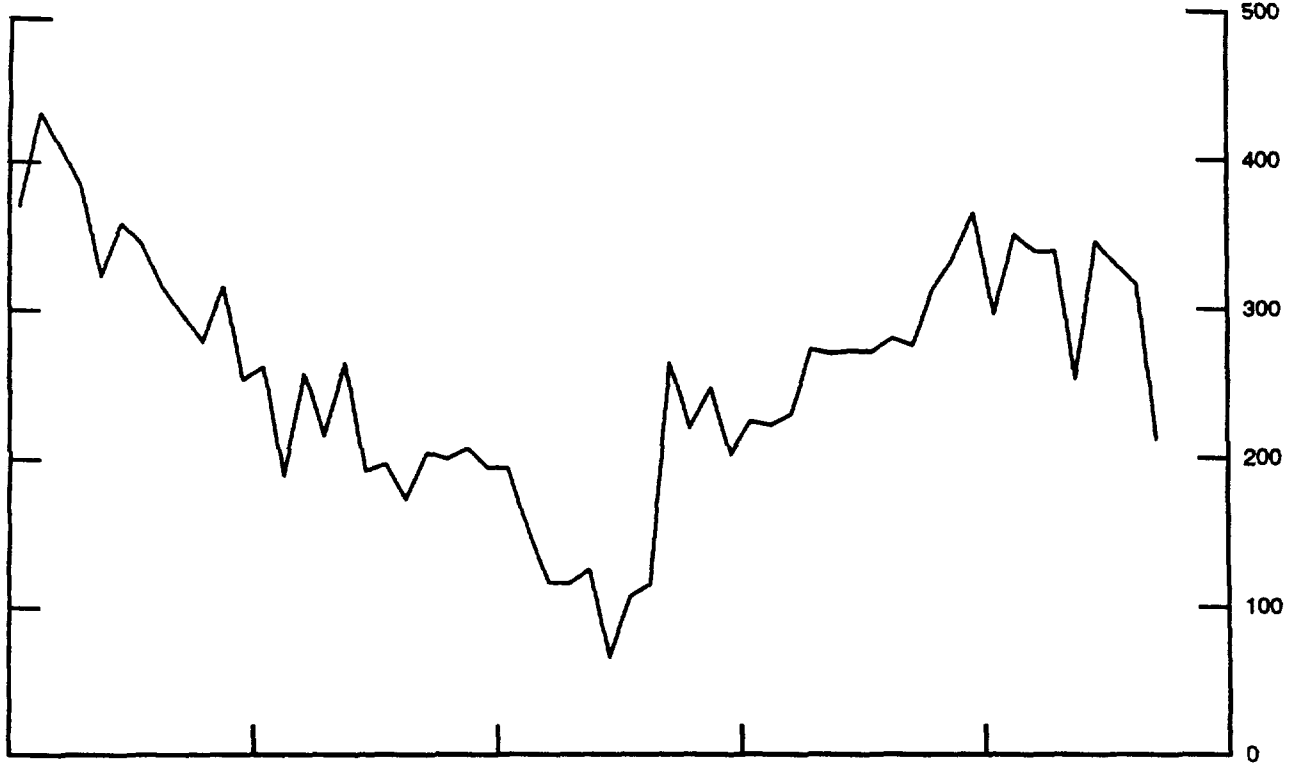
service industries. Factory jobs dropped a total of 37,000 in August and September, after a steep increase over the prior few months. These gyrations may well reflect, to at least a degree, the usual vagaries of seasonal adjustment. Certainly the anecdotal information does not suggest that there has been a broad retrenchment in manufacturing. Indeed, factory employment edged up slightly for the third quarter as a whole. Over the past couple of months, the machinery industry--where demand has been boosted by strong gains in exports and domestic investment spending--has shown job gains. In contrast, some industries, such as textiles and apparel, where product demand has been relatively weak, have shed workers. Looking forward, it may be noted that, given the uptrend in manufacturing productivity, factory employment is likely to be rather flat as industrial activity increases at a pace more in line with the expansion of plant capacity.

Some of the slowing in private employment growth has been offset by what appears to be a one-time surge in public school jobs at the beginning of the school year. The relatively late September payroll survey may have picked up more teachers returning to work than is usually the case. An additional caveat is that the preliminary estimates of state and local government employment often are revised substantially.

As reported in the household survey, the civilian unemployment rate fell back to 5.4 percent in September, after rising to 5.6 percent in August. Unemployment rates for workers 25 years of age and older returned to levels close to the lows for the year, and the jobless rate

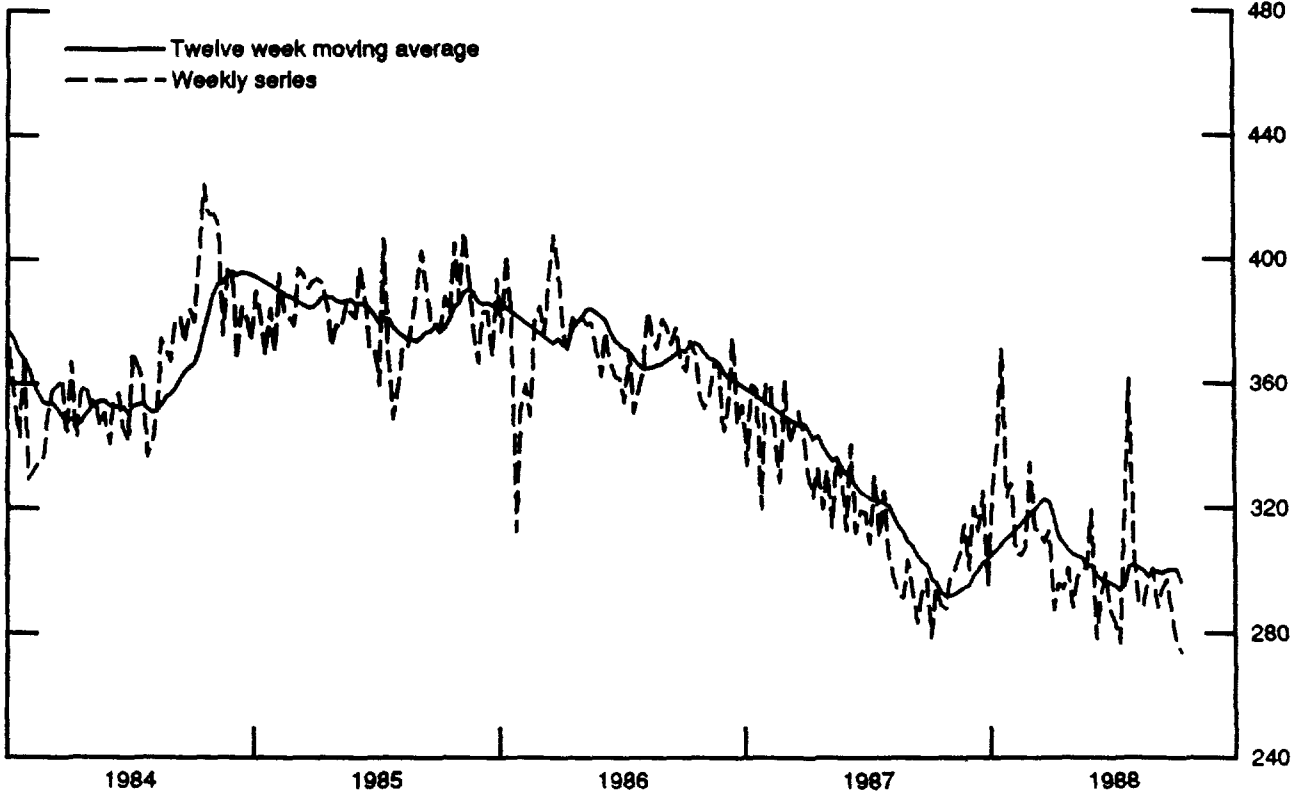
TOTAL NONAGRICULTURAL PAYROLL EMPLOYMENT

Monthly change, three month mov. avg., thous.



INITIAL UNEMPLOYMENT INSURANCE CLAIMS, STATE PROGRAMS <1>

Thousands



<1> Seasonally adjusted by FRB

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

October 1988	1985	1986	1987	1988		
				Q1	Q2	Q3
<u>Hourly earnings index, wages of production workers¹</u>						
Total private nonfarm	3.1	2.3	2.6	3.1	3.8	3.1
Manufacturing	3.3	1.6	1.9	1.6	2.9	2.5
Contract construction	1.6	2.5	.7	4.1	1.1	3.0
Transportation and public utilities	2.9	2.8	2.9	2.7	4.8	2.1
Trade	2.1	1.8	2.3	2.8	4.2	3.3
Services	4.2	3.2	4.6	4.2	5.7	4.5
<u>Employment cost index²</u>						
Compensation, all persons	3.9	3.2	3.3	5.7	5.2	3.6
By occupation:						
White collar	4.8	3.5	3.7	4.8	5.3	4.0
Blue collar	3.2	2.7	3.1	6.7	4.7	2.3
Service workers	3.0	3.1	2.4	5.2	6.2	4.7
By sector:						
Goods-producing	3.4	3.1	3.1	6.7	4.4	2.6
Service-producing	4.4	3.2	3.7	4.7	5.8	3.8
By bargaining status:						
Union	2.6	2.1	2.8	6.1	4.4	2.8
Nonunion	4.6	3.6	3.6	5.3	5.3	3.8
Manufacturing	3.3	3.3	3.1	6.9	4.3	2.8
Wages and salaries, all persons	4.1	3.1	3.3	3.5	4.5	3.3
Benefits, all persons	3.5	3.4	3.5	10.6	7.2	3.9
<u>Major collective bargaining agreements³</u>						
First-year wage adjustments	2.3	1.2	2.2	--	--	2.5
Total effective wage change	3.3	2.3	3.1	--	--	2.8
<u>Labor costs and productivity, all persons¹</u>						
Compensation per hour	4.5	4.2	4.1	3.5	4.2	--
Output per hour	1.5	1.2	1.9	3.4	-1.4	--
Unit labor costs	2.9	3.0	2.1	0.1	5.7	--
<u>Manufacturing</u>						
Compensation per hour	4.9	3.3	1.6	5.4	3.0	--
Output per hour	4.5	2.8	3.4	3.2	3.6	--
Unit labor costs	.4	.5	-1.8	2.2	-6	--

1. Changes are from final quarter of preceding period to final quarter of period indicated at a compound annual rate. Seasonally adjusted data.

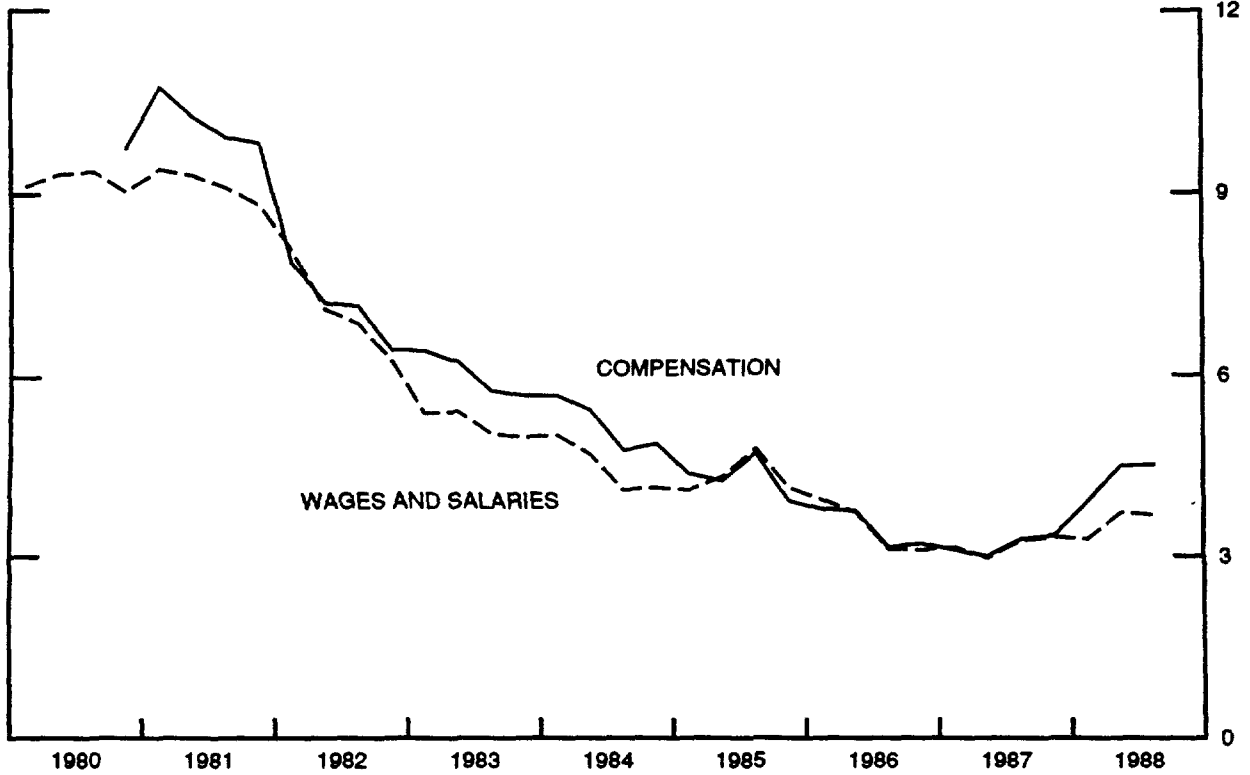
2. Changes are from final quarter of preceding period to final quarter of period indicated at a compound annual rate. Data are seasonally adjusted by Board staff.

3. Averages for year to date of agreements covering 1,000 or more workers; not seasonally adjusted.

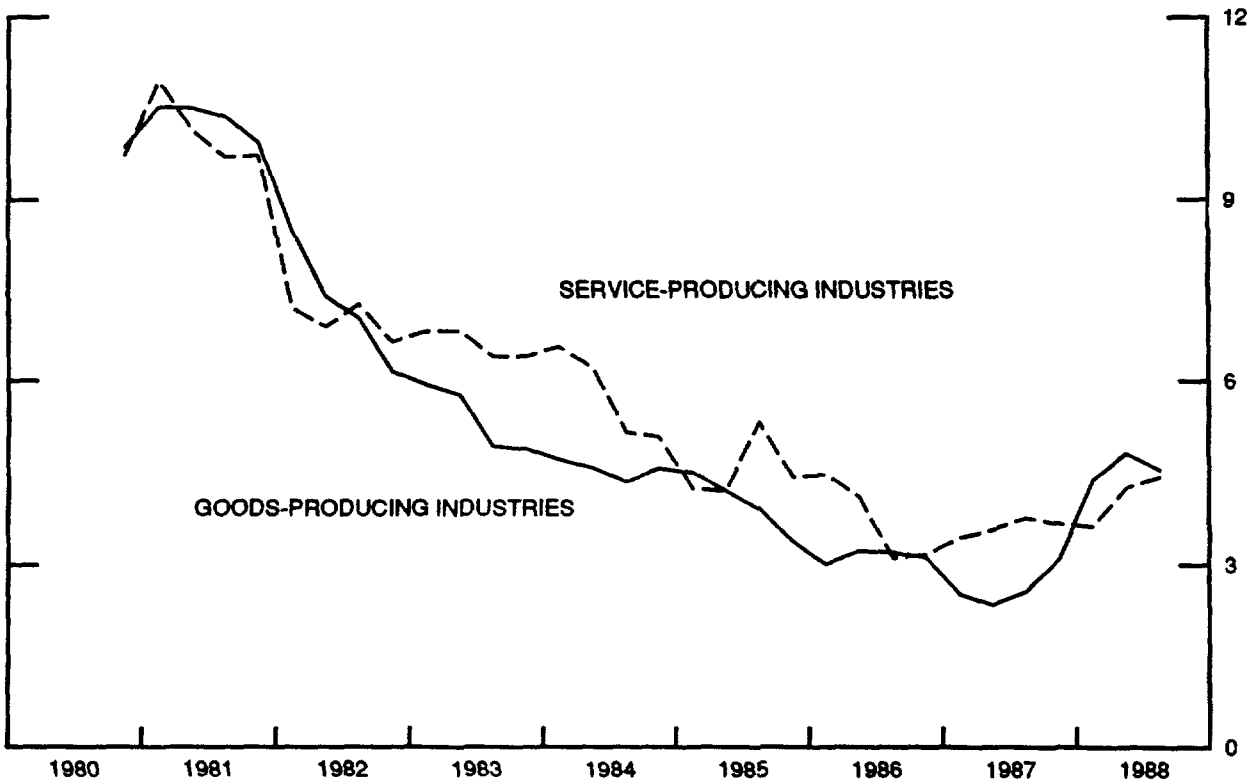
Employment Cost Indexes Private Industry Workers

ALL INDUSTRIES

Twelve month percent change



COMPENSATION BY SECTOR



for young adults reached a new low, consistent with reported "shortages" of entry level workers. Data on unemployment insurance claims suggest that labor demand has remained firm since the September labor market survey. Indeed, the levels of initial claims and insured unemployed dropped to new lows for the year in early October.

Private compensation costs, as measured by the employment cost index, rose 4.5 percent in the twelve months ended in September, the same as the 12-month change recorded in June. Wages and salaries grew at 3.7 percent over the past year, unchanged from the second quarter, while the rate of increase in benefit costs rose slightly to 6.7 percent. The BLS does not seasonally adjust the ECI data. The Board staff's adjustment of these data suggests that wage and, especially, benefit increases fell off substantially in the third quarter after a big surge in the first half. The ECI figures, in effect, tend to confirm the recent pattern of leveling in 12-month changes exhibited by the less comprehensive hourly earnings index for production workers. Another set of data on hourly compensation will be released early next week in association with the productivity and cost series.

Industrial Production and Capacity Utilization

Growth in industrial production was small in August and September, after a surge in July. Nonetheless, the advance in production for the third quarter as a whole was 6.8 percent at an annual rate. In September, electricity output fell sharply, as usage returned to a more normal level after the heat wave earlier in the summer. Production of home goods is estimated to have moved down last month, after posting

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

	1987 ¹	1988			1988		
		Q1	Q2	Q3	July	Aug.	Sept.
		---Annual rate---			---Monthly rate---		
Total Index	5.8	3.9	4.6	6.8	1.2	.2	.0
Products	4.9	6.3	4.4	5.6	.8	.3	.0
Final products	4.6	6.0	5.1	5.9	.7	.4	.0
Consumer goods	3.2	5.8	4.0	5.5	.9	.4	-.3
Durable goods	4.2	-6.1	13.2	4.1	.0	.8	.1
Automotive products	4.4	-4.5	23.2	.4	-2.1	.8	1.0
Home goods	4.0	-7.3	6.2	7.0	1.6	.8	-.6
Nondurable goods	2.8	10.1	1.1	6.0	1.1	.3	-.4
Clothing	4.0	2.7	.0	2.0	.5	.0	.1
Consumer energy	.8	15.5	-9.6	5.0	2.0	1.6	-4.0
Equipment	6.3	6.4	6.3	6.3	.6	.3	.2
Business equipment	7.0	9.3	11.6	9.8	.8	.5	.5
Defense & space equip.	1.9	2.6	-9.2	-3.4	.2	-.3	-.3
Intermediate products	5.9	7.1	2.2	4.6	1.0	.2	.0
Construction supplies	4.7	10.9	2.1	-.2	.5	-.4	.1
Materials	7.2	.3	4.8	8.7	1.8	-.1	.0
Durable goods	8.0	3.8	8.2	8.6	1.4	-.1	.4
Nondurable goods	8.1	-2.1	3.3	6.2	2.1	-.5	.3
Energy materials	4.5	-4.7	-1.2	11.9	2.3	.3	-1.2
Manufacturing	5.9	4.7	5.6	6.4	1.0	.1	.2
Mining	7.6	-6.6	3.7	5.5	2.3	-.8	.2
Utilities	2.9	8.6	-9.2	10.9	1.5	2.1	-4.3

1. Change from 1986-Q4 to 1987-Q4.

strong gains in the preceding two months, and clothing output remained sluggish. However, automobile assemblies rose about 5 percent to 7.4 million units at an annual rate in September, and this gain was only partly offset by lower output of light trucks. Production of business equipment continued to expand briskly in September, largely owing to a rise in the output of manufacturing equipment; production of commercial equipment, particularly computers, was lackluster throughout the third quarter, after strong advances earlier this year.

Total materials production has followed a pattern similar to that of products, with strong gains early in the summer giving way to flatness in August and September. Output of chemical materials and parts for both consumer durables and equipment posted strong gains in September. But production of energy materials, primarily electricity, and basic metal materials, mainly steel, declined in September, after surging earlier in the quarter.

In October, automakers' schedules call for another rise in assemblies, to 7.7 million units at an annual rate. Truck production in October, however, is likely to be up only slightly, owing to a 13-day strike against Chrysler that was settled on October 21. Raw steel production declined steeply in the first two weeks of the month and, despite an upturn last week, should depress industrial output for the month.

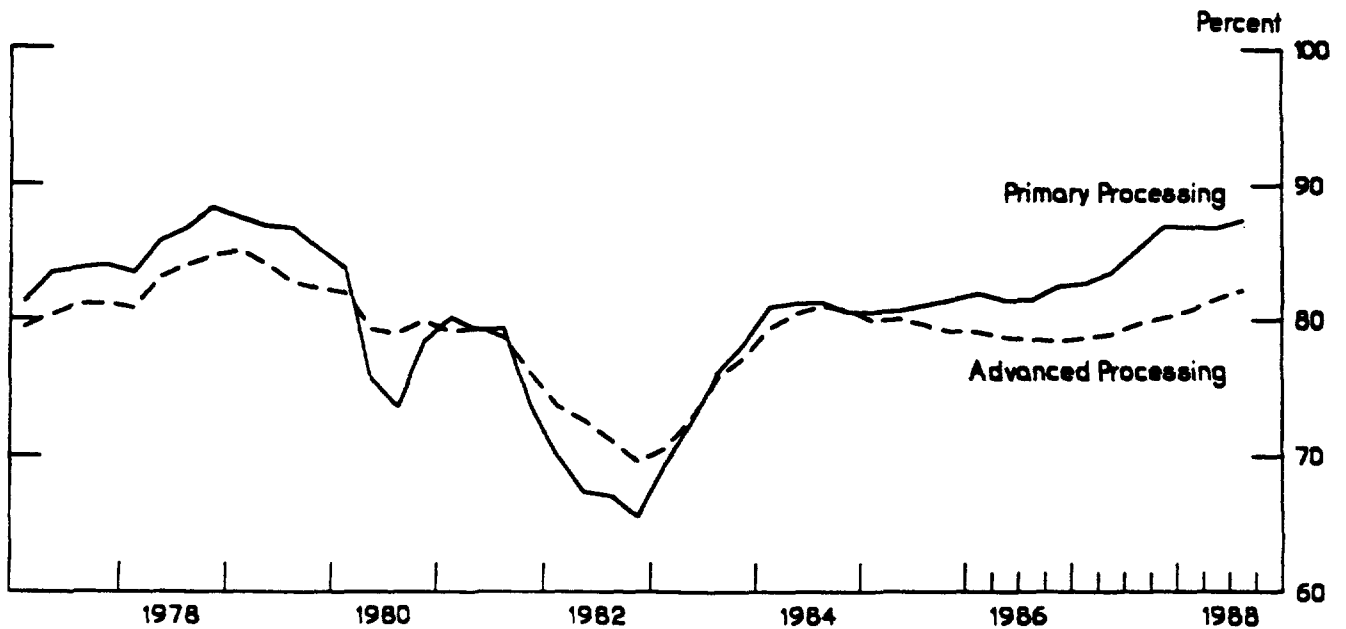
While the picture is not entirely clear, there are some indications that pressures may have eased a bit in some parts of the industrial sector. Purchasing managers continue to report shortages in nonferrous

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

	<u>1978-80</u>	<u>1982</u>	<u>1967-87</u>	<u>1987</u>	<u>1988</u>		
	High	Low	Avg.	Dec.	July	Aug.	Sept.
Total industry	86.9	69.5	81.5	82.4	83.8	83.8	83.6
Manufacturing	86.5	68.0	80.6	82.6	83.9	83.8	83.8
Primary processing	89.1	65.0	81.7	87.6	87.8	87.2	87.2
Advanced processing	85.1	69.5	80.1	80.3	82.2	82.2	82.2
Durable manufacturing	86.3	63.7	78.7	80.1	82.3	82.3	82.4
Nondurable manufacturing	87.0	74.2	83.5	86.4	86.2	85.9	85.8
Mining	95.2	76.9	86.7	81.5	83.2	82.8	83.1
Utilities	88.5	78.0	86.9	80.0	81.9	83.6	79.9
Industrial materials	89.1	68.5	82.2	83.6	84.5	84.3	84.2
Raw steel	98.9	36.1	80.2	89.2	95.1	98.0	95.8
Aluminum	97.4	58.8	87.3	95.8	100.8	100.5	99.8 ¹
Paper materials	97.3	79.9	91.7	101.6	100.0	97.5	97.3 ¹
Chemical materials	87.9	63.5	81.0	90.9	88.8	88.6	88.8 ¹

1. Unpublished staff estimates.

Capacity Utilization in Manufacturing
(Quarterly, seasonally adjusted)



metals, bearings, and various chemicals, but their list no longer includes steel products or dynamic random access memory chips. In the case of steel, aggressive buying during the period of shortages apparently contributed to the accumulation of some excess inventories, particularly at steel service centers; however, there are few, if any, indications of a weakening in underlying demand for steel. In contrast, industry reports suggest sales of semiconductors have slowed, owing in part to declines in output of military goods and a slowing in the production of computers. In addition, there are reports that inventories of broadwoven fabric held at producing mills have increased as unfilled orders dropped over the year ending in June. As a result, utilization rates in the yarn and broadwoven fabric industries have fallen, and further production cuts are probable.

With industrial production unchanged in September, capacity utilization in manufacturing, mining, and utilities decreased 0.2 percentage point to 83.6 percent. The decline resulted principally from the sharp drop in electric generation; the operating rate for total manufacturing was virtually unchanged. The overall capacity utilization rate in the third quarter was 83.7 percent, almost a percentage point above that in the previous quarter.

Personal Income and Consumption

Real disposable personal income rose 4-3/4 percent at an annual rate in the third quarter and has increased more than 4 percent over the past year. Although the growth of nominal personal income slowed a bit last quarter, disposable income was boosted by a decline in nonwithheld

PERSONAL INCOME
(Average monthly change at an annual rate;
billions of dollars)

	1987	1988		1988		
		Q1	Q2	June	July	Aug.
Total personal income	26.3	15.6	19.7	23.5	26.4	7.2
Wages and salaries	16.8	7.1	17.6	19.1	24.2	7.7
Private	14.5	4.8	15.7	17.3	22.1	5.6
Other labor income	1.0	.6	.7	1.0	1.1	1.0
Proprietors' income	1.4	4.9	-3.0	-2.7	-4.3	-7.4
Farm	-6	5.1	-5.5	-4.9	-6.8	-8.4
Rent, dividends and interest	6.1	-.2	4.9	5.5	4.4	5.0
Transfer payments	2.1	8.1	.5	1.6	2.7	1.3
Less: Personal contributions for social insurance	1.1	4.8	1.1	1.2	1.4	.5
Less: Personal tax and nontax payments	4.5	-6.7	.0	-.3	4.6	1.6
Equals: Disposable personal income	21.8	22.3	19.6	23.8	21.8	5.6
Memo: Real disposable income	7.5	11.4	3.1	11.9	6.2	-5.6 ^e

e--Estimated.

tax payments, which had surged in the second quarter. In addition, real income growth also was supported by a moderate slowing in the rate of consumer price inflation.

Real personal consumption expenditures accelerated to a 3-1/2 percent annual pace in the third quarter. Spending on nondurables improved from the lackluster pace seen this spring--despite a reduction in purchases of gasoline; and spending on services rose sharply--only in part because of temporary heat-related factors. In contrast, spending for motor vehicles and for other durable goods was little changed from the second-quarter average.

Taking a longer perspective, consumption growth has continued to slow in the past year from the pace seen earlier in the expansion (chart), while the growth of real disposable income has remained rapid. On net, consumption growth has been slower than income growth since the stock market crash, and consequently, the saving rate has moved up somewhat. Within consumption, the most notable slowing has occurred in spending on goods--both durable and nondurable. On the other hand, spending on services has moved upward at a fairly steady pace.

Domestic Motor Vehicles

Domestically produced autos were sold at a 7-1/2 million unit annual rate (BEA seasonals) during September--about the same as the average for the first eight months of the year. Domestic sales of light trucks slowed in September from an exceptionally brisk July-August pace to a 4 million unit annual rate. During the first 20 days in

RETAIL SALES
(Seasonally adjusted percentage change)

	1988			1988		
	Q1	Q2	Q3	July	Aug.	Sept.
Total sales	2.2	1.8	1.0	.5	-.1	-.4
Total less auto dealers, nonconsumer stores, and gasoline stations	1.2	2.1	1.8	.5	.4	-.1
Durable goods stores	4.9	1.8	-.8	.1	-1.4	-1.0
Automotive dealers	5.9	.4	-1.0	.9	-2.2	-1.9
Furniture and appliances	5.7	5.3	-.8	-2.3	.0	.4
Other durable goods	1.2	2.2	.7	.7	-1.6	-.5
Nondurable goods stores	.6	1.8	2.1	.8	.7	.0
Apparel	-1.0	2.0	3.2	2.1	-.2	.7
Food	1.2	2.4	2.1	.8	1.1	-.4
General merchandise ¹	-.2	.8	1.1	.0	-.4	.6
Gasoline stations	.8	1.3	1.2	-.1	1.8	-.2
Other nondurables	1.1	3.1	4.6	2.5	.9	-2.2
Memo: GAF ²	1.1	2.2	1.1	-.1	-.2	.5

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

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

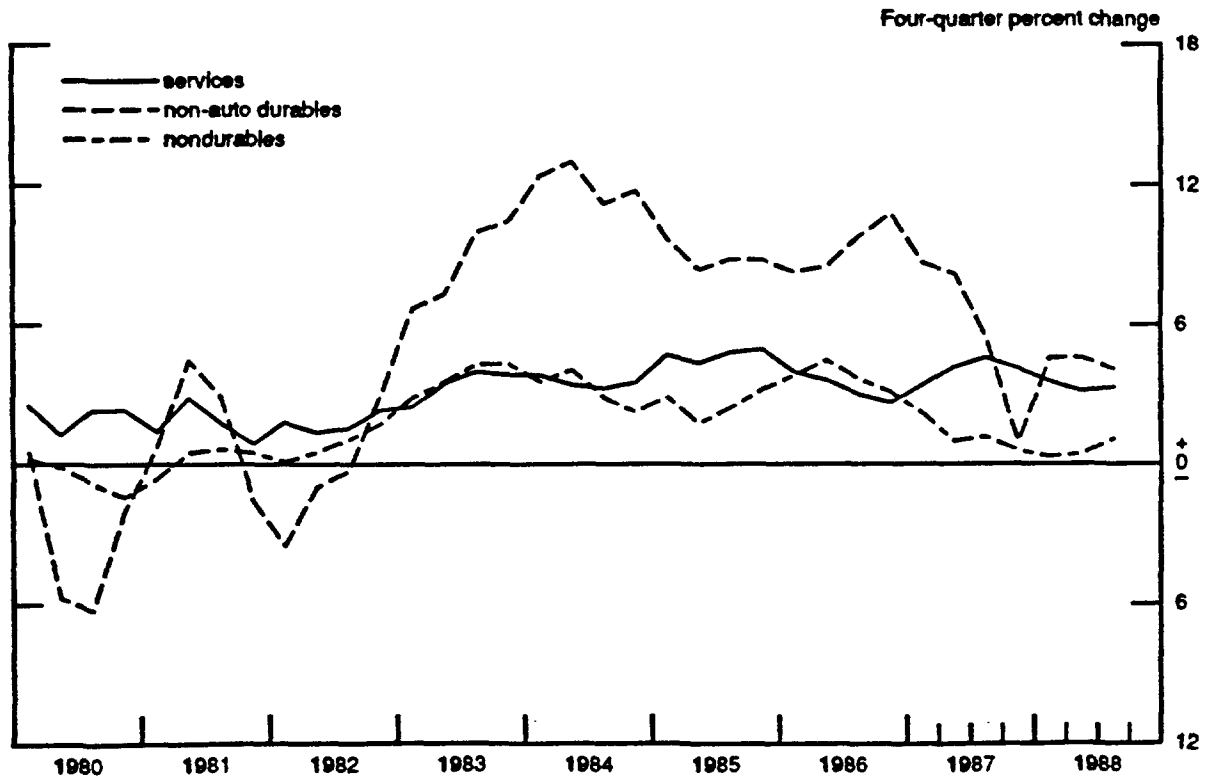
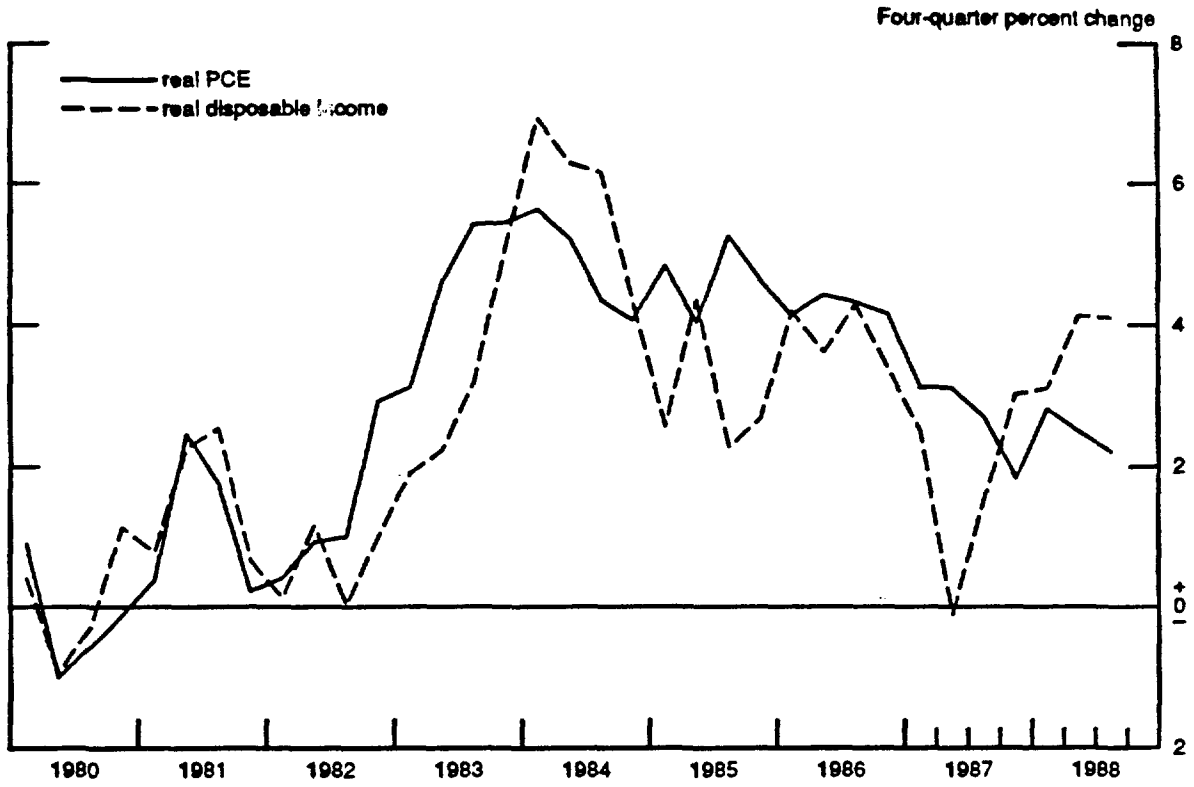
SALES OF AUTOMOBILES AND LIGHT TRUCKS
(Millions of units at an annual rate, BEA seasonals)

	1987	1988			1988		
		Q1	Q2	Q3	July	Aug.	Sept.
Autos and light trucks ¹	14.9	15.5	15.4	15.6	15.8	15.7	15.3
Autos	10.3	10.8	10.6	10.7	10.8	10.6	10.7
Light trucks	4.6	4.7	4.8	4.9	5.0	5.1	4.6
Domestically produced ²	11.0	11.7	11.7	11.8	12.2	11.7	11.6
Autos	7.1	7.6	7.5	7.6	7.8	7.4	7.6
Light trucks	3.8	4.1	4.2	4.2	4.4	4.3	4.0
Imports	4.0	3.8	3.7	3.8	3.6	4.0	3.6
Autos	3.2	3.2	3.1	3.1	3.0	3.2	3.1
Japanese	2.2	2.1	2.1	2.1	2.1	2.2	2.1
Korean	.3	.5	.5	.4	.5	.4	.4
European	.7	.6	.5	.6	.4	.6	.6
Light trucks	.8	.6	.6	.7	.6	.8	.6

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

2. Includes vehicles produced in Canada and Mexico for General Motors, Ford, and Chrysler.

Longer-Run Trends in the Growth and Composition of Consumption



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

	1988			1988		
	Q1	Q2	Q3	July	Aug.	Sept.
<u>Producers' durable equipment</u>						
Shipments of nondefense capital goods	4.8	3.8	1.9	.6	1.0	-1.2
Excluding aircraft and parts	3.9	4.3	1.8	.3	1.7	-1.5
Office and computing equipment	5.6	6.6	-.8	-2.0	.7	-4.8
All other categories	3.4	3.7	2.5	.9	1.9	-.7
Shipments of complete aircraft ¹	34.4	4.4	--	18.3	--	--
Sales of heavy-weight trucks	8.7	-.5	-2.7	.3	-2.1	.6
Orders of nondefense capital goods	6.1	1.1	8.2	2.1	6.9	-11.9
Excluding aircraft and parts	4.3	3.4	3.7	3.1	5.1	-8.1
Office and computing equipment	5.3	8.6	-1.8	.3	5.9	-18.9
All other categories	4.1	2.1	5.1	3.9	4.9	-5.3
<u>Nonresidential structures</u>						
Construction put-in-place	-5.5	1.4	--	.0	-1.4	--
Office	-3.1	4.1	--	.6	.1	--
Other commercial	-8.4	6.0	--	-.7	-6.1	--
Public utilities	-8.8	-.2	--	5.5	-.3	--
Industrial	-2.6	-.2	--	-4.1	-3.0	--
All other	-2.0	-3.5	--	-4.8	1.4	--
Rotary drilling rigs in use	-2.1	6.7	-8.0	-2.3	-5.0	-4.5

1. From the Current Industrial Report (CIR) titled "Civil Aircraft and Aircraft Engines." To estimate PDE spending for aircraft, BEA uses the aircraft shipments shown in that report, not the corresponding M-3 series. The CIR does not provide information on aircraft orders.

October, auto sales fell back to a 7 million unit pace, while truck sales strengthened.

The 1989 model year started with inventory positions apparently well in hand at all three domestic automakers. As of September 30, new car stocks averaged a normal 60-days' supply for the industry as a whole; of the three major producers, GM had the largest supply, at 67 days. Prospects apparently have grown brighter in the automakers' judgment, as fourth-quarter assembly plans have been strengthened by 1/2 million units since midyear, to a 7.8 million unit annual rate.

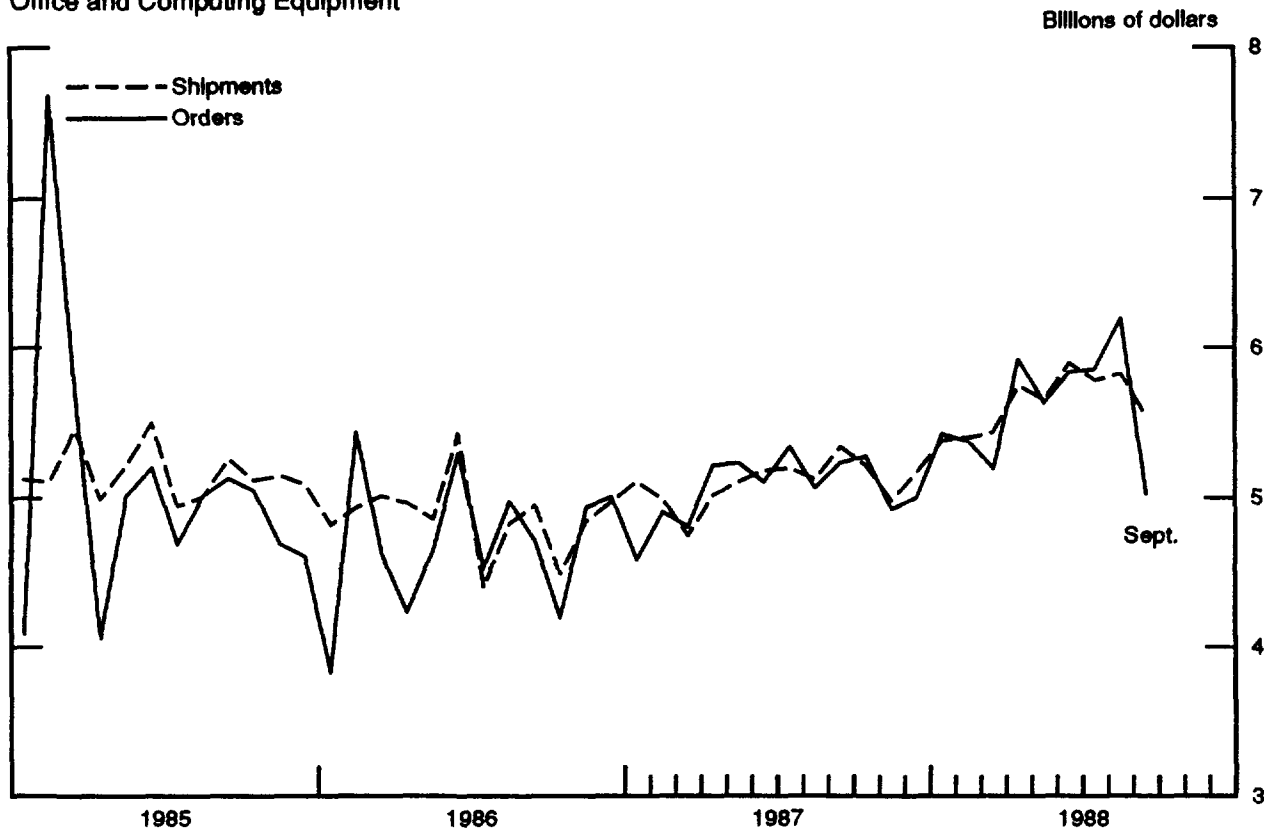
All three automakers began the current model year offering sales incentives, though, it would seem, more as a normal marketing strategy rather than a device for unloading excess stocks. Chrysler and GM introduced new programs covering models from both 1988 and 1989. However, they appear somewhat less extensive in model coverage, and less generous in rebate amounts, than earlier programs. To date, Ford has offered no rebates on 1989 models, but is maintaining incentives on 1988 models.

Business Fixed Investment

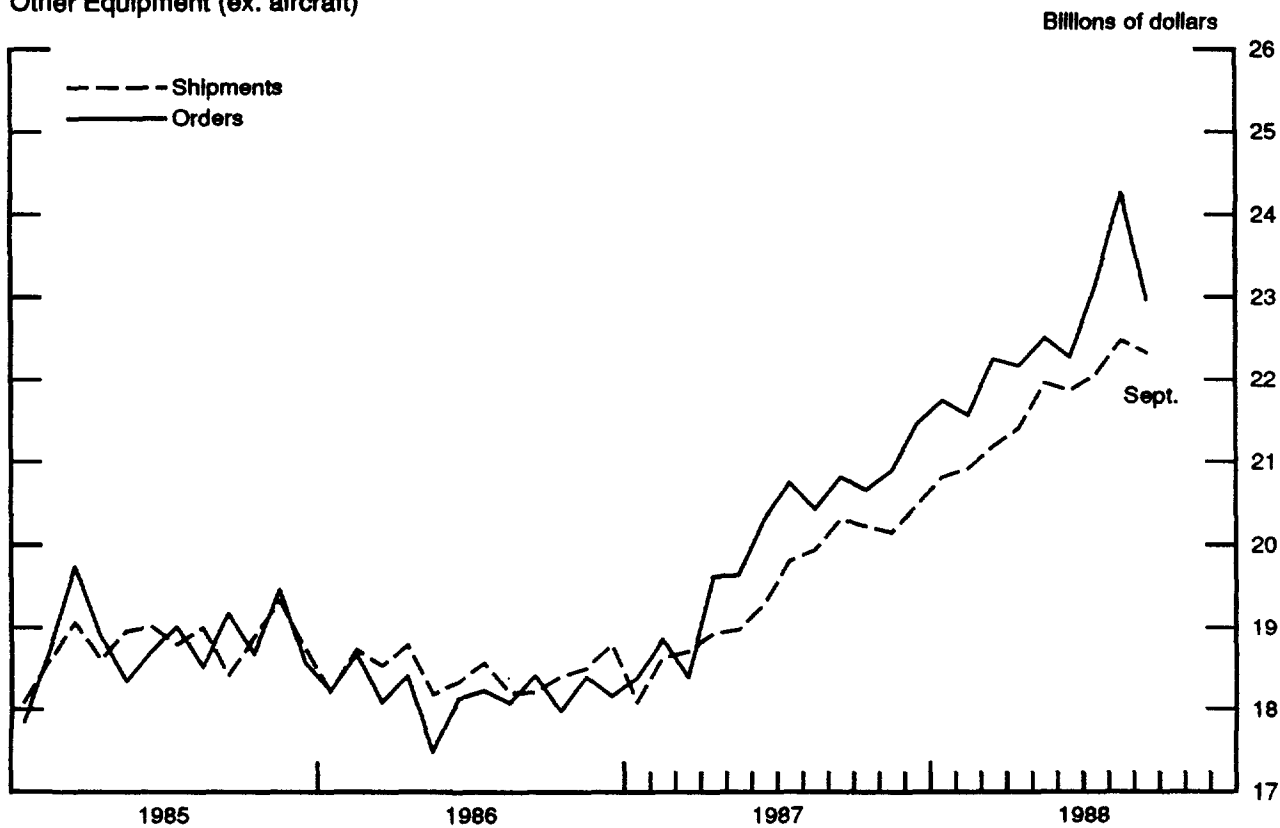
Growth in real outlays for business equipment slowed to about a 6 percent annual rate in the third quarter, after averaging more than 20 percent in the first half of the year. Investment in information-processing equipment grew more slowly than in the first half of the year, and outlays for other types of equipment were up only slightly from the level of the third quarter. It is the staff's understanding that these third-quarter figures did not incorporate fully the September

RECENT DATA ON ORDERS AND SHIPMENTS

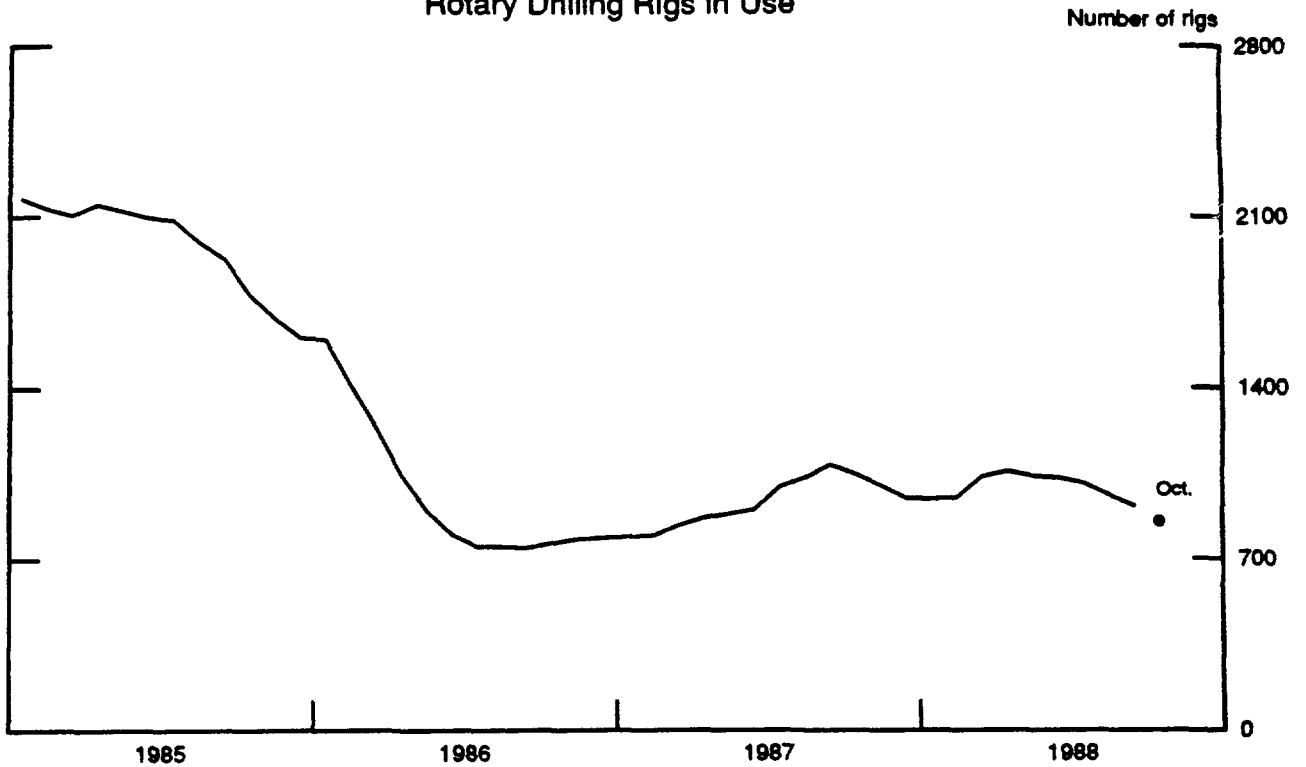
Office and Computing Equipment



Other Equipment (ex. aircraft)

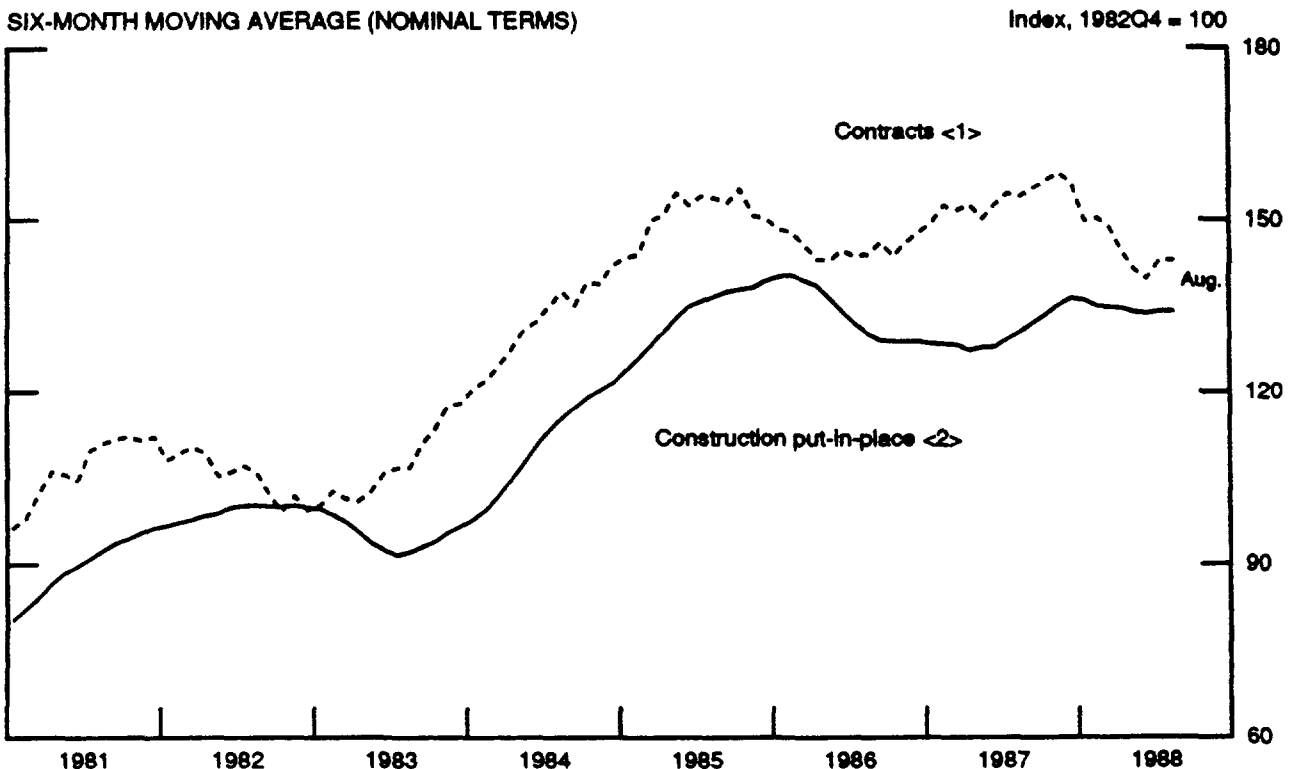


Rotary Drilling Rigs in Use*



* From Baker Hughes rig count.
 October datum is the average of first two weeks.

Nonresidential Construction Put in Place and Construction Contracts



<1> From F.W.Dodge. Includes industrial, commercial, and institutional construction.
 <2> Includes the building components of nonresidential construction, i.e., industrial, commercial, institutional, and hotels and motels.

data on capital goods shipments, which became available the day before the GNP report. Taking account of the September data would suggest a somewhat smaller-than-reported gain in equipment spending.

The outlook for business equipment spending appears relatively strong. Despite a sharp decline in September, new orders for nondefense capital goods, excluding aircraft and parts, were up 3-3/4 percent and should support a modest rise in equipment outlays in the fourth quarter. The third-quarter increase in these nonaircraft orders reflected gains for electrical and industrial machinery that more than offset a decline in new orders for office and computing equipment.

Real spending on nonresidential structures rose 1-1/2 percent at an annual rate in the third quarter, the second quarter in a row of relatively little change. Outlays for mining and drilling structures were about the same as in the second quarter; according to the BEA, a further decline in the number of oil rigs in operation was offset by a rise in footage drilled. Elsewhere, the July-August average of construction put-in-place, which includes all nonresidential structures except oil and gas wells, was unchanged from its second-quarter level. Increases in the construction of office buildings and public utilities were offset by declines in industrial, institutional, and other commercial building. The value of new construction contracts, a broad indicator of future building, has fallen sharply this year, suggesting that outlays will show little improvement through early 1989.

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

	1987	1988		1988		
	Q4	Q1	Q2	June	July*	Aug.
Current cost basis:						
Total	82.4	39.7	54.7	61.0	59.7	70.0
Total ex. auto	68.2	61.3	41.8	52.4	58.0	50.5
Manufacturing	29.0	22.3	21.1	22.7	21.9	21.3
Wholesale	23.8	26.5	13.1	19.0	27.7	13.1
Retail	29.6	-9.1	20.5	19.3	10.1	35.5
Automotive	14.2	-21.6	12.8	8.6	1.6	19.4
Ex. auto	15.3	12.5	7.7	10.7	8.5	16.1
Constant dollar basis:						
Total	57.6	39.9	19.4	21.5	-15.5	--
Total ex. auto	44.4	50.0	8.4	15.0	-12.3	--
Manufacturing	14.4	15.8	5.8	6.4	1.2	--
Wholesale	18.1	22.7	.0	.2	-7.0	--
Retail	25.1	1.5	13.7	14.9	-9.8	--
Automotive	13.2	-10.1	11.0	6.5	-3.2	--
Ex. auto	11.9	11.6	2.7	8.4	-6.6	--

*Constant dollar data for July do not include revisions indicated in data on current cost basis.

INVENTORIES RELATIVE TO SALES¹
(Months supply; based on seasonally adjusted data)

	Range in ² preceding 12 months:		1987	1988		1988		
	Low	High	Q4	Q1	Q2	June	July	Aug.
Current cost basis:								
Total	1.48	1.53	1.53	1.53	1.51	1.50	1.50	1.50
Total ex. auto	1.46	1.51	1.49	1.51	1.49	1.47	1.48	1.47
Manufacturing	1.56	1.62	1.61	1.62	1.58	1.56	1.59	1.56
Wholesale	1.21	1.30	1.27	1.31	1.30	1.28	1.28	1.28
Retail	1.56	1.64	1.65	1.60	1.61	1.60	1.60	1.62
Automotive	1.74	2.06	2.06	1.76	1.86	1.86	1.85	1.95
Ex. auto	1.50	1.55	1.54	1.55	1.54	1.53	1.53	1.53
Constant dollar basis:								
Total	1.48	1.52	1.52	1.52	1.51	1.51	1.52	--
Total ex. auto	1.46	1.51	1.49	1.51	1.50	1.49	1.50	--
Manufacturing	1.58	1.62	1.61	1.62	1.59	1.58	1.60	--
Wholesale	1.22	1.32	1.29	1.32	1.32	1.31	1.32	--
Retail	1.51	1.59	1.61	1.57	1.59	1.59	1.58	--
Automotive	1.65	1.93	1.93	1.73	1.83	1.83	1.82	--
Ex. auto	1.47	1.53	1.52	1.53	1.52	1.52	1.52	--

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. Range is for the 12-month period preceding the latest month for which data are available.

Business Inventories

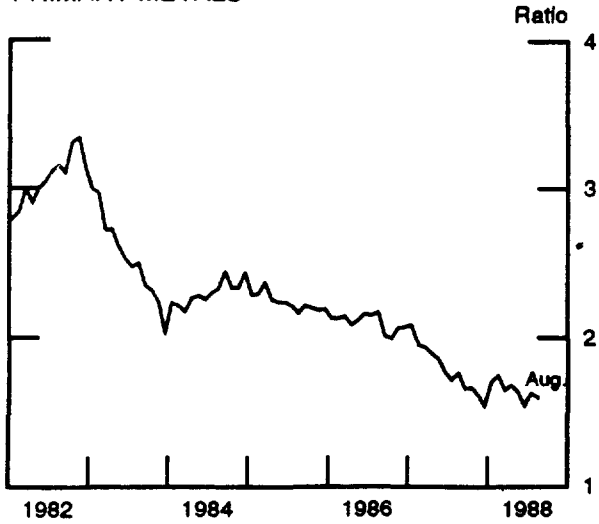
The pace of nonfarm business inventory investment was estimated by the BEA--on the basis of two month's data--to have risen a little in the third quarter, with most of the additional stockbuilding in manufacturing and wholesale trade. At manufacturing and trade establishments, excluding auto dealers, inventories in current-cost terms expanded at an annual rate of \$54 billion, on average, in July and August--the only months for which data are available--compared with the \$42 billion accumulation in the second quarter. Nevertheless, the pace of inventory investment in recent months has been about in line with the growth in sales, as inventory-sales ratios have changed little since late spring.

Manufacturers' inventory investment in July and August continued to be concentrated in a few industries--notably machinery, transportation equipment, and industrial materials--that have experienced relatively robust demand in domestic and overseas markets. Moreover, inventory-sales ratios have remained at historically low levels for a wide range of manufactured products (chart). The most notable exception is in the textile industry, where some inventory overhang has emerged and evidently is leading to production adjustments.

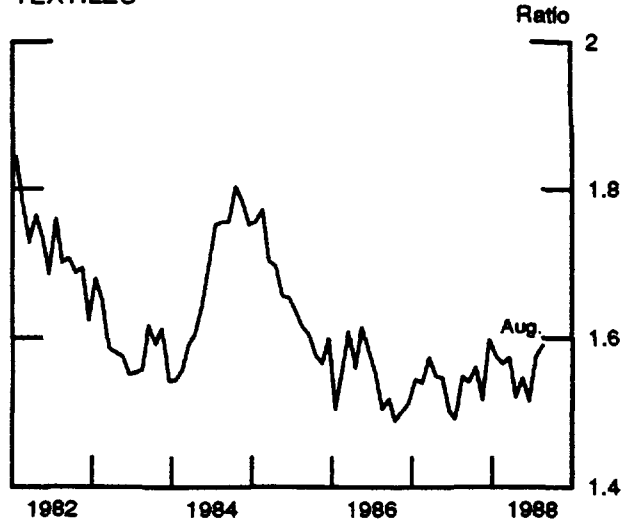
Stockbuilding in the wholesale trade sector remained brisk in July and August. On a current-cost basis, inventories of machinery, industrial and business equipment, and electrical goods rose sharply, while stocks at grain elevators and apparel distributors were reduced. In the retail sector, inventory investment picked up in August after

Inventories - Sales Ratios, Selected Manufacturing Industries
 (Current-cost data)

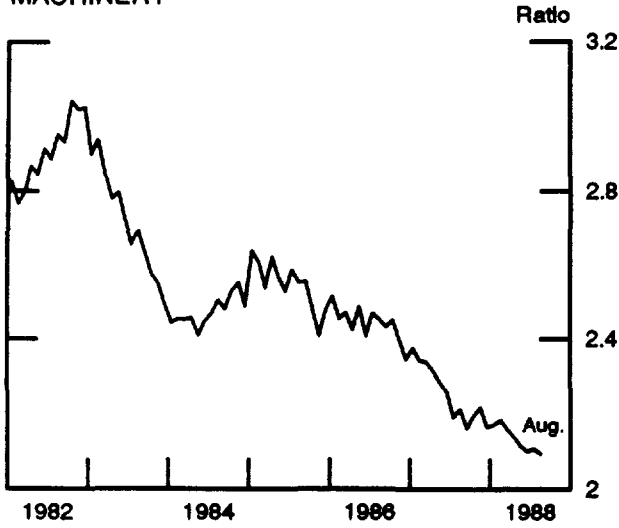
PRIMARY METALS



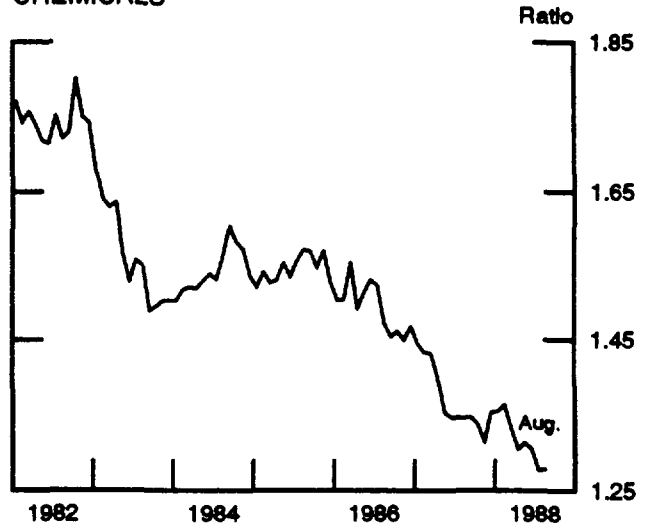
TEXTILES



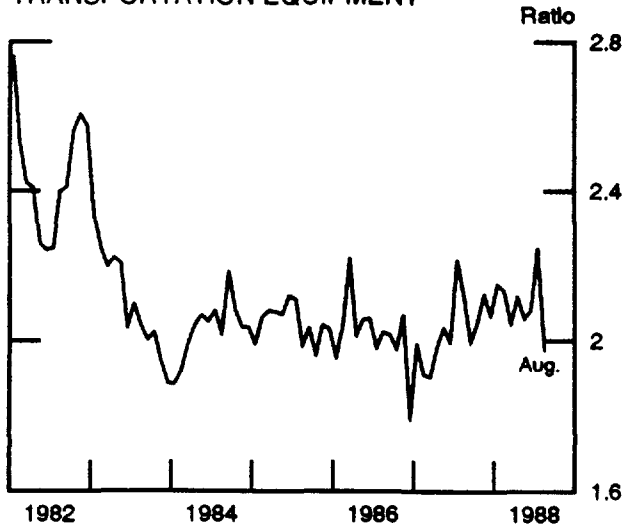
MACHINERY



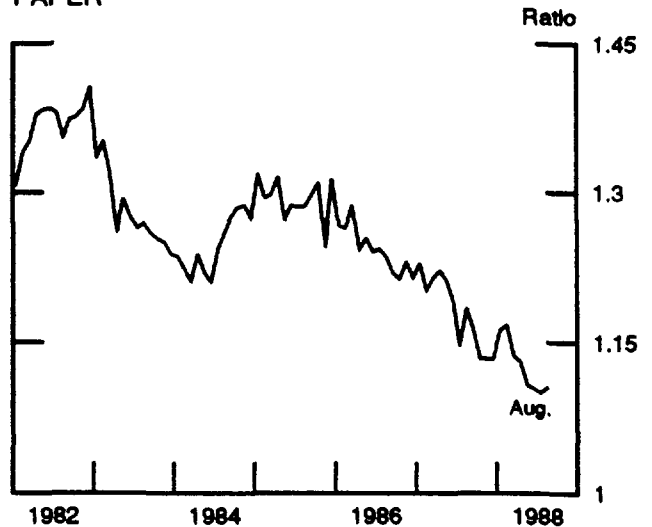
CHEMICALS



TRANSPORTATION EQUIPMENT



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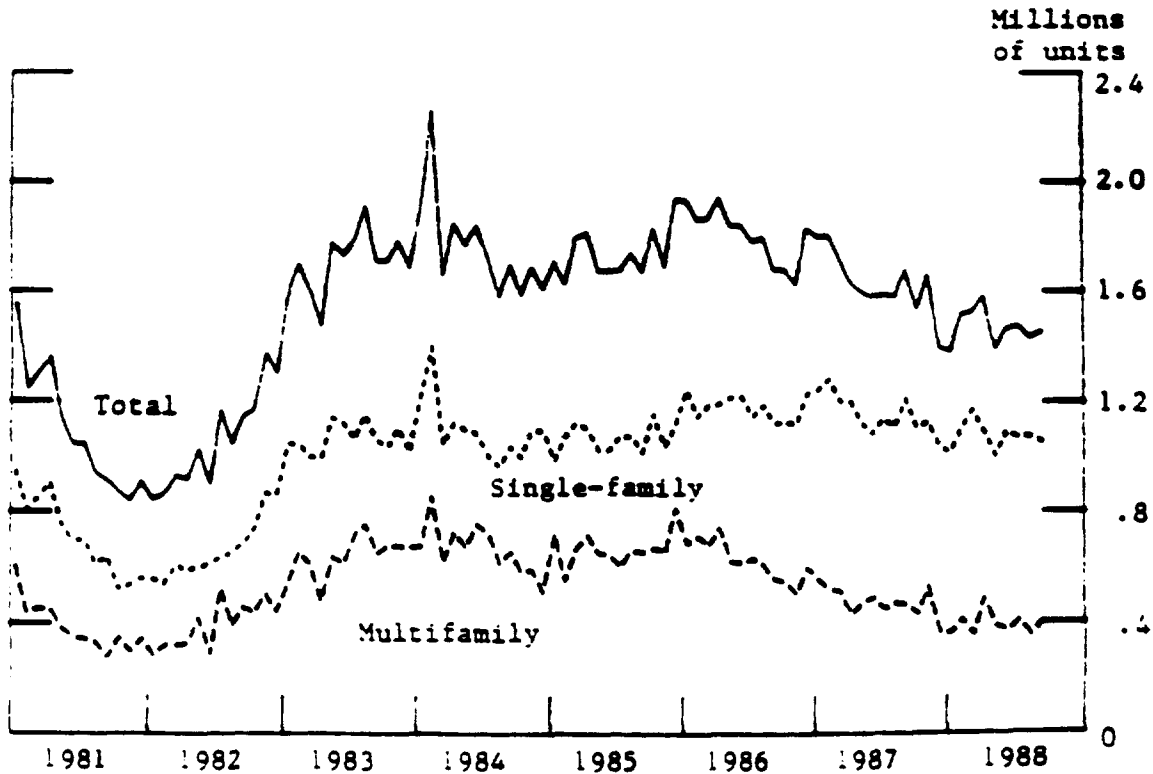


PRIVATE HOUSING ACTIVITY
(Seasonally adjusted annual rates; millions of units)

	1987	1988			1988		
	Annual	Q1	Q2	Q3 ^P	July ^r	Aug. ^r	Sept. ^P
All units							
Starts	1.62	1.48	1.48	1.45	1.48	1.43	1.45
Permits	1.54	1.38	1.46	1.43	1.42	1.46	1.40
Single-family units							
Starts	1.15	1.10	1.06	1.06	1.07	1.08	1.05
Permits	1.02	.98	.98	1.00	.98	1.02	.98
Sales							
New homes	.67	.63	.69	n.a.	.71	.71	n.a.
Existing homes	3.53	3.25	3.64	3.66	3.63	3.71	3.63
Multifamily units							
Starts	.47	.38	.42	.39	.41	.36	.40
Permits	.51	.40	.48	.43	.44	.44	.42

p--preliminary estimates. r--revised. n.a.--not available.

PRIVATE HOUSING STARTS
(Seasonally adjusted annual rate)



slowing in July. Overall, the pace of nonauto trade inventory accumulation in recent months has been in line with sales; based on the current-cost data, inventory-sales ratios for most types of trade establishments have been stable since May, at around the upper end of the ranges of the past year.

Housing Markets

Total housing starts have been little changed, on net, in recent months. In September, starts edged up to 1.45 million units at a seasonally adjusted annual rate, as a decline in single-family starts was more than offset by a rebound in multifamily starts. The recent level of home sales, however, suggests considerably greater strength in the single-family market. From June through August, new home sales held steady at a level of about 710,000 units, the strongest pace since the spring of 1987. Existing home sales from June through September also were at their highest level in more than a year. Surveys taken through late September by the National Association of Homebuilders suggest that the relative weakness in starts of single-family housing compared with sales of new homes may reflect growing concern among builders about prospective housing market developments.

Nationwide inventories of new homes were reduced to 365,000 units in July and August, representing about 6.3 months' supply at recent selling rates. Last January, the stock-sales ratio stood at 7.7 months' supply. The inventory situation is characterized by significant regional disparities. For example, the Northeast has experienced a significant buildup of unsold new homes, relative to sales, in the past

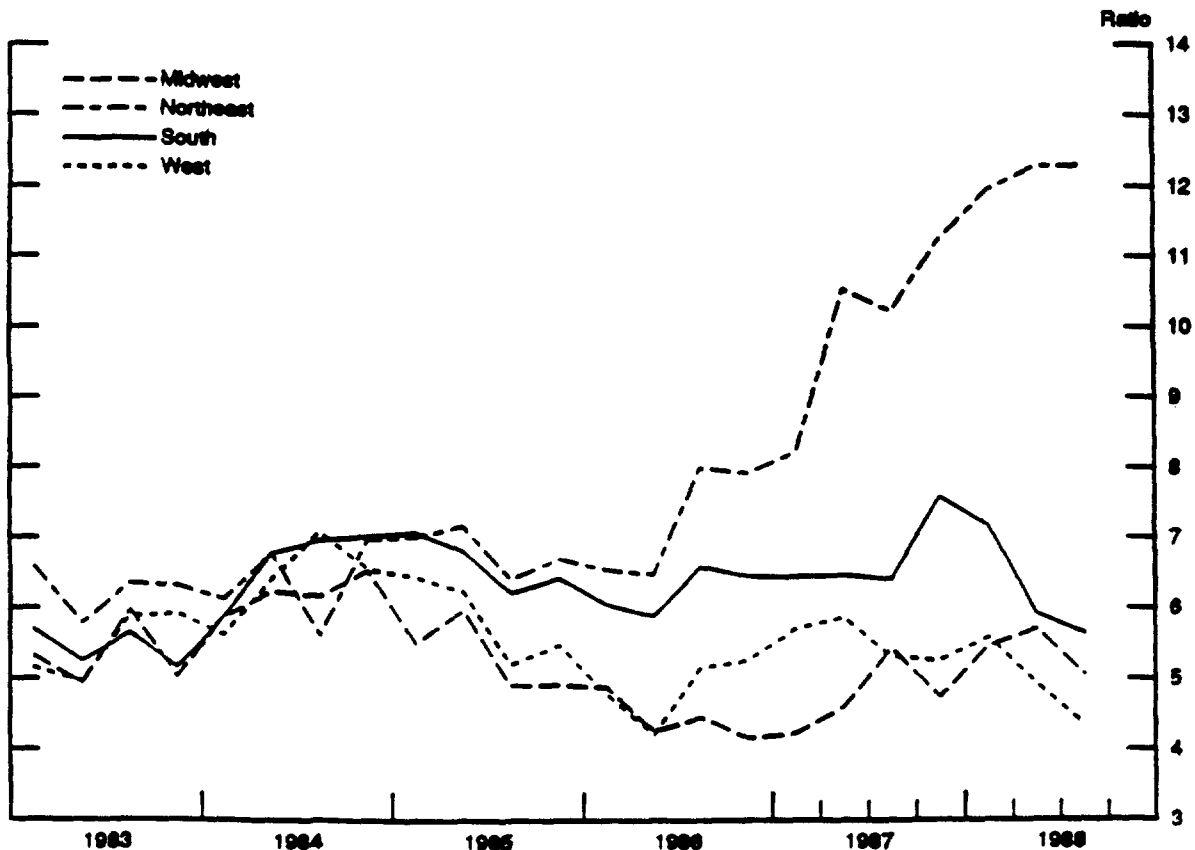
REGIONAL NEW HOME SALES AND PRICES
(Percent change from year ago)

Series	Period	Region			
		Northeast	South	Midwest	West
New home sales	1985	18.7	5.2	10.5	6.8
	1986	23.2	-0.9	13.1	15.7
	1987	-12.8	-15.8	2.1	-5.5
	1988-H1	-9.2	-6.4	-9.5	.5
	1988-July-Aug. ¹	-7.4	4.9	7.2	14.9
New home median price ²	1985	14.5	4.6	-6.5	7.7
	1986	22.9	7.8	9.9	2.3
	1987	13.4	8.5	8.2	17.2
	1988-H1	6.4	3.9	10.4	14.3
	1988-July-Aug.	n.a.	n.a.	n.a.	n.a.

1. Percent change from year ago, based on average sales in July and August.

2. Transactions prices, not adjusted for changes in structural attributes of houses sold.

Ratio of New Home Inventory to Monthly Sales



July and August average is plotted for the third quarter of 1988

two years (chart). Earlier, builders may have been motivated by strong demand to boost the stock of homes for sale. However, in 1987 and the first half of 1988, new home sales declined in the Northeast--likely reflecting homebuyer resistance to previous extraordinary price increases and, perhaps, some weakness in financial services employment. A further buildup of inventories, apparently largely involuntary, has followed. In the South, a gradual decline in inventories has been accompanied by decreasing sales, resulting in an inventory-sales ratio that has moved in a narrow range since mid-1985. In the Midwest and West, inventories have remained at relatively low levels relative to new home sales.

Federal Government

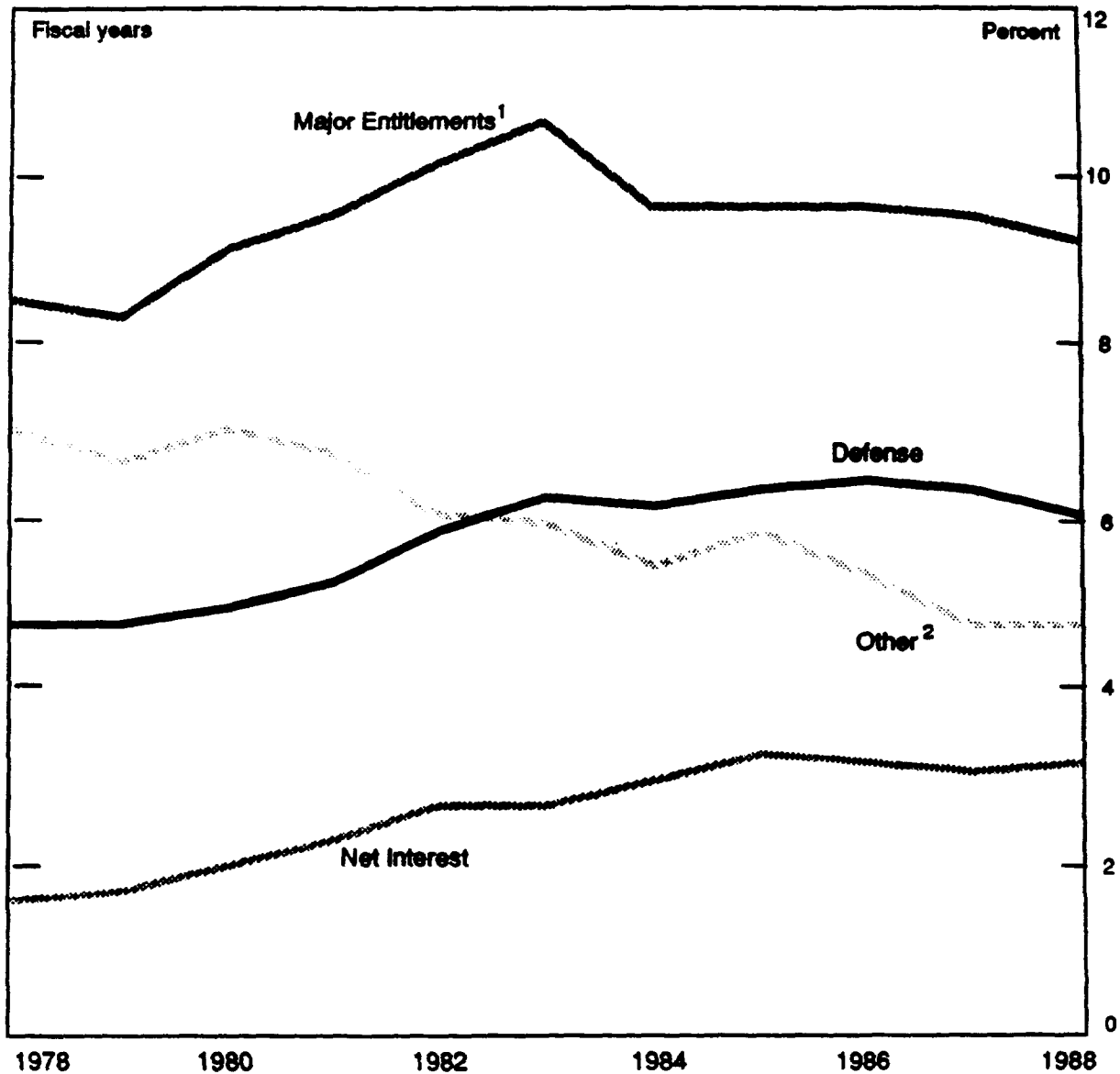
The federal government entered fiscal 1989 with all 13 appropriations bills enacted and without the temporary disruptions or need for the continuing resolutions of recent years. Indeed, this was only the second time since 1948 that all budget appropriations were completed on time. The new appropriations implemented the spending limits agreed upon in last fall's budget summit accord. Other legislation enacted this term with important budget effects includes the drought relief act, which is estimated to increase FY1989 spending by at least \$4 billion, and the Medicare Catastrophic Coverage Act. The medicare expansion is purported to be budget neutral, but will raise both receipts and outlays in future years; FY1989, the effects on both receipts and outlays are less than a billion dollars.

TOTAL FEDERAL BUDGET AND GNP

Total Budget as a Percent of GNP			
Fiscal year	Outlays	Receipts	Deficit
1983	24.3	18.1	-6.3
1984	23.1	18.1	-5.0
1985	24.0	18.6	-5.4
1986	23.6	18.3	-5.3
1987	22.8	19.4	-3.4
1988 ^e	22.3	19.0	-3.2

e—estimate

Major Categories of Federal Spending as a Percent of GNP



1. Health, low-income assistance and retirement programs.
2. Nondefense discretionary programs and some "mandatory" spending such as agriculture and deposit insurance.

As expected, OMB's final sequester report indicated that no automatic spending cuts are required to meet the FY1989 Gramm-Rudman-Hollings (GRH) budget requirement. The report took account of legislation enacted and regulations promulgated through October 15. OMB estimated the deficit on a GRH basis at \$145.5 billion, above the \$136 billion target but just under the \$146 billion trigger. It should be noted that the GRH deficit estimate is not a projection of the actual deficit because the Gramm-Rudman law requires OMB to use the economic and technical assumptions from their Mid-Session Review and excludes one-time deficit-reducing actions, such as asset sales.

The final budget figures for FY1988 will be released within the next few days. On the basis of 11 months of actual data from the Monthly Treasury Statements and Daily Treasury Statements for September, it appears that the total budget deficit will exceed the FY1987 level of \$150 billion.¹ The deficit as a percent of GNP, however, declined for the third year in a row (chart), with both receipts and outlays down in relative terms. Major entitlements (retirement, health, low-income assistance) and national defense, which had been dominant factors in outlay growth earlier, both contracted as shares of GNP, while net interest payments rose more rapidly than GNP. The most dramatic--and largely offsetting--shifts in outlays were the sharp increase in aid to

1. Uncertainty about the FY1988 deficit remains because of coverage and timing differences between the Daily Treasury Statements (DTS) and final budget reports in the Monthly Treasury Statement for September. For example, notes issued by the FSLIC in thrift rescues count as outlays but are not reported in the DTS; and checks issued at the end of September will be counted in the FY1988 totals, but may not appear on the DTS until they clear in October.

depository institutions and the decline in agricultural support payments.

State and Local Governments

Real spending by state and local governments rose at a 2-1/2 percent annual rate in the third quarter, down a bit from the 3-1/4 percent increase over the first half of the year. Available monthly data show construction spending in real terms down 2-1/4 percent in August, to a level more than 1-1/2 percent below its second-quarter average. Total employment for the sector rose nearly 100,000 in September, reflecting a surge in public school jobs. Over all, job gains at state and local governments were relatively modest earlier in the summer, and for the third quarter as a whole, employment growth averaged 40,000, only a little more than the 34,000 average monthly rise during the first half of the year.

With the 1988-89 fiscal year under way for all states, budget plans suggest sustained growth in nominal outlays. A recent survey by the National Conference of State Legislatures indicates that states as a group expect general funds spending to increase 6-1/2 percent in fiscal year 1989, similar to the 6-1/4 percent rise the previous year.² Education accounts for the largest share of outlays in virtually all states, with the sum of elementary-secondary and higher education spending constituting at least half the total. For fiscal year 1989, spending for elementary-secondary schools is expected to advance 7-1/2 percent, while expenditures for higher education are projected to rise a

2. At the state level, the general funds budgets are the main operational budgets and represent 61 percent of total state revenue. They typically do not include construction expenditures.

bit under 5 percent. Outlays from the general fund for the operation of state correctional facilities for adults--which in recent years have been the fastest growing component of general funds spending--are expected to increase 9-1/2 percent this fiscal year, 1 percentage point less than last year.

Prices

Rising food prices contributed significantly to inflation rates in the third quarter. Energy prices increased markedly in August, but turned down in September. Outside of food and energy, prices at the consumer level increased somewhat more slowly in the third quarter than during the first half of the year, while at the producer level, inflation picked up from the first-half pace. The consumer price index for all urban consumers rose 0.4 percent in August and 0.3 percent in September. Producer prices of finished goods were up 0.4 percent in September, after a 0.6 percent rise in August.

The CPI for food rose at a 0.6 and 0.8 percent monthly pace in August and September, respectively, with continued large increases for fruits and vegetables, poultry, and cereal and bakery products. At the farm level, prices of crude foods rose about 1-1/2 percent in September, to a level about 15 percent above a year earlier. Moreover, upward pressures on consumer food prices seem likely to continue in the near term. Since the mid-September pricing date for the PPI, price changes in spot markets for food commodities have been mixed but, on balance, suggest that the October PPI for crude foods may be up somewhat further, mainly reflecting higher cattle prices.

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

	Relative importance Dec. 1987	1987	1988			1988	
			Q1	Q2	Q3	Aug.	Sept.
			----Annual rate----			-Monthly rate-	
All items ²	100.0	4.4	4.2	4.5	4.8	.4	.3
Food	16.1	3.5	1.4	7.1	9.9	.6	.8
Energy	7.6	8.2	-4.9	4.2	2.7	.9	-.6
All items less food and energy	76.3	4.2	5.4	4.3	4.0	.2	.4
Commodities	25.8	3.5	4.7	3.9	3.1	-.3	.8
Services	50.6	4.5	5.9	4.5	4.1	.5	.1
Memorandum:							
CPI-W ³	100.0	4.5	3.5	4.9	4.9	.4	.3

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

2. Official index for all urban consumers.

3. Index for urban wage earners and clerical workers.

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

	Relative Importance Dec. 1987	1987	1988			1988	
			Q1	Q2	Q3	Aug.	Sept.
			----Annual rate----			-Monthly rate-	
Finished goods	100.0	2.2	2.7	4.6	5.7	.6	.4
Consumer foods	25.9	-.2	6.0	9.4	8.8	.4	1.2
Consumer energy	9.6	11.2	-18.5	4.8	-4.6	2.2	-3.3
Other consumer goods	40.1	2.7	5.7	2.4	6.6	.3	.4
Capital equipment	24.4	1.3	3.2	3.6	5.4	.4	.8
Intermediate materials ²	95.0	5.4	4.3	7.4	5.3	.4	.4
Excluding energy	82.5	5.2	8.2	6.9	7.2	.4	.6
Crude food materials	39.5	1.8	17.7	30.5	23.5	2.2	1.6
Crude energy	41.9	10.7	-24.1	12.2	-29.0	.1	-3.1
Other crude materials	18.6	22.6	15.9	-7.0	9.2	.9	-.6

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

2. Excludes materials for food manufacturing and animal feeds.

PRICE INDEXES FOR COMMODITIES AND MATERIALS¹

	Last observation	Percent change ²			
		1988			
		1986	1987	To Sept. 13 [*]	Sept. 13 [*] to date
1. PPI for crude materials ³	Sept.	-8.9	8.9	2.3	n.a.
1a. Ex. food and energy	Sept.	1.8	22.6	4.8	n.a.
1b. Ex. food and energy, seas. adj.	Sept.	1.7	22.8	4.1	n.a.
2. IMF commodity index ³	Sept.	-7.9	30.8	4.4	n.a.
2a. Metals	Sept.	-.5	51.9	9.6	n.a.
2b. Nonfood agric.	Sept.	8.5	47.5	-13.8	n.a.
3. Commodity Research Bureau					
3a. Futures prices	Oct. 24	-9.1	11.7	6.0	-1.2
3b. Industrial spot prices	Oct. 21	5.1	19.2	3.4	-.2
4. <u>Journal of Commerce</u> industrials	Oct. 24	-1.4	10.7	3.1	-2.8
5. <u>Economist</u> (U.S. dollar index)	Oct. 18	-4.7	42.5	8.6	-.6
5a. Industrials	Oct. 18	5.8	62.6	6.3	.2
6. Dow-Jones Spot	Oct. 24	-8.9	17.0	.2	.2

1. Not seasonally adjusted.

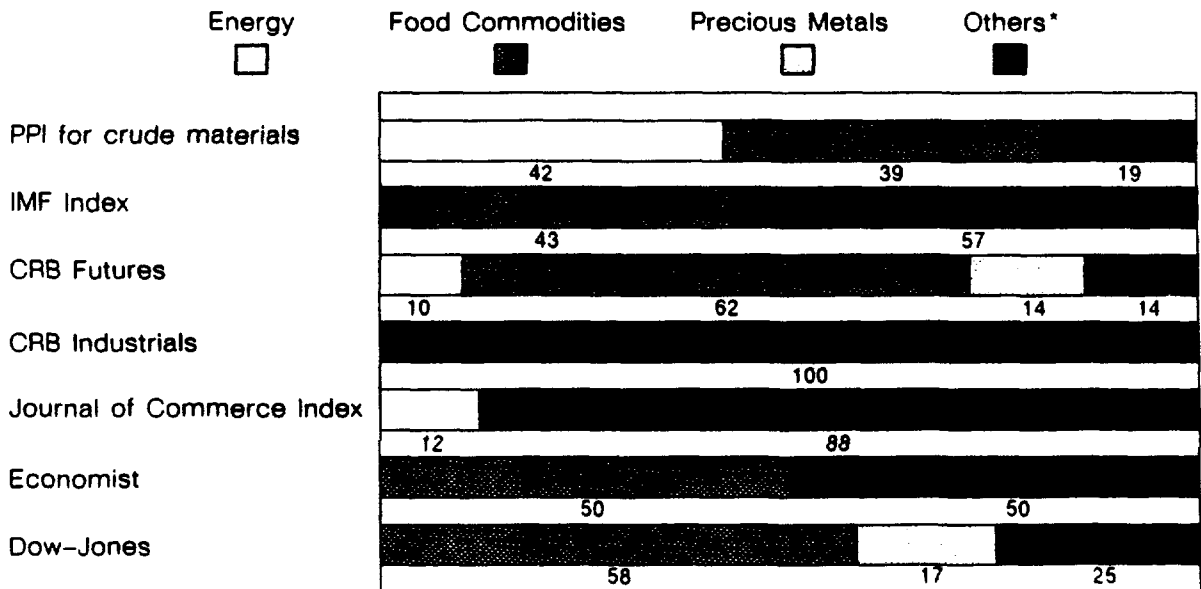
2. Change is measured to end of period, from last observation of previous period.

3. Monthly observations. IMF index includes items not shown separately.

n.a.--Not available.

*Week of the September Greenbook.

Index Weights



*Forest products, industrial metals, and other industrial materials.

CPI energy prices dropped 0.6 percent in September, retracing much of the gain posted in August. Gasoline prices fell 1.7 percent in September; temporary disruptions of production at domestic refineries early in the summer had led to tighter stocks and rising prices of gasoline in July and August in spite of lower crude oil costs. However, a subsequent rise in imports of higher priced gasoline, in conjunction with a rebound in domestic production in the latter half of the summer, helped restore inventories to more normal levels by mid-August, contributing to the September decline in gasoline prices at both the refinery and retail levels. Additional sizable declines in gasoline prices are anticipated over the next few months, reflecting the continued pass-through of the lower crude oil costs.

Excluding food and energy items, the CPI for goods dropped 0.3 percent in August, but turned up 0.8 percent in September. A sharp swing in apparel prices mainly was responsible for this monthly pattern, which reflected larger-than-normal discounting at the end of the summer clothing season, followed by the introduction of fall and winter items at markedly higher prices. Prices also rose sharply in September for other goods, notably new cars and pharmaceuticals. The increase for cars (0.8 percent) reflected primarily less than typical end-of-model-year discounting. Nonenergy service prices increased 0.4 percent in August, but rose only 0.1 percent in September; the September index was held down by large declines for out-of-town lodging and for tuition.³

3. Both reflected difficulties in seasonal adjustment. The BLS has indicated that rates at resorts, particularly on the East coast, were lowered earlier than usual at the end of the summer season. Tuition fees, which are typically adjusted in September, rose somewhat less than in recent years.

Over the past year, the CPI for goods and services other than food and energy rose at nearly a 4-1/2 percent rate, only a little more than the rise for the same period in 1987.

At the producer level, the rise in prices of finished goods less food and energy rose 0.6 percent in September, boosted, in part, by higher prices for motor vehicles. Prices of cars and trucks increased 1-3/4 percent, after seasonal adjustment, accounting for about 1/4 percentage point of the increase in this PPI component; similar to the situation for the CPI, the seasonally adjusted increase partly reflected less discounting than has occurred in recent years. Even abstracting from motor vehicles, there was a significant acceleration of producer prices in other categories of consumer and capital goods in the third quarter.

The PPI for intermediate materials (less food and energy) rose 0.6 percent in September, similar to the 7 percent average annual rate since late last year. In contrast, increases in prices of crude nonfood materials less energy have slowed significantly this year; they have risen at about a 5-1/2 percent annual rate for the year to date, after climbing more than 20 percent in 1987.

Since the pricing date for the September PPI, price changes in spot markets for industrial materials have continued to be mixed, with a further climb in copper prices but declines for aluminum, hides, and rubber. The domestic commodity price indexes based mainly on industrial materials have registered relatively small changes so far this year. The price of gold--which has relatively little industrial use--generally has trended down during the year, coinciding with the strengthening of the dollar, as well as the decline in oil prices.

DOMESTIC FINANCIAL DEVELOPMENTS

SELECTED FINANCIAL MARKET QUOTATIONS¹
(Percent)

	1987		1988		Change from: FOMC Sept. 20	
	Jan.-Feb. lows	Oct. 16 ²	Feb lows	FOMC Sept. 20 Oct. 25		
Short-term rates						
Federal funds ³	5.95	7.59	6.38	8.15	8.30	.15
Treasury bills ⁴						
3-month	5.30	6.93	5.59	7.20	7.44	.24
6-month	5.31	7.58	5.77	7.38	7.55	.17
1-year	5.35	7.74	6.10	7.50	7.59	.09
Commercial paper						
1-month	5.81	7.94	6.41	8.01	8.16	.15
3-month	5.73	8.65	6.45	8.08	8.28	.20
Large negotiable CDs ⁴						
1-month	5.85	7.92	6.44	8.06	8.19	.13
3-month	5.80	8.90	6.49	8.17	8.43	.26
6-month	5.78	9.12	6.55	8.45	8.53	.08
Eurodollar deposits ⁵						
1-month	6.00	7.79	6.60	8.16	8.25	.09
3-month	6.00	8.69	6.69	8.27	8.51	.24
Bank prime rate	7.50	9.25	8.50	10.00	10.00	.00
Intermediate- and long-term rates						
U.S. Treasury (constant maturity)						
3-year	6.34	9.52	7.28	8.56	8.48	-.08
10-year	7.01	10.23	8.11	8.97	8.83	-.14
30-year	7.29	10.24	8.32	9.06	8.93	-.13
Municipal revenue ⁶ (Bond Buyer)	6.92	9.59	7.76	7.88	7.77	-.11
Corporate A utility (recently offered)	8.78	11.50	9.63	10.30e	10.06e	-.24
Home mortgage rates ⁷						
S&L fixed-rate	9.10	11.58	9.84	10.40	10.28	-.12
S&L ARM, 1-yr.	7.52	8.45	7.59	8.12	8.13	.01

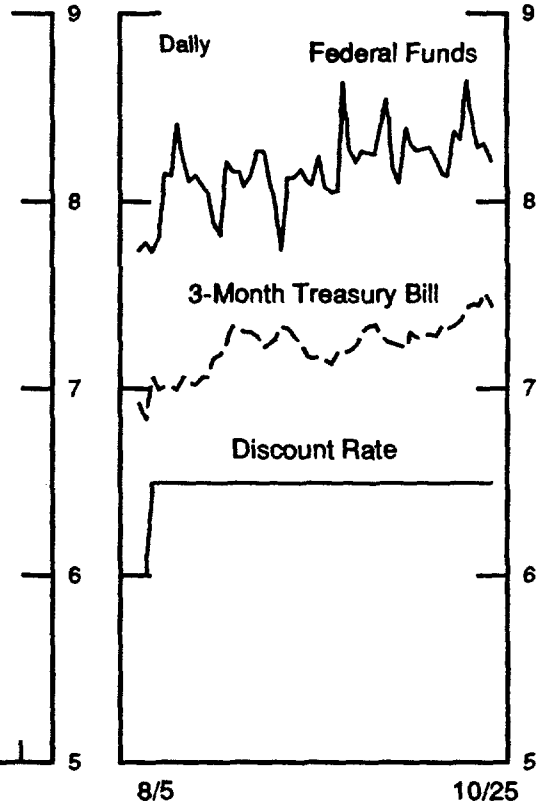
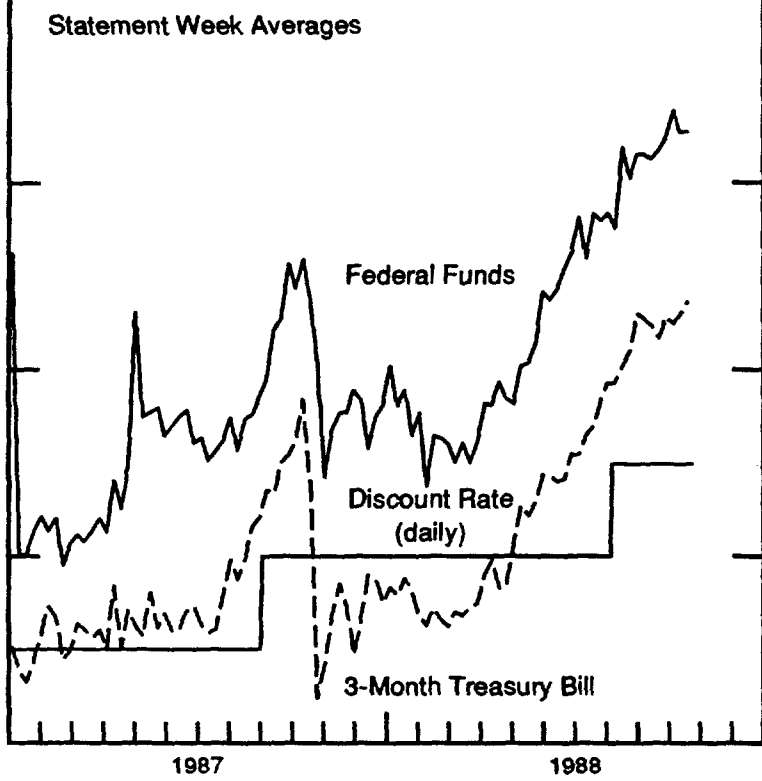
	1986	1987		1988		Percent change from: FOMC Sept. 20
	Year-end	Record highs	Lows	FOMC Sept. 20	Oct. 25	
Stock prices						
Dow-Jones Industrial	1895.95	2722.42	1738.74	2087.48	2173.36	4.11
NYSE Composite	138.58	187.99	125.91	152.44	158.87	4.22
AMEX Composite	263.27	365.01	231.90	298.63	304.38	1.93
NASDAQ (OTC)	348.83	455.26	291.88	384.10	386.12	.53

1. One-day quotes except as noted.
 2. Last business day prior to stock market decline on Monday, October 19, 1987.
 3. Average for two-week maintenance period closest to date shown except lows shown which are one-week average ending Feb. 25 and Feb. 10, respectively. Last observation is average to date for maintenance period ending 11/2/88.

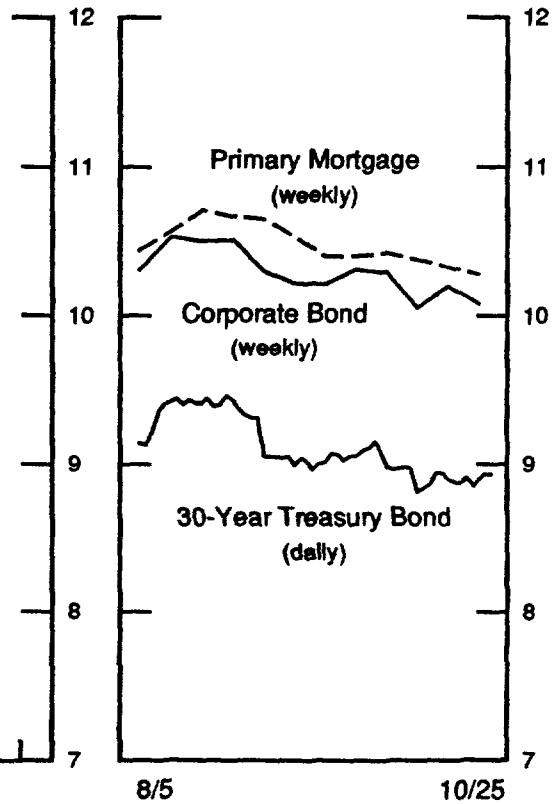
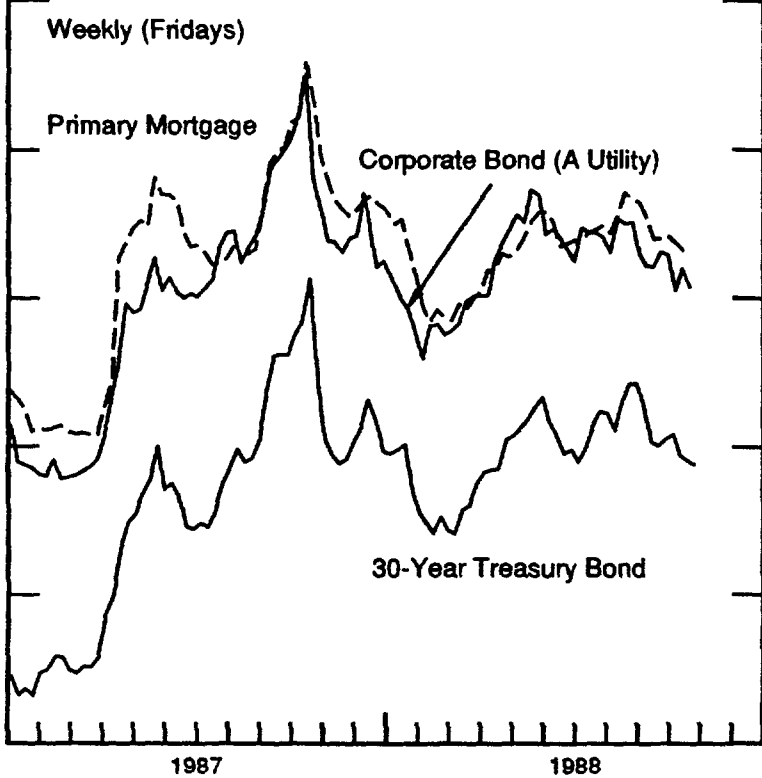
4. Secondary market.
 5. Average for statement week closest to date shown.
 6. One-day quotes for Thursday.
 7. Quotes for week ending Friday closest to date shown.
 e--estimate.

Selected Interest Rates* (percent)

Short-Term



Long-Term



*--Friday weeks through October 21, Wednesday weeks through October 19.

DOMESTIC FINANCIAL DEVELOPMENTS

Short-term market rates of interest have edged higher on balance since the September 20 FOMC meeting. In the bond markets, however, prices have been buoyed by hopes that weak energy prices and more moderate economic expansion will obviate any substantial further tightening of money market conditions. In recent days, though, some of these gains have been given back in the market for 30-year Treasury bonds, owing to new supply authority, and in the market for industrial bonds, owing to concerns about merger-induced leveraging. Still, the term structure of interest rates in recent weeks has been flatter than at any time since July 1986.

With deposit rates still in the process of catching up with earlier increases in market rates, high opportunity costs have continued to foster sluggish growth of the monetary aggregates. M1 was unchanged in September and M2 rose only slightly; this pattern of weakness was sustained in early October. M3 also increased little in September, when bank credit was flat and a large influx of government deposits satisfied a good part of bank funding needs, but this aggregate seems to have accelerated somewhat in October. For the year, M2 is running a little below and M3 a little above the midpoints of their 1988 ranges.

Overall credit demands increased, on balance, in September, at about the reduced pace of recent months. Borrowing by nonfinancial business apparently remained subdued as some pickup in bond offerings was offset by further weakness in business loans at banks and commercial

MONETARY AGGREGATES
(based on seasonally adjusted data unless otherwise noted)

	1987 ¹	1988 Q2	1988 Q3p	1988 Jul	1988 Aug	1988 Sep p	Growth Q4 87- Sep 88p
-----Percent change at annual rates-----							
1. M1	6.2	6.3	5.3	9.1	0.2	0.0	4.7
2. M2	4.0	7.7	3.7	3.7	2.3	1.3	5.7
3. M3	5.4	7.5	5.6	6.8	3.7	1.7	6.4
-----Percent change at annual rates-----							Levels bil. \$ Sep 88p
<u>Selected components</u>							
4. M1-A	2.8	3.9	3.3	4.8	0.7	-0.7	504.1
5. Currency	8.7	8.4	7.1	8.2	5.2	7.5	208.5
6. Demand deposits	-1.0	1.0	0.7	2.9	-2.5	-6.6	288.4
7. Other checkable deposits	13.6	10.6	9.0	17.1	-0.9	0.9	278.3
8. M2 minus M1 ²	3.3	8.2	3.2	1.9	3.1	1.8	2252.6
9. Overnight RPs and Eurodollars, NSA	4.1	3.0	-2.5	-44.4	36.9	-37.3	77.9
10. General purpose and broker/dealer money market mutual fund shares, NSA	5.8	3.3	-3.1	3.7	6.3	0.5	230.9
11. Commercial banks	2.5	6.8	5.1	4.9	3.8	4.0	964.8
12. Savings deposits, SA, plus MMDAs, NSA ³	1.8	3.2	1.2	2.2	-3.1	-7.9	543.9
13. Small time deposits	3.5	11.8	10.1	8.8	12.6	19.4	420.8
14. Thrift institutions	3.5	9.1	2.8	1.6	2.8	2.5	977.1
15. Savings deposits, SA, plus MMDAs, NSA ³	0.8	2.3	0.3	2.1	-1.8	-10.7	399.9
16. Small time deposits	5.6	14.0	4.7	1.3	6.1	11.8	577.2
17. M3 minus M2 ⁴	11.2	6.9	12.9	18.4	8.9	3.4	816.1
18. Large time deposits	8.5	7.6	15.6	17.9	13.2	19.8	523.3
19. At commercial banks, net ⁵	11.2	6.7	21.4	25.1	20.4	18.3	352.3
20. At thrift institutions	3.4	9.3	4.1	2.1	0.0	22.2	171.0
21. Institution-only money market mutual fund shares, NSA	3.0	-30.6	-23.3	-20.9	-11.3	-4.3	83.7
22. Term RPs, NSA	32.8	25.1	8.8	7.9	-19.5	-16.9	119.3
23. Term Eurodollars, NSA	13.8	19.4	36.9	34.9	75.3	-8.3	100.9

-----Average monthly change in billions of dollars-----

MEMORANDA:⁶

24. Managed liabilities at commercial banks (25+26)	6.2	7.8	2.3	3.9	10.8	-7.7	602.3
25. Large time deposits, gross	3.5	1.5	6.3	6.2	6.7	6.0	419.4
26. Nondeposit funds	2.7	6.3	-4.0	-2.3	4.1	-13.7	182.9
27. Net due to related foreign institutions, NSA	2.9	3.9	0.2	2.1	7.9	-9.5	9.2
28. Other ⁷	-0.2	2.4	-4.1	-4.4	-3.8	-4.2	173.7
29. U.S. government deposits at commercial banks ⁸	0.3	-1.0	0.8	-1.8	-4.4	8.7	24.5

1. Amounts shown are from fourth quarter to fourth quarter.
 2. Nontransactions M2 is seasonally adjusted as a whole.
 3. Commercial bank savings deposits excluding MMDAs grew during August and September at rates of 7 percent and -1.9 percent, respectively. At thrift institutions, savings deposits excluding MMDAs grew during August and September at rates of 4.5 percent and -3 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. Dollar amounts shown under memoranda are calculated on an end-month-of-quarter basis.
 7. Consists of borrowing 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 borrowing from the Federal Reserve and unaffiliated foreign banks, loan RPs and other minor items). Data are partially estimated.
 8. Consists of Treasury demand deposits and note balances at commercial banks.
- p - preliminary

paper. Long-term borrowing by state and local governments rose, primarily reflecting an increase in offerings of housing bonds, and federal borrowing declined less than seasonally. Data on the household sector suggest that the pace of mortgage and consumer debt expansion was well maintained during the third quarter, although little information is available for September.

Monetary Aggregates and Bank Credit

The monetary aggregates grew quite slowly in September, with particular weakness evident in their liquid components. M1 was unchanged during the month, while growth in M2 and M3 slowed to annual rates of only 1-1/4 and 1-3/4 percent, respectively. Preliminary and partial information suggests that M3 growth has rebounded somewhat in October, but that growth in the other aggregates has continued near the reduced September pace.

M1 was restrained last month by a further decline in demand deposits. The weakness in demand deposits likely reflects the growing opportunity cost of holding these non-interest-earning accounts, together with reduced compensating balance requirements. Other checkable deposits were little changed last month, as rates on these deposits have adjusted sluggishly to advances in short-term market rates.

Growth in the nontransactions component of M2 slowed to a 1-3/4 percent annual rate in September, with only small time deposits registering a significant increase. With the deposit rate curve

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

	1986:Q4	1988					Levels
	to						bil.\$
	1987:Q4	Q2	Q3 ^P	July	August	Sept. ^P	Sept. ^P
----- Commercial Bank Credit -----							
1. Total loans and securities at banks	7.9	11.5	4.3	6.3	7.2	- .7	2373.6
2. Securities	5.0	8.3	- .3	-4.8	4.6	- .7	546.6
3. U.S. government securities	9.6	12.1	2.2	-8.6	8.6	6.5	352.4
4. Other securities	-1.9	1.6	-4.5	1.8	-2.4	-12.8	194.3
5. Total loans	8.9	12.5	5.6	9.6	7.9	- .7	1826.9
6. Business loans	7.0	15.8	3.2	12.0	2.2	-4.6	597.1
7. Security loans	.8	-18.4	-30.5	-21.4	46.6	-113.7	36.3
8. Real estate loans	18.8	13.3	12.6	12.3	13.9	11.3	644.7
9. Consumer loans	5.1	8.8	5.6	3.1	5.9	7.6	349.2
10. Other loans	-3.1	13.8	-1.6	11.4	2.4	-18.4	199.6
----- Short- and Intermediate-Term Business Credit -----							
11. Business loans net of bankers acceptances	7.2	16.1	3.0	11.8	1.4	-4.2	593.5
12. Loans at foreign branches ²	-4.1	4.1	26.3	-48.5	63.2	66.0	21.1
13. Sum of lines 11 & 12	6.8	15.8	3.7	9.9	3.3	-1.9	614.6
14. Commercial paper issued by nonfinancial firms	-1.6	12.2	-4.8	-22.3	9.4	-1.3	90.3
15. Sum of lines 13 & 14	5.7	15.3	2.6	5.7	3.9	-1.7	704.9
16. Bankers acceptances: U.S. trade related ^{3,4}	13.3	-9.5	-7.3	-7.3	-11.0	-3.7	32.2
17. Line 15 plus bankers acceptances: U.S. trade related	6.0	14.1	2.2	5.1	3.3	-1.8	737.1
18. Finance company loans to business ³	19.3	12.1	n.a.	9.2	4.8	n.a.	223.8 ⁵
19. Total short- and intermediate-term business credit (sum of lines 17 & 18)	8.8	13.7	n.a.	6.0	3.6	n.a.	962.0 ⁵

*Data in this table have been benchmarked to March 1988 commercial bank call reports. The benchmark affects data back to January 1987.

1. Average of Wednesdays.

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

3. Based on average of data for current and preceding ends of month.

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

5. August data.

n.a.--not available

p--preliminary

steepening further last month, savings deposits and MMDAs declined substantially, while small time deposits rose at a 15 percent rate. Growth in small time deposits remained uncharacteristically skewed toward commercial banks, where a 19-1/2 percent rate was recorded. However, thrifts resumed pricing their accounts more aggressively, and expansion in their small time deposits picked up to a 11-3/4 percent annual rate. Inflows to small time deposits at both banks and thrifts appear to have remained heavy in October. Runoffs of overnight RPs and Eurodollars acted as a drag on M2 in September and appear to be doing so again this month.

Large time deposits, which had been growing rapidly in recent months, accelerated further in September as issuance by thrift institutions picked up sharply. The overall expansion of the non-M2 portion of M3, however, slowed as other components related to managed liabilities continued to run off.

Banks paid down managed liabilities, despite weakness in core deposits, as Treasury deposits increased and bank credit contracted slightly, the first decline this year. Bank securities portfolios shrank in September as net acquisitions of U.S. government securities were insufficient to offset a sharp decline in other securities, particularly municipals. Bank holdings of municipals have been declining, albeit unevenly, for two years, owing to the Tax Reform Act, which removed carrying cost deductibility on issues in excess of \$10 million that were acquired after August 1986.

Loan portfolios also shrank as business and security borrowings ran off. The decline in business loans reflected, in part, a pause in merger-related financing, which had added substantially to loan demand earlier in the quarter. Growth in real estate loans fell off slightly, but remained in double digits, buoyed in small part by an acceleration of home equity loan balances to an annualized growth pace around 30 percent.

Consumer loans were the only major category to accelerate in September, growing at a 7-1/2 percent annual rate despite bank issuance of about \$2 billion of asset-backed securities. Adjusting for securitization, consumer loans at banks grew at about a 10 percent pace in September, a 2 percentage point step-up over the previous month. (See the section on consumer installment credit for further discussion of the securitization of consumer loans.)

Data for large banks through mid-October point to growth in bank credit this month. Net acquisition of government securities appears to have strengthened, while holdings of other securities have resumed growing. Lending to businesses also has firmed. As a consequence, banks have continued to issue large amounts of CDs, while term RPs and Eurodollars have remained high.

Business Finance

Borrowing by nonfinancial businesses in September remained sluggish, as a decline in bank loans and commercial paper (the first since March 1987) more than offset a pickup in bond issuance. The

pickup in bond volume followed a drop in corporate bond yields of 50 basis points since late August and a flattening of the yield curve. Data available for October suggest maintenance of the higher level of bond offerings, a substantial increase in commercial paper outstanding, and some pickup in borrowing from banks.

The overall moderation in borrowing by nonfinancial businesses in the third quarter is consistent with the significant slowing in net equity retirements that accompanied a temporary slackening in merger and acquisition activity. Recent announcements of several mega-deals, including a massive bid for RJR Nabisco, suggest that share retirements may surge to a record in the current quarter, likely pushing borrowing up noticeably. In reaction to increased merger and buyout activity, the yields on bonds of industrial companies thought vulnerable to a buyout increased appreciably; the spread between industrial and utility A-rated bonds is up roughly 40 basis points from usual conditions.

Since the last FOMC meeting, most stock indexes have climbed to post-crash peaks, but have declined slightly in recent days. Share prices remain about 15 percent below the record highs of late August 1987 when the price-earnings ratio for the S&P 500 also peaked at 23 (based on prior 12-month reported profits). Owing to continued strength in earnings and only moderate increases in share prices, the P-E ratio for the S&P 500 has declined from 15-1/2 at the end of 1987 to 12-1/2 at the end of September 1988.

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

	1987	1988					
	Year	Q1	Q2 ^p	Q3 ^p	Aug. ^p	Sept. ^p	Oct. ^e
Corporate securities - total ¹	24.08	23.56	25.09	19.85	18.87	22.51	20.60
Public offerings in U.S.	21.89	22.17	22.50	17.76	17.50	19.80	19.00
Stocks--total ²	4.45	3.89	3.68	3.91	3.50	3.10	3.00
Nonfinancial	2.32	.76	1.65	1.47	1.20	.80	1.00
Utility	.57	.32	.31	.13	.20	.15	.20
Industrial	1.75	.44	1.34	1.34	1.00	.65	.80
Financial	2.12	3.13	2.03	2.44	2.30	2.30	2.00
Bonds--total ¹	17.44	18.28	18.82	13.85	14.00	16.70	16.00
Nonfinancial	6.61	6.59	7.93	5.07	5.25	5.80	6.00
Utility	2.02	2.25	2.55	1.13	.35	1.80	1.50
Industrial	4.59	4.34	5.38	3.94	4.90	4.00	4.50
Financial	10.83	11.69	10.88	8.78	8.75	10.90	10.00
By quality ³							
Aaa and Aa	3.27	3.83	3.11	1.75	2.70	1.45	1.50
A and Baa	5.20	7.06	7.24	3.84	3.30	5.55	5.50
Less than Baa	2.77	1.33	2.85	2.70	2.70	2.30	3.50
No rating (or unknown)	.07	.16	.14	.07	.10	.10	.10
Memo items:							
Equity-based bonds ⁴	.87	.13	.37	.32	.09	.39	.25
Mortgage-backed bonds	5.19	5.47	4.16	3.82	4.58	3.80	4.80
Other asset-backed	.96	.53	1.32	1.67	.60	3.49	.60
Variable-rate notes	1.88	1.44	1.35	.80	1.09	.35	.20
Bonds sold abroad - total	2.03	1.34	2.40	2.01	1.34	2.70	1.50
Nonfinancial	.94	.39	.87	.81	.83	1.00	.65
Financial	1.09	.95	1.53	1.20	.51	1.90	.85
Stocks sold abroad - total	.16	.05	.19	.08	.03	.01	.10
Nonfinancial	.12	.04	.14	.07	.01	.00	.10
Financial	.04	.01	.05	.01	.02	.01	.00

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 or Standard and Poors if unrated by Moody's. Excludes mortgage-backed and asset-backed bonds.

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

p--preliminary. e--staff estimate.

ACTIVITY IN THE EQUITY MARKETS
BEFORE AND AFTER THE OCTOBER 1987 BREAK

	January 1987 to September 1987	October 1987	November 1987 to September 1988
<hr/>			
<u>Average daily trading volume</u>		(millions of shares)	
NYSE	181	277	169
NYSE block volume	93	146	92
AMEX	14	18	10
NASDAQ	149	185	125
		(thousands of contracts)	
S&P 500 Futures	81	81	46
S&P 100 Options	444	466	218
<hr/>			
<u>Average monthly flows into open-end equity mutual funds</u> ¹	3819	(millions of dollars) -7218	-813
<hr/>			
<u>Average monthly equity issuance</u>			
Nonfinancial	2853	1581	1113
Industrial	2132	1359	889
Utilities	721	222	224
Closed-end funds	927	138	1414
Initial public offerings ²	1007	1288	344

1. Through August 1988.

2. Excluding closed-end funds.

For brokerage firms, reduced trading volume has been a continuing problem. As indicated in the top portion of the table above, volume has declined on all major stock exchanges, and trading of derivative instruments has been cut in half. This lighter trading has reflected a pullback by all classes of investors, especially individuals. The attitude of individual investors is reflected, too, in the net outflow from open-end equity funds, which is shown in the middle of the table. Further confirmation of a falloff in direct retail trading in equities is provided by data on commission income of NYSE member organizations, which fell more than 25 percent from the first half of 1987 to the first half of 1988. As shown in the second line of the table, NYSE block

III-10
 TREASURY AND AGENCY FINANCING¹
 (Total for period; billions of dollars)

	1988		1988		
	Q3 ^p	Q4 ^e	Sept. ^p	Oct. ^e	Nov. ^e
<u>Treasury financing</u>					
Total surplus/deficit (-)	-36.0	-70.4	10.1	-28.2	-30.9
Means of financing deficit:					
Net cash borrowing from the public	42.6	47.6	15.5	10.2	20.0
Marketable borrowings/ repayments (-)	32.8	41.0	12.2	7.4	18.5
Bills	16.2	18.7	5.1	5.1	6.6
Coupons	16.7	22.3	7.1	2.3	11.9
Nonmarketable ²	3.8	4.5	.4	2.2	.8
Other borrowing ²	5.9	2.1	3.0	.7	.7
Decrease in the cash balance	-4.9	27.3	-31.4	13.6	21.5
Memo: Cash balance at end of period	44.4	17.1	44.4	30.9	9.4
Other ³	-1.8	-4.5	5.8	4.4	-10.6
<u>Federally sponsored credit agencies, net cash borrowing⁴</u>					
	10.3 ^e	--	5.3 ^e	--	--
FHLBs	8.2	--	4.7	--	--
FNMA	1.0 ^e	--	.0 ^e	--	--
Farm Credit Banks ⁵	-1.7	--	.2	--	--
FAC ⁵	.5	--	.0	.0	--
FHLMC	.7 ^e	--	.2 ^e	--	--
FICO	.9	--	.0	.0	.7
SLMA	.7	--	.2	--	--

1. Data reported on a not seasonally adjusted, payment basis.
 2. Securities issued by federal agencies under special financing authorities (primarily FSLIC).
 3. Includes checks issued less checks paid, accrued items and other transactions.
 4. Excludes mortgage pass-through securities issued by FNMA and FHLMC.
 5. Financial Assistance Corporation, an institution within Farm Credit System, was created in January 1988 by Congress to provide financial assistance to Farm Credit Banks. It first issued bonds in July 1988.
- e--staff estimate.
p--preliminary.
- Note: Details may not add to totals due to rounding.

volume remains near pre-October 1987 levels; however, much of this activity reflects dividend-capture trades, which yield especially low income to brokers. Unless trading activity picks up soon, necessary cost cutting by brokerage firms likely will result in additional layoffs in coming months.

By almost any measure, new issuance of equity by nonfinancial firms has been lackluster since the crash, especially compared with the very high flows in the first three quarters of 1987. Closed-end funds, in contrast, have enjoyed success in tapping the equity market for funds, but most of these have been invested in fixed-income securities.

Treasury and Sponsored Agency Financing

The federal budget deficit is expected to deepen this quarter to \$70 billion from \$36 billion in the third quarter. The impact of the projected widening of the deficit on marketable borrowing, however, is anticipated to be muted considerably by a projected \$27 billion drawdown of the Treasury's cash balance. Even so, marketable borrowing is projected to increase \$8 billion in the fourth quarter, and the Treasury is expected to use all segments of the maturity spectrum to raise additional funds, including an appreciable increase in regular 3- and 6-month bills at weekly auctions. Nonmarketable borrowing also is expected to increase, owing to a projected pickup in SLGS. Issuance of FSLIC notes, given to acquirers of insolvent thrifts, surged to \$6 billion in the third quarter, boosting the deficit, though not the Treasury's immediate cash needs; such issuance, however, is projected to slow this quarter.

Passage of the technical corrections bill to the 1986 Tax Reform Act, which contained provisions eliminating limitations on Treasury bond issuance, will enable the Treasury (assuming the bill becomes law in time) to include a long-bond in the November mid-quarter refunding; the prospect of a 30-year issue raised yields in that maturity range slightly relative to yields on 10-year notes.

In the market for securities of federally sponsored credit agencies, spreads relative to Treasury securities narrowed or remained the same in recent months. At the most recent offering of Farm Credit System (FCS) securities in late October, spreads over Treasuries on shorter-maturity issues were about 25 to 40 basis points below their levels of two months ago. The drop was attributed to the smaller size of recent offerings of FCS securities. Recent reports suggesting that the Farm Credit System would require more than the \$4 billion of assistance provided by federal legislation apparently have had little effect on spreads. The FCS continued to pay down debt during the third quarter, primarily through purchases of outstanding high-coupon bonds issued in the early 1980s, with funds provided, in part, by the Financial Assistance Corporation.

Spreads of Federal Home Loan Bank (FHLB) security yields over Treasuries appear to have changed little, despite heavy borrowing by the FHLBs to finance recent large increases in advances to member institutions and the steady stream of publicity surrounding the financial problems of FSLIC and the savings and loan industry. The Financing Corporation (FICO) began to use its \$3-3/4 billion bond

authority for the new fiscal year, launching a \$700 million public offering of 30-year bonds in late October. The spread of 77 basis points over 30-year Treasury bonds was the lowest recorded on any of the agency's offerings. The improvement in the spread generally has been attributed to the recent stripping of the bonds to form zero coupon securities. In addition, the spread probably benefited from the agency's decision to sell the bonds competitively rather than distributing them through a group of dealers and from recent shifts out of bonds of industrial firms thought to be likely takeover targets.

Municipal Securities

New issues of long-term tax-exempt securities totaled about \$9-1/4 billion in September, up some \$2-1/4 billion from August and slightly above the average for the first eight months of the year. Offerings may edge still higher this month. The Bond Buyer 30-year revenue yield declined 11 basis points over the intermeeting period.

Most of the pickup in September reflected issuance for new capital, especially to fund housing activity. Housing-related issuance jumped to \$1-3/4 billion in September, up sharply from the \$1/2 billion 1988 monthly average through August. While congressional action to extend the tax-exempt status of housing-related bonds beyond the December 31 deadline was still in doubt, some municipalities decided to complete deals before year-end. Issuance of housing bonds may decline in upcoming months, however, because Congress extended the tax-exempt status on housing bonds through 1989.

GROSS OFFERINGS OF MUNICIPAL SECURITIES
(Monthly rates, not seasonally adjusted, billions of dollars)

	1986	1987	1988			1988		
	Year	Year	Q1	Q2	Q3 ^p	Aug.	Sept. ^p	Oct. ^f
Total offerings ¹	14.39	10.44	8.68	11.73	11.39	12.87	10.21	11.70
Total tax-exempt	14.04	10.05	8.46	11.41	11.16	12.65	9.86	11.50
Long-term	12.25	8.53	7.94	9.20	8.65	6.97	9.24	10.00
Refundings ²	5.29	3.80	3.05	3.18	1.76	1.65	2.27	--
New capital ³	6.96	4.73	4.89	6.02	6.89	5.32	6.97	--
Short-term	1.79	1.52	.52	2.21	2.51	5.68	.62	1.50
Total taxable	.35	.39	.22	.32	.23	.22	.35	.20

p--preliminary. f--staff forecast.

1. Includes issues for public and private purposes; also includes taxable issues.

2. Includes all refunding bonds, not just advance refundings.

3. Does not include tax-exempt commercial paper.

In late September, the Securities and Exchange Commission, in connection with release of its report on the 1983 Washington Public Power Supply System default, tightened disclosure standards for municipal securities. Underwriters are now required to evaluate potential municipal issuers and to have a reasonable basis for believing in the accuracy of the key representations about the securities they seek to underwrite. The SEC's new ruling applies to both competitive and negotiated underwritings in excess of \$10 million, which currently represent about one-fourth of all municipal issues and about two-thirds of the dollar volume. Thus far, the SEC's action has not had a noticeable effect on the market for new municipal issues.

Mortgage Markets

Growth of mortgage debt appears to have picked up in the third quarter, reflecting better sales of new and existing homes this summer. Growth of real estate loans at commercial banks was strong throughout

the quarter, while the increase in mortgage assets at FSLIC-insured thrifts during the first two months of the quarter substantially exceeded the rate recorded earlier in the year.

Much of the increase in the growth of mortgage credit at banks and thrifts reflects the increased originations of adjustable-rate mortgages (ARMs). The ARM share of newly originated conventional home loans has continued to trend upward through early September, reaching a level of 64 percent. Despite the recent run-up in the ARM share of mortgage originations, however, new issues of federally related mortgage-backed pass-throughs edged up slightly to a seasonally adjusted \$13.6 billion in August.

Activity in secondary mortgage markets does not appear to have been affected by the recently established risk-based capital guidelines for commercial banks. Despite claims that differing treatment of FHLMC and FNMA securities as compared with GNMA's could have serious consequences, yield spreads on these assets in the secondary market appear to be relatively unchanged. The most likely effect, if any, of the new guidelines is to increase commercial banks' tendency to hold their mortgage assets in security form, because the comparatively low capital requirement on holdings of mortgage-backed securities raises the incentives to swap unsecuritized mortgages for mortgage-backed securities.

Secondary market yields on FRMs have declined about 10 basis points since the last FOMC meeting, maintaining relatively tight spreads over long-term Treasuries. In the primary market, the contract rate on

MORTGAGE ACTIVITY AT ALL FSLIC-INSURED INSTITUTIONS
(Monthly averages, billions of dollars, seasonally adjusted)

	Mortgage transactions			Net change in ¹ mortgage assets		
	Origina- tions	Commit- ments	Sales	Total	Mortgage loans	Mortgage- backed securities
1985	16.4	14.9	8.2	4.1	4.2	-.2
1986	22.1	19.8	14.1	4.7	1.3	3.4
1987	21.1	20.1	10.3	6.1	2.4	3.7
1988-Q1 r	18.6	17.8	7.7	2.6	3.6	-.9
Q2 r	19.7	19.1	10.1	5.8	3.4	2.4
1988-Apr. r	18.7	17.7	10.4	5.9	2.7	3.2
May r	19.5	19.0	9.4	5.1	3.6	1.4
June r	20.8	20.5	10.4	6.4	3.8	2.6
July r	19.9	18.8	8.8	6.5	4.6	2.0
Aug. p	22.7	22.7	8.4	7.5	7.2	.3

1. Net changes are adjusted to account for structural changes caused by mergers, acquisitions, liquidations, terminations, or de novo institutions.

NEW ISSUES OF MORTGAGE-BACKED PASS-THROUGH SECURITIES
BY FEDERALLY RELATED AGENCIES
(Monthly averages, billions of dollars)

Period	Seasonally adjusted				Not seasonally adjusted	
	Total	GNMAs	FHLMCs	FNMA's	Total	ARM-backed
1985	9.0	3.8	3.2	2.0	9.0	.3
1986 r	21.6	8.2	8.3	5.0	21.6	.7
1987 r	19.6	8.1	6.3	5.3	19.6	1.2
1988-Q1	9.4	3.7	2.6	3.1	8.5	.9
Q2	13.1	4.4	3.0	5.8	12.5	3.0
1988-Apr.	12.9	3.4	3.1	6.4	11.0	3.0
May	11.9	4.2	2.4	5.2	11.1	2.3
June	14.7	5.6	3.4	5.7	15.4	3.8
July r	13.4	5.8	3.3	4.3	15.4	1.6
Aug. p	13.5	5.8	3.8	3.9	14.2	n.a.
Sept.p	n.a.	n.a.	3.1	4.6	n.a.	n.a.

r--revised. p--preliminary.

new commitments for 30-year, fixed-rate conventional home loans has fallen about 12 basis points in the intermeeting period to 10-1/4 percent, while the average initial rate on ARMs has been about unchanged. The FRM-ARM initial rate spread is now the smallest since the beginning of the year. If sustained, the reduced rate advantage of ARMs may lead to a reduction in the ARM share.

Consumer Installment Credit

Growth in consumer installment credit rebounded in August to a 10 percent annual rate, about equal to the average pace for the first eight months of the year. Revolving credit--primarily credit cards but also including unsecured personal lines of credit--was the strongest component of installment credit in August, as it has been all year. From the end of last year through August, revolving credit outstanding increased at a 17-1/4 percent annual rate, auto credit grew at a 10-1/2 percent clip, and the large "other" category grew at only a 3-1/2 percent rate.

Securitization of consumer loans accelerated during the third quarter. Newly originated securities amounted to \$5.5 billion in the quarter compared with \$5.0 billion in the first half of the year. Cumulative originations since the first consumer loan-backed issue was packaged in 1985 have totaled \$30.5 billion, of which \$21 billion is estimated to be currently outstanding. Auto loans have accounted for two-thirds of all such originations, but securitization of credit card receivables by banks and major retailers has picked up substantially in 1988.

CONSUMER CREDIT
(Seasonally adjusted)

	Percent change (at annual rate)						Net change (billions of dollars)		Memo: Outstandings (billions of dollars)
	1986	1987	1988		1988		1988		1988
			Q1	Q2	July ^r	Aug. ^p	July ^r	Aug. ^p	Aug. ^p
Total installment ¹	10.4	7.2	10.7	9.5	6.7	10.1	3.62	5.44	653.4
Installment, excluding auto	5.7	6.2	8.0	10.7	8.3	10.4	2.52	3.15	367.8
Selected types									
Auto	17.4	8.6	14.4	7.9	4.7	9.7	1.11	2.29	285.6
Revolving	11.8	16.8	15.9	17.3	14.7	18.0	2.12	2.62	177.6
All other	1.7	-1.5	1.2	4.8	2.5	3.3	.40	.53	190.2
Selected holders									
Commercial banks	8.5	7.4	13.2	13.0	11.6	16.0	2.91	4.04	307.2
Finance companies	20.4	4.8	11.4	1.9	-7.8	1.2	-.94	.15	144.0
Credit unions	5.9	6.4	7.6	11.2	7.9	5.8	.53	.41	85.9
Savings institutions ²	14.5	12.4	7.1	13.5	16.2	12.8	.91	.73	68.9
Memorandum:									
Total ³	9.0	6.1	8.2	7.6	4.2	9.5	2.49	5.87	721.1

1. Includes items not shown separately.

2. Savings and loans, mutual savings banks, and federal savings banks.

3. Installment plus noninstallment.

r--revised. p--preliminary.

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

CONSUMER INTEREST RATES
(Annual percentage rate)

	1985	1986	1987	1988				
				Apr.	May	June	July	Aug.
At commercial banks ¹								
New cars (48 mo.)	12.91	11.33	10.46	...	10.55	10.93
Personal (24 mo.)	15.94	14.83	14.23	...	14.40	14.81
Credit cards	18.69	18.26	17.92	...	17.78	17.79
At auto finance cos. ²								
New cars	11.98	9.44	10.73	12.29	12.29	12.32	12.44	12.64
Used cars	17.59	15.95	14.61	14.82	14.81	14.83	14.99	15.16

1. Average of "most common" rate charged for specified type and maturity during the first week of the mid-month of each quarter.

2. Average rate for all loans of each type made during the month regardless of maturity.

Securities backed by consumer loans have appealed to a broad spectrum of investors. According to two of the key underwriting firms, insurance companies and mutual funds have been the most active investors this year, with domestic and foreign banks, savings institutions, and nonfinancial corporations acquiring smaller shares. The development of securitization of consumer loans has been driven by the greater efficiency available from "unbundling" the various aspects of credit intermediation. Depository institutions, in particular, may find securitization attractive because capital requirements on consumer loans generally exceed the amount of capital that unregulated competitors allocate to support the risks associated with such investments.

INTERNATIONAL DEVELOPMENT

U.S. Merchandise Trade through August

In August, the seasonally adjusted U.S. merchandise trade deficit was \$10.6 billion. This was larger than the deficit in July, but smaller than the deficit in June, and illustrates the volatility of monthly numbers.

U.S. MERCHANDISE TRADE: MONTHLY DATA
(Billions of dollars, seasonally adjusted, Census basis)

	Exports	Imports		Balance	
		CIF	Customs	CIF	Customs
1988-Jan	24.5	35.8	34.3	-11.3	-9.8
Feb	24.5	38.9	37.7	-14.4	-13.2
Mar	26.9	38.6	36.6	-11.7	-9.8
Apr	26.0	36.3	34.8	-10.3	-8.8
May	27.5	37.2	35.7	-9.8	-8.3
Jun	26.3	39.5	37.9	-13.2	-11.7
Jul ^r	26.5	36.0	34.5	-9.5	-8.0
Aug ^p	27.5	39.7	38.1	-12.2	-10.6

r--revised

p--preliminary

For July-August combined, the deficit on a balance-of-payments basis is estimated to have been slightly smaller than that recorded in the second quarter. (See the table on the next page.) Exports rose 1-1/2 percent in July-August from the second quarter; if sustained, this would be the eighth consecutive quarterly increase. The expansion in the value of exports over the past year has been close to 25 percent; most of the increase has been in volume (at least through 1988-Q2). Data on prices for the third quarter will become available on

Thursday, October 27, and will be described in the Greenbook supplement. Most of the increase in the value in July-August from the second quarter was in nonagricultural exports, particularly capital goods (largely a wide range of machinery items) and durable consumer goods (such as home entertainment equipment, numismatic coins, jewelry, and artwork). By

U.S. MERCHANDISE TRADE: QUARTERLY DATA, BOP BASIS
(Billions of dollars, seasonally adjusted annual rates)

	Exports			Imports			Balance
	Total	Ag.	Nonag.	Total	Oil	Non-oil	
1985	216	30	186	338	50	288	-122
1986	224	27	197	369	34	335	-144
1987	250	30	220	410	43	367	-160
1986-1	216	29	188	358	42	317	-142
-2	228	26	202	363	31	332	-135
-3	225	27	199	372	32	340	-147
-4	227	28	199	381	32	348	-154
1987-1	227	26	201	387	35	352	-159
-2	239	28	211	398	40	357	-158
-3	260	33	226	418	51	367	-159
-4	272	31	242	437	45	392	-165
1988-1	301	36	265	442	40	402	-141
-2*	318	39	280	439	41	398	-121
J-A*	323	40	283	441	40	401	-118

*/ FR staff estimates; includes unpublished revisions to data.

area, seasonally adjusted nonagricultural exports to Latin America, Japan, and the Asian NIEs (which together account for more than 40 percent of total U.S. nonagricultural exports) rose in July-August, as they had during the first two quarters of the year. Exports to Western Europe (over 25 percent of nonagricultural exports) declined slightly

from the second-quarter level and have held at a fairly steady level during the year. Nonagricultural exports to Canada (about 25 percent of nonagricultural exports) dropped 10 percent in July-August, importantly reflecting declines in shipments of automotive parts at the time of model change-over.

Agricultural exports increased 4 percent in July-August. On a seasonally adjusted basis, sharp increases in the value of some commodities (such as soybeans, corn, and meat) were nearly offset by declines in the export value of others (particularly wheat, cotton, and tobacco). The drought in the United States resulted in sharply higher prices of exports of wheat, corn, and soybeans. For wheat, the increase in price was more than offset by a decline in quantity (shipments to the Soviet Union were large in the second quarter and negligible in the third quarter). Exports of corn increased in both price and quantity. The quantity of exports of soybeans fell less than their price increased.

Imports of petroleum and products declined slightly in value in July-August compared with the second quarter. (See the table below.) Volume increased to an average of 7.6 million barrels per day (mbd) from 7.4 mbd in the second quarter. This volume increase mostly reflects increased imports of gasoline in August to meet shortages in the United

IMPORTS OF PETROLEUM AND PRODUCTS
(BOP basis, seasonally adjusted, value at annual rates)

	1987			1988			
	Year	Q3	Q4	Q1	Q2*	Jul-Aug	Aug
Value (Bil. \$)	42.88	51.04	45.15	39.82	41.02	40.39	41.99
Price (\$/BBL)	17.33	18.26	17.46	15.23	15.16	14.49	14.22
Volume (mbd.)	6.78	7.66	7.08	7.14	7.39	7.63	8.07

States that partly resulted from a refinery accident in May and interruption in deliveries via the Mississippi due to the drought. A sharp drop in price more than offset the increase in volume. By August, the average price of imported oil was \$14.22 per barrel, about \$1.00 per barrel less than the average for the second quarter. In both September and October, prices of imported oil are estimated to have declined further, by about 50 cents per barrel per month, as OPEC members continued to produce oil at a rate estimated to be in excess of 20 mbd, well above their quota levels. Oil prices in spot markets have been very volatile recently; however, on average, spot prices have trended down since the September Greenbook.

After rising during the second half of 1987, the value of non-oil imports has held at a fairly steady level thus far in 1988; non-oil imports in July-August were only marginally above the second-quarter level and slightly below the first-quarter level. In the first two quarters of this year, import prices rose at about a 10 percent annual rate (fixed-weight basis) and the quantity declined a bit. Price and quantity developments for July-August will be discussed in more detail in the Greenbook supplement. In July-August, there were offsetting movements in the value of imports in the major trade categories. The value of imported food, industrial supplies other than gold, automotive products from countries other than Canada, consumer goods, and computers and accessories recorded moderate increases from second-quarter levels. These increases were largely offset by declines in imports of automotive

products from Canada, gold, and aircraft (from an unusually high second-quarter level). There were declines in imports from Western Europe (partly the drop in aircraft imports) and Canada (importantly automotive products), while imports from Japan and from developing countries in Asia and Latin America increased.

U.S. International Financial Transactions

U.S. banks increased their net claims on own foreign offices by \$10 billion in September (line 1 on the International Banking Data Table), reversing the large inflow in August. The August inflow reflected an increased reliance on managed funds as commercial bank credit expanded at a 7 percent annual rate while deposit growth slowed sharply. During September, declines in holdings of loans and securities together with an increase in U.S. Government deposits allowed commercial banks to reduce their reliance on managed liabilities including net Eurodollar borrowing.

Credit extended to nonbanks from foreign branches of U.S. banks (line 2) increased in August and September, as the prime-LIBOR spread widened 50 basis points during the two months, inducing some borrowers to switch to LIBOR-based loans, which are generally booked offshore. Eurodollar deposits of U.S. nonbank residents (line 3) rose in August (reflecting in part increased deposits by bank holding companies at their foreign affiliates), but they ran off in September and early October as bank funding pressures eased.

In August, foreign net purchases of U.S. corporate stocks and bonds slowed from the brisk pace of the previous four months (lines 2a and 2b

INTERNATIONAL BANKING DATA
(Billions of dollars)

	<u>1985</u>	<u>1986</u>	<u>1987</u>				<u>1988</u>				
	Dec.	Dec.	Mar.	June	Sept.	Dec.	Mar.	June	July	Aug.	Sept.
1. Net Claims of U.S. Banking Offices (excluding IBFS) on Own Foreign Offices and IBFS	28.2	22.3	9.1	5.0	-7.8	-10.9	8.7	4.8	-6.6	-14.5	-4.9
(a) U.S.-chartered banks	32.4	31.7	21.5	16.3	12.6	15.2	27.8	17.0	15.0	8.2	16.6
(b) Foreign-chartered banks	-4.2	-9.4	-12.4	-11.3	-20.3	-26.1	-19.0	-21.8	-21.6	-22.7	-21.5
2. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	18.7	16.8	16.0	15.6	17.1	15.8	19.1	19.7	18.8	20.2	21.4
3. Eurodollar Holdings of U.S. Nonbank Residents <1>	111.1	124.5	134.0	135.7	141.1	132.6	128.9	138.1	137.8	142.6	140.5

9-ΔI

<1> Includes term and overnight Eurodollars held by money market mutual funds.

Note: These data differ in coverage and timing from the overall banking data incorporated in the international transactions accounts. Line 1 is an average of daily data reported to the Federal Reserve by U.S. banking offices. Line 2 is an average of daily data. Line 3 is an average of daily data for the overnight component and an average of Wednesday data for the term component.

on the Summary of U.S. International Transactions Table), but still registered a net inflow of \$2-1/2 billion. The slower pace of bond purchases coincided with sharply lower Eurobond issuance by U.S. corporations. In September, U.S. corporations issued nearly \$3 billion in Eurobonds, as the steadier foreign exchange value of the dollar and reduced concern about higher U.S. interest rates induced a rebound in fixed-rate, dollar-denominated Eurobond issuance. U.S. residents accelerated their purchases of foreign stocks in August, bringing the outflow from securities purchases for the year to \$5-1/2 billion (line 2c).

Net private foreign purchases of Treasury securities declined to about \$1/2 billion in August (line 3), despite a substantial increase in net borrowing by the Treasury. Private foreigners purchased net long-term Treasuries at about the pace of the second quarter, but they sold net \$1 billion worth of Treasury bills. Contributing to the bill sales was a widening in the spread between interest rates on Eurodollar deposits and Treasury bills, which averaged 130 basis points in August, compared to 110 basis points in the second quarter.

Foreign official reserve assets in the United States declined by \$1 billion in August (line 4) as a \$3-1/2 billion decrease in holdings by G-10 countries was largely offset by increases by Latin American and other European countries.

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

	1986	1987	1987		1988				
	Year	Year	Q3	Q4	Q1	Q2	June	July	Aug.
Private Capital									
Banks									
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	22.3	47.8	30.8	11.0	-2.6	15.5	0.4	-5.0	12.1
Securities									
2. Private securities transactions, net <1>	65.9	36.6	11.5	-6.9	-2.1	11.2	3.4	3.6	1.5
a) foreign net purchases (+) of U.S. corporate bonds	53.5	26.4	7.5	2.8	2.6	9.0	3.5	3.3	2.0
b) foreign net purchases (+) of U.S. corporate stocks	18.0	16.8	5.4	-7.4	*	1.0	0.8	1.0	0.6
c) U.S. net purchases (-) of foreign securities	-5.5	-6.7	-1.5	-2.3	-4.8	1.2	-0.9	-0.7	-1.1
3. Foreign net purchases (+) of U.S. Treasury obligations	4.0	-7.3	-2.8	0.5	7.0	5.6	0.6	2.9	0.4
Official Capital									
4. Changes in foreign official reserves assets in U.S. (+ = increase)	33.5	47.7	0.9	19.8	24.8	6.5	-3.9	0.2	-1.2
a) By area									
G-10 countries (incl. Switz.)	30.8	38.8	-5.7	15.6	17.7	-0.8	-5.4	-1.7	-3.6
OPEC	-8.3	-8.9	-1.3	-2.8	-1.6	-1.6	-0.8	-0.1	-0.4
All other countries	10.8	17.8	7.9	7.1	8.7	8.9	2.4	2.2	2.8
b) By type									
U.S. Treasury securities	34.4	43.2	0.8	19.1	27.7	5.9	-3.0	-0.6	-1.8
Other <2>	-1.0	4.5	0.1	0.7	-2.9	0.7	-0.9	0.9	0.6
5. Changes in U.S. official reserve assets (+ = decrease)	0.3	9.1	*	3.7	1.5	*	-0.4	-3.4	-4.1
Other transactions (Quarterly data)									
6. U.S. direct investment (-) abroad <4>	-27.8	-44.5	-7.9	-19.7	-6.4	-0.1	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S. <4>	34.1	42.0	15.0	11.7	7.3	13.4	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) <3> <4>	-9.1	4.1	-1.1	-2.8	3.1	-3.1	n.a.	n.a.	n.a.
9. U.S. current account balance <4>	-138.8	-154.0	-42.0	-33.5	-36.9	-33.3	n.a.	n.a.	n.a.
10. Statistical discrepancy <4>	15.6	18.5	-4.4	16.3	4.3	-15.7	n.a.	n.a.	n.a.

MEMO:

U.S. merchandise trade balance -- part of line 9 (Balance of payments basis, seasonally adjusted)

-144.5 -160.3 -39.7 -41.2 -35.2 -29.9 n.a. n.a. n.a.

<1> These data have not been adjusted to exclude commissions on securities transactions and therefore, do not match exactly the data on U.S. international transactions as published by the Department of Commerce.

<2> Includes deposits in banks, commercial paper, acceptances, borrowing under repurchase agreements, and other securities.

<3> Includes U.S. government assets other than official reserves, transactions by nonbanking concerns, and other banking and official transactions not shown elsewhere. In addition, it includes amounts resulting from adjustments to the data made by the Department of Commerce and revisions of the data in lines 1 through 5 since publication of the quarterly data in the Survey of Current Business.

<4> Includes seasonal adjustment for quarterly data.

<*> Less than \$50 million.

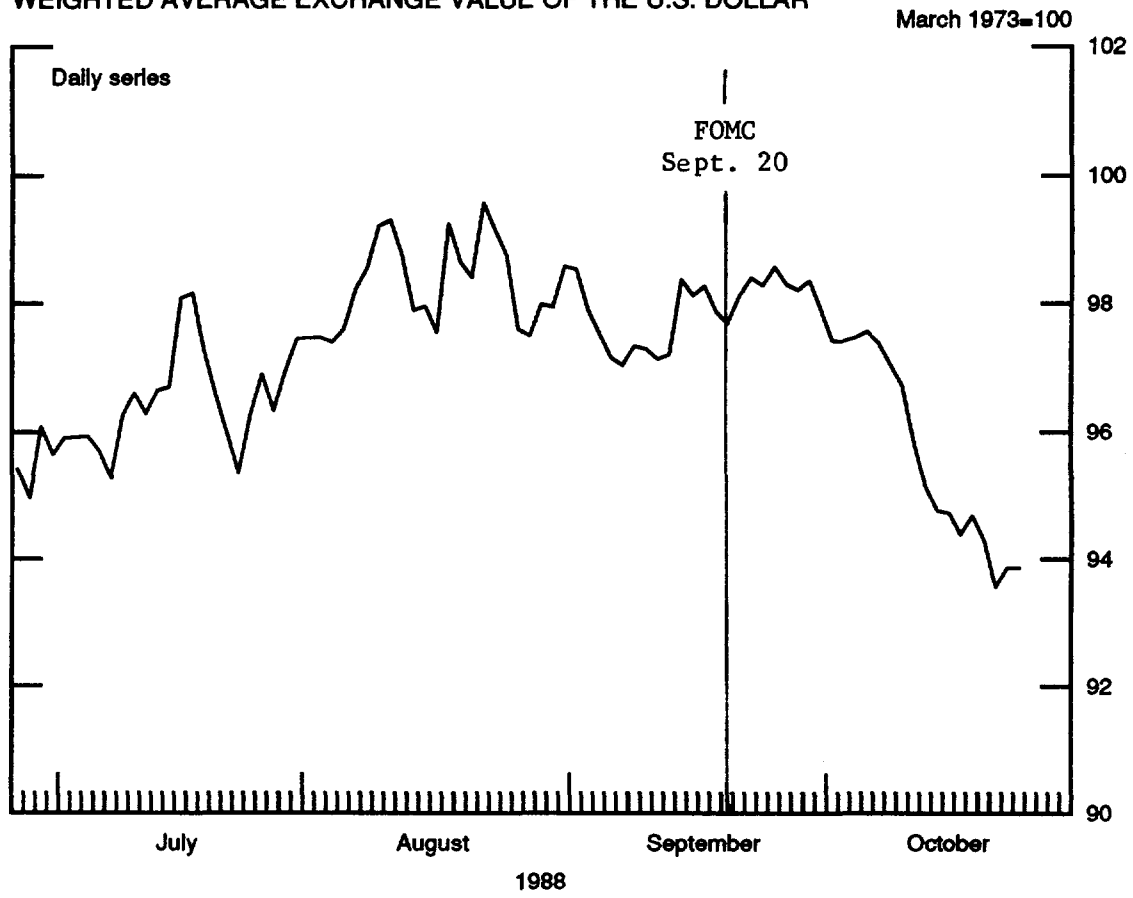
NOTE: Details may not add to total because of rounding.

. Partial information for September indicates a small increase in official reserves at the FRBNY (about \$3/4 billion),

Foreign Exchange Markets

After a period of relatively narrow exchange-rate fluctuations, the foreign-exchange value of the dollar declined in the later half of the intermeeting period. Amid comments by officials that a further rise in the value of the dollar might be detrimental to external adjustment in the United States and to price stability abroad, downward pressures on the dollar began to consolidate. Expectations of further tightening by the Federal Reserve diminished following the release of the somewhat weaker-than-expected data on nonfarm payroll employment in September and the large downward revision to payroll employment in August. The dollar's decline was further fueled by an apparent change in assessment about the pace of external adjustment, reinforced by the release of data showing that the U.S. trade deficit in August was larger than expected. Late in the period, the dollar fell even further following the release of data showing lower-than-expected U.S. GNP growth in the third quarter. On balance, since the September FOMC meeting, the trade-weighted, foreign-exchange value of the dollar in terms of the other G-10 currencies has declined more than 4-1/2 percent. The dollar has fallen about 5 percent against the mark and about 6-1/4 percent against the yen.

WEIGHTED AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR



The declines in oil prices during the intermeeting period and expectations that monetary authorities are less likely to tighten policies have helped yield curves in Germany and Japan to flatten, allowing long-term interest rates to fall while short-term rates rose slightly. The decline in long-term rates is most striking in Japan, where the yield on the bellwether bond has fallen about 45 basis points since the time of the September FOMC meeting to 4.70 percent. The average of long-term bond yields in Germany has eased nearly 20 basis points to 6.09 percent. As for the short maturities, three-month interest rates in Japan and Germany are up about 10 basis points each, to 4.28 percent and 5 percent, respectively, while call money rates are little changed in Germany and up slightly in Japan.

As the prospects for price stability in the major countries improved with the decline in oil prices during the intermeeting period, the price of gold dipped below \$400 for the first time since early 1987. Gold's dollar price subsequently recovered somewhat, as the dollar declined later in the period, to end at about \$408, down about 1/2 percent from its level at the time of the September meeting. In terms of marks and yen, however, the price of gold has moved sharply lower.

. Pressure on the franc appears to have abated following the 1/4 percentage-point increase in France's money-market intervention rate to 7-1/4 percent. The Desk sold \$100 million against marks on each of two days early in the intermeeting period, as the dollar edged above DM 1.88 on those days. The proceeds were split evenly between the System and Treasury accounts.

U.S. bank lending to foreigners

The dollar value of U.S.-chartered banks' claims on foreigners decreased by \$18.3 billion (5 percent) in the second quarter of 1988. The foreign exchange value of the dollar in terms of other G-10 currencies rose on average 8.3 percent during the period. After adjustment for the effect of exchange rate changes on non-dollar claims, total claims on foreigners are estimated to have declined by \$10 billion.

Without adjustment for exchange rate changes, claims on the G-10 countries fell \$6.5 billion during the second quarter, a 4 percent decline. Claims on other industrial countries fell by \$2.4 billion (9 percent), and claims on offshore centers fell \$6.9 billion (13 percent).

Claims on Eastern European countries (including the U.S.S.R.) rose \$200 million, with claims on the U.S.S.R. rising \$100 million. However, U.S.-chartered bank claims on most Eastern European countries have remained minimal and U.S. banks generally have not participated in the

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

	Changes (no sign = increase)						Out- standing 6/30/88
	1985 Year	1986 Year	1987 Year	Q4	Q1	Q2	
Total, all countries	-20.4	4.3	-8.1	-6.0	-10.2	-18.3	353.0
Non-OPEC developing countries	-7.6	-4.5	-2.4	-0.1	-3.3	-2.7	91.3
of which:							
(Latin America)	-3.9	-0.2	-2.2	-1.6	-2.1	-2.1	66.2
(Asia and Africa)	-3.5	-4.3	-0.3	1.3	-0.8	-0.7	25.3
OPEC countries	-3.6	-1.7	-2.3	-1.8	-0.2	-0.7	16.4
Eastern Europe	-0.3	-0.9	-0.2	-0.3	-0.1	0.2	3.1
Smaller developed countries	-3.7	-3.7	0.0	0.3	0.0	-2.4	23.8
G-10 countries	-2.1	12.0	2.3	4.7	-3.2	-6.5	150.6
Offshore banking centers	-2.7	0.3	-8.8	-10.0	-1.7	-6.9	45.8
Miscellaneous	-0.4	2.9	3.4	1.3	-1.8	1.0	22.4
Memorandum:							
Total, adjusted for exchange rate changes (staff estimates)	-29	-11	-25	-17	-9	-10	

reported recent increase in bank lending to these countries. Total BIS-reported bank claims (quarterly series) on Eastern Europe rose \$24 billion (33 percent) from end-1985 to March 1987, with claims on the U.S.S.R. increasing \$11 billion (50 percent) over the same period. However, perhaps only 20 percent of these amounts reflects new lending by BIS-reporting banks rather than valuation effects on non-dollar

claims resulting from the appreciation in the exchange rates of the other major currencies against the dollar. From end-1985 to June 1987, U.S. bank claims on Eastern Europe fell \$1 billion (24 percent), with claims on the U.S.S.R. increasing but remaining small.

The decline in value of U.S. bank claims on non-OPEC developing countries continued in the second quarter, falling by \$2.7 billion, or approximately 3 percent. There were declines in claims on all of the heavily indebted Latin American countries with the exception of Colombia, which drew about \$850 million under its 1988 new money package. This contributed to an increase in U.S.-chartered banks' claims on that country of approximately \$200 million. U.S. bank claims on Mexico declined \$1.4 billion, or approximately 6 percent. This brings the decline in U.S.-bank reported claims on Mexico to \$4.2 billion (17 percent) in the year ending June 1988. A large fraction of this decline was probably related to the prepayment of debt covered by the government's FICORCA arrangement by the Mexican private sector.

Preliminary data acquired from bank press releases indicate that large U.S. banks continued to reduce their claims on heavily indebted developing countries in the third quarter through debt swaps, loan sales, and related transactions. These transactions have largely been associated with prepayments and debt-for-equity programs. Reductions in exposure and charge-offs were generally at a slower rate than prevailed in the prior three quarters, but above the rate of decline that prevailed on average in 1987.

Indicative secondary market prices for bank loans to the Baker-15 countries have declined 9.2 percent on a weighted average basis since early June. (See table.) Nearly all of the Baker-15 countries have

experienced declines in the price of their debt. Large declines were registered in the prices for debt of Venezuela, Nigeria, and Ecuador, perhaps reflecting worsening prospects for oil prices. However, the price of Mexico's debt fell by a smaller percentage amount. The price of Brazil and Argentina's debt has also fallen in excess of 10 percent over the period. The price of Chile's debt remained relatively stable in the period surrounding the plebiscite.

INDICATIVE PRICES FOR BANK LOANS TO
HEAVILY INDEBTED DEVELOPING COUNTRIES
(Average of bid and offer price, expressed
as a percentage of face value)

Countries ¹	6/29/87	12/31/87	3/2/88	6/9/88	10/13/88	Change from 6/9/88 to 10/13/88 (percent)
Brazil	61.5	46.5	46.4	52.9	46.4	-12.3
Mexico	56.4	50.5	48.0	52.1	47.1	-9.6
Argentina	48.0	34.5	28.8	26.5	22.4	-15.5
Venezuela	70.5	58.0	53.9	55.9	46.5	-16.8
Chile	69.8	61.8	59.3	60.5	58.4	-3.5
Philippines	69.5	50.4	51.0	54.3	51.8	-4.6
Yugoslavia	75.5	49.8	46.8	45.8	47.5	3.7
Nigeria	30.0	30.5	29.8	29.0	24.0	-17.2
Colombia	85.3	66.5	66.0	65.8	66.3	0.8
Ecuador	49.5	37.3	34.3	28.3	16.5	-41.7
Peru	13.5	8.0	6.5	6.5	6.0	-7.7
Morocco	66.3	53.5	50.5	49.8	50.5	1.4
Cote d'Ivoire	63.5	42.5	34.5	30.0	28.0	-6.7
Uruguay	74.3	60.0	60.5	60.5	60.5	0.0
Bolivia	10.0	12.0	12.0	12.0	10.5	-12.5
Baker-15 countries ²	59.2	47.4	45.2	48.0	43.6	-9.2

1. Ranked by December 1986 BIS quarterly bank claims.

2. Weighted-average of secondary market prices. The weight of each of the 15 countries is the value in December 1986 of BIS quarterly bank claims on that country divided by total claims on the 15 countries.

Source: Salomon Brothers.

Developments in Foreign Industrial Countries

The pace of real growth in the major foreign industrial economies appears to have rebounded somewhat in the third quarter, following a pronounced slackening of activity in the second quarter. Real GNP declined in the second quarter in both Germany and Japan, and real growth rates were below first-quarter levels in France, Italy, and the United Kingdom. In Germany, partial third-quarter data on industrial production, manufacturing orders, and unemployment suggest a resumption of growth, while in Japan an increase in industrial production and real exports through August also suggests a rebound in third-quarter real growth. Stronger activity in the third quarter also appears indicated in France, while third-quarter data for Canada, Italy, and the United Kingdom have been mixed.

Although the level of inflation remains generally low in the major foreign industrial countries, it has risen somewhat recently. In each of the foreign G-7 countries except Italy, the 12-month rate of consumer price inflation has increased in the latest month for which data are available.

Germany's monthly trade and current account surpluses continue above those recorded in comparable periods last year. The Japanese trade surplus widened in September but the cumulative surplus so far this year remains somewhat below last year's level. In the United Kingdom, and to a lesser extent France, the size of recent external deficits has raised concerns over economic overheating.

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

	Q4/Q4 1986	Q4/Q4 1987	1987 Q4	1988			1988					Latest 3 months from year ago 2/
				Q1	Q2	Q3	May	June	July	Aug.	Sept.	
Canada												
GDP	1.2	6.1	1.6	.8	1.0	n. a.	*	*	*	*	*	4.9
IP	-.3	8.5	2.5	1.2	1.1	n. a.	1.2	.1	-.5	n. a.	n. a.	7.3
France												
GDP	2.0	2.7	.7	1.5	.5	n. a.	*	*	*	*	*	3.6
IP	-.3	3.6	.6	.6	.6	n. a.	1.0	2.6	.7	.0	n. a.	4.5
Germany												
GNP	2.3	2.4	.8	1.4	-.2	n. a.	*	*	*	*	*	3.4
IP	.8	1.5	.7	1.1	.3	n. a.	.3	2.9	-3.7	5.6	n. a.	3.6
Italy												
GDP	3.0	2.8	.3	1.3	.6	n. a.	*	*	*	*	*	3.1
IP	2.8	5.7	3.3	2.7	-.7	n. a.	-2.6	1.5	2.9	n. a.	n. a.	3.0
Japan												
GNP	2.0	5.5	1.8	2.7	-1.0	n. a.	*	*	*	*	*	5.6
IP	-.6	8.1	3.4	3.2	-.2	n. a.	-2.3	3.3	-.9	2.7	n. a.	9.3
United Kingdom												
GDP	4.4	4.3	.7	1.1	.4	n. a.	*	*	*	*	*	4.1
IP	2.3	4.1	1.0	-.7	2.4	n. a.	.9	-.9	.0	1.3	n. a.	3.2
United States												
GNP	2.0	5.0	1.5	.8	.7	n. a.	*	*	*	*	*	4.2
IP	1.0	5.8	1.7	1.0	1.1	1.6	.5	.3	1.2	.1	.0	5.6

1. Asterisk indicates that monthly data are not available.
2. For quarterly data, latest quarter from year ago.

CONSUMER AND WHOLESALE PRICES IN MAJOR INDUSTRIAL COUNTRIES
(Percentage change from previous period) 1/

	Q4/Q4 1986	Q4/Q4 1987	1987			1988			1988				Latest 3 months from year ago
			Q2	Q3	Q4	Q1	Q2	Q3	June	July	Aug.	Sept.	
Canada													
CPI	4.3	4.2	1.4	1.2	.7	.8	1.3	1.1	.1	.6	.3	.1	4.0
WPI	.3	4.3	1.3	1.4	1.1	1.1	.8	n. a.	.2	.2	.2	n. a.	3.8
France													
CPI	2.1	3.2	.9	.6	.5	.5	1.0	.9	.3	.3	.3	.2	2.8
WPI	-3.4	2.6	.5	.5	1.0	1.1	.8	n. a.	*	*	*	*	3.5
Germany													
CPI	-1.0	1.0	.4	-.0	-.0	.5	.5	.1	.2	-.1	.1	.0	1.2
WPI	-9.0	-.7	.0	-.4	-.2	.1	1.1	.4	.9	-.5	.2	.2	1.4
Italy													
CPI	4.7	5.2	1.0	1.1	1.7	1.1	1.0	1.0	.3	.3	.4	.5	4.9
WPI	-2.4	4.6	1.0	.8	1.2	1.1	1.3	n. a.	.3	.2	.7	n. a.	4.7
Japan													
CPI	.1	1.1	1.2	-.2	-.4	-.2	-.6	.0	-.2	-.1	-.1	1.1	.8
WPI	-9.1	-.6	-.7	1.3	-.4	-1.2	-.3	.9	.3	.6	.1	.1	-.9
United Kingdom													
CPI	3.4	4.1	1.5	.2	1.1	.5	2.4	1.4	.4	.1	1.1	.5	5.5
WPI	4.2	3.9	1.1	.5	1.1	1.3	1.5	.8	.3	.1	.4	.4	4.7
United States													
CPI (SA)	1.3	4.4	1.2	.9	.9	.8	1.2	1.2	.3	.4	.4	.3	4.1
WPI (SA)	-1.9	2.5	1.1	.7	.0	.2	1.1	1.3	.4	.5	.6	.4	2.6

1. Asterisk indicates that monthly data are not available.

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

	1986	1987	1987			1988			1988			
			Q2	Q3	Q4	Q1	Q2	Q3	June	July	Aug.	Sept.
Canada												
Trade	7.1	8.3	2.1	2.3	1.6	2.1	2.2	n. a.	1.2	1.5	.7	n. a.
Current account	-6.7	-8.0	-1.9	-2.1	-2.6	-1.3	-1.8	n. a.	*	*	*	*
France												
Trade	.1	-5.2	-2.0	-1.0	-1.0	-.9	-1.0	n. a.	-.2	-.6	-1.4	n. a.
Current account	3.0	-4.1	-.8	-.9	-2.3	1.3	n. a.	n. a.	*	*	*	*
Germany												
Trade (NSA)	52.5	65.9	15.5	15.2	20.1	15.0	19.9	n. a.	8.1	6.0	4.9	n. a.
Current account (NSA)	39.7	45.4	10.9	7.8	15.3	8.6	15.0	n. a.	5.4	3.0	2.5	n. a.
Italy												
Trade	-1.9	-8.9	-2.6	-2.7	-2.6	-2.9	-1.6	n. a.	-.8	-1.1	n. a.	n. a.
Current account (NSA)	2.6	-1.1	1.1	1.6	-1.6	-5.1	n. a.	n. a.	*	*	*	*
Japan												
Trade	82.4	79.5	19.5	17.8	18.3	20.8	16.7	17.8	5.2	6.2	5.5	6.1
Current account 2/	85.8	87.0	21.3	19.9	20.5	23.1	17.6	n. a.	5.2	4.9	6.2	n. a.
United Kingdom												
Trade	-12.4	-15.9	-3.9	-5.0	-5.3	-7.1	-8.2	n. a.	-2.7	-4.5	-3.1	n. a.
Current account	.1	-3.0	-.5	-1.4	-2.3	-5.1	-5.4	n. a.	-1.8	-3.7	-2.2	n. a.
United States												
Trade 2/	-144.5	-160.3	-39.6	-39.7	-41.2	-35.2	-29.9	n. a.	*	*	*	*
Current account	-138.8	-154.0	-40.9	-42.0	-33.5	-36.9	-33.3	n. a.	*	*	*	*

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.

Individual country notes. Real economic activity in Japan appears to have rebounded in the third quarter after a 3.9 percent (s.a.a.r.) decline in real GNP in the second quarter. Industrial production in July and August averaged 1.8 percent (s.a.) above the second-quarter level, and August data on producers' inventories of finished goods indicate that the recent increase in stocks has leveled off, providing scope for continued expansion of industrial output in coming months. Housing starts rose strongly (s.a.) in August after declining for most of the past year, but residential investment is expected to be weak in coming months. Although retail sales fell 2.7 percent (s.a.) in August, MITI attributed the drop to special factors.

Recent surveys of investment intentions indicate strong capital spending growth through FY 1988 (ending March 31, 1989). An average of six private sector surveys indicates that nominal capital spending will increase 12.9 percent in FY 1988, more than twice the increase estimated in surveys last spring. August data on labor market conditions indicate some easing of the recent tight conditions. The unemployment rate increased from 2.5 percent (s.a.) in July to 2.6 percent in August, and the ratio of job offers to applicants declined from 1.09 to 1.07.

The inflation rate remains low, although it increased slightly in September. The Tokyo index of consumer prices increased 1 percent in September compared with a year earlier, primarily due to the effect on food prices of unusually cold summer weather. The all-commodities index of wholesale prices in September was 0.9 percent below its level of a year ago.

Japan's trade surplus widened (s.a.) in September, as imports declined more rapidly than exports. The cumulative surplus for the first nine months of the year was \$73.8 billion (s.a.a.r.), compared with a surplus of \$81.6 billion in the same period last year. In volume terms, exports expanded 1.2 percent (s.a.) in September while imports declined 3.2 percent. The cumulative current account surplus through August was \$77.7 billion (s.a.a.r.), compared with \$88.5 billion in the first eight months of 1987.

The Diet continues its debate over tax reform. The prospects for passage of the LDP's tax reform bill this year improved during the past month when two of the opposition parties agreed to end their boycott of tax reform deliberations. As a concession to opposition parties, which have held up tax reform citing concerns about recent insider trading scandals, a stricter capital gains tax provision likely will be incorporated in the bill.

The pace of economic activity appears to have accelerated in Germany in the third quarter. Industrial production surged 5.6 percent (s.a.) in August, after falling 3.7 percent in July. This volatility was due mainly to an abnormal pattern of summer holidays that was not offset by the normal seasonal adjustment process. Comparing the July-August average with the May-June average shows a more moderate increase of 0.4 percent, to a level 3.1 percent above a year earlier. Strength in new manufacturers' orders has pointed to further gains in industrial production, although the orders data may have also been distorted by the unusual summer holiday pattern. Manufacturers' new orders rose 5.2

percent (s.a.) in real terms in August, after showing no change in July. While the increase over the past year has been broadly based, orders for capital goods (up 8 percent) and foreign orders (up 9.3 percent) have led the way.

Employment in Germany grew by 110,000 in the first eight months of 1988, an increase of 0.6 percent (s.a.a.r.). The unemployment rate edged down from 8.8 percent (s.a.) in August to 8.7 percent in September, below its 9 level at the end of 1987. The absence of an even larger decline in unemployment in part reflects high inflows of immigrants from Soviet bloc countries, estimated to be as high as 200,000 for this year.

The consumer price index was unchanged (n.s.a.) in September and was up 1.4 percent from its year-earlier level. Wholesale prices rose 0.2 percent (n.s.a.) in September and were up 2 percent from a year earlier. Rising import prices--up 0.5 percent (n.s.a.) in August and 3.3 percent since March--have been a key factor behind recent increases in the broader price indexes.

Since the first quarter, the foreign sector has been an important source of strength for the German economy. The monthly trade surplus in each of the five months through August has exceeded year-earlier levels. The cumulative trade surplus has been \$45.9 billion (n.s.a.) so far in 1988, exceeding the \$39.5 billion surplus in the first eight months of 1987. The higher surplus so far this year has been almost entirely due to a sharp increase in German exports to other West European countries, offsetting a 35 percent decline in Germany's surplus with the United

States. The monthly current account surpluses in June, July and August exceeded year-earlier levels. As a result, the cumulative surplus in 1988 climbed to \$29.2 billion (n.s.a.) through August, versus \$26.4 billion in the first eight months of 1987.

Growth in the average level of M3 jumped to 9.6 percent (s.a.a.r.) in September. As a result, the average level of M3 in August stood 6.7 percent above the target base period of 1987-Q4, making it unlikely the Bundesbank will meet the target of 3 to 6 percent set for this year.

French economic activity appears to have been buoyant in the third quarter. Industrial production rose 0.7 percent (s.a.) in the July-August period to a level 4.9 percent above that of a year ago. The trade deficit widened dramatically in August to \$1.4 billion (s.a.), the largest monthly gap since early 1983 and twice July's deficit. The deterioration was largely accounted for by a surge in imports from other EC countries, especially Germany. In addition to exerting pressure on the franc within the EMS, the August trade deficit prompted Finance Minister Berezovoy to say that France's external trade deficit could point to a slight overheating in the economy. Pressures on the franc stemming from the news of the deficit as well as public sector strikes led the Bank of France to raise its money market intervention rate to 7-1/4 percent from 7 percent on October 18.

In the United Kingdom, indications of real activity in the third quarter have been mixed, following the slowing of the pace of real GDP growth to 1.6 percent (s.a.a.r.) in the second quarter. Industrial production increased by 1.3 percent (s.a.) in August, and the

unemployment rate declined for the 26th consecutive month in September, while retail sales volume fell by 1 percent (s.a.) in September. The 12-month rate of consumer price inflation rose to 5.9 percent in September, the seventh consecutive monthly increase. The trade and current account deficits remained at near-record levels in August. For the first eight months of the year, the cumulative current account deficit was \$24.6 billion (s.a.a.r.), far greater than the \$1.2 billion deficit in the same period last year.

There is some evidence that Canadian real growth may have slowed in the third quarter from the 4 percent (s.a.a.r.) real GDP growth rate of the second quarter. In July, the monthly GDP figure was unchanged (s.a.) while industrial production declined 0.5 percent (s.a.). The unemployment rate averaged 7.9 percent (s.a.) in the third quarter, up from 7.7 percent in the second quarter. The trade surplus declined sharply (s.a.) in August. However, the cumulative trade surplus so far this year, at \$9.8 billion (s.a.a.r.), remains slightly above the surplus rate in the same period last year. Conservative Prime Minister Brian Mulroney has called a general election for November 21 which will decide the fate of the U.S.-Canada Free Trade Agreement. Polls indicate that the Conservatives have a substantial lead.

In Italy, industrial production rose 2.9 percent (s.a.) in July and was 6.9 percent above its level of a year ago. In September, consumer prices were up 4.8 percent from a year earlier, slightly below the 5.0 percent increase registered in August. Through July, the trade deficit

was \$9.6 billion (s.a.a.r.), larger than the \$7.6 billion deficit in the same period last year.

The 1989 budget was approved by the cabinet and submitted to parliament on September 29. It implies a budget deficit equal to 10.2 percent of GDP, a reduction from the projected 1988 budget deficit of 11 percent of GDP. The recent adoption of a reform in parliamentary procedure that eliminates the use of the secret ballot has increased the likelihood that the proposed budget will be approved quickly and without major amendments. The use of the secret ballot contributed to the fall earlier this year of the government of Giovanni Gorla by permitting members of Prime Minister Gorla's own party to vote against the budget in secret.

Economic Situation in Major Developing Countries

On October 17, the U.S. Treasury and the Federal Reserve announced they were prepared to develop a bridge loan providing up to \$3.5 billion to Mexico in support of measures taken by the Mexican government to counter the effects of recent declines in oil prices. Consumer price inflation in Brazil registered 24 percent in September for the third consecutive monthly increase in excess of 20 percent; many observers project even higher inflation in coming months. In late September, the World Bank reached agreement on \$1.25 billion in policy and sector loans to Argentina; these loans are scheduled for Executive Board consideration on October 27. Negotiations between Argentina and the commercial banks in mid-October led to, as an initial move, a \$100 million payment by Argentina in overdue interest on new money loans made

in 1985 and 1987. Venezuela has simplified its multiple exchange rate system and substantially devalued effective exchange rates for imports, exports, and debt/equity swaps. Yugoslavia has asked for a modification of the terms of its IMF standby, approved in June, in light of higher than expected inflation. Peru's consumer prices rose 114 percent in September, spurred by drastic devaluation and increases in public sector prices.

Individual country notes. On October 17, the U.S. Treasury and Federal Reserve announced that they were prepared to develop a short-term bridge loan of up to \$3.5 billion to Mexico in support of Mexico's economic policies and, in particular, of new measures taken by the government to counter the effect of the recent decline in oil prices. The loan would be repaid from disbursements on loans to be developed with the World Bank and the IMF. The policy measures include a tightening of monetary policy, new cuts in public sector expenditures, and an acceleration of the privatization program. At the same time, President-elect Salinas announced an extension of 30 days (to the end of 1988) of the freeze in the peso/dollar exchange rate, minimum wages, public sector prices, and controlled private sector prices. Discussions have begun with the World Bank on a financing package that may exceed \$1.5 billion, and Mexico will apply to the IMF for assistance under the Compensatory and Contingency Financing Facility that may be as much as \$600 million.

In line with the newly announced tightening of monetary policy, the 28-day Treasury bill rate rose by 206 basis points at the October 18 auction, compared with the previous week. The new expenditure cuts

amount to the equivalent of 0.15 percent of GDP for the balance of this year, or, on an annualized basis, are equivalent to 0.7 percent of GDP.

In August, the Mexican trade surplus was only about \$174 million, the lowest since April 1982. As recently as June 1987, it was \$1 billion. Exports have remained stable, but imports surged to \$1.8 billion, the highest level since December 1981. In September, the CPI rose by 0.6 percent, the lowest monthly increase in 12 years.

Consumer prices rose 24 percent in September in Brazil compared with 21 percent in August and 24 percent in July. Many observers of the Brazilian economy are projecting even higher inflation in coming months. On the other hand, financial markets have calmed somewhat in the past week. After jumping from 38 to 50 percent in mid-October, overnight interest rates have been hovering at about 42 percent on a monthly basis. The provision in the new constitution limiting real interest rates to 12 percent has been temporarily relaxed pending enabling legislation from Congress. Borrowing and lending through the banking system have returned to normal.

Brazil's trade surplus continues to show strength. September's trade surplus was \$1.9 billion, second only to August's record \$2.1 billion surplus, bringing the trade surplus to \$14.5 billion in the first nine months of the year. Signing of the new money package and rescheduling formally agreed to in September is nearing completion. The package is expected to become effective shortly, allowing \$4.6 billion of the \$5.2 billion new money package to be disbursed by year end.

In late September, World Bank management announced agreement with the Argentine authorities on \$1.25 billion in policy-based and sector

loans to Argentina, conditional on continued economic reforms. The terms of the accord do not require agreement between Argentina and the IMF on a stand-by arrangement; negotiations on such an agreement are proceeding. In the context of talks between Argentina and its commercial bank creditors, Argentina on October 19 announced the payment of \$100 million in overdue interest on new money loans made in 1985 and 1987; total interest arrears to commercial banks are estimated at more than \$1.2 billion.

As a result of the anti-inflation program initiated by Argentina in early August, monthly inflation fell from 28 percent in August to 12 percent in September. On September 12, key business groups agreed to freeze prices through the end of October, and on October 14, they agreed to guidelines limiting average price increases to 4 percent monthly through March 1989. Inflation is expected to show further improvement in October, though considerable uncertainty persists regarding longer-term inflation prospects. Financial markets have remained calm, and the government has tightened liquidity in order to contain the demand for foreign exchange. Central bank sales of dollars, which reached a cumulative total of \$470 million by October 14 since August 4, also helped to contain the value of the free market dollar to about 15 australes, roughly 23 percent above the official rate. Argentina's trade surplus in the first seven months of 1988 reached \$1.7 billion compared with about \$0.6 billion during the same period last year.

In mid-October, Venezuela simplified its multiple exchange rate system, moving imports of food staples and medicines from the 7.5 bolivars per dollar-rate (bs/\$) that applied previously to the official

rate of 14.5 bs/\$. Exports were moved from the official rate to the free market exchange rate, currently about 37 bs/\$, while foreign investors in certain export industries will be allowed to exchange Venezuelan foreign debt for equity at the free market exchange rate, rather than the official rate, as well. The Central Bank drew down the second half of a \$500 million short-term, renewable credit line with the Bank for International Settlements in September following a drawing of equal magnitude in August. (The disbursements were against a swap of SDRs.) Largely as a result of these drawings, holdings of foreign exchange reserves have been stabilized.

Inflation continued to abate last month. Venezuela's consumer price index rose 1.7 percent in September, following a 2.4 percent increase in August. So far this year the CPI has risen 17 percent, compared with a 28 percent increase in the same period a year ago.

Yugoslavia has asked the IMF to modify the terms of its SDR 306 million stand-by arrangement approved on June 28, 1988. The program's targets were based on expected inflation of 95 percent in the year to December 1988, but that figure is now expected to be about 200 percent.

Consumer prices rose 114 percent during September in Peru, compared with a 22 percent increase in August. The more than doubling of the price level largely reflects the impact of a government austerity program that drastically devalued the currency and raised public sector prices. Widespread shortages and social unrest followed in the wake of the program's implementation; prospects for the measures' success are very uncertain.