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February 1, 1989

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 economy remained fairly strong in the fourth quarter. Gains in employment were sizable through December, and the estimated rise in real GNP for the quarter was 3 percent at an annual rate, after adjusting for the drought losses in agriculture. Although business investment and net exports weakened somewhat, consumer spending continued to grow at a substantial pace, and housing activity also was strong. Price inflation in recent months has been running in about the same range as over the past year, but, against the backdrop of tightening labor markets, the trends in labor costs have continued to deteriorate.

Labor Market Developments

Payroll employment rose 280,000 in December, and monthly increases over the quarter averaged more than 300,000. Manufacturing employment surged last quarter, after a flat third quarter, and job gains in services continued to be sizable. The increase in manufacturing was concentrated in durable goods industries, especially in machinery and some materials industries where order backlogs have been rising. The gains in nonfarm employment, coupled with an increase in the workweek, resulted in fourth-quarter growth in production worker hours of 3.5 percent at an annual rate. The civilian unemployment rate was 5.3 percent in December--matching the low for the current expansion. Initial claims for unemployment insurance rose a bit around the end of 1988 and into early 1989, but then dropped back again in mid-January; similar ups and downs often have been observed at this time of year and may reflect difficulties of seasonal adjustment through the holiday period.

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

	1987	1988	1988			1988		
			Q2	Q3	Q4	Oct.	Nov.	Dec.
-----Average Monthly Changes-----								
Nonfarm payroll employment ²	286	305	346	227	306	236	404	279
Strike-adjusted	283	304	345	229	301	230	393	279
Manufacturing	38	34	46	2	68	99	70	34
Durable	21	23	35	7	44	58	43	30
Nondurable	16	11	12	-6	24	41	27	4
Construction	21	25	39	19	18	1	39	13
Trade	68	81	81	52	77	63	90	79
Finance and services	114	121	141	93	123	105	128	135
Total government	28	31	20	51	14	-40	68	14
Private nonfarm production workers	208	212	258	124	223	219	259	190
Manufacturing production workers	30	23	30	-3	52	80	55	22
Total employment ³	257	189	291	123	213	203	374	62
Nonagricultural	252	191	311	105	207	141	374	107

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			1988		
			Q2	Q3	Q4	Oct.	Nov.	Dec.
Civilian, 16 years and older	6.2	5.5	5.5	5.5	5.3	5.3	5.4	5.3
Teenagers	16.9	15.3	15.2	15.3	14.6	15.0	14.1	14.8
20-24 years old	9.7	8.7	8.7	8.5	8.7	8.6	8.7	8.7
Men, 25 years and older	4.8	4.2	4.2	4.1	4.1	4.0	4.2	4.1
Women, 25 years and older	4.8	4.3	4.3	4.4	4.2	4.2	4.2	4.1
White	5.3	4.7	4.7	4.8	4.6	4.6	4.6	4.6
Black	13.0	11.7	11.9	11.3	11.3	11.2	11.2	11.6
Fulltime workers	5.8	5.2	5.1	5.1	5.0	5.0	5.0	5.1
Memo:								
Total National ¹	6.1	5.4	5.4	5.4	5.3	5.3	5.3	5.3

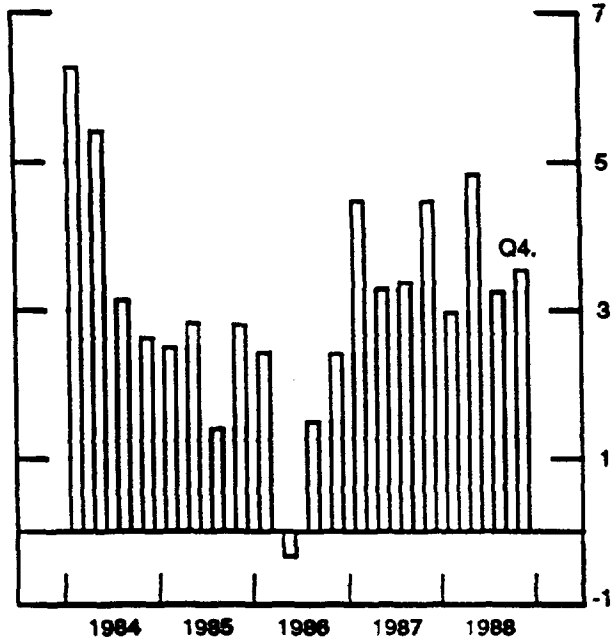
1. Includes resident armed forces as employed.

Employment growth in the household survey fell short of that in the payroll survey in the fourth quarter, as it did through much of 1988; over the year, household employment was up 2-1/4 million, while the number of payroll jobs rose more than 3-1/2 million. This gap is large by historical standards, and the Bureau of Labor Statistics has been unable to establish the sources of the difference. In any event, both surveys show employment rising faster than the growth of the labor force and suggest that activity in 1988 probably continued to be more rapid than can be sustained over the long haul.

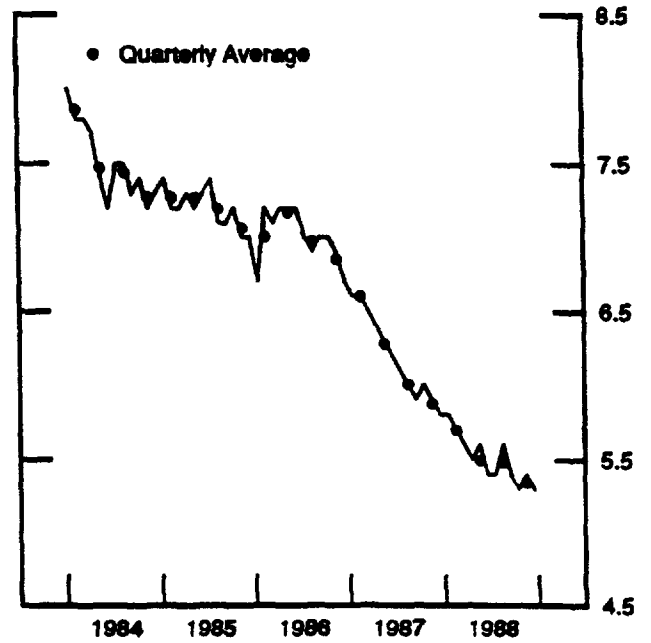
The tightening of labor markets has been accompanied by an acceleration in labor costs. Total private compensation, as measured by the Employment Cost Index, rose at a 4-3/4 percent annual rate in the fourth quarter (based on data that have been seasonally adjusted by the Board's staff) and advanced nearly 5 percent over the year as a whole, after rising 3-1/4 percent in 1987. Both the wage and benefit components of compensation costs accelerated in 1988. Wages and salaries grew a bit more than 4 percent in 1988--about 3/4 of a percentage point above the pace in 1987. Meanwhile, benefit costs jumped sharply last year, rising 6-3/4 percent, after a 3-1/2 percent increase in 1987.

About one-fourth of the acceleration in hourly compensation in 1988 reflected the hike in the social security tax rate that took effect last January. The remainder--amounting to about 1-1/4 percentage points--seems to have resulted largely from the tightening of labor markets, which is forcing employers either to boost wages or to add more generous benefit packages if they are to attract and retain workers. Among blue-collar workers, and in the goods-producing sector, the acceleration in hourly

AGGREGATE PRODUCTION WORKER HOURS *

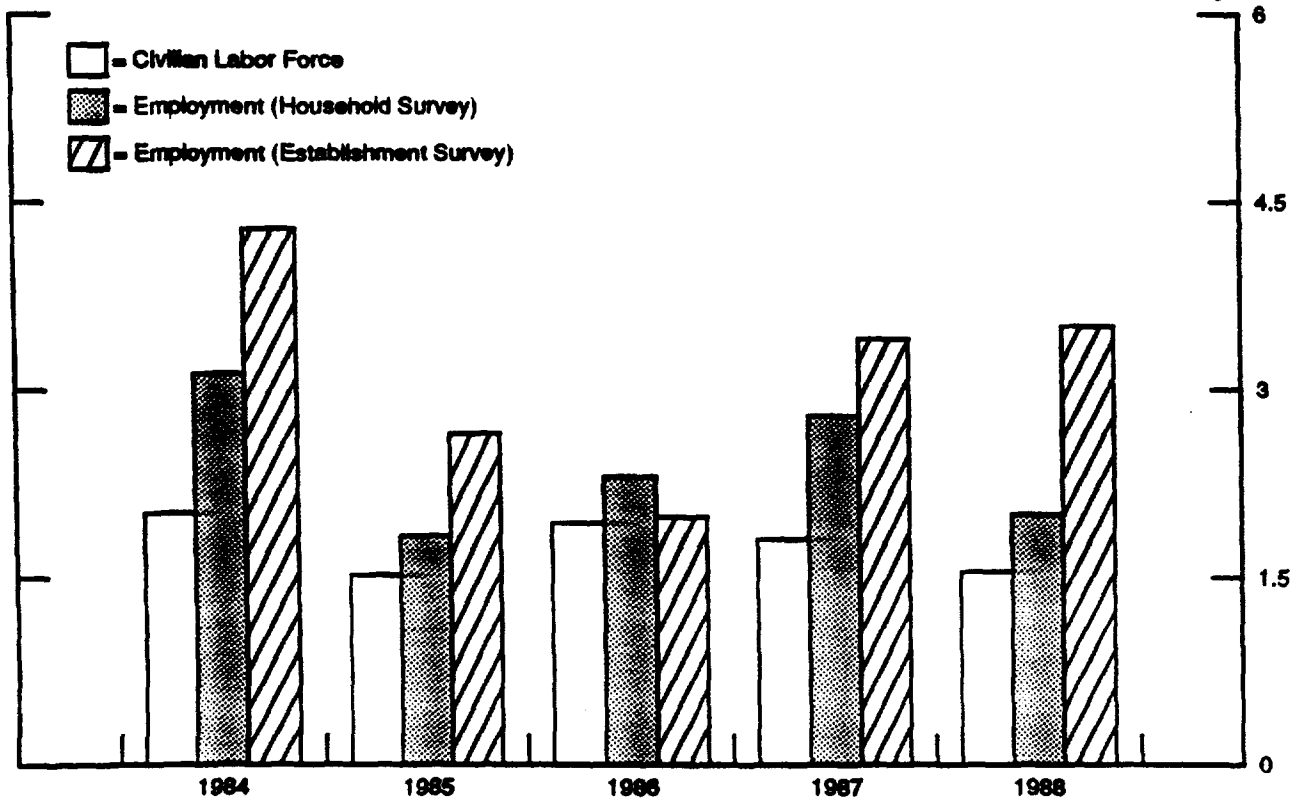


CIVILIAN UNEMPLOYMENT RATE (percent)



* Quarterly percentage change at an annual rate

LABOR FORCE AND EMPLOYMENT



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

	Annual		1988			
	1987	1988	Q1	Q2	Q3	Q4
<u>Hourly earnings index, wages of production workers¹</u>						
Total private nonfarm	2.6	3.5	3.1	3.8	2.9	4.1
Manufacturing	1.9	2.5	1.6	2.9	2.3	3.1
Contract construction	.7	2.4	4.1	1.1	3.1	1.5
Transportation and public utilities	2.9	2.9	2.7	4.8	1.7	2.5
Trade	2.3	3.8	2.8	4.2	3.3	4.8
Services	4.6	4.9	4.2	5.7	4.4	5.4
<u>Employment cost index²</u>						
Compensation, all persons	3.3	4.9	5.7	5.2	3.8	4.8
By occupation:						
White collar	3.7	5.0	4.9	5.4	4.1	5.7
Blue collar	3.1	4.4	6.8	4.5	2.7	3.6
Service workers	2.4	5.3	5.3	6.0	5.5	4.3
By sector:						
Goods-producing	3.1	4.4	6.7	4.4	2.7	3.6
Service-producing	3.7	5.1	4.7	5.8	4.2	5.8
By bargaining status:						
Union	2.8	3.9	6.1	4.3	3.1	2.1
Nonunion	3.6	5.1	5.4	5.4	3.8	5.9
Manufacturing	3.1	4.5	7.2	4.2	3.1	3.3
Wages and salaries, all persons	3.3	4.1	3.5	4.5	3.4	5.0
Benefits, all persons	3.5	6.8	11.0	6.7	4.8	4.8
<u>Major collective bargaining agreements³</u>						
First-year wage adjustments	2.2	2.6	--	--	--	--
Total effective wage change	3.1	2.6	--	--	--	--
<u>Labor costs and productivity, all persons¹</u>						
Compensation per hour	4.1	--	3.5	4.2	5.6	--
Output per hour	1.9	--	3.4	-2.4	1.9	--
Unit labor costs	2.1	--	0.1	6.8	3.7	--
<u>Manufacturing</u>						
Compensation per hour	1.6	--	5.4	3.0	4.7	--
Output per hour	3.4	--	3.2	3.7	5.2	--
Unit labor costs	-1.8	--	2.2	-.7	-.5	--

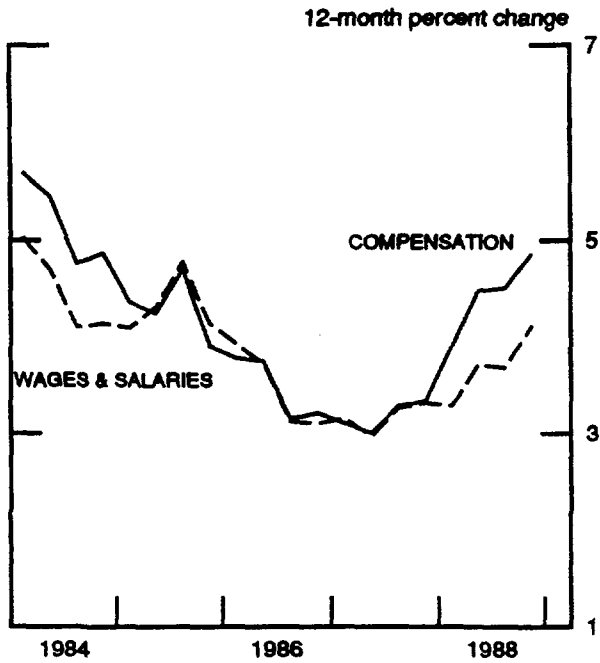
1. Changes are from final quarter of preceding period to final quarter of period indicated. Seasonally adjusted data.

2. Percentage change at an annual rate, measured from the final month of preceding period to final month of period indicated; seasonally adjusted by the Federal Reserve staff.

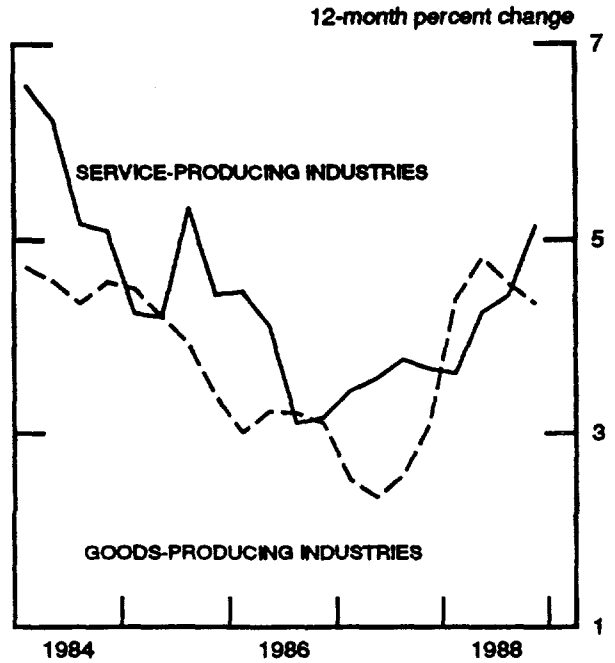
3. Agreements covering 1,000 or more workers.

Employment Cost Indexes: Private Industry

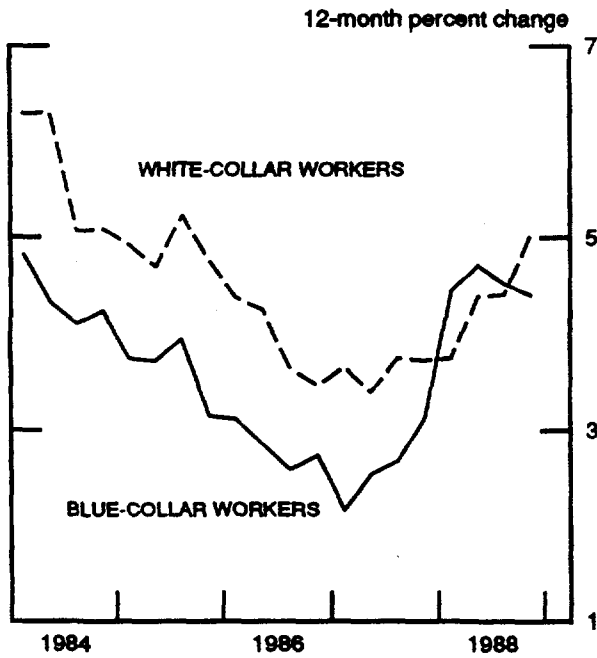
ALL INDUSTRIES



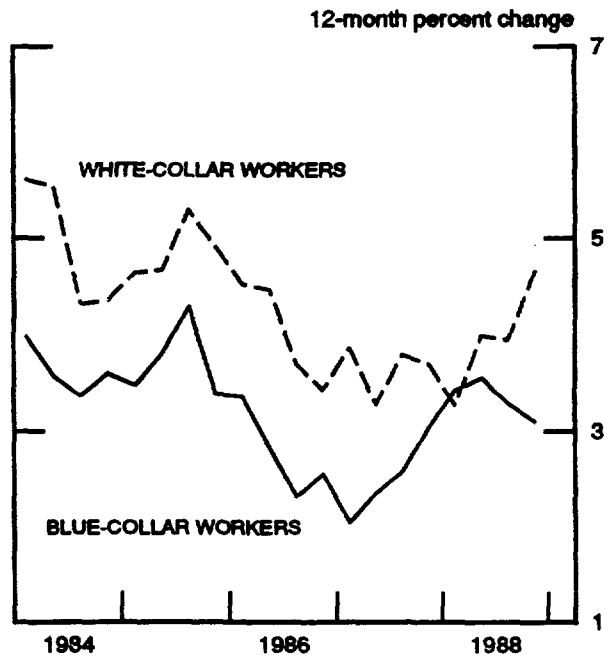
COMPENSATION BY SECTOR



COMPENSATION BY OCCUPATIONAL GROUP



WAGES AND SALARIES BY OCCUPATIONAL GROUP



INCREASES IN HOURLY COMPENSATION AND ITS COMPONENTS¹
(Private Nonfarm Workers)

	Share of total Compensation	1986	1987	1988
Compensation	1.00	3.2	3.3	4.9
Wages and salaries	.72	3.1	3.3	4.1
Benefits	.28	3.4	3.5	6.8
Paid leave	.07	5.9	4.7	4.2
Supplemental Pay	.03	1.7	5.5	8.0
Insurance	.06	2.2	5.0	11.3
Retirement and Savings	.03	0.8	-6.3	-4.8
Legally Required	.09	4.4	5.1	9.5
Other	.00	-17.0	7.0	9.1

1. Percent change from last month of preceding period to last month of period indicated; the details on benefits are estimated by the Federal Reserve staff, based on the Employment Cost Index and on unpublished data from the Bureau of Labor Statistics.

GROWTH IN SELECTED COMPONENTS OF INDUSTRIAL PRODUCTION
(Percent change from preceding comparable period)

	1987 ¹	1988 ¹	1988			1988		
			H1	Q3 ^r	Q4 ^p	Oct. ^r	Nov. ^r	Dec. ^p
			---Annual rate---			---Monthly rate---		
Total Index	5.8	5.0	4.2	7.1	4.2	.5	.4	.3
Products	4.9	5.2	5.3	6.4	3.7	.5	.1	.3
Consumer goods	3.2	5.7	4.9	6.6	6.5	1.4	-.2	.5
Autos	-6.3	13.7	14.2	-5.9	36.3	3.8	-.3	4.0
Ex. autos	3.5	5.4	4.6	7.0	5.6	1.3	-.2	.4
Business equipment	7.0	7.9	10.5	9.4	1.3	-.5	.6	.2
Office and comp. mach.	9.4	5.6	18.0	.1	-10.8	-3.3	1.1	n.a.
Ex. OCM	6.2	8.6	8.0	12.9	5.8	.4	.4	.5
Ex. OCM and motor veh.	6.4	8.4	8.3	14.0	3.3	.0	.3	.1
Defense and space	1.9	-3.1	-3.5	-2.6	-2.7	-.3	-.4	-.1
Construction supplies	4.7	5.1	6.4	.9	6.9	.7	1.1	.6
Business supplies	6.7	5.3	3.3	10.1	4.7	.2	.2	.4
Materials	7.2	4.6	2.5	8.3	5.1	.7	.8	.2
Durable	8.0	6.9	6.0	9.0	6.8	.7	.7	.0
Consumer durable parts	1.8	9.4	11.0	5.5	10.1	.4	1.9	.5
Equipment parts	6.3	6.8	8.6	8.3	2.0	.4	.2	-.3
Basic metals	21.3	3.4	-7.9	24.7	7.8	.8	-.7	-.3
Nondurable	8.1	4.2	.6	7.6	8.2	1.6	.4	1.1
Textile	6.5	-3.8	-7.2	1.1	-1.6	.3	-.9	.0
Paper	5.9	2.3	1.0	8.5	-1.0	.3	-.7	1.5
Chemical	12.6	6.8	.3	11.4	16.2	2.8	1.2	1.5
Energy	4.5	-.1	-3.0	7.7	-2.0	-.4	1.4	-.4
Memo:								
Manufacturing	5.9	5.5	5.1	7.2	4.8	.6	.3	.3

1. From the fourth quarter of the previous year to the fourth quarter of the year indicated.

r -- revised

p -- preliminary

compensation last year was entirely in the form of increased benefits. In contrast, white-collar workers, and those in the service-producing sector, saw a big pickup in both benefits and wages; it is in these areas that unemployment rates currently are the lowest and in which the anecdotal evidence of labor shortages have been the most frequent.

Among the components of benefits, the rise in the cost of insurance benefits was especially rapid--more than 11 percent over the year, according to estimates derived from unpublished BLS reports. Some firms reportedly have added medical insurance benefits to their compensation packages in order to attract workers. The increases in most other types of benefits also were rapid in 1988, the only major exception being the contributions to employee retirement plans; because these plans have been well-funded, employers were able to trim their contributions in 1988.

Industrial Production and Capacity Utilization

Total industrial production was up 0.3 percent in December, bringing the gain for the fourth quarter as a whole to 4.2 percent at an annual rate. Sharp increases in assemblies of motor vehicles boosted the output of both consumer goods and business equipment last quarter. Production of nonauto consumer goods also continued to advance briskly. In contrast, output of business equipment turned sluggish, in part reflecting a steep drop in the output of computing machines, which constitute about one-fourth of the business equipment index. Apart from motor vehicles and computers, production of capital goods continued to rise in the fourth quarter, although much less rapidly than over the first three quarters of the year. Output of materials increased 5 percent at an annual rate during the fourth quarter, down about 3 percentage points from the third-quarter advance.

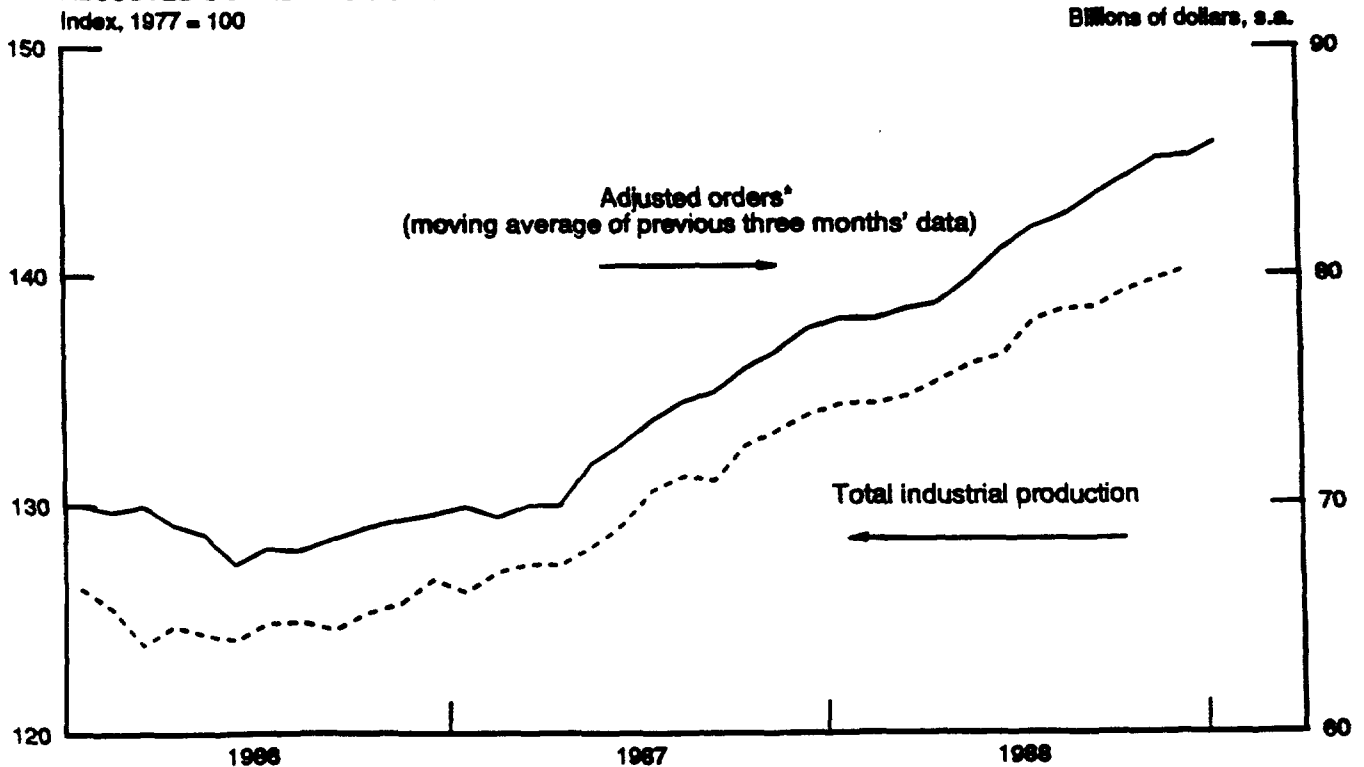
NEW ORDERS FOR DURABLE GOODS*
(Percent change from preceding period, seasonally adjusted)

	Share, 1988	1988		1988		
		Q3	Q4	Oct.	Nov.	Dec.
1. Total durable goods	100	.2	5.1	2.9	.1	6.4
2. Industries with orders data	83	.8	4.6	2.6	-.3	6.7
3. Defense capital goods	8	-29.5	30.0	43.1	-21.5	21.1
4. Nondefense aircraft	6	32.4	9.1	-5.8	23.5	46.0
5. Excl. defense capital goods and nondefense aircraft	69	2.7	1.9	-.3	.7	1.9
6. Nondefense capital goods excl. aircraft	24	4.5	-3.3	.4	-.8	-1.9
7. All other categories**	46	1.7	4.7	-.7	1.5	3.8

* The detail on advance orders and shipments is confidential.

** Includes primary metals, most fabricated metals, most stone, clay, and glass products, motor vehicle parts, electronic components, household appliances, scientific instruments, and miscellaneous durable goods.

ADJUSTED DURABLE GOODS ORDERS AND INDUSTRIAL PRODUCTION
Index, 1977 = 100



* Adjusted orders equal bookings for durable goods industries that report unfilled orders, excluding orders for defense capital goods and nondefense aircraft (line 5 of the table above). Value shown at time t is a moving average of data from time t-1, t-2, and t-3.

Output of durable and nondurable materials continued to post strong gains, but the production of energy materials declined, as a drop in electricity generation last quarter retraced most of the increase posted during last summer's heat wave.

Recent data on durable goods orders suggest that the growth in industrial production is likely to be maintained in the near term. In particular, orders surged toward year-end for metals, some construction materials, and household durables. For manufacturing as a whole, the strength in these orders more than offset the sluggishness in bookings for nondefense capital goods in the last two months of 1988.¹

Capacity utilization in manufacturing increased nearly 1/2 percentage point during the fourth quarter, to 84-1/2 percent. Over the four quarters of 1988, the manufacturing operating rate climbed another 2 percentage points, after a rise of 2-1/2 percentage points in 1987; factory utilization in the fourth quarter was at the highest level since 1979. The operating rate for primary processing industries rose 1-1/4 percentage points last year, to 88-1/4 percent, and the utilization rate for advanced processing industries gained 2-1/2 percentage points last year to 82-1/2 percent. The rise in the operating rates over the past year has been accompanied by continued rapid increases in the prices of intermediate materials and a marked acceleration in the prices of manufactured goods.

1. Orders for durable goods tend to lead industrial production by about two months, on average, if one uses an orders series that excludes those industries in which orders are identical to shipments and therefore do not provide any lead information, or in industries in which the lead times are so long, as in the case of aircraft and defense industries, as to have little practical value for predicting near-term activity levels. The adjusted durables orders series plotted in the attached chart refers to total orders excluding defense capital goods and nondefense aircraft.

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

	1967-87	1973	1978-80	1987	1988		
	Ave.	High	High	Q4	Q2	Q3	Q4
Total industry	81.5	88.6	86.9	82.1	82.8	83.8	84.1
Manufacturing	80.6	87.7	86.5	82.3	83.2	84.0	84.4
Primary processing	81.7	91.9	89.1	86.9	86.8	87.5	88.2
Advanced processing	80.1	86.0	85.1	80.1	81.5	82.4	82.6
Durable manufacturing	78.7	87.4	86.3	80.0	81.5	82.4	82.9
Primary metals	79.6	101.9	97.1	88.8	85.7	89.7	90.5
Iron and steel	78.6	105.8	100.3	90.4	84.8	89.6	89.9
Nonferrous metals	81.2	95.6	91.1	86.7	86.8	89.9	91.3
Fabricated metal products	77.8	85.0	87.4	79.9	82.7	83.9	84.6
Nonelectrical machinery	78.1	89.0	86.0	76.8	81.0	82.6	82.2
Motor vehicles & parts	78.1	97.1	93.3	80.0	82.5	82.0	86.1
Autos	76.4	91.8	93.3	68.9	73.3	72.1	77.8
Nondurable manufacturing	83.5	88.8	87.0	85.6	85.6	86.3	86.5
Textile mill products	85.0	92.1	88.3	92.8	89.5	89.4	88.6
Paper and products	88.5	95.6	92.7	95.7	94.5	95.1	94.5
Chemicals and products	78.9	88.6	82.9	84.8	86.3	88.5	89.7
Petroleum products	86.9	99.6	91.7	85.4	86.1	85.0	86.0
Mining	86.7	92.8	95.2	81.2	81.5	82.3	82.8
Utilities	86.9	95.6	88.5	80.6	79.9	81.9	81.4
Memo:							
Industrial materials	82.2	92.0	89.1	82.9	83.0	84.3	84.9
Raw steel	80.2	106.0	98.9	88.9	86.9	96.8	89.5
Aluminum	87.3	95.7	97.4	94.1	99.2	100.5	100.2
Paper materials	91.7	98.4	97.3	99.2	97.8	98.8	97.5
Chemical materials	81.0	92.5	87.9	89.1	87.3	88.6	90.9

1. Data for iron and steel, nonferrous metals, textile mill products, paper and products, chemicals and products, raw steel, aluminum, paper materials, and chemical materials are unpublished estimates for December.

Personal Income and Consumption

Although retail sales have shown a good deal of month-to-month variability of late, the trend in consumption spending still looks quite strong. In real terms, total personal consumption expenditures rose nearly 3 percent at an annual rate in the fourth quarter. Spending for household durables rose vigorously as did the outlays for other discretionary items such as boats and aircraft. Outlays for services are estimated to have advanced at an annual rate of 3-3/4 percent, reflecting big increases in real spending for medical care, airline travel, and recreation. Expenditures on motor vehicles surged in December, but were little changed for the fourth quarter as a whole. Spending for nondurables rose moderately in the fourth quarter, after a steep rise in the previous period.

The overall strength of consumer spending has been buttressed by sizable gains in income. Real disposable personal income was up 0.7 percent in December and increased at an annual rate of 4-3/4 percent in the fourth quarter, boosted by hefty gains in wages and salaries, a rapid rise in interest income, and another round of big government subsidies to farmers. With income gains outstripping the growth of consumer spending, the saving rate moved up almost 1/2 percentage point in the fourth quarter, to 4.6 percent.

Consumption expenditures, in real terms, rose 3-1/2 percent over the four quarters of 1988--a much bigger rise than in 1987--and there is little in the recent data to suggest that growth of consumption will move to a significantly lower trajectory in the near term. Indeed, in view of the continued strong growth of real income, favorable readings on consumer sentiment, and the recent run-up in the stock market, it appears that

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

	1988	1988		1988		
		Q3	Q4	Oct.	Nov. ^r	Dec. ^p
Total personal income	22.3	23.3	30.8	63.5	-8.2	37.1
Wages and salaries	14.7	15.8	18.4	33.1	7.4	14.6
Private	12.6	13.7	16.2	31.1	5.1	12.5
Other labor income	.9	1.0	1.0	1.0	1.0	1.0
Proprietors' income	.2	-2.6	1.5	18.1	-26.2	12.6
Farm	-1.5	-4.4	-1.1	14.3	-27.7	10.1
Rent, dividends and interest	5.3	8.0	8.4	8.5	8.3	8.4
Transfer payments	3.3	2.0	2.7	5.0	1.7	1.3
Less: Personal contributions for social insurance	2.0	.9	1.1	2.1	.5	.7
Less: Personal tax and nontax payments	.1	3.2	4.0	6.4	1.8	3.7
Equals: Disposable personal income	22.2	20.1	26.8	57.1	-10.0	33.4
Memo: Real disposable income	8.0	4.5	13.2	32.4	-12.0	19.1

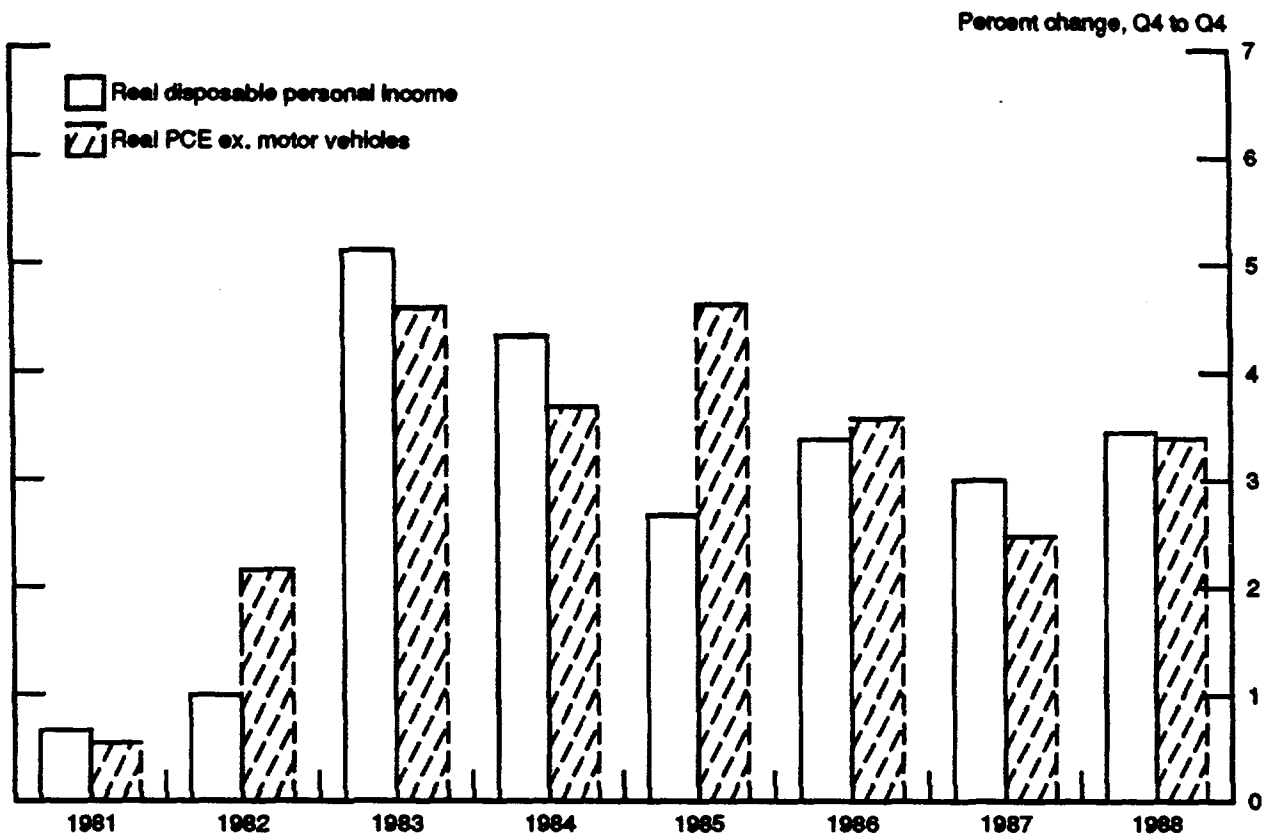
r--Revised.
P--Preliminary.

REAL PERSONAL CONSUMPTION EXPENDITURES
(Percent change from preceding period)

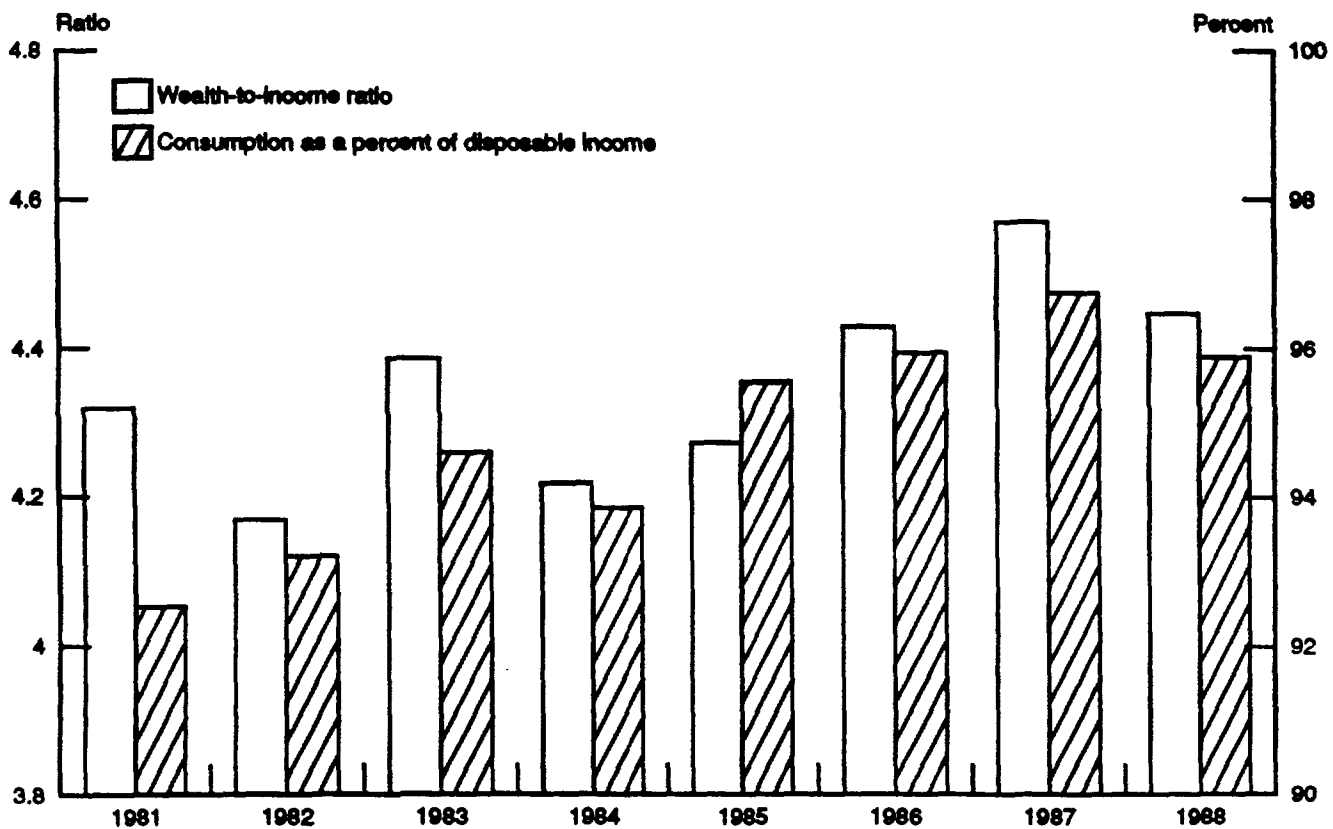
	1987	1988	1988		1988		
			Q3	Q4	Oct.	Nov.	Dec.
	-Annual rate-		----Monthly rate----				
Personal consumption expenditures	1.8	3.6	3.9	2.8	0.5	0.2	0.7
Durable goods	-2.4	6.4	-0.2	2.1	-0.1	0.3	3.4
Excluding motor vehicles	1.0	6.3	0.2	5.5	1.1	0.2	0.8
Nondurable goods	0.6	2.0	5.0	1.9	0.2	0.7	-0.2
Services	4.2	3.8	4.5	3.7	0.9	-0.2	0.4
Excluding energy	4.3	3.5	3.4	4.1	0.5	0.2	0.3
Memo:							
Personal saving rate (percent)	3.2	4.2	4.2	4.6	5.0	4.4	4.4

r--Revised.
p--Preliminary.

INCOME AND CONSUMPTION (EX MOTOR VEHICLES)



WEALTH AND CONSUMER SPENDING



consumers are positioned to keep spending on an upward course in the near term.

Autos and Trucks

Domestic production of automobiles was 8-1/4 million units at an annual rate (BEA seasonals) in December and was scheduled at 7-3/4 million in January. Meanwhile, sales of domestically produced cars have been unusually volatile--soaring to 8.4 million units in December and falling to 6 million in the first 20 days of January. Some of the recent swing in sales apparently reflected large fleet purchases in December that may have "borrowed" from January. Moreover, some incentive programs had been scheduled to expire at the end of 1988 and probably contributed to a bunching of purchases at year-end.

Because the strong sales pace in December about matched the high level of production, inventories of domestically produced cars did not rise further from the elevated November level. However, stocks probably built up further in January. In light of the relatively high level of inventories, automakers have introduced a new round of incentive plans. Looking ahead, it seems likely that production plans will be trimmed as the first quarter progresses and that incentive plans will be expanded further.

Business Fixed Investment

Real spending for business fixed investment fell 3-3/4 percent at an annual rate in the fourth quarter, according to BEA's advance estimate, reflecting declines for both equipment structures. However, the estimate for structures is likely to be revised up as the result of strong December gains that were reported after the release of the GNP data. Over the four quarters of 1988, equipment spending increased 10 percent; most of the

1
SALES OF AUTOMOBILES AND LIGHT TRUCKS
 (Millions of units at an annual rate, BEA seasonals)

	1987	1988	1988		1988		1989
			03	04	Nov.	Dec.	Jan. ²
Autos and light trucks	14.89	15.45	15.70	15.15	14.78	16.07	n.a.
Autos	10.28	10.64	10.66	10.49	10.16	11.53	n.a.
Light trucks	4.61	4.81	5.04	4.65	4.61	4.54	n.a.
Domestically produced ³	10.87	11.74	11.96	11.59	11.34	12.38	n.a.
Autos	7.08	7.54	7.60	7.47	7.24	8.39	5.9
Light trucks	3.79 _r	4.21	4.35	4.12	4.10	3.99 _r	n.a.
Imports	4.02	3.70	3.74	3.55	3.43	3.69	n.a.
Autos	3.20	3.10	3.06	3.02	2.91	3.14	n.a.
Light trucks ⁴	.82	.60	.69	.53	.51	.55	n.a.

Note: Data on sales of trucks and imported autos for the current month are preliminary and subject to revision.

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

2. Average for first 20 days.

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

4. Based on seasonals for domestic light trucks.

r--revised

growth came in the first half of the year, when there was a surge in spending for computers. Outlays for nonresidential structures declined in 1988, reflecting softness in virtually all major categories.

New bookings for nondefense capital goods fell 1 percent in the fourth quarter, despite strong gains in aircraft orders in November and December; excluding aircraft and parts, new orders were down 3-1/4 percent for the quarter. The office and computing equipment market remains the area of most pronounced weakness. Industry sources have indicated that the rapid increase in computer orders earlier in the year was largely in the PC and workstation end of the market, as businesses substituted desktop equipment for larger minicomputers. More recently, trade reports have suggested that uncertainty about price developments and potential new technical standards in the desktop market have led many firms to postpone new computer purchases. If these reports are correct, then the computer market likely will rebound--although the timing of any such turnaround is subject to considerable uncertainty.

In addition to the softness in the demand for computing equipment, new bookings for other equipment--especially communication equipment and other types of nonelectrical machinery--also have weakened somewhat. However, orders have remained above shipments in recent months--though the gap narrowed toward year-end--and the existing backlog of unfilled orders is likely to support further advances in shipments in the near term.

With regard to structures, spending in the fourth quarter was down for drilling structures and commercial buildings other than offices; industrial construction picked up, after little change earlier in the year. Looking ahead, it seems likely that the trend in spending for nonresidential

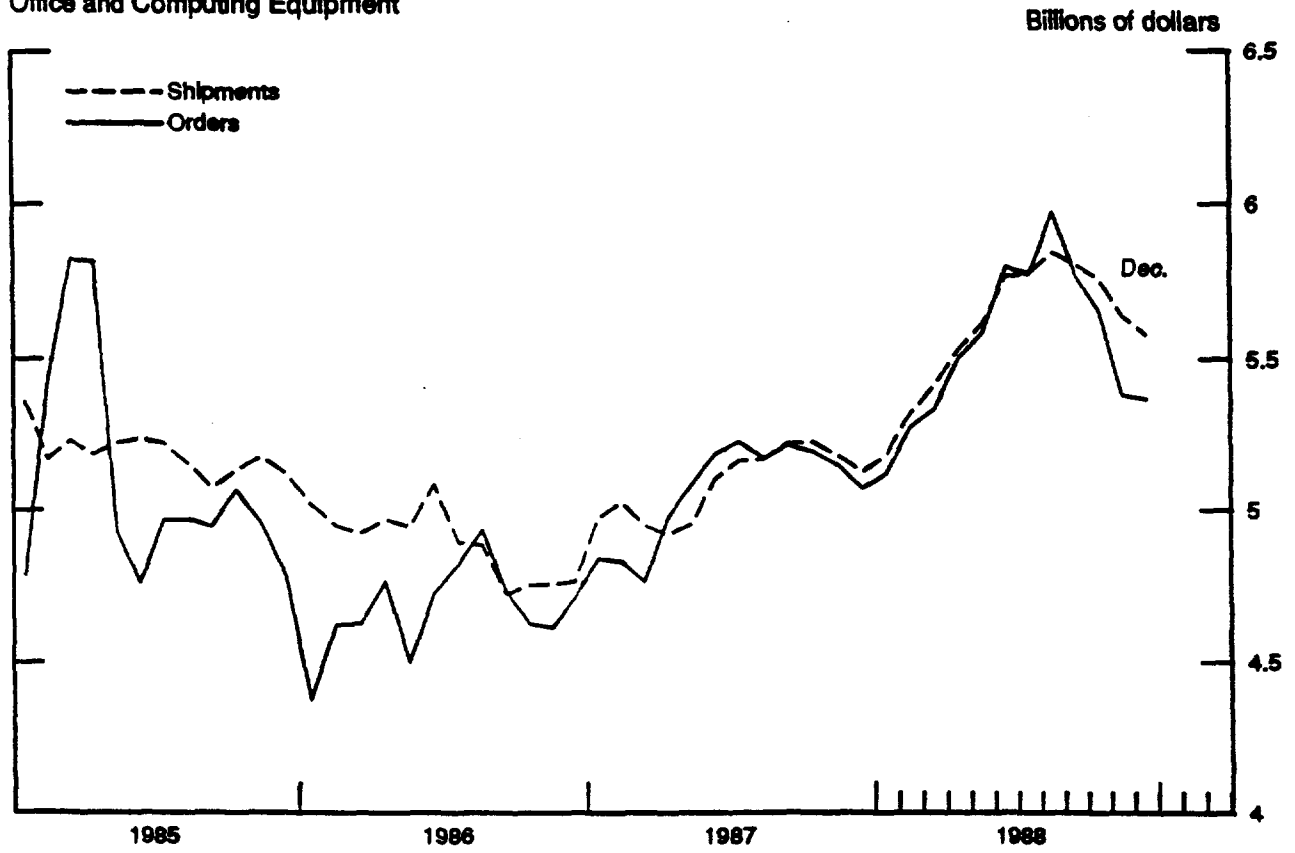
BUSINESS CAPITAL SPENDING INDICATORS
 (Percentage change from preceding comparable periods;
 based on seasonally adjusted data)

	1988			1988		
	Q2	Q3	Q4	Oct.	Nov.	Dec.
<u>Producers' durable equipment</u>						
Shipments of nondefense capital goods	3.8	2.6	.6	.2	-.2	-.3
Excluding aircraft and parts	4.3	2.4	.5	-1.2	.6	2.5
Office and computing equipment	6.6	.7	-3.9	-2.1	-3.0	2.1
All other categories	3.7	2.8	1.6	-.9	1.5	2.6
Shipments of complete aircraft ¹	12.1	-8.8	--	14.8	-29.0	--
Sales of heavy-weight trucks	-.8	-2.3	6.9	8.8	4.2	-12.2
Orders of nondefense capital goods	1.1	9.1	-.8	-.7	3.4	7.8
Excluding aircraft and parts	3.4	4.5	-3.3	.4	-.8	-1.9
Office and computing equipment	8.6	-.4	-7.0	5.5	-2.0	-4.0
All other categories	2.1	5.8	-2.3	-.7	-.5	-1.4
<u>Nonresidential structures</u>						
Construction put-in-place	1.4	1.6	1.4	.4	.7	2.6
Office	4.1	1.0	.4	1.8	-1.8	7.5
Other commercial	6.0	-2.4	-3.9	-5.6	-1.2	5.4
Public utilities	-.2	10.1	.3	-3.0	2.4	.4
Industrial	-.2	.1	11.7	12.5	5.2	-6.1
All other	-3.5	-3.4	4.2	4.2	.3	2.9
Rotary drilling rigs in use	6.7	-8.0	-16.4	-6.0	-7.4	-5.3

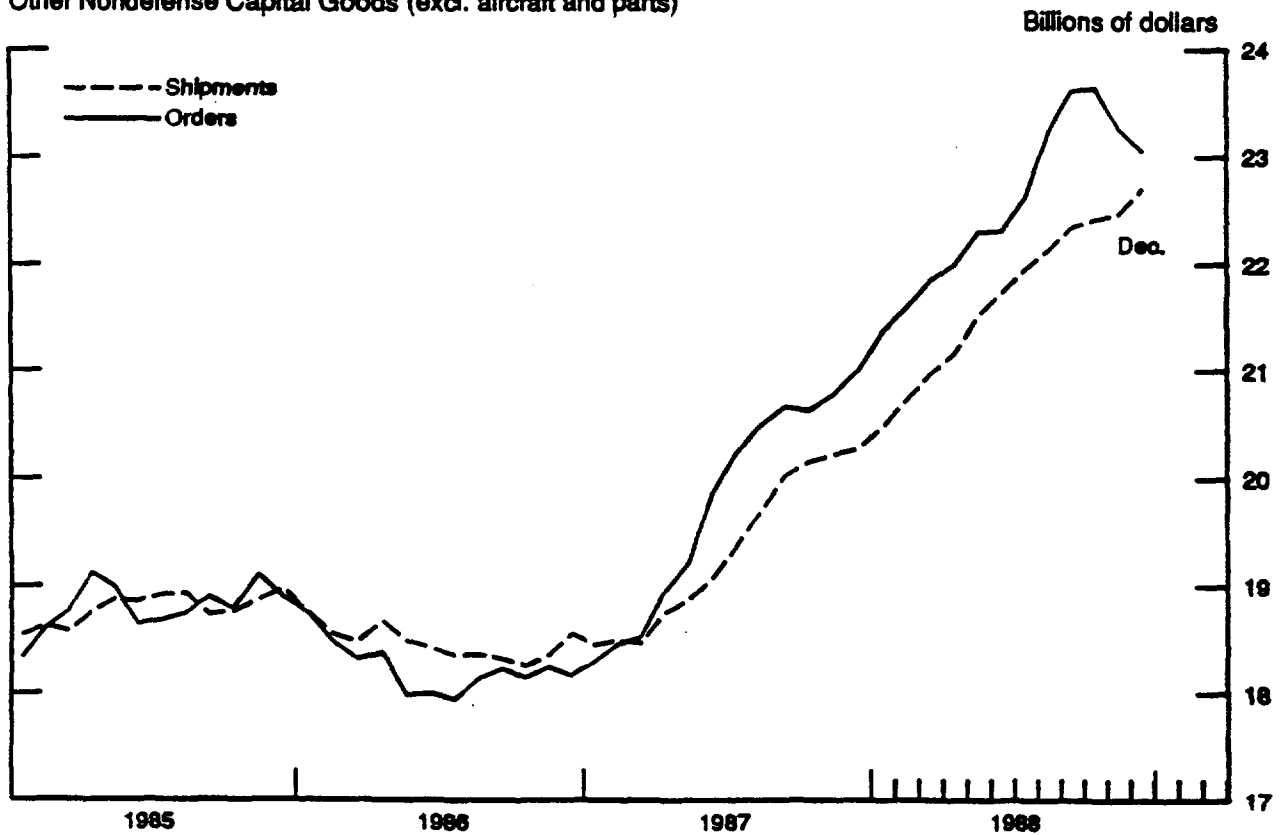
1. From the Current Industrial Report (CIR) titled "Civil Aircraft and Aircraft Engines" Seasonally adjusted with BEA seasonal factors. To estimate PDE spending for aircraft, BEA uses the aircraft shipments shown in that report, not the corresponding Census series. The CIR does not provide information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

RECENT DATA ON ORDERS AND SHIPMENTS (three-month moving average)

Office and Computing Equipment

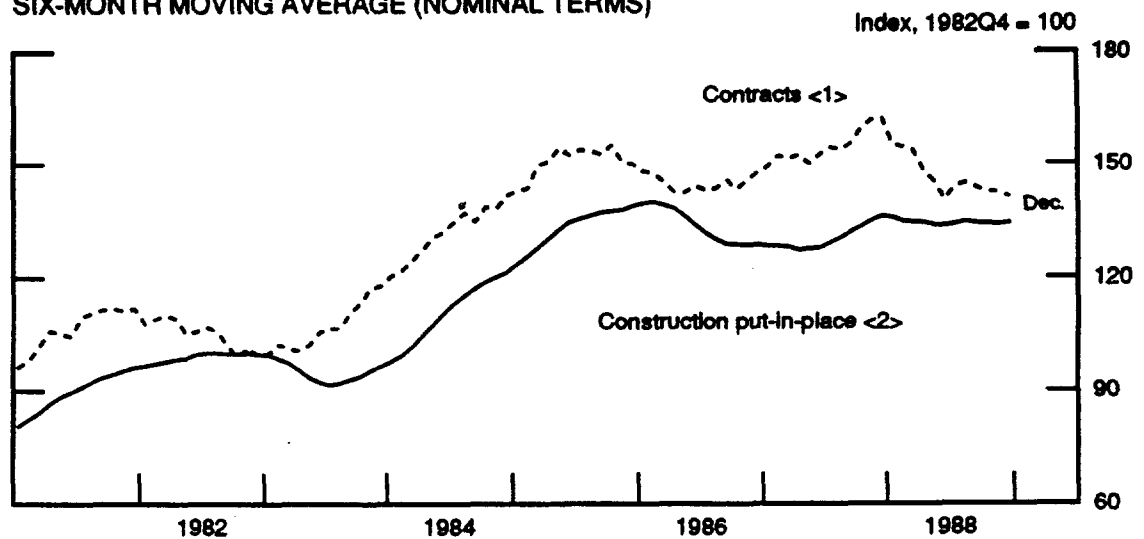


Other Nondefense Capital Goods (excl. aircraft and parts)



Nonresidential Construction Put-in-Place and Construction Contracts

SIX-MONTH MOVING AVERAGE (NOMINAL TERMS)



<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.

SURVEYS OF PLANT AND EQUIPMENT EXPENDITURES
(Percent change from previous year, current dollars)

	1988 ¹	Planned for 1989		
		Commerce (Oct.-Nov.)	McGraw-Hill (Sept.-Oct.)	ECAP ² (Oct.-Nov.)
All business	10.4	6.0	5.8	5.3
Manufacturing	12.8	4.3	6.9	6.3
Durable	9.5	2.0	4.8	5.8
Nondurable	15.9	6.4	8.7	6.7
Nonmanufacturing	9.0	7.0	5.1	4.6
Memo: ³				
Mean error		-.4	-1.0	-1.8
Mean absolute error		2.6	4.0	4.7

1. As estimated in the October-November Commerce Department Survey.

2. Economic Consulting and Planning Inc. (ECAP) is the successor firm to the Merrill Lynch Economic Consulting Group.

3. Estimated from 1970 for McGraw-Hill and ECAP and from 1985 for Commerce Department.

construction will be relatively flat in 1989, as the value of new nonresidential construction contracts has been stuck on a plateau for some time. In addition, petroleum drilling activity, as measured by the number of rigs in use, declined in the fourth quarter and continued to fall in the first three weeks of January; a firming of activity is possible, however, if oil prices hold in the higher range of recent months.

The Commerce Department's survey of plant and equipment spending, taken in October and November, indicates that capital spending will continue to rise this year, albeit at a slower pace than in 1988. Firms expected to increase nominal outlays 6 percent this year, after an estimated 10-1/2 percent rise in 1988. The expectations are similar to the spending plans reported earlier in the private surveys. Much of the slowdown is expected to occur in manufacturing, where the Commerce Department survey shows a rise in spending next year of 4-1/4 percent, compared with a 12-3/4 percent estimated gain for 1988. Nonetheless, these spending plans in manufacturing still translate into further increases in capacity, as it is the level of investment, not the change, that influences the growth of the capital stock.

Taken at face value, the surveys suggest that the weakness observed currently in the near-term data will prove temporary; although a wide confidence interval must be put around the fall Commerce survey forecast, it has in the past provided an unbiased estimate of business fixed investment.

Business Inventories

Business inventory investment slowed somewhat, on average, in October and November; in 1982 prices, stocks in all manufacturing and trade rose at an average annual rate of \$19.7 billion in the October-November period, compared with a \$25.5 billion accumulation in the third quarter. Much of

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

	1988			1988		
	Q1	Q2	Q3	Sept.	Oct.	Nov.
Current-cost basis:						
Total	39.7	54.7	77.4	76.9	3.9	41.9
Total ex. auto	61.3	41.8	54.8	39.0	27.8	35.6
Manufacturing	22.3 ^a	21.1	23.3	23.8	19.5	23.5
Wholesale	26.5	13.1	21.1	13.4	9.3	-.9
Retail	-9.1	20.5	33.0	39.7	-24.9	19.3
Automotive	-21.6	12.8	22.6	38.0	-23.9	6.3
Ex. auto	12.5	7.7	10.4	1.8	-1.0	13.0
Constant-dollar basis:						
Total	39.9	19.4	25.5	33.4	17.2	22.1
Total ex. auto	50.0	8.4	16.8	9.5	3.5	3.9
Manufacturing	15.8	5.8	5.7	6.7	4.5	.7
Wholesale	22.7	.0	8.1	6.7	3.9	-3.7
Retail	1.5	13.7	11.7	20.0	8.8	25.1
Automotive	-10.1	11.0	8.7	23.9	13.7	18.3
Ex. auto	11.6	2.7	3.0	-3.9	-5.0	6.9

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

	1988			1988				
	Range in ²		Q1	Q2	Q3	Sept.	Oct.	Nov.
	Low	High						
Current-cost basis:								
Total	1.50	1.53	1.53	1.51	1.52	1.51	1.50	1.50
Total ex. auto	1.47	1.51	1.51	1.49	1.49	1.48	1.47	1.47
Manufacturing	1.56	1.62	1.62	1.58	1.58	1.57	1.57	1.56
Wholesale	1.26	1.30	1.31	1.30	1.30	1.29	1.27	1.28
Retail	1.58	1.65	1.60	1.61	1.65	1.65	1.61	1.61
Automotive	1.74	2.10	1.76	1.86	2.07	2.10	1.94	1.92
Ex. auto	1.51	1.55	1.55	1.54	1.54	1.53	1.52	1.52
Constant-dollar basis:								
Total	1.50	1.53	1.52	1.52	1.52	1.52	1.51	1.51
Total ex. auto	1.48	1.51	1.51	1.50	1.50	1.50	1.48	1.48
Manufacturing	1.58	1.62	1.62	1.59	1.59	1.58	1.58	1.58
Wholesale	1.29	1.32	1.32	1.32	1.33	1.33	1.31	1.31
Retail	1.55	1.62	1.57	1.59	1.61	1.62	1.61	1.61
Automotive	1.70	1.93	1.73	1.83	1.93	1.97	1.93	1.95
Ex. auto	1.50	1.53	1.53	1.52	1.52	1.53	1.51	1.51

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.

II-24
SELECTED INVENTORY-SALES RATIOS
 (Based on constant-dollar data)

	<u>Cyclical reference points</u>			November 1988
	1981 Low	1982 High	1984/1985 High	
Manufacturing and trade	1.58	1.72	1.56	1.51
Manufacturing	1.88	2.04	1.80	1.58
Primary metals	2.38	3.51	2.65	1.84
Nonelectrical machinery	2.86	3.44	2.49	1.82
Electrical machinery	2.55	2.63	2.49	2.16
Transportation equipment	2.17	2.78	2.29	2.07
Textile*	1.58	1.84	1.80	1.50
Home goods & apparel*	1.81	2.16	2.06	1.84
Merchant wholesalers	1.26	1.45	1.34	1.31
Durable goods	1.91	2.35	1.96	1.83
Nondurable goods	.75	.84	.87	.86
Retail trade	1.38	1.49	1.50	1.61
Automotive dealers	1.54	1.90	1.71	1.95
Retail ex. autos	1.31	1.41	1.45	1.51
General merchandise*	2.37	2.56	2.67	2.44
Apparel*	2.44	2.79	2.81	2.78

*Based on current cost data; constant-dollar data are not available for this category.

the recent stockbuilding has occurred at auto dealers; elsewhere, inventory accumulation has been small on balance, suggesting that businesses continue to take a cautious approach to inventory investment.

In manufacturing, recent inventory buildups occurred mainly in industries producing capital equipment and production materials and supplies--such as primary metals, machinery, aircraft, chemicals, and rubber and plastics. A similar pattern was evident through much of last year. For most manufacturing industries, inventory-shipments ratios at the end of November were near the low end of the range set over the past year. In the nonauto trade sector, wholesalers' stocks, on net, rose only slightly in October and November, as buildups in inventories of machinery, electrical goods, and metals were nearly offset by drawdowns in farm products and petroleum stocks. At the retail level, increases in nonauto inventories generally have kept pace with growth in sales. In particular, at general merchandise and apparel stores, where stocks became a bit burdensome during the holiday season last year, inventories appeared to be under control this year. The November inventory-sales ratios for these two types of stores were below the levels reported last winter and early last spring.

Housing Markets

Residential construction moved up in the fourth quarter. Total housing starts climbed to a 1.54 million unit annual rate, owing largely to a strengthening in single-family construction. Building permit issuance, a roughly coincident and less volatile indicator of the onset of construction, also firmed last quarter. Sales of houses in the resale market were up about 4 percent for the quarter, reflecting a surge in sales in December.

Sales of new homes through November remained close to the healthy third-quarter pace.

The rise in mortgage interest rates late in 1988, only some of which has been reversed by recent declines, is likely to exert some restraint on homebuilding in the period ahead. On net, the rates on conventional fixed-rate mortgages rose about 1/2 percentage point from early November to late January. Although an easing in the demand for single-family homes thus seems likely in the early months of 1989, some rescheduling of construction activity owing to unusually moderate winter weather could bolster starts temporarily in this market segment.

In the multifamily sector, starts were little changed in December at 410,000 units (SAAR), close to the average pace for the year as a whole. However, multifamily construction in 1988 dropped 14 percent below the 1987 total and was one-third less than the average of the 1983-87 period. Vacancy rates on multifamily units remain elevated in the South, despite some easing from the record-high levels of 1987. Vacancy rates have turned up in the Northeast over the past year, but have declined sharply in the West. On balance, the outlook for activity in the multifamily market appears weak.

The past year was marked by further changes in the regional mix of housing activity. In the Northeast, starts of single-family units fell 12 percent, inventories of unsold new homes rose, and the uptrend in home prices slowed considerably. Double-digit rates of increase in new home prices during earlier years of the current expansion likely spurred speculative construction and some over-building in that region. Meanwhile, price increases also resulted in sharply reduced housing affordability,

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

	1987	1988	1988		1988		
	Annual	Annual	Q3	Q4 ^P	Oct. ^r	Nov. ^r	Dec. ^P
All units							
Permits	1.53	1.45	1.43	1.53	1.52	1.52	1.54
Starts	1.62	1.49	1.47	1.54	1.53	1.56	1.52
Single-family units							
Permits	1.02	1.00	.99	1.05	1.03	1.05	1.06
Starts	1.15	1.08	1.06	1.13	1.14	1.14	1.11
Sales							
New homes	.67	n.a.	.71	n.a.	.73	.67 ^P	n.a.
Existing homes	3.53	3.63	3.67	3.81	3.67	3.67	4.09
Multifamily units							
Permits	.51	.45	.43	.48	.49	.47	.48
Starts	.47	.41	.40	.41	.40	.42	.41

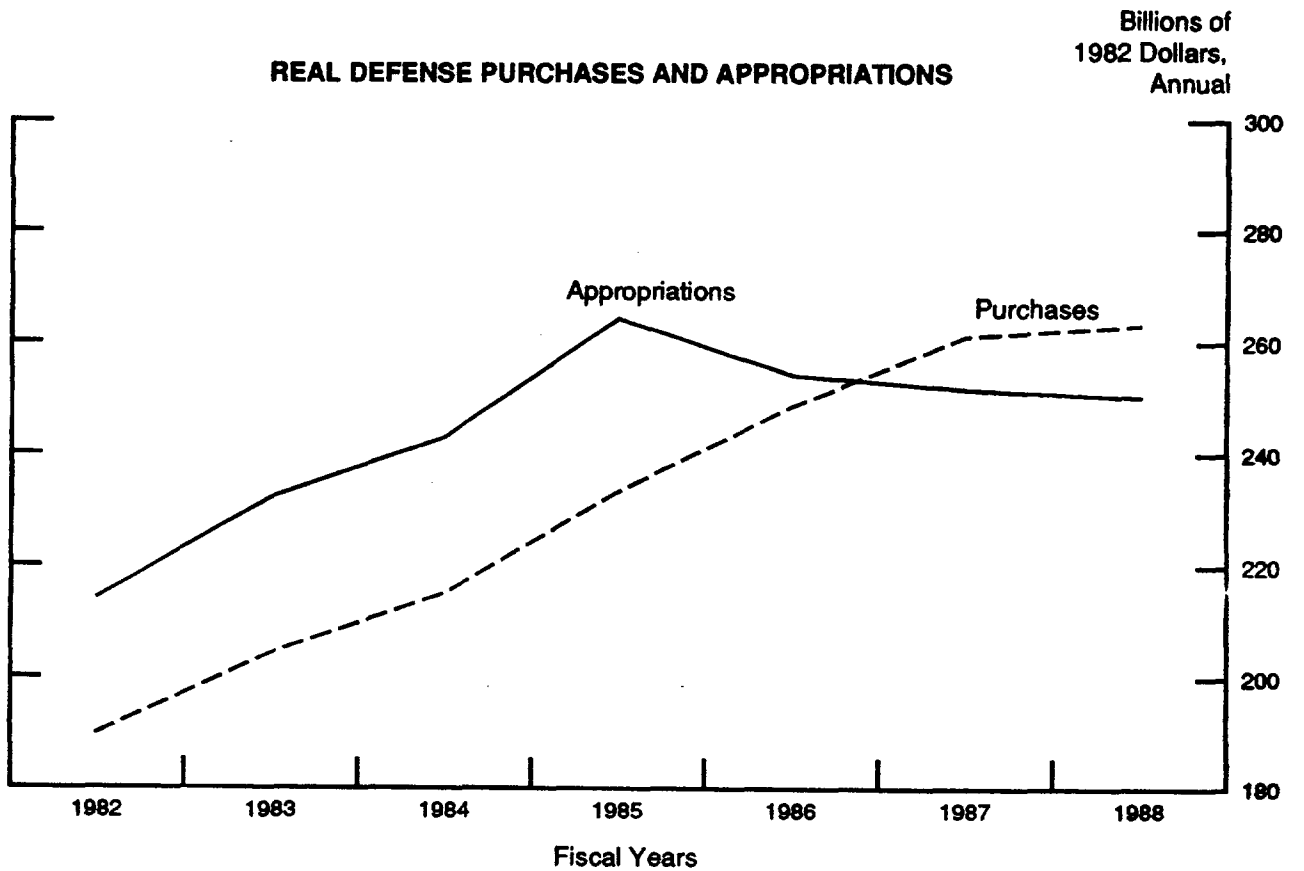
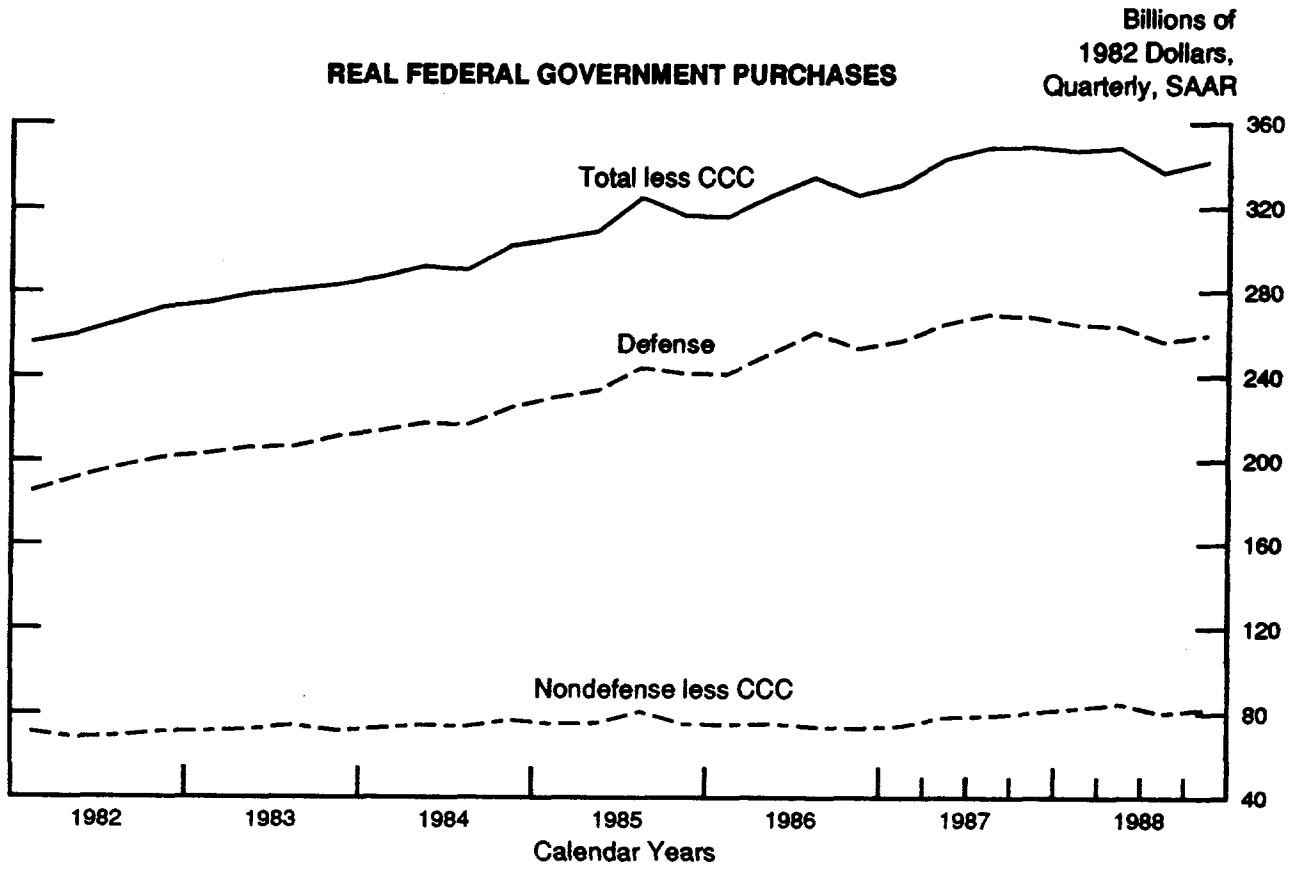
p--preliminary estimates. r--revised.

which likely depressed demand in the Northeast. Starts of single-family homes also eased in the South and Midwest regions in 1988. By contrast, the West recorded a modest increase in single-family housing starts in 1988, and price increases for both new and existing homes have picked up in that region in recent quarters; to date, inventories of new homes in the West have remained well-aligned with sales.

Federal Government

Total real purchases of goods and services by the federal government, excluding those of the Commodity Credit Corporation (CCC), rose at an annual rate of 7 percent in the fourth quarter, a departure from the gradual downtrend seen in previous quarters. Nondefense purchases, which have fluctuated around a plateau since late 1987, were little changed in the fourth quarter. In the case of defense, annual budget appropriations, adjusted for inflation, have declined since fiscal year 1985. Defense purchases, which lag appropriations, have been volatile in recent quarters and indeed posted a sizable rise in the fourth quarter. Nonetheless, these purchases were down 3-1/4 percent from a year earlier.

The total budget deficit for December was about \$11 billion, bringing the deficit for the first quarter of fiscal year 1989 to \$67 billion. This was about equal to the deficit over similar periods of each of the last two fiscal years, if allowance is made for shifts in fiscal 1988 in the timing of social security payments. On the spending side, net interest payments and outlays for deposit insurance are running substantially higher than the year-earlier figures--and the full effect of the FSLIC activities at the end of December may not have been fully reflected in the monthly data. Receipts in the first quarter of the fiscal year 1989 were 8 percent higher than a



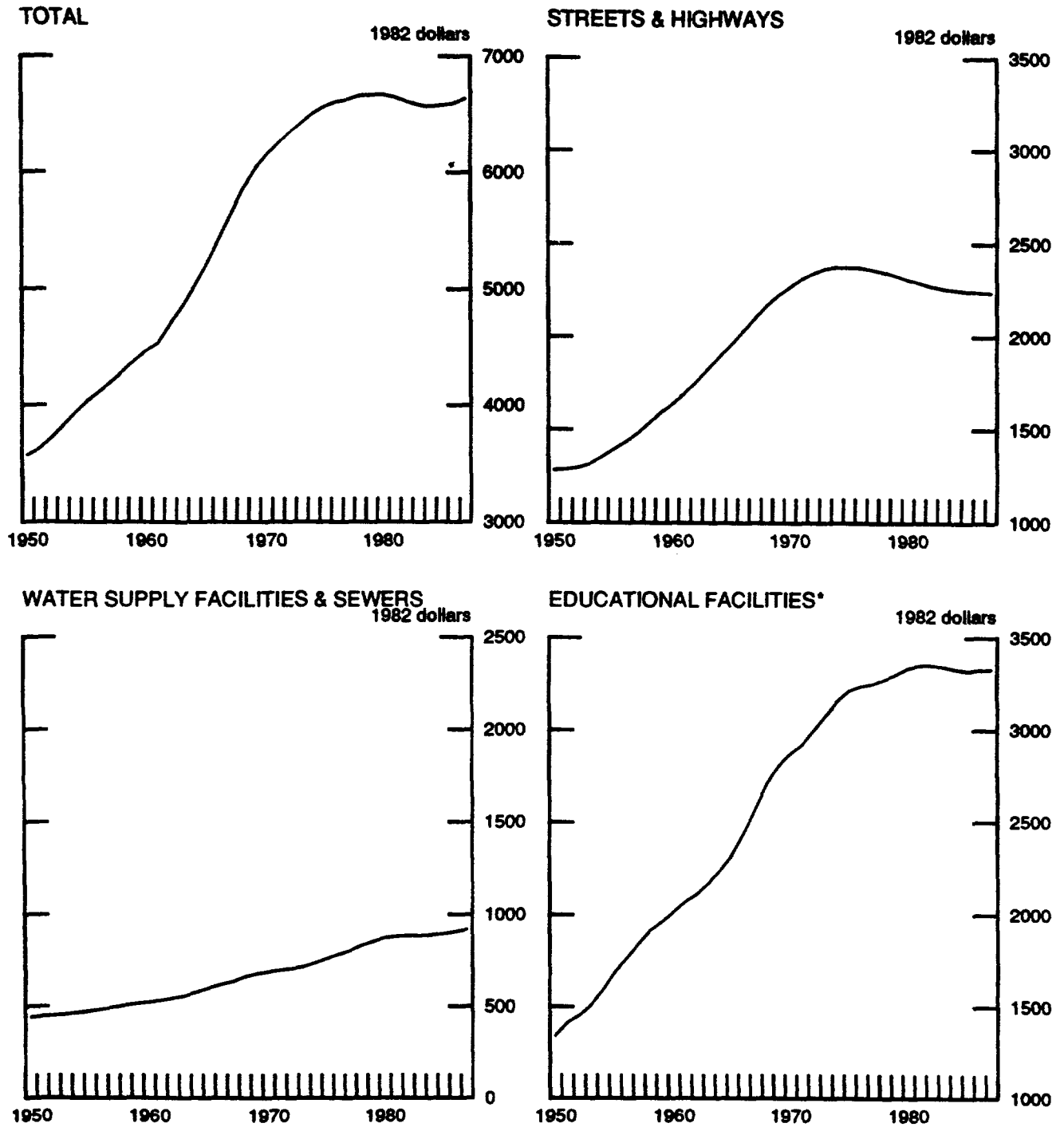
year earlier. The level and composition of receipts still are being affected by the Tax Reform Act of 1986; corporate income taxes were 18 percent higher than a year earlier, while personal income taxes were up only about 7 percent.

The Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) have released revised budget estimates for the current fiscal year. OMB now projects a deficit of \$160 billion, up sharply from its July estimate of \$133 billion. Higher estimates for outlays for deposit insurance and net interest payments largely were responsible for the upward revision. CBO also revised its summertime estimate from \$148 billion to \$155 billion, with a \$5 billion increase for net interest and a \$7 billion increase for deposit insurance being partially offset by slightly higher revenues. For fiscal year 1990, OMB projects a current-services deficit of \$127 billion. The Reagan Administration proposed to reduce this deficit to \$92.5 billion through \$26 billion in outlay reductions, \$2 billion in tax increases, and \$6 billion in asset sales. In contrast, CBO projects a current services deficit in fiscal year 1990 of \$141 billion. (The Reagan Administration's proposals and the CBO analysis are presented in greater detail in an appendix.)

State and Local Government Sector

BEA's advance estimates show real purchases of goods and services by state and local governments up at about a 4 percent annual rate in the fourth quarter, substantially above the 1 percent pace during the summer. Part of the fourth-quarter gain reflected a 9 percent increase in real construction spending; newly-available data for December indicate that construction was even stronger than shown in the advance GNP figures.

NONMILITARY PUBLIC CAPITAL STOCK
 (Per capita, except where noted; in 1982 dollars)



* — Public educational capital stock per person from 5 to 24 years of age.

Notes: Streets and highways include those federally owned; the other two categories are state and local only.

The three components shown account for 62 percent of total nonmilitary public capital stock.

Nevertheless, gains in construction spending in the past two years have fallen short of the 8 percent per year increases from 1984 to 1986.

There continue to be reports of increased demands for investment in state and local infrastructure, perhaps reflecting a shortfall in the stock of capital relative to the services demanded by constituents. After trending upward at a fairly steady pace over much of the postwar period, the real net stock of public capital (including federally owned, nonmilitary capital, which constitutes 17 percent of the total) has changed little, on balance, in the 1980s, although there has been a slight upturn since 1984. The stocks of educational facilities per student, and highways and streets per capita, are down slightly from earlier highs, while the capital stock of water supply systems and sewers has continued to edge up.

The advance in public construction between 1984 and 1986 was facilitated by the healthy fiscal position of state and local governments in the early years of the expansion, coupled with increased issuance of public-purpose municipal bonds. However, in the last two years, new funds raised through issuance of public-purpose, tax-exempt debt have slackened, and many governments have experienced an erosion of fiscal positions. Indeed, the operating and capital accounts deficit for all state and local governments (excluding social insurance funds) swelled further in the fourth quarter. It is estimated that 30 states will be ending fiscal year 1989 with relatively weak positions in their general funds, compared with about 15 states in the two preceding fiscal years. Many of the states with fiscal problems have relatively strong economies, as measured by state unemployment rates. In these states, much of the fiscal distress appears to have resulted from aggressive spending programs and estimates of revenue that were too

optimistic. In the remaining 10 states, most notably including the energy states, poor fiscal situations appear to reflect weak economic performance. To cope with the fiscal tightness, many states have proposed spending curbs. Several states also are considering ways to raise receipts, focusing on highway user charges and alcohol and cigarette taxes, rather than changes in general sales and income taxes.

Prices

Price inflation generally held steady toward the end of 1988, at a somewhat elevated pace relative to recent years. Producer prices of finished goods increased 0.3 percent in November and 0.4 percent in December, and the CPI for all urban consumers rose 0.3 percent in both months. Over the year as a whole, the CPI rose 4-1/2 percent, the same as in 1987. The PPI for finished goods advanced 4 percent last year, nearly 2 percentage points more than in the preceding year. In both the CPI and PPI, food prices picked up markedly last year, as a result of the drought, while energy prices decelerated after their 1987 rebound. Price acceleration at the producer level in 1988 was sharp for finished goods other than food and energy, and a pickup also was evident at the consumer level for other goods and services.

Upward pressures on retail food prices have eased markedly since the summer. The CPI for food rose 0.1 percent in November and 0.3 percent in December, as further increases for dairy and cereal and bakery products were partly offset by declines for meats and poultry. At the farm level, crude food prices dropped back sharply in November, but part of this decline was retraced in December. As of late January, the futures quotations for major livestock and crop commodities were indicating little net change, on

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

	Relative Importance		1988	1988		1988	
	Dec. 1987	1987		Q3	Q4	Nov.	Dec.
					-Annual rate-		-Monthly rate-
All items ²	100.0	4.4	4.4	4.8	4.1	.3	.3
Food	16.1	3.5	5.2	9.9	2.3	.1	.3
Energy	7.6	8.2	.5	2.7	.4	.2	-.2
All items less food and energy	76.3	4.2	4.7	4.0	4.6	.3	.3
Commodities	25.8	3.5	4.0	3.1	4.2	.1	.3
Services	50.6	4.5	5.0	4.1	5.4	.5	.4
Memorandum:							
CPI-W ³	100.0	4.5	4.4	4.9	4.1	.2	.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		1988	1988		1988	
	Dec. 1987	1987		Q3	Q4	Nov.	Dec.
					-Annual rate-		-Monthly rate-
Finished goods	100.0	2.2	4.0	6.5	2.6	.3	.4
Consumer foods	25.9	-.2	5.7	10.0	-.7	.0	-.1
Consumer energy	9.6	11.2	-3.4	-.7	6.9	1.2	.2
Other consumer goods	40.1	2.7	4.8	6.6	4.1	.3	.7
Capital equipment	24.4	1.3	3.5	6.5	1.4	.3	.3
Intermediate materials ²	95.0	5.5	5.5	4.9	4.9	.6	.6
Excluding energy	82.5	5.2	7.2	7.2	6.7	.7	.4
Crude food materials	39.5	1.8	14.2	23.0	-10.2	-6.0	2.1
Crude energy	41.9	10.7	-9.4	-26.1	11.6	-1.4	6.5
Other crude materials	18.6	22.6	6.0	8.5	7.7	.7	1.0

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

2. Excludes materials for food manufacturing and animal feeds.

average, in the prices of crude foods over this coming year. However, with stocks of most crops much lower than in recent years, prices in coming months are likely to be unusually sensitive to the weather and to other factors affecting production or demand; indeed, wheat prices in particular have shown some upward pressure in response to the persistence of dry weather in a number of farming areas.

Retail energy prices were virtually flat in the fourth quarter and over the year as a whole. In December, increases for fuel oil and electricity were more than offset by a 1-1/2 percent decline in gasoline prices, as gasoline supplies were replenished after disruptions during the summer. The decline in gasoline prices occurred despite a sharp pickup in crude oil costs, and refiners' margins were brought down markedly. Both spot and posted prices of crude oil have moved up substantially further since December, and the higher cost of crude oil will likely show up in retail prices of petroleum products in coming months.

Excluding food and energy items, the CPI rose 0.3 percent in November and December. Retail apparel prices retreated somewhat, after sharp increases in the preceding two months, but prices were up for most other goods and services. At the producer level, prices of consumer goods other than food and energy jumped 0.7 percent in December, reflecting large gains for tobacco products, women's apparel, and passenger cars.

The CPI excluding food and energy rose 4-1/2 percent during 1988, continuing the modest acceleration that has been under way since early 1987. Consumer prices for nonfood, nonenergy goods rose 4 percent, the second consecutive year of about 1/2 percentage point acceleration. Price

increases for apparel and new cars--of about 5 and 2 percent respectively--were similar to those in the preceding year. However, price rises accelerated for a variety of other goods, notably for household items, medical care, personal care, and recreational goods. The CPI for nonenergy services was up 5 percent, also 1/2 percentage point above the increase in 1987.

The acceleration in consumer prices excluding food and energy in 1987 had reflected the effect of rising import prices; but this past year it has been influenced by the direct and indirect effects of the pickup in domestic labor costs. This is evidenced most clearly by the producer price index, which measures prices of domestically produced goods. Producer prices for finished goods (nonfood, nonenergy) rose 4-1/4 percent in 1988, double the 1987 pace. The acceleration was widespread among consumer goods, and also was evident in several types of capital equipment.

In addition to higher labor costs, an acceleration in price increases for intermediate materials (less food and energy) probably has contributed to the pickup in prices of finished goods. Prices of intermediate materials and components had accelerated from about mid-1986 through late 1987, and increases in these prices have been running around 7 percent at an annual rate over the past five quarters. The increases last year were largest for products of the metals, chemicals, and paper industries, which have operated at high levels of capacity utilization.

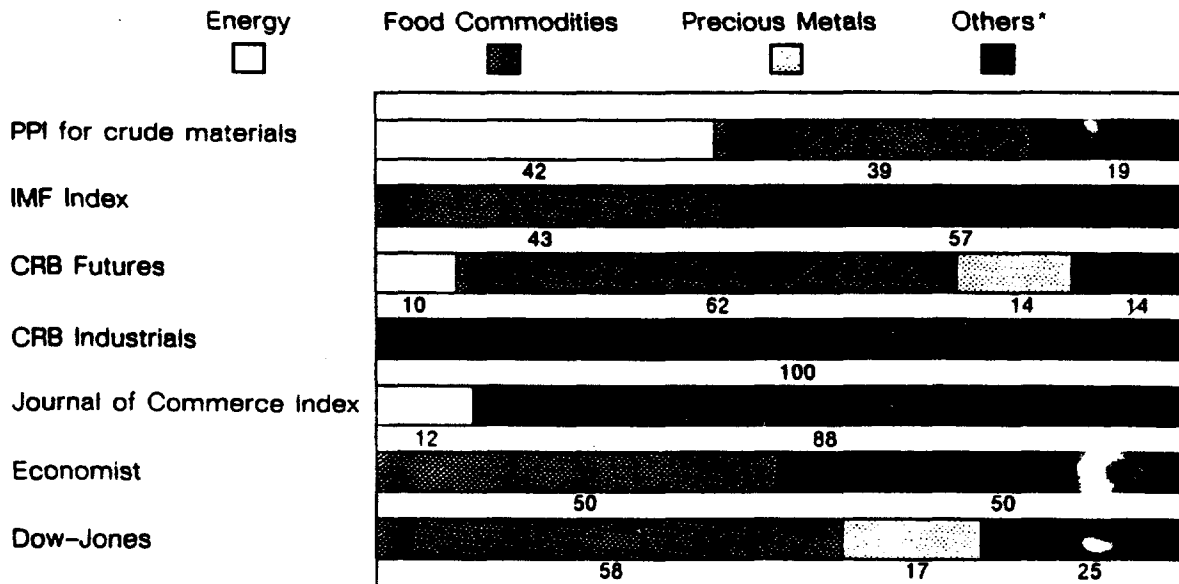
The increase in the PPI for crude nonfood materials less energy in 1988, of 6 percent, was much less than the 23 percent climb of 1987. However, the rise in crude materials prices remained above the rate of finished goods inflation. More recently, prices have firmed in a number of

PRICE INDEXES FOR COMMODITIES AND MATERIALS¹

	Last Observation	Percent change ²			
		1986	1987	1988	
				To Dec. 6 [*]	Dec. 6 [*] to date
1. PPI for crude materials ³	Dec.	-8.9	8.9	2.8	n.a.
1a. Ex. energy	Dec.	1.8	22.6	6.0	n.a.
1b. Ex. food and energy, seas. adj.	Dec.	1.7	22.8	6.1	n.a.
2. IMF commodity index ³	Dec.	-7.9	30.8	12.6	n.a.
2a. Metals	Dec.	-5	51.9	33.7	n.a.
2b. Nonfood agric.	Dec.	8.5	47.5	-9.4	n.a.
3. Commodity Research Bureau					
3a. Futures prices	Jan. 30	-9.1	11.7	5.1	-1.0
3b. Industrial spot prices	Jan. 27	5.1	19.2	5.7	5.5
4. <u>Journal of Commerce</u> industrials	Jan. 30	-1.4	10.7	2.1	2.1
5. <u>Economist</u> (U.S. dollar index)	Jan. 24	-4.7	42.5	13.3	2.3
5a. Industrials	Jan. 24	5.8	62.6	14.3	4.6
6. Dow-Jones Spot	Jan. 30	-8.9	17.0	1.3	1.8

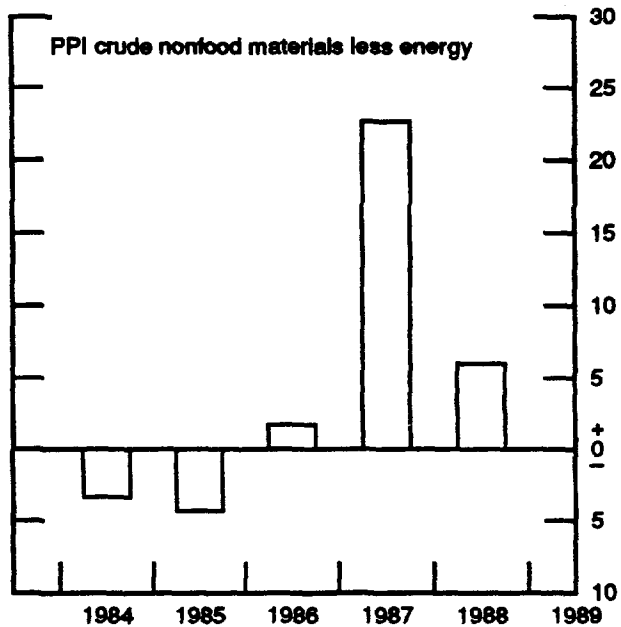
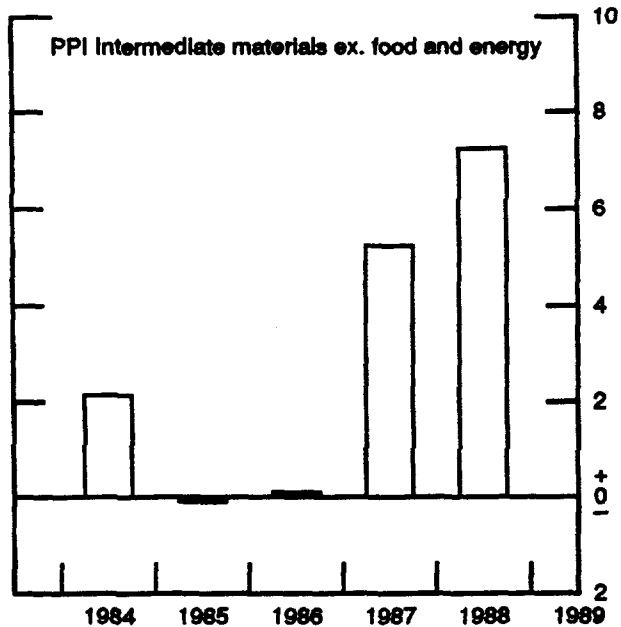
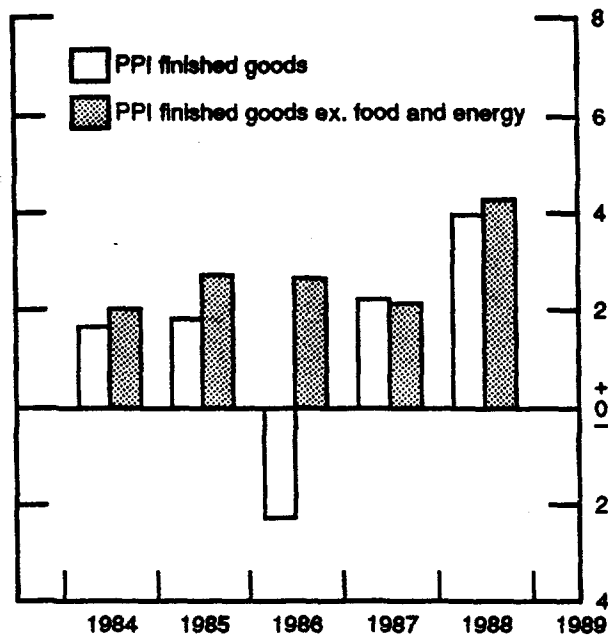
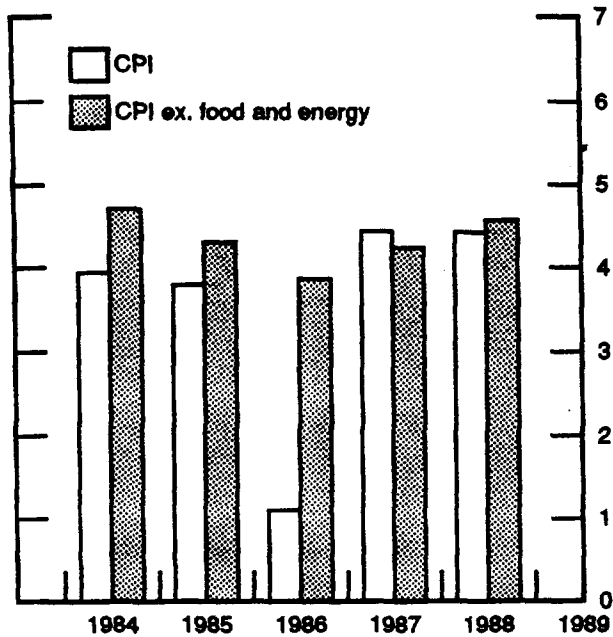
1. Not seasonally adjusted.
 2. Change is measured to end of period, from last observation of previous period.
 3. Monthly observations. IMF index includes items not shown separately.
 n.a.--Not available.
 *Week of the December Greenbook.

Index Weights



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

Inflation Rates, 1984-1988 ¹



1. Percent changes, December to December

spot markets for industrial commodities, and the domestic commodity price indexes based mainly on industrial materials have moved above their 1988 ranges.

APPENDIX

FEDERAL BUDGET ESTIMATES FOR 1990 AND THE LONGER-RUN BUDGET OUTLOOK

President Reagan's FY1990 Budget was submitted to the Congress on January 9, as required by law. President Bush is expected to indicate his own budget priorities in an address on February 9.¹ Alternative projections that may be used by the Congress as the base for its deliberations are contained in CBO's January 24 report on the economic and budget outlook. Hearings are now under way and the congressional target is a budget resolution by mid-April.

The Reagan budget proposes to reduce the federal deficit to \$93 billion in FY90 and to achieve a surplus by FY94 (line 3 of table 1). Even without enactment of the Reagan program, the OMB projects that the deficit would decline over the next five years, from \$127 billion in FY90 to near balance by FY94 (line 1 of the table). This "current services" estimate assumes that budget authority is held constant in real terms for all discretionary programs including defense, that programs for entitlements and other mandatory spending continue to operate as specified in current laws, and that the tax law is unchanged. In contrast, CBO projects that the deficit in FY90 will be \$141 billion under current spending and tax policies (line 4) and would decrease merely to \$122 billion by 1994.

Table 1

ESTIMATED BUDGET SURPLUS/DEFICIT(-)
(Billions of dollars, fiscal years)

	1989	1990	1991	1992	1993	1994
<i>Administration</i>						
1. Current services	-160	-127	-102	-70	-37	-9
2. <i>Effect of proposals</i>	-2	34	35	37	39	42
3. Policy budget	-162	-93	-67	-32	2	33
4. CBO baseline	-155	-141	-140	-135	-129	-122
Memo:						
5. Gramm-Rudman target	-136	-100	-64	-28	0	n.a.
6. Gramm-Rudman trigger		-110	-74	-38	0	n.a.

n.a.--not applicable.

1. Press reports have indicated that the National Economic Commission, which is charged with making specific recommendations to reduce the budget deficit, will report on March 1, as required by law.

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CBO's baseline estimates differ from the administration's current services figures mainly because their economic assumptions are more pessimistic. Aggregate receipts in the two sets of budget projections, shown in table 2, are quite close, as the higher inflation in CBO's economic outlook roughly offsets the effects of their slower assumed growth of real income.² On the spending side of the budget, however, the administration's more optimistic projections of inflation and nominal interest rates lower their projections of outlays.³ Differences in technical assumptions, such as those for FSLIC spending, also affect the budget figures.⁴

Both OMB and CBO raised their estimates of the deficit from levels forecast last summer. The administration's projections contain slightly higher estimates of receipts for both FY89 and FY90 than in the August Mid-Session Review but substantially higher outlays (almost \$28 billion for FY89 and \$16 billion for FY90). The continued surge in deposit insurance outlays and higher interest costs account for close to two-thirds of the rise in 1989 outlays; the upward revisions in OMB's estimates of outlays for 1990 are considerably more widespread, though the increase of \$10 billion in interest outlays looms large. CBO's deficit projections were revised up by lesser amounts--\$7 billion in FY89 and \$5 billion in FY90. In CBO's estimates, upward revisions of outlays, largely for interest and deposit insurance, outweighed the increase since last July in their estimates for receipts.

The focus of the Reagan budget initiatives remains essentially the same as it has for the last several years (see table 3). The budget does not call for any major changes in tax law. In the near term, the projected growth of receipts averages 8 percent over FY89 and FY90, mainly reflecting the assumed expansion of nominal income and employment. However, current law also provides a boost in payroll taxes in January 1990, when the combined employer-employee Social Security tax rate rises 0.27 percentage point.

On the outlay side, relatively small increases in spending--totaling \$5.1 billion in FY90--are slated for defense, international affairs, science, and a few other programs deemed to have a high priority. Outlay reductions--in almost all cases requests similar to those in earlier Reagan budgets--are proposed for some entitlements (Medicare, Medicaid, civil

2. Particularly in the near term, CBO appears to be slightly more optimistic than the Treasury about the volume of receipts associated with a given amount of income (particularly personal income).

3. The administration's economic assumptions are indicated as being premised broadly on the policies put forth in the budget, including the contour of deficit reduction. Thus, they might argue that failure to achieve the roughly \$40 billion deficit reduction in their proposals for the 1992-1994 period would imply higher interest rates than in their projections.

4. Unlike past years, there appear to be few definitional differences between the administration's current services and CBO baseline concepts, and they are relatively insignificant.

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Table 2

COMPARISON OF ADMINISTRATION CURRENT SERVICES AND CBO BASELINE ESTIMATES
(Billions of dollars)

	Fiscal years					
	1989	1990	1991	1992	1993	1994
Receipts						
Administration	976	1058	1137	1209	1278	1342
CBO	983	1069	1140	1209	1280	1359
Outlays						
Administration	1136	1185	1238	1278	1315	1350
CBO	1138	1209	1280	1344	1410	1480
Deficit						
Administration	160	127	102	70	37	9
CBO	155	141	140	135	129	122

COMPARISON OF ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS

	Calendar years					
	1989	1990	1991	1992	1993	1994
-----Percent change, year-to-year-----						
Nominal GNP						
Administration	7.3	6.9	6.6	6.0	5.5	4.9
CBO	7.2	6.4	6.5	6.4	6.4	6.5
Real GNP						
Administration	3.2	3.2	3.3	3.2	3.2	3.2
CBO	2.9	2.1	2.2	2.2	2.3	2.3
GNP deflator						
Administration	3.9	3.6	3.2	2.7	2.2	1.7
CBO	4.2	4.2	4.2	4.1	4.1	4.1
-----Percent, annual average-----						
Civilian unemployment rate						
Administration	5.3	5.2	5.0	5.0	5.0	5.0
CBO	5.5	5.5	5.5	5.6	5.6	5.6
Three-month Treasury bill rate						
Administration	6.3	5.5	4.5	4.0	3.5	3.0
CBO	7.9	7.1	6.7	6.4	6.1	5.9

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Table 3

COMPOSITION OF ADMINISTRATION BUDGET PROPOSALS: CHANGE FROM CURRENT SERVICES¹
(Billions of dollars)

	Fiscal years					
	1989	1990	1991	1992	1993	1994
Outlays:						
National defense		2.1	5.5	7.5	11.0	14.9
International affairs, space and science, and justice	*	2.6	3.6	5.3	6.1	6.7
Human resources ²	0.4	-15.4	-20.4	-24.2	-28.0	-32.0
Net interest	0.1	-1.2	-2.9	-4.5	-5.8	-6.9
Other domestic programs	1.0	-20.7	-16.8	-18.0	-19.3	-21.6
Subtotal, outlays	-1.5	-32.6	-31.0	-33.8	-36.0	-38.8
Receipts ³	*	-1.8	-3.8	-3.6	-3.3	-3.2
TOTAL EFFECT ON DEFICIT:	1.5	-34.4	-34.8	-37.4	-39.3	-42.0

Source: OMB, The Budget of the United States Government, Fiscal Year 1990,
January 1989.

Note: Estimates exclude the effect of the administration's credit reform proposal.

*--\$50 million or less.

1. Current services assumes that budget authority is held constant in real terms for all discretionary programs including defense, that programs for entitlements and other mandatory spending continue to operate as specified in current laws, and that tax law is unchanged.
2. Education, training, employment, and social services; Health; Medicare; Income security; Social security; and Veterans functions.
3. Receipt increases are shown as a negative because they reduce the deficit.

service pensions, and agricultural support payments); reduction or outright elimination is again requested for a variety of domestic discretionary programs. With the suggested policy changes, growth of total outlays in the next two years is expected to average 4 percent. This is a little faster than the assumed rate of inflation for the economy as a whole, but, apart from defense, interest, and Social Security, outlay growth would fall well below that inflation rate. President Bush is expected to propose some changes in priorities from those in the Reagan budget, but the overall magnitude of deficit reduction proposals is likely to be similar.

The proposals in the Reagan budget for FY90 meet the requirement under Gramm-Rudman-Hollings that the deficit decline to at least \$100 billion, even after excluding roughly \$6 billion of asset sales proposed in the budget but disallowed in the deficit calculation for G-R-H purposes. The OMB has estimated the FY90 deficit at \$126 billion under current laws, when calculated as required by Gramm-Rudman. Thus, a minimum of \$16 billion in deficit-reducing actions by October 20 is indicated in order to avoid a sequestration of \$26 billion. The first OMB sequestration report, to be issued in August, will reflect an updated economic forecast, newly emerging spending trends, and legislation enacted by August 15. (OMB's sequester reports are the only ones relevant to the occurrence and amount of sequester.)

Coupled with the ebbing of real defense purchases already in train from past cuts in appropriations, the deficit-reducing initiatives in the final Reagan budget--if fully enacted--would amount to a fairly restrictive fiscal policy for 1990. As measured by the Board staff's new fiscal indicator, the absolute value of the restraint would be only slightly smaller than the absolute value of the stimulus in 1982 and 1983, when the ERTA tax cuts first went into effect.

The remainder of this appendix provides perspective on five key areas of the budget, each of which is likely to be a focal point of the upcoming debates on fiscal policy.

Revenues

The numerous tax laws enacted over the Reagan years have had a substantial effect on the level and structure of receipts. The sum of tax law changes since 1981 is estimated by the Treasury to reduce total receipts by \$171 billion in FY89 and by \$195 billion in FY90 (see table 4). The Economic Recovery Tax Act of 1981 had the largest effect, lowering the level of revenues by an estimated \$323 billion in FY90; other tax law changes have generally increased receipts.⁵ The composition of total receipts also has been changed: nearly all the reduction since 1981 has fallen on individual income taxes, estimated to have been lowered by a total of \$200 to \$300 billion per year over the 1988-92 horizon; corporate taxes have been increased \$25 billion to \$45 billion over the horizon, and social insurance taxes have been increased about \$28 billion.

5. Effects of tax law changes were calculated at currently projected income levels.

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The number and magnitude of the changes in tax law have, of course, complicated forecasts of future revenues. The effect of the Tax Reform Act of 1986 has been especially difficult to estimate, and according to figures provided in the administration's budget document, the act now is not expected to be revenue neutral. Treasury currently estimates that tax reform reduced revenues by roughly \$9 billion last year, and they expect the reforms to lower revenues by \$24 billion in FY89 and by \$20 billion in FY90 from what they would have been under previous law. These estimates of revenue loss are about \$5 billion larger in FY88, and \$7 billion larger in FY89 and FY90, than previous administration projections; and they are considerably more than CBO estimates. Furthermore, a permanent revenue loss in the neighborhood of \$20 billion per year is projected into the future by the Treasury but not by CBO. The Treasury attributes a greater revenue loss to personal income tax receipts, as it finds the effects of lower rates outweighing the revenue gains from the base-broadening on personal taxes by a wider margin than CBO. (Among the major base-broadening changes were limitations of consumer interest deductions, tax deferral opportunities, and passive investment losses.) CBO has not done a new study of the revenue effects of the 1986 act in isolation from other developments involving receipts, as it is still too early for data to be available from audited tax returns filed after the act became effective. Even with such data, the precise effects of such complex and extensive legislation would be difficult to measure.

The Reagan budget proposes about a dozen relatively small further changes to the tax code, with the net effect of reducing the deficit by \$1 billion in FY90 and by about \$3 billion annually in subsequent years. The largest change would extend the Medicare payroll tax to all state and local workers hired before 1986. A portion of such workers do not pay the Medicare tax, yet they frequently qualify for Medicare benefits at age 65 because their spouse is covered or because they have short periods of employment when they did pay the tax. Extending the payroll tax coverage would raise about \$2 billion annually beginning in FY90. This proposal has been considered and rejected by the Congress recently.

Other general revenue proposals include allowances for an FY90 loss of \$2.1 billion in receipts related to business R&D activities, an FY90 gain of \$0.9 billion in receipts from extending aviation-related taxes, and minor gains from other fees. In addition to these proposals for new or increased fees that show on the receipts side of the ledger, proposals also are made regarding a number of user fees and other income categorized as "offsetting receipts." These proposals reduce the outlay side of the budget by a total of \$1 billion in FY90 and represent an effort to recover costs of activities more directly, resulting in greater efficiency than general revenue funding. Similar efficiency arguments apply to income from two regulatory proposals: sale of chlorofluorocarbon production rights (\$400 million in FY90) and sale of licenses for use of some broadcast frequencies (\$2.2 billion in FY90).

Defense Outlays

Compared with other Reagan budgets, the FY90 version requests a rather small increase in the military budget. Relative to the current services

Table 4

REVENUE IMPACT OF RECENT TAX LEGISLATION BY ACT
(Unified receipts basis, billions of dollars)

	Fiscal years				
	1988	1989	1990	1991	1992
Economic Recovery Tax Act of 1981	-264.4	-290.9	-322.8	-357.7	-397.6
Tax Equity and Fiscal Responsibility Act of 1982	57.3	55.7	57.2	61.2	64.7
Highway Revenue Act of 1982	4.9	5.1	5.1	5.1	5.1
Social Security Amendments of 1983	24.6	30.9	23.4	23.8	25.2
Other legislation enacted in 1983 ¹	-.6	-.9	-1.4	-1.7	-1.9
Deficit Reduction Act of 1984	25.4	27.7	31.0	33.8	37.9
Consolidated Omnibus Budget Reconciliation Act of 1985	2.9	3.0	3.0	3.2	3.5
Tax Reform Act of 1986 ²	-8.9	-24.4	-20.3	-16.4	-20.9
Other legislation enacted in 1986 ³	5.8	5.6	4.1	3.1	4.0
Legislation enacted in 1987 ⁴	10.6	16.6	18.7	18.1	14.9
Legislation enacted in 1988 ⁵	--	.3	6.7	7.6	6.9
Total enacted since 1981	-142.6	-171.3	-195.3	-219.8	-258.3

Source: OMB, The Budget of the United States Government, Fiscal Year 1990, January 1989.

1. Interest and Dividends Tax Compliance Act of 1983 and Railroad Retirement Revenue Act of 1983.
2. Estimates include increases in the earned income credit, which is scored as an outlay in the unified budget.
3. Includes Federal Employees' Retirement System Act, the Omnibus Budget Reconciliation Act, Superfund Amendments and Reauthorization Act, and the Continuing Resolution for 1987.
4. Omnibus Budget Reconciliation Act of 1987 and Continuing Resolution for 1988.
5. Includes Medicare Catastrophic Coverage Act of 1988, Family Support Act of 1988, and the Technical Corrections and Miscellaneous Revenue Act of 1988.

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

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estimate that holds defense constant in real terms, the administration has requested 2 percent growth in spending authority. In FY90, this is estimated to result in an increase in outlays of only about \$2 billion. However, because the requested increase in spending is for continued modernization of strategic and conventional forces and involves procurement of new equipment, the rise in outlays is much greater in subsequent years; maintaining 2 percent real growth in appropriations is estimated to raise outlays by \$15 billion in FY94, relative to the zero real growth baseline.

In recent years the Congress has not fully funded the Reagan military budget requests. In FY86 and again in FY87 the nominal levels of defense appropriations were actually cut from the previous year; for FY88 and FY89, defense appropriations were held to zero real growth as part of the late-1987 budget summit agreement. These reductions from previous requests have scaled back force structure from that envisioned in earlier years of the Reagan administration and have slowed spending for a number of defense projects, such as the Strategic Defense Initiative. (Nonetheless, SDI funding has grown, and for FY90 the administration is requesting \$6 billion for SDI research and construction, nearly \$2 billion more than appropriated for the current year.) The current defense budget request anticipates little change in the present configuration of defense forces and anticipates some postponements in outlays for maintenance.

The changes in defense spending resulting from lower appropriations have had a direct effect on the growth of GNP. Defense outlays increased through 1987 in real terms, reflecting the large backlog of appropriations and deliveries of equipment. In 1988, however, nominal growth of military outlays slowed considerably; in real terms, defense purchases fell 3.2 percent from the fourth quarter of 1987 to the fourth quarter of last year on a national income accounts basis. Based on appropriations through FY89, real military spending is expected decline further this year. Since these purchases are measured largely on a delivery basis, much of the production and employment effect is already occurring.

Deposit Insurance

Actions to deal with deposit insurance obligations at troubled depository institutions is expected to have significant budgetary effects. Expenditures associated with assisted mergers of some large banks have swelled FDIC net outlays recently but, of course, aid to thrifts is greater by far. Before 1986, net outlays by FSLIC were about zero, as premiums roughly offset agency spending. However, net outlays rose to \$1.2 billion in FY86, \$4.3 billion in FY87, and \$8.1 billion last year. (The recent outlay figures are net of both FICO funds and premium income.) Not all of the gross outlays reflected in these figures represent actual cash; promissory notes are also recorded as outlays. However, assistance agreements that guarantee the interest income and book value of nonperforming assets create a contingent liability for which outlays are recorded only when payments are actually made. Thus, the amount of immediately recorded outlays does not correspond to the total costs reported in the press for closing or merging various institutions, nor do the budget costs recorded so far represent the total costs likely to emerge over time.

In the budget, the administration assumed that net spending by FSLIC in FY89 will match that of FY88--about \$8 billion. For FY90, the administration has assumed a drop in FSLIC net outlays to \$2 billion as offsetting receipts are projected to surge; larger net figures are projected for subsequent years. Given the widely discussed range of estimates for funds needed to meet the thrift industry problems, any budget estimates for FSLIC are somewhat arbitrary pending legislative clarification.

Health Care

Many of the budget cuts in recent years have been directed at stemming the growth of outlays for health care. As shown on table 5, federal spending on health encompasses a wide range of programs, with direct payments to providers through Medicare and Medicaid accounting for the largest portion of expenditures. Overall, nearly 14 percent of the federal budget, or \$146 billion, was devoted to health care in one form or another last year. Moreover, despite efforts to cut spending, health remains the fastest growing area of outlays.

Despite pressures for overall budget stringency, a major expansion of the Medicare program was enacted last year--the Medicare Catastrophic Coverage Act of 1988. But the expanded coverage clearly reflected a different budget philosophy than the one used a quarter century earlier when Medicare was initiated. The additional coverage provided under Medicare, which begins this year and phases-in provisions over the next several years, is purported to be deficit neutral. Virtually all of the added expenses are borne by the recipient population through insurance premiums; furthermore, a major feature of the new premium structure is that part of an individual's additional premium is a function of the annual income of the enrollee, reducing the expected value of Medicare for higher-income recipients.

In the Reagan budget for FY90, one-fourth of the proposed cuts in outlays from current-services levels is derived from health programs; the total cut from all health care programs is expected to be \$8 billion in FY90 and \$21 billion by FY94. The budget proposes to curb Medicare costs by further limiting increases in payments for some physician services and reducing payments for medical equipment and hospital outpatient care. Enrollees' premiums for the Supplementary Medical Insurance portion of Medicare would be set to yield 25 percent of estimated costs, resulting in an increase in receipts relative to current law.⁶ In addition, the administration wishes to cut grants to states for Medicaid. Current law provides that the states administer Medicaid under broad federal guidelines;

6. Under current law, these premiums are required to change each January by the lesser of the cost-of-living adjustment in Social Security benefits or the amount needed to pay for 50 percent of program costs. However, in recent years, the Congress has held the amount of costs to be covered by premiums to 25 percent. Eliminating the option of raising premiums only by the rate of the Social Security COLA would reduce net federal costs relative to current services because the rate of increase in Medicare costs is likely to remain substantially more than the anticipated COLAs.

Table 5

FEDERAL SPENDING ON HEALTH CARE
(Billions of dollars)

Program	FY1967	FY1987	FY1988
1. Medicare	2.7	75.1	78.9
<i>Part A, Hospital Insurance</i>		50.8	52.7
<i>Part B, Supplementary Medical Insurance</i>		30.8	34.9
<i>Proprietary receipts (mainly SMI premiums)</i>		-6.5	-8.8
2. Medicaid (<i>federal share</i>)	1.2	27.4	30.5
3. Federal employees health benefits	.3	1.8	1.8
4. Other health care programs (<i>Health block grants to states, Indian health services, drug abuse programs, and other</i>)	.5	3.4	3.8
5. Health research (<i>mainly NIH</i>)	.9	5.6	6.6
6. Education and training	.3	.6	.5
7. Consumer and occupational health and safety	.2	1.2	1.3
8. Military medical care <1> (<i>Active duty military treatment, nonactive duty military treatment, and nonactive duty CHAMPUS <2></i>)	8.5	11.1	11.9
9. Veterans medical care and hospital services	1.4	10.3	10.8
Total	16.0	136.5	146.1
<i>Memoranda:</i>			
Total federal outlays	157.5	1003.8	1064.0
Health care as a percent of total outlays	10.2	13.6	13.7

Sources: CBO and OMB budget documents.

1. CBO, Reforming the Military Health Care System, Table 2. CBO figures are based on OMB's summary of military medical activities.
2. CHAMPUS is the Civilian Health and Medical Program of Uniform Services.

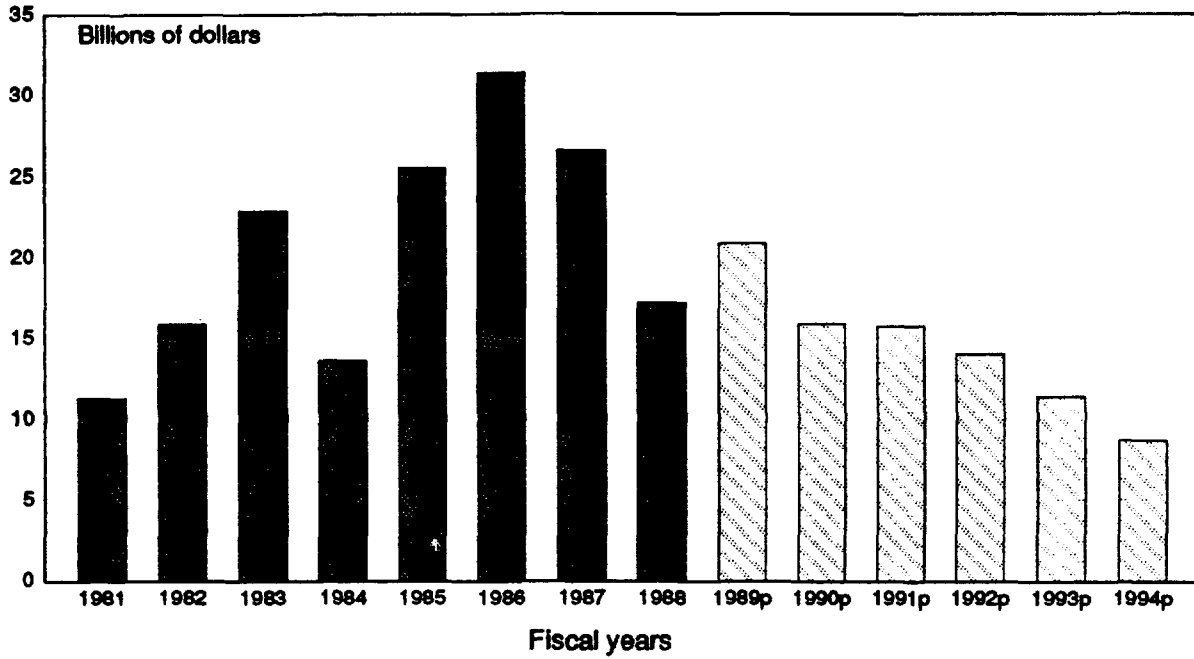
the cost of the program is shared, with the federal government paying from 50 percent to 80 percent of total outlays.

Agriculture

Another major determinant of the recent growth in spending has been changes in federal farm payments. Spending under the agriculture function in the budget, which includes all the Commodity Credit Corporation support programs as well as other federal activities in the farm sector, has had no discernible trend in recent years (see chart). In FY87 and FY88, declining expenditures helped to hold down the deficit; the particularly sharp drop in FY88 was due in part to the effects of the drought, which raised market prices of crops and thereby reduced subsidy payments.

The administration estimates that some increase in agriculture outlays is likely in the current year, owing in part to drought relief payments to farmers. For FY90 and subsequent years, the administration projects reductions in agriculture spending. Included in these estimates is a proposal to cut farm income stabilization programs by about \$3 billion annually from current services levels, either through reducing target prices on crops or through eliminating some acreage eligible for deficiency payments. In any case, the volatility of federal agricultural payments contributes considerable uncertainty to the estimates of federal spending in the near term. Adding to that uncertainty is the likelihood that agriculture policy will be a major congressional issue during the current session, as provisions enacted in the huge 1985 farm bill expire in 1990.

AGRICULTURE OUTLAYS



p — Projected by OMB.

Source: The Budget of the United States Government, Fiscal Year 1990, January 1989.

SELECTED FINANCIAL MARKET QUOTATIONS¹
(Percent)

	1987		1988		1989	Change from:
	Jan.-Feb. lows	Oct. 16 ²	Feb lows	FOMC Dec.14	Jan.31	FOMC Dec.14
Short-term rates						
Federal funds ³	5.95	7.59	6.38	8.55	9.18	.63
Treasury bills ⁴						
3-month	5.30	6.93	5.59	8.12	8.39	.27
6-month	5.31	7.58	5.77	8.33	8.42	.09
1-year	5.35	7.74	6.10	8.45	8.36	-.09
Commercial paper						
1-month	5.81	7.94	6.41	9.28	9.04	-.24
3-month	5.73	8.65	6.45	9.11	9.07	-.04
Large negotiable CDs⁴						
1-month	5.85	7.92	6.44	9.40	9.04	-.36
3-month	5.80	8.90	6.49	8.34	9.17	-.17
6-month	5.78	9.12	6.55	9.31	9.32	.01
Eurodollar deposits⁵						
1-month	6.00	7.79	6.60	9.50	9.11	-.39
3-month	6.00	8.69	6.69	9.31	9.26	-.05
Bank prime rate	7.50	9.25	8.50	10.50	10.50	.00
Intermediate- and long-term rates						
U.S. Treasury (constant maturity)						
3-year	6.34	9.52	7.28	9.21	9.13	-.08
10-year	7.01	10.23	8.11	9.19	9.01	-.18
30-year	7.29	10.24	8.32	9.06	8.84	-.22
Municipal revenue⁶						
(Bond Buyer)	6.92	9.59	7.76	7.96	7.58	-.38
Corporate A utility						
(recently offered)	8.78	11.50	9.63	10.16e	10.03e	-.13
Home mortgage rates⁷						
S&L fixed-rate	9.10	11.58	9.84	10.46	10.60	.14
S&L ARM, 1-yr.	7.52	8.45	7.59	8.35	8.54	.19

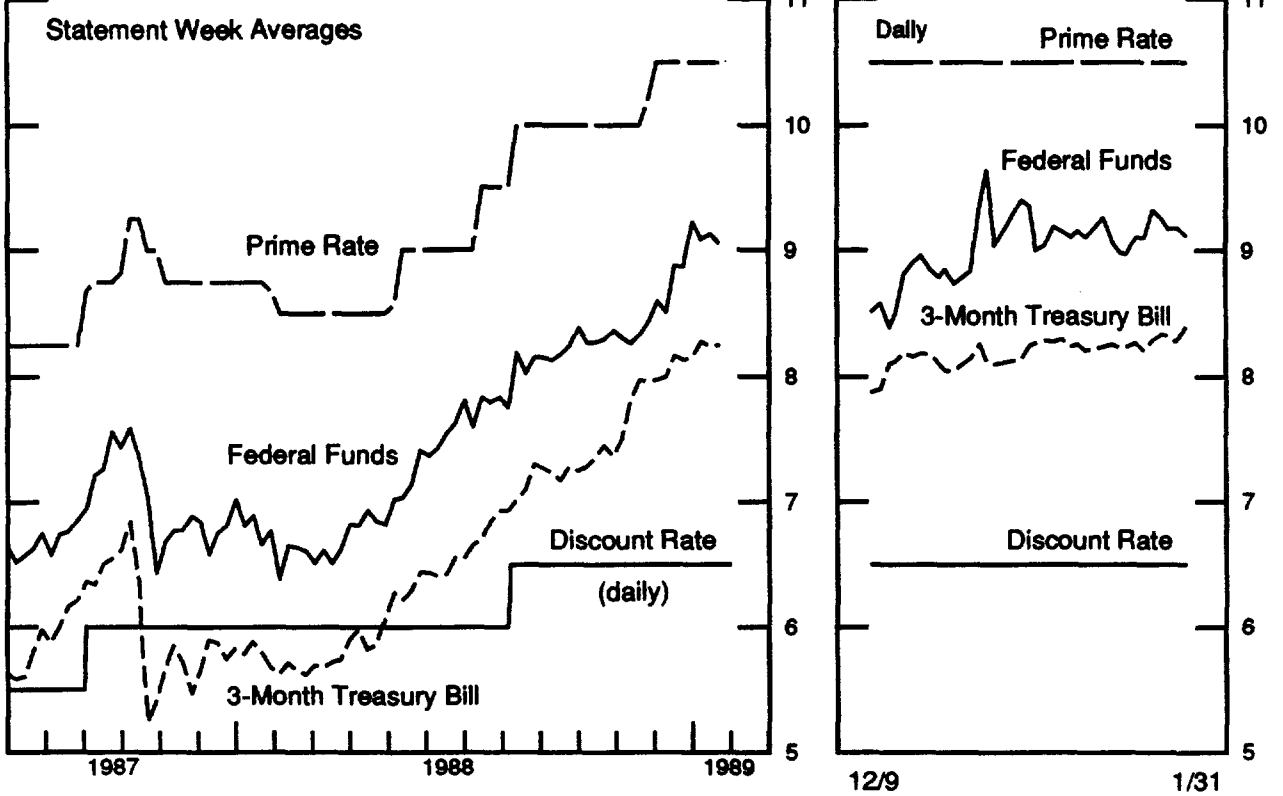
	1986	1987		1988	1989	Percent change from:
	Year-end	Record highs	Lows	FOMC Dec.14	Jan.31	FOMC Dec.14
Stock prices						
Dow-Jones Industrial	1895.95	2722.42	1738.74	2134.25	2342.32	9.75
NYSE Composite	138.58	187.99	125.91	154.72	166.63	7.70
AMEX Composite	263.27	365.01	231.90	295.00	323.02	9.50
NASDAQ (OTC)	348.83	455.26	291.88	372.77	401.30	7.65

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 2/8/89.

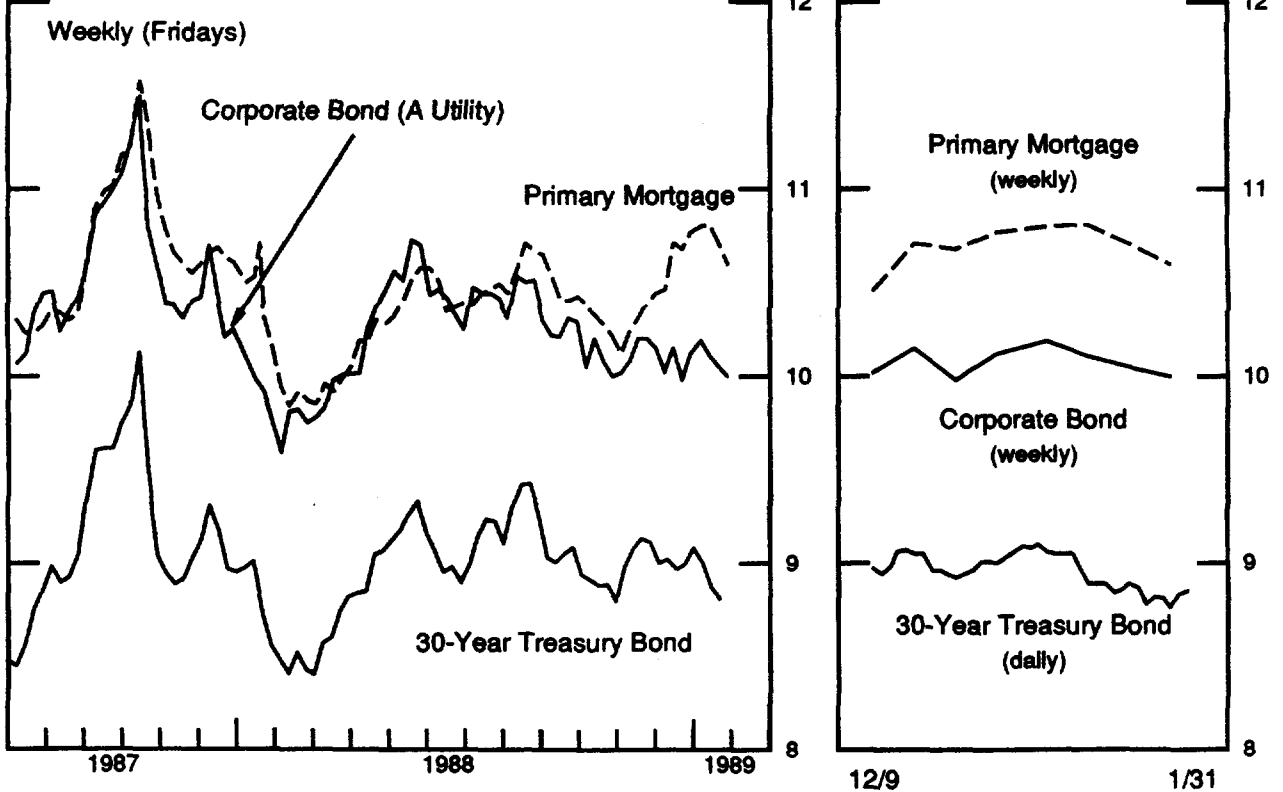
4. Secondary market.
 5. Average for statement week closest to date shown.
 6. Based on one-day Thursday quotes and futures-market index changes.
 7. Quotes for week ending Friday closest to date shown.
 e--estimate

Selected Interest Rates* (percent)

Short-Term



Long-Term



*--Friday weeks through January 27, Wednesday weeks through January 25.

DOMESTIC FINANCIAL DEVELOPMENTS

The federal funds rate has risen about 1/2 percentage point since the last FOMC meeting in response to tightening bank reserve positions. However, the markets evidently had been anticipating some firming, and with year-end pressures abating, most private short-term rates are unchanged or down somewhat on balance. Bond yields, too, have moved lower, on net, reflecting in part the strengthening private demand for dollar assets that has driven the U.S. currency upward on exchange markets of late. The dollar and bond prices both responded positively to indications that the Federal Reserve continued to place a high priority on restraining inflation. Equity investors apparently were encouraged by these developments, and share prices have posted hefty advances.

Growth of M2 and M3 slowed to the 1 to 3 percent range in January, as a result of a sizable decline in transactions deposits and a net weakening in growth of other deposits as well. The opportunity cost of holding deposits has generally risen over the last two months. M1 contracted in January at about a 4 percent annual rate.

Private credit demands in the aggregate appear still to be growing faster than nominal GNP. Borrowing by nonfinancial businesses is estimated to have picked up recently, with rapid growth in commercial paper and bank loans offsetting a cutback in issuance of securities. All indications are that an active housing market has continued to generate substantial growth in home mortgage debt, while consumer borrowing seems to be sticking to a path of fairly moderate expansion. Municipal bond issuance has strengthened, buoyed by the drop in rates. Federal borrowing, in contrast,

is dropping in the current quarter, owing to a smaller deficit and the availability of large year-end Treasury cash balances.

Monetary Aggregates and Bank Credit¹

Growth of the monetary aggregates is estimated to have slowed in January, owing largely to a sharp drop in transactions deposits induced at least in part by the rising opportunity cost of holding such deposits. Although currency growth remained robust, demand deposits declined at a 15 percent annual rate, and OCDs, which had been relatively strong in November and December, also declined. As a result, M1 contracted at a 4 percent annual rate in January and M2 growth sagged to a 1 percent annual rate. Growth in M3 dropped to a 3 percent rate, despite some pickup in its non-M2 components.

A runoff in savings deposits and MMDAs accelerated in January at both banks and thrifts, curtailing growth in the nontransactions component of M2. Funds apparently have been diverted from these deposits--whose rates have been flat in recent months--to market instruments, as suggested by the large amount of noncompetitive tenders at recent Treasury auctions. Some shift also has been occurring within M2, as small time deposits continued the pattern of strong growth established in the fourth quarter. Rates on small time deposits also have lagged market rates, but to a much lesser degree than rates on the more liquid deposits. As has been the case since the second quarter of last year, growth in savings and small time deposits has been much weaker at thrifts than at commercial banks; indeed thrifts experienced outflows of such deposits in December and January, likely

1. The monetary aggregates reported herein do not incorporate benchmarking and seasonal factor revisions, which will be reported in the Bluebook. Those revisions, however, do not materially alter the picture.

III-3
MONETARY AGGREGATES
(based on seasonally adjusted data unless otherwise noted)

	1988 ¹	1988 Q3	1988 Q4	1988 Nov	1988 Dec	1989 Jan pe	Growth Q4 88- Jan 89pe
-----Percent change at annual rates-----							
1. M1	4.2	5.2	1.3	0.3	6.3	-4	½
2. M2	5.4	3.6	3.0	6.9	4.9	1	¾
3. M3	6.3	5.7	4.4	6.8	4.4	3	¾
-----Percent change at annual rates-----							
							Levels bil. \$ Dec 88
<u>Selected components</u>							
4. M1-A	2.5	3.4	1.2	-2.1	6.4	-5	507.3
5. Currency	8.0	7.1	6.2	4.6	8.0	9	211.7
6. Demand deposits	-1.3	0.7	-2.5	-7.1	5.0	-15	288.1
7. Other checkable deposits	7.5	8.8	1.6	4.7	6.0	-2	280.5
8. M2 minus M1 ²	5.8	3.1	3.6	9.2	4.4	3	2279.6
9. Overnight RPs and Eurodollars, NSA	-5.3	-4.0	-8.7	-17.4	73.7	42	79.5
10. General purpose and broker/dealer money market mutual fund shares, NSA	7.7	-3.1	10.9	35.3	14.1	12	240.8
11. Commercial banks	6.8	5.1	7.4	12.5	5.3	5	985.9
12. Savings deposits, SA, plus MMDAs, NSA ³	1.3	1.2	-2.0	9.1	-5.9	-9	543.6
13. Small time deposits	14.6	10.1	20.0	17.1	19.6	21	442.4
14. Thrift institutions	5.3	2.7	0.5	0.6	-2.6	-2	974.8
15. Savings deposits, SA, plus MMDAs, NSA ³	-3.5	0.4	-9.5	-7.9	-9.8	-13	390.0
16. Small time deposits	12.3	4.5	7.5	6.4	2.3	6	584.8
17. M3 minus M2 ⁴	10.0	13.6	9.5	6.2	2.6	8	837.4
18. Large time deposits	11.1	15.7	12.9	3.2	6.3	6	534.8
19. At commercial banks, net ⁵	11.8	21.4	14.2	3.4	11.4	7	361.7
20. At thrift institutions	9.7	4.5	10.2	3.5	-4.1	3	173.2
21. Institution-only money market mutual fund shares, NSA	-0.8	-23.3	10.9	39.7	2.7	14	87.6
22. Term RPs, NSA	13.3	12.0	3.9	26.2	-36.0	17	122.8
23. Term Eurodollars, NSA	10.3	38.1	6.8	37.5	18.8	-44	103.8
-----Average monthly change in billions of dollars-----							
<u>MEMORANDA:⁶</u>							
24. Managed liabilities at commercial banks (25+26)	3.3	1.8	2.2	6.5	-0.8	-1	607.1
25. Large time deposits, gross	3.3	6.4	2.8	0.3	4.2	3	428.2
26. Nondeposit funds	0.0	-4.6	-0.7	6.2	-5.0	-3	178.9
27. Net due to related foreign institutions, NSA	-0.5	0.1	0.0	5.3	-1.1	-3	9.1
28. Other ⁷	0.5	-4.8	-0.7	0.9	-3.9	0	169.8
29. U.S. government deposits at commercial banks ⁸	0.0	0.8	0.7	-8.5	4.5	-8	26.7

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 December and January at rates of -6.8 percent and -12 percent, respectively. At thrift institutions, savings deposits excluding MMDAs grew during December and January at rates of -4.5 percent and -9 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.
- pe - preliminary estimate

reflecting less aggressive pricing at those institutions as well as recent adverse publicity.

The non-M2 component of M3 picked up to an 8 percent annual rate in January, largely reflecting a rebound in term RPs and strength in institution-only MMMFs. Returns on the latter increased relative to market rates in early January. With limited funding needed to cover moderate asset growth, commercial banks issued fewer large time deposits than in December, despite the smaller inflows of core deposits and an estimated \$8 billion decline in Treasury balances at banks. At thrifts, however, large time deposit issuance edged up and, overall, the large time deposit component of M3 remained on a growth path of about 6 percent in January.

Bank credit is estimated to have resumed expanding in January, although to only a 4 percent annual rate, owing to considerably stronger loan growth. Securities holdings declined as municipal securities continued to run off rapidly. The upturn in loan growth reflected a sharp acceleration in business loans to an 18 percent annual rate; this pickup was due to double-digit growth of loans at large U.S. banks and continued acceleration in loans booked by foreign-related institutions. The strength of business loans at large banks was associated in part with a sharp decline in loans booked at foreign branches of U.S. banks, as market rates have risen relative to the prime rate. About 4 percentage points of January's business loan growth was estimated to be merger-related. Real estate loans bounced back from a slow December pace, and consumer loans continued to exhibit some strength even as securitization of consumer loans picked up.

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

	1987:Q4	1988					Levels
	to	Q3	Q4	Nov.	Dec. ^P	Jan. ^P	bil.\$ P Jan.
	1988:Q4						
----- Commercial Bank Credit -----							
1. Total loans and securities at banks	7.2	4.3	4.4	6.0	.1	4.1	2406.5
2. Securities	4.5	- .2	3.7	2.4	.4	-9.4	547.5
3. U.S. government securities	7.2	2.3	9.5	5.7	13.8	-1.3	360.5
4. Other securities	-.4	-4.7	-6.8	-3.7	-24.0	-24.5	187.0
5. Total loans	8.1	5.6	4.7	7.1	.0	8.1	1859.0
6. Business loans	6.5	3.2	2.2	-2.4	1.4	17.8	608.8
Security loans	-5.5	-29.4	3.3	-28.1	-22.3	-13.0	36.5
8. Real estate loans	13.0	12.6	11.4	13.3	7.3	10.3	668.9
9. Consumer loans	8.4	5.5	6.3	6.9	9.6	8.1	356.0
10. Other loans	0.0	-1.8	-12.8	23.3	-40.9	-25.5	188.8
----- Short- and Intermediate-Term Business Credit -----							
11. Business loans net of bankers acceptances	6.6	3.1	2.7	-2.4	2.2	17.5	605.7
Loans at foreign branches ²	30.5	24.1	.0	-16.6	-16.8	-62.6	20.0
3. Sum of lines 11 & 12	7.3	3.8	2.5	-2.9	1.6	14.9	625.8
14. Commercial paper issued by nonfinancial firms	15.6	-4.8	54.0	24.4	92.0	49.2	106.7
15. Sum of lines 13 & 14	8.3	2.6	9.1	.7	13.5	20.0	732.5
16. Bankers acceptances: U.S. trade related ^{3,4}	-6.3	-7.3	24.8	26.5	70.6	n.a.	34.2 ⁵
17. Line 15 plus bankers acceptances: U.S. trade related	7.6	2.2	9.9	1.9	16.1	n.a.	754.8 ⁵
18. Finance company loans to business ³	n.a.	10.9	n.a.	9.3	n.a.	n.a.	232.9 ⁶
19. Total short- and intermediate-term business credit (sum of lines 17 & 18)	n.a.	4.2	n.a.	3.6	n.a.	n.a.	977.8 ⁶

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. December data.

6. November data.

n.a.--not available.

p--preliminary

Business Finance

Total borrowing by nonfinancial businesses has picked up over the past two months, as a large increase in short-term borrowing has more than offset lower bond issuance. Commercial paper recorded another sharp increase in January after December's bulge, and the total of bank loans to business and nonfinancial commercial paper advanced at a 14 percent annual rate in December and 20 percent in January. Nevertheless, borrowing seems relatively low in light of apparently large credit needs of the business sector. Net equity retirements are estimated to have reached a record annual rate of \$195 billion in the fourth quarter of 1988 and are projected at near that rate in the first quarter of 1989, buoyed by the RJR-Nabisco deal. At the same time, the underlying gap between capital outlays and internal funds remains quite wide.

Several factors have contributed to the recent growth of nonfinancial commercial paper, which has amounted to more than \$11 billion over the past two months. First, issuance of investment-grade industrial bonds diminished sharply after the RJR-Nabisco LBO was announced, and holders of RJR bonds experienced sizable losses. The enlarged shorter-term credit demands of investment-grade firms has focused on the commercial paper market, where such firms generally can obtain funds most cheaply. Second, in December, commercial paper may have been an especially attractive source of funds compared to bank loans priced off Eurodollar rates, because the spread between the one-month LIBOR and the one-month commercial paper rate widened substantially.

Since the last FOMC meeting, only four firms have issued investment-grade bonds, with one of these issues carrying a "poison put" covenant that

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

	1987	1988				1989	
	Year	Year ^P	Q3	Q4 ^P	Nov. ^P	Dec. ^P	Jan. ^e
Corporate securities - total ¹	24.08	21.92	20.51	18.54	22.09	12.08	18.30
Public offerings in U.S.	21.89	20.03	18.42	17.03	19.20	12.00	16.00
Stocks--total ²	4.45	3.50	3.83	2.61	3.20	2.00	3.50
Nonfinancial	2.32	1.14	1.50	.61	.60	.50	2.50
Utility	.57	.24	.16	.17	.10	.10	2.20
Industrial	1.75	.90	1.34	.47	.50	.40	.30
Financial	2.12	2.36	2.33	1.97	2.60	1.50	1.00
Bonds--total ¹	17.44	16.53	14.59	14.42	16.00	10.00	12.50
Nonfinancial	6.61	6.07	5.14	4.60	5.50	2.55	3.50
Utility	2.02	1.76	1.17	1.07	.90	.25	.80
Industrial	4.59	4.31	3.97	3.53	4.60	2.30	2.70
Financial	10.83	10.46	9.45	9.82	10.50	7.45	9.00
By quality ³							
Aaa and Aa	3.25	2.67	1.90	1.84	1.27	1.50	2.50
A and Baa	5.20	5.39	4.12	3.13	2.27	2.01	2.00
Less than Baa	2.77	2.51	2.69	3.17	4.77	1.84	2.50
No rating (or unknown)	.07	.07	.04	.05	.00	.00	.05
Memo items:							
Equity-based bonds ⁴	.87	.28	.32	.31	.34	.00	.03
Mortgage-backed bonds	5.19	4.63	4.17	4.70	6.25	2.40	3.50
Other asset-backed	.96	1.26	1.67	1.53	1.44	2.25	2.00
Variable-rate notes	1.88	1.12	.86	.84	1.21	.72	1.00
Bonds sold abroad - total	2.03	1.80	2.01	1.46	2.83	.05	2.30
Nonfinancial	.94	.65	.81	.55	1.03	.00	.75
Financial	1.09	1.15	1.20	.91	1.80	.05	1.55
Stocks sold abroad - total	.16	.09	.08	.05	.06	.03	.00
Nonfinancial	.12	.08	.07	.05	.06	.03	.00
Financial	.04	.01	.01	.00	.00	.00	.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.

allows the bondholders to sell their bonds back to the firm at par in the event of a major restructuring. New offerings of junk bonds also have been moderate, but heavy issuance seems likely to resume as soon as investment banks seek to arrange takeouts of the bridge loans they recently have extended to facilitate mergers and LBOs.² For example, RJR is slated to issue more than \$7 billion in junk bonds over the next few months.

Most stock price indexes have advanced 8 to 10 percent since mid-December and now are above their levels on October 16, 1987, the Friday before the crash. Because corporate profits have climbed since that time, price-earnings ratios are well below pre-crash levels. For example, the P-E ratio for the Standard and Poor's 500 was just over 12 at the end of January, compared with about 21 in the week before the crash. With P-E ratios lower, few nonfinancial firms have been issuing equity. The surge in nonfinancial issuance in January largely reflects \$2 billion in shares swapped in a merger between two utilities, rather than a broad rebound.

Treasury and Sponsored Agency Financing

The staff forecast for the first-quarter federal budget deficit is \$62 billion, not seasonally adjusted, about \$5-1/2 billion less than the deficit posted last quarter. In anticipation of the seasonal tax inflow during the second quarter, the Treasury is expected to cover \$25 billion of the first-quarter deficit out of its cash balance. Marketable borrowing is expected to fall \$8 billion from fourth-quarter levels, with the reduction

2. On December 21, 1988, Drexel Burnham Lambert, Inc., agreed to plead guilty to felony charges related to securities law violations and to pay \$650 million in fines and civil restitution. The news had little immediate effect on the junk bond market. However, Drexel has not underwritten any new issues since December 22, which contrasts with their average of 6-1/2 issues a month in 1988.

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

	1988	1989	1989		
	Q4	Q1 ^e	Dec.	Jan. ^e	Feb. ^p
<u>Treasury financing</u>					
Total surplus/deficit (-)	-67.6	-62.1	-11.6	2.8	-26.3
Means of financing deficit:					
Net cash borrowing from the public	53.7	31.5	12.0	5.5	13.2
Marketable borrowings/repayments (-)	36.9	28.7	1.8	5.6	11.9
Bills	15.5	3.7	-6.0	1.9	-.7
Coupons	21.4	25.1	7.7	3.7	12.6
Nonmarketable ²	6.3	2.8	1.1	.0	1.2
Other borrowing ²	10.5	.0	9.1	.0	.0
Decrease in the cash balance	10.8	24.7	-12.3	-10.1	20.1
Memo: Cash balance at end of period	33.7	8.9	33.7	43.7	23.6
Other ³	3.1	5.9	11.9	1.7	-7.0
<u>Federally sponsored credit agencies, net cash borrowing⁴</u>					
	12.5 ^e	--	6.5 ^e	--	--
FHLBs	9.0 ^e	--	4.4 ^e	--	--
FNMA	-.5	--	.1	--	--
Farm Credit Banks	-.6	--	-.3	--	--
FAC ⁵	.2	--	.0	.0	--
FHLMC	.4 ^e	--	.2 ^e	--	--
FICO	2.1	--	1.4	.0	--
SLMA	2.0	--	.7	--	--

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.

to be concentrated in the weekly bill sector.³ Nonmarketable borrowing is expected to decrease about \$4 billion, owing largely to a slowdown in SLGS issuance. In addition, "other borrowing" is likely to decline appreciably as the pace of FSLIC note offerings slackens.

In the first quarter, net cash raised through coupon securities is expected to increase somewhat from fourth-quarter levels, and gross auction sizes should be a bit larger in a few cases. During the second half of 1988, the increase in stripping activity reportedly augmented the demand for long-term bonds, and may have contributed to the inversion of the long end of the Treasury yield curve. The heavy stripping activity was fueled primarily by demand from pension funds adjusting to changes in accounting rules prior to year-end.⁴

Borrowing by the federally sponsored credit agencies was robust in the fourth quarter, totaling \$12.5 billion. The Federal Home Loan Banks (FHLBs) alone borrowed \$9 billion, largely to finance advances to member institutions, which have relied heavily upon this source of funds in view of their weak deposit growth. Despite the FHLBs' large borrowing in recent months and more adverse publicity about the thrift industry, yields on FHLB issues have declined somewhat relative to yields on Treasury securities since early fall, a development that reportedly owes to the absence of heavy bond issuance by most other agencies and by corporations.

3. About \$12 billion less in new cash is expected to be raised than in the fourth-quarter bill auctions; the gross size of the auctions likely will increase slightly because a larger volume of bills is maturing.

4. FASB 87 includes new rules affecting the rate at which pension funds can discount deferred liabilities, allowing more favorable discount factors for plans that match their liabilities with similar duration assets. Because the duration of the long-maturity payments of stripped bonds is similar to pension fund liabilities, the rule change caused funds' demand for strips to soar.

Reflecting the large volume of savings and loan resolutions by the FSLIC, the Financing Corporation raised \$2.1 billion during the fourth quarter. The FSLIC consolidated 75 thrift institutions in December, raising total mergers and liquidations to 225 for all of 1988. The combined assets of the thrifts resolved in December totaled \$70 billion, almost twice the assets of thrifts resolved during the previous 11 months. Nearly half of the December FSLIC-assisted agreements were completed in a flurry of activity in the final five days of the year as acquirers captured tax advantages that will be significantly reduced in 1989.⁵

Municipal Securities

Gross new issues of long-term tax-exempt securities totaled a brisk \$10-3/4 billion in December, and available data point to strength in this sector in January. December's volume stemmed from a substantial increase in issuance for new capital, especially transportation, education, and hospital bonds. For all of 1988, according to the most recent data from Public Securities Association (PSA), municipal volume totaled about \$110 billion, about half the volume of the tax-related surge in 1985, but approximately even with the 1987 total. The PSA forecasts that municipal tax-exempt volume will climb to about \$120 billion during 1989, owing primarily to increased demand for new capital to finance investment in solid-waste disposal, roads, bridges, and other infrastructure needs.

5. The principal tax benefits available to acquirers of thrifts are the ability to carry forward losses and the exemption of FSLIC assistance payments from federal taxation. The Technical and Miscellaneous Revenue Act of 1988 reduced the amount of losses that can be carried forward by 50 percent of the amount of tax-free FSLIC assistance payments, effective in 1989.

The 40 basis point decline in yields on long-term municipal securities over the intermeeting period has reduced the ratio of tax-exempt to taxable yields to its lowest level in five years. This sharp decline has occurred despite possible future downgradings of bonds issued by New York State, Connecticut, and New Jersey, each of which has suffered a significant revenue shortfall.

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

	1987	1988	1988			1988		1989
	Year	Year ^P	Q2	Q3	Q4 ^P	Nov.	Dec. ^P	Jan. ^f
Total offerings ¹	10.44	10.78	11.73	11.55	11.17	10.52	11.56	--
Total tax-exempt	10.05	10.54	11.41	11.32	10.99	10.14	11.43	10.50
Long-term	8.53	8.96	9.20	8.80	9.91	8.55	10.71	9.50
Refundings ²	3.80	2.73	3.18	1.87	2.83	2.72	2.27	--
New capital	4.73	6.23	6.02	6.93	7.08	5.83	8.44	--
Short-term ³	1.52	1.58	2.21	2.52	1.08	1.59	.72	1.00
Total taxable	.39	.24	.32	.23	.18	.38	.13	--

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.

p--preliminary. f--forecast.

Mortgage Markets

Contract interest rates on commitments for conventional fixed-rate home loans and for adjustable-rate mortgages (ARMs) declined a bit most recently, but are a little higher than in the week preceding the last FOMC meeting. Lenders have continued to offer sizable initial rate discounts on ARMs, in order to gain or retain market share and loan-origination fees. The FHLBB's December survey of conventional home mortgage loans closed show that an estimated 60 percent of ARMs closed in the first five working days of the month carried initial discounts, with an average discount in excess of 200

ARM DISCOUNTS
(December 1988)

Size of discount (basis points)	Average initial rate (percent)	Average base rate (percent) ¹	Percent of total
0	8.92	8.91	39
100 or fewer	8.33	8.74	7
101 - 200	8.68	10.44	16
201 - 300	8.18	10.59	29
301 or more	7.75	11.35	9
All discounted loans	8.27	10.43	61

1. The base rate represents the rate to which the loan will adjust following the discount period. If an index-plus-margin formula determines the adjusted rate, the base rate uses the current value of the index.

Source: FHLBB survey of conventional home mortgages closed during the first five working days of the month.

AVERAGE ARM INDEX VALUES AND INITIAL RATE SPREADS
(Percent)

Period	Initial ARM rate	One-year Treasury	FHLB 11th District cost of funds	ARM spreads	
				Treasury	11th District
(1)	(2)	(3)	(4)	(2)-(3)	(2)-(4)
1985	9.04	8.43	9.52	1.61	.52
1986	8.42	6.46	8.24	1.96	.18
1987	7.82	6.76	7.38	1.06	.44
1988	7.90	7.65	n.a.	.25	n.a.
1988-Q1	7.66	6.78	7.59	.88	.07
Q2	7.71	7.30	7.55	.41	.17
Q3	8.00	8.00	7.70	0	.30
Q4	8.22	8.53	n.a.	-.31	n.a.
1988-Jan.	7.85	6.99	7.62	.86	.23
Feb.	7.61	6.64	7.65	.97	-.04
Mar.	7.52	6.71	7.51	.81	.01
Apr.	7.58	7.01	7.52	.57	.06
May	7.71	7.40	7.50	.31	.21
June	7.85	7.49	7.62	.36	.23
July	7.84	7.75	7.59	.09	.25
Aug.	8.01	8.17	7.66	-.16	.35
Sept.	8.14	8.09	7.85	.05	.29
Oct.	8.12	8.11	7.83	.01	.29
Nov.	8.15	8.48	7.91	-.33	.24
Dec.	8.39	8.99	n.a.	-.60	n.a.

basis points. To compensate for the reduced interest revenues associated with initially discounted rates, many lenders have increased the number of points charged and also the normal markup over the index rate applicable after the discount period, which is now as high as 3 percentage points for some newly originated loans.

Another perspective on ARM discounting is provided by historical comparisons between average initial ARM rates and two common ARM indexes. The degree of ARM discounting appears particularly large when ARM rates are compared with rates on one-year Treasuries. Over the course of last year, average initial ARM rates dropped from 90 basis points above to 60 basis points below the one-year Treasury rate. However, when ARM rates are matched against the FHLB System's 11th District Cost-of-Funds Index, ARM discounting appears to have stabilized since the middle part of last year.

Both originations and new commitments to originate mortgages increased at FSLIC-insured institutions in November, after declining in each of the two preceding months. These institutions acquired \$4.3 billion of mortgage-related assets in November, despite a sharp slowing in growth of holdings of whole mortgage loans. The strong pickup in thrift net investment in mortgage-backed securities likely reflects a desire by thrifts to carry some of their ARM loans in securitized form, possibly to enhance their value as collateral for borrowings.

The increased demand for securitized ARMs is reflected in the pattern of issuance of federally related mortgage-backed pass-through securities. While offerings of fixed-rate pass-throughs have been flat to declining in recent months, agency issuance of ARM-backed securities has picked up. A sizable proportion of the agency ARM pass-throughs are backed by loans

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	18.6	17.8	7.7	2.6	3.6	-.9
Q2	19.7	19.1	10.1	5.7	3.2	2.5
Q3 r	21.5	20.8	8.7	6.0	5.1	.9
1988-Apr.	18.7	17.7	10.4	6.0	2.7	3.3
May	19.5	19.0	9.4	5.1	3.6	1.5
June	21.0	20.5	10.4	6.1	3.4	2.6
July	19.8	18.8	8.8	6.7	4.5	2.2
Aug.	22.8	22.7	8.2	7.8	7.4	.3
Sept. r	22.0	20.9	9.1	3.5	3.5	.1
Oct. r	19.0	19.0	8.5	5.5	5.2	.3
Nov. p	20.9	20.6	10.7	4.3	1.9	2.4

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	21.6	8.2	8.3	5.0	21.6	.7
1987	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
Q3 r	13.6	5.8	3.5	4.3	14.9	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	13.5	5.7	3.5	4.3	15.3	1.6
Aug.	13.6	5.9	3.8	3.9	14.3	2.8
Sept. r	13.6	5.8	3.2	4.6	15.0	4.5
Oct. r	12.2	3.5	3.6	5.1	12.3	2.2
Nov. p	n.a.	n.a.	4.4	6.2	n.a.	2.4

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

indexed to the FHLB's Cost-of-Funds index, but Treasury-indexed ARM securities also remain popular.

Consumer Installment Credit

Consumer installment credit rose at an 8-1/4 percent annual rate in November, paced again by strong growth in revolving credit. Preliminary data from holders accounting for about two-thirds of the total suggest that installment credit growth remained around that rate again in December.

Suppliers of consumer credit have been raising larger amounts of funds through issuance of securities backed by consumer loans. From their inception in May 1985 through year-end 1988, \$35 billion of these asset-backed securities has been publicly marketed. At the end of 1988, approximately \$23 billion remained outstanding, including most of the credit-card-related volume and about half of the auto-backed volume. There have been a number of private placements as well, but data are virtually nonexistent; estimates for this segment range from \$4 billion to \$8 billion of offerings. Market participants reportedly anticipate further strong growth of consumer credit securitization well into 1990, spurred in large part by risk-based capital requirements.⁶ Citibank has already gotten this year off to a strong start by offering a \$1 billion credit-card-backed issue in late January.

6. Consumer loans at commercial banks will be in the 100 percent risk category; the process of securitization--sale, without recourse, of a loan pool to a third party that issues the securities--results in removal of the loans from the balance sheet. Thus, the capital requirement is eliminated while, in almost all instances, the bank retains income from both the origination and servicing fees on the loan pool.

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
			H1	Q3	Oct. ^r	Nov. ^p	Oct. ^r	Nov. ^p	Nov. ^p
Total installment ¹	10.4	7.2	10.2	5.6	7.2	8.1	3.91	4.48	661.7
Installment, excluding auto	5.7	6.2	10.7	7.1	8.4	10.0	2.58	3.09	374.2
Selected types									
Auto	17.4	8.6	7.9	3.6	5.6	5.8	1.33	1.39	287.5
Revolving	11.8	16.8	17.3	13.6	17.5	20.3	2.60	3.06	184.3
All other	1.7	-1.5	4.8	1.2	-.1	.2	-.02	.02	189.8
Selected holders									
Commercial banks	8.5	7.4	13.0	11.6	15.6	13.0	4.01	3.38	316.3
Finance companies	20.4	4.8	1.9	-5.6	-2.0	-2.1	-.24	-.25	142.2
Credit unions	5.9	6.4	11.2	3.0	6.6	9.4	.47	.67	86.7
Savings institutions ²	14.5	12.4	13.5	7.1	-10.8	5.2	-.62	.30	68.1
Memorandum:									
Total ³	9.0	6.1	7.6	4.5	4.6	8.4	2.79	5.07	728.7

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				
				May	Aug.	Sept.	Oct.	Nov.
At commercial banks ¹								
New cars (48 mo.)	12.91	11.33	10.46	10.55	10.93	11.22
Personal (24 mo.)	15.94	14.83	14.23	14.40	14.81	15.06
Credit cards	18.69	18.26	17.92	17.78	17.79	17.77
At auto finance cos. ²								
New cars	11.98	9.44	10.73	12.29	12.64	12.93	13.10	13.20
Used cars	17.59	15.95	14.61	14.81	15.16	15.46	15.67	15.75

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.

PUBLIC ISSUES OF CONSUMER ASSET-BACKED SECURITIES
(\$ millions)

	Original issue volume during year			Total
	Automobile	Credit card	Other	
1985	899	0	0	899
1986	9,870	0	206	10,076
1987	6,372	2,410	616	9,398
1988pe	5,273	7,420	1,953	14,646
Total issuance	22,414	9,830	2,775	35,019

	Outstanding balances (12/31)			Total
	Automobile	Credit card	Other	
1985	851	0	0	851
1986	9,560	0	206	9,766
1987	12,094	2,410	704	15,209
1988pe	11,996	9,390	2,068	23,455

pe--preliminary estimate.

Note: Totals may not add due to rounding.

The market has evolved from one dominated by auto-backed issues in 1986 and 1987--especially those of GMAC and Chrysler--to one featuring credit card issues in 1988. In part, this evolution resulted from overcoming the difficulty in structuring and pricing credit-card-backed securities as well as reduced activity by the major auto finance companies in 1988. Other significant developments in 1988 were the first sales of securities backed by boat loans, rapid expansion of manufactured-housing-backed securities, and the entry of Citibank, Sears, Wards, Penney's, and Spiegel into the credit card securities market. Continual broadening of the techniques used in asset-backed securitizations to include, for instance, use of a senior subordinated debt structure for some issues reflects efforts to reach a wider range of investors--some of whom may face legal constraints on the types of securities they may hold.

INTERNATIONAL DEVELOPMENTS

U.S. Merchandise Trade

In November the seasonally adjusted U.S. merchandise trade deficit was \$11 billion (Census basis, Customs valuation), compared with an \$8.8 billion (revised) deficit in October. The deficit widened as imports rose sharply and exports fell slightly. Valued on a CIF basis the November deficit was \$12.5 billion, while the revised deficit for October was \$10.3 billion.

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

	<u>Exports</u>	<u>Imports</u>		<u>Balance</u>	
		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	26.5	36.0	34.5	-9.5	-8.0
Aug	27.5	39.8	38.1	-12.3	-10.6
Sep	28.0	38.7	37.2	-10.7	-9.2
Oct ^r	27.8	38.1	36.6	-10.3	-8.8
Nov ^p	27.2	39.7	38.1	-12.5	-11.0

r--revised.

p--preliminary.

Among the categories of imports showing the largest increases from October to November were consumer goods and capital goods. The small decline in exports was spread across various trade categories.

For October and November combined, the merchandise trade deficit is estimated to have been \$123 billion at a seasonally adjusted annual rate (balance-of-payments basis), slightly larger than the \$116 billion third-quarter rate. While the value of exports increased at an annual rate of 1.2 percent, the value of imports increased at a rate of 7.4 percent (see table on next page).

In constant 1982 dollars, exports fell slightly from the third quarter to October/November, due to a decline in agricultural exports (mostly the result of a slowing in shipments of corn to the Soviet Union and wheat to China). In October/November the volume of nonagricultural exports rose at an annual rate of 4 percent. The volume of non-oil imports increased by 3.2 percent at an annual rate in October/November, and the increases were widespread across trade categories. The largest increase was in passenger cars from Japan and Germany, which rose from somewhat depressed levels in the third quarter. Other increases were in industrial supplies and consumer goods.

Staff estimates suggest that the value of nonagricultural exports increased to all areas of the world in October/November, with the exception of Japan and the Asian newly industrialized economies. The decline in agricultural exports affected every region of the world, except Western Europe. Non-oil imports from industrial countries increased sharply (particularly: Canada 11 percent, Japan 8 percent, and Western Europe 6 percent). Non-oil imports from Taiwan and Korea both dropped by more than 12 percent.

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

	Exports			Imports			Balance
	Total	Ag.	Nonag.	Total	Oil	Non-oil	
- - - - - Current dollars - - - - -							
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
-3	327	41	286	443	39	404	-116
Oct/Nov ^e	328	37	291	451	35	416	-123
- - - - - Constant 1982 dollars - - - - -							
1987-1	249	31	218	416	70	347	-168
-2	263	34	229	420	72	349	-157
-3	286	40	246	446	88	358	-160
-4	299	35	264	459	81	378	-160
1988-1	327	39	288	463	82	381	-135
-2	341	40	301	459	85	373	-118
-3	342	38	304	465	87	379	-122
Oct/Nov ^e	341	34	307	469	87	382	-128

e--Staff estimate. Constant dollar estimates are derived using the fourth-quarter deflators from the GNP accounts.

The volume of oil imports was essentially flat in October and November from the third-quarter rate, while oil prices fell sharply. Since the OPEC accord in mid-November, spot prices have risen significantly, returning to levels recorded in the first half of 1988.

OIL IMPORTS
(BOP basis, seasonally adjusted, value at annual rates)

	1987		1988				
	1987	Q4	Q1	Q2	Q3	Oct	Nov
Value (Bil. \$)	42.88	45.15	39.82	41.02	39.34	35.32	35.14
Price (\$/BBL)	17.33	17.46	15.23	15.16	14.21	12.70	12.65
Volume (mbd.)	6.78	7.08	7.14	7.39	7.56	7.60	7.59

Import and Export Prices

Prices of non-oil imports (n.s.a.) rose on average 10 percent at an annual rate in the fourth quarter, according to data released by the Bureau of Labor Statistics. This was the same rate of increase as prevailed in the first two quarters of the year and follows a price decline on average in the third quarter. For the four quarters of 1988 as a whole, the increase in non-oil import prices was 6.9 percent.

All the major categories of imports shown in the table on the next page posted higher rates of price increase in the fourth quarter than in the third. An important influence on these price movements was the exchange value of the dollar which, after appreciating during the third quarter, declined during the fourth quarter.

Prices of exports on average declined at an annual rate of 0.8 percent in the fourth quarter, led by a 21.3 percent decline in the price of foods, feeds, and beverages and a 3.6 percent drop in the price

IMPORT AND EXPORT PRICE MEASURES
(percentage change from previous period, annual rates)

	<u>1987</u>	<u>1988</u>				<u>1988Q4</u>
	Q4	Q1	Q2	Q3	Q4	1987Q4
- - - - - BLS prices ¹ - - - - -						
Imports, Total	5.9	4.7	11.0	-5.0	6.4	4.1
Oil	-32.9	-36.7	23.0	-32.8	-28.9	-21.9
Non-oil	11.7	10.0	10.1	-1.9	9.9	6.9
Food, Feed, Bev.	11.9	5.8	0.0	-3.5	4.3	1.6
Industrial Supplies	11.1	14.6	24.8	0.0	10.9	12.2
Paper and Stocks	11.3	22.4	9.0	9.8	5.0	11.4
Nondurables	18.3	14.4	13.6	0.3	2.9	7.6
Chemicals	24.8	15.8	9.7	7.1	10.0	10.6
Capital Goods	16.3	6.5	7.7	-6.0	10.3	4.4
Computers and Parts	8.4	0.7	4.7	14.0	-2.4	0.7
Ex Comp. and Parts	16.5	7.8	7.8	-6.6	12.1	5.0
Autos and Parts	7.6	10.7	7.0	0.6	10.2	7.0
Consumer Goods	11.3	9.6	6.9	-4.1	8.2	5.0
Exports, Total	8.2	6.1	11.7	8.2	-0.8	6.3
Food, Feed, Bev.	45.3	8.2	56.2	63.6	-21.3	21.4
Industrial Supplies	10.4	8.7	15.2	1.2	0.4	6.3
Capital Goods	1.2	5.3	3.6	2.4	3.2	3.5
Computers and Parts	-0.4	1.3	-1.1	3.8	-3.5	0.1
Ex Comp. and Parts	1.6	5.7	4.5	2.4	4.5	4.3
Autos and Parts	2.0	-0.8	2.0	2.0	5.7	2.2
Consumer Goods	4.1	7.8	2.0	2.4	5.7	4.5
- - - - - Prices in the GNP accounts - - - - -						
Fixed-Weighted						
Exports, Total	3.3	8.7	8.1	13.8	0.4	7.7
Imports, Total	4.7	3.3	6.3	-0.8	1.2	2.5
Imports, Non-oil	8.7	12.8	7.5	2.4	6.7	7.3
Deflators						
Exports, Total	0.1	2.6	9.2	9.9	1.7	5.8
Imports, Total	5.2	1.6	1.4	-1.8	3.9	1.2
Imports, Non-oil	3.8	8.1	4.1	0.1	9.5	5.4

1. Not seasonally adjusted, surveyed last month of each quarter.

of computers, peripherals, and parts. However, with the exception of industrial supplies, prices of other exports rose at a faster pace in the fourth quarter than in the third quarter. Despite the large fourth-quarter decline, the index for prices of exports of foods, feeds, and beverages closed the year 21.4 percent higher than a year ago, due in part to the summer drought. Prices for industrial supplies, capital goods (excluding computers), and consumer goods all showed increases throughout each quarter of the year. For the year, prices of exports rose 6.3 percent on average (Q4/Q4).

U.S. International Financial Transactions

Net private purchases of Treasury securities by foreigners rose to \$8 billion in November (see line 3 on the Summary Table of U.S. International Transactions), as the spread between U.S. and foreign interest rates widened considerably during that month. Over half of the net purchases in November were made by Japanese residents; of these purchases an unusually large share was concentrated in bills, reflecting the particularly large increase in the spread between U.S. and Japanese short-term interest rates.

Net private purchases of corporate bonds by foreigners also picked up in October and remained strong in November (line 2a). The rate of Eurobond issuances by U.S. corporations in the two months was about equal to that in the first three quarters of 1988 (\$2 billion per month), but the share of newly issued bonds denominated in foreign currencies rose to one half from an average of one third in the first three quarters. Activity in the Eurobond market slowed markedly in

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

	1986	1987	1987		1988					
	Year	Year	Q3	Q4	Q1	Q2	Q3	Sept.	Oct.	Nov.
<u>Private Capital</u>										
Banks										
1. Change in net foreign positions of banking offices in the U.S. (+ = inflow)	22.3	47.5	30.8	11.0	-3.0	17.0	-1.1	-8.6	0.9	2.4
Securities										
2. Private securities transactions, net ¹	65.9	36.4	11.4	-7.0	-2.2	10.9	6.2	1.0	-1.7	3.0
a) foreign net purchases (+) of U.S. corporate bonds	53.5	26.4	7.5	2.8	2.6	8.9	7.0	1.9	2.6	2.7
b) foreign net purchases (+) of U.S. corporate stocks	18.0	16.8	5.4	-7.4	*	1.0	1.2	0.4	-0.8	*
c) U.S. net purchases (-) of foreign securities	-5.5	-6.9	-1.6	-2.4	-4.9	1.0	-2.0	-0.6	-3.5	0.3
3. Foreign net purchases (+) of U.S. Treasury obligations	4.0	-7.3	-2.8	0.5	7.0	5.6	3.5	0.1	-0.1	8.0
<u>Official Capital</u>										
4. Changes in foreign official reserves assets in U.S. (+ = increase)	33.5	47.7	0.9	19.8	24.8	6.5	-2.2	-1.7	5.9	5.6
a) By area										
G-10 countries (incl. Switz.)	30.8	38.8	-5.7	15.6	17.7	-0.8	-7.0	-1.6	4.4	3.5
OPEC	-8.3	-8.9	-1.3	-2.8	-1.6	-1.6	-0.8	-0.4	-1.4	1.3
All other countries	10.8	17.8	7.9	7.1	8.7	8.9	5.6	-0.3	2.9	0.9
b) By type										
U.S. Treasury securities	34.4	43.2	0.8	19.1	27.7	5.9	-3.8	-1.4	4.6	5.2
Other ²	-1.0	4.5	0.1	0.7	-2.9	0.7	1.5	-0.3	1.3	0.4
5. Changes in U.S. official reserve assets (+ = decrease)	0.3	9.1	*	3.7	1.5	*	-7.4	0.1	-0.6	2.4
<u>Other transactions</u> (Quarterly data)										
6. U.S. direct investment (-) abroad ⁴	-27.8	-44.5	-7.9	-19.7	-6.4	-0.1	-5.6	n.a.	n.a.	n.a.
7. Foreign direct investment (+) in U.S. ⁴	34.1	42.0	15.0	11.7	7.3	13.1	8.1	n.a.	n.a.	n.a.
8. Other capital flows (+ = inflow) ^{3,4}	-9.1	4.6	-1.0	-2.8	3.1	-6.5	6.9	n.a.	n.a.	n.a.
9. U.S. current account balance ⁴	-138.8	-154.0	-42.0	-33.5	-36.9	-33.7	-30.9	n.a.	n.a.	n.a.
10. Statistical discrepancy ⁴	15.6	18.5	-4.4	16.3	4.3	-12.8	22.5	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 -30.2 -28.5 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 to 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.

December and U.S. corporate issuance fell to \$50 million. In January the Eurobond market picked up, but new U.S. corporate issues remained well below the pace of 1988. Market commentary attributes the lack of new U.S. issues to investor concern about the risk associated with corporate restructurings, and only the most highly rated U.S. corporations find the Euromarket attractive. Demand for U.S. dollar-denominated bonds was strong in January, but favorable swap opportunities allowed issuers to convert debt denominated in high yielding currencies, such as Canadian and Australian dollars, into U.S. dollar obligations paying significantly less than comparable U.S. dollar bonds. As a result, the proportion of foreign-currency denominated bonds issued by U.S. corporations remained relatively high. Foreign private net purchases of U.S. corporate stock were again negligible in October and November.

Net U.S. purchases of foreign securities (line 2c), which had averaged less than \$3/4 billion per month from June through September, rose to over \$3-1/2 billion in October, at a time when interest rate differentials were stable and the dollar came under downward pressure. U.S. residents made \$1/4 billion net sales of foreign securities in November, as U.S. interest rates rose relative to foreign rates.

Foreign official reserve assets in the United States rose \$6 billion in October and \$5-1/2 billion in November (line 4),

. OPEC members' reserve holdings in

INTERNATIONAL BANKING DATA
(Billions of dollars)

	1986		1987				1988				
	Dec.	Mar.	June	Sept.	Dec.	Mar.	June	Sept.	Nov.	Dec.	Jan. ²
1. Net Claims of U.S. Banking Offices (excluding IBFS) on Own Foreign Offices and IBFS	22.3	9.1	5.0	-7.8	-10.9	8.7	-4.8	-4.9	-6.1	-4.9	-2.1
(a) U.S.-chartered banks	31.7	21.5	16.3	12.6	15.2	27.8	17.0	16.6	20.1	21.6	22.6
(b) Foreign-chartered banks	-9.4	-12.4	-11.3	-20.3	-26.1	-19.0	-21.8	-21.5	-26.2	-26.5	-24.7
2. Credit Extended to U.S. Nonbank Residents by Foreign Branches of U.S. Banks	16.8	16.0	15.6	17.1	15.8	19.1	19.7	21.4	22.4	21.2	19.5
3. Eurodollar Holdings of U.S. Nonbank Residents ¹	124.5	34.0	135.7	141.1	132.6	128.9	138.1	141.1	140.1	145.3	144.3

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.

2. Through January 16, 1989.

the United States rose by \$1-1/4 billion in November, marking the first significant increase since the first quarter of 1986. Preliminary data for December, based on holdings at FRBNY, indicate continued accumulations by Taiwan and OPEC countries.

U.S. banks increased their net claims on own foreign offices by \$1 billion in December (line 1 on the International Banking Table), reversing the net inflow reported earlier in the fourth quarter. Rapid increases in small time deposits, and slow growth in business loan demand, permitted banks to rely less on non-deposit funds in general and Eurodollar borrowing in particular.

Foreign Exchange Markets

The trade-weighted, foreign-exchange value of the dollar rose about 6-1/4 percent since the last FOMC meeting on December 14, nearly reversing its decline in October and November. The dollar appreciated about the same amount against the yen; against the mark, the dollar rose 8 percent. The dollar strengthened despite the release of U.S. trade data for October and November showing larger-than-expected deficits, two rounds of European interest-rate increases,

. Market commentary, focusing on the continuing upward movement of the federal funds rate, attributed the dollar's strength to an actual and prospective tightening of monetary policy in the United States. Expectations that interest rates in the United States would remain firm were reinforced late in the period by remarks from Chairman Greenspan indicating that current levels of inflation were too high.

Changes in interest-rate differentials, however, show a mixed picture of support for the dollar. Short-term dollar-yen interest-rate differentials did move in favor of dollar-denominated assets during the intermeeting period. While the federal funds rate rose nearly 60 basis points from mid-December to about 9-1/8 percent, the call money rate in Japan fell almost 30 basis points to just below 4 percent. At the three-month maturity, the U.S. Treasury bill rate firmed nearly 30 basis points to 8.69 percent on a yield basis, while the gensaki rate rose less than 10 basis points to about 4.25 percent.¹ In contrast, interest rates on mark-denominated assets appear to have moved with those on dollar assets, leaving short-term differentials little changed (and the mark inexplicably weak). The call money rate in Germany, after some year-end volatility, is expected to settle about 75 basis points higher than its mid-December level of 5 percent, the three-month interbank rate in Germany rose about 50 basis points to around 6 percent.

Long-term interest-rate differentials narrowed during the intermeeting period. While the nominal yield on long-term U.S. Treasury securities declined, the average of long-term bond yields in Germany rose nearly 30 basis points to 6.66 percent and the yield on the bellwether bond in Japan rose slightly more to 4.82 percent.

1. The 90-day CD rate, usually used by the staff to indicate short-term rates in U.S. money markets, is not used in this comparison since it and other private rates appeared to be more affected by seasonal pressures around year end.

As shown in the table below, the Bundesbank raised the Lombard rate a total of 1 percentage point since December 14 in two steps to 6 percent and the discount rate 1/2 percentage point to 4 percent.

Selected Official and Market Interest Rates

	<u>December 14</u>	<u>January 31</u>	<u>change</u>
<u>Germany</u>			
Discount	3.50	4.00	0.50
Lombard	5.00	6.00	1.00
3-month interbank	5.55	5.95	0.40
<u>France</u>			
Money-market intervention	7.25	8.25	1.00
5-10 day RP	7.75	9.00	1.25
3-month interbank	8.31	8.88	0.57
<u>Switzerland</u>			
Discount	3.00	4.00	1.00
Lombard	5.00	6.00	1.00
3-month interbank	5.00	5.63	0.63
<u>Netherlands</u>			
Discount	4.00	5.00	1.00
3-month interbank	5.70	6.35	0.65
<u>Belgium</u>			
Discount	7.25	8.25	1.00
Lombard	7.50	8.50	1.00
3-month interbank	7.38	7.75	0.37
<hr/>			
<u>United States</u>			
3-month CDs	9.34	9.20	-0.14
3-month Treasury bills	8.41	8.69	0.28

These actions were taken to dampen money-supply growth and to work against a tendency toward rising domestic prices and a further decline in the mark. Official interest rates in several other European

countries were raised a total of 1 percentage point or more, in conjunction with the increases in Germany.

Desk sales of dollars against marks during the period totaled nearly \$2 billion, with the proceeds split evenly between the Treasury and System accounts.

U.S. bank lending to foreigners

The dollar value of U.S.-chartered banks' claims on all foreigners increased about \$4.5 billion (1 percent) in the third quarter of 1988. During this period the foreign exchange value of the dollar in terms of other G-10 currencies rose on average by 2.3 percent. After adjustment for the effect of exchange rate changes on the value of non-dollar claims, total claims on foreigners are estimated to have increased by \$7 billion.

The decline in U.S. bank claims on non-OPEC developing countries continued in the third quarter, with reported claims declining by \$4.3 billion, or about 5 percent. Preliminary staff estimates suggest a decline of a similar amount in the fourth quarter. In the first three quarters of 1988 U.S. bank claims on non-OPEC developing countries declined by \$10.7 billion, or about 11 percent, compared with an average annual decline of about \$5 billion in the previous three years. In the

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

	Changes (no sign = increase)						Out- standing 9/30/88
	1985 Year	1986 Year	1987 Year	1988			
				Q1	Q2	Q3	
Total, all countries	-20.3	-0.3	-3.8	-9.0	-19.2	4.5	357.6
Non-OPEC developing countries	-7.6	-5.1	-1.4	-3.7	-2.7	-4.3	87.0
of which:							
(Latin America)	-3.9	-0.6	-1.7	-2.2	-2.1	-2.2	64.0
(Asia and Africa)	-3.5	-4.4	0.0	-1.0	-0.5	-2.5	23.0
OPEC countries	-3.6	-2.0	-2.2	0.0	-0.7	1.1	17.5
Eastern Europe	-0.3	-0.9	-0.2	-0.1	0.2	0.0	3.1
Smaller developed countries	-3.7	-4.2	0.6	-0.1	-2.5	-1.0	22.7
G-10 countries	-2.1	10.6	3.3	-3.4	-6.0	-0.3	150.2
Offshore banking centers	-2.7	-1.6	-7.2	0.0	-8.2	2.7	48.6
Miscellaneous	-0.4	2.9	3.4	-1.7	0.7	5.9	28.1
Memorandum:							
Total, adjusted for exchange rate changes (staff estimate)	-29	-11	-25	-8	-11	7	

third quarter, there were declines in U.S. bank claims on all heavily indebted countries in Latin America with an especially large decline of \$1.2 billion (5.5 per cent) in U.S. bank claims on Brazil. The decline in claims on Brazil was spread widely among U.S. banks and resulted from participation in official and unofficial debt/equity exchanges as well as

debt writeoffs. The decline in U.S. bank claims on Asian and African countries was largely concentrated in claims on Taiwan that were associated with repayment of dollar loans that were used to speculate on an appreciation in the New Taiwan Dollar.

U.S. bank claims on most other country groupings changed little in the third quarter of 1988. U.S. banks hold a relatively small proportion of total bank claims on Eastern European countries (about 4 percent of all banks in the BIS reporting area) and to date U.S. banks have shown limited interest in increasing their exposure to these countries. The large increase in U.S. bank claims on the miscellaneous category of foreigners largely represents short-term repurchase transactions with the World Bank that are associated with its active program of asset and liability management.

The price of bank claims on heavily indebted countries in the secondary market declined in the third and fourth quarters of 1988, and this decline continued in early 1989. (See accompanying table.) The declines in secondary market prices were widespread among the Baker-15 countries with the exception of Chile. These declines are consistent with net sales into that market by U.S. and other banks that are revising their strategies with respect to long-term lending to the developing countries. Several large Canadian banks are known to have made large net sales to reduce exposure levels in their accounting year that ended on October 31, 1988.

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/}	12/31/87	88Q1 ^{2/}	88Q2 ^{2/}	88Q3 ^{2/}	88Q4 ^{2/}	1/19/89
Brazil	46.5	47.8	50.6	46.4	40.4	34.4
Mexico	50.5	48.9	50.4	46.9	43.1	38.6
Argentina	34.5	28.5	24.5	23.4	21.5	19.9
Venezuela	58.0	53.9	54.9	48.5	41.3	37.1
Chile	61.8	58.0	61.0	60.1	57.5	60.4
Philippines	50.4	51.0	54.3	52.5	49.5	46.6
Yugoslavia	49.8	47.0	46.0	47.8	45.5	44.5
Nigeria	30.5	29.8	29.0	24.0	24.0	20.0
Colombia	66.5	66.0	65.8	66.3	58.0	56.4
Ecuador	37.3	32.5	26.0	19.0	13.0	13.0
Peru	8.0	6.5	6.8	5.8	5.5	5.5
Morocco	53.5	50.5	49.8	50.5	48.5	47.5
Cote d'Ivoire	42.5	31.5	30.3	28.0	25.0	20.0
Uruguay	60.0	60.8	60.0	60.5	60.0	60.0
Bolivia	12.0	12.0	12.0	10.5	10.5	10.5
Baker-15 countries ^{3/}	47.4	45.7	46.6	43.4	39.2	36.0

1. Ranked by December 1986 BIS quarterly claims.
2. Prices last reported within quarter.
3. Index of weighted-average secondary market value of LDC debt. The weight of each of the 15 countries is the December 1986 BIS quarterly claims on that country divided by the total BIS quarterly claims on the 15 countries combined.

Source: Salomon Brothers.

Developments in Foreign Industrial Countries

The pace of economic activity abroad showed signs of slowing in the fourth quarter, following a relatively strong third quarter. In Germany, provisional fourth-quarter data indicate that real GDP grew at between 0 and 2 percent (s.a.a.r.). In Japan, industrial production slowed slightly in the fourth quarter; while in the United Kingdom, Canada, and France, a range of monthly indicators, including industrial production, suggest some slowing in growth. Only in Italy does growth appear to have maintained its third-quarter pace.

Signs of a resurgence of inflation in the foreign G-7 countries are mixed. In Japan, consumer prices rose in January to a level 1.6 percent above that of a year earlier. In Germany, recent increases in consumer, wholesale, and import prices in December and January have raised concerns, although part of the sharp increase in January reflects increased excise taxes. In the United Kingdom the December retail price index was 6.8 percent above its level a year earlier, with much of the increase due to the rise in short-term interest rates that has raised the mortgage interest cost component of the retail price index. In Italy, the January price level was 5.7 percent above its level a year earlier, although part of the increase was due to the introduction of a value-added-tax on foods and newspapers.

Trade and current account imbalances did not improve in the major foreign industrial countries during the fourth quarter. In Japan and Germany, trade and current account surpluses increased in November, although Japan's trade surplus narrowed in December. The United Kingdom

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

	Q4/Q4 1987	Q4/Q4 1988	1988				1988					Latest 3 months from year ago 2
			Q1	Q2	Q3	Q4	Aug.	Sept.	Oct.	Nov.	Dec.	
Canada												
GDP	6.1	n. a.	.7	1.0	.7	n. a.	*	*	*	*	*	4.0
IP	8.5	n. a.	1.2	1.1	.7	n. a.	1.3	.1	-.4	-.3	n. a.	3.7
France												
GDP	2.6	n. a.	1.1	.4	n. a.	n. a.	*	*	*	*	*	3.1
IP	3.2	n. a.	.9	1.0	2.5	n. a.	.0	1.0	-3.2	3.8	n. a.	4.5
Germany												
GNP	2.4	n. a.	1.4	-.2	1.3	n. a.	*	*	*	*	*	3.3
IP	1.5	n. a.	1.1	.3	1.8	n. a.	6.6	-2.0	-1.0	-.1	n. a.	3.4
Italy												
GDP	2.7	n. a.	1.3	.8	1.5	n. a.	*	*	*	*	*	3.9
IP	5.7	n. a.	2.7	-.7	.1	n. a.	-5.8	3.4	3.1	1.4	n. a.	4.7
Japan												
GNP	5.7	n. a.	2.4	-.8	2.2	n. a.	*	*	*	*	*	5.7
IP	8.1	7.9	3.2	-.2	2.5	2.2	2.7	.5	-1.0	2.8	.5	7.9
United Kingdom												
GDP	4.0	n. a.	1.7	.3	1.1	n. a.	*	*	*	*	*	3.4
IP	4.1	n. a.	-.7	2.4	.7	n. a.	1.3	.4	-.5	.1	n. a.	3.4
United States												
GNP	5.0	2.7	.8	.7	.6	.5	*	*	*	*	*	2.7
IP	5.8	4.9	1.0	1.1	1.7	1.0	.3	.2	.4	.4	.3	4.9

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 1987	Q4/Q4 1988	1987		1988				1988			1989	Latest 3 months from year ago
			Q3	Q4	Q1	Q2	Q3	Q4	Oct.	Nov.	Dec.	Jan.	
Canada													
CPI	4.2	4.1	1.2	.7	.8	1.3	1.1	.8	.5	.3	.0	n. a.	4.1
WPI	4.3	n. a.	1.4	1.1	1.1	.9	.8	n. a.	.2	.4	n. a.	n. a.	3.5
France													
CPI	3.2	3.0	.6	.5	.5	1.0	.9	.6	.2	.1	.2	n. a.	3.0
WPI	2.6	n. a.	.5	1.0	1.1	.8	2.7	n. a.	*	*	*	*	5.7
Germany													
CPI	1.0	1.5	.0	.0	.5	.5	.1	.4	.1	.2	.2	1.0	1.9
WPI	-.7	2.7	-.4	-.2	.1	1.1	.4	1.2	.4	.5	.8	n. a.	2.7
Italy													
CPI	5.2	5.2	1.1	1.7	1.1	1.0	1.0	1.9	.8	.8	.3	.8	5.5
WPI	4.6	n. a.	.8	1.2	1.1	1.3	1.2	n. a.	.4	.9	n. a.	n. a.	5.1
Japan													
CPI	1.1	1.5	-.2	.4	-.2	.6	.0	1.0	.7	-.3	-.4	.2	1.5
WPI	-.6	-1.4	1.3	-.4	-1.2	-.3	.9	-.8	-.6	-.6	.0	n. a.	-1.4
United Kingdom													
CPI	4.1	6.5	.2	1.1	.5	2.4	1.4	2.1	1.0	.5	.3	n. a.	6.5
WPI	3.9	4.9	.5	1.1	1.3	1.5	.8	1.2	.5	.4	.3	n. a.	4.9
United States													
CPI (SA)	4.4	4.3	.9	.9	.8	1.2	1.2	1.1	.4	.3	.3	n. a.	4.3
WPI (SA)	2.5	3.4	.7	.0	.2	1.0	1.4	.7	.0	.3	.4	n. a.	3.4

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)

	1987	1988	1987		1988				1988			
			Q3	Q4	Q1	Q2	Q3	Q4	Sept.	Oct.	Nov.	Dec.
Canada												
Trade	8.3	n. a.	2.3	1.6	1.8	2.2	2.6	n. a.	.4	.4	.3	n. a.
Current account	-8.0	n. a.	-2.1	-2.6	-1.2	-1.9	-1.6	n. a.	*	*	*	*
France												
Trade	-5.2	-5.9	-1.0	-1.0	-.9	-1.0	-1.9	-2.0	.1	-.7	-.6	-.7
Current account	-4.1	n. a.	-.9	-2.3	1.3	-.6	-1.2	n. a.	*	*	*	*
Germany												
Trade (NSA)	65.9	n. a.	15.2	20.1	15.0	19.9	17.0	n. a.	6.0	5.8	7.5	n. a.
Current account (NSA)	45.4	n. a.	7.8	15.3	8.6	15.0	8.7	n. a.	3.1	4.3	5.9	n. a.
Italy												
Trade	-9.1	n. a.	-2.8	-2.5	-3.1	-1.6	-2.9	n. a.	-1.0	-.7	-.5	n. a.
Current account (NSA)	-1.1	n. a.	1.6	-1.6	-5.1	1.1	n. a.	n. a.	*	*	*	*
Japan												
Trade	79.5	77.3	17.8	18.3	20.8	16.7	17.8	21.9	6.1	7.2	7.6	7.1
Current account 2	87.0	n. a.	19.9	20.5	23.1	17.6	17.8	n. a.	6.6	6.8	7.4	n. a.
United Kingdom												
Trade	-15.9	-36.2	-5.0	-5.3	-7.1	-8.2	-9.4	-11.5	-1.8	-5.1	-3.4	-3.0
Current account	-3.0	-25.3	-1.4	-2.3	-5.1	-5.4	-5.9	-9.0	-.7	-4.0	-2.7	-2.3
United States												
Trade 2	-160.3	n. a.	-39.7	-41.2	-35.2	-30.2	-28.5	n. a.	*	*	*	*
Current account	-154.0	n. a.	-42.0	-33.5	-36.9	-33.7	-30.9	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.

registered record trade and current account deficits in the fourth quarter, although both narrowed somewhat in November and December from the record levels achieved in October. In Italy and France, trade balances deteriorated, reflecting, in part, the continued deterioration of these countries' bilateral trade balances with Germany.

Individual country notes. The pace of real activity in Japan remained strong in the fourth quarter, but may have slowed somewhat from the rapid third-quarter pace. Industrial production increased 2.2 percent in the fourth quarter, compared with a 2.5 percent increase in the third quarter. The rate of capacity utilization (s.a.) rose sharply in November by 4 percent. New machinery orders fell slightly in November after a strong rise in October, but domestic private orders increased in both months. New housing starts (s.a.) fell 6.4 percent on average in October and November from the third-quarter level, after rising 6.9 percent in the third quarter.

Labor market conditions remained tight, with the unemployment rate at 2.4 percent in October and November and the job-offers-to-applicants ratio rising further. In light of the tight labor market, the major unions plan to press for a larger share of corporate profits this year during the coming spring wage round. The two largest unions may ask for a 6 to 8 percent rise in nominal wages, compared with the 4.4 percent increase in 1987/88.

The Tokyo area consumer price index rose sharply in October, as unusually cold weather pushed up prices of fruits and vegetables, but then declined in both November and December, leaving the fourth-quarter average

1.5 percent above its level a year earlier. In January, this index increased 1.6 percent from its level a year earlier. The wholesale price declined 1.1 percent (n.s.a.) in December from its level a year earlier, and 0.8 percent in the fourth quarter from its level a year earlier.

Japan's trade surplus widened in November but narrowed in December, bringing its surplus for the year to \$77.3 billion, only \$2.2 billion less than in 1987. Exports rose in value by 15.6 percent in 1988 while imports surged 25.4 percent. Volume estimates show exports increased 5.1 percent while imports jumped 16.6 percent.

On December 24, the Diet passed the first major reform of the Japanese tax structure since 1950 that included a controversial 3 percent consumption tax. The number of personal income tax brackets will be compressed from the present 6 to 5, with the top rate falling from 60 to 50 percent, effective January 1989. The corporate tax rate will be reduced from 42 to 37.5 percent, phased in over a two-year period starting in April 1989. The 3 percent consumption tax and a 20 percent withholding tax on capital gains will be introduced in April 1989. After these changes, the proportion of total tax revenue coming from indirect taxes will be about 33 percent, up from 27 percent currently. This tax package should result in a net tax reduction of 2.6 trillion yen on a full year basis, and a one-time increase in consumer prices of about 1 percent.

Economic growth slowed in Germany in the fourth quarter of 1988. Provisional data suggest that real private consumption showed strength and that real net exports edged up, but that all other spending categories did not increase from their third-quarter levels. Part of this apparent easing

in growth is due to the effects of abnormal weather, variations in the number of working days, and new accounting procedures for foreign trade. Industrial production fell three months in a row through November, declining 3.1 percent (s.a.) over that period, to a level that was 2.8 percent above its year-earlier level. The November decline has been attributed to bad weather, and a rebound in December is widely anticipated. Supporting this view is a rebound in new orders, which rose 1.8 percent (s.a.) in November, and in real retail sales, which surged 7.8 percent in November to a level 4.2 percent above that of a year earlier. The unemployment rate has declined for five consecutive months to a rate of 8.3 percent in December. The capacity utilization rate in manufacturing rose to 88.7 percent in the fourth quarter of 1988, its highest level since 1973, and 3.7 points above its level a year earlier.

The tightening of labor markets and the rise in capacity utilization have raised concerns about the future course of inflation. Consumer prices in January increased by 1 percent (n.s.a.) and were 2.5 percent above their level a year earlier. This increase reflects, in part, the impact of the increase in consumer excise taxes that took effect January 1. In December, consumer prices rose 0.2 percent. Wholesale prices also accelerated sharply, rising 0.8 percent (n.s.a.) in December to a level 3.5 percent above that of a year earlier. One factor contributing to higher prices has been the decline in the value of the deutsche-mark, which on balance fell 2.9 percent against the currencies of Germany's major trading partners in the year ending December 1988, contributing to a 3.9 percent rise in import prices over that period, and 1.4 percent in December alone.

The monthly trade surplus surged to \$7.5 billion (n.s.a.) in November, bringing the cumulative surplus for the year to \$65.2 billion, up \$7.2 billion from the same period in 1987. The current account surplus also rose sharply in November, to \$5.9 billion, raising the cumulative surplus to \$42.5 billion, up \$2.6 billion from the same period in 1987. Comparing the first ten months of 1987 and 1988, Germany's trade surplus with the United States was down 36 percent, to \$6.9 billion, while its surplus with other EEC countries was up 36 percent, to \$38.1 billion. Of concern to German policymakers has been the sharp increase in the private long-term capital account deficit, which soared from \$7.8 billion to \$42.2 billion in the first 11 months of 1987 and 1988, respectively.

Growth in M3 was 6.7 percent during 1988 (Q4 over Q4), exceeding the Bundesbank's target range of 3-to-6 percent, the third successive year of monetary overshooting. In mid-December, the Bundesbank announced that its monetary target for 1989 (Q4 over Q4) is for M3 growth of "about 5 percent", which represents a slight tightening in monetary policy. Government fiscal policy, which was mildly expansionary in 1988, will be somewhat restrictive in 1989, largely due to increased consumer excise taxes and the new withholding tax on bond interest, both of which went into effect January 1.

France recorded a trade deficit of \$5.9 billion in 1988, the largest deficit in five years. Part of this deterioration in the trade balance has been due to strong growth, particularly in investment, which has caused imports to surge. The Bank of France announced in December a renewal of its target range of 4 to 6 percent for M2 for 1989. Data through November

indicate that M2 growth in 1988 is very likely to have fallen in the targeted range.

In the United Kingdom, recent data suggests that the sharp increase in interest rates implemented by British monetary authorities in the second half of last year has started to slow the overheated pace of economic activity. Industrial production rose by 0.1 percent (s.a.) in November following a 0.5 percent fall in the previous month. The volume of retail sales was down 0.1 percent (s.a.) in December, the second consecutive monthly decline. The unemployment rate declined again in December to 7.2 percent (s.a.), the 29th consecutive monthly decline.

In Canada, the U.S.-Canada Free Trade Agreement, which will reduce trade barriers over a five-year period, cleared the Canadian Parliament in late-December and was implemented on January 1. Studies predict that by the mid-1990s Canada's GDP will be about 2 percent higher, and the price level 2.5 percent lower, as a result of the agreement. The first stage of the Canadian tax reform, passed by Parliament last fall, goes into effect on April 1 1989. It is intended to be revenue neutral, reducing personal income tax rates while expanding the tax base. It also cuts the number of marginal rates to three, the highest of which is now 29 percent. (Hefty provincial taxes mean that overall tax rates are much higher.) The second stage, which is before Parliament, is expected to be introduced in 1990. It contains a national value-added tax and may include a further reduction in income taxes.

Economic Situation in Major Developing Countries

In December, the Mexican government announced economic policy guidelines for the first seven months of 1989. Following the inauguration of President Salinas on December 1, foreign exchange market pressures on the Mexican peso have eased. On January 16, the Brazilian government announced the "Summer Plan" aimed at achieving greater price stability. Episodes of military unrest in Argentina in December and January add to the climate of uncertainty associated with upcoming presidential elections in May. In Venezuela, outgoing President Lusinchi announced a three-month suspension of payments on principal on public debt to commercial banks effective January 17. At the end of December, Colombia reached an agreement with commercial banks to provide new money. On February 1, Peru's government announced major economic policy changes to be implemented over the next four months.

Individual country notes. In December, the Mexican government announced economic policy guidelines for the first seven months of 1989. On January 1, Mexico resumed daily peso devaluations at a rate averaging 1 peso per day, the minimum wage was raised by 8 percent, and many public sector prices were raised by 30-40 percent. Effective January 11, a 10 percent tariff was imposed on many imports previously entering duty free or with a duty of 5 percent.

The 1989 public sector budget calls for reducing the overall deficit to 6.4 percent of GDP from an estimated 10.8 percent in 1988. Interest payments on domestic debt are expected to fall by 4.5 percent of GDP, but the estimate is based on an assumed fall in the inflation rate from

52 percent in the 12 months ending December 1988 to 18 percent by December 1989. Excluding interest payments, the budget is in surplus, but revenues are expected to fall more than other expenditures in 1989 because oil prices are expected to fall.

Following the inauguration of President Salinas on December 1, foreign exchange market pressures have eased. This has led to a 200 basis point decline in the 28-day Treasury bill rate from its December high to 50.3 percent at the January 24 auction. Consumer prices rose by 2.1 percent in December and are likely to record a larger rise in January, following the January 1 price and wage adjustments.

On January 15, Brazilian President Sarney announced the "Summer Plan" aimed at achieving greater price stability. In addition to some increases in public sector prices that had already been announced on January 13, the proposed measures include the following: 1) a 17 percent devaluation; 2) freezing of prices on 180 items for an indefinite period; 3) elimination of the wage adjustment formula that adjusted for past increases in inflation; 4) a government commitment not to spend in excess of revenues; and 5) a reduction in the public sector work force by an estimated 60,000 and a reduction in the number of government ministries. A "new cruzado" was created, equal to 1,000 old cruzados and worth about \$1. The government also suspended the program that allows foreign banks to reallocate loans denominated in Brazilian currency that are due to the Central Bank before they are due to foreign creditors ("relending") and imposed new controls on debt to equity conversions. Congress has since approved several of the

components of the plan, including the price freeze, fiscal targets, and elimination of the wage indexing rule.

Following the announcement of the measures and a two-day bank holiday, the Central Bank authorities have been holding the overnight interest rate at roughly 25 percent per month. In the parallel market, the dollar premium over the official exchange rate fell from more than 70 percent before the plan's announcement to about 45 percent in the period after the announcement, before increasing to about 60 percent at the end of January. The 1988 trade surplus was the largest ever at over \$19 billion.

To be eligible to receive the next \$600 million drawing from last year's \$5.2 billion new money agreement with commercial banks, Brazil needs to gain World Bank Executive Board approval for a controversial \$500 million power sector loan. This loan has not yet been scheduled for Executive Board consideration. Brazil must receive a waiver of performance criteria and agree on an economic plan for 1989 to receive the next tranche of its stand-by arrangement with the IMF. The tranche is for only SDR 31 million. After some delay, Brazil made a scheduled \$530 million interest payment to commercial banks in January.

In Argentina, a military uprising was suppressed without violence during December 2-5, 1988. On January 23, 1989, insurgents of uncertain affiliation were suppressed following heavy fighting after invading a military base. These incidents have not directly endangered Argentine democracy or economic stability, but they have contributed to uncertainty associated with upcoming presidential elections in May.

Inflation has continued to decline in recent months, falling from 9.1 percent on a monthly basis in October to 5.7 percent in November and 6.8 percent in December. In December 1988, Congress approved the 1988 budget and a tax reform package for 1989. In early January 1989, the government and business groups agreed to extend the current system of negotiated price increases and exchange rate depreciation from February until the end of June. Exchange rates for various categories of imports and exports will be unified by the end of the year. The combined fiscal deficit, which includes operating losses of the Central Bank, declined from 7.1 percent of GDP in 1987 to an estimated 5.3 percent in 1988. To achieve targets required by loans recently approved by the World Bank, the deficit must be reduced to 2.4 percent of GDP in 1989.

In December 1988, Argentina made a payment of \$70 million in overdue interest on new money loans made in 1985 and 1987. This followed a \$100 million payment in October 1988, and brought these loans current through the end of 1988; however, interest arrears on earlier loans currently exceed \$2 billion. The authorities are currently negotiating with the commercial banks on a new financing package for 1989. Talks on a new program with the IMF are continuing as well.

In Venezuela, outgoing President Lusinchi in late December announced a three-month suspension of payments on principal on public debt to commercial banks effective January 17. Interest continues to be paid. The Bank Advisory Committee agreed to the suspension on January 12. President-elect Perez is expected to implement major economic policy changes with the

support of the IMF and World Bank and begin negotiations on rescheduling the foreign commercial bank debt soon after his inauguration on February 2.

Venezuela registered a current account deficit of \$5 billion last year as imports surged. A fall in oil export revenues more than offset a 30 percent increase in non-oil export revenues. The deficit was financed mainly through an expansion of trade credit and a draw-down in reserves.

At the end of December, Colombia reached agreement with commercial banks providing roughly \$1.7 billion in new money during 1989 and 1990 to refinance \$1.85 billion in maturing obligations. Commitments to the financing package are currently being raised. The bank advisory committee has endorsed a 90-day postponement of principal repayments, starting January 1, 1989, pending completion of the loan.

On February 1, Peru's government announced major economic policy changes to be implemented over the next four months. The currency was devalued by 23.9 percent devaluation. Also planned are cuts in subsidies on public sector goods, increases in oil prices, increases in the minimum wage, and further devaluations.

The government's measures and implicit acknowledgement of IMF and World Bank support signal a major effort to reintegrate Peru into the world financial community. Deteriorating economic conditions over the past few months had intensified social unrest and contributed to the growing opposition within President Garcia's ruling party. In December 1988, prices were 1,700 percent higher than a year earlier. In early January, price and wage adjustments were announced and the official exchange rate was devalued by 26 percent.